

# **United Nations Economic Commission for Europe**

## **A Guide to Promoting Good Governance in Public Private Partnerships**

**PRESENTED TO THE INTERNATIONAL CONFERENCE ON KNOWLEDGE SHARING  
AND CAPACITY BUILDING ON PROMOTING SUCCESSFUL PUBLIC-PRIVATE  
PARTNERSHIPS IN THE UNECE REGION**

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## **Preface**

The Public Private Partnership (PPP) Alliance of the United Nations Economic Commission for Europe (UNECE) was established in 2001 to improve the awareness, capacity and skills of the public sector in developing successful PPPs in Europe. To this end, the Alliance prepares guidelines on best practices in PPPs, as well as preparing other PPP-related educational and training materials, and sponsoring PPP conferences and workshops. At its last Meeting, the PPP Alliance agreed, in light of the lack of information available on the topic, to prepare guidelines on the subject of good governance in PPPs.

Following UNECE reform a new Committee on Economic Cooperation and Integration has been established to promote competitiveness. This Committee takes over the previous work of the former Alliance. In order to finalize the Good Governance Guidelines, the Government of Israel has offered to host an international Conference, inviting experts from different countries to provide their experience and best practice in creating good governance conditions for PPPs. A network of experts has also been established, incorporating the experts from the former Alliance group, to implement a work programme on PPPs, which has been agreed by the Committee at its first session.

## **Avant propos**

Over the past fifteen years governments have been struggling to achieve economic development and competitiveness through improving their basic infrastructure. Increasingly governments are turning to the private sector for the financing, design, construction and operation of infrastructure projects. Once rare and limited, these public – private partnerships (PPPs) have emerged as an important tool for improving economic competitiveness and infrastructure services. They are increasingly being considered as a mechanism to fill an infrastructure ‘deficit’ in many ECE countries.

## **Misconceptions and challenges in PPPs**

However, undertaking a PPP is a challenging exercise. Many governments lack knowledge and information about these instruments. A number of misconceptions and misunderstandings have surrounded PPPs. Some governments’ initial attempts to implement PPPs have suffered and many PPPs have not been fully successful. The complexity and expense of the PPP process has proved daunting. Consequently many Governments at local and national levels have begun to lose faith in the model and their capacity to overcome the many technical, financial and legal challenges. Frustrations over these difficulties have emerged, with governments sometimes blaming the private sector for the breakdown and sometimes the private sector blaming the governments.

## Purpose of the Guide

In view of the above, the purpose of this Guide is to demonstrate how governments and the private sector can together address the challenges by improving governance in PPPs, and thereby maximize the benefits and the contribution of PPPs to bridging the infrastructure gap and improving economic development and competitiveness.

This Guide is organized as follows:

**The Introduction:** Definitions, Benefits, Misconceptions and Challenges: defines PPPs, the various models and the benefits that can be generated. It also describes the misconceptions surrounding PPPs and the challenges emerging from their complexity and cost, the implications for those in specific situations such as many small and medium sized enterprises and the economically and socially disadvantaged groups in society. It identifies the areas for improvement.

The next five chapters describe the governance challenge in each of these areas, what governments can do to deal with them and appropriate solutions. It presents in each chapter five overall key principles or recommendations for ensuring good governance in PPPs.

**Chapter 1** explores how to promote a sound overall legal, regulatory, policy, and institutional framework. It posits that the: *PPP process should be feasible and simple and undertaken within a comprehensive and transparent legal framework.*

**Chapter 2** describes the ways governments can increase the capacity to develop and manage PPP projects within both the public and private sectors, asserting that the *PPP process needs to be streamlined and simplified, and equipped by persons with the necessary skills and training. This is most effectively accomplished by establishing PPP task forces within Governments.*

**Chapter 3** describes the importance of and the means by which governments should address the risks in PPPs, presenting the view that *Governments and private sector need to develop realistic expectations about PPPs, establish balanced contracts, and optimise risk-sharing to achieve success.*

**Chapter 4** explores how governments can encourage transparency and contends that *PPPs should be undertaken within a transparent framework that promotes openness and competition in the tendering process.*

**Chapter 5** describes how governments can address suspicions and criticisms of PPPs amongst the media and civil society by making PPPs more socially acceptable i.e., by increasing public accountability, sustainable development, security, safety, and fair employment practices. This Chapter asserts that the *PPP process needs to promote accountability and sustainable development, to achieve benefits for all, and especially the socially and economically disadvantaged*

The final chapters and annex identify some tools for implementing the above-mentioned good governance best practices.

**Chapter 6** Provides a set of case studies, demonstrating the effectiveness of good governance practices in a number of successfully-implemented PPPs.

**Chapter 7.** Discusses benchmarking success in PPP governance, and provides a methodology for demonstrating progress in these areas.

# Part I. Overview of PPPs

## Introduction. OVERVIEW OF PPPs:

Many citizens around the world and especially in transition economies face an ‘infrastructure deficit’, evidenced by congested roads, poorly-maintained transit systems and recreational facilities, deteriorated schools, hospitals, and water and water treatment systems, and other infrastructure assets which are either non-existent or in urgent need of repair. These problems in turn impose huge costs on societies, from lessened productivity and reduced competitiveness, to an increased number of accidents, health problems and lower life expectancy. PPPs over the last fifteen years have emerged as one of the most important means to bridge this gap. Governments are thus interested in improving the pathways whereby private funds can be attracted to invest in programs of public works or services within a suitable contractual framework.

## Definitions and basic principles

### Definitions

At present there is no universally acknowledged definition of PPPs but rather different forms of PPP.

- *US definition:* A Public-Private Partnership is a contractual agreement between a public agency (federal, state or local) and a private sector entity. Through this agreement, the skills and assets of each sector (public and private) are shared in delivering a service or facility for the use of the general public. In addition to the sharing of resources, each party shares in the risks and rewards potential in the delivery of the service and/or facility. (Source: The National Council for Public-Private Partnerships, [www.ncppp.org](http://www.ncppp.org))
- *Canada definition*
- *United Kingdom definition*
- *European Union definition*

### Forms (Methods) of PPPs

Public-private contracts cover different forms of long-term contracts drawn-up between legal entities and public authorities. They aim at financing, designing, implementing and operating Public sector facilities and services. The normal terminology for these contracts describes more or less the functions they cover. Contracts that concern the largest number of functions are "Concession" and "Design, Build, Finance and Operate" contracts, since they cover all the above-mentioned elements: namely finance, design, construction, management and maintenance. They are usually financed by user fees (e.g., for drinking water, gas and electricity, telephone, public transport, etc.). Privately financed-contracts for public facilities and public works cover the same elements but in general are paid, for practical reasons, by a public authority and not by private users (public lighting, hospitals, schools, roads with shadow tolls, i.e., payments based on traffic volume, paid by the government in lieu of tolls).

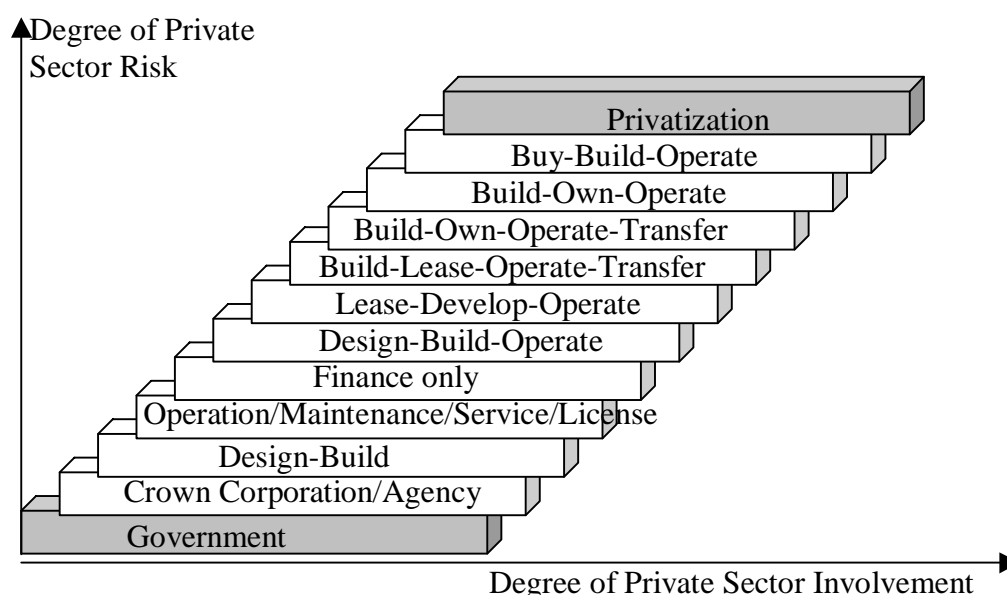


Build Operate and Transfer (BOT) and lease and maintain contracts are also long-term contracts. They call for a specific service provided by a private company and, are normally used for projects requiring more moderate investment than the first mentioned contracts. Other nontraditional forms of contract may also be used for PPPs, as shown in the Chesapeake Forest case study (Chapter 6) in which revenues generated by a renewable natural resource, timber, are used to fund public services.

Public Private Partnerships thus cover all current legal/economic forms that make it possible for private funds to invest in public infrastructure and services. Typically in a PPP, a public authority (federal or local) entrusts a private operator with the long-term implementation of a project. Frequently, this involves large-scale and complex construction and operation. This type of partnership is based on a contract between a public body (the conceding authority) and a private company (the concessionaire).

Private sector participation in PPPs may be devised in a variety of different forms, ranging from publicly owned and operated to fully privatized assets.

The options available for delivery of public services range from direct provision by a ministry or government department to outright privatization, where the government transfers all responsibilities, risks and rewards for service delivery to the private sector. Within this spectrum, public-private partnerships can be categorized based on the extent of public and private sector involvement and the degree of risk allocation. A simplified spectrum including the above models for public-private partnerships follows (Canada):



Source: [http://www.pppcouncil.ca/aboutPPP\\_definition.asp](http://www.pppcouncil.ca/aboutPPP_definition.asp)

#### In more detail:

*Buy-Build-Operate (BBO)*: Transfer of a public asset to a private or quasi-public entity usually under contract that the assets are to be upgraded and operated for a specified period of time. Public control is exercised through the contract at the time of transfer.

*Build-Own-Operate (BOO):* The private sector finances, builds, owns and operates a facility or service in perpetuity. The public constraints are stated in the original agreement and through on-going regulatory authority.

*Build-Own-Operate-Transfer (BOOT):* A private entity receives a franchise to finance, design, build and operate a facility (and to charge user fees) for a specified period, after which ownership is transferred back to the public sector.

*Build-Operate-Transfer (BOT):* The private sector designs, finances and constructs a new facility under a long-term Concession contract, and operates the facility during the term of the Concession after which ownership is transferred back to the public sector if not already transferred upon completion of the facility. In fact, such a form covers BOOT and BLOT with the sole difference of the ownership of the facility.

*Build-Lease-Operate-Transfer (BLOT):* A private entity receives a franchise to finance, design, build and operate a leased facility (and to charge user fees) for the lease period, against payment of a rent.

*Design-Build-Finance-Operate (DBFO):* The private sector designs, finances and constructs a new facility under a long-term lease, and operates the facility during the term of the lease. The private partner transfers the new facility to the public sector at the end of the lease term.

*Finance Only:* A private entity, usually a financial services company, funds a project directly or uses various mechanisms such as a long-term lease or bond issue.

*Operation & Maintenance Contract (O & M):* A private operator, under contract, operates a publicly-owned asset for a specified term. Ownership of the asset remains with the public entity. (Many do not consider O&M's to be within the spectrum of PPP's and consider such contracts as service contracts).

*Design-Build (DB):* The private sector designs and builds infrastructure to meet public sector performance specifications, often for a fixed price, turnkey basis, so the risk of cost overruns is transferred to the private sector. (Many do not consider DB's to be within the spectrum of PPP's and consider such contracts as public works contracts).

*Operation License:* A private operator receives a license or rights to operate a public service, usually for a specified term. This is often used in IT projects.

### **Classification of PPPs by different organizations**

Other classification systems may also be applied. The World Bank Database, for example, classifies PPPs into four major categories:

- Management and lease contracts
- Concessions (or management and operation contracts with major private capital expenditure)
- Greenfield projects
- Divestitures

*Management and Lease Contracts.* A private entity takes over the management of a state-owned enterprise for a fixed period while ownership and main investment decisions remain with the state. Such lease contract are often called “*affermage*”. It is important to determine the limit between who is responsible for renewals and the routine maintenance, major works, and repairs which are to be considered as investment. In some cases significant capital cost are to be incurred by the contractor under such contracts, which will then become very similar to concession. There are two subclasses of management and lease contracts:

- Management contract. The government pays a private operator to manage the facility. The operational risk remains with the government.
- Lease contract. The government leases the assets to a private operator for a fee. The private operator takes on the operational risk.

*Concessions.* A private entity takes over the management of a state-owned enterprise for a given period during which it also assumes significant investment risk. The Database classifies concessions according to the following categories:

- Rehabilitate, operate, and transfer. A private sponsor rehabilitates an existing facility, then operates and maintains the facility at its own risk for the contract period.
- Rehabilitate, lease or rent, and transfer. A private sponsor rehabilitates an existing facility at its own risk, leases or rents the facility from the government owner, then operates and maintains the facility at its own risk for the contract period.
- Build, rehabilitate, operate, and transfer. A private developer builds an add-on to an existing facility or completes a partially built facility and rehabilitates existing assets, then operates and maintains the facility at its own risk for the contract period.

*Greenfield Projects.* A private entity or a public-private joint venture builds and operates a new facility for the period specified in the project contract. The facility may return to the public sector at the end of the concession period. The Database classifies greenfield projects in four categories:

- Build, lease, and own. A private sponsor builds a new facility largely at its own risk, transfers ownership to the government, leases the facility from the government and operates it at its own risk, then receives full ownership of the facility at the end of the concession period. The government usually provides revenue guarantees through long-term take-or-pay contracts for bulk supply facilities or minimum traffic revenue guarantees.
- Build, own, transfer, or build, own, operate, transfer. A private sponsor builds a new facility at its own risk, owns and operates the facility at its own risk, then transfers ownership of the facility to the government at the end of the concession period. The government usually provides revenue guarantees through long-term take-or-pay contracts for bulk supply facilities or minimum traffic revenue guarantees.
- Build, own, and operate. A private sponsor builds a new facility at its own risk, then owns and operates the facility at its own risk. The government usually provides revenue guarantees through long-term take-or-pay contracts for bulk supply facilities or minimum traffic revenue guarantees.
- Merchant. A private sponsor builds a new facility in a liberalized market in which the government provides no revenue guarantees. The private developer assumes construction, operating, and market risk for the project (for example, a merchant power plant).

*Divestitures.* A private entity buys an equity stake in a state-owned enterprise through an asset sale, public offering, or mass privatization program. The Database classifies divestitures in two categories:

- Full. The government transfers 100% of the equity in the state-owned company to private entities (operator, institutional investors, and the like).
- Partial. The government transfers part of the equity in the state-owned company to private entities (operator, institutional investors, and the like). The private stake may or may not imply private management of the facility.
- Source: [http://ppi.worldbank.org/resources/ppi\\_methodology.aspx](http://ppi.worldbank.org/resources/ppi_methodology.aspx)

The IMF presents PPPs as seen in the table below:

<u>PPP SCHEMES AND MODALITIES</u>	
<b>Schemes</b>	<b>Modalities</b>
Build-own-operate (BOO) Build-develop-operate (BDO) Design-construct-manage-finance (DCMF)	The private sector designs, builds, owns, develops, operates and manages an asset with no obligation to transfer ownership to the government. These are variants of design-build-finance-operate (DBFO) schemes.
Buy-build-operate (BBO) Lease-develop-operate (LDO) Wrap-around addition (WAA)	The private sector buys or leases an existing asset from the government, renovates, modernizes, and/or expands it, and then operates the asset, again with no obligation to transfer ownership back to the government.
Build-operate-transfer (BOT) Build-own-operate-transfer (BOOT) Build-rent-own-transfer (BROT) Build-lease-operate-transfer (BLOT) Build-transfer-operate (BTO)	The private sector designs and builds an asset, operates it, and then transfers it to the government when the operating contract ends, or at some other prespecified time. The private partner may subsequently rent or lease the asset from the government.

Source: Public-Private Partnerships. IMF. 2004, p. 8.

### **Different categories of PPPs to be covered by the Guide**

The Guidelines will cover the different models of PPPs:

- Concessions in the large sense of the definition given by the interpretative communication of the EU Commission which include all kind of delegation of public services to the private sector
- Private Finance Initiative where the financing is essential and the delegation mainly limited to the service to the facilities rather than to the public.
- Other forms of PPPs

### **Differences between Public-Private Partnerships, Privatization and Public Procurement**

PPPs should not be confused with privatization. Under a PPP, accountability for delivery of the public service is retained by the public sector whereas under a privatization, accountability moves across to the private sector (the public sector might retain some regulatory price control).

PPPs constitute an approach to introducing private management into public service by means of a long-term contractual bond between an operator and a public authority. Fundamentally, it secures all or part of the public service, supported by private funding and calling upon private sector know-how. Privatization means transferring a public service or facility to the private sector, sometimes together with its ancillary activities, for it to be managed in accordance with market forces and within the framework of an exclusive right granted by a ministerial or parliamentary act (or sometimes a license). Even if the granting of a license is not contractual (unlike the concession) but, rather, subject to an official authorization, it is usually conditional on the due respect of several commitments (terms of reference or “cahiers des charges”). This is to ensure that the private party will deliver what used to be a public service under the same (or better) conditions in terms of the quality and the continuity of the service. If he fails to comply with such commitments, the licensee may lose his license and the service will be returned to the public domain or be entrusted to another licensee. In this respect the License is not very far from a concession and the privatization of the service is more like the delegation of the public service to a private entity and remain a form of public-private partnership. The full privatization is where one service which used to be a public service is no longer considered as such and fully opened to market forces with only some normal regulation of the market to ensure fair competition like for any other private market.

PPPs differ also from public procurement. Public procurement refers to the purchase, lease, rental or hire of a good or service by a state, regional or local authority. Procurement is chosen because of the simplicity of goods or services desired, the possibility to choose from numerous providers, and the wish to contain costs. PPPs are more complex, frequently larger in financing requirements, and are long-term as opposed to one-off relationships. PPPs frequently provide the developer with the right to operate over an extended term, to charge fees to users and to assume key responsibilities e.g. design, construction, finance, technical and commercial operation, maintenance etc. However, PPPs are related to traditional public procurements in that PPP providers are often selected on the basis of public procurement procedures.

What in fact differentiates the PPP from public procurement and privatization is the partnership spirit which should be reflected through the respect of several Basic Principles.

### **Basic principles of PPPs**

The development of public-private partnerships is based on certain essential principles. The parties involved should determine by contract the public objectives, the scope and nature of risk transfer, and the degree of private sector management.

#### *The principle of risk transfer*

This principle is often expressed as follows: The party best able to manage a given risk is the party who should bear that risk. For example, the government, as the issuer of new or revised regulations, can best control regulatory risk. Typically, the public authority, as a sovereign body, is the guarantor of the long-term risk - political and systemic. The service provider is responsible for design, installation and maintenance as well as the financing. When it delegates a service, the public authority pays only on condition that the service has been carried out satisfactorily.

#### *Performance specifications and competition*

When a public authority contracts for infrastructure and services, in effect it "purchases" a service. The specifications should be neither technical nor indicate the means of delivery but be rather a definition of expected performance. The Public sector as a client should express its needs in terms of service levels and standards, i.e. specifications in terms of performance or outputs. It should set the standard of service expected throughout the contract lifespan. It must not stipulate the methods to be used. Competition is established on the basis of requirements (or performance) and not prescriptively.

#### *Maintaining the value of public assets*

PPP contracts frequently do not transfer public property to the private sector. They do, however, establish the public assets maintenance level for very long periods (25 to 99 years), a discipline the public body often overlooks in public state-owned management. At the contract's end, public assets may revert to traditional public property management.

#### *The quest for innovation*

Competition stimulates innovation in public management. The quest for innovation is clearly signaled as valuable in PPP contracting. The totality of the functions operated by the private sector invites new ideas in order to obtain better results. Competitive procedures must support this quest for innovation.

#### *Non-discrimination*

All economic entities, public and private, should be treated equally and no discrimination should be allowed in the competition for PPP contracts. The basis for proposal evaluation should be made public.

#### *Stability and renegotiation*

The concept of stability and renegotiation is enshrined in the PPP contract: on the one hand the contract has a certain stability between parties, on the other hand, the contract needs to

adjust to changed conditions. Typically, contracts with duration greater than 20 years are subject to renegotiation. If the public interest changes during the lifetime of the contract, the state has a right to require the private partner to change the conditions set out in the agreement in order to match the new requirements. (see chapter 5)

#### *Continuity*

In view of the sensitivity of the services being provided to the public, it is important to ensure within the framework of the PPP contract that services continue to be provided to the general public. Suppliers have the right to stop the provision of services only in cases allowed by the PPP legislation or by the contract. In case the providers fail to provide such services, private companies should take all possible measures to overcome the difficulties causing the discontinuation of the services and resume normal service as quickly as possible.

#### *Open competitive tenders*

As a rule in all countries PPPs are established through open competitive tender. Only in rare exceptional cases due to the interest of the state and national security, should PPP contracts be given to a private entity without a competitive process.

#### *Transparency and accountability*

In PPP contracts the state and members of the public must have access to detailed information on the private provision of public services. Information gives the public the possibility to give valuable feedback so that services provided under a PPP can be evaluated and improved.

#### *Laissez-faire*

The State does not, under almost any circumstance, have a right to interfere in the activities of a private company. The private company makes its administrative, human resource and other commercial decisions independent of the state. To it belongs the output which it produces and the profits from its activities.

#### *Guarantees and other types of public support for PPPs*

The state can use a number of incentives and guarantees to support PPPs. For example, in projects with a clear socio-economic interest, the state can provide special aid. The tools for this support vary: in exceptional cases, subsidies; issuing of national bonds, loan guarantees; reduction in the amount of concession payments, exclusivity clauses in toll roads, etc (see Chapter 3 in the Guide).

#### *Compensation*

If the state for one reason or another ends the contract, then it must compensate the private company for the loss of its investment and the loss of income.

#### *Optimum public management*

The method of public management, which consists in the private sector bringing in investment, service and financing of public services, is nowadays considered by a very large number of countries a standard and desirable management practice. Savings made as compared to management by the public authority have been regularly described and encouraged by various institutions. It is no longer in doubt that the introduction of private management within the public sphere brings tangible savings and proven service quality. Managing services and public infrastructure by way of a PPP represents optimum public

management: the private sector regains its historical role in delivering public services and the public sector gains by the efficiencies so delivered. The public sector loses none of its authority since private operators need to be supervised not only for the sake of sound contract management but to ensure that service quality is maintained

#### *Value for Money*

The project should achieve value for money. This principle can be interpreted in different ways. If it is interpreted as the public entity selecting a bid from the private entity because it is the cheapest, the lowest bid may not represent the best value. A long-term perspective should be adopted: The public authority should base its choice on the evaluation of the whole life economics of the project in the light of the risks borne by the private partner.

The public authority must protect the Public Purse. Throughout the contract's lifespan, the private partner must provide a high-level quality service, which the public authority would have difficulty in matching, or providing by other means.

## **The Misconceptions**

The difficulty is that in some emerging economies and/or economies in transition such principles are often ignored at the time when PPP appears to the government as an alternative to the public financing of infrastructure due to some misconceptions. The most frequent misconceptions are the following:

- *‘Contracts are sufficient for getting started In PPPs, only a strong contract between the parties is needed. Putting in place the overall legal, policy and institutional framework can wait:* In an effort to start a PPP programme quickly, governments have been under a wrong assumption that it was sufficient to put in place a strong contract with the private sector and that establishing the legal, policy and institutional framework could begin afterwards. This misconception has resulted in insufficient attention to policy, legal and institutional frameworks in PPPs. Projects once started often unravel. Such a practice cannot work if governments wish to develop a deal flow. The success or failure of PPPs can often be traced back to the initial design of PPP policies, legislation and guidance or the lack thereof.
- *PPPs are all embracing panaceas that can be implemented all at once irrespective of the competence, knowledge and skills on the part of governments:* PPPs are very complex but Governments have been eager to start as quickly as possible without pacing themselves. Such a myth lead to countries with no experience of PPPs to launch numerous projects before they have the capacity and knowledge, leading them often to repeat the mistakes of those who started earlier
- *PPPs provide a number of infrastructure assets, roads, bridges, power plants etc., to Governments either free or little cost and no risk:* Often sponsors have tended to ‘over sell ‘the promise of PPPs to countries and to hide the extent to which governments share risks and provide support to projects. The misconception that the private sector can do everything itself leads to a poor understanding of the Government’s own role in PPPs, which is critical. Governments do need to share



costs and accept certain risks with the private entity. Such a perspective can induce poor risk optimization, which in turn will lead to higher costs of projects

- *PPPs are sophisticated technical financial transactions.* PPPs are certainly highly technical. However the risk is that governments view them solely as financing instruments when in fact they represent a very different way of working. This sometimes leads to a failure to ask whether the project is acceptable to the public. Do they want it? People tend to be overlooked and projects go ahead with it being assumed that the projects will be socially acceptable. Policy makers need to give emphasis to shareholder returns but must also focus on improving the delivery of essential services to the general public.
- *Using a PPP can bring private money into public coffers and be an additional source of payment for government departments.* In countries with weak experience of mixing private funding with public funding, there is sometimes little understanding on the need of governments to let the private sector obtain a return on their investments. The funding provided is not a fund to be used either part or in whole for public civil servants. The financing provided has to earn a return for the private sector. It is not an extra fund for public sector use untied to specific projects. This myth has been the basis for corruption

## Challenges

At present, on top of these misconceptions a number of new difficulties have emerged in the development of new PPPs in certain countries. It appears that instead of being a useful model, the PPP concept is becoming less and less clear, and less and less attractive to the governments in the region. Many governments who recognize the crucial need for private financing and operation of public infrastructure and who are also willing to make such a move are now becoming frustrated, after some unsuccessful experience, in trying to set up a PPP. They consider therefore that PPPs are much too complex, too sophisticated, too long and too expensive.

As a result of the involvement of different experts (legal in particular but also financial, technical and environmental) representing each of the numerous participants in any PPP negotiation, even simple matters often become difficult even impossible to solve. Therefore, there is little or no room left for small and medium size projects due to the huge associated development cost.

Due to the complexity of PPP negotiations and as a result of some basic misunderstandings and lack of training and expertise on the public sector side, the governments and/or municipalities of the region, have developed strong objections against the PPP. They now often consider that the so called Public Private Partnership does not reflect a real partnership, that the states and the municipalities involved in such PPPs are not fairly treated and moreover, that they may be deceived deliberately by the private parties.

***Be realistic about what a partnership can achieve.***

Across the USA, 94 percent of water systems (roughly 5,000 enterprises) are publicly controlled. Most of them are owned and operated by municipalities. At the same time partnerships with private companies help local authorities to provide access to capital and to improve the efficiency of the waterworks. The need for new spending for all water systems in the country estimates at about \$1 trillion over the next 20 years.

The number of public-private partnerships (PPPs) in USA water sector increased from about 400 in 1997 to about 1,100 in 2003. One of well-known PPPs was started in Atlanta (Georgia) in 1999. Under the 20-year concession contract, signed between the nation's second largest investor-owned water services company United Water and Atlanta, United Water was to make \$800 million water-system repairs during the next 5 years.

But in the three years under the concession, city residents and officials complained that service was poor, management was even worse and fraught with water main breaks. In striking the deal with United Water, city officials undertook to apply as much as \$20 million a year to capital improvements. But at most the city has managed to achieve only \$10 million in annual investments. In January 2003 both sides acknowledged failure and agreed to cancel the contract.

The main lesson of the Atlanta collapse is that cities and private companies needed to be realistic about what a partnership can achieve.

Source: Douglas Jehl. As Cities Move to Privatize Water, Atlanta Steps Back. "New York Times", February 10, 2003.

## **Objective of the Guidelines and basic Good Governance Principles**

The overall objectives of the "Guide on Good Governance" is to work toward a better understanding of the basic principles necessary for the private financing of public infrastructure: It presents five basic principles to address misconceptions and to rebut the above mentioned challenges. These principles are addressed both to Governments and the private sector.

**Principle 1** - *PPP process should be feasible, streamlined and as clear as possible within an overall comprehensive legal framework. (Governments need to impose model, standardised contracts which can lower the costs and promote more cost-effective procedures. The key benefit of a standard contract is improved *quality* of the contractual documents )*

**Principle 2** - *PPP process needs to be equipped by persons with the necessary skills and training assisted by a competent PPP task force and public officers well trained in PPPs, which will enable the process to be carried out in a much simpler cost effective fashion. PPP process needs a competent private sector as well.*

**Principle 3** - *Governments and private sector need to develop realistic expectations, balanced contracts, and shared risks to achieve success* (PPPs need to show balanced contract provisions, fair risk allocation and distribution of rewards).

**Principle 4** - *PPPs should be undertaken within a transparent selection process that promotes competition* (PPPs should work through a clear selection process open to all, tendering procedures should be also simplified and made as easy as possible reducing the length of time to project closure)

**Principle 5** - *PPP process needs to promote clarity, value for money, public accountability, and sustainable development, designed to achieve benefits for all especially the socially and economically disadvantaged* (due respect and consideration needs to be given for end-users or consumers especially of economies in transition, who are not used to paying for public services, promoting fair reporting of the project and joint decision making).

In Part I we will now the steps and appropriate solutions to be taken to achieve these principles and Part II will present the recommendations improving good governance more transparency and accountability and simplification of the PPP process.

# Chapter 1. IMPORTANCE OF A LEGAL AND POLICY FRAMEWORK

## *Misconception*

*‘Contracts are sufficient for getting started. In PPPs, only a strong contract between the parties is needed. Putting in place the overall legal and policy framework can wait’*

In fact, Government should give priority to establishing an appropriate overall legal and policy framework, which lies at the heart of good governance in PPPs. They need to create in this respect a stable PPP policy framework.

**Principle 1** - *PPP process should be clear, feasible, streamlined and as simple as possible, within an overall comprehensive legal framework and a stable PPP policy environment. (Governments need to impose standardised model contracts, which can improve the quality of the contractual documents, lower the costs and promote more cost-effective procedures.)*

## **CHALLENGES- Key challenges in creating a conducive legal and policy framework**

A number of challenges are apparent in PPP processes:

- Lack of clear and stable policies
- A weak legal framework that gives inadequate authority and security to public and private partners
- Expensive, time-consuming, and non cost-effective procedures
- Highly-complex legal contracts

## **SOLUTIONS**

### **1. Existence of a general and stable PPP policy framework**

Governments should formulate a policy or special programme to promote the use of the PPP model for the following reasons:

- To identify the objectives which they hope to achieve through their involvement in public private partnerships.
- To provide guidance to government staff in initiating and evaluating PPP proposals.
- To allow Governments to communicate their position on PPPs to other interested parties, including potential partners, labour unions, and the members of the public.

## **Topics to be covered in the policy**

The scope and content of a policy on PPPs will vary from one government to another. However it should consider:

- The types of services or projects for which it will consider PPPs
- The forms of PPPs it will consider
- The degree of risk it is prepared to accept as well as how it intends to manage risk
- Risks it is not prepared to accept
- The criteria for determining whether PPPs are a viable method of service delivery
- Its policy on the involvement of stakeholders throughout the process, consistent with legislation, as well as on fundamental principles such as transparency, accountability and social inclusiveness
- The types of partners eligible to become involved in PPPs with the government.

## **Preparing the PPP Policy**

An important consideration in preparing the policy is the need for considerable consultation with affected stakeholders. Given that the policy may impact various existing policies and arrangements, it is essential that stakeholders affected by the new policy be given an opportunity to be involved in its preparation. Groups and agencies that might be involved in the preparation of the policy include: Local chambers of commerce; Local construction industry; Potential private partners; Residents; taxpayers and voters; labour unions; Environmental groups and other NGOs; and Consumer organizations.

As it concerns the sectors for which PPPs are being proposed, thorough studies of the social, economic and financial implications of the projects should be carried out. It should be clear that before a project obtains the required approval of the respective state bodies, all stages for such approval must be followed in order to prevent subsequent cancellation of licences required under relevant legislation. In this respect, one could think of permission under laws on zoning, protection of the environment, expropriation of land, use of underground water reserves, etc.

## **Establishing Procedures**

In addition to establishing policy it is also advisable to provide guidance for government staff and potential bidders with respect to procedures that address the following:

- Overview of the stages the government intends to follow in the process of establishing PPPs
- Identification of key persons, committees and stakeholders involved in the various stages of the PPP process and description of the roles and responsibilities of those involved
- An indication of the key decisions required at various stages in the PPP process and identification of who is empowered to make those decisions, and appeal or challenge procedures, as applicable.
- The requirement for the involvement of stakeholder groups, the public and electors at various stages in the PPP process.

## Consistency

If there are municipal or sector-specific policy frameworks, care should be taken to avoid contradictions and overlapping.

## 2. Legal Frameworks

A legal framework should give security to both public and private partners<sup>1</sup>:

- **Existence of the general concession/PPP legal framework**

A general concession-PPP law, as opposed to multiple sector-specific concession laws may be required. The requirements and extent of any PPP law will also depend on the nature of the legal system. Under common law systems, the requirement for extensive PPP law is often less. In the UK and Australia for example, PPPs have been successfully implemented with very little PPP law. In civil code systems this is less likely.

Table 1.  
**Select countries where PPP concession laws were introduced 1974-2005**

Countries	Name of the law	Year
Norway	«Law on concessions»	1974
Montenegro	«Law on concessions in the Republic Montenegro »	1991
Croatia	«Law on concessions»	2006
Kyrgyz Republic	«About concessions and foreign concession enterprises in the Kyrgyz Republic »	1992
Moldova	«About concessions»	1995
Bulgaria	«Law on concessions»	1997
Serbia	«Law on concessions»	1997
Costa Rica	«Law on concessions»	1998
Ukraine	«About concessions»	1999
Norway	<i>State Authorities (Public Private Partnership Arrangements) Act</i>	2002
Russian Federation	«About concession agreements»	2005

Source: V. Varnavsky. Public-Private Partnerships. Moscow. Nauka. 2005, p. 255.

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<sup>1</sup> The Global Best Practice presented below follows the EBRD Concession Checklist core areas, such core areas being created on the basis of international standards developed in the concession field (mainly the UNCITRAL Legislative Guide on Privately Financed Infrastructure Projects adopted in 2000 (the "PFI Guide")) and experience in implementing PPP projects. They will be completed, where appropriate with additional (*effectiveness*) elements.

- Provisions whereby sector-specific laws are complementary to the general PPP law are useful (e.g. FYROM, Romania, Jamaica),
- Such a law must be flexible so that it is able to provide for individual frameworks under which projects can be designed and implemented, as opposed to a rigid mandatory prescriptive regime.

### **Existence of clear definitions and boundaries of a PPP granting legislation**

#### **Main features**

- Definition of the term "PPP" and "concession" with clear boundaries, especially with respect to: (i) sector-specific legislation permitting PPP, (ii) municipal legislation permitting PPP (iii) public procurement legislation.
- Cross- references in one law can enable the drawing of clear boundaries (e.g. Bulgaria: cross references in concession law and municipal activities law).
- Definition of public authorities empowered to grant PPPs/enter into project agreements (the "Contracting Authority"). The Contracting Authority must have the legal right under the law to enter into a project agreement.
- Definition of private persons to whom PPPs can be granted. The definition should be non discriminatory on the basis of nationality. It should be possible for private investors to incorporate a locally registered privately owned limited liability company to act as the Project Company to implement the PPP project and for those private investors to manage the affairs of such Project Company to protect their interests. There should be no legal restriction on the ability of foreign investors to dispose of their equity investment in the Project Company at market prices and to repatriate the profits out of the country.
- It may be appropriate to include in the legislation certain restrictions on equity sales (e.g. during the construction period or safeguards as to whom equity may be sold)
- A definition of a non-limited list of sectors in which concessions may/may not be granted.

#### **Relevant European Community rules**

- The European Community ("EC") (i) does not define the term PPP and (ii) does not lay down any special rules covering PPPs.
- However, the Directive on the coordination of procedures for the award of public works contracts, public supply contracts and public service contracts of 31 March 2004 ("Public Contracts Directive") defines and regulates precisely "public contracts".

Moreover, the *Interpretative Communication on Concessions* of 29 April 2000<sup>5</sup> ("Communication on Concessions") defines the characteristics of concessions and general rules to be respected in the concession granting process.

Finally, the European Commission has recently published: (i) Guidelines for Successful Public-Private Partnerships (March 2003) ("PPP Guidelines") and (ii) the Green Paper On Public-Private Partnerships and Community Law on Public Contracts and Concessions (April 2004) ("PPP Green Paper") and [(iii)

Communication On Public-Private Partnerships and Community Law on Public Contracts and Concessions (November 2005)].

The PPP Green Paper provides that "In general, the term [PPP] refers to forms of cooperation between public authorities and the world of business which aim to ensure the funding, construction, renovation, management or maintenance of an infrastructure or the provision of a service". It specifies furthermore that the following elements normally characterize PPPs:

- Relatively long duration of the relationship;
- Funding, in part from the private sector (public funds, *"in some cases rather substantial"*, may be added);
- Important role of the economic operator (participates at different stages of the project: design, completion, implementation, funding); and
- Distribution of risks between the public and the private partner; risks generally borne by the public sector are transferred to the private operator (not necessarily all or major).

The term **concession** is defined indirectly in the Communication on Concessions, by defining the scope of application of the Communication and by distinguishing concessions from public contracts:

*"This communication therefore concerns acts attributable to the state whereby a public authority entrusts to a third party -by means of contractual act or a unilateral act with the prior consent of the third party - the total or partial management of services for which that authority would normally be responsible and for which the third party assumes the risk. Such services are covered by this communication only if they constitute economic activities (...) "*

**Public contracts** (supply, works and service contracts) are contracts for pecuniary interest concluded in writing between one or more economic operators and one or more contracting authorities and having as their object the execution of works, the supply of products or the provision of services (Public Contracts Directive, art. 1).

In addition, the **Public Contracts Directive** defines *"public works concession"* and *"service concession"*:

- **public works concession:** *"a contract of the same type as a public works contract except for the fact that the consideration for works to be carried out consists either solely in the right to exploit the work or in this right together with payment";*
- **service concession:** *"a contract of the same type as a public service contract except for the fact that the consideration for the provision of services consists either solely in the right to exploit the service or in this right together with payment".*

A public works concession is distinguished from a public works contract in that the works concession involves the transfer of the risks inherent in operation. A privately-operated toll motorway is an example of a public works concession. However, if



public authorities guarantee reimbursement of the financing, this would be considered as a public works contract. The distinction between a services concession and a public service contract is based on the same criteria: transfer of risks inherent in operation

Finally in developing PPP legislation reference might also be made to the **EU procurement directives** introducing competitive dialogue procedures.

**Existence of fair and transparent selection process and tender rules**  
**(see chapter 4)**

Basic provisions include:

- Mandatory competitive procedures for PPP award.
- Publication of information related to the competitive procedure; requirement of international publication for "important"/"strategic" projects.
- Public access to PPP-related information.
- Limited/exceptional circumstances allowing direct negotiations (e.g. urgent need for ensuring continuity of services, short duration/low investment value, national defence/security, existence of only one source capable of providing the service, unsuccessful competitive procedure).

*For example,  
Lithuanian  
Concession Law  
should be  
considered.*

Provisions should provide both clear guidance (guaranteeing a certain degree of objectivity and minimum standards) and sufficient flexibility for Contracting Authorities to respond appropriately while organising procedures for pre-selection and requests for proposals. The provisions should avoid long and non-transparent project agreement negotiations, and provide a procedure for aggrieved bidders and third parties.

The selection process procedure should ensure that the public sector project sponsor eventually obtains the best "value for money" proposal and that the selected proposal is "affordable" by the public sector project sponsor.

**Possibility to conclude project Agreements allowing a proper allocation of risks, and to obtain necessary approval**

- Existence of a "model concession agreement" or model provisions serving as guidance (e.g. provisions on early termination/compensation, tariff setting, and service standards).
- Absence of unnecessary or unrealistic/compulsory requirements or interference from the public (obligations, tariff, termination, compensation). The public sector should be aware that such requirements drive up the project cost, and may render it financially suspect or nonviable.
- All the necessary administrative documents (authorizations, licenses) to implement the PPP project must be obtainable.
- Existence of an effective regulatory framework ensuring that there is no abuse of dominant position, that consumers are protected and that the private sector

service providers and investors are able to earn a fair return for the risks that they are taking. Regulation can be through the contract or via an independent single-sector or multi-sector regulator.

Subject to complying with all the required rules and regulations, there must be no legal constraint to the Project Company operating the PPP project and providing the public service.

### **Possibility of international arbitration**

Disagreements during the course of a PPP contract are common. Rather than litigation, arbitration can play a useful role in resolving disputes. Arbitration is performed on the basis of an agreement, explicit or tacit, prior to or after the dispute arose. If the parties agreed on arbitration, as a rule, any ordinary court of law will reject jurisdiction, at least if the relevant law so provides. Most countries have a law

#### ***Recent trends in arbitration***

- Use of foreign courts to make arbitration settlements
- Increasing interest in the use of mediation

on commercial arbitration, some of which are based on the UNCITRAL Model Law on International Commercial Arbitration. Often, arbitration takes place with an institutional arbitration tribunal.

In European arbitration, popular places to arbitrate include Stockholm, Moscow, Paris (the Arbitration Court of the International Chamber of Commerce), Zurich, Geneva, or London, all of which apply their own rules of procedure but allow also the application of other rules, such as UNCITRAL Rules.

In the considering arbitration rules for PPPs, it might also be helpful to refer to dispute resolution procedures set out, for example, in the UK's SPOC4.<sup>2</sup>

### **Requirements related to property and land use rights**

#### **Rules that safeguard property rights:**

- Legal provisions and restraints on expropriation;
- Recognition/protection of private ownership, possible transfer of ownership rights, proper registration of ownership rights, clear enforcement mechanisms, no restrictions for foreigners;
- Rights of way over neighbouring land should be permitted for purposes of supplying utilities and for access.
- Subject to complying with all the required rules and regulations, there must be no legal constraint to the ability of the Project Company to have the unfettered use of the land forming the site of the PPP project and to be able to construct the necessary assets, which will be utilized by the Project Company to provide the required public services.

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<sup>2</sup> Released in March 2007 UK

## **Requirements related to environment**

Clear environmental law as regards the PPP project (need for environmental impact assessments, permits and or licenses, responsibility for past environmental damage, applicable standards, clear procedure to be followed, etc).

### **3. Standard model contracts**

It is important to have standard model contracts to avoid re-inventing the wheel and causing unnecessary expense.

In the UK, the Government decided to standardize PFI contracts: The Standardization of PFI Contracts was developed (SoPC 4 see UK Government, 2007):

- To promote a common understanding of the main risks;
- To allow consistency of approach and pricing across a range of similar projects; and
- To reduce the time and costs of negotiation by enabling all parties concerned to agree a standard approach without extended negotiations.

In the UK all PFI schemes must be SoPC4 compliant. To avoid uncontrolled sector specific derogations from the model contract at time of writing all derogations from SoPC4 require specific prior approval from HM Treasury.

### **4. Use of more flexible innovative and less costly PPP models**

The traditional PPP approaches are useful but in some cases they have limitations. The procurement process is sometimes long and costly making it unsuitable for small projects or those with a short lead-time. The length of the contract and relative uncertainty about costs mean that a great deal of pressure is applied on both parties to negotiate a contract upfront that is acceptable in the long-term. For the public sector embarking on a PPP, the outcome may be clouded in uncertainty. Uncertainties might be present as a result of latent defects (flaws in the existing infrastructure that are not apparent until the work begins), policy changes (implying change in service requirements), demand risks (resulting from the introduction of user choice, for example), changes in public needs e.g. from population ageing or rapid changes in the technology. For projects that are especially vulnerable to these uncertainties, simpler and more innovative models can be used.

#### *Alliancing*

Where uncertainty about the nature of the infrastructure or services required meeting project objectives is irresolvable (unknown technological risks, for example) using an alliancing model can allow projects to go forward. Alliancing is a term used to describe delivery models in which the focus is on encouraging close collaboration between the public and private sectors through the use of payment mechanisms that ensure that the interests of all parties are aligned with the project objectives. The aim

is to avoid the adversarial relationships and acrimony that sometime characterize more conventional procurement models, and instead seek to ensure that all parties working together collaboratively for the good of the project. This model can be particularly useful in the defence sector, where projects can be large and indivisible and where well-defined outputs are often precluded from the outset.

The Netherlands has frequently used alliancing in economic development projects. Such projects often have diverse output requirements (specific number of social and affordable housing units, designated areas for public space and community centres and a target level of growing economic activities and traffic flow, among others) that require expertise and resources from various public and private partners in order to meet the projects' objectives and share the risks. The alliancing model connects flexibility to effective project implementation to overcome the challenge of joint delivery.

### *Bundling projects*

A single small project can be as costly to organize, bid, and manage as a large project; these costs are referred to as "transaction costs". Traditional PPP processes can generate high transaction costs when weighed against the project's modest revenue streams. This high cost can deter possible private partners from bidding if they feel future revenue is unlikely to outweigh transaction costs. Bidding on building individual hospitals, for example, requires substantial investment but presents relatively small returns compared to the expense of construction and maintenance. It is the complexity not the size of the project that drives up the cost. The scale of transaction costs is a concern for both the public and private sectors.

One way to address this problem is by bundling together several projects. By contracting with just one partner to provide several small-scale projects, the public sector can reduce the length of the procurement process as well as transactions costs. In Australia, bundling sometimes takes the form of grouping hospital construction with ancillary structures and commercial activities, thereby creating enough revenue generation to balance against building and procurement costs.

### *Incremental partnership*

Another option for smaller projects is an approach termed incremental partnerships. Under this model, the government enters into a framework agreement with a private sector partner that procures the infrastructure and services on behalf of the public sector. As its requirements becomes clearer, the government agency can "call off", or stop specific projects if they appear unproductive. The private sector partner competitively procures the services and infrastructure from subcontractors but retains overall responsibility for service levels assessed against clearer performance measures. There is no exclusivity for the private sector partner – the public sector retains the right to use alternative providers if it wishes. This avoids the weaknesses associated with 'big bang', large-scale contracts that are difficult to reverse and require a long-term commitment from both parties.

### *Using the Competitive Dialogue*

In complex contracts where a contracting authority is not objectively able to:

- *Define the technical means capable of satisfying its needs or objectives; or*
- *Specify either the legal or financial make up of a project or both*

a new form of arrangement – competitive dialogue – is often used by governments. It involves working with bidders to develop technical and commercial solutions. While this approach leads to solutions that overcome the inherent complexity of PPPs, the contracting authority must still work to ensure fairness in the tendering procedures and avoid discrimination.

## Chapter 2. WAYS AND MEANS GOVERNMENTS CAN BUILD THE CAPACITY TO DELIVER PPP PROJECTS

### *Misconception*

*‘PPPs are all embracing panaceas that can be implemented all at once irrespective of the competence, knowledge and skills on the part of governments’*

In fact PPP processes require a skilled government and private sector

**Principle 2:** The PPP process needs to be equipped by persons with the necessary skills and training assisted by a competent PPP task force, which will enable the process to be carried out in a much simple, cost effective fashion. PPP process needs a competent private sector as well. Governments need to build the skills in both the public and private sectors.

## CHALLENGES

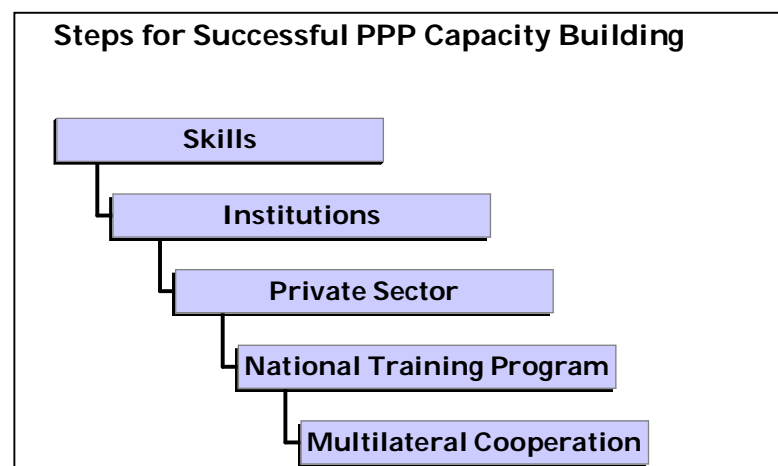
Ideally, governments need to create a centre of excellence, with world-class experience, multi-functional expertise top line skills and management in best practice to take PPPs forward. This should act as the brain centre for the PPP units spread across states and local and regional authorities. But the challenges are that many Governments lack:

- PPP units
- Information on the private sector including the ministries where PPPs are most likely to be used such as transport, energy, water and municipal services.
- New skills necessary to promote PPPs including those required to maximize the developmental impact of PPPs in ways that make PPP contribute to sustainable development
- Training and capacity building programmes in PPPs in general

## SOLUTIONS

Developing the capacity to undertake PPPs takes time. There is no ‘big bang’ solution but rather incremental steps. The key steps in increasing the capacity of governments are:

- First, identifying the skills and new approaches that are needed.
- Second, placing these skills in a new institutional entity to maximise their influence
- Third, building a strong rapport with the private sector
- Fourth, establishing strong national PPP training programmes supported by the international community, with the involvement of the private sector and in cooperation with other national partners.



### 1. Skills required

There are many skills required – negotiation, financial contractual and the cultivation of different approaches. Many of these are listed in the annex to this chapter. Of these, the following are the most important:

- Viewing projects over the longer term- the like cycle approach
- Identifying output specifications as opposed to a focus on the input specification, which is done in traditional procurement. This in turn places a premium on quality rather than price considerations
- Partnership skills: training government officials to develop partnerships with the private sector and with the right motivation and spirit
- Training for the after care of PPPs once the projects have begun, namely equipping the public sector to monitor PPP projects to ensure that they meet their objectives.

For countries getting started, the first requirement will be to hire consultants. This is a skill in itself, as only careful judgement can determine whom to select and the tasks to be given. As it stands today, certain countries issue guidance on the hiring of consultants as advisers to PPP projects.

## **2. Using the skills in dedicated Institutions, PPP Units/task forces**

The next step is placing the skills in a separate entity or task force in order to maximise the influence and impact. A PPP Unit usually set up within Governments has responsibility for the implementation of the Government's PPP Programme. PPP Units are used by both small and large economies. How advisable is it for governments, which are beginning a PPP programme and have little experience in PPPs to establish such Units?

On the negative side, establishing cross- sectoral PPP unit can:

- Exacerbate rivalries within Governments and amongst Ministries who might feel that their work is being taking away;
- Create simply another tier of bureaucracy. Such an eventuality can occur if Governments do not give their Units a clear set of objectives;
- Risk creating conflicts of interest. For example if a cross sectoral PPP unit is established that both provides inputs into the approval process for PPPs and has a mandate to promote them, or even more so, receive compensation for deal closure, then there is a real risk that a conflict of interest may arise.

But outweighing these negatives are the many pluses of establishing PPP Units:

- Increase significantly the flow of successful PPPs: There is clear evidence that the creation of PPPs increases the likelihood of developing a successful stream of PPP projects. (See table)
- Send out a positive political signal to the private sector that the Government is serious about developing a PPP programme.
- Mobilise the essential skills base for a PPP programme

### **Location of the PPP Unit**

Typically, PPP Units are often placed under the auspices of the Ministry of Finance. The reasons for basing a PPP unit in a cross sectoral ministry are the following:

- Ability to help spread best practice across sectors,
- More efficient use of scarce PPP expertise, and
- More effective implementation.



PPP Units can also be located within special Ministries e.g. Transport, Health, and Education etc. sometimes functioning in coordination with a central unit under the auspices of the Ministry of Finance. In the UK, for example, a number of operating ministries such as in health have their own PPP units.

### Setting up a PPP Unit

PPP units are established at different levels of government, national, regional and local and there is no 'one size fits all' concerning the allocation and distribution of tasks between PPP units at different levels of Governments and different government departments. A PPP unit should not blindly emulate models but develop its own specific, workable formats that are economically beneficial, financially feasible and politically acceptable.<sup>1</sup> PPP approaches should suit the structures of government.

*In certain countries the adoption of a PPP policy framework document and the creation of a PPP task force are required by the concession law (for instance, consider Bosnia and Herzegovina).*

### Role of the PPP Unit

The key role of the PPP Unit is to help develop and intelligently support the management of the project preparation process. This is an area where most governments have little expertise. The PPP Unit is first and foremost responsible for developing a project pipeline. It is important to develop well prepared projects especially given the long term contractual nature of many PPP deals and the scrutiny they will subsequently be subject to by lenders' credit committees, and the public. The critical moment for the work of the PPP unit is right at the initial stages of the PPP programme where the main tasks are to lay the foundations of the PPP programme.

The National PPP Unit should support all kinds of sub-national project executing agencies or line ministries in the following:

- **Policy development:** facilitating and reducing bid times and costs and improving the quality of the PPP procurement process with standardised contracts and procedures, ensuring national consistency. Practically, it can help the relevant procuring authority (particularly one that is new to PPP or if the project is particularly new or complex) more confidently manage the whole process (including external advisors) from the development of the initial project design, through to the bid evaluation process and post financial close. Units can do this by, for example, providing experienced people to sit on the individual project decision making boards and stiffening the back of the public sector at key decision making points.

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<sup>1</sup> For example, an important sophisticated analytical technique to evaluate whether a PPP option should be selected from a public sector alternative is the 'Public sector comparator' (PSC). But it is not clear how easily this can be transplanted into other governmental environments. It is not even clear that the use of the PSC makes sense where there are no other public sector financing alternatives.

- **‘Championing’ the PPP process**, consulting with investors and communicating to line ministries their concerns regarding legal and institutional bottlenecks to the implementation of PPP projects
- **Education and training**: supporting the government officials to learn their different duties and tasks
- **Developing the market**: A central approach in developing the market for PPPs (see below) is helpful as it can provide a consistency of approach across a wider range of projects which can avoid the private sector playing one part of the public sector off against another (e.g. the development of the standardised contract in the UK, which has helped significantly here) while also reducing the time and cost incurred by private sector bidders to learn/accept new rules for each separately administered market (another benefit of standardization).

At the regional / local level, the PPP Unit is typically responsible for:

Implementation and procurements: accordingly, ownership of projects by the relevant procuring authority from its inception makes sense.

In federal and local relationships, there is no easy solution as each country will be different. Rather it is important to create mechanisms that encourage coherence and consistency wherever possible.

### **Leadership of the PPP process**

It should be added that the PPP Unit must have its own clear ideas on programme management. It must have developed its approach to managing advisors, and for engaging with the contractors, service providers and providers of long term debt and equity finance i.e. it needs to be in a position to lead the programme from the front.

### **Should the PPP Unit be located inside or outside governments?**

Another consideration is whether PPP units should be located outside or inside governments. Here the consideration is by hiring staff outside the regular civil service a better pay and career structure can be provided to retain and attract people with the right skills. Under such arrangements, staff would receive incentives for closing deals in reasonable time and also receiving penalties for not keeping to the targets set for project delivery.

Such a system however may work in countries with lots of experience in public private cooperation but is not a good option where there is already a big differential between pay in the public and the private sectors. At the same time it is critical for Units to retain good staff and provide adequate incentives to do so.

## **Retaining staff**

A key point is that Governments can often find it hard to recruit and retain PPP talent (compared to the private sector) because of:

- (i) rigid or formal recruitment systems (with limited secondment in from the private sector, and limited lateral entry into civil service positions),
- (ii) frequent intra-departmental transfers and lack of specialists and
- (iii) salary differentials with private sector (which not only hinder recruitment of experts but also lead to departure to the private sector of public officials with valuable PPP experience and expertise)

Hence the design of structures to counter this and the ability/willingness that PPP programmes will require resources and effort to run properly. The consequences of not doing so can be much more costly in poorly prepared and managed projects.

## **Importance of making the PPP Unit accountable for its performance**

Another part of the institutional infrastructure complementary to the work of PPP Units is the role of bodies that can independently scrutinise projects after they have been signed in order to determine whether or not policy objectives have been met. This is not a role for a PPP Unit but is vital as a source of independent and technically competent review of projects, which can be used to feed back into further development of policy and guidance.

## **An example of the PPP Unit model**

Partnerships UK (PUK). is one example of a PPP Unit which encapsulates some of these principles and modalities. PUK was formed in 2000 to succeed the Treasury Taskforce in providing Department-wide centralised support. This allowed the Treasury to concentrate on developing PFI policy, while setting up a separate centre with the expertise to help procuring authorities on more specific transaction-related and day-to-day issues. Hence PUK has a specific public sector mission set out as:

***“to support and accelerate the delivery of infrastructure renewal, high quality public services and the efficient use of public assets through better and stronger partnerships between the public and private sectors”.***

As a Public Private Partnership itself, PUK has a 51% private sector equity ownership, with HM Treasury and the Scottish Executive making up the remaining share. PUK has around 50 professional staff, many retained for more than five years. With over 600 signed projects, the majority of which are moving into or already in their operational phase, the UK has also looked to provide greater support to projects as they make their transition from procurement to the operational stage. Operational Taskforce acting on behalf of the UK Treasury was created within PUK to work to this effect. The Operational Taskforce is a source of support, guidance and advice for operational projects; advising on contract management strategy, market testing, contract variations and a host of other PFI related issues.

### **3. Developing the private sector as a partner for PPPs**

At the outset one of the main challenges - which is often overlooked - will be to develop a market for PPP projects. A market for PPP projects is a supply of private companies that can bid for projects, which the Government believes, are appropriate to be done as a PPP. In some countries PPP units are established but projects do not occur because the private sector is not available to become partners and there is thus a need to generate a project portfolio where private partners are ready to cooperate.

#### *Identifying a PPP project portfolio to get started*

Experience shows that private sector capacity is best built by embarking on a pilot programme. The challenge here is to select the right projects and sectors where the possibility of achieving success is realistic.

#### *Pilot programme*

The following are some suggestions for starting a pilot programme:

- 1) The project must be one for which there is plainly a social and economic need and the delivery of which is recognized as important to most political opinions.
- 2) The project should be one that involves known and tested technologies and for which there is a market place of potential suppliers with whom to enter into partnership.
- 3) The project should be one that is on the main priority list of the sponsoring Ministry or Agency (there has been a tendency for sceptical Ministries to offer up their lower priority schemes for PPPs).
- 4) The project payment stream must be clearly affordable by the sponsoring Ministry or Agency (and/or supported by Ministry of Finance issued guarantees).
- 5) The project should be of a sufficient size to interest international financiers and concession companies.
- 6) Ideally, the initial pilot schemes should represent a range across the key public service sectors and be representative of likely future schemes. From the public sector's point of view, it is very important from the outset to be aiming to develop methods and methodologies, which will be replicable.

Based on the above and taking account of current experience a good checklist for identifying the right pilot projects is the following:

- Likelihood of strong competition
- Bankability
- Clear case for value for money
- Evidence of public sector capacity in place to manage the complex process

- Relative project simplicity i.e. straightforward payment mechanisms, straightforward project structure (in some cases countries have bundled projects to achieve minimum scale but in so doing have created complexity). Complexity of these projects is almost universally underestimated by governments, especially at the pilot phase when experience is limited
- Pilot projects should ideally be part of a future pipeline as bidders will therefore be more inclined to take interest
- Payment stream not only affordable but the public authority responsible for payments must be credit worthy (or suitable credit enhancing mechanisms put in place)

### *Sectors and projects*

In most countries traditionally PPPs are started in transport and then move to other sectors. But this is changing as PPPs are increasing in sectors such as health and education. Governments should look at the sectors where PPPs have been especially successful:

- United Kingdom: in the areas of schools, hospitals, prisons and defence facilities and roads, as well as the challenges encountered in IT PPP projects
- Canada: energy, transport, environment, water, waste, recreation, information technology, health, education
- Greece: transport projects: airport and roads
- Ireland: road and urban transport systems
- Australia: transport and urban regeneration
- Netherlands: social housing and urban regeneration.
- Spain: toll roads and urban regeneration.
- US: projects, which combine environmental protection, commercial success and rural regeneration such as, for example: Educational Facilities, Transportation, Water and Wastewater Services, Real Estate, Public Safety, Public Parks and Facilities, National Defence Housing, Telecommunications.

One model that can be used to develop the PPP marketplace is transport/ urban renewal projects where environment, health, transport and regeneration considerations are combined and integrated into an overall PPP. Under such a scheme a government releases underused assets such as real estate around a transport hub such as a railway station and allows the private sector to commercialise the area through the building of shops, offices and recreational areas. The private developer can unlock value from an underutilised asset, turning it into a financial asset. The government gives over the asset so that the developer becomes responsible for rebuilding and then operating and maintaining it. Such innovative deals for example, have transformed small cities throughout Spain and offer an innovative model to other counties. In the U.S. as well, this approach has been used to renovate ageing railway stations in inner cities, while promoting transit-oriented development.

The country can realise a host of benefits from this innovative model:

- The railway station / port / harbour / etc. can be built quickly, spurring economic development faster than would otherwise have been possible

- Long-term maintenance risks are shifted to the private sector
- And the country releases greater value from the land than would be possible under government ownership – all with reduced or no expenditure of tax revenues.

*(ii) Promoting links with the private sector*

Overall it should be stated at the outset that strong signals from top level government officials showing commitment to the PPP programme are key to engaging with the private sector and without this it is very difficult to launch and maintain a PPP programme.

PPP units should maintain a strong dialogue with all players in the market. This often starts purely as a need to liaise over PPP technicalities and to provide the private sector with information. The role usually develops because the Unit reports to colleagues and Ministers the key findings about market attitudes and companies' responses to public sector actions and statements, and also reports details and views about the private sector's capacity. The Unit often develops its role in the process and adds a new dimension to its role, leading it to become responsible for 'macro-management' of infrastructure investment generally (conventional and PPP). Sometimes the unit can publish 'Infrastructure Investment Plans' which provide the private sector with information on its plans schedules, etc.

PPP Units should try to hold annual conferences about infrastructure investment, to update the private sector on policies and procurement opportunities. It can also allow influential market speakers to show confidence in its plans and arrangements, which is important as a signal to others considering where to invest. This can be done in collaboration with private conference organizers who are experienced and have networks amongst the financial and PPP community and can offer the service free to the host government.

In addition the PPP Unit can hold regular seminars for the commercial advisers - legal, technical, and financial. Advisers play a central role and they can facilitate dialogue between the partners in accordance with government policies and technical guidance. They also give the Unit considerable support and advice informally. The PPP unit will be invited to speak at events sponsored by various players - construction companies, banks, etc. - to provide information. The PPP Unit will invariably invite all the main players to 'one to one' meetings for discussions about their strategies and plans.

Communication with the private sector often evolves from technical discussion on specifics, to an open exposition of the Unit's planned investments and to finally a free and open discussion about delivery issues. This has included, with the cooperation of Ministers, a healthy political debate about PPP.

#### **4. National PPP training programmes**

The fourth step is establishing national PPP training programmes to build the expertises of government officials. The training of public sector officials by experienced public and private sector bodies saves repeating errors identified elsewhere and shortens the learning and implementation time.

The development of PPP expertise will take time, since in every case, the PPP model should be adapted to local circumstances. In thinking about the range of options available in terms of national training programs, it is essential to first assess those training approaches which will not achieve the goals. Taking an approach for example in which training occurs outside the operational environment will not lead to positive results. It does not make sense to assume that key understandings of PPPs can occur in a PPP course lasting a few weeks. Neither can it be said that only classroom training or only training outside of one's home country will suffice.

A national training program that has a greater chance of success, on the other hand, must include training within the operational environment. By taking an incremental approach, setting and then following international standards, perpetually pursuing new knowledge of PPPs and being trained by country-specific PPP educators, developing good governance best practices through case studies, and engaging in on-site project preparation, national training programs increase their chances of success. Overall, "training by doing" inside the operational environment may provide the best solutions for PPP education.

Examples of different types of national PPP training programmes are the following:

- Spain: SEOPAN, the Association of major Spanish contractors and concessionaire groups has established with a local management-training institute an MBA program which has produced students to work in the field of concessions.
- Netherlands: Within the Ministry of Transport a number of large PPP projects have been brought under the supervision of a single management entity and a PPP Knowledge Pool was established on 1 September 2006. The purpose of this Knowledge Pool is to bundle, develop and spread financial and economic and legal and contractual knowledge and expertise in the area of PPP within the Ministry. The Knowledge Pool is dedicated internally to facilitate the key positions in the different PPP projects. The rationale is to build expertise on the basis of delivering a few successful pilot projects which reflect the Ministry's new orientation in PPPs towards reliable and predictable access of transport services.
- United Kingdom: Partnerships UK runs one or two times a year a PPP Foundation course specifically for public sector PPP task force officials involved with the development and management of PPP programmes.

## **5. Multilateral cooperation**

Multilateral cooperation is important in PPP training programmes because it saves resources and avoids reinventing the wheel each time a country launches a PPP programme. National PPP Units in this regard have helped other government to establish their own Units and to help with training on a bilateral basis.

Gradually, over time, a consensus has emerged that there is a need now to make such valuable *ad hoc* arrangements more formalised in a new multilateral framework of cooperation. At the UNECE in 2001, an international Conference called for the creation of a PPP Alliance to build the capacity of public sector entities to undertake successful PPPs for sustainable development. Several meetings were held under the auspices of the UNECE PPP Alliance. In the years that followed the concept of a multilateral forum for PPP capacity building grew and various institutions have begun to put these proposals into reality.

## **EPEC**

The European Commission, jointly with the European Investment Bank, endeavors to establish a European PPP Expertise Centre (EPEC). EPEC is intended to be a platform to exchange experience about PPP and to help develop PPP policies where Member States or responsible public authorities at regional level wish such kind of support. It is proposed that this body will become operational in 2008

Amongst further proposed steps to meet a new interest amongst the ‘catching up’ economies who are approaching PPPs for the first time, one suggestion is the:

### **Creation of an international PPP Expertise Training Centre**

Such a training centre for government civil servants would have the following benefits:

- Prepare the training models for use in the region
- Build a foundation of skills for PPP officers
- Complement the anticipated strengths of the EPEC by providing practical training in all aspects of PPPs to policymakers and decision-makers
- Establish synergies with groups like EPEC in terms of effectively addressing physical infrastructure needs, such as transport links and energy supply, as well as with matters of social infrastructure, such as education, healthcare, and other services that are unevenly spread.

### **A PPP advisory board**

Guiding the process it may be also helpful to establish a small but influential body of top PPP experts drawn from the private sector. Such an informal body could provide guidance to the training process, ensuring standards and competences are achieved, and promoting synergies between EPEC and the training centre. It could also hold informal consultations with government ministers on PPP policy making.

## **Conclusions**

- Training is a critical component for a successful PPP programme and good governance
- New skills need to be established and channelled through PPP units
- Supportive national training programmes will be required
- Multilateral efforts to support such national programmes should be established and these should be complementary with each other and have a pan European coverage



## ANNEX- The New Skills required in PPPs

PPPs do require a new number of skills. Some of the key public management skills - described in detail below -required are the ability to:

- create a long-term political commitment for PPPs;
- identify sectors where PPPs are the best option;
- prepare contracts and organize procurement;
- develop optimal financial and risk-sharing mechanisms;
- balance the interests of different groups of stakeholders;
- measure PPP performance; and
- coordinate and mobilize necessary PPP expertise as seen below.

Some Government responsibilities for PPPs	
<p><b>Framework</b></p> <ul style="list-style-type: none"> <li>• Adopting legal provisions to enable the granting of PPP contracts</li> <li>• Establishing or identifying regulatory authorities</li> <li>• Managing government support to infrastructure projects</li> <li>• Managing public relations and information</li> </ul> <p><b>Project identification and analysis</b></p> <ul style="list-style-type: none"> <li>• Identification and prioritizing projects amenable to partnerships</li> <li>• Hiring advisers</li> <li>• Performing a preliminary review of project costs and benefits (without duplicating the analysis to be performed by the private sector), especially in cases where the government will be assuming some of the market risk</li> <li>• Reviewing legal and regulatory issues</li> <li>• Determining preliminary selection criteria</li> <li>• Granting permission for the project to go ahead (for example the opening of the bidding process)</li> <li>• Setting a timetable for the project</li> </ul> <p><b>Enabling and supporting measures</b></p> <ul style="list-style-type: none"> <li>• Granting permits and other necessary authorizations (such as rights of way and environmental permits)</li> <li>• Determining the form of government support for the project</li> </ul>	<p><b>Design of PPP arrangements</b></p> <ul style="list-style-type: none"> <li>• Choosing legal instruments</li> <li>• Allocating responsibilities</li> <li>• Choosing and designing pricing rules and performance targets</li> <li>• Determining bonuses and penalties</li> <li>• Determining duration and termination</li> <li>• Designing adaptation mechanisms to new or unforeseen circumstances</li> <li>• Choosing and designing dispute settlement mechanisms</li> </ul> <p><b>Contract award</b></p> <ul style="list-style-type: none"> <li>• Choosing the award method</li> <li>• Making decisions about prequalification and shortlisting</li> <li>• Determining bid structure and evaluation method</li> <li>• Determining bidding rules and procedures</li> <li>• Proceeding with the bidding</li> <li>• Negotiating</li> </ul> <p><b>Exercise of regulatory function through autonomous regulatory agency</b></p> <ul style="list-style-type: none"> <li>• Implementing regulatory rules</li> <li>• Supervising and monitoring</li> <li>• Enforcing rules (for example imposing penalties)</li> </ul>

### Mobilising long-term political commitment

Public-Private Partnerships are usually designed to last for at least 30 years, and both the public and private sectors need to show a long-term commitment to be viewed as serious potential business partners. Clear long-term political commitments are therefore needed by governments, which wish to facilitate successful PPPs. In contrast, perception of political instability or potentially radical political changes can discourage investors from participating in a project.

Implementing PPPs means that the government must evaluate the aggregate of its long-term government commitments. This is because PPPs can go on for much longer than even long-term government budgeting. By taking long-term commitments into account, Governments can benefit in two ways:

1. Improved affordability evaluation for each project. Availability of public finance within the entire lifespan of the project should be taken into account in cases where end-user payments are not big enough to achieve economic equilibrium.
2. Concerns about eventual transfer of costs from current to future generations are reduced.

### Identification of PPP opportunities

Mechanisms need to be put in place to evaluate whether a PPP project is a viable option, and this can be done by evaluating whether private financing can be justified, and by constructing a public sector comparator. A public sector comparator is a model on how the public could have offered the same services without using private financing and private management. Besides obtaining a figure for the project alternative costs, experience shows that public sector comparators provide essential information and introduce a higher degree of consistency in PPP proposal evaluations.

### Legal/Negotiation skills

A prerequisite for successful PPPs is a credible legal and regulatory framework as shown in chapter 1, that protects private sector interests and property rights and enables commercial contracts to be legally enforced. It is also of vital importance that the government agencies have the necessary authority to grant concessions and licenses, and this is often made possible through specific concession laws.

No contract can be totally complete, because not all the information regarding the PPP is available at the time of contracting. It is therefore important to have mechanisms in place that can solve disputes and potential conflicts of interests in a cost efficient manner.

### Procurement skills

Government procurement in terms of PPPs is very different from the traditional way of providing public services, because PPPs require clear specifications of outputs instead of inputs.

Establishing a PPP usually involves a formal procedure that must be predictable, transparent and fair in order to attract as much interest from potential private investors as possible. A sound PPP procurement process usually involves a number of steps where each step requires different types of skills, and extensive coordination is required (For more information, see chapter 4).

### Finance and Risk Distribution skills

Introduction of PPPs creates a need for an understanding of private sector logic within the public sector, especially in the area of finance and risk management. Knowledge about private sector logic makes it easier to (1) create successful PPP models, and (2) distribute risk between private and public partners.

The government must be prepared to take on at least some of the risks of the project, and that is especially true for risks that the public sector to a large extent controls. The government can, for instance, issue guarantees against political risks. Some projects may not be commercially viable on their own, and the government may therefore have to take on some of the commercial risks. Risk distribution and allocation is dealt with in Chapter 3.

### Communication Strategy

Public support is a requirement for the success of any PPP project, and clear communication is therefore essential. Different groups of stakeholders may have fundamentally different views on PPPs, and different priorities and expectations. A clear communication strategy should be an integral part of any PPP project, especially within politically sensitive areas.

Communication about PPPs is a never-ending process, and information that can be shared without jeopardizing the intellectual property rights of the private sector should be shared. The opposition to PPP projects should not be allowed to provide an unbalanced portrayal of what the project means for the public.

All partners should be involved in the process of communication, and public and private partners should cooperate on a common communications strategy. This will ensure a consistent message, and reduce potential confusion. Fairness and confidentiality should be ensured throughout the process.

### Stakeholder Management

Stakeholders are those that have a particular interest in PPPs, as individuals or as a group. There are essentially two types of stakeholders: internal stakeholders, such as employees, and external stakeholders, like customers and environmental groups. Employees are particularly important, because their motivation directly influences the efficiency of the PPP.

Stakeholder Consultation is when a PPP brings stakeholders together for exchange of ideas and opinions, and this is an approach with many benefits. Most importantly, information is shared instead of being kept secret, and this makes it easier to make well-informed decisions to the benefit of both the PPP and the community. Stakeholders should be involved as early as possible, but the ideal way of

involvement may vary depending on the scope of the PPP and the political and cultural context. Stakeholder Consultation has also proven to greatly reduce the risk of adverse publicity, because problems can be identified and addressed at an early stage.

Stakeholder Consultation can be quite time-consuming, but the potential benefits of reaching a mutual understanding and obtaining business critical information far outweigh the drawbacks.

### Performance Management

It is important to build the capacity to manage contracts *throughout* their operational life and possibly even to alert those developing new programmes that disproportionate emphasis is all too often placed on the procurement phase only. Governments must be able to measure the performance of PPPs in a neutral way to ensure that the service requirements and specifications are fulfilled. This should be done by using Key Performance Indicators (KPIs) that are agreed upon beforehand. KPIs must be quantifiable, and should leave no room for different interpretations from one year to the next.

Finding the appropriate Key Performance Indicators (KPIs) is not an easy task, and too-detailed measurements could generate both obstacles to private sector innovation and unnecessarily high expenses for the Government agency responsible for performance assessment.

The Key Performance Indicators (KPIs) will be different for different Public-Private Partnerships, but some of the most common ones are:

- Quantitative measures of use/capacity
- Quantitative measures of quality
- Quantitative measures of customer satisfaction
- Quantitative measures of environmental impact

### Auditing and accounting

Auditing is necessary for verifying that PPPs are in compliance with their contract terms, and to verify the correctness of the processes leading to the establishment of a PPP. Auditors should get involved as early in the PPP procurement process as possible to identify potential problems before they escalate. Typical tasks of an external auditor would include:

- Reviewing the PPP procurement process. External auditors should, at a minimum, be involved in the process before the Invitation to Negotiate is issued.
- Auditing the accounting treatment of PPPs, particularly on whether the assets in a PPP should be included in the balance sheet of the public sector or not.
- Identifying and addressing conflicts of interests
- Ensuring contract compliance throughout the life of the PPP

Bodies like the UK's National Audit Office are equipped to review PPP projects once they are in place to assess if policy objectives, such as value for money, have been achieved. These can then form useful sources of feedback into the further development of policy and guidance. Clearly developing the capacity of such bodies is a critical issue.

### Managing consultants

Governments need to develop in house the necessary skills and processes properly to select, appoint and manage consultants. In particular, the public sector must try and ensure it does not pay for the same advice many times over.

### Sustainable development

The skills required include

- Creative partnering – outside governments - ensuring that the projects by adding a partner can achieve higher developmental goals.

Integrating the inputs – inside government - from different departments such as health, education, and transport - to ensure sustainable and developmental outcomes.

## **Chapter 3: HOW GOVERNMENTS SUPPORT PROJECTS AND SHARE RISK OPTIMALLY WITH THE PRIVATE SECTOR IN PPPs**

### *Misconception*

*‘Through PPPs, Governments can acquire infrastructure assets, roads, bridges and power plants, either free or little cost and at no risk’*

In fact Governments must share risks with their private partners and need to accept risks and /or make tangible contributions to the project in order to make it viable and successful.

**Principle 3** - *Governments and private sector need to develop realistic expectations, balanced contracts, and shared risks to achieve success (PPPs need to show balanced contract provisions, fair risk allocation and distribution of rewards)*

## **Definitions**

### **What is risk?**

‘Risk’ is the chance of an event occurring which would cause actual project circumstances to differ from those actually assumed when forecasting project benefits and costs.

The various types of risk in PPPs, commercial, political environmental etc., are set out in Annex 1 below.

### **Why is it so important?**

It is at the core of project profitability for the private party and efficiency and effectiveness in the delivering of public sector objectives. Because management of risks holds the key to project success or failure, projects are about risks, about their evaluation and their acceptance or avoidance.<sup>1</sup>

### **What are the benefits of transferring risks to the private sector?**

Governments gain a number of benefits from transferring risk to the private sector. The effect of risk transfer is that the project in question will frequently achieve better value for money and benefit from greater efficiency gains than they otherwise would if retained under government control.

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<sup>1</sup> Chris Furnell, ‘Risk identification and risk allocation in project finance transactions’ paper presented at the faculty of Law, the University of Melbourne, May 2000, cited in Partnership Victoria ‘Risk Allocation and Contractual issues’ page 16

Ultimately, this can have a further knock-on effect on government spending levels by lowering the project's revenue cost over its lifetime. The process of allocation of identified risk to the private sector also insulates the government from these risks. Typically, much of the burden of project development and maintenance is shifted to the sponsors in the private sector. This, in turn, reduces the contingent risks the government would otherwise have to face.

## **CHALLENGES -**

The overall challenge is a weak understanding by government and the private sector of risk allocation in PPP projects; specific challenges include:

- Difficulty in allocating risks
- Highly complex issues involved

## **Some factors for Governments to consider in risk allocation**

### **1. Risk allocation is not a science**

It is now a truism of project finance that risks should be borne by the party best able to manage them. As a risk allocation tool, however this principle does little more than provide general guidance.

The acceptance by the parties to a PPP of specific risks is not an easy process. In fact, the allocation of risk often takes place after a long and difficult negotiation. Each side tries to shift the risk to the other. Accordingly, many projects often fail to take place because the parties have failed to agree on the allocation of risk.

### **2. The private sector has major concerns over accepting certain types of risk**

The starting point of many concession based projects in emerging markets will be a wide ranging assumption of risk by the private sector. However, typically, the private sector is reluctant to accept certain types of risk.

One of the critical risks is demand risk – the risk that there is not enough demand for the service and the likelihood that the project company will be unable to pay back the loan from insufficient revenues. When dealing with projects such as toll roads or rail projects, this type of risk is very difficult to calculate. This is especially true in transition economies in which the economy is trying to grow to levels that have never been seen before and forecasting demand is therefore a difficult exercise.

It is an assumption by the government sector that the private sector should take demand risk. However, increasingly the private sector is asking for more support from the government side in the form of subsidies, grants or guarantees in order to assume this risk.

Another risk which is a major concern of the private sector in PPPs is the political, legal and regulatory risk: first there is a concern that governments will come in unilaterally and change the rules. The swing from a positive approach to PPPs to a negative approach and cancellation of PPPs after an election is unfortunately commonplace in some countries. In some cases however the PPP can survive. For instance, the A1 road project in Poland survived eight changes of government during its negotiation process. Second, the private sector often faces difficulties in obtaining planning and other approvals to start projects and suffers from red tape and unnecessary interference which delays the project.

With regard to the first issue of government changing the conditions of the agreement, clearly because of the long duration of projects, such change may be in the public interest. However, it is important prior to the government changing the conditions of the project, that the private partners are consulted. Another related concern from the private sector's perspective is the government's right to terminate or 'step into' a project and take it over from the private sector. The private sector's anxieties concerning termination and step in can be partly addressed through contractual clauses which:

- In the case of a step in, relate only to emergency access and where there had been a material service default (which includes continuous or repeated non-material defaults); and
- In the case of termination, seek to ensure that 'cure periods' are fair and that as far as possible, the conditions under which termination or government step –in may occur, are clearly specified and limited to material defaults so as to avoid hair trigger termination events

Regard must also be paid to the potential effects of lengthy cure periods and particular defaults, on government's capacity to deliver core services and its ability to deliver or procure the delivery of replacement ancillary services, which the private party is unable to provide.

With respect to 'red tape', Governments can intervene to smooth over such problems in order to facilitate the project to start on time.

*There 'is a general perception that a private sector provider is 'contracting with the umpire' which creates a general unease about changes to all areas of legislation and policy'*

Source: Partnerships Victoria

With respect to the lenders to the PPP project, Governments need to take account of the fact that the lenders are extremely risk averse. Even the most socially desirable projects will be turned down by the lenders if they perceive it to have too many risks and this is a major source of disappointment and frustration of the public sector.



### **3. Governments should provide support to projects in order to lower the risk the private sector assumes.**

One of the central objectives in structuring a concession agreement should be to strike a suitable balance in terms of risk allocation. This is especially true in large scale construction projects such as the Trans European Networks. Here massive private sector investment is being sought. However the private sector will not accept the various commercial risks for these projects, including:

- The risk that in the promotion and development stage of the project, there is still no guarantee that the project will take place;
- The high-risk construction phase due to the likelihood of cost overruns throughout the lifetime of the project and;
- The uncertain revenues once a project starts operating and the potential for policy changes to undermine the viability of the project.

The whole PPP challenge revolves around the injection of sufficient public sector resources into a project to lower risks sufficiently to stimulate the desired levels of private sector investment. If the public sector does not plough enough resources or fails to offer other ways of lowering commercial risk, then projects such as TENS will not be realized as desired. The key challenge therefore for governments is to achieve an optimal allocation in the various risks and to mitigate, where possible, the risks assumed by the private sector by providing the necessary support to make the project attractive to the private sector.

The various forms of support which the government can give to a project in order to mitigate the risk to the private sector are found in the annex.

### **4. Care is required in providing guarantees**

Guarantees may be an appropriate form of government intervention, in particular to shield the private sector from risks that it cannot anticipate or control. Thus, many PPP contracts provide for minimum revenue guarantees that limit the private sector's exposure to demand risk.

Another case occurs when a government issues a guarantee to a sub- regional authority which has no credit worthy status but seeks to undertake a PPP with a private partner. However such a guarantee is not a sovereign guarantee of indebtedness but an affirmation by a creditworthy state party committed to by a non-creditworthy state party.

However these types of guarantees and supports by governments have to be provided with care:

- They take on liabilities which have important fiscal implications for the governments
- There is a risk too that inadvertently the governments create a ‘guarantee culture’ where the private sector seeks guarantees as an alternative to managing the risk themselves. The whole point of the PPP is to improve performance of the project which is done by using the risk to its investments as an incentive to the private sector to perform well.
- Because guarantees are valuable to beneficiaries and provided at the discretion of government, this can undermine governance.

In reviewing this issue, government officials may wish to follow IMF Guidance on the subject. Such guidelines argues that such guarantees do not count as part of a sovereign guarantee ceiling calculation, provided that they are being provided to commercially viable entities and it is unlikely at the outset that they will be called absent in the occurrence of an unforeseen event.

## **5. Flexibility is important in risk allocation.**

Every situation is unique and there are no hard and fast rules or models over risk allocation. Often governments can introduce less orthodox and flexible tools in risk sharing which can have welcome benefits. For example, over thirty years ago the Spanish government in an effort to upgrade its roads around its coastal seaside resorts to boost tourism took a brave decision and assumed the exchange rate risk on the project, something which according to common practice may have been considered to be ill judged. Exchange rate protection continues up to the present day. However, based on a calculation today of the costs of taking on such a risk and not taking into account the externalities of the benefits from tourism flowing from the improvement in the roads, it appears that, over this period, the government lost nothing in accepting this risk.

## **6. Benefits should be shared from successful risk sharing**

After a PPP project such as prison, school, or hospital is built, the level of risk falls substantially. This is because with the facility built, the risk that the facility may not be completed on time disappears. As a result, banks become receptive to review the interest rates it charges and to cut the cost of the loan. This leads to the creation of financial surplus and raises the question of who should gain from the success, bearing in mind that it has been typically the private sector that has taken on the construction risk in the first stage of the project?

Current practice suggests that all parties, rather than one exclusively, should share in the gains and that gains could be shared out by a formula agreed by the various parties before the agreement is signed.

## 7. Penalties can be used to ensure the availability of the service

Governments are particularly concerned about the risk of non-availability of the service they have contracted the private entity to provide. Governments should accordingly define what is meant by the service being 'available'. Typically, a service is available when it is provided in accordance with 'Availability Standards', these being the set of performance indicators against which the standard of service delivery is measured. The risk of unavailability should be borne by the private party. Accordingly, payment under the contract must depend on the services being available. The private party should not be paid – or should be paid a reduced charge – if the service is unavailable.

## 8. Tools can be used by governments to better manage PPP of risk

Governments can adopt a number of tools to manage risk:

- A government should **identify** at the start of projects certain generic risk categories. These overlap, so governments should take care in using them. However a good starting point may be to use a checklist of the risks, which typically apply to infrastructure service projects. The use of generic risk categories should not however take the place of detailed consideration of the risks of particular project by experienced personnel. A brainstorming session, which includes these personnel, is advised for identifying project risks.
- A **risk matrix** later on can be a useful tool to both government and the private sector. It should apply to each project phase and set out the government's preferred position on allocation. During the pre-tender and tender phases, it can assist government practitioners in listing all the relevant project risks and their proposed allocation. During negotiations it can act as a checklist to ensure all risks are addressed, and after signing of the contract it can be a useful summary of the risk allocation effected by the contract.
- **Risk mitigation** In the case that the private entity defaults on its obligation to provide a basic services, Governments have various mechanisms for mitigating risks such as these:
  - Insurance mechanisms- many of the risks that governments assume are not insurable, but some may be. For example, the risk of a force majeure event damaging a State-owned network essential to the operation of the private component of the project may be insurable.
  - Research before issuing tenders: specifying desired outcomes of the project (taking into account government policy), application that the project is in the public interest (see next chapter); confirming legal ability to contract with the private partner; public sector benchmarking, building up the Public Sector Comparator and determining what constitutes value for money; identifying and facilitating required government approvals.

- Strategic planning and development of regulatory framework: regulatory arrangement should be in place so that the private sector when bidding knows what it can expect in terms of such features as monopoly franchises.
- Best practice tender and evaluation processes: best practice tender and evaluation processes should be adopted to ensure selection of the best bidder. Best practice processes include developing clearly-defined bid criteria, creating a framework to handle transparency issues and constructing clear and informative bid documents (see chapter 4).
- Monitoring and review: once the project starts the government team should establish a risk monitoring system to ensure that services are delivered according to contracted performance specifications; payment for services is appropriately verified, and ongoing surveillance that the project is progressing.

## Conclusions

In conclusion:

- Risk allocation is a complex part of PPP Governance
- Governments should accept a sensible amount of risk in order to facilitate projects
- Consideration of what is ‘sensible’ requires careful analysis
- The private sector is also limited in its capacity to accept risk, e.g. shareholders’ returns

## ANNEX 1

Some of the major risks and their allocation in a PPP

<i>What is the risk?</i>	<i>How does it arise?</i>	<i>How should it typically be allocated?</i>
<i>Design or development risk</i>		
Design defect	Design fault in tender Specifications	Public sector to bear risk
	Contractor design fault	Liquidated damages to be paid by contractor; once liquidated damages are exhausted, erosion of project company's returns
<i>Construction risk</i>		
Cost overrun	Within construction consortium's control (inefficient construction practices, and so on)	Contractor to bear risk through fixed-price construction contract plus liquidated damages; once liquidated damages are exhausted, erosion of project company's returns
	Outside construction consortium's control: changes in the overall legal framework (changes of laws, increased taxes, and so on)	Insurer risk if insurance is available; once insurance proceeds are exhausted, erosion of project company's returns
	Outside construction consortium's control: actions of government that specifically affect the project (delays in obtaining approvals or permits, and so on)	Public sector to bear risk
Delay in completion	Within construction consortium's control (lack of coordination of subcontractors, and so on)	Liquidated damages to be paid by contractor; once liquidated damages are exhausted, erosion of project company's returns
	Outside construction consortium's control (an unexpected event, and soon)	Insurer risk, if risk was insured; once insurance proceeds are exhausted, erosion of project company's returns
Failure of project to meet performance criteria at completion	Quality shortfall, defects in construction, and so on	Liquidated damages to be paid by contractor; once liquidated damages are exhausted, erosion of

		project company's returns
Technological risk	Emergence of new technology renders project obsolete or noncompetitive	Project company to bear risk
<i>Operating cost risk</i>		
Operating cost overruns	Change in practice of operator at project company's request	Project company to bear risk
	Operator failure	Liquidated damages to be paid by operator to the project company; once liquidated damages are exhausted, erosion of project company's returns
Failure or delay in obtaining permissions, consents, and approvals	Public sector discretion	Public authorities to bear risk
Changes in prices of supplies	Increased prices	Allocation of risk to the party best able to control, manage, or bear it (supplier, project company, or users)
Non-delivery of supplies on the part of public authorities	Public sector failure	Public authorities to bear risk
<i>Revenue risk</i>		
Changes in tariffs	In accordance with the terms of the contract (for example, indexation of tariffs leads to reduced demand)	Project company to bear risk
	Government breach of the terms of the contract	Public sector to bear risk
Changes in demand	Decreased demand	Project company to bear risk
Shortfall in quantity or shortfall in quality leading to reduced demand	Operator's fault	Liquidated damages to be paid by the operator; once liquidated damages are exhausted, erosion of project company's returns
	Project company's fault	Liquidated damages to be paid by the project com-

<i>Financial risk</i>		
Exchange rates; interest rates	Devaluation of local currency; fluctuations	pany to public authority Project company to bear risk (hedging facilities might be put in place)
Foreign exchange	Non-convertibility or non-transferability	Public sector to bear risk; in case of contract termination, compensation to be paid by government
<i>Unexpected event risk</i>		
Acts of God	Floods, earthquakes, riots, Strikes, and so on	Insurer risk, if risk was insured; otherwise, risk to be borne by project company
Changes in law	Changes in general legal framework (taxes, environmental standards, and so on)	Normally, project company to bear risk (public sector could bear risk when changes are fundamental and completely unforeseeable; for example, switch from free market to central planning)
	Changes in legal or contractual framework directly and specifically affecting the project company	Public sector to bear risk
<i>What is the risk?</i>	<i>How does it arise?</i>	<i>How should it be allocated?</i>
<i>Performance risk</i>		
Political unexpected event	Breach or cancellation of contract; expropriation, creeping expropriation, failure to obtain or renew approvals	Insurer's risk, if risk was insured; otherwise risk to be borne by public sector; in case of contract termination, compensation to be paid by government
<i>Environmental risk</i>		
Environmental incidents	Operator's fault	Liquidated damages to be paid by the operator; once liquidated damages are exhausted, erosion of project company's returns
	Pre-existing environmental liability	Public sector to bear risk

Source: Kerf and others (1998).

## ANNEX 2

### Public Authority Support for PPPs

#### Rationale of public authority support

- A decision to support the implementation of a project is based on an assessment by the government of the economic and social value of the project and whether it justifies particular government support (certain projects cannot be financed by the private sector alone at an acceptable cost, others cannot materialize without government support, given the appreciation of an overall investment climate in the countries)
- Three distinct justifications are generally presented in favour of government support: (i) the existence of uninsurable political risks, (ii) a policy decision that certain services should be provided at below real cost and thus subsidized to reduce user fees, and (iii) the theory that the government has a lower cost of risk bearing than private investors

Political risks traditionally include the risk of expropriation, the risk of political violence (war, terrorism, etc.) and convertibility and transfer risk. However, the definition of political risks can extend to modifications of legal framework, unfavourable regulatory decisions of failure by publicly-owned enterprises to uphold their obligations to the project

- Government financial support can be provided through three basic instruments (i) subsidies, (ii) financial instrument (debt, equity), or (iii) guarantees.
- When defining public authority support, care should be taken *inter alia* (i) not to breach international/regional obligations of the country, (ii) to choose the most appropriate methods for estimating the budgetary costs of support measures, taking into account the present value of future costs or loss of revenues and (iii) to ensure transparency (timely communication to all bidders).

#### **Possibility to provide different forms of public support**

##### Public loans and local guarantees

###### Public loans

- Interest free or low interest loans in order to lower the project's financing costs
- Subordinated loans provided by the Government may enhance the financial terms of the project by supplementing senior loans provided by commercial banks

*e.g. M5 Toll Motorway project in Hungary: for the first six and half years of commercial operations, the government provided the private sector consortium with compensation in the form of a subordinated loan faculty, repayable after discharge of project indebtedness to senior lenders, in the event that the consortium's actual revenues, for whatever reasons, were below certain levels.*



- Available to all projects Companies in a given sector or temporary assistance to the Project company in the event that certain project risks materialize
- *Limitation:* to a fixed sum or to a percentage of the total project cost

### Loan guarantees

- public guarantees by the Contracting Authority or other government agency for the repayment of loans ( can be limited to certain events) by such company. Such guarantees usually have lower costs than loan guarantees provided by commercial lenders
- loan guarantees are generally not recorded as expenses until such time as a claim is made , but may represent a substantial contingent liability ( significant exposure in the event of total failure by the Project Company).
- *Limitation;* to a fixed sum or to percentage of the total project costs/defined circumstances under which guarantees can be extended ( e.g. prior exhaustion of all other remedies available to lenders under the project agreement , the loan agreement or a direct agreement with the Contracting Authority).

### Equity participation

- Direct or indirect equity participation in the project company assures public involvement in and support for the implementation and operation of the projects and helps achieve a more favourable ratio between equity and debt ( by supplementing equity provided by the projects sponsors when other sources of equity capital such as investment funds are not available).
- *Limitation:* care should be taken to distinguish public equity participation from a total public guarantee.

### Subsidies

- Tariff subsidies to supplement Projects Company's revenue when the project income falls below a certain minimum level; conceived as an alternative to the full commercial freedom to determine tolls, tariffs , etc.

*e.g. Perpignan-Figueras Rail Concession between France and Spain: state subsidy covering 57 per cent of the construction costs.*

- Subsidy support can be provided by the government to cover the difference between the full commercial price and the actual user charge so as to retain incentive for private sector efficiency
- Subsidies usually take the form of direct payments to the project company ( lump

sum payments or payments calculated specifically to supplement the project company's revenue): audit and financial disclosure provisions in the projects agreement required. An alternative to direct subsidies may be to allow the project company to cross-subsidize less profitable activities with revenue earned in more profitable ones

- *Limitations:* (i) requirements of competition laws (many countries prohibit the provision of subsidies not expressly authorized by legislation) and (ii) requirements of international/regional agreements.

## **Sovereign guarantees**

Pursuant to sovereign guarantees, the State, or sub-sovereign entity, does not guarantee the Project Company or the lenders the repayment of the loans but rather the 'proper behaviour' and the respect of the commitments of the Contracting Authority and /or of the other concerned public authorities. It should be noted however that a failure to respect such commitments will give rise to the monetary obligation to pay damages, which could include *inter alia*, costs incurred to lenders under acceleration of loans in case of default.

### **(a) Performance guarantees**

- Guarantees issued by the host governments to cover the breach of obligations assumed by the Contracting Authority under the project agreement
- Performance guarantees are useful instruments to protect the project company and the lenders from the consequences of default by the Contracting Authority or other public authority assuming specific obligations under the project agreement.
- Performance guarantees are used where the Contracting Authority is a separate legal entity that does not engage the responsibility of the government itself. However if a Contracting Authority is a truly corporatized entity, the performance risk cannot easily be considered as a political risk, but rather as a commercial risk
- Central government cannot provide guarantees against risks related to the behaviour of other entities (e.g. decentralized political authorities). To add credibility to the government's own commitment, other instruments may be needed, such as government's performance guarantees or guarantees by multilateral institutions counter guaranteed by the government. Performance guarantees can also be issued in the name of a public financial institution of the host country
- The legislation should enable the government to efficiently manage and assess the project risks and determine the level of direct and contingent liabilities it can assume, e.g. *Off-take Guarantee*: Government guarantees payment of goods and services supplied by the Project company to public entities

In the scope of “power purchase agreements”, resources (or cash flow) are provided to meet (i) debt service, (ii) operation and maintenance costs and (iii) return on investment.

*Supply guarantees:* protect the parent company from the consequences of default by the public sector entities providing goods and service required for the operation of the facility (e.g. fuel, electricity, water) , or to secure payment of which the Contracting Authority may become liable under the supply agreement

General guarantees: provided to protect the Project Company against any form of default by the Contracting Authority rather than default on specifically designated obligations. General guarantees are not very frequent, but can be used when the obligations undertaken by the contracting Authority are not commensurate with its credit worthiness (e.g. municipal concession).

#### (b) Guarantees against Adverse Acts of Governments

- guarantees that the Project Company will not be prevented by the Government from exercising certain rights that are granted to it under the project agreement or that derive from the laws of the country
- **foreign exchange guarantees:** guarantees (i) convertibility of the local earnings into foreign currency, (ii) the availability of the required foreign currency to meet all foreign debt-service obligations , foreign dividend and management payment and (iii) the transferability abroad of the converted sums
- **Expropriation guarantees:** assures the company and its shareholders that they will not be expropriated without adequate compensation (includes confiscation and nationalization).

#### **Tax and customs benefits**

Legislation on foreign direct investment often provides special tax regimes to encourage foreign investments (tax exemptions, reductions, benefits). Such regimes should be carefully analyzed and provided only when they benefit the Project or are needed to attract investors. Examples of such benefits include:

- Exemption from corporate tax of the concession period( tax holiday)
- Exemption from income tax for foreign project staff/lenders
- Exemption or reduction from real estate tax
- Exemption from or reduction of import duties on equipment, raw materials and components of the construction and operation and maintenance of the project
- Tax concessions on royalties
- Tax refund for foreign investors reinvesting their profits in new infrastructure projects in the country
- Deductions from taxable income for the cost of certain expenses such as electricity, water and transport
- Capital/ allowances in the form of depreciation or amortization

## Protection from competition

- Assurance given by the host government to the Project Company that no competing infrastructure projects will be developed for a certain period and with a certain perimeter, up to a defined threshold ( e.g. traffic, consumption, etc.) and that no agency of the government will compete with the Project Company, directly or through the concessionaire. This may be particularly important in toll roads projects, where an additional road could undercut the revenue flow. Such provisions must be carefully reviewed by the Public Sector, however. Given the long-term nature of PPP contracts, population growth or other factors may render such provisions problematic.
- Limitations: (i) requirements of competition laws (risks of monopolies than put national customers at a disadvantage) and (ii) requirements of international /regional agreements

## Ancillary revenue sources

- Allowing the Project Company to diversify its investment through additional concession for the provisions for ancillary services or the exploitation of other activities (e.g. right to collect tolls on an existing bridge, or the right to charge fees for the use of a facility built by the Contracting Authority.
- Necessity of legislation allowing the right to use property of the Contracting Authority for purposes of charging fees for the use of a facility built by the Contracting Authority.

*e.g. Sydney Harbour Tunnel Project: sponsors obtained the concession to operate the existing Sydney bridge as one of the incentives and the bridge toll was increased to the same level as the toll for the tunnel*

## Possibility to create, perfect and enforce reliable security instruments

In the context of non-sovereign transactions, lenders look to the cash flow and assets of the project company to secure payment of their loans. In this respect, lenders will pay particular attention to how much and how fast they can recover their unsatisfied claim through realization of charged assets, and how simple the whole process will be.

Creation, perfection and enforcement of lenders' security instruments (see examples below) requires that the legal system does not contain legal or regulatory impediments. Examples of such impediments include:

For the creation of a security: necessity of precise identification of cadastre for mortgage or pledge or other attachment on movable or immovable assets;

- For the perfection of a security: difficulties to verify the existence of prior ranking claims (poor state of corresponding registries), unclear thus costly procedures for registration, impossibility to attach public property, immunity;

- For the enforcement of a security: difficulties in repossession and selling of collateral.

### **Security interests in property assets**

- Mortgages over land, and buildings and other fixed assets
- (Floating) charges over movable assets, including projects inventory and receivables production/work in progress, intangibles. And other personal property and interests
- Pledge on shareholders equity participation in the borrower, on the borrower's interest in the major projects agreements
- Assignment of rights underlying major project authorizations

### **Escrow accounts**

- Control and retain cash flow relating to the project

## **Chapter 4. ACHIEVING OPENNESS AND TRANSPARENCY IN PPPs: CHALLENGES AND SOLUTIONS**

*Misconception:*

*Using a PPP can bring private money into public coffers and be an additional source of payment for government departments.*

In fact, the funding provided is not a fund to be used either part or in whole for public civil servants. The financing provided has to earn a return for the private sector. It is not an extra fund for public sector use untied to specific projects.

**Principle 4** *PPPs should be undertaken within a transparent selection process that promotes competition* (PPPs should work through a clear selection process open to all, tendering procedures should be also simplified and made as easy as possible reducing the length of time to project closure)

### **CHALLENGES -**

- Lack of capacity in organizing competitive tenders especially at local levels
- Public suspicion at non –transparent PPP deals
- Poor administrative procedures for competitive tendering that exclude SMEs

### **SOLUTIONS: A TRANSPARENT, NEUTRAL AND NON-DISCRIMINATORY PPP PROCUREMENT SYSTEM**

Solutions lie in the creation of rules that tackle uncertainty and discretion. Such rules can be categorized as follows:

- (i) Provisions which make procurement policies and practices transparent shedding light on the secretive worlds where corruption flourishes
- (ii) Provisions, which provide for neutrality – establish clear, specific and predictable rules that do not provide scope for discretion and prevent any conflict of interest and provide a means of complaint and monitoring the implementation of the rules
- (iii) Requirements not to discriminate

### **(i) Transparency in PPP procurement**

Transparency in PPP procurement means ensuring that information about the PPP procurement and contractual administration regime and individual PPP opportunities are made available to all interested parties (and particularly to potential suppliers and service providers). It means the right of access to that information. It also means ensuring that procurement policies and practices are seen to be transparent and in all respects that the information provided.

Transparency encourages open and competitive procurement regimes thereby helping the government agency and the private sector entity achieve economic benefits. So under a transparent regime:

- PPP opportunities should be made public;
- Supplier evaluation and contract award criteria should be made known to all interested competitors in advance for each individual project;
- Any changes relating to individual PPP opportunities should be made known to all participants;
- Details of procurement decisions should be made known after the contracts have been awarded;
- Detailed records of individual contract award processes should be kept. Interested parties such as the media, individual citizens, trade unions, investors, etc. should be able to become acquainted with the contents of the contract. This will improve the involvement of stakeholders and make monitoring of the procedures possible;
- Equally crucially, the method of procurement chosen should be the most transparent possible. There is a need to ensure secrecy of the bid especially as its leaking could benefit a competitor. And also it is important to maintain secrecy in some cases where the procurement involves the protection of protection of patents and copyrights, or for national security reasons. In general however it is important to ensure the principles and objectives are established to ensure transparency in the procurement process.

### **ii) Neutrality**

It is important that the operation of the entire procurement and award process is and is seen to be neutral and fair. For example, enough time must be given to potential suppliers and service providers to prepare and submit their bids. Selection and award criteria must be neutral and non-discriminatory and should eliminate any scope for discretion. Thus, any technical specification relating to the service being procured should be drafted so as not to favour particular projects.

Under a neutral system, evaluation of tenders is usually done in two stages (which may nevertheless take place concurrently). First, tenders are checked to assess whether they meet all the eligibility requirements. Do the project provider have any required qualifications? Also do they have the financial and technical capability to fulfil contract? These eligibility requirements must have been made known in advance and should not be changed during the course of the tender. Then all the eligible candidates are evaluated according to the criteria, which have been set down into the tender notice or documents.

Providing this framework of rules however is insufficient in itself. For them to be effective there must also be a means to enforce them. Accountability needs to be introduced into the process. There are three elements to this:

- First the potential supplier should have the right to complain to an independent domestic tribunal if they believe that the PPP procurement has been handled inconsistently with the law. That tribunal should have the authority to order the correction of an infringement or compensation for the loss of damages suffered to a supplier. And pending the outcome of the challenge, it must be able to provide rapid interim measures, including the suspension and of the tender process, to correct infringements and preserve commercial opportunities.
- Secondly an independent monitoring authority - with powers to self-initiate investigations into the PPP procurement practices- can play an important role in monitoring the implementation of the rules by individual procuring entities. The institutional framework should differentiate between those who carry out the procurement function and those who have oversight responsibilities. In this regard it is now generally advisable to establish an agency, which has responsibility for overall procurement policy formulation in the PPPs and the authority to exercise outright oversight regarding the proper application of the procurement rules and regulations. In Canada, the use of ‘fairness and process auditors’ – third party independent experts – provide a level of assurance to government sponsors, bidders and the public that the procurement process was fair, equitable, and appropriate.
- Thirdly there must be no conflict of interest in the selection procedure. The contracting authority should be completely independent of the projects and the companies involved in the bidding, in order to avoid a conflict of interest For example, a small local authority in Denmark implemented a new PPP financing system where public assets were sold to private enterprises and then rented back. No Danish community up until that time had been able to offer such high standards of service through public funds. However, following a newspaper investigation it was alleged that companies had given money to the soccer club in return for obtaining contracts from the local authority. The mayor was a shareholder of the company and chairman of the soccer club, which was to play in the new soccer stadium.



### **(iii) Non –discrimination**

It is very important that procedures offer opportunities for all companies irrespective of the country of origin. Non-discrimination is usually achieved through the creation of rules specific to this issue, as well as more general requirements not to act in a manner which could reduce competition. It is not just foreign bids that should not be discriminated against. Bids from SMEs should also be encouraged and treated in a non-discriminatory fashion.

### **International rules and national best practice**

There are numerous models of best practice in creating open procedures for tendering, based on international and regional agreements. In 1994 the UN Commission on International Trade Law adopted the UNCITRAL Model Law on Procurement of Goods, Construction and set-vices. The objectives of the UNCITRAL Model Law include promoting competition among suppliers and contractors; providing for fair and equitable treatment of all suppliers and contractors and; achieving transparency in procurement procedures.

Within the European Union (EU), strict rules for open government procurement apply. Several European Commission (EC) directives deal with public procurement of supplies and works, including the construction and the telecommunication sectors. The EC has the authority to impose sanctions for breach of EU competitive tendering rules in Public sector procurement and construction. In addition, beneficiaries of EU funds must comply with EU competitive tendering rules when contracting third parties for the performance of projects financed under such funding. The main purpose of the EU directives is to set a standard procedure for the award of Public sector contracts in order to stimulate competition. Under EU legislation, in principle, public tendering is mandatory for contracts with a value over ECU 200,000. Within the EU, such directives must be transformed into national legislation.

The World Trade Organization's General Agreement on Trade in Services is the first multilateral agreement, which establishes rules regarding trade in services. Currently, the question of whether rules on government procurement should be added to the General Agreement is under discussion. An Agreement on Government Procurement is already available but it covers only a limited number of services, including construction, environmental services, computer services, and value-added telecommunications services.

## COUNTRIES' EXPERIENCES WITH PPP PROCUREMENT

The following describes in detail the practices of three countries, the Netherlands, UK and the US in PPP procurement.

### THE NETHERLANDS<sup>1</sup>

Procurement Process. The Dutch PPP Knowledge Center has identified key principles that should be fulfilled by the PPP procurement process:

- a. sufficient competition must be elicited;
- b. there must be an opportunity for early consultation so that both municipality and developers/operators can form a good picture of precisely what the municipality wishes to achieve and what the market has to offer by way of solutions;
- c. the intellectual property rights and innovative ideas put forward by developers/operators during the consultation must be adequately protected; market players must be able to count on complete confidentiality;
- d. to prevent erosion of capital it is important that no extensive and costly design efforts are required of several candidates at once;
- e. the procedure must comply with the rules laid down in the European public procurement directives, where applicable.

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<sup>1</sup> The Dutch PPP Knowledge Center (Kenniscentrum) was established in 1999 under the auspices of the Dutch Ministry of Finance, and its key function is to develop and share knowledge and experience about PPPs.

The Netherlands chose a gradual approach to development of PPPs, because the Dutch PPP Knowledge Center realized early on that developing a flourishing PPP Industry requires care and incorporation of lessons learned through pilot projects. They started off by creating a policy framework, including guidelines, contract types, instruments to compare PPPs with traditional implementation agreements, recommendations for market consultation, and advice on correct implementation of the European Directives on public procurement of PPPs. Thirty PPP pilot projects within a wide variety of sectors were approved by the parliament to establish an experience base for PPPs in the Netherlands, and to enable to further development of its PPP framework. Most of these PPP pilot projects are for infrastructure projects (including urban development), but the Netherlands has also used PPPs within Research and Development to create stronger incentives for innovation. The Netherlands is also using PPPs as a way to help impoverished countries. For instance, the Dutch Ministry of Development Cooperation is working together with the Netherlands Water Partnership to help governments, knowledge institutes, businesses and non-governmental organizations (NGOs) in the water sector in developing countries.

The Dutch government distinguishes between two types of PPPs: PPP Joint Ventures and Integrated Contracts like DBFM (Design, Build, Finance and Maintain), DBFO (Design, Build, Finance and Operate) and BOT (Build, Operate and Transfer). The PPP Joint Ventures in the Netherlands are different from Integrated Contracts in that the private sector is brought in earlier in the process, that risks and revenues are shared in a different manner, as are the types of responsibilities borne by each party. The Netherlands has considerable experience with Joint Venture PPPs at the local level, and this type of cooperation is often chosen for urban renewal and expansion, greenfield development, and industrial estates. The Dutch PPP Knowledge Center favours public procurement, because competitive pressure is necessary to maximize value for money. Private funding is not the primary aim of PPPs in this country, but is rather seen as a way to improve the incentive structures.

The three common options when it comes to selecting a procurement process are an open procedure, a restricted procedure, and a negotiated procedure. The procedure chosen should be selected based on the "ideal fit" with the above criteria. However, the EU procurement rules must be followed, and this means that concessions that can be classified as public works (e.g. roads) have to conform to the rules of the EU Works Directive. This will normally limit the selection of procedure to an open or restricted procedure for public works, while a negotiated procedure within a sector not covered by the EU Works Directive could result in a PPP Joint Venture.

The Netherlands also has a special type of PPP in which a private sector company enters a Joint Venture with a local municipality, and this Joint Venture will then award contracts. Traditional PPP contracts are awarded to a single company that designs, builds, and operates the infrastructure project. Joint Venture PPPs are different, because the different phases may be performed by completely different companies. This makes the internal mechanisms in the PPP more transparent. A Dutch-style Joint Venture PPP is typically established through a negotiated procurement procedure that will generally adhere to the following procedures:

Advertisement. An initial advertisement of the project and its objectives is conducted, to help identify interested private parties.

Market Sounding. Interested private sector companies are consulted. The goal of these consultations is twofold. First, they should enable the industry to get a clear picture of the municipality's requirements. Second, they should enable the municipality to get a clear picture of the private sector's capability and interest in the municipality's project. This is a technical consultation only; there is no negotiation of prices at this stage. The firms, which participate in the sounding phase, do not receive a distinct competitive advantage in subsequent stages of the procurement.

Draft Requirements. After the municipality has gained an insight into what the private sector has to offer through the market sounding, a general schedule of requirements is drafted. Interested parties are informed about the criteria and the relative importance of the factors before they make their bids. This helps provide equal opportunities to all bidding parties, and ensures that the procurement procedure is transparent and verifiable.

Bids. Making companies participate in costly design efforts before they know that they are awarded the contract is widely viewed as unfair, and can diminish private sector participation. The bidding process is therefore structured in such a way as to establish reasonable limits on bidder "investment" in tender preparation. However, the following documentation has to be provided:

- A plan of approach
- A draft design of mass modelling study
- An estimate of production costs in open tender to an accuracy of +/- 20%
- A business plan with a performance forecast for the first five years of operation
- The offered profit-sharing rights for the municipality and the desired share of losses (optional)

Selection, negotiation and Joint Venture agreement. Based on its published evaluation criteria, the municipality selects one or two of the bidders, who are then given a chance to elaborate on their plans and designs. The conditions under which both parties are willing to enter a Joint Venture are explored, and a Joint Venture agreement is signed with the selected partner. The Joint Venture is then registered as a private (NV) or limited (BV) company depending on the size, the ownership structure, and the preferences of the parties. Limited companies are governed by stricter rules, and this results in a higher level of transparency. The shares of the new Joint Venture are distributed between the municipality and the selected bidder according to the result of the negotiations.

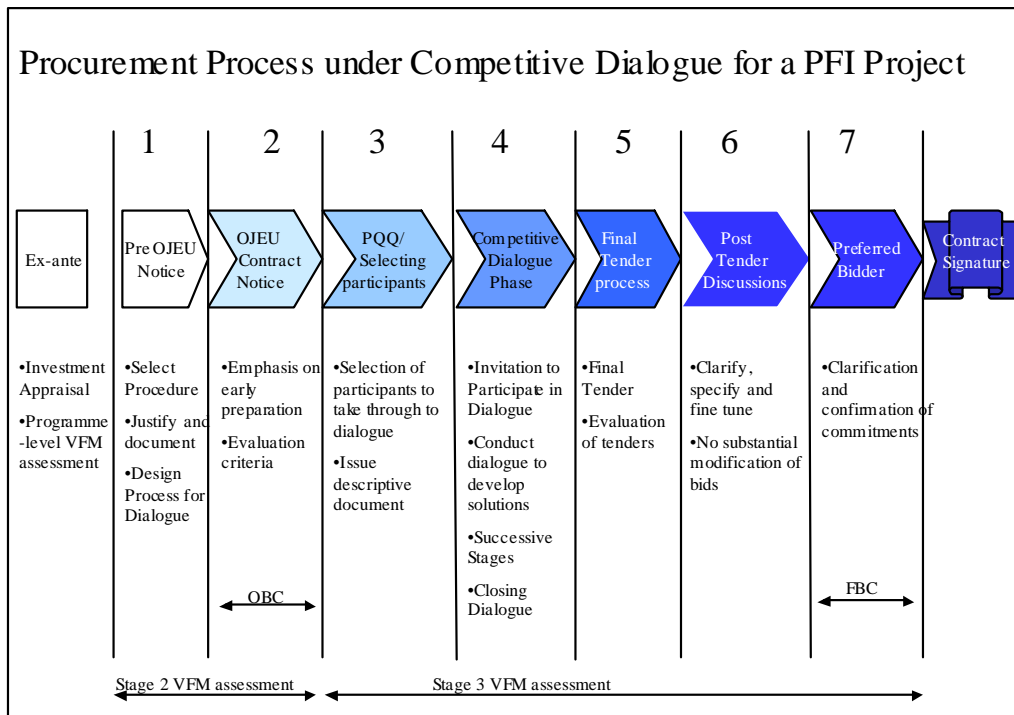
Design. The Joint Venture may award contracts to third parties, and these contracts will be awarded in accordance with EU-rules and regulations. The public procurement rules apply also in cases where the Joint Venture wants to award a contract to a company affiliated with the private sector partner in the Joint Venture. One way to ensure an open transparent process is to employ a design contest, which is quite popular in the Netherlands. Design contests are especially widespread in city planning, where the different proposals may be covered by local media to encourage citizen involvement. The proposals are judged by a panel of experts, but informal opinion polls are frequently employed as well. If more than one prizewinner is selected to elaborate on their plans, they are compensated for the extra work put into the project. Design contests are regulated by the EU Services Directive.

Contract Award. The Joint Venture awards contracts according to the EU Works Directive.

## **UNITED KINGDOM**

The decision to use PFI for the procurement of public infrastructure and services follows a rigorous investment decision process. The latter involves individual Departments deciding upon a capital investment strategy, with specific investment options being appraised using the UK's Green Book guidance. Capital projects are then prioritised within a Department's overall capital programme, and following that those project areas which may suitable for the asset and service requirements to be procured through PFI, are identified.

A three-stage value for money assessment- covering both qualitative and quantitative assessment- is then initiated to ensure projects selected for PFI procurement are only chosen where this represents value for money. The Competitive Dialogue procedure is a new procurement procedure introduced in the EU Public Sector Procurement Directive (2004/18/EC). This was implemented into UK law via the Public Contracts Regulations SI 2006/5) with effect from 31 January 2006. Following the incorporation into English Law of the EU Public Sector Procurement Directive, it is considered that the competitive dialogue process will be the relevant procurement procedure for the majority of PFI projects. The diagram below details how the competitive dialogue procedure is envisaged to work for a PFI project:



### The first three phases

During these early stages contracting authorities should plan in detail how the different stages of the procedure will be conducted, particularly the structure of the dialogue phase, as an Outline Business Case is compiled. The OBC sets out details on potential costs, management of risks, and timelines involved in the projects. Contracting authorities are also required to publish a contract notice setting out their needs and requirements, which are defined in the notice itself during this stage. The prequalification of participants, following the expression of interest, is carried out in accordance with the relevant provisions of Articles 44 to 52 of the directive. It aims to identify bidders with the capacity to fulfil the contract. Qualified candidates are then invited to participate in dialogue phase of the procurement.

### The dialogue phase

Under competitive dialogue procedure, the competitive stage or dialogue occurs before the final tender process, and consequently there are strict rules on the conduct of discussions at the post tender stage. For this stage it is important for authorities to define at the outset how they plan how the dialogue phase will be conducted and on what basis bidders will be excluded at progressive stages of the dialogue. The dialogue ends once the authority identifies a procurement solution which meets requirements. The authority then declares that the dialogue is concluded. Final tenders are then submitted: all commercial issues of substance must be finalized in advance.

### Post-tender discussions

In post tender discussions after the submission by bidders of final bids, authorities can ask tenderers to clarify, specify and fine tune, as long as it does not change the bid in a way that distorts competition or has a discriminatory effect.

**Preferred bidder**

On selection of the preferred bidder, the contracting authority can ask the preferred bidder to clarify aspects of the tender or confirm commitments contained in the tender as long as this does not have the effect of distorting competition or impose additional burdens on the bidder.

**Alcatel standstill and contract signature**

On selection of the preferred bidder, the authority notifies all who submitted final bids stating its decision and the preferred bidder. At this point, the Alcatel standstill requirement means the authority must allow a 10 days standstill period before contract signature. This affords bidders the opportunity to request the reasons their particular bid was not selected and the authority must respond three days before the end of the standstill period. If there are no challenges during this period, the authority may proceed to contract signature.

**UNITED STATES**

The United States differs from the previous examples in that it has no central PPP unit at the national level, and no overarching standard methodology for developing and implementing PPPs. At the federal level, legislation providing authority to establish PPPs is enacted on an agency-by-agency basis, so that the procedures for implementing a PPP to provide, for example, electricity for a national park, would differ, in their specifics, from the procedures for providing power to a military installation. At the state level, enabling legislation is developed on a state-by-state basis. However, at all levels there is a focus on the principles of open competition. To demonstrate how this functions in practice, this paper will discuss two PPP initiatives, one at the federal level and one at the state level.

The U.S. Department of Defence (DoD) has a policy of relying first on the private sector to provide housing for its 1.5 million active duty servicemen and women, and their families. This is done by paying the military personnel a housing allowance, which they can use to rent the housing of their choice in their local community. However, many U.S. military installations are located in remote rural settings, with little commercially available housing, or in high-cost urban areas, with little quality housing affordable for a military family. Where there is a deficit of acceptable housing available, based on cost, commuting time, and other established criteria, DoD traditionally financed, designed, built, and maintained government-owned housing on the base. By the mid-1990s, DoD owned and operated approximately 300,000 family housing units.

Amidst competing budget priorities, it proved difficult for DoD to obtain the construction and renovation funds necessary to keep the housing inventory up-to-date. In 1995, on-base housing had an average age of 33 years, and more than 60 percent, approximately 200,000 units, was regarded as substandard by then-current DoD standards.

Assessing this situation in 1995, DoD estimated that US \$16 billion in supplemental funding would be required to bring the existing housing inventory to acceptable levels through a combined programme of replacement and renovation. A funding increase of this magnitude was simply not attainable. In response to this problem, DoD approached the U.S. Congress, and requested statutory authority to enter into Public-Private Partnerships for provision of family housing.

Congress recognized the need for action, and the National Defense Authorization Act for Fiscal Year 1996 (Public Law 104-106) provided DoD with a number of new capabilities. These included the ability to:

- form limited liability partnerships with developers, and invest directly in military housing through stock or bond purchases, or other debt or equity instruments;
- sell, convey, or lease DoD real property to the private sector and use the proceeds to finance a housing-related partnership;
- provide direct loans to developers to help them acquire or build housing; and other authorities.

To encourage the creative application of these new authorities, DoD created a DoD-wide initiative. Under this programme, DoD granted each of the military services, the Army, Air Force, and Navy (to include the Marine Corps) the power to determine which of these new authorities they would apply in any given situation. DoD did, however, establish two mandatory requirements:

- Each Service must eliminate all of its inadequate housing by 2010, and,
- In any given transaction, the developer must provide at least two-thirds of the total capital investment.

The success of this programme has exceeded DoD's expectations, and the replacement and renovation of the substandard housing will be completed in 2008, two years ahead of the original goal. The entire \$16 billion backlog will have been eliminated in 12 years from the start of the DoD initiative. The majority of installation-specific projects have required no government capital investment. In addition, the benefits transcend the avoidance of capital investment: the U.S. General Accounting Office reviewed the first dozen partnerships and concluded that the life cycle cost of these agreements would be 11 percent less than the cost of equivalent government-built housing units.

The programme's success can be attributed in large part to the open competition practices employed by the military services. While the specific partnership structures employed varied from service to service and installation to installation, open competition was universally practiced.

Pre-procurement. Each installation performs a detailed business case analysis of its housing requirements and potential partnership approaches. A key consideration is

whether one partnership for the entire installation is feasible, or whether multiple PPPs should be established for geographically-dispersed housing areas.

Procurement. All partnership opportunities are publicly announced, in the U.S. government's Internet-based procurement portal (early opportunities were announced in print, then in print and web-based media; current announcements are posted only via the Internet). Requests for Tender for each installation are performance-based. The government identifies the required number of units, the mix two-bedroom, three-bedroom, and other units, community standards, and certain material standards, and the developers are free to propose their own design solution and community amenities. Draft requests for proposal are released for public review and comment. Pre-proposal conferences are held, to further address questions and comments, and responses to questions and amendments to the Request for Tender are posted on the Internet. The Request for Tender also identifies the evaluation criteria to be used for tender evaluation purposes.

Typically, a two-step tender process is employed. In the first step, firms (and/or teams of firms) submit conceptual overviews of their partnership proposal, together with past performance data, and information on corporate capacity and financial stability. These firms with the highest evaluations are asked to submit comprehensive proposals. This two-step process helps to encourage broad participation from the developer community, because it reduces the cost of testing a design concept.

Evaluation. Tender evaluations are conducted by an independent board of reviewers, who use a Tender Evaluation Plan and evaluation criteria developed specifically for the individual acquisition. Each evaluator documents their rankings, with supporting rationale, so that the evaluations can be reviewed for consistency and objectivity.

Award and Appeals. Contract award decisions are publicly announced on the Internet, with direct notification of unsuccessful bidders, who can receive briefings on the evaluated strengths and weaknesses of their proposals. In addition, there is an established appeals procedure, based upon standard processes in the Federal Acquisition Regulations.

Contract Monitoring. Contract performance is evaluated based on the criteria in the Request for Tender. Contract administration staff are assigned at each installation. Dispute resolution is based upon the procedures established by the Federal Acquisition Regulations.

At the state level, the State of Virginia has one of many established programmes. The State of Virginia's Public-Private Transportation Act (PPTA) of 1995 is a legislative framework enabling the Virginia Department of Transportation (VDOT) to enter into agreements authorizing private sector entities to develop and/or operate transportation facilities. Private sector entities may identify a need, such as a new connector highway or light-rail system, and submit an unsolicited proposal to VDOT.



Alternatively, VDOT may identify a requirement which may be appropriate for a Public-Private Partnership solution, and issue a Request for Tender. Proposal/project evaluation is then a six-phase process:

1. **Quality Control:** Does the proposal address needs identified in the appropriate local, regional, or state transportation plan? Will it provide a more timely, efficient, or less costly solution than the public sector? Is there appropriate risk sharing?
2. **Independent Review Panel (IRP):** The proposal is reviewed by an Independent Review Panel with members from the State Transportation Board (STB), VDOT, transportation professionals, academics, and representatives of the affected jurisdictions. The review is based either on the basic criteria established by the law (which is available on the Internet) or on a modified version of these criteria, as provided in the State's published Request for Tender. Public Meetings and input are part of the process.
3. **State Transportation Board Recommendations:** The STB reviews the proposals and recommendations of the IRP and recommends to VDOT whether to proceed with the project. A decision to proceed means that VDOT will advance to a public request for detailed proposals. Such requests are advertised on the State's procurement website and are open to participation by any responsible party. The Request for Tender will identify the State's evaluation criteria.
4. **Submission and Selection of Detailed Proposals.** VDOT forms a proposal review committee and requests detailed proposals. Based upon its review, VDOT may select none, one, or more proposals for further negotiation.
5. **Negotiations.** If the quality of proposals merits, VDOT will negotiate for the interim and/or the comprehensive agreement which will, among other things, outline the rights and obligations of the parties, set a maximum return of rate of return to the private entity, determine liability, and establish dates for termination of the private entity's authority and dedication of the facility to the State.
6. **Agreement.** The negotiated agreement undergoes final legal review, and is then submitted for signature and implementation. State law also provides for debriefings of unsuccessful bidders and an appeals process.

This process has been successful in generating effective partnerships. The first project to be completed as a result of this law was the Pocahontas Parkway, in 2002. This is a 14.1 kilometer, four-lane road, including a high-level bridge over the James River, which connects two major commuting routes in the Richmond, VA area. The business model was based on the premise that commuters would be willing to pay a modest toll to reduce their commuting time. After one adjustment in the toll price, in 2004, due to traffic volume being slightly under projections, this project is now performing well.

### *Other provisions necessary in promoting transparency and openness*

Achieving transparency and openness is only one part of the cure. Other requirements included:

- A robust statutory authority for doing PPPs
- A strong independent auditing system
- Strong consumer groups and associations
- An active and investigative media
- A dynamic and plentiful supply of interested bidders in the market place: if there are too few bidders the offer should be withdrawn. With only one or at best two private entities interested to bid, there is a risk of anti- competitive practices by the bidders.
- Adequate compensation for civil service

### **Concluding comments: Applying Best Practices elsewhere**

The preceding pages have provided an in-depth discussion of the public-private partnership procurement process in the Netherlands, The United Kingdom, and the United States. The first two countries are all members of the European Union, which provides a common set of procurement regulations. Nonetheless, each country uses its own unique approach to soliciting and evaluating partnership proposals. The United States, a non-EU nation, has its own distinct procurement regulations, at both the federal and state levels. Yet a common factor, uniting all of these PPP programmes, is their commitment to the principles of open competition, which is reflected throughout the procurement process.

## Chapter 5. ACHIEVING SOCIAL ACCEPTABILITY: CHALLENGES AND SOLUTIONS

### *Misconception*

*‘PPPs are sophisticated financial tools used by Governments to take the financing off the balance sheet and ‘hide’ the true value of the expenditure from the general public’*

PPPs are technical and complex instruments and initially attracted interest from governments solely for financial reasons. But governments should look beyond the transaction to the wider social and environmental potential of the PPP model. The key purpose of PPPs should be to improve the lives of the members of the public, making PPPs achieve social objectives, improving the environment, and also providing new employment opportunities.

**Principle 5** – *The PPP process should be ‘popularized’ through increased public accountability improving their contribution to sustainable development, and delivering of real benefits for all especially the socially and economically disadvantaged. 3Ps should become 4 Ps with the added ‘P’ representing the ‘people’.*

## CHALLENGES

Low public confidence in PPPs is due to the perception that PPPs:

- Fail to take account of the interests of the socially and economically disadvantaged
- Suffer from a lack of transparency and are not accountable to the public
- Sacrifice security and safety for profit
- Reduce employment and benefits; and have a
- Detrimental impact on the welfare of other stakeholders, SMEs, local communities, NGOs etc...

## SOLUTIONS

### **1. Guarding the public interest:**

There are concerns that the government sector loses control over the delivery of essential services - such as health, water and education- when PPPs are used.<sup>1</sup> In

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<sup>1</sup> Best practice policy to address the concerns and ensure that the public interest is protected in undertaking PPPs is presented below. It is based on the practice of Partnerships Victoria in Australia.

considering PPP arrangements, Governments will wish to clearly define the ‘public interest’ in order to protect it.

### *The core service question*

The decision as to whether services constitute core services which should not be delivered by the private sector should be made by government on a case-by-case basis. If the whole service is considered to be a core service, there will be no scope for a PPP arrangement with the private sector. Ultimately, it is a decision for government to determine the point at which the core ends and the ancillary services begin. Not all public services provided to the community are necessarily core in the sense that government needs to provide these services itself.

In practice core services are delivered in a context which generally does not preclude participation by private parties. The services performed by doctors and nurses within public hospitals, teachers within government educational facilities and judges within courts are widely regarded as core services which it is a function of government to provide. However, there is no reason, in principle, why supporting infrastructure and ancillary services within those services cannot be delivered by the private sector. PPPs have been used in many countries to provide educational and health infrastructure and service.

### *Value for money question*

Before a project is begun a full cost/benefit analysis should be undertaken. Often when government approves the project and where it seeks to involve the private sector through the undertaking of a PPP, private sector bids are assessed against public sector benchmarks to determine value for money. The quantitative benchmarking tool is the Public Sector Comparator. (PSC).

Value for money is maximized by allocating risk optimally (optimal risk allocation and its application to PPPs are explored in Chapter 3) The PSC is used to estimate the hypothetical risk adjusted cost to government of delivering the proposed project using the most efficient form of government delivery. The PSC is then compared against private bids. Care should be taken however to ensure that the comparison is between genuinely comparable items. There is a strong possibility that bids will not be

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Under their practice the decision as to whether or not a service should be delivered as a PPP project depends on three questions:

- Which if any part or parts of the proposed service is a service which government itself should deliver to its citizens? (the core services question)
- For all other aspects of the service and supporting physical infrastructure, what is the project model that delivers the best value for money? (the value for money question)
- Do the outcomes of the value of money question satisfy the public interest criteria articulated in the policy? If not can the public interest criteria be satisfied by either building safeguards into the contract or through regulatory measures (and at what costs), or should the project be reconceived to ‘reserve’ further areas of service for provision directly by government? (The public interest).

identical to the proposed service specifications, and risk allocation outlines in the bid documentation on which the PSC is based. To compare such a bid with the PSC without appropriate adjustment would be therefore misleading.

If the bids are more expensive than the PSC, and the level of service delivery and the risk allocation in the bids is similar, in the absence of other offsetting qualitative benefits, the project would be best delivered as a public project. This decision should be based on the total cost of each alternative, i.e., considering not only the estimated contract cost, but also the cost to the government of contract monitoring and administration.

### *The public interest question*

The public interest should be rigorously addressed during the pre-tender stage of the project. For each potential PPP a public interest test should be undertaken to ascertain whether the public interest can be protected satisfactorily. Typically the public interest has various aspects:

- **Protection of community rights** ( including legal rights through planning and appeals process)
- **Protection of public rights** ( of access to the facility health and safety and cases to information)
- **Protection of user rights** ( including privacy, access for disadvantaged groups and consumer rights)

These can be elaborated in a series of public interest elements articulated in the policy:

**Effectiveness.** Is the project effective in meeting government objectives?

**Accountability and transparency.** Do the arrangements ensure that the community can be well informed about the obligations of government and the private sector partner and that these obligations can be oversights by an objective third party.

**Affected individuals and communities.** Have those affected been able to contribute effectively at the planning stages and are their rights protected through fair appeals processes and other conflict resolution mechanisms?

**Equity** Are there adequate arrangements to ensure that disadvantaged groups can effectively use the infrastructure?

**Public access.** Are there safeguards that ensure ongoing public access to essential infrastructure?

**Consumer rights** Does the project provide sufficient safeguards for consumers, particularly those for whom governments have a high level of duty of care, and/or those who are most vulnerable.

**Security.** Does the project provide assurances that community health and safety will be secured?

**Privacy** Does the project provide adequate protection of users' rights to privacy?

## **2. Public accountability**

One of the main challenges for government is to ensure that the public is receiving value for money and transparency of public services commissioned from the private sector. There is often public concern at the lack of:

- Information on the companies now providing public services, their size, their spread etc.
- Information on the terms and conditions of contracts, as typically, contracts between the public and the private sector contain commercially sensitive information, and are not put into the public domain.
- Information on the extent of the financial contribution paid by the public sector to the project.

In the vast majority of cases projects are guided by good propriety principles and no unethical practices are being hidden from the public. However, the very lack of such information can cause unfounded suspicions and the confidence of the public will be gained if transparency and fairness are the watchwords.

### *Strict contractual provisions*

The Government can enforce delivery of services by strict conformity to the contract with the private entity. Although contracts are complex and not easily understood by the general public they can provide a strong instrument for achieving accountability especially if the targets and performance indicators are clearly identified and understood.

Private organizations may seek to establish that certain aspects of their operations are commercially confidential. This puts limitations on accountability which could present a challenge to local authorities and national governments. Consequently, the contracts ought to have demands of accountability and that there should be a structure in which the organizations delivering the service are open to such accountability. Increasingly PPP contracts are stressing such a feature.

Contrary to this argument is a counter view that relying solely on economic gains (and the resultant penalty) if targets are not met, squeezes out other values and motivations, such as public service or duty. But such new arrangements do not squeeze out other

motivations. Generally speaking, those who offer public services under the new arrangements do so for a mixture of motivations, economic gain, job satisfaction, a sense of personal and social responsibility and altruism, and this should be recognized.

Another objection is that the public good in many instances cannot be delivered on the basis of cost-benefit analysis and contractual obligations and that certain functions of the civil services will not be amenable to the market place. The test (as suggested in 1. above) for dividing what remains in the public realm and what can be delivered under PPP arrangements is a political decision. But generally this decision is best made according to pragmatic grounds – will the service under the PPP achieve value for money - rather than on ideological grounds.

### *Monitoring performance and independent auditors*

Monitoring performance in meeting targets set out in contracts is a major task to ensure accountability of services. There needs to be good performance assessment and measurement in the public services and this work is best accomplished by independent bodies, set up to monitor performance in specific sectors, with responsibility to put their findings into the public arena and to make that information readily available to the public. This information will also help the public improve the choices they make in the use of public services.

Increasingly too the number and differences amongst the suppliers of public services to governments continues to grow: not just still public entities, but also fully private, NGOs, charities and also social enterprises are becoming engaged. The principle of monitoring performance to ensure that the members of the public receive value for money should be the same for whatever entity is providing the service, public, private or some other type of entity.

A key challenge is not just to establish the auditors and independent bodies to monitor performance; it is also to define targets in such a way that they can be effectively used in practice. For example, how to audit data on outcomes and productivity in hospitals? Another case is prisons, a sector where PPPs have been quite successful but where setting performance standards and designing outcome-based performance requirements is particularly complicated due to the risk of unintended consequences. One example: tough financial penalties for escapes from prisons unintentionally might cause a climate in which prisoners' maltreatment increases.

Furthermore one of the features of the PPP is that the public sector is contractually linked to a private entity for a considerable period of time, i.e., for 25 years or more. This can be a burden for future generations of taxpayers with paying for, for example, hospital configurations which have been designed for today's era. While the contracts usually allow for changes over time, this will have to come at a price. The challenge here is that those who monitor will not know whether these long-term contracts represent long-term value for some years to come. Accordingly, the monitoring must in a sense anticipate these emerging problems and deal with them before they become a drain on the taxpayer.

### *Accountable to the citizens*

Increasingly the providers – be they public or private - of social services can no longer expect to deliver what they want in terms of services. They must take into account what the beneficiaries want and need. In overall state systems of health for example, patients are being offered choice as to the hospital, the time of treatment and even the doctor that is best able to treat them. Until recently it was assumed that the only persons who should have choice in health and education were those who could afford it. By increasing choice the governments can create incentives to providers to improve services and performance as funding will follow the choices the beneficiaries make.

This policy will in turn ensure that providers begin to increase their use of customer services and consultations, which can score how well services are responding to customer demands. Increasingly, the UK local authorities, for example, publish tables, which present the performances of providers in health and education. Instead of services being scored purely by top down inspections they would be scored by the users themselves. By applying these mechanisms to providers of PPP services and ensuring that they consult with the customers in these ways, the acceptability of PPPs will increase amongst members of the public.

### *Involvement of stakeholders*

A key consideration of Government should be a well-conceived and executed program of empowerment of key stakeholders in PPP activities, since there are many benefits of early and consistent involvement.

- Managing the fear of change and the unknown by providing an open, transparent process.
- The proposal itself can be shaped to meet the needs of the end user as well as other stakeholders
- Consultation may lead to the identification of innovative and cost-effective ideas.
- By bringing in end users and those involved in providing the service, their objectives, needs, and concerns can be identified and addressed in the PPP.

In order to avoid difficulties at later stages, project teams should prepare a consultation and communication strategy that involves all the key stakeholders at appropriate times. These key stakeholders can include, for example: councils or boards, local government staff, the public or end users of the service, unions, approval agencies, other agencies included in the lending of the service. The strategy itself should facilitate communication between the local government and the stakeholders, and various methods of disseminating information and receiving responses should be provided. Moreover, it should include the following:

- Objectives of the consultation and communications strategy
- Identification of key stakeholder groups and their particular interests
- Milestones in the project where consultation and communication is desirable (or required)
- A timeframe and points where stakeholder involvement is required



- Overall approach and methods used for informing stakeholders and receiving input from them
- Media involvement in the communication process
- Methods for meeting statutory requirements

The consultation program should be tailored to the scope of the project as well as stakeholder interest. Larger, more controversial projects should incorporate extensive consultation incorporating a variety of approaches and methods over an extended time period, while smaller projects might require less effort.

### *Even-handed regulation*

Public accountability needs to be protected. However it should not go in another direction, which is to lead to over- bureaucratic control and poor as opposed to ‘good’ regulation. Generally, an even handed approach to providers of services needs to be adopted, with the same rules for entry to the market for providers, whoever they are and wherever they come from. Governments must achieve the right balance is opening up the PPP process to outside scrutiny and the need to deliver an effective and efficient stream of projects.

### **3. Maximizing the social contribution of PPPs**

A concern is that the transfer of management of service to the private sector risks increasing the tariff and thus excluding the socially and economically disadvantaged. One of the challenges is that when some projects are retransferred to the private sector they are already subsidized services, which do not reflect the true costs.

But tariff increases are not necessary and Governments can step in to protect those who are at risk from higher charges. Governments, for example, can increase the aid to the project (see above) so as to ensure the continuity of existing and new services to socially and economically disadvantaged groups is not jeopardized.

A good example of subsidy with the intention of both making accessible the service to the poor and making the overall price affordable to poor and vulnerable groups was the Pamir power project in Tajikistan. The project established a special social protection tariff scheme. The tariff will increase gradually over 10 years with additional flexibility but the key objective is that the tariff and the especially mobilized funds will ensure that those who cannot afford the current prices will nevertheless receive electricity. This power project in Tajikistan shows that it is possible to attract the private sector into a scheme that improves the social welfare in one of the poorest countries and one of the poorest regions in Central Asia.<sup>2</sup>

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<sup>2</sup> However, although the prospects for the project are excellent it is important that they are linked to an overall programme of income generation and increased livelihoods so that the project will become itself sustainable when the subsidy runs out. In general very large PPP projects in countries where the skills and knowledge are undeveloped carry certain extra risks. For example, often to fill the knowledge gap countries will require the import of experts, labour force, and materials. Moreover the restricted financial possibilities of some countries will demand financial expertise and other resources. In such circumstances one could question the value of such kind of complicated and costly projects. They will have more marginal positive effects because they will not leverage new knowledge and skills

Another concern is that PPPs do not give back sufficiently to local communities in terms of local employment. This is not the case, however, in many PPPs. For example, in Canada an Economic and Industrial Benefits Plan formed part of the contract to design, build operate, maintain and rehabilitate the Fredericton-Moncton highway in New Brunswick. In this case, over 30 New Brunswick-based engineering, construction and material supply companies worked on the project and, at peak construction, 1,300 of the 1,400 workers were local. Over 92 per cent of the work was sourced locally.

#### **4. Sustainable development**

Environmental concerns are becoming a factor for selecting the PPP model. Numerous UN bodies have encouraged governments to adopt PPPs as a tool for sustainable development. Investors in PPPs too have a financial motivation for taking environmental considerations into account, because the effective use of resources and reduction of waste both in design and construction, means lowered whole life costs, and hence higher margins. Citizens too demand more attention from their governments to the social and environmental impact of projects.

While the importance of sustainable development has grown in the rationale for PPPs there is still a considerable way to go before these considerations will predominate. There are both technical and conceptual challenges for enhancing the contribution of PPPs to sustainable development:

- Technical issues: establishing the necessary lifetime costing can be a challenge, because assessing all future costs of potential damage to the environment is not an easy task. New environmental treaties like the Kyoto-protocol means that polluting the atmosphere with greenhouse gasses quickly can turn into a cost. This aspect was taken into account by the City of Vancouver and Maxim Co for the Vancouver Landfill Cogeneration Plant. Under this arrangement Maxim has financed, built and is operating a world class cogeneration facility to convert waste to energy. It raised 83 per cent of the Can dollars 10.3 million project cost through debt financing arranged by Corpfinance International – principally a 20 year 7.8 per cent fixed interest rate, non recourse loan for 7.6 million – and provided equity for the balance. Under matching 20 year agreements, the facility uses landfill gas collected by the City to generate electrical and thermal energy.
- Definitions and concept: sustainability’ is often interpreted solely in terms of the environmental sphere. Again, the interpretation of what is meant by ‘sustainable development’ may limit the spread of true ‘sustainability’ principles in the PPP process. There is a need for a more integrated and holistic approach to the interpretation of ‘sustainable development’ For example very little attention is placed on the social or socio-economic aspect

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that can be used elsewhere and thus not contribute to sustainable development. From this perspective, small projects may be of more importance in the initial stages because of the need for employment of local citizens and use of local materials. Local employment will leverage new knowledge and practical experience and this will mean a significant stimulus to the local economy.

of procurement. Social aspects are considered more difficult to include in procurement activities.

### **Recommendations:**

On a **European level**, the biggest driving force in including sustainability criteria in PPPs is, the EU Sustainable development strategy but though the will is there to promote sustainability through procurement, the EC guidance on incorporating green and social considerations have to date little impact and are in most cases, remain unknown by procuring authorities.

While mandatory principles may be undesirable there **is a need for a widespread** dissemination of best practice information of sustainability in PPPs on a European and national scale, in order to facilitate the development of appropriate guidelines and promote the adoption and understanding of sustainability in public private partnerships.

### **Contracting Authority**

There is a need for sustainable development advisors, to help the contracting authorities ensure that sustainability considerations will be consistently included in PPPs.

The contracting authority must send a clear signal to the private sector that sustainability will be rewarded in evaluation bids and in the award of contract. There must be a consistent interpretation of value for money based on whole life costing, and not cheapest bid wins. This would be aided by expert sustainability advisors, and led by national or European requirements.

It is evident then that the importance of whole life costing needs to be fully understood. To develop properly, the methodology of WLC needs to benefit from feedback on how predicted costs work out in practice. Partnerships for Schools in the UK, for instance, are investing £1 million on gathering evidence on the links between standards and educational standards (Green Alliance, 2004). More studies need to be carried out in order to illustrate the benefits of WLC, and hence promote its uptake.

### **Private Sector**

The private sector appears to be leading the way in advancing true and integrated sustainability principles in PPP / PFI programmes. This is not driven from top-down policies relating to public procurement or PPPs, on a global, EU or national scale. Instead, the incorporation of sustainability principles is based on a company's internal core policy. Corporate social responsibility and sustainable development strategies are fully integrated into every operation of the company. Many companies voluntarily include sustainability criteria into their project bids, and schemes.

*A strengthening and further promotion of CSR and global business social and environmental accountability will facilitate the consistent incorporation of sustainability in public private partnerships.*

Companies have a comprehensive understanding of sustainability. They actively include social, socio-economic as well as environmental aspects in their PPP operations. This makes an interesting contrast to how sustainability is often interpreted by public bodies (on a European, national and contracting authority level), which tend to focus on environmental sustainability.

Much could be learned by the public authorities, on how the private sector approaches sustainability. Sharing of private sector sustainability expertise would facilitate a more holistic and streamlined interpretation of sustainability in PPP projects.

However, there seems to be a large range of private sector opinions regarding the incorporation of sustainability principles into PPP projects. While some companies maintain that there is a strong business case for sustainability, others in the private sector perceive it to be too risky.

There needs to be a much wider dissemination of best practice case studies, and a sharing of information among private sector PPP professionals, as to the reality of incorporating sustainability principles into PPP bids and operations. This would bridge the existing perception gap, and aid in a consistent implementation of sustainability criteria in public private partnerships.

## **Advisors**

Advisors have a central role to play in developing PPPs on a global and European scale. While they have an internal business CSR policy and sustainable development strategy, this is not integrated into their work involving PPP markets. This provides an interesting contrast to the core business ethic of corporate social responsibility and sustainable development, portrayed by some of the major players in the PPP private sector.

Realizing their influence in developing foreign PPP markets, it would be highly beneficial to the spread of sustainable development principles, if these advisors actively incorporated sustainability criteria throughout their work with PPPs. This could be achieved through the strengthening of their internal CSR and SD policies, and meaningfully integrating these ideals as core business policy throughout all of their firm's activities.

## **5. Enhanced Safety and Security**

### **Challenge**

There is a concern that in PPPs the private sector will pursue its profit motives at the expense of safety and security. This is a particular concern in the case of transport projects. In the UK the privatization of the railways gave over responsibility to safety and maintenance to the private sector. In one case, the private entity failed to carry out adequate safety checks and maintenance, leading to a railway disaster with tragic loss of life.

## **Solutions**

The issue in PPPs is not that the private entity saves profits by failing to pay the extra costs that ensure of safety. The issue is rather whether the private entity complies with the safety standards set out in the contract. Failure to comply leads to a variety of problem including abatement of its fee, penalty charges, and ruinous litigation. Accordingly, there is every incentive for the private entity to comply. Often in accidents, the problem is human error which can happen whether the entity is run by the public or by the private sector.

Evidence shows moreover that there is no contradiction between a private entity running a facility and the meeting of safety requirements. In Ontario, for example, the local government in an effort to meet the demand faced by a dual driving test system contracted with Serco, a firm from the United Kingdom, to operate driver examination services. It is believed to be the first time that driver examination services across an entire jurisdiction have been delegated to a single private company. Serco paid the Ministry of Transportation and concession fee of Canadian Dollars 114 million, and retains the driver examination fees charged. The Ministry retains control over examination standards and the amount of fees charged through a prescriptive concession agreement. Since the partnership began, wait times to take a driver's test have been significantly reduced from up to 15 months to an average of 6 weeks and overall customer service has improved. The project demonstrates that it is possible to improve customer service and value to the taxpayer without compromising public safety.

Combining private sector management skills and latest technologies with government projects to develop roads can also enhance safety. An example is the above mentioned, 195 km highway project in Canada between Moncton and Fredericton. Construction was completed less than 4 years compared to the 15 years it would typically take under traditional methods. Since the new highway replaced a dangerous section of road, the rapid construction of the highway, meant that lives were saved more than ten years sooner than would otherwise have been the case. Moreover, the attention given to designing a highway that would improve driver safety has had impressive results. The highway has seen a 70 per cent reduction in fatalities on the road between Fredericton and Moncton. This is a greater safety improvement than expected from the conventional wisdom that upgrading major arteries from two to four lanes will reduce fatal accidents by a third.

## **Chapter 6. INTRODUCING AND DEMONSTRATING SOLUTIONS**

### **THE CHESAPEAKE FOREST PROJECT:**

A Case from the United States

#### **What is the Chesapeake Forest Project?**

The Chesapeake Bay is the largest estuary in the United States, and a major area of both recreational and commercial fishing for the State of Maryland. The environmental quality of the Bay has been seriously threatened by wastewater discharges from growing population centres and minimal controls of agricultural run off (both fertilizers and animal by-products). In response, area governments have made restoration of the Bay an environmental priority, including an increased interest in land and wetlands management. However, both state and local governments lack the financial and personnel resources to fully address these issues. It was in this context that the Chesapeake Forest Project was created.

In 1999, a private lumber company sought to divest its land holdings in the State of Maryland, and offered the State the opportunity to purchase this land, which consisted of 238 parcels totalling more than 58,000 acres in five counties, and included large areas of unbroken forest, more than 4,000 acres of wetlands, and established populations of several threatened and endangered species. Much of this land bordered on existing State-owned parkland and forest, creating a unique opportunity to buffer a large area from deforestation and development. However, the State lacked both the funding to acquire the land and the personnel resources to manage the land once purchased. In addition, the cessation of timber harvesting on the offered lands would have caused an unacceptable loss of employment in largely rural regions of the state. Nonetheless, the State regarded the potential to safeguard these lands from development and protect the forest as a unique environmental opportunity. Recognizing its fiscal and personnel limitations, the State entered into a two-phase public-private partnership to purchase and manage the land. In the initial phase, the State worked with NGOs to acquire funding to help purchase the land and plan for the sustainable management of the forest. In the second phase, the State entered into a unique public-private partnership which requires the private sector partner to manage the entire property according to environmental standards closely monitored and supervised by the public sector and, in return to harvest a sustainable level of wood products from specified portions of the lands. The revenues from the timber harvest generate the necessary income to make the project completely economically self-sustained and at the same time generate revenues for both the State of Maryland and local governments, as well as the private partner.

The public-private partnership serves to achieve the following economic, social and environmental objectives:

- provide a steady flow of economic activity and employment to support local businesses and communities;
- prevent the conversion of forested lands to non-forest uses;
- contribute to improvement in water quality, as part of the larger Chesapeake Bay restoration effort;
- protect and enhance habitat for threatened and endangered species;
- maintain soil and forest productivity health; and,
- protect visual quality and sites of special ecological, cultural and historical interest.

### **Who were the public and private partners?**

The Chesapeake Forest Partnership (CFP) was developed in a two-stage process, with varying partners at the different stages. The State of Maryland Department of Natural Resources (DNR) is the public agency with direct responsibility for oversight of the management of all phases of the CFP. .

A major philanthropic foundation aided in the initial acquisition of a portion of the property. This foundation has a focus on environmental concerns and accordingly makes grants for such purposes as will be “in the public interest.” Priorities include regional economic development, land preservation, and watershed restoration and protection, all of which are compatible with the objectives of the CFP.

A non-profit public interest group with a focus on environmental concerns was another participant in the process of development the Sustainable Forest Management Plan which was implemented as part of the CFP. The final partner is a for-profit forestry firm which performs the forestry management under the implemented PPP.

### **How was the partnership structured?**

For the initial land acquisition that ultimately led to the partnership, the State of Maryland provided \$16.5 million in order to purchase half of the 58,000 acres. The non-profit public interest group, acting on behalf of the philanthropic foundation, purchased the remaining 29,000 acres for \$16.5 million with the intent to later gift the land to the State. The gifting, done in December 2000, carried with it a number of stipulations about land use that would become a key part of the CFP agreement.

The initial phase in development of this partnership covered only the 29,000 acres provided by the non-profit group. Terms of the non-profit group’s gifting of the land included commissioning of a detailed Sustainable Forest Management Plan to be implemented over a three-year transition period. A private environmental firm was then contracted to manage the Chesapeake Forest lands in conformance with the State’s environmental standards and regulations, based upon the Sustainable Forest Management Plan. The contract also provided the firm with the option for participation in the final partnership agreement, when implemented. The unique

aspect of this PPP, however, was that it was self-funded. The Sustainable Forest Management Plan included identification of areas in the forest where wood products could be harvested without negative environmental impact, and an environmentally sustainable level of harvesting. The private partner managed the harvesting operations, the revenues from which pay for the contract and provide additional funds to both the State and local governments. In addition, the controlled continuation of timber harvesting activities helped address the economic concerns of the local communities.

Due to concerns about the viability of this model, the State agreed to cover any losses incurred by the private in the first two years; after that the private partner would assume the risks associated with the partnership's profitability. However, the partnership succeeded in generating a profit in its first two years, and in each subsequent year. With professional management of the lands, profitability should continue to increase over time.

Based upon the success of the PPP for management of the initial 29,000 acres, the terms of the final contract for this PPP between the State of Maryland and the private company cover the entire 58,000-acre forest tract. The private partner is the same company initially contracted to manage the non-profit's portion of the forest, with the award based on performance during the transition period. .

Under this partnership, the private company is responsible for all land management, based on an annual per-acre fee for basic management services, including harvesting timber. The private partner is responsible for subcontracting all fieldwork (e.g., cutting trees, transporting wood products to the purchasing mills, and replanting), and paying all subcontractor bills. Receipts from the sale of timber products are paid directly to the State and the State does the financial management of the accounts. The first fifteen percent of the revenues each year are dispersed to the local counties; only once this payment to the local counties has been made may the private manager begin to collect its management fee.

The contractor gets paid an annual "base fee" paid out in monthly installments for implementing the requirements of the contract for the management of the 58,000 acre forest. This includes implementation of the annual work plan, which involves approximately 2,500 acres of forestry harvesting annually. The contractor gets a secondary payment based on a per acre fee at the end of each quarter based on the actual acres of work completed over the quarter. For both payments, the contractor must submit an invoice that details the work completed and the work accomplishments are verified by the Forest Manager and the local Regional Manager prior to the payment of fees out of the State's Chesapeake Forest Fund.

The private manager must generate enough income from timber harvests each fiscal year in order to cover the fifteen percent payment to the localities and an independent forest management fee defined by the contract. All fees and expenses incurred by the contractor during the fiscal year must be paid from income generated from the Chesapeake Forest Project during that fiscal year. The contractor assumes a great deal of risk since there is no carry over of capital from year to year and no other source of funds are available to pay the contractor should they fail to generate sufficient income to pay its fees in any given year. All of this provides a strong



incentive to keep the project economically self-supporting. Since its implementation, the partnership has been profitable, with revenues increasing annually. An independent annual audit also provides a layer of objective third party review of the financial aspects of the project. The forest certification is done under the Sustainable Forestry Initiative as well as the Forest Stewardship Council and qualifies under the stringent sustainability criteria as a well-managed plantation.

## **Conclusions**

The innovation of this partnership lies in the fact that it uses a renewable natural resource, the Chesapeake Forest's wood products, to fund environmental services needed by the State. Instead of having to hire professional foresters and support staff to manage these lands to its standards, the State has the land managed by its private partner. The State avoids expending public funds and, instead, generates revenue while ensuring the sustainable management of the forest. This model may be exportable to the areas where services are required, and sustainable development of natural resources may be used to fund them.

The project is also a model of transparency, involving NGOs, local government, the public, and private industry in the discussions of the need for the project, its financing, and its structure. The annual audits of the project finances, with full public disclosure, and performance monitoring by DNR, ensure accountability as well.

As this case study shows, much can be learned from analysis of projects like this one. In fact, it is reasonable to believe that the Chesapeake Forest Project may serve as a template towards developing future case studies of other innovations in PPP as well.

## Chapter 7. BENCHMARKING SUCCESS

The following describes in tabular form the main practices, laws and institutions which need to be established if good governance practice in the above mentioned five areas is to be improved. These procedures, desirable outcomes etc. have been identified in the preceding chapters.

Policymakers can use the following indicators below to measure progress in achieving good governance. The model presents benchmarks based on the ingredients of good governance previously identified. The indicators are scaled from 1 to 5, being 1 very poor, 2 poor, 3 moderate, 4 good and 5 very good. Once the indicators are graded, they should be added within each sub-sector and then divided by the maximum possible result and then by 100 to achieve a percentage. Each section is divided into thematic subsections, which contain desired conditions measured by specific indicators.

The model below is preliminary, and will have to be further tested and developed. The specific grading criteria for each indicator, e.g. what it takes to get a score of 5 for the “award procedure”, are still under development and testing these indicators against specific cases will add to, and refine the indicators.

Benchmarking										Score						
Transparency										1	2	3	4	5		
Participation of citizens																
Consumers' organizations																
involvement in projects																
Media exposure																
Proposal of projects by civil society and/or NGOs																
Use of constitutional tools for decision-making process																
inclusion of referendum in the Constitution																
regularity of its use																
level of citizens' awareness of its existence and purpose																
Public Procurement																
Selective procedure																
General applicable law for all tender processes																
Specific laws according to the sector																

			Harmonized rules under regional unification initiatives							
			Corporate governance requirements							
			Award procedure							
			Tender appeal procedure							
			<b>Open Participation and non-discrimination</b>							
			Companies whose headquarters are not based in the country are successful in tender processes							
			Early publication of tender offers in local and international newspapers							
			Open competition rules							
			Level playing field							
			<b>Good negotiation platform</b>							
			Expertise and dedication of negotiators							
			Independence of judgment							
			Defined goals and objectives in the negotiation process							
			<b>Coordination</b>							
			Special governmental agency in charge of coordinating the project proposals and commencement of tender process							
			Web site information and on-line pre-registration							
			<b>Organized data gathering</b>							
			Centralized database with possible and actual contractors							
			Due diligence on the bidders' financial and technical performances							
			<b>Contractors' registry</b>							
			Qualification of contractors according to specific standards							
			Contractors' updated profile							
			Regular advertisement of status of contractors							
			<b>Due authorization to grant permits, concessions or licenses</b>							
			Legal delegation of authority to officials to sign on behalf of the government							
			Regulation about permits and/or licenses at a national level							
			Divulgation of information about granted permits, licenses and/or concessions							
			<b>Strong anti-corruption measures</b>							
			<b>International level</b>							
			Anti-bribery Convention							









			Diversification								
			Level of understanding of citizens about the key elements of a PPP project								
			Access to media								
			Polls among users and consumers on performance of the private company								
			Polls to measure public's satisfaction with the service								
			<b>Safety and Security</b>								
			<b><i>Specialized Safety and Security agency</i></b>								
			Performance								
			Instauration of preventive measures								
			Level of spread of information related to security measures								
			Periodic exams in the project								
			<b><i>Strong insurance policy</i></b>								
			Regulation of insurance market								
			Existence of covenants in agreements								