

ANNEX 1

Frequently Asked Questions on PPPs

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I. What is a PPP? How is it different from public procurement or privatisation?

It is easy to become confused by the ever-increasing number of definitions and synonyms for PPPs. The working definition used in this Reference Guide (Section 3.1) captures the key defining feature of a PPP: 'A PPP is a long-term contractual arrangement for the delivery of public services where there is a **significant degree of risk sharing between the public and private sectors**'. Thus, a contract wherein both the public and private sectors have a significant stake, and consequently share the risks in delivering the infrastructure services, is a PPP.

This definition of a PPP also alludes to its other characterisations, namely:

- It is a **long-term** contract, typically for a period of 10 to 20 years (although there are some PPPs that may be of a shorter duration of, say, three to five years);
- It is a **partnership** agreement between the public and private sectors, in that both parties have a mutual interest and a unified commitment.

These three characteristics define a PPP and distinguish it from other forms of private participation in infrastructure. Variations of these characteristics in terms of the degree of risk sharing or the number of years of the contract, define the different types of PPP models, such as concessions, BOTs and DBFOs.

Unhelpfully, the term PPP has come to refer to anything between pure private provision and pure government provision. However, there are key differences between PPPs and these two methods of infrastructure service delivery. Pure private provision, or privatisation, involves the transfer of responsibility for asset construction and ownership, service delivery and revenue collection to the private sector. Thus the private sector bears 100 per cent of the risks of infrastructure service delivery. The role of government is restricted to regulation. On the other hand, pure public provision (also often referred to as 'traditional public procurement') refers to the contracting out of infrastructure services by the government to private sector contractors, with the public sector retaining almost 100 per cent of the risk. Under these contracts, there are few efficiency incentives, unlike in a PPP wherein payments are linked to specific performance criteria. For example, under a PPP contract for a road, payments may be made on the basis of a certain specific quality of the road surface, whereas in the case of traditional procurement, the payments may be linked to the number of kilometres of road area.

2. What are the key benefits of PPPs?

Governments around the world have embraced PPPs because they offer three main types of benefits:

- The ability to **develop new infrastructure services** despite short-term fiscal constraints;
- **Value for money** through efficiencies in procurement, construction and operation; and
- Improved **service quality and innovation** through use of private sector expertise and performance incentives.

However, these benefits will only be achieved if the project is properly designed and structured from the outset.

3. How can PPPs be structured to achieve public policy goals? Do PPPs always lead to an increase in user charges?

By allocating different risks to the entity best able to manage them, PPPs can be structured to achieve a range of public policy goals, including the acceleration of new infrastructure investment, improved efficiency in operations and management leading to lower cost service provision, access to advanced technologies and know-how not available to the public sector, and contractually enforced social and environmental standards. Where these goals are not achieved ex post it will typically be the result of poor contractual design or project structure.

Involving the private sector in infrastructure generally entails a shift towards full cost-recovery, which can mean higher tariffs in situations where state-owned enterprises were previously subsidised by the taxpayer. However, tariff increases are by no means inevitable, for four key reasons:

- If the PPP is well-structured, involving the private sector achieves efficiencies which drive down long-term costs – this is at the core of the benefits of a PPP, in which private sector innovation and greater efficiency will potentially lower the costs of infrastructure service delivery;
- The government may continue to pay for services through annual payments to the private service provider (i.e. services for the consumer remain free at the point of delivery) – this can be structured as a PFI type contract, or in the form of shadow tolls, revenue guarantees, etc. by the government to the private operator;
- The service provider may cross-subsidise by charging lower fees to those less able to pay and increasing charges for corporate customers – as has often been the case for energy and water sector PPPs, wherein a higher tariff is charged for industrial/urban users to subsidise use by domestic/rural consumers;
- The government may decide to channel explicit subsidies to the poorest user groups in order to facilitate affordability of the infrastructure service.

Overall, it is unlikely that a PPP will lead to higher costs for services, but payment for the service from direct users and indirect contributors, such as taxpayers, may change.

4. When is PPP an appropriate approach for delivery of infrastructure services?

It is important to recognise that a PPP is one of many options available to the government for the delivery of an infrastructure service (the others include direct public sector provision, contracting of the private sector and other forms of private participation, such as service contracts and privatisations). When deciding whether a PPP is the appropriate approach, it is important to assess whether these other options offer greater benefits to taxpayers and customers.

The key criteria for assessing whether a PPP is an appropriate approach include the following:

- **Does the project offer value for money to the public sector?** It is important to compare the costs of alternative methods of provision of the infrastructure service to ensure that the PPP offers value for money for the public sector. There may be cases where public sector provision (or any other model) may be the preferred approach. For example, the UK Treasury notes that in certain instances the PFI procurement structure is unlikely to deliver value for money, such as when equity and accountability in public service delivery cannot be met or where authorities require a significant degree of short-term flexibility due to fast-changing service requirements (for example, in information technology projects). This is also the case when the investment is small and the benefits of PFI do not justify the significant costs incurred during the PFI procurement process (for projects of less than £20 million capital value).
- **Do the project economics add up and is the project 'bankable'?** In assessing the appropriateness of a PPP approach, it is important to structure the project in such a way that it is bankable. For example, where affordability of the infrastructure service is a key constraint, a PPP approach may not be the most appropriate option unless the government can guarantee the payments for the infrastructure service (whether directly through fixed payments or through some guarantee for a minimum level of revenue). Or the project may be so risky that the cost of the investment may be far too high in relation to the expected return from the project.
- **Is a supportive enabling environment in place to facilitate the PPP?** If a supportive legal and regulatory framework for PPPs is not in place, following the PPP approach needs to be carefully considered, as it may lead to inefficient project development and operation. While some PPPs have gone ahead without the support of an enabling framework, it is questionable whether this was the most appropriate and efficient solution. Closely related to this is the level of capacity in the country (both in the public and private sectors). There needs to be capacity within government to develop, procure and manage the PPP contract, as well as good quality sponsors who are able to deliver the project outcomes efficiently.
- **Is the country infrastructure sector suitable for PPPs?** Some infrastructure sectors may be more suitable than others for the PPP approach in general and specific types of PPP in particular. It has usually been the case that private participation in a country is first introduced in the telecoms sector and only slowly introduced into the water sector, given the political sensitivities around charging for water services.
- **Is the infrastructure sector/asset of strategic importance to the country?** There may be certain infrastructure sectors/assets that are of strategic importance to the security of a country. In these cases, the PPP route may not be the most appropriate. For example, roads near territorial boundaries where there is an ongoing dispute may not be appropriate for PPPs – not least because the risks for private sector investors would be too high.

5. What are the differing objectives and risks facing governments and investors in a PPP?

The government, sponsors and investors all have different objectives and consequently face different risks under a PPP arrangement:

- The key concerns for the **government** are whether the service is delivered and the PPP offers value for money. A related concern is contingent liabilities, both during project development up to financial close and during the construction and operational phases of the project (note that even where the government does not provide an explicit guarantee for a PPP project it will typically be expected to step in and pick up the cost in cases where projects fail).
- **Investors and lenders** are most interested in ensuring that their capital gets repaid over the lifetime of the project with a suitable return. Hence, the key risks from the perspective of the investors are unexpected reductions in the project revenues, increases in costs and consequent delays or default on loan repayments or dividends. These risks can be managed through robust feasibility analysis, the introduction of competent management and the use of various guarantee mechanisms (e.g. to hedge interest rate or currency risk). Investors will also seek insurance against expropriation and other political risks over which they have no direct control.

6. What type of risks can be allocated to the private sector? How much risk is the private sector willing to take in lower-income countries?

The private sector is typically willing to accept construction and operating risks, over which it can exercise a reasonable degree of control. The level of demand risk the private sector is willing to bear depends critically on the quality of data underpinning market studies. Typically, investors will require some form of minimum revenue guarantee from governments or international agencies; these can take the form of ridership guarantees for transport projects or off-take agreements backed by a credit-worthy entity for utility services. The private sector will not typically accept political or *force majeure* risk.

In developing countries, investors are likely to demand a higher financial return for accepting construction and operating risks. They are also unlikely to accept significant demand risk because of low quality data on demand volumes and willingness to pay. The higher cost of PPP projects and the greater degree of risk that needs to be held by the public sector (or international agencies) should be weighed against the benefits of delivering much-needed infrastructure services in situations where the alternative is often no service provision.

7. What are the different payment mechanisms for PPPs?

Payment mechanisms refer to the modalities for payment for the infrastructure services, i.e. the mechanisms through which private operators earn their revenues. They

are instrumental in delivering effective risk transfer and provide a means to re-align private profit motives and achieve efficient public service provision.

Most payment mechanisms can be split into two broad categories: direct user charges and availability/performance-based payments.

User charges

This payment mechanism places a strong emphasis on the transfer of demand risk to the private sector. The private operator sells services directly to consumers (usually the general public or businesses) and charges a fee or toll for these services. Common examples include toll roads and water utilities.

Availability performance-based payments

These mechanisms have a much lower degree of demand risk transfer and place greater emphasis on the transfer of construction and performance risk. Optional payment mechanisms include:

- **Availability-based payments:** Payments are based upon the availability of a facility when required. This mechanism is common for PFI-based projects in the UK such as hospitals or schools. Penalties may be incurred if the facility is unavailable. However, the definition of what constitutes availability must incorporate its varying degrees and the varying impacts that it may have (e.g. closing a bridge in the rush hour compared with in the middle of the night).
- **Performance-based payments:** Governments may provide financial support to PPP projects in the form of shadow tolls or guarantees for a minimum level of revenue. These are usually linked to the performance of the project, but may also be provided for directly in the PPP contract.

Other mechanisms

The above mechanisms are broad types, and it is likely that a project may be a hybrid of both approaches. For example, the mechanisms for the UK PFI project to set up the Liverpool Women's Hospital information support system are 70 per cent availability, 20 per cent performance and 10 per cent usage. Toll roads may often have an availability element supporting their user charges.

In addition, output-based aid (usually provided by donor agencies) provides an important source of funding for PPP infrastructure projects.

8. How can competitive pressure be ensured throughout the bidding process? What should be done if there is only one bidder?

Competition in the bidding process is key to achieving value for money for the government, as the private sector will find innovative ways of delivering the infrastructure service at the lowest possible cost. However, a competitive environment needs to be

carefully structured in order to ensure appropriate incentives; for example, if renegotiations are the norm in the country, the private sector bidders may be incentivised to provide an over-aggressive bid, in the belief that the contract may be renegotiated for more realistic terms at a later date.

There are a number of ways through which the government can ensure greater competitive pressure in the bidding stage:

- **First**, the project should be marketed well, so that the private sector is made aware of the project and thus its potential to submit a bid. Different media/options may be followed, such as roadshows or advertisements in the print media;
- **Second**, the procurement process and all relevant project information should be clearly provided to the private sector so as to reduce the costs of bidding and consequently encourage its participation;
- **Third**, the duration of the procurement process should be reasonable. In some countries, procurement of the private sector sponsor has taken a few years, which can drive away the private sector because of the additional costs incurred, as well as changes in circumstances which may impact on the terms of their bid.

However, there may be cases where a project has a sole bidder. In such cases, the following measures may be considered:

- **Repackaging the project:** Limited private sector interest may be due to the underlying project economics not adding up. There may then be advantages in the government repackaging the project to make it more attractive to the private sector, thereby soliciting a greater number of competitive bids.
- **Detailed due diligence of the sole bidder:** If a single bid has been received for the project, the government should carry out a detailed due diligence on the bid/sponsor to ensure that it is getting a good deal. Although this may not be the lowest priced bid, given the absence of competitive pressure, there are other aspects to be considered, such as the cost of running an additional procurement exercise and whether or not the private sector in the country is developed enough to result in a number of bidders for one project. Thus in certain circumstances, it may make sense to explore the sole bid further through a detailed assessment of the capabilities, creditworthiness and experience of the sponsor. This is key to ensuring the success of the project.

9. How much time and cost is involved in developing PPP projects?

PPP projects are inherently complex and resource intensive. There are few short cuts to designing and structuring PPPs properly because of the need to identify and allocate risks that will generally be specific to the project, the sector and the country. The minimum cost of developing a PPP is likely to be US\$3–5 million; for this reason pursuing small projects (e.g. projects less than US\$20 million in total value) makes limited sense from a value for money perspective. The timeframe from concept to

financial close is typically between three and five years and can be longer for especially complex or risky transactions.

For larger projects, the amount spent on advisory fees should be considered an investment that will be returned over the lifetime of the project through cost and efficiency savings brought about by private sector participation. Of course, if the contract is poorly designed these savings might not be achieved, or they might accrue entirely to the private investor. That is why it is important that governments have access to high quality advisers to ensure they can negotiate a fair deal with private sponsors.

Although the time and cost of developing a PPP project may appear high, this should be weighed against the fact that governments, especially in lower-income developing countries, have often failed to deliver essential infrastructure services to the majority of the population over a period of many decades, and that where infrastructure services have been provided, they have often been of low quality and relied on heavy public subsidies.

10. Why have there been so few successful PPPs in the lower-income countries of the Commonwealth?

There are two main reasons. First, the costs and risks of developing PPPs in poorer countries are typically much higher than elsewhere. As a result, sponsors are reluctant to invest significant time and resources in developing projects which may not deliver an acceptable financial rate of return. Second, projects in poorer countries tend to be smaller in size (often less than US\$100 million), which means the absolute financial returns available are insufficiently attractive to large infrastructure investors.

Solutions to these problems include establishing (publicly-backed) project development facilities to help design and structure bankable projects; using international facilities to access long-term finance and help mitigate project risks; and tapping domestic capital markets for investment, supported by credit guarantees.

11. How is the global financial crisis affecting PPP projects in emerging markets?

The global economic and financial crisis is having a major adverse impact on private sector infrastructure investment in low-income developing countries. First, there has been a general reduction in risk appetite for infrastructure assets in developing countries, especially in relation to greenfield projects. Second, there has been a reduction in the availability and a sharp increase in the real cost of debt, especially longer-term debt. Third, there has been a related reduction in the availability of equity for greenfield investments arising from a refocusing by public and private equity investors on recapitalising existing businesses rather than investing in new ones.

Consequently, it has become significantly more difficult for project sponsors to raise the financing required to get PPPs to financial close. This is especially the case for projects in smaller economies and those without a track record of successfully

completed transactions. Until long-term liquidity returns to the markets, we are likely to see a sharp decline in the number of infrastructure PPPs in developing countries. Those transactions that do proceed are likely to have to rely heavily on the development finance institutions as anchor investors. Where commercial debt is available, it will generally require the support of credit guarantees (e.g. from GuarantCo) to persuade lenders to reduce the cost of funds and extend tenors beyond three or four years.

At the time of writing, major uncertainties remain as to how long it will take for liquidity to return to the markets, and as to the extent to which, during the interim, the DFIs will be willing and able to step in to help fill the financing gap. The good news is that collectively the DFIs have strong balance sheets, having accumulated large reserves during the boom years of the last decade. There have also been announcements of major new initiatives to support infrastructure investments in developing countries (e.g. the IFC's Infrastructure Crisis Facility). Now is the time for the DFIs to play the counter-cyclical role for which they were designed.

12. What are the most common mistakes to avoid when considering and developing PPP transactions?

PPP project development is a complex, expensive and time-consuming process. Every effort must be made to make the process as efficient as possible. Some common mistakes to avoid when developing a PPP are:

- Lack of a project champion within the public sector;
- Lack of ownership and leadership of the project among the project developers (public or private sector);
- Lack of detailed feasibility studies (to be carried out by relevant experts);
- Overly ambitious project development timeframe;
- Selecting advisers on the basis of cost only, without a detailed consideration of their quality and experience;
- Lack of effective engagement with relevant stakeholders.

13. What are the main reasons for the failure of PPP contracts?

PPP contracts can fail for a number of reasons. Some of the most common reasons for their failure are:

- Poor feasibility analysis, particularly in terms of forecasting demand for the infrastructure service. A number of PPP contracts have failed because revenues have fallen well short of projections. In some cases this is the result of inadequate feasibility analysis or aggressive bidding.
- Weak private sector sponsor in terms of lack of skills and experience to deliver the infrastructure services.

- An inappropriate enabling environment in terms of a poor legal and regulatory framework, as well as weak enforcement capacity.
- Lack of a proper contract management and monitoring framework by the public sector, from the initial project development and procurement stages through to post-financial close phases of construction and operation.
- Political issues related to the application or increase of tariffs for the use of the infrastructure service. This has particularly been the case for water sector projects in developing countries.

Macroeconomic shocks, such as a financial crisis or foreign exchange fluctuations, may reduce the profitability of the project and lead to its ultimate failure.