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PRIVATE SECTOR
CONTEXT

Municipal Public-Private Partnership Framework

19

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1.0

Purpose of this Module

When a PSP considers a municipal PPP, it will perform due diligence and test whether the risks and investment potential merit investment of time and money for due diligence. The PSP approaches this task in a way often very different from municipal staff.

The following sets out a few issues that are critically important to the PSP to help the municipality understand the kind of issues that are important for the PSP and the due diligence it will perform. The feasibility study¹ and the PPP agreement² should address these issues. Municipalities should review their projects from the perspective of the PSP to understand better the PSP's perspective and priorities in advance of the bidding process and to prepare for the kind of questions and concerns that the PSP will likely raise.

¹ See Module 4: Feasibility Study.

² See Module 11: Sample Municipal PPP Agreement.

2.0

Private Context

The key concerns of the PSP will be discussed here around a series of key questions that potential investors will ask when considering a project. This is not an exhaustive discussion, rather it is meant to help municipalities understand some of the key issues relevant to private investors.

2.1 Is This Project Important?

PSPs know that projects that are important to the municipality and to the people have a better chance of closing, and of succeeding. Projects that are only important to a particular municipal official or political party are probably less likely to succeed. Indications of the importance of a project include the project's presence on the priority list of the

government, the assessment of economic impact that the project will have on the local community and on the country at large, and the level of engagement with the local community (in the identification and design of the project as well as its implementation).

2.2 Does the Project Have a 'Champion' within the Municipal, Provincial, or National Government?

PSPs realize that projects will require someone influential enough to coordinate different government entities and identify solutions for the project through the various obstacles that projects are bound to face through the process of development and bidding. The identity of the government champion is not generally disclosed in

the bid documents or other documents shared by the municipality; this is research that the PSP will undertake on its own. This assessment will include the context of the 'champion', including timing of the next election, and the likelihood of the champion remaining in power.

2.3 What Are the Regulatory or Legal Approvals the Project Requires?

The PSP will need to understand all of the permits and licenses that need to be obtained at different stages of the project, before implementation, during implementation, and throughout operation. Which approvals the municipality will secure and which ones the PSP has to secure, and which of these approvals are sensitive or difficult/time-consuming to secure. Even though the municipality may take on the responsibility of securing key regulatory and legal approvals, the PSP will need a solid understanding of the probability of getting all

required approvals and the likely time-frame for the same. The PSP will assess the risks and associated costs of waiting to commence construction or commence operations after construction, due to delays in securing approvals. The PPP agreements will need to explain how and under what conditions, if at all, the municipality will compensate the PSP for any delays in securing these approvals or where the approvals require different performance obligations or investments than are anticipated in the PPP agreement.

2.4 Is Demand Real, or Just Hopeful?

There is a tendency for demand assessments to suffer from optimism bias (see Guidance Note section 2.2), in particular where the assessment is performed by a party incentivized to implement the project. A municipality, for example, is likely to assume a much higher level of demand for a project than might other project parties. Studies of traffic forecasts and similar demand forecasts show a consistent overestimation of demand by governments, investors, and lenders, with lenders being the most conservative.

Potential investors will discount any demand forecast provided by the municipality (even if produced by an expert), to address the impact

of any optimism bias. Potential investors often undertake their own demand assessment. Even if they do not undertake a comprehensive assessment (for example, if the municipality has undertaken a comprehensive study through a reputable expert), PSPs would undertake a quick assessment of demand to validate the municipality's study and to determine how much they should discount it or possibly apply a more optimistic assessment than that of the municipality. More often than not, a population growth-driven assessment of demand is not adequate for PSPs; they typically need more granularity with respect to demand projections.

2.5 What is the Source of the Demand?

Potential investors need to understand the sources of demand. Are the high-demand segments located in some specific geographical areas within the municipality or is it based on some demographic parameters, such as age or income? For example, for a water supply distribution PPP, potential investors would need a detailed breakdown of demand across the service area to assess the robustness of the demand from various segments and also its likely projected growth. This information is also used to design the project better and also

plan operation of the project to fit actual needs. Potential investors take seasonal variations in demand into account because it directly affects cash flows of a project and consequently debt servicing and other payout obligations. Also, if the seasonality is high enough, PSPs also look at seasonality of labor demands and operating costs across different seasons. This can help design operating cost efficiencies.

2.6 Are Revenues Real or Just Hopeful?

Just as demand forecasts are often optimistic, so too are revenue forecasts. Potential investors would like to understand the basis for determination of the tariff for the services being provided by the project, how the tariff is regulated, any administrative or bureaucratic approvals required, and whether users/people are likely to pay the proposed tariff (affordability and willingness to pay). Investors will compare proposed tariffs with similar services offered in neighboring municipalities and countries. They will also make an assessment of how strong the municipality and the provincial/national government are, and whether they would be able to withstand any resistance against tariffs from citizens/users.

The potential investor will assess carefully all revenue forecasts and will question all assumptions and discount forecasts provided by the municipality. Just like demand forecasts, revenue forecasts are subject to optimism bias—that is, those promoting

the project will have a tendency to interpret data to show more healthy revenues than might be merited, whether this optimism is conscious or unconscious.

PSPs would like to understand how tariff revisions will take place. The PPP agreement will establish a baseline tariff and generally an agreed formula for tariff increases. Where there is a regulator (whether or not independent), the parties will need to agree how to resolve situations where the regulator sets a tariff that is inconsistent with the PPP agreement. If tariff revisions for the entire period of the PSP contract are already set by regulation, and that regulation cannot be modified, the PPP agreement will use this as its baseline. Potential investors will assess the risk that tariffs are not increased, or that those increases do not meet expectations. PSP financial models will likely test for scenarios where tariffs do not meet agreed levels and the impact this will have on project financial viability.

2.7 Is the Municipality Creditworthy?

Particularly for projects where the municipality pays for the service—for example, supply of treated bulk water to the municipality or operation and maintenance of the municipality's sanitary landfill site—investors need to understand the credit position of the municipality, its history of paying bills on time, its management of its finances, and so on. Where possible, the municipality should share whatever financial information it can to help potential

investors understand the risk involved and create confidence among potential investors. Investors will make higher provisions for working capital (assuming delayed payments) and for operating costs for any perceived risk associated with the municipality fulfilling its financial obligations.

2.8 Is the Project Configuration Best Suited to Deliver the Service Standards and Profitability of the Project?

PSPs would like to explore different project configurations to maximize revenue while still delivering the specified service levels. For example, in a bus terminal, while maintaining basic standards of making a bus bay available within, for example, two minutes of a bus arriving, the potential investor will want the flexibility to ensure maximized space for retail outlets, restaurants, office space, etc.

Use of space outside of operating hours can also provide some interesting opportunities, for example using the bus terminal as a parking facility for buses as well as other vehicles at night. Can the facilities include a hotel or other associated facilities? Any limitations on the use of the facilities will be carefully analysed by the PSP.

2.9 Is the Project Engineering Design Best Suited to Deliver the Desired Service Levels?

Potential investors would typically undertake a thorough investigation into the proposed engineering design, in particular where the design has been mandated or only some elements of the basic project engineering design are mandated by the municipality or at law. The due diligence process will assess whether the mandated elements

of the engineering design are appropriate given the specific project site conditions and service requirements. Investors also prefer to have the opportunity to propose value additions or cost reductions, to establish their competitive advantage and also maximize investor returns.

2.10 Is the Project Construction/implementation Time Line Adequate?

Potential investors are keen to complete project construction/implementation as early as possible to commence operations and start revenue flows. However, the time allowed for construction, testing, and commissioning needs to provide sufficient space for the construction to be delivered to the quality desired. The investor will also need to understand the process for approval at different stages of construction, who within the municipality

will review, test, and approve, and the likelihood of delays in approvals. Municipalities need to think through which stages are really critical from a technical point of view and how to monitor and approve in the most efficient manner possible—the 'must haves' rather than the 'good to haves'.

2.11 Are All Materials/Inputs Available and What Are the Associated Costs and Lead Times?

The potential investor will perform extensive due diligence on project construction/implementation costs and the time required for completion of construction/implementation. Potential investors will be concerned about an underestimation of construction costs and therefore undertake their own detailed assessment. Usually as part of the feasibility study, even when undertaken by reputed experts, detailed engineering design is not done and construction costs are arrived at based on quick and rough engineering design and estimation of bills of quantities. Material costs need to be based on competitive market rates, providing for inflation in material costs between estimation and

actual project implementation (which generally involve a delay of as much as three years, which makes an accurate calculation almost impossible). Lead times required for material availability will affect the inventory of materials that the construction contractor needs to carry and consequently the working capital requirement, which also add to construction cost. Some construction requires long lead items which must be ordered long before delivery (for example, specialized steel, tunnel boring machines, and turbines). The procurement process and construction milestones should provide for such time constraints.

2.12 Are Potential Employees With Requisite Skills Available?

The PSP will need access to skilled labor. It is advantageous to the municipality, and generally to the PSP, to source such labor locally. However, such skilled labor may not be available, or may be more expensive locally. Potential investors want to understand the availability and costs of relevant skilled labor in the vicinity of the project. Finding the right people for each project is absolutely critical to the PSP's ability to implement and operate projects. While potential investors typically have a centralized team for engineering and project finance

mobilization, they typically recruit project-specific implementation and operations teams and appoint a senior manager with project management and operations experience, from their headquarters, to lead that team.

The PSP will need to understand the implications of local content rules, and what local content is most appropriate to include in project planning.

2.13 What Is the Risk That Costs Go Up or Revenues Go Down?

Once costs, revenues, and demand are forecast, the potential investor will assess what might happen to cause costs to go up, revenues to go down, or otherwise undermine the financial projects for the project. The investors will assess the likelihood of such events and potential impact and apply sensitivity analysis to the project financials, to assess the impact on the project if the event or series of events occurs. For example, where will the project source cement, is the cost of cement likely

to go up? How easy is it to access labor with the requisite skills and experience? Are income taxes likely to increase? Might tariffs for project services be reduced by law? By considering these risks in advance, the municipality can address them in advance to reduce their impact on potential bids, for example the municipality may want to set up an experienced, independent regulator with the power to set tariffs and impose performance standards.

2.14 Is the Security Structure Available to Lenders Adequate?

Where the PSP needs to mobilize debt from banks or financial institutions (often 70–80 percent of the total investment), it will be critical that the project is bankable, that is, that lenders are willing to lend to the project based primarily on the project's financials and structure. Lenders will test whether the project financials are adequate to enable debt servicing (interest and repayment of principal)

comfortably, and also whether the lenders have a security structure that enables them to ensure recovery of their loan.

Because assets typically cannot be repossessed in case of default of the loan and are often immovable (such as a road or a bus terminal) or have limited value when moved away from their

location, the lenders will want security over the project cash inflows. Lenders often ask the PSP to create an escrow account where all project revenues flow. Lenders also seek, in addition to the escrow account, the creation of a debt service reserve account with cash equivalent to say three months of forecast revenues.

Lenders will also want step-in rights; where the PSP is not performing its obligations, the lender has the right to replace the PSP with another PSP with similar or better technical and financial credentials.

The municipality can offer different forms of support, for example the municipality may contribute capital to the project as a subsidy or as equity to reinforce

project financials. The municipality (or the national government) may offer guarantees or other credit enhancement to protect the lenders in the event of certain risks (such as demand shortfall) to make the project less risky.

Such security structures enhance the potential investors' and lenders' confidence in the project and result in securing competitive bids. If municipalities offer this in their bid documents, it bolsters the PSP's ability to find a good lender and loans at more competitive rates, which in turn makes bids better VFM.

2.15 How Will Foreign Exchange Risk Be Managed?

Revenues from municipal services are generally denominated in local currency. Financing available for PPPs is more often foreign sourced. In many cases, foreign financing offers longer tenor and a lower interest rate. But, if the exchange rate between the local currency and the currency of financing

changes, this may limit the ability of the project to repay debt. Local currency debt mitigates the foreign exchange risk, but generally offers a shorter tenor, a higher interest rate, and lower amounts of borrowing available.

2.16 What Are the Expected Minimum Service-Level Obligations and Are They Realistic?

PSPs are keen to understand how service levels will be monitored and measured, for example, with support from an independent engineering consulting company or by municipal staff. The identity of the monitoring official, their compensation arrangements and terms of reference will create specific incentives, which the PSP will want to understand. The bid documents need to outline the required service levels, how they will be measured, and what penalties will be imposed for non-achievement, in as much detail as possible.

The desired service levels need to be realistic given the other supporting infrastructure and in line with the typical levels of operation and maintenance in other municipal infrastructure. Finally, the penalties to be levied for non-achievement of service levels need to be specified and realistic, that is, in line with the project revenues. Overly strict penalties will result in over-designing of facilities with associated costs and maintenance inefficiencies (and less advantageous bid prices).

2.17 Will Municipality Fulfill its Obligations?

The municipality may decide not to comply with its obligations, may change rules or regulations, may impose new permits or licenses, or create other constraints, in particular in the event of a change in government or after an election. The PSP will have little power to resist such changes, even where they are fundamental to the success of the project.

Potential investors will review the municipality's history of respecting contracts, using its power to deprive investors of assets or opportunities, and the frequency and transparency of the regulatory and permitting authority wielded by the municipality.

2.18 Can the Courts Be Trusted to Be Fair and to Enforce Arbitral or Other Awards?

Even if the project provides protection to the private investor, those protections are legal and contractual in nature. Local courts may not be perceived as trustworthy. In some countries, the courts are viewed as likely to take the side of the government over the private sector, or of local investors over foreign investors. Arbitration can be perceived as a more independent way to resolve disputes.

Once the dispute is resolved, that award must be enforced. Local court decisions or local arbitration will need to be enforced based on local laws. International arbitration in many countries is enforced in accordance with international treaties, and is therefore preferred by most foreign investors.

2.19 Is the Project Part of a Larger PPP Program/Pipeline?

A large program of PPP projects offers better opportunities for potential bidders. Bids are expensive to develop. A potential bidder will assess its likelihood of winning the bid before incurring the expense of bidding. If there is a large program of PPP projects that will be let over the short to medium term by the municipality or in the country, then the potential bidder will assess whether it might

win one of the projects when deciding whether to bid. The potential bidder can justify the cost of bidding for one project against the likelihood of winning one or more of multiple projects. This will result in more and better bidders entering the market and pursuing individual projects.

2.20 Will the Bidding Process be Open, Transparent, and Fair?

The PSP will be concerned to know if the investment required to develop a bid and perform due diligence on a project will provide a fair opportunity to win the project. A bidder may not choose to bid if another bidder has an unfair advantage, including right to match or the ability to cancel the bid process and have the project awarded directly.