

# IFC Advisory Services in Public-Private Partnerships

## LESSONS FROM OUR WORK IN INFRASTRUCTURE, HEALTH AND EDUCATION



In partnership with Australia, Austria, Brazil, Canada, France, Ireland, Italy, Japan, Kuwait, the Netherlands, Norway, Spain, Sweden, Switzerland, the United Kingdom, the United States, the Public-Private Infrastructure Advisory Facility, the Global Partnership on Output-Based Aid, the Private Infrastructure Development Group, the African Development Bank, the Asian Development Bank, the Brazilian Development Bank, the Caribbean Development Bank, the Central American Bank for Economic Integration, the European Investment Bank, the European Bank for Reconstruction and Development, the Inter-American Development Bank, the Infrastructure Consortium for Africa, and the Islamic Development Bank.

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# Message from the Director

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Access to electricity, clean water, sanitation services, a transportation network, basic health care, and education are critical to improved living standards and economic development.

In developing countries, the public sector alone cannot deliver the resources needed to increase access to these basic public services. Analysts estimate that investments in infrastructure should be seven to nine percent of GDP to sustain broader economic growth and reduce poverty. Yet, on average, developing countries invest less than four percent of their GDP in infrastructure each year. Private sector engagement is necessary to close that gap.

IFC Advisory Services in Public-Private Partnerships helps governments implement public-private partnership transactions and expand private-sector participation to increase the quality and quantity of investments in infrastructure, health, and education, while limiting public sector funding and risk. IFC is the only multilateral agency that offers direct advisory services to governments on private-sector participation in these sectors. Our impact is enhanced by our strong partnerships with donors, regional and national development banks, and other international organizations.

This publication highlights some of our experiences and lessons learned in working on more than 277 projects in 88 countries over the past 21 years. The SmartLessons that follow demonstrate the business case for private sector investment and show what worked and what should be done differently.

We hope that you find this publication useful and welcome your comments.

July 2010



Laurence Carter, Director  
IFC Advisory Services in Public-Private Partnerships

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# Mission Difficult...but Not Impossible

## Making Public-Private Partnerships Work for the Poor

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*Public-private partnerships (PPPs) hold great promise for improving public services for the poor in emerging markets. But charting the political waters; balancing the needs of governments, consumers, investors, and lenders; and making the transaction transparent and sustainable are challenging tasks and not for the faint of heart. This SmartLesson summarizes 10 years of lessons of IFC's Advisory Services in Public-Private Partnerships in its role as transaction advisor to governments on more than 100 mandates.*

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PPPs involve a government contracting with a private sector company for delivery of infrastructure and/or services. As transaction advisor, IFC enters into a formal transaction mandate with a government client to structure and implement a PPP-type transaction. IFC's work typically involves:

- analyzing the project's fundamentals;
- reviewing PPP options and recommending a transaction structure;
- providing financial modeling of the PPP project;
- promoting the project to investors and getting their feedback;
- preparing the PPP contract and tender procedures; and
- assisting in conducting the tender and selecting the winner.

IFC seeks to focus on first-of-a-kind transactions with high developmental impact in frontier sectors (such as health) and regions or countries that often present difficult challenges and so are of less interest to commercial advisors and investment banks.

### RESULTS

Over the past 10 years, IFC's Advisory Services in Public-Private Partnerships has signed 112 advisory

mandates (including 43 active mandates) and successfully completed 36 mandates. Recent highlights include the Lesotho Hospital PPP, power generation and distribution PPPs in Albania, small independent power projects in rural Philippines, and a new airport terminal in Amman, Jordan. Roughly 40 percent of current advisory mandates are in International Development Association (IDA) countries.

Transactions typically take 18–24 months to complete, and IFC's success rate is about 40–50 percent (excluding active mandates still under way). Delays and failure to complete a transaction have an opportunity and morale cost on staff, so the department makes a considerable effort to glean lessons that will increase the success rate and speed up implementation.

### LESSONS LEARNED

*Lesson 1: Politics is (and will always be) the main cause of death for transactions.*

It may be vested interests who would lose from a transaction (especially a privatization) that eventually sabotage it. Or a government realizes that the project may not be acceptable to the public at the necessary tariffs. Or the transaction simply runs out of time to be completed before elections.

Political factors are the single most important impediment to success. Yet this is an area that IFC tends to pay less attention to, since most staff are primarily technicians. But ignore it at your peril. Here is some practical guidance to minimize political risk:

- Avoid taking on mandates within 12 (maybe even 18) months before elections, since most governments avoid anything potentially controversial close to elections (and some countries actually have laws that prohibit major new contractual obligations within a specified period before elections). Two of our successful mandates (Romania dialysis, Kenya telecom) completed tenders just two days before national elections. And the Moatize mining PPP was signed one month before elections. But one municipal client stopped a water project, citing concerns about water tariffs, just ahead of elections.
- Assess top-level political commitment before signing a mandate. Best if there is also a project champion with status and clout. Many of our successful transactions have had strong client champions and top political support, such as the Panama and Lima power

privatizations, Queen Alia International Airport in Jordan, Kenya-Uganda Rail, Kenya Airways, South African national parks, Polynesian Blue, and our small-power projects in the Philippines. In contrast, we had a failed airline privatization and a failed airport concession transaction due to the lack of high-level political support.

- Identify and assess vested interests who would lose from the transaction. Several of our projects in different sectors—electricity, water, transport, and health—never reached tender, primarily for this reason.
- Check in advance to determine whether provincial or local-level transactions need national buy-in. In one of our municipal service projects, we needed approvals at the municipal and national levels—an extremely lengthy process because governments kept changing. When we finally got approval of the bidding documents at both levels, the municipal government got cold feet due to upcoming elections and stopped the process.



SONEL power utility, Cameroon. Transaction closed in 2001.

- Work closely with the World Bank to provide the broader necessary perspective on country politics and economics.

*Lesson 2: Project fundamentals should be sound.*

Is the project needed (by the public), affordable (for consumers and the government), attractive (to investors), and legal (without new laws)? These questions seem obvious but can easily be overlooked in the rush to respond to a government request. It doesn't require a huge, lengthy analysis before signing a mandate, but some quick answers can be gleaned by:

simply unrealistic. In two Middle East and North Africa countries, we were asked by governments (unrealistically) to find PPP operators for new public hospitals that had been built (with external loans) but lacked funding for operations. Fortunately, we discovered this before signing a mandate and were able to back out gracefully.

- Seeing whether it can be done under existing laws. If not, try for a decree, regulation, or government decision, but don't count on new laws being passed to get it done. The absence of enabling legislation stopped our work on water PPPs in three different countries, though for different legal reasons in each case.



Polynesian Airlines, Samoa. Transaction closed in 2003.

- Checking investor (and lender) interest informally with a few local and international players.
- Doing quick back-of-the envelope calculations to see the project's impact on consumer prices or the government budget. We have rejected several requests from governments for airport concession transactions due to low passenger volume (in one case, fewer than 12,000 passengers annually). In two water projects in Africa and Latin America, we recommended against proceeding with the transaction after our preliminary analysis showed that the tariffs required for project viability were

- Doing some quick analysis on whether the project (service type, level, and location) is really needed by the public. Avoid the "white elephant" syndrome, driven by politics, not need. And check for other more cost-effective measures such as improving throughput (for example, ports) or efficiency in consumption (for example, water metering) or buying the service from existing private providers (for example, hospitals).

The scope of the PPP project is also important. In principle, the greater the risk and responsibility transferred to the private sector, the greater the



potential gains in efficiency and service quality (if well structured). Don't use PPPs solely as a financing technique to avoid public capital expenditures. But be aware that increased private sector participation and responsibility also tend to generate more opposition from public sector employees.

### *Lesson 3: Plan and manage your team and consultants for maximum efficiency and results.*

Transactions typically require a diverse team of financial and transaction experts (usually IFC staff); technical and sector specialists who can best determine project needs, sizing, and specifications; and transaction lawyers to vet the legal framework and put the project into proper contracts.

But getting the team in place, funded, and functioning as an efficient unit is not straightforward. Often the technical consultants and lawyers are funded in part through donor funds, which may take time to arrange. And hiring the consultants requires adherence to IFC procurement guidelines, which also takes time.

The data and information that IFC requires from its consultants for transactions are very specific and transaction-driven. So it is imperative to ask for only what is needed for the transaction analysis and contract documents. We're not here to do studies.

You can accelerate the transaction preparation and get effective results by:

- Obtaining donor funds before signing the transaction mandate (or in parallel with mandate negotiations);
- Compiling available client and project data before the consultants are on board, so they don't waste time searching for it; and
- Having a joint kick-off session with the team, the consultants, and the client team to set everybody off on the same track.

The global/local approach is crucial to success—both in signing transaction mandates and in successfully implementing the transactions. IFC's Advisory Services in Public-Private Partnerships was at the forefront of the global/local movement, setting up regional-based managers and local staff starting in the early 2000s. The results have been clear: many more mandates signed and better productivity (more mandates per staff). Being close to clients (in this case, governments) is absolutely essential for success. In many cases, an IFC local presence can help keep a transaction on track and moving quickly.

### *Lesson 4: Make the contract bankable and sustainable.*

There are really two hurdles in this business. The first is getting to a successful transaction. The second—and more important—is having it last. In practice, keep in mind several things:

- Check and recheck the risk allocation matrix with investors and lenders to get their reaction and identify any deal breakers early on. Don't stray too far from accepted international practices.
- Governments often have an unrealistic view of what they can get from investors and what they have to give up in return. Although it is the transaction advisor's job to communicate the concerns of investors or lenders (and identify unrealistic assumptions of the client), it helps to have investors tell the government directly. Nothing has the same impact as a major investor telling the government why it won't participate. The art in this business is separating the real deal breakers from the desirable-but-not-essential list. But, sometimes, clients don't take our advice. In a municipal water PPP in Latin America, we experienced two failed tenders due to unrealistic expectations of the municipality about what it could get from the market.
- Pay particular attention to the pricing and PPP payment structure and adjustment formulae. They

may well be the most important element of the contract for incentivizing performance and efficiency.

- A balanced contract and good regulation are the most effective tools for sustainability (and yet the hardest to achieve in many client countries). If a deal is too good to be true (for one side or the other), chances are it won't last. And if it depends on big price increases for consumers, it is probably doomed to failure. A major reason for the success and sustainability of some of our power and water transactions was our ability to close the transaction with the same, or even reduced, consumer tariffs (for example, the Panama power privatization resulted in an immediate 10 percent reduction in consumer tariffs).

*Lesson 5: Be sure there is transparency throughout the process.*

In all these transactions, IFC's reputation is most at risk if investors or the government believe that there has been favoritism or a lack of neutrality or transparency, particularly in structuring and implementing prequalification and bidding. Such a perception can result in lawsuits, negative press, and a tarnished reputation.

Transparency sounds easy, but in fact there are decisions throughout a transaction that affect the perception of transparency. Traditionally, IFC has followed a somewhat rigid approach that favors objectivity and simplicity over subjectivity and complexity.

How does this work? Typically, where there is a prequalification process as a precursor to bidding, we favor quantifiable and verifiable technical and financial criteria, such as "at least five years' experience as an operator of a water distribution company serving at least two million customers," or "net worth of at least \$300 million as of year-end 2008." But setting these criteria necessarily involves some degree of arbitrariness and can cause complaints, generally from local firms that are not big enough to prequalify on their own. True,

the decision on the precise prequalification criteria is the government's, not IFC's, but it is our job to advise the client on right-sizing the criteria for the project and on the implications of different criteria for who will prequalify and who won't.

Despite our best efforts to set quantifiable and verifiable criteria that will not be subject to dispute in interpretation, we often face interpretation disputes over such issues as accounting standards applied to financial criteria, the definition of an affiliate (and whether its experience counts), and so on. You can never completely eliminate the possibility of a complaint, but you can go a long way toward removing the possibility of interpretation disputes.

In the bidding, we have tended to favor price-only bids, with sealed envelopes opened and read in a public ceremony. This means no business plans, no technical proposals, and no other documents that could be subjectively evaluated (and hence prone to disputes) or later prove to be a hollow promise.



Suape TECON, Brazil. Transaction closed in 2001.

This approach works best for straightforward projects that are not very conducive to innovative technical solutions or major differences in approaches by bidders. The possibility for complaints and corruption is minimized, but at the cost of rigidity.

Increasingly, we are faced with complex projects where bidders may have valid differences in design and approach that should be considered and cannot be readily standardized into a price-only bid. It may be for a new airport (for example, Amman) or a new hospital (for example, Lesotho). In these cases, we recommended a set of criteria for evaluating technical proposals, which may be either pass/fail or weighted with the financial proposals. It's not perfect or completely objective, but rather a recognition that some projects are just too complex or innovative to suit a price-only bid procedure.

### *Lesson 6: Exiting—is there ever a graceful way?*

Our experience clearly demonstrates that the longer it takes to sign a mandate, and the longer it takes to implement a transaction once a mandate has been signed, the less likely it is that it will result in a successful transaction. And, as noted earlier, mandates that drag on will waste resources and hurt staff morale. Staff don't want to work on projects that take a long time and are not ultimately successful. But it may be hard for IFC to abandon a mandate if the government still wants to pursue it, since the government is also an IFC shareholder.

We have introduced three actions to address this problem:

- We spend more time on due diligence of a project's political risk and fundamentals before signing a transaction mandate. If a project has little chance of success, it is better to find out before signing the mandate (and therefore not sign it).
- We try to include additional monthly fees if the

transaction goes beyond a specified time frame (for factors beyond IFC's control). This signals at the time of mandate negotiations that time has a cost and we are not prepared to work on a transaction indefinitely.

- We are now including more explicit exit clauses in our transaction mandates; this allows IFC to terminate a mandate if it becomes clear that the transaction is not advancing or has little chance of success.

## CONCLUSION

When many of these factors go in our favor, we can have quick successes. One of our largest transactions—a \$950 million privatization of the electricity distribution company in Ceara State (Brazil)—was also one of the fastest: eight months from mandate signing to closing. Top political support, excellent counterparts, good tariff levels, and a sound legal environment all contributed. But when the negatives start piling up, mandates can drag on mercilessly for years without relief. Applying our lessons in mandate selection and execution can reduce—but probably not completely eliminate—these poor-performing mandates and increase our overall hit rate.

## ABOUT THE AUTHOR

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Approved by Laurence Carter, Director, IFC Advisory Services in Public-Private Partnerships.

February 2009

# The Value of the “Value for Money” Approach When There’s No Money

*Value for Money (VfM) is a technique used by advisors during the design phase of an infrastructure project with private participation to identify whether the participation of the private sector creates enough value for governments to offset the incremental cost of private financing. Primarily used in developed or middle-income countries—where there is more money and more options—a central question is this: Should we also use this tool for projects in low-income countries? I believe so, and in this SmartLesson, I will try to explain the use of this tool, using the experience gained during the design of a health project in Mexico, to show the benefits of the VfM tool regardless of the country.*

## INTRODUCTION

Starting from the beginning, why does a government look for a public-private partnership (PPP) to provide infrastructure? MONEY, either in the form of private financing or as savings created by the use of private management. PPPs are used on the basis of creating value from combining the strengths of the public and private sectors to provide a more efficient public service for the population (the ultimate goal).

Because of the limited resources and the current financial crisis, it is more important than ever to have solid transactions based on value creation instead of only using private financing. Because the VfM tool specifically helps to identify the value created for governments from private-sector participation, VfM can be particularly useful for low-income countries, such as those that receive assistance from the World Bank’s International Development Association (IDA), which provides financing for the poorest countries. In such countries, it is even more important to ensure that scarce resources will be used under the most efficient structure (including public works).

This SmartLesson is based on our experience in providing advisory services to the Institute of State Employees of the State of Mexico. VfM was used to justify why

a PPP structure was better than simply building two new hospitals with public debt. The VfM exercise was thus developed in conjunction with specialized consultants, different entities of the client, and the IFC advisory team.

## VALUE FOR MONEY: THE TOOL

VfM is based on a simple concept: Compare how much it would cost the government to build and run such an infrastructure facility if completed by the public sector (the reference project), versus the cost under a PPP scheme.

Costs for the reference project are compared to the costs of the PPP project, as follows.

<b>Reference project</b> (amounts should include VAT if applicable)	
Risks assumed	\$
Operating expenses	\$
Financial cost	\$
Equipment cost	\$
Construction expenses	\$
Construction cost	\$
<b>Total Cost of Reference Project</b>	<b>\$</b>



**Public-Private Partnership project**  
(amounts should include VAT if applicable)

Risks retained	\$
Operating expenses retained	\$
NPV of PPP payments	\$
Transaction expenses	\$
<b>Total cost of PPP project</b>	<b>\$</b>

The VfM is calculated by subtracting the total cost of the PPP project from the cost of the reference project; if the result is a positive number, then there are benefits to bringing in private participation.

**VALUE FOR MONEY: EXPLAINING EACH CONCEPT**

Both the reference project and the PPP project are based on the same assumption: cash flow from the government perspective.

*The Reference Project*

The calculation for the reference project asks how much the government will pay if the project is done as a public works project (including contingencies and risks associated).

**Risks assumed:** This number comes from the risk matrix and reflects the net present value (NPV) of all the possible contingencies weighted by a probability that they may occur during the construction and operational phases.

**Operating expenses:** This is the net present value of running the facility. In a hospital, for example, this would include staff salaries, the cost of medicine and treatments, building and equipment maintenance, etc., as well as the value-added tax (VAT), if applicable.

**Financial cost:** Based on the assumption that the government will issue a bond for 100 percent of the

investment (including expenses) to finance construction and equipment of the infrastructure, this number is the NPV of the interest payments for that bond issue. As an option, you can take the total cost of the last bond issued (including fees) and use that number.

**Equipment cost:** This is the cost of the equipment. In most cases, there is a component in foreign currency, so you should use the most appropriate exchange rate. This exchange rate should be the same for the PPP project. And don't forget about VAT, if applicable.

**Construction cost:** This is tricky. Here's my preferred approach to get this number: in this section, I put the "efficient" cost of building this facility; and for "efficient" I use the cost that a private-sector company under private contract would charge. Inefficiencies due to public procurement should then go to the risk matrix. This approach is simple, and the number will be the same under the PPP project. Another approach is to include the inefficiencies of public procurement in this calculation. The construction cost will be different under the PPP project and should include the cost of insurance for risks transferred. This approach obviously is more complex.

**One note:** The numbers that are net present valued should be discounted at the real discount rate of the project. However, this number is always under discussion. For example, projects done in Mexico at the federal level are discounted at a 10 percent real rate, while projects at the sub-national level are discounted at a 12 percent real rate.

**THE PPP PROJECT**

The calculation for the PPP project is based on the estimated total amount that the government will either pay or assume the risk to pay under a PPP scenario.

**Risks retained:** This is the net present value of the risks that the government retains (also include VAT, if applicable). The calculation comes from the risk allocation portion of the risk matrix.

**Operating expenses retained:** Depending on the services transferred to the private sector, this calculation includes the net present value of the operating expenses that the government will be funding. This is where most of the value can be created. Allowing the private sector to use its creativity, long-term vision, private management expertise, and smart investments, likely creates savings in the long run.

**NPV of PPP payments:** From the government’s perspective, there are two kinds of payments that should be considered here: (1) payments that the government makes directly to the private sector, such as availability payments and public funds to reduce private investments; and (2) payments made by the users of the service that are not directly received by the government because of the PPP structure (e.g. toll payments). In the case of availability payments, please be sure to include VAT, if applicable. Also, the data for availability payments come from the financial model. Such amounts should be calculated to cover the debt payment, operating expenses, taxes, insurances, and profitability of the private sector. Debt conditions usually vary depending on the financial situation; for example, for the hospital, we are assuming a 60 percent debt structure.

**Transaction expenses:** Because it is using a PPP structure, the government incurs expenses that under a public works structure would not occur—for example, the cost of advisors (such as IFC), specialized consultants, lawyers, etc. Therefore, such expenses are considered transaction expenses.

**BUILDING THE RISK MATRIX**

Creating the risk matrix to calculate the “total risks assumed” is perhaps the most challenging task, as it requires careful understanding of the project and the players involved. Building a risk matrix is based on four questions:

- What are the risks associated with the project?
- What will be the impact if such risks happen?

- What is the probability of the risks occurring?
- If the risks do occur, how frequently would this happen (daily, monthly, annually, etc.)?

In countries where we usually work, there are no formal data to use, so we have to rely on people’s knowledge and experience. Therefore, to answer these questions, the IFC team held a number of workshops with the client, external consultants, and those inside the government who could provide their knowledge related to public works, finance, planning, etc.

The first workshop was about defining the risks. We prepared an initial document with what we thought were the risks associated with the project. Preparation of this document helped us to be more efficient because at the workshop we were all on the same page. By going down the list, we asked the different people involved for their thoughts, and the ensuing discussion helped us to identify additional risks or omit those we had originally included. The key here is to ensure representation from all the relevant stakeholders and be sure to make a clear summary of the discussion.

For the hospital example, we categorized the risks into different groups to help ensure that we covered most of them:

- design risks;
- construction risks that could cause a cost overrun;
- construction risks that could cause a delay;
- risks associated with the equipment that could cause a cost overrun;
- risks associated with the equipment that could cause a delay;
- operating risks.

The second workshop was about determining the impact, probability, and timing of the risks. This was more complex than the first workshop because people had to be as honest as possible, since this is where inefficiencies were presented and measured. To encourage honesty, it is very important to let people

know that such inefficiencies are mostly because of the government’s way of working and not because of the people. During this workshop, the discussion is about magnitude and not about exact numbers. Because the magnitude must be translated into numbers, it is good to set up a standard way of translating this. For example, something that “always happens” means a 90 percent probability, while something not likely to happen is a 10 percent probability. It is also good to avoid the extreme situations of 100 percent and 0 percent because if a risk is identified as something that could happen, a 0 percent probability assumes that it will never happen. If something is 100 percent or 0 percent, then it is not a risk; it is a fact.

During the discussion, it is important to constantly go back to the participants and review the probabilities. Ask them if, given these numbers, such risk should remain with the given probability. In most cases, you will find that the group will adjust the numbers.

For consistency of the numbers, it is important to finish this workshop in one session and with the same people. Ask for two to three hours of discussion, and don’t let the session end without finishing the exercise. Although this exercise is not about getting exact numbers, it is important that there are consistent numbers in magnitude. To calculate the “total risks assumed,” you will need the NPV of the risks involved in the project and the time frame of when people think it might occur. To answer this question, we defined “moments”(which are at the beginning of the construction period, the end, and sometimes in the middle) by a percentage. For the operation phase, we did the same thing and defined moments either on a monthly or an annual basis, in a certain year, etc.

See Table 1 in the annex for a partial view of the risk matrix that we developed at the end of the first and second workshops.

The third workshop was about determining the risk allocation to calculate the “risks retained” number on the PPP project analysis. We started by reviewing the

NPV of the risks, and then allocated the risks borne by the private sector. To allocate these risks, try to use 0 percent and 100 percent as much as possible. For example, in our project, the public sector decided to keep doctors and nurses under the government’s control (hired by the Institute of State Employees of the State of Mexico), therefore bearing 100 percent of the risk and the cost if, for any reason, one of the doctors did not show up for work that day.

See Table 2 in the annex for a partial view of the risk allocation matrix for the hospital project.

## THE VALUE FOR MONEY TABLE

When we had all the different elements, the VfM table (see page 10) was completed showing our project with a positive value for money. During the exercise, the

Value for Money for the hospital project	
<b>Reference project</b>	
Risks assumed (VAT incl.)	\$968,139.50
Operating expenses (NPV)	\$3,481,930.72
Financial cost (NPV)	\$297,893.25
Equipment cost	\$205,620.17
Construction expenses	\$183,024.46
Construction costs	\$324,000.00
<b>Total Reference Project</b>	<b>\$5,460,608.11</b>
<b>Public-private project</b>	
Risks retained	\$321,278.60
Operating expenses retained	\$1,635,501.99
NPV of PPP payments (incl. VAT)	\$2,142,518.07
Transaction expenses	\$3,225.00
<b>Total PPP</b>	<b>\$4,102,523.66</b>
<b>Total Reference Project (a)</b>	<b>\$5,460,608.11</b>
<b>TOTAL PPP (b)</b>	<b>\$4,102,523.66</b>
<b>Value for Money (a-b)</b>	<b>\$1,358,084.44</b>
*Numbers were modified	

client realized that having doctors and nurses under the government's control represented over 40 percent of the risks retained (\$103,697). However, the client decided to go ahead with this project keeping doctors and nurses under government control.

## LESSONS LEARNED

*Lesson 1: The VfM tool helps to identify where value is created, but all the calculations must be inside the financial model to really help in the decision-making process.*

While doing the exercise, the client realized how much money it was losing because of the poor system for medicine control and limitations due to the union. It was at this juncture that the client decided to contract out administration of the medications to a private party even if the cost of the medicines was to be absorbed by the Institute of State Employees. To make this decision and adjustment, it was important to keep all the elements within the financial model and have them linked to the basic assumptions, as this helps keep the numbers updated and make it easier to manage the different scenarios of risk allocation.

*Lesson 2: Political consensus is critical. Having different stakeholders participate in the workshops helps to build it.*

Workshop activities are based on identifying areas in which the private sector is more efficient than the public sector; therefore, if discussions are not managed appropriately, they can become awkward. Worse yet, some stakeholders could block the project. To address this issue, the project team stated from the beginning (and repeated often) that inefficiencies on the public side are usually caused by the way the government works (e.g. annual budgets, changes in priorities, changes due to political interference, etc.). Because the team framed the challenges as a problem in the process and not caused by the people, the stakeholders were more confident in telling us the real numbers and supporting the project. In another example, we invited

members of the Ministry of Finance to participate in the workshops to allow them to take part in creating solutions and give them confidence that the VfM exercise was properly done.

## CONCLUSION

The VfM tool helps both the clients and ourselves to have a clear vision of which risks can be transferred to the private sector and which will be retained by the public sector. Having this information serves as an easy checklist when writing the legal contract, to ensure that all the transferred risks are really transferred and to help the public sector start thinking about measures to mitigate the effects of the retained risks—e.g. in the case of the cost of medicines, the client started to work on a structure to allow them to “share” pharmacies with their other hospitals to reduce inventory costs.

In addition, the VfM tool proved very useful in giving confidence to the client about the use of a PPP. Even though the state of Mexico had the resources, it was trying to improve its credit rating and still had considerable financial needs. With a limited capacity to take on new debt, the Minister of Finance needed to be confident that the best structure was used to build the two new hospitals.

One of the main criticisms of VfM is that the tool is extremely easy to manipulate. However, the value of the VfM tool is based on the confidence in its numbers. Having different stakeholders participate in the analysis workshops helps to ensure confidence about the numbers. Moreover, having participants from the Ministry of Finance gives total transparency. Ultimately, the use of this tool was important to the state of Mexico to ensure that its money would be well spent—a concern shared by other countries and in particular by poor countries, where resources are very limited.



# Annex

Table 1: Partial view of the risk matrix for the hospital project, developed after the first and second workshops.

Description	Probability	Impact (% base)	Base	Timing (when could it happen?)	NPV
<b>Construction risk</b>					
Change of design	70%	10%	Construction cost	75% Construction	18,360
Increase of scope	30%	20%	Construction cost	75% Construction	15,737
Lack of budget	10%	20%	Construction cost	65% Construction	5,341
Materials price increase	20%	15%	Construction cost	50% Construction	8,229
<b>Equipment risk</b>					
Exchange rate	20%	15%	Equipment cost	65% Construction	5,074
Delivery delays due to purchase order	30%	1	Monthly budget	65% Start	2,038
Installation works not ready	20%	2	Monthly budget	65% Start	2,717
<b>Operation risk</b>					
Failure to get certifications/permits	40%	10%	Annual budget	Start	13,376
Delay on having staff hired	20%	5%	Annual budget	Start	3,344
Delay on having staff trained	20%	5%	Annual budget	Annual	3,344
Availability of medical staff	40%	10%	Annual budget	Annual	<b>103,697</b>
Availability of support staff	10%	3%	Annual budget	Annual	7,777
Availability of medicines (pharmacy)	30%	10%	Annual budget	Annual	77,773
Pharmacy losses	50%	3%	Annual budget	Annual	38,886
Lack of maintenance of equipment	20%	5%	Annual budget	Annual	25,924
Lack of medical equipment	15%	5%	Annual budget	Annual	19,443
Obsolete medical equipment	20%	7%	Equipment cost	Annual	17,240

*Note: numbers were modified*

Table 2: Partial view of the risk allocation for the hospital project, developed after the third workshop.

Description	NPV	Risk Distribution (%)		NPV Distribution	
		Public	Private	Public	Private
<b>Construction risk</b>					
Change of design	18,360	100%	0%	18,360	-
Increase of scope	15,737	100%	0%	15,737	-
Lack of budget	5,341	0%	100%	-	5,341
Materials price increase	8,229	0%	100%	-	8,229
<b>Equipment risk</b>					
Exchange rate	5,074	0%	100%	-	5,074
Delivery delays due to purchase order	2,038	0%	100%	-	2,038
Installation works not ready	2,717	0%	100%	-	2,717
<b>Operation risk</b>					
Failure to get certifications/permits	13,376	50%	50%	6,688	6,688
Delay on having staff hired	3,344	65%	35%	2,174	1,170
Delay on having staff trained	3,344	65%	35%	2,174	1,170
Availability of medical staff	<b>103,697</b>	100%	0%	<b>103,697</b>	-
Availability of support staff	7,777	0%	100%	-	7,777
Availability of medicines (pharmacy)	77,773	100%	0%	77,773	-
Pharmacy losses	38,886	0%	100%	-	38,886
Lack of maintenance of equipment	25,924	0%	100%	-	25,924
Lack of medical equipment	19,443	15%	85%	2,916	16,527
Obsolete medical equipment	17,240	20%	80%	3,448	13,792
<i>Note: numbers were modified</i>					

## ABOUT THE AUTHOR

Juan Luis Flores joined IFC in 2007 and is currently a Senior Investment Officer for IFC's Advisory Services in Public-Private Partnerships, responsible for Mexico and Central America. Prior to joining IFC, Juan Luis was the Structured Finance Director for a Mexican commercial bank.

Approved by Richard Cabello, Regional Manager for Latin America and the Caribbean, IFC Advisory Services in Public-Private Partnerships.

May 2009



Centro Médico entrance, Mexico.

# Delivering the Goods: Multi-Donor Approaches to Project Development and Funding

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*Getting several bilateral and multilateral donors to collaborate on the development and funding of partnerships with the private sector can be a daunting task. IFC has, however, participated in such a partnership—the Private Infrastructure Development Group—which has successfully delivered results on the ground.*

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## BACKGROUND

In 2000, the UK government, through the Department for International Development (DFID), reached the conclusion that it made sense to use aid financing to help mitigate risks that constrained private-sector investment in badly needed infrastructure development, improvement, and expansion in developing countries. In seeking to develop an approach, DFID decided to bring in as many like-minded donors as possible so as to provide a single interface for both governments and potential private investors for the development and financing of infrastructure projects.

As a result, the Private Infrastructure Development Group (PIDG) was launched in 2002. The World Bank Group has been a member since its inception, first through the International Bank for Reconstruction and Development (IBRD) window and, since 2007, through IFC. Current members are Austria, Ireland, the Netherlands, Sweden, Switzerland, the UK, and IFC.

## THE APPROACH

Realizing that the in-house capacity in the capital markets sector ranged from limited to nonexistent on the part of most of the PIDG members, an approach was

adopted that sought to draw on available private-sector expertise and experience with project development and investment. At the same time, PIDG donors retain control of overall policy in order to ensure maximum developmental value and to limit any “subsidy” element to the absolute minimum necessary to mitigate risks that constrain private-sector investment. All donor members have a say on whether or not a new facility should be established under the PIDG umbrella, but those donors contributing to a specific facility lead the more detailed operational criteria for that facility.

The model that was developed was based on a standard commercial company approach, with donors setting investment policy and country/sector limits and the company’s board of directors making the decisions on individual investments within those policy parameters. Company equity is held by a trust fund established by the PIDG specifically for this purpose, and board members are selected and appointed by a nominated committee representing participating donors. Project identification and day-to-day company management functions are contracted out to commercial management companies recruited by open competition.

In order to have a single interface with which the board could interact at the donor level, and to ensure that all parties abide by the governing principles, the



participating donors convene biannually as a Governing Council, which is serviced by a program management unit tasked with day-to-day management of the PIDG and the implementation of council decisions. The diagram below illustrates the overall approach.

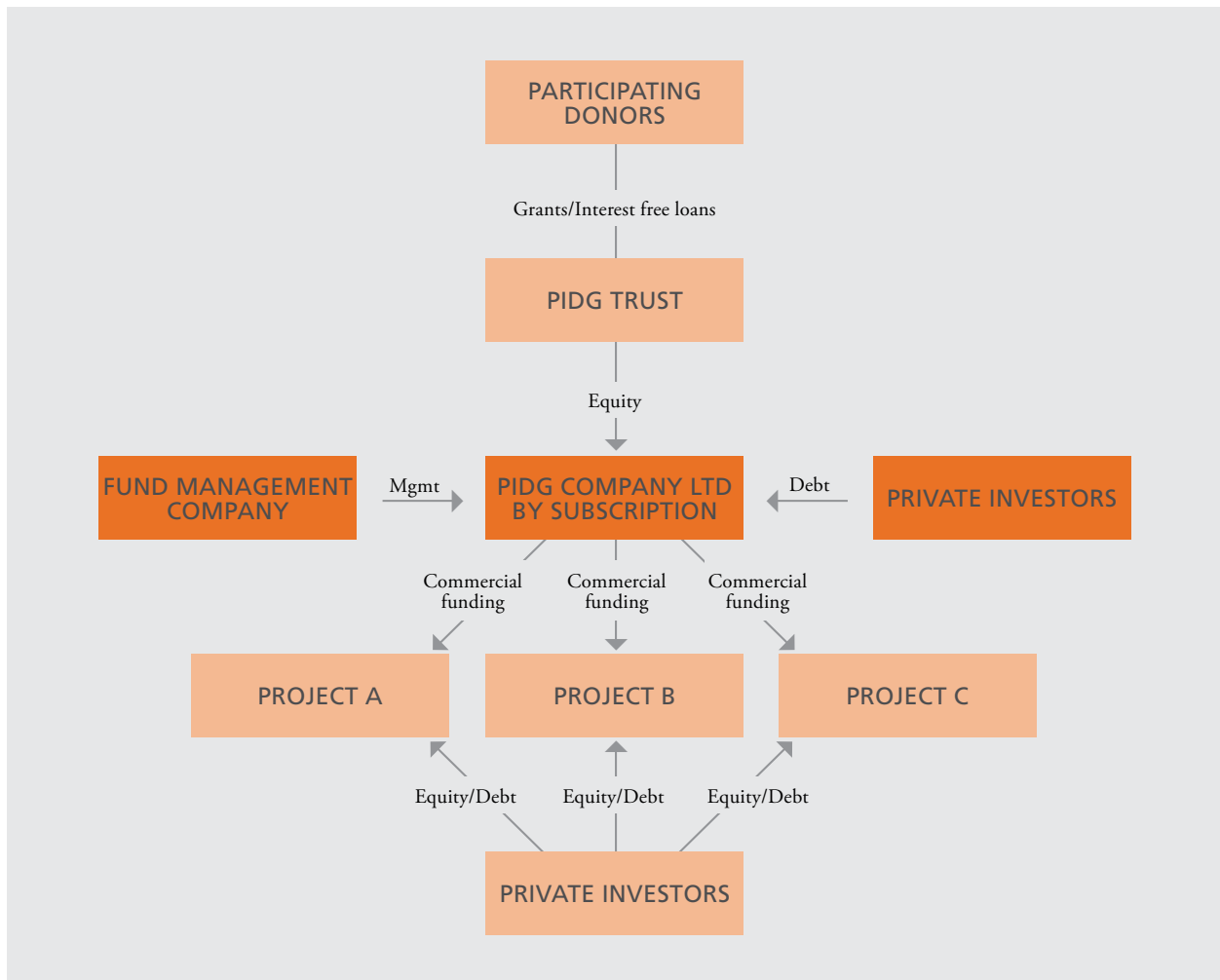
### OUTCOMES TO DATE

Using the above-mentioned approach, the PIDG has to date established three companies: Emerging Africa Infrastructure Fund Limited (EAIF) to provide long-term hard currency debt; GuarantCo Limited to provide local currency guarantees; and InfraCo Limited, a developer of greenfield investment opportunities.

In addition, the PIDG provides direct grant funding support to IFC's Advisory Services in Public-Private Partnerships through a specially established trust fund at IFC (the DevCo trust fund), which is used to pay for consultants who develop and take forward IFC advisory mandates. The PIDG also has its own technical assistance fund for local capacity building for both the private and public sectors in association with PIDG projects.

### RESULTS

As of July 2009, the PIDG donors had jointly invested a total of \$334 million in all the PIDG's facilities and operations. There were 30 projects to which loans/



guarantees had been issued by EAIF and GuarantCo, plus 15 projects developed by InfraCo and DevCo that had been successfully concluded with private-sector investors. These projects have included investment commitments of \$9.5 billion by the private sector, i.e. approximately 30 times the expenditure to date by the PIDG donors. (It also needs to be borne in mind that most of the PIDG donors' investment is in the form of equity through the PIDG trust fund, which is itself making a return.)

## LESSONS LEARNED

Over the seven years since the PIDG established its first company, a number of lessons have been learned as to what approaches work in setting up donor-funded private companies in the development sector, and the pitfalls that await those seeking to establish similar multi-donor mechanisms.

### *Lesson 1: Nominate a single donor to be responsible for developing a facility or company.*

EAIF was the first PIDG facility established (and therefore would generally be expected to take longer to develop). EAIF was initially developed and taken forward by DFID, with other interested donors “buying in” once the company was up and running. EAIF was launched in two years, from inception to full operation.



InfraCo Chanyanya Irrigation, Zambia

In contrast, the next PIDG facility to be developed (GuarantCo) was initially developed jointly by two PIDG donors. After three years, however, the joint development approach was abandoned because working with two governments—each with different rules, regulations, and drivers—proved difficult. GuarantCo was eventually taken forward by a single PIDG donor, with others “buying in” on completion, and was then fully operational within a year.

### *Lesson 2: Manage donor expectations with care: It's best to under-promise and over-deliver.*

In taking forward a new initiative, the project officer has an understandable tendency to use the most optimistic assumptions (often without fully spelling out the potential downside) in order to gain interest and investment from the donors. The project officer is faced with the twin problems of needing to forecast tangible results within the time scale of funding horizons (usually three years for bilateral donors) while operating within what is practical for a complex, innovative, and often untested initiative.

In the case of the PIDG, the first initiative (EAIF) got off to a good start because of a backlog of projects seeking long-term debt, but then it stalled from a predictable lack of suitable bankable projects. EAIF made no new loans for almost a year while efforts were made to identify new investment opportunities. This led to donors' disillusionment, which was difficult to overcome once business picked up and further equity was required. In retrospect, it would probably have been better to highlight this potential problem from the outset, but this was not done in order to encourage initial investment commitments.

In the case of InfraCo, donors made it clear from the outset that they would be seeking high developmental returns from the initiative. In response, a concept was adopted that specifically targeted a number of projects that would generate high direct developmental returns (as

opposed to indirect returns through increased growth). In practice, such projects have been difficult to develop, have taken longer than anticipated to bring to the point of sale, and are proving difficult to sell under current capital market constraints. The consequence is that donors are loath to increase equity inputs to InfraCo at a time when this is sorely needed, saying that they want to see results before making further investment. In retrospect, it would have been better to have made it clear to donors that, in order to achieve some early wins and thus demonstrate success, more straightforward projects (which would demonstrably bring quicker returns to investors) would be appropriate during the early years of the new facility.



EaIF Safel Roofing Project, Kenya

*Lesson 3: Make it clear from the outset that it is the company's board and not the donors who have the responsibility for project selection.*

During the early days, the PIDG was “feeling its way” with the donors, trying to take forward a concept (grant investment from aid donors in private development/investment companies) that was completely new to all involved. As a consequence, an arrangement was initially put in place under which all projects being presented to the companies’ investment committees would be submitted to participating donors on a 10-day “no objection” basis. This system soon became a constraint to project development because the donors

felt compelled to ask detailed questions about each and every project if they were to give their approval, and the 10 days became many weeks.

The donors were eventually persuaded to abandon the 10-day consultation period and to trust the decisions on project selection made by the boards, limiting donor (shareholder) inputs to holding the boards accountable for complying with the investment policy set by the donors. Much friction and many delays would have been avoided if such a policy had been put in place from the outset.

## CONCLUSION

There are advantages to all concerned (donors, developing countries, and the private sector) by providing donor support for the development and funding of private-sector projects in infrastructure (and other) sectors in developing countries through multi-donor approaches such as the PIDG. Bilateral donors, particularly those with smaller aid budgets, are able to participate in and guide multi-million dollar investment programs; IFC gains access to significant amounts of grant funding; and recipient-country governments and the private sector have a single interface with an experienced investment professional and a quick, non-bureaucratic decision on an investment request.

## ABOUT THE AUTHOR

John Hodges was Head of DFID's Infrastructure Department until his retirement in 2002, and Program Manager of the Private Infrastructure Development Group (PIDG) until June 2009.

September 2009

# DFID







## Lessons in Power



## Bringing Reliable Electricity to Rural Areas of the Philippines

*Electric cooperatives (ECs) in the Philippines are generally undercapitalized and their operational performance is poor. As a result, the supply of electricity in rural areas is unstable, with frequent outages and fluctuating voltages. IFC Advisory Services in Philippines found that a principal reason was the ECs' lack of sound capital expenditure (capex) plans and introduced a new product to address the issue. The results from the pilot training of six ECs in post-conflict areas of Mindanao will be replicated in all ECs in the country and will ultimately bring an estimated \$274 million worth of investments in capex and power generation, and reduce greenhouse gas emissions by 600,000 metric tons per year starting in 2015. To get to this point, IFC learned five key lessons about the importance of building strong relationships to "sell" ownership of the program to clients and pivotal stakeholders and to ensure program sustainability through local consultants and partner organizations.*

### BACKGROUND

Securing a reliable supply of electricity for rural homes and small and medium enterprises (SMEs) is a key ingredient in bringing economic opportunities to the country's least well off. In rural parts of the Philippines, electricity is delivered through a network of 119 ECs that account for seven million electricity connections, or 75 percent of total connections. The ECs' poor operational performance caused 10 percent productivity losses for SMEs. These inefficiencies contribute to the high cost of electricity, which, at \$14 per kilowatt hour, is one of the most expensive in Asia.

Under its Rural Electrification program, IFC's Advisory Services partnered with the Association of Mindanao Rural Electric Cooperatives (AMRECO), one of the country's biggest groupings of ECs. The Rural Electrification program aimed to strengthen the capacity of AMRECO's 33 member ECs to plan and manage their operations in a financially sustainable manner, particularly through capex investments.

The ECs are now trained to write sound capex plans that include demand forecasting and operational improvements. Capex planning refers to a five-year

program that systematically lines up projects to improve the operating efficiency of the ECs. The capex plan, a key element of the ECs' broader business planning, incorporates a financing and rate impact study. Such plans match demand with supply and distribution and present requests for rate enhancements before regulatory agencies. The realistic rates justify new investments to make ECs improve their operations.

Initially, six ECs participated in six months of training, which resulted in identifying the need for \$26.59 million in new capex investments in five years in these pilot ECs' electricity distribution areas. The capex plans so impressed the Energy Regulatory Commission (ERC) and the National Electrification Administration (NEA), which had met with little success in getting ECs to submit realistic capex plans, that they mandated the replication of the program in all of the 119 ECs that make up two of every three electricity connections in the country. The ERC promptly approved the six ECs' capex plans, whereupon another group of 16 ECs began similar training, with AMRECO acting as project leader. Thirteen of the ECs are paying the full cost.

On August 5, 2009, the heads of the NEA and ERC signed a memorandum of agreement with IFC Advisory Services, the Philippine Rural Electric Cooperatives Association (PHILRECA), the National Association of General Managers of Electric Cooperatives, and AMRECO to adopt the “Electric Cooperatives Distribution Utility Planning Manual” based on IFC-developed templates for capex plans submitted for ERC’s approval and as a vital document in the NEA’s supervision of the ECs.

At the request of the NEA and ERC, the IFC Rural Electrification team is scaling up its capex planning workshops to the rest of the country. IFC has agreed to train 30 of 86 rural ECs in Luzon and Visayas, the two other island groups that, together with Mindanao, form the Philippine archipelago. IFC will partner with PHILRECA, the “mother” association of Philippine ECs, and ensure its capability to train the ECs. The ECs are paying the full cost, as they expect the gains to far outweigh the costs. As a result of systems improvement from the training, the ECs’ total systems losses alone could be reduced by two percent, saving them \$28 million per year.

The following five lessons from the project may help facilitate capacity-building projects in other areas.

## LESSONS LEARNED

### *Lesson 1: Find a project leader who can secure client buy-in.*

Understanding the problem and coming up with the correct solution are essential to any intervention, but they are not enough. In rural settings, where decision making originates from or revolves around the dominant personality of one person, finding that particular opinion leader is paramount. In AMRECO, for instance, the views of the president carried so much weight in decision making that the Rural Electrification team made sure that he was briefed first and his suggestions heeded before a proposal would be made to the entire board.

In PHILRECA, the general manager was the one who had to be convinced first of a proposal’s merits.

After a thorough study of why ECs were not delivering stable and lower-priced electricity to rural areas, IFC determined that ECs lacked the expertise, particularly in engineering analysis and system planning, to come up with appropriate capex plans. This, together with the ECs’ inability to perform appropriate tariff analysis and their inexperience in justifying proposals for rate increases, prevented them from recovering legitimate costs.

The ECs were ill-positioned to secure long-term financing for their capex needs. Commercial banks had little understanding of ECs, and the ECs could neither package their requests with adequate feasibility support nor describe to the banks the true nature of EC credit risks and strengths.

The key, therefore, was to train the ECs in capex planning and in remedies for other critical deficiencies. IFC, however, took care not to impose the solution on the prospective client ECs. It searched for a competent trainer and found the ideal “relationship builder” in Jed Sevilla, who would later organize and manage the capex planning workshops and guide the ECs, step by step, through the process. Sevilla was previously the general manager of an EC in Sultan Kudarat province in central Mindanao. His technical expertise and relevant experience were known to the clients and earned their confidence. He also had close relationships with the relevant NEA and ERC officials. More critically, he got AMRECO and its member ECs to attend and produce masterful results that won the endorsement of the NEA and ERC. He also prepared AMRECO to become the subsequent trainer of other Mindanao ECs.

### *Lesson 2: Give clients a voice in the selection of consultants.*

IFC knows the right type of consultants for specific projects, usually better than the clients do, so IFC brings

this value as it makes the final choice of consultants. But it is helpful for IFC to shortlist the consultants and get the clients' input confidentially before making the final choice. The clients will then feel they have a bigger stake in the consultants' success and exert more effort to work harmoniously with them.

Contrary to initial beliefs that, if they were given a greater voice in choosing consultants, the ECs would be likely to choose those who were more congenial than technically competent, this did not happen. The ECs preferred consultants whose technical capabilities they were familiar with, having met them at the NEA-sponsored competency training for ECs conducted by the University of the Philippines College of Engineering.

In another IFC business line, a foreign consultant was chosen by IFC for his specific expertise, but he and the clients could not work harmoniously with one another, and a replacement had to be found.

*Lesson 3: Choose consultants and partner organizations that know the clients' specific culture and can be more accessible to them over the long term.*

The Rural Electrification team's work with the ECs proved that it is critical for consultants to have a good understanding of the cultural makeup and dynamics of clients. People from the West have a rather strict interpretation of time. Filipinos, on the other hand, have a more fluid concept of time. Local managers, particularly those from rural environments, often appear to be prognosticating or even negligent when, in fact, they are operating on a different psychological clock. Knowing this, IFC adjusted project time frames to factor this in. If they wanted the EC trainees to come in at 8 o'clock in the morning, the program had to say it would begin at 7 o'clock because attendees would habitually come in an hour late, with the senior managers arriving even later. IFC staff from Manila would avoid booking a night flight for the return home; they knew the proceedings would be delayed,

and they were better off departing the next morning. Often, the EC manager would say, "I will dig up those papers and sign them tomorrow; what's the hurry?" So the Rural Electrification team would work beforehand with his staff to prepare the papers and present them to the manager at the right moment, and he would sign them. "No problem. Let's go have dinner," the manager would say.

In some ECs, the managers have close kinship or long-standing personal ties with one another. This colors decision making and requires consultants who know how to work in this "family" environment.

Local consultants also provide the advantage of being available to work with the clients for a longer time than the IFC intervention. This helps ensure the sustainability of the program and its benefits.

*Lesson 4: Identify pivotal stakeholders and give them a sense of "ownership" of the project.*

The two regulatory agencies supervising ECs, the NEA and ERC, were pivotal. For some time, they had been trying with limited success to get the ECs to submit sound five-year comprehensive capex plans. Knowing these past attempts, the Rural Electrification team made sure that both agencies, as well as all previous players who had been helping the ECs, remained on board during the implementation of the project.

IFC presented the two agencies with the project design, objectives, and benefits and gave top officials regular updates, while seeking their suggestions and active participation. When the capex plans were completed, they were presented during an "ERC Engagement Workshop" to the ERC commissioners as well as to the NEA administrator and senior managers. Their inputs were sought and incorporated into the plans, giving the officials "ownership" of the project. This facilitated their approval of the ECs' capex plans and their adoption of the training outputs as the official template for training all 119 ECs.

Another major improvement, which the regulatory officials appreciated, was the fact that the capex plans were made comprehensive to cover five years, unlike the dozens of individual capex decisions that the ECs used to submit year after year for the ERC's approval. Before the IFC-supported templates, each EC submitted individual projects in various styles for every year. The ERC commissioners and technical staff had to pore over the submissions of 119 ECs, and this resulted in all sorts of regulatory delays and disapprovals.

*Lesson 5: Synergies with other IFC programs can extend the development impact and sustainability of projects.*

The Electric Power Industry Reform Act was passed in 2001 to end government dominance of the industry in favor of the private sector. The law sought to ensure adequate power supply so as to bring down the cost of electricity. Incentives were given to independent power producers, but for years there was little private-sector investment in establishing more independent power producers or improving their generation because the main off-takers for the electricity supply, the ECs, were seen as poor financial risks.

The Rural Electrification team synergized with the Sustainable Energy Finance team to create a two-pronged approach to bring a stable electric supply to rural areas and, in the process, to mitigate the effects on climate change. As the Rural Electrification team was helping the ECs prepare sound capex plans, the Sustainable Energy Finance team was supporting a leading bank in its plan to provide financing to the ECs' capex requirements. With these capex plans being approved by ERC, it would be easier for the bank to establish the risk profile or creditworthiness of the ECs' loan applications.

In the case of the Philippine archipelago's island groups and remote villages, the Small Power Utility Group (SPUG) of the National Power Corporation provides them electricity through small generating units that

either are connected to the main grid or are off-grid. A number of the ECs in the SPUG areas also took the capex plan training so they could become reliable and creditworthy distributors of rural electricity, which in turn provides an incentive for generators under SPUG to operate in remote areas.

## IT'S ALL ABOUT RELATIONSHIPS

Relationships are seen almost everywhere as being critical to the success of IFC programs. But the diversity of cultures and country situations requires that IFC choose program leaders and consultants who are sensitive, adaptable, and accessible in working with clients. Relationships also help in identifying synergies among IFC programs that would greatly contribute to their combined development impact. As IFC moves on to create other opportunities, the good, productive relationships it creates along the way ensure the sustainability of intended program benefits.

## ABOUT THE AUTHORS

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November 2009

# Five Keys to Powering Up a Private-Sector Participation Transaction: The Albanian Experience

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*Privatizing electricity utilities while policy and regulatory reforms are still ongoing may not always be advisable. However, IFC's experience with privatization of electricity distribution in Albania shows that when there is strong political will and commitment, when the process of privatization is well integrated with other reform initiatives, and when a fair public-private balance is maintained, it is possible to successfully introduce private-sector participation.*

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## BACKGROUND

Albania was a net power exporter at the beginning of the economic transition in the early 1990s, but growing demand turned the country into a net importer by 1998. Heavy reliance on hydroelectric production; the government's inability to mobilize adequate investments; mismanagement of the state-owned electricity utility Korporata Energjitike Shqiptare (KESH); and inadequate tariff levels made it impossible for the sector to keep up with the demand. Large-scale expensive imports further constrained the sector's financial stability. As a result, the country suffered from major electricity supply shortages associated with extensive and regular load sheds of 400 to 900 gigawatt hours per year.

To address the electricity sector's shortcomings, the government of Albania decided to undertake a series of initiatives that aimed to improve constraints in generation and interconnection, reduce dependence on hydroelectric production, and liberalize the electricity market. The government also decided to unbundle and privatize the electricity distribution sector, and in January 2007 retained IFC as its lead advisor in the process.

Privatization of the electricity distribution sector in Albania required restructuring the state-owned

electricity utility and establishing new market operators. Privatization also called for a number of policy and regulatory reforms to allow for a competitive electricity market, consistent with European Union (EU) requirements, and for a sound regulatory regime with proper energy pricing and tariff policies. Such reforms were far from being complete when the privatization process started. However, this offered an opportunity to introduce the right public-private balance in the newly drafted regulatory framework. The coordination among ongoing electricity reform initiatives and the integration of privatization with regulatory and legislative review helped structure the electricity market and the transaction in such a way as to increase potential investors' interest.

The strong political commitment and the partnership that IFC built with the government helped bring all stakeholders on board and accelerate the reform implementation process, without which the transaction would have never closed successfully.

The excellent cooperation between IFC and the World Bank also proved critical in achieving donor community consensus on major regulatory issues and in structuring an attractive transaction. The partial risk guarantee, a World Bank financial instrument designed to help governments mitigate political and regulatory risks,



helped to increase and maintain investors' interest in the process of privatization. Also of paramount importance to the success of the transaction were coordinating efforts by the U.S. Agency for International Development (USAID), which was heavily involved with electricity regulatory reform and market liberalization.

The transaction was completed successfully in May 2009 when the CEZ Group paid €102 million for the purchase of 76 percent of the Albanian electricity distribution company, Operatori i Sistemit te Shperndarjes (OSSH). CEZ is an electricity utility based in the Czech Republic. In the past decade CEZ has become a leader in the electricity market in Central Europe and one of the most profitable power companies in Europe, with a proven track record of turning around distressed power utilities.

## LESSONS LEARNED

*Lesson 1: When the optimum privatization structure is not feasible, it may be advisable to settle for second-best options.*

Privatization of electricity distribution utilities in developing and transition economies is often intended to improve the supply of electricity and service quality, reduce losses, and expand the distribution network by securing adequate investment that the public sector has failed to provide. However, some of the objectives of privatization may not be achieved in full when they are perceived by the private sector as unaffordable and unacceptable. In such cases, instead of striving to achieve the optimum results and risk transaction failure, second-best options should be adopted to secure a long-term partnership with a strategic investor and address all other privatization objectives.

The privatization package in Albania included the electricity public supply function, together with the distribution network, while the responsibility of securing an electricity supply to satisfy tariff customers' demands was allocated to the private sector. However,

discussions with power companies that had recently privatized distribution utilities in the region made it clear that under the current situation, the private sector would not be prepared to take on the risk of securing electricity supplies to satisfy customers' demands. All potential investors who attended privatization events in Tirana invariably confirmed that such a risk was unaffordable and unacceptable to the private sector. The uncertainties were many: volatile hydrology, fluctuating energy market prices, and doubts about the government's ability to complete the ongoing initiatives and undertake new ones to increase generation and interconnection capacities.

Under such circumstance, the second-best option was to divide the supply function into wholesale and retail. The risk of securing electricity supplies to satisfy customers' demands was allocated to the wholesale public supplier, which remained under government ownership. The retail public supplier, responsible for purchasing electricity from the wholesale public supplier at a regulated price and selling it to end consumers, was privatized together with the distribution system operator. This model was applauded by all power companies that met with the Minister of Economy and the IFC team in April 2009.

*Lesson 2: To ensure economic, social, and political sustainability of the transaction, establish a fair balance between the public and private share of interest and risk.*

When structuring a private-sector participation (PSP) transaction, allocation of risk among parties must be done in such a way as to ensure an increase in efficiency at the lowest possible cost. The process is not quite straightforward, as it is often difficult to determine which party can cover certain risks at the lowest costs; and occasionally portions of the same risk must be allocated to different parties. To achieve the desired increase in efficiency, the performance of the private operator is generally benchmarked against performance standards or indicators. In addition, a fair return on

investment is essential in order to secure the private sector's interest in the transaction.

In the electricity distribution business, the private operator is typically expected to improve efficiencies by reducing distribution losses, expanding distribution networks, and increasing cash collections. To ensure the private sector's commitment and reduce the risk of renegotiations, reasonable performance standards must be specified in the regulatory and/or transaction documentation. Such standards must be clearly defined and easy to monitor by the regulator or contracting authority. To allow for a fair return on investment and provide further incentives to the private operator to reduce distribution losses and increase collections, the performance standards must be measured against elements of the distribution and retail tariff calculation formula.

In Albania, the new tariff methodologies, drafted under the privatization framework, allow the distribution operator to make sufficient revenue to cover operating costs and investments, including the cost of energy purchased to cover technical and nontechnical distribution losses. The private operator was asked to commit to a loss reduction schedule as part of the privatization offer (see chart below).

While allowing a fair return on investment is important to attracting the private sector, the deal may prove to

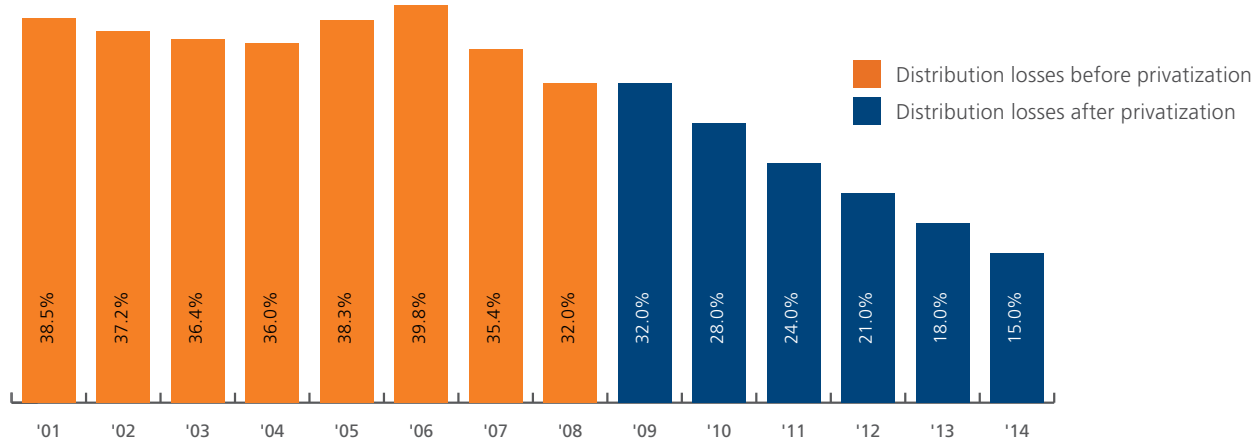
be both politically and economically unsustainable if tariffs are set at unaffordable levels. The adverse effect of unaffordable tariffs would also increase private-sector costs. Therefore, designing and implementing a satisfactory mechanism to protect vulnerable consumers is beneficial to all. In Albania, a deferred revenue compensation mechanism was introduced to prevent tariffs from reaching unaffordable levels.

*Lesson 3: Restore investors' confidence by effectively mitigating the regulatory risk.*

In recent years, private investors have shown reduced interest in the distribution utilities of developing countries. The number of bidders and, consequently, the degree of competition in similar transactions in the sector have been limited. The reasons for this include a weak institutional and administrative framework in the electricity sector, incomplete regulatory regimes and tariff policies, and the poor performance record of regulatory institutions.

To add to this, privatization of the electricity distribution company in Albania was initiated soon after privatization of the electricity distribution company in neighboring Macedonia. Continuous disputes over regulatory and contractual issues between the government of Macedonia and the Austrian electricity company (EVN), which had recently purchased the majority of the

*Figure 1: Distribution losses before and after privatization*



Macedonian electricity distribution utility, increased investors' sensitivity to regulatory and political risks in the region.

To restore investors' confidence, privatization efforts in Albania focused on establishing a sound regulatory framework, with proper energy pricing and tariff policies, and effectively mitigating the regulatory risk. The latter was achieved by introducing contractual political commitment and proper dispute resolution mechanisms. To this extent, the Regulatory Statement, a document that specifies tariff calculation formulas and key performance indicators, was attached to the share purchase agreement that was signed by the Albanian government and the winning bidder and then ratified by the Albanian Parliament. To further help mitigate the regulatory risk and backstop the government's commitment to the pre-agreed regulatory framework, the World Bank offered a partial risk guarantee (PRG).

The PRG is a financial instrument the World Bank designed a few years ago to help countries mitigate political and regulatory risk in order to enhance investor interest and reinforce confidence in newly established regulatory frameworks and institutions. It must be noted that the PRG cannot be put in place until the privatization agreement has been signed. The process of structuring the PRG and finalizing the necessary contractual agreements among the parties involved—the World Bank, the government, the investors, and the commercial bank issuing the letter of credit—may add to the time and costs of the transaction. This is why, if a PRG is needed to support the privatization of a distribution utility, it is best if the World Bank is involved as early as possible in the process.

#### *Lesson 4: Involve the private sector early in the process of policy and regulatory reform.*

Involving the private sector in the process of electricity policy and regulatory reform may help increase the chances of drafting an impartial regulation and structuring a PSP transaction that is attractive to

private investors. Potential investors' feedback may be as constructive as that of any other stakeholders, and will especially help with assessing how much risk the private sector is prepared to take.

To achieve this, traditional activities used for the recruitment of potential investors, such as market sounding or pre-bid conferences, are also used to discuss and get investors' feedback on major transaction and regulatory issues. As an example, an Investors' Roundtable, sponsored by USAID and organized by IFC in April 2008, not only informed potential investors about the transaction and the process, but also presented them with the new regulatory framework and asked for their feedback on key issues and risks.

All of the comments and recommendations received during this process highlighted some of the major issues that the government and the regulator needed to address in order to improve the regulatory framework and enhance attractiveness of the transaction. The interesting fact was that comments were provided not only from the companies that later participated in the tender process, but also from those that didn't. They gave disinterested, free-of-charge advice and shared their knowledge, views, and concerns on the electricity market model and distribution tariff methodologies. Making potential investors part of the regulation review helped strengthen their confidence in a transparent and professionally run process.

#### *Lesson 5: Resist government pressure to achieve rapid closure, and focus instead on the need to address all major issues.*

Governments in developing countries are often in a hurry to privatize and off-load loss-making, debt-ridden electricity utilities. In addition, political pressure from upcoming elections usually adds to the governments' desire to close transactions rapidly. For this reason, it is important to constantly assess and, where possible, resist the pressure by governments to achieve rapid closure by making them aware of the high risks associated

with offering a transaction that may not be ready for the market or rushing investors to submit their proposals before they have had an opportunity to properly assess all of the issues and risks.

To comply with clients' request for rapid closure and still address all major issues, it is often necessary to implement in parallel as many processes as possible and also to use synergies with other ongoing initiatives. However, the closer you get to election day, the more difficult it becomes to find the right balance between government pressure to speed up the process and the need to address outstanding issues.

As an example, despite everybody's efforts during the privatization process in Albania, there were still outstanding issues that could not be resolved by the bid submission deadline at the end of September 2008. The government was not prepared to move the deadline because of the general elections scheduled in June 2009. To overcome this obstacle, the IFC team identified the five most critical issues and convinced the government that potential bidders be allowed to make comments on them.

Introducing changes in the process and allowing for conditional bids at that stage was quite risky, but it was the only way to maintain bidders' interest in the process and satisfy the government's request to close the bidding process by the preferred date.

The five issues—the level of return on equity, the initial level of distribution losses, the purchase price adjustment mechanism, the property title, and long-term debt—were negotiated with the winning bidder and included in the share purchase agreement and the regulatory statement. Some items, such as the initial level of losses and the current level of bad debt, both of which needed extensive work and study, could not be defined during the negotiations. As a solution, the private operator was given the responsibility to complete, within the first year of operation, one study on the level of losses and one study on the age of the receivables. The two studies will be audited by

independent auditors selected by both CEZ Group and the regulator.

## CONCLUSION

IFC's experience in Albania shows that integration of the privatization process with reform implementation initiatives is of paramount importance in the effectiveness of transaction advisory work. From the beginning of an advisory mandate, it is important to obtain donor support as well as the commitment of the highest political levels in the country. This commitment and support must be maintained throughout the project to ensure successful implementation of the transaction and a long-term partnership with a strategic investor.

However, the long-term success of the privatization is still to be tested. It will take a few years before we know whether CEZ will be able to turn OSSH around. A major concern remains the regulator's ability to monitor OSSH performance effectively with regard to reduction of losses, increase of collections, and adequacy of the investment to upgrade the distribution network and improve the quality of service. It is imperative that donors such as USAID and the World Bank remain involved—the former with providing assistance to the regulator in implementing the new regulatory framework, and the latter with making sure that all parties follow the terms agreed to in the regulatory framework and privatization agreement as defined in the partial risk guarantee documentation.

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November 2009



Power lines bring electricity to rural areas of Albania.



# Ashta Hydropower: Turning a Doubtful Concept into a Technological Trailblazer

*IFC played a key role in helping the Republic of Albania structure and implement its first large public-private partnership (PPP) transaction in the energy sector, which brought a strong and reliable international investor into the country. Verbund, Austria's largest electricity company, won a 35-year concession to build and operate the Ashta plant—the first major hydropower plant built in Albania in 30 years. Verbund will invest more than \$220 million in the project, resulting in an expected savings on Albania's electricity imports in excess of \$45 million during the first five years of the plant's operation. But the project has not been without its challenges! From design to bidding to contracts, we learned what it means to persevere—as described in the SmartLesson below.*

## BACKGROUND

Some 30 years ago, Albania not only satisfied its own domestic electricity needs but also exported its surplus to neighboring countries. In contrast, it now experiences frequent power outages that affect the country's economic development and require it to rely on costly energy imports. Albania's power-generation system is based almost entirely on hydroelectric plants, the most important of which exploit the Drin River basin.

In February 2001, Albania's power utility, Korporata Elektroenergetike Shqiptare, contracted the China Water & Electricity Corporation (CWE) to build a hydropower plant on the lowest reach of the Drin River, at Bushati, on a turnkey basis. The CWE plan featured a diversion weir, a headrace canal, an aboveground powerhouse, and a tailrace channel conveying the turbine-design discharge of 540 cubic meters per second to the Buna River, some 4.5 kilometers downstream of its confluence with the Drin. However, this plan would affect the levels of Lake Shkodra (an important wildlife refuge shared by Albania and Montenegro), raising environmental and socioeconomic questions as

well as riparian-rights issues for the two neighboring countries.

In August 2001, the government suspended the CWE contract so that the German engineering firm Lahmeyer International (LI) could conduct an independent assessment of the plan's technical, environmental, financial, and economic feasibility. One of LI's suggested approaches envisaged reducing the tailrace channel length so as to discharge the powerhouse outflow back into the Drin River upstream of the Buna confluence, slightly decreasing the available head but eliminating most of the project's adverse environmental and social impacts, and avoiding riparian issues.

The LI study took only a few months, but there was no forward movement on the project until the fall of 2006, when the Albanian Ministry of Economy, Trade, and Energy (METE) retained IFC to:

- create a legislative framework that would be conducive to PPPs and reflect best international practice;
- help establish a PPP unit within METE; and
- identify, structure, and implement a pilot PPP transaction in the hydropower sector.

IFC drafted a new Concession Law, adopted in early 2007, and helped establish a PPP unit within METE. Afterwards, IFC studied the technical and financial viability of a number of potential hydropower projects, and concluded that a modified version of the original Bushati project, incorporating LI's approach to discharge the powerhouse outflow back into the Drin River upstream of the Buna confluence, offered the best prospect for a pilot PPP project in hydropower. However, there is no such thing as an easy hydropower project.

It took a lot of effort on IFC's part to persuade the government to move from the old design to the new design with a reduced capacity. To avoid confusion with the original CWE plan, the new project was named Ashta, after the village where the powerhouse would be situated under the new project design. In May 2007, the government approved the new concept as the first pilot PPP transaction to be implemented under the new concession law.

Between July and September 2007, IFC reviewed all previous studies and design work, refined the overall concept, and prepared a baseline design that could be realized on the Ashta site. This baseline design specified some elements of the plan as essential to its viability, leaving sufficient flexibility for private investors to present sound and innovative technical solutions within these clearly defined boundaries. Next came an Environmental, Social, Health, and Safety Screening Study, in line with IFC standards and Equator principles, and several rounds of public consultations with the affected communities.

In January 2008, the prequalification phase began, resulting in 12 submissions, 10 of which met the prescribed criteria. Nine international companies took part in a bidders conference in April 2008 and performed extensive technical and legal due diligence. In the following months, the IFC team pre-negotiated the tender documents with potential investors in a transparent and nondiscriminatory manner, incorporating some of their most substantial comments. During this

stage, the government's reluctance to assume or share any of the project risks became evident. Besides the hydrological, geological, environmental, and land-acquisition risks typically associated with hydropower developments, Ashta is totally dependent on the water releases from state-owned upstream hydropower plants and subject to a rudimentary regulatory framework (regulations on minimum ecological flows, water off-takes for irrigation, cascade operation rules, potential liabilities associated with existing structures, and so on)—factors that constituted an obstacle to potential participants, several of whom abstained from bidding. Those bidders that did not withdraw expressed concerns with these uncertainties and with the government's reluctance to address them during the discussion phase.

In June 2008, two international investor groups (Verbund of Austria and a consortium of Electrabel of Belgium and Compagnie Nationale du Rhône of France) submitted technical and financial bids. In early July 2008, Verbund was selected as the winning bidder, and the contract was signed two months later.

## LESSONS LEARNED

### *Lesson 1: Projects require definition—and sometimes redefinition.*

Hydropower plans are extremely location- and design-sensitive. Consequently, unless the project to be developed has already been defined to a degree sufficient to estimate with some accuracy its costs—including the expenses required to mitigate its social and environmental impacts—as well as its predicted benefits, it becomes impossible to consider a PPP approach until its engineering, economic, social, environmental, and other features have been properly established. In the case of Ashta, the concept had already been well studied, but it still was necessary to review previous findings by means of technical due diligence. As a result, IFC proposed a design that avoided the environmental and social flaws of the original Bushati

design. We also proposed renaming the project “Ashta” so as to provide it with a new “face” and cut links with the past environmental and social issues. This turned out to be a very good move and a great example of how proper marketing and management of public attitude can play a key role in making a project with a difficult history happen.

*Lesson 2: Something’s gotta give.... We have to understand the client’s objectives—and help the client understand what is realistic.*

Initially, the government wanted the entire output of the new hydropower plant to be subject to an off-take agreement between the future operator and the state-owned generation company. The government also insisted on having the highest possible installed capacity—in the 60 to 70 megawatt range—at the lowest possible tariff.

The reality in the case of a run-of-river plant, such as Ashta, is that there is usually a tradeoff between the maximum installed capacity and the minimum tariff level, since these plants lack a storage reservoir that would allow regular water releases and ensure optimal energy outputs. In practice, such plants benefit from economies of scale only up to a point: once the plant reaches the size at which it has the lowest production cost per kilowatt-hour, installing additional capacity simply increases the project cost without achieving correspondingly higher benefits.

The IFC team analyzed various alternatives and explained their advantages and drawbacks to the relevant stakeholders. Our estimates indicated that the lowest production costs per kilowatt-hour would be achieved with an installed capacity of 40 to 50 megawatts. METE finally agreed to have the off-take price as the most important evaluation criterion, so long as the total installed capacity was not allowed to fall below 40 megawatts. IFC’s assumptions turned out to be right, since the winning bid offered the lowest tariff at the installed capacity of 48.2 megawatts.

*Lesson 3: Don’t forget about the bidders: understand their concerns and work with your client to address possible issues.*

Being the most downstream plant on the Drin cascade, the Ashta plant is totally dependent on water releases from the plants upstream. So the winning bidder was understandably concerned that the state-owned generation company might retain water in its reservoirs for extended periods and release it at times when it would be most advantageous for energy trading purposes (for example, at peak power times). Since Ashta has almost no storage, extreme water releases upstream would spill over the weir without producing any electricity—negatively affecting the project’s economic performance and potentially causing extensive flooding of neighboring villages.

The IFC team assisted in drafting a Cascade Coordination Agreement between the winning bidder, Verbund, and the state-owned generation company, to ensure fair and transparent rules for cascade regulation and safety management. The agreement provides for regular water releases under normal flow, and sets clear rules for information sharing and crisis management in case of extraordinary events such as floods. Verbund considered this issue a deal breaker and wouldn’t have signed without the agreement.

*Lesson 4: It is extremely difficult to pre-negotiate a perfect contract that will fit all possible scenarios.*

In IFC Advisory Services, we usually try to pre-negotiate concession contracts with interested investors to the maximum possible extent prior to the bid submission date, so as to ensure transparency and avoid lengthy post-award negotiations (during which the granting authority is in a less favorable bargaining position). All prequalified investors are invited to submit comments to the contractual documents, which are then reviewed and accepted (or rejected) by the client and its advisers. This iterative process is usually done in two rounds,

combined with the bidders conference, where such comments are discussed with all prequalified investors in a transparent manner.

In the case of Ashta, many investors were reluctant to comment on certain technical aspects of both the concession agreement and the off-take agreement, fearing that they would disclose confidential information. As a result, the contractual documentation was fairly advanced from the commercial point of view, where all investors seemed to be in relative agreement, but was very general from the technical side. Technical language (such as metering, scheduled outages, construction process) was based on the baseline project design that IFC and its consultants prepared for the tender.

The winning bid presented by Verbund included an innovative solution based on the StrafloMatrix™ technology—a new concept for developing hydropower at low-head sites where dams, weirs, or canals already exist. Projects that may not be financially viable, based on conventional turbines and generators, may now be developed using this method. The StrafloMatrix™ design relies on a factory-assembled grid, or matrix, of standardized generating units. Complete modules, including all the associated mechanical and electrical equipment, are shipped to the project site, where they can be readily installed into existing structures with minimal civil works required. The advantages of this concept are its low investment cost, easy and inexpensive maintenance, and shorter construction periods, compared to conventional plants. Since this approach is new and original, we spent considerable time during the final negotiations reviewing and adjusting the project's technical details and the contractual terms to best reflect the peculiarities of the winning bid.

The principal lesson here is: when drafting and pre-negotiating contractual documents with investors, rather than getting lost in technical minutiae, the team should focus on the main commercial terms of the project, the major risks envisaged, and their allocation, as well as on a set of fair and transparent

evaluation criteria. Since you never know exactly what technical solution investors will come up with, a certain degree of contractual flexibility is desirable, provided it's fair to all parties. Details stemming from different technologies can (and in some cases must) be hammered out only after the winning project is known.

*Lesson 5: Technical and financial bids should be evaluated separately, but if the client insists on reviewing them simultaneously, you may have to get creative to maintain objectivity in the process.*

When evaluating final bids in an IFC Advisory Services mandate, we prefer to open the technical part of an offer first, to see whether it is complete, compliant with all the essential project requirements, and technically sound. If it is, the technical offer receives a “pass” score, and only then is the bidder's financial offer opened. If a technical offer receives a “fail” score, the corresponding financial offer is not opened, and the entire package is returned to the rejected bidder.

However, Albanian legislation required that both technical and financial offers be opened simultaneously and be evaluated using a predetermined set of weighted criteria in a comprehensive scoring formula.

To avoid subjectivity in the evaluation of the technical criteria, the IFC team recommended a binary approach whenever a simple and transparent grading formula could not be established. For example, an investor could receive either ten points or zero for “environmental and social acceptability of the project.” Since such a project feature is either acceptable or not acceptable (“pass or fail”), saying that one offer is “more” acceptable than the other and assigning acceptability grades for it is inherently subjective. (You can't be “partly” married.)

The only financial criterion used was the off-take price per kilowatt-hour of electricity produced, leaving no room for ambiguity. But since the legislation required technical and financial offers to be opened at the same

time, the evaluation committee started unintentionally leaning toward the best financial offer from the first moment. The IFC team insisted that the evaluation committee conduct a thorough technical examination of both offers before making any recommendation to the contracting authority. Several independent experts studied both offers in great detail for almost three weeks and, to the great relief of all parties involved, found both offers to be compliant and technically feasible.

*Lesson 6: Important issues not addressed in the early stages of the tender can have a potentially devastating effect later.*

During the transaction-structuring phase, our team made a number of recommendations regarding the risk allocation and the necessary changes to the regulatory framework required to make the transaction more attractive. The government, in an effort to shift project risks to the future concessionaire, initially refused many of the recommendations. Moreover, it also wanted to remove certain events (such as sudden tax increases) from the MAGA (Material Adverse Government Action) clause, putting the overall viability of the deal at stake.

At the same time, certain regulations (minimum ecological flow requirements, irrigation use of water, and so on) required further refinement to comply with commonly accepted standards. IFC warned the client that investors would need clear “rules of the game” for their financial modeling purposes (for example, a four percent versus an 11 percent residual flow requirement would have changed the economics of the project completely), but the government did not focus sufficiently on those concerns in the early stages.

As the tender progressed and the contractual documents were pre-negotiated, most of the prequalified investors raised those same issues. After several rounds of investors’ comments, the METE agreed to make changes to the contractual documentation (and to refine existing

regulations), thus essentially saving the deal. However, delays in addressing these issues in the early stages of the project shifted the timetable and possibly discouraged some investors from bidding.

## FINAL WORD: MAKING CHANGE HAPPEN

The Ashta hydropower plant is a great example of how IFC’s involvement can bring about real change by fostering innovative solutions. Our advice, perseverance, and out-of-the-box thinking helped turn an old, environmentally and socially questionable concept into a sustainable project using the latest technology in hydropower generation.

## ABOUT THE AUTHOR

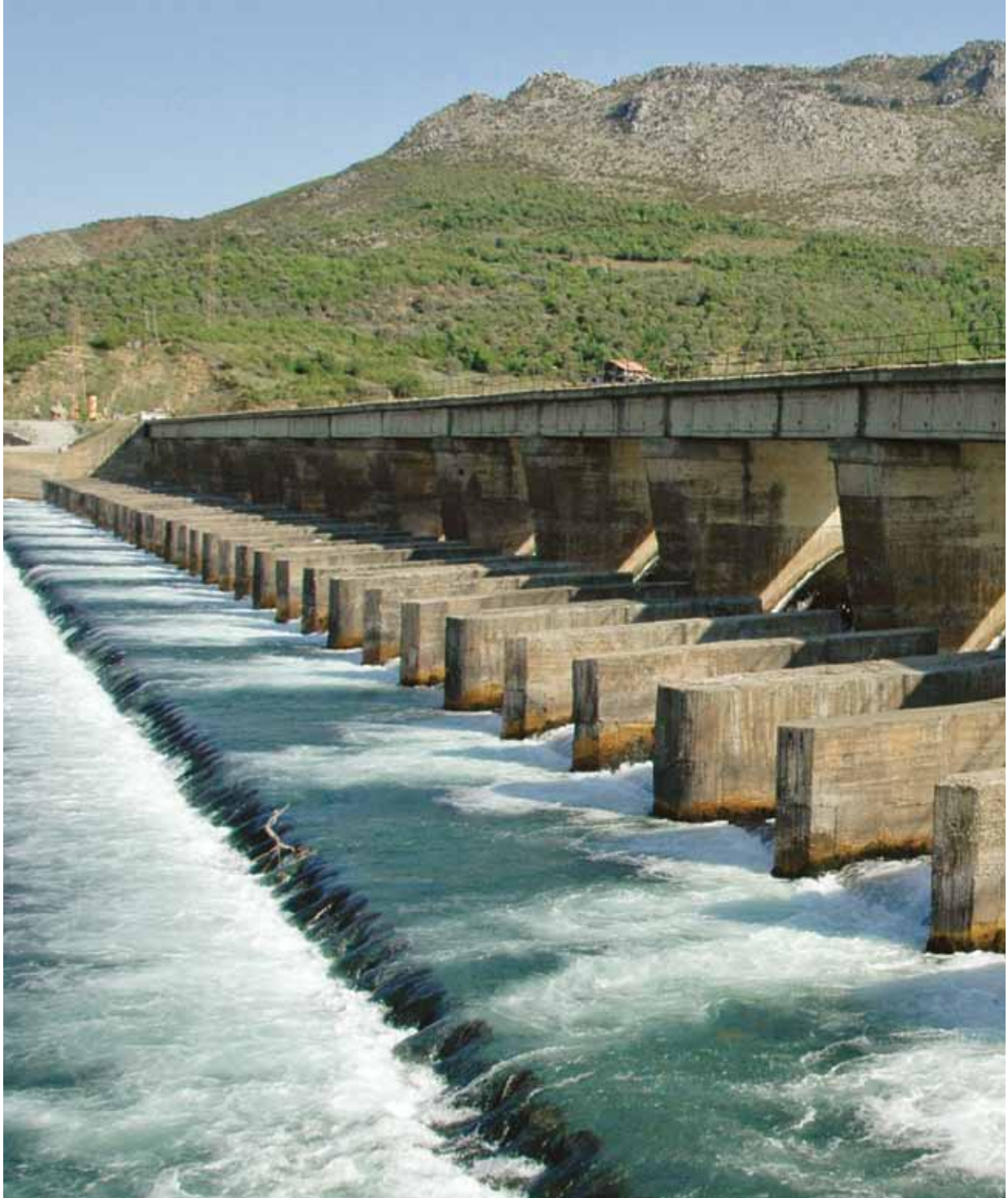
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The author would like to acknowledge Georgi Petrov and Nikola Mihajlovic for their valuable comments and contributions to this SmartLesson.

May 2009

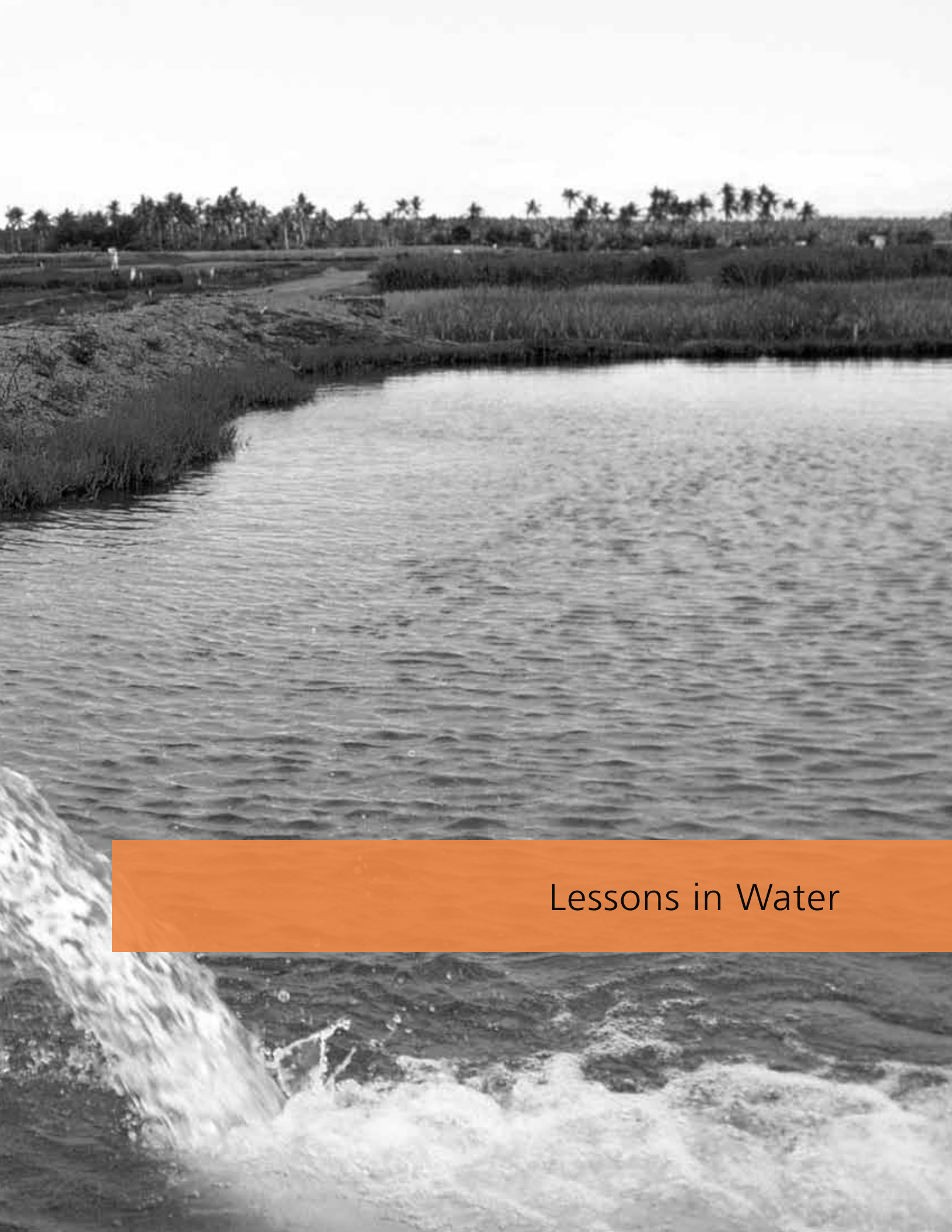




The Ashta run-of-river hydropower plant weir.







Lessons in Water

# A First for IFC!

## Desalination Project at King Abdulaziz Airport in Jeddah, Saudi Arabia

*The King Abdulaziz Airport (KAIA) Desalination Project is the first-ever transaction that IFC has advised on in the desalination sector. The successful transaction closed in June 2007, and this SmartLesson provides both a summary of the important aspects of the transaction to assist in knowledge management, and a series of lessons learned during the course of executing this mandate.*

### BACKGROUND

The General Authority for Civil Aviation (GACA) of Saudi Arabia appointed IFC as lead advisor to structure and implement a public-private partnership for a new desalination project at KAIA, the main international gateway and hub for Saudi Arabian Airlines. KAIA served over 14 million passengers in 2005, including the religious Hajj and Umrah traffic. It occupies 105 square kilometers, including four terminals, cargo facilities, a housing compound for employees, an air force base, and a dedicated nursery.

The city of Jeddah, with a population of about 2.8 million in 2006, faces huge water shortages. Because the local municipality was unable to supply water due to a lack of adequate production and network

around KAIA, GACA has relied on its internal (captive) desalination plants and funded and operated these plants using its own resources. Over the years, GACA built three captive desalination plants, with a total capacity of 33,000 cubic meters per day, out of which only one plant, with a capacity of 25,000 cubic meters per day, was operational (see Table 1).

All three desalination plants owned and operated by GACA were nearing the end of their economic life, and although Plant III was relatively new, it was poorly maintained. This resulted in an unreliable supply to GACA and a very high production cost. Moreover, water production was insufficient to meet current and projected growing demand, as shown in Figure 1.

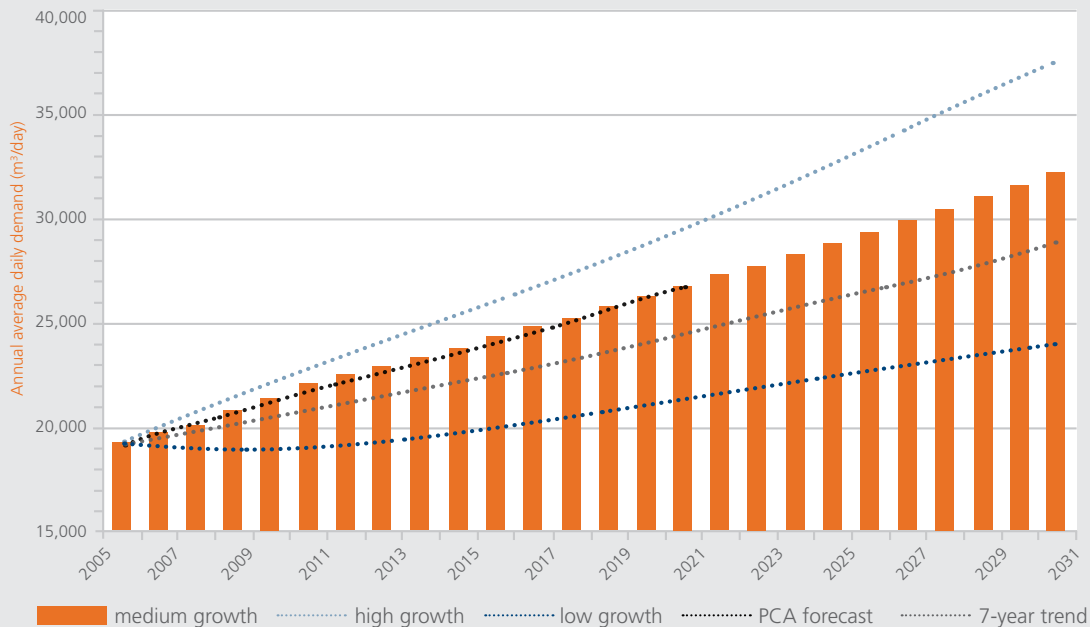
*Table 1: Existing capacity and projected demand as of 2005*

PLANT OPERATIONAL	PLANT I NOT OPERATIONAL	PLANT II 1978-2005	PLANT III 1997-2005	TOTAL
Design capacity m <sup>3</sup> /day	6,000	25,000	2,000	33,000
Actual capacity m <sup>3</sup> /day	0	25,000	2,000	27,000
Average production m <sup>3</sup> /day	0	21,298	0	21,298
Water production m <sup>3</sup> /day*	0	2,060	0.900	1.975

\*Excludes capital costs.



Figure 1: Forecast water production requirements (under different growth scenarios)



Note: The CAA forecast figures are adjusted to remove cooling and boiler water and take into account discussions with CAA.

## DESALINATION TECHNOLOGIES

There are two major types of desalination technologies:

1. Thermal technologies involve heating seawater and collecting the condensed vapor (distillate) to produce potable water. They require high energy for vaporization (phase change) and have a limited scale of operation. Examples of thermal desalination technologies include multistage flash (MSF), multi-effect distillation (MED), and vapor compression distillation (VCD).
2. Membrane-based technologies involve passing seawater through membranes to separate the salts, and then adding chemicals to produce potable water. Examples of membrane-based technologies include electrodialysis (ED) and reverse osmosis (RO). The basic difference between ED and RO is in how the membranes are used: ED uses an electric potential to move salts selectively through a membrane,

whereas RO uses pressure for separation, allowing the fresh water to pass through the membrane, leaving behind the salts.

## REFURBISH VERSUS BUILD NEW PLANT

The choice the IFC-led team faced was whether it was better to refurbish the existing MSF plant, which had a capacity of 25,000 cubic meters per day, or consider building a new plant using potentially a new technology. Based on a comparison of capital expenditures, production costs per cubic meter of water, the requirement of additional future capacity, and the environmentally friendly nature of the RO technology, IFC and its technical consultants advised that building a new RO plant made more sense (see Table 2).

Significant improvements in the RO technology over the last 10 years helped reduce the capital and operating cost of RO plants, contributing to the growing reputation

of RO as the most economical and environmentally friendly desalination method (see Table 3).

RO provides the following advantages:

- it is energy efficient;
- it requires lower capital cost;
- it is easier to maintain;
- it has the flexibility to expand capacity easily to meet demand; and
- it requires a smaller footprint.

## PROJECT STRUCTURE

Figure 2 depicts the project structure, and the following points summarize the structure's key aspects:

- GACA and the investor sign a 20-year take-or-pay water purchase agreement under a build-operate-transfer arrangement. The payment structure includes an output price and a capacity price (to cover fixed costs).
- The investor finances, designs, constructs, operates, and maintains a new seawater RO desalination plant

with an initial capacity of 30,000 cubic meters per day, increasing to 35,000 cubic meters per day in Year Eight, and decommissions the old MSF plant.

- Off-taker commitment is guaranteed through GACA's reliance on the project for 100 percent of water demand. Moreover, a credit enhancement through an escrow account of \$2.5 million is established and funded by the purchaser (GACA) to secure payment obligations to the investor.
- GACA provides the use and quiet enjoyment of existing infrastructure and project site for the duration of the contract, which is to be transferred back to GACA at the end of the contract.
- GACA is responsible for supplying electricity to the project.
- The investor is required to rehabilitate the site, since the footprint of the site will be much reduced under the RO technology. Because the site is in a very nice residential neighborhood right on the Red Sea coast, the investor is also obligated to beautify the site so that it is aesthetically better than before.

Table 2: Cost comparison: Refurbishment vs. new plant

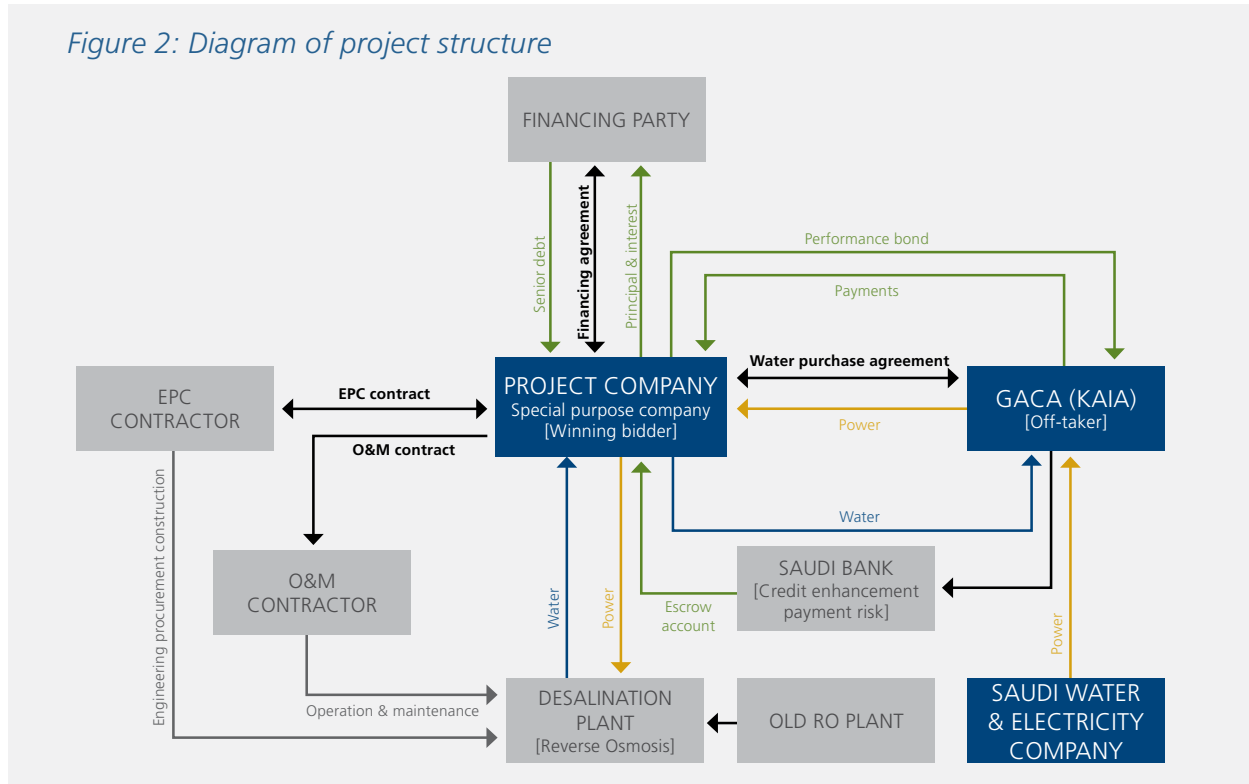
OPTION	CAPACITY (m <sup>3</sup> /day)	CAPITAL COST (millions)	PRODUCTION COST (m <sup>3</sup> )*
Refurbish MSF plant	25,000	26,000	\$1.95
		SAR 93.60**	SAR 7.02
Build new plant with RO technology	30,000	\$27.50	\$0.80
		SAR 99.00	SAR 2.88

\*Assumes a capital charge equivalent to an internal rate of return of 15 percent. \*\* Saudi Arabian Riyals.

Table 3: Comparison of the economics of the desalination processes

		MSF	MED	VCD	RO
Capital cost (m <sup>3</sup> /day)	\$	1,200-1,500	900-1,000	950-1,000	700-900
	SAR	4,320-5,400	3,240-3,600	3,420-3,600	2,520-3,240
Total production cost (m <sup>3</sup> )	\$	1.10-1.25	0.75-0.85	0.87-0.95	0.68-0.82
	SAR	3.96-4.50	2.70-3.06	3.13-3.42	2.45-2.95

Figure 2: Diagram of project structure



## KEY COMMERCIAL RISKS AND MITIGATING FACTORS

### Demand risk: Mitigating factors

- Take-or-Pay Agreement: GACA pays capacity payment, regardless of lower demand or consumption, throughout the 20-year concession period.
- Initial plant capacity is established based on medium-term, base-case demand; additional capacity installed in future tailored to actual demand growth

### Energy supply and price risk: Mitigating factors

- GACA is responsible for energy supply.
- Interruption of energy supply will trigger force majeure mechanism.
- Pass-through of energy price changes through tariff indexation

### GACA payment risk: Mitigating factors

- Credit enhancement of GACA's payments through an escrow account mechanism until GACA acquires sufficient credit standing.
- Credit enhancement mechanism is reinstated whenever GACA's credit standing falls below a minimum level.

### GACA performance risk: Mitigating factors

- GACA's obligation under Water Purchase Agreement (WPA) to make full payments based on Contracted Capacity should act as deterrent.

### Seller performance risk: Mitigating factors

- Prolonged underperformance allows GACA to terminate and buy the plant at cost of outstanding debt.

### *Seawater quality risk: Mitigating factors*

- Contract cost opener for material deviation of seawater quality (cost consequences to be reflected in tariff adjustments); dispute resolution through an independent expert.
- Force majeure affecting seawater availability will trigger force majeure mechanism under WPA.

## **BIDDING AND RESULTS**

The project proved to be attractive, and ten firms were prequalified from a total 16 applications. Of these ten firms, six submitted bids. Bidding was organized as a two-envelope procedure in which the technical bid was evaluated first, and only those bidders that passed the technical evaluation were invited to the commercial bid opening. The rationale for this procedure was to ensure that: (a) GACA obtained the best value for the water from technically capable bidders, and (b) the bidding remained as transparent as possible.

Since two of the six bids received did not pass the technical criteria, four commercial bids were opened. To select the winning bidder, the commercial bid was then evaluated in a public opening based on the lowest price of water quoted. The criterion for contract award was based on the lowest price of water delivered to GACA over the 20-year concession period (lowest evaluated bid price), as shown below:

**Evaluated Bid Price = [Base Capacity Price \* Annual Contracted Capacity (Years 1–20)] + [Base Output Price \* Annual Output (Years 1–20)]**

This formula was designed to discourage dishonest bidders from distorting the bid price by loading the capacity payment and not taking the risk on the projected output required by GACA (which was provided to the bidders) during each year of the concession.

Of the four Saudi Arabian and international groups that participated in the commercial bidding process in December 2006, the consortium led by SETE

Technical Services S.A. of Greece—in association with Aquatech International Corporation of the United States, Haji Abdullah Alireza and Company of Saudi Arabia, and WTD Srl of Italy—was selected as the winning bidder. Financial closure occurred in June 2007. With a 21-month construction schedule, the project is expected to become fully operational by March 2009.

The project significantly lowered the cost of water and introduced international best practices to operate the desalination plant at the airport, leading to a more sustainable and better-quality water supply for the airport. It is estimated that the price quoted by the winning bidder will save GACA about \$12 million per year as a result of technical, economic, operational, and managerial efficiencies, with a total net present value fiscal impact of \$401 million over the concession period. Savings are further increased when the capital costs avoided are taken into account.

## **KEY LESSONS FROM THE MANDATE EXECUTION**

### *Lesson 1: Risk allocation must be appropriate.*

It is important that a particular risk be allocated to the party best suited to assume it. An open and transparent dialogue between counterparties helps achieve appropriate risk allocation. It ensures that all issues and investors' concerns are brought to the surface and taken into consideration when formulating the structure of the transaction and the accompanying project agreements. It also reduces the probability of post-signing negotiations.

For example, investors—who are used to securing the counterparty risk, including payment risk and termination risks by sovereign guarantees—wanted GACA to provide such guarantees, which would have added at least six months to the timetable for approvals. But a fair-risk allocation in the concession agreement avoided the need for sovereign guarantees. With the



help of open and transparent dialogue and fair-risk allocation, we negotiated an acceptable structure that includes an escrow account for payment risks and an implicit undertaking of the Ministry of Finance through its support of GACA for the termination risk.

### *Lesson 2: A transparent bidding process is vital.*

To avoid any reputational risks for IFC, it is extremely important that the bidding process remain transparent. The IFC team made sure that all bidders were treated fairly and that the information was disseminated to all bidders. Due to the public opening of the commercial bid, the bidders were confident that no particular bidder would be favored, and the transparency of the process ensured credibility and produced a very good result for GACA. The losing bidders were all complimentary about the process.

### *Lesson 3: Commitment by the client is critical.*

Client commitment is a key factor and needs to be part of our initial assessment when deciding whether to engage in the mandate. All projects require difficult decisions and can face severe delays, or at worst may fail, if the counterparty is not committed to a successful outcome. We faced several challenges during the course of executing this mandate, particularly while negotiating the credit enhancement required for the project. However, GACA was committed to the successful conclusion of the project, so it understood the requirements of the private investors and made commercial decisions.

### *Lesson 4: Timing is key.*

Government approvals were delayed due to holidays (summer, Hajj, and Christmas) and to the steep learning curve, since it was one of GACA's first projects of this kind. Also, all bidders (as usual) asked for extensions to the bid date, and the client made some decisions that weren't timely. Although we completed the project in 18 months (from kick-off to bidding), we could

have saved four to six months had the client made timely decisions. We should build this sort of delay into our budgets and always try to fast-track as much as possible to help clients avoid excessive deliberation.

### *Lesson 5: Consultant selection is extremely important.*

Although we did not have any institutional knowledge based on past mandates in this sector, the selection of high-quality technical consultants gave us the necessary expertise. We were able to understand the technical dynamics of the desalination industry fairly quickly, thanks to the excellent work of our international and local technical consultants—a consortium of Nippon Koei (Japan), Richard Morris Associates and Chris Ricketson Associates (UK), and Dar Al Taqnia (Saudi Arabia).

## PROGRESS UPDATE

The project started commercial operations in January 2009—two months ahead of schedule. The investors were naturally incentivized to start commercial operations as quickly as possible because that meant they would get paid earlier.

### ABOUT THE AUTHOR

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Approved by Moazzam Mekan, Manager, IFC Advisory Services in Public-Private Partnerships, Middle East and North Africa.

February 2009

# Never Test the Depth of the Water with Both Feet: Lessons from the Sinking of the Bangalore Water Project

*Water—possibly the most important resource on earth—is also one of the most politically contentious. Public systems account for 90–95 percent of access to water and sanitation services across the world, yet their coverage is not universal, and the quality available is often questionable. Expansion of access to water—through improvement of public distribution networks or through private sector participation (PSP)—is a key component of the World Bank Group’s global strategy, though the project team leader and the policymaker have to tread this field carefully. Given that water is a public good, any suggestion of PSP is likely to raise suspicions in many quarters about its form and intent.*

*In a newly liberalizing and highly unequal market society such as India, the envisaged reforms under the Greater Bangalore Water and Sanitation Project (GBWASP) were scuttled precisely because of the suspicions and fears that PSP in the water sector can stir. The project is a study in how to manage and address these fears; valid or not, the sheer perception of inequity is potent enough to derail a potentially unique and successful project.*

## **GREATER BANGALORE WATER & SANITATION PROJECT: WATER UNDER THE BRIDGE?**

Bengaluru—the Silicon Valley of India—is the third largest city in the country by population and geographic spread, with a population of 5.3 million people in 2001. (Unofficial figures are closer to 10 to 12 million—a decadal growth rate of 61 percent!) This growth, spurred by the information technology boom, has inflicted a massive burden on existing public utilities. The city has grown administratively as well, incorporating 110 villages and eight municipalities to form Greater Bangalore. A 2002 survey of this expanded city by the Bangalore Water Supply and Sewerage Board (BWSSB) revealed that nearly 40 percent of urban households did not have access to water (see Box 1).

In 2004, the Government of Karnataka state appointed IFC as Lead Transaction Adviser to the BWSSB to

structure a public-private partnership (PPP) project to provide water and sewerage services 24/7 to the Greater Bangalore region. IFC was mandated to oversee the selection of a private firm to operate and manage the water distribution and sewerage system for the eight newly added municipalities serving approximately 1.2 million people, predominantly urban poor.

The World Bank-managed multidonor facility—Water and Sanitation Program (WSP)—and IFC jointly supported this project, which directly addressed issues of access to affordable and good-quality water for the urban poor. However, toward the completion and submission of the transaction structure design, the project was suspended in the wake of demonstrations against water-sector privatization generated by a similar project in Delhi (circa 2003–05) in which IFC was not involved. The project further suffered from slackened political support in the face of these protests, and eventually the traction was lost over time due to a high turnover of project champions in the government.

*Box 1: Access to water services intrinsically linked to the extreme poverty & disease burden*

- More than one billion people lack access to safe water. Close to two billion lack access to sanitation. Most live in low- and middle-income countries.
- Each year, nearly a billion people suffer from diarrheal illnesses caused by unsafe water. Millions more suffer from other water-related diseases. Poor people, especially the very young and the elderly, tend to be the most at risk.
- Safe water is scarce because it is often undervalued and used inefficiently.
- As a country's economy becomes stronger—as its gross national product (GNP) per capita rises—a larger percentage of its people tend to have access to safe water and sanitation.
- Thoughtful decision making by all user groups generally leads to improvements in the supply of safe water for all at affordable prices.

**LESSONS:  
THE BABY & THE BATH WATER**

*Lesson 1: Water wars in the media: Build a communication strategy.*

In a crucial infrastructure sector such as water, it is important to identify the right stakeholders at the right time and at all levels—the organization (engineers at BWSSB), community, civil society, and government. Policymakers and advisors alike must engage with them constantly, anticipate their concerns, and incorporate their voices into community outreach efforts and project structures. The GBWASP teaches us that such projects not only require commitment from political agencies, but must also be supplemented by a concerted, organic, and targeted dialogue derived from a broad-based stakeholder consultation campaign.

As water is a social good that is crucial for individual life and longevity, PSP in the sector sets off alarm bells. If advisors and decision-makers are so convinced of its efficacy in improving access, quality, and usage by those without this basic need, then that message must be honestly conveyed to the public. The end user should be

the primary focus, irrespective of “economic rationality” (a practically and theoretically challenged concept, anyway) when structuring such projects, especially when the restructuring of public utilities may result in increased user charges. To wit, solutions proposed must be socially, politically, and economically feasible, apart from being simply technically and financially viable.

Stakeholder participation workshops and dissemination strategies are paramount. All the media coverage the GBWASP attracted (see Box 2) indicates that the project team failed to communicate the benefits of the proposed project. The responsibility of advisors and policymakers to educate consumers about the changes that the PPP will bring to their lives exists throughout the project cycle. This process can help project teams sound out the solutions they propose and, ultimately, improve their project structures through feedback from the end user and other stakeholders.

*Lesson 2: Taming the rapids: Be proactive in managing the turnover of key champions.*

During an 18–24-month period, including the strategy phase of the project, there were four sequential chairmen

### *Box 2: The Voice of opposition in the media*

- “Will the operator be incentivized to provide the last mile to people who can pay little and live in hard-to-reach shanties?”—*India Together*.
- “...When faced with uncertainty, government’s response is to clamp down on information.... These are the old ways of wearing down the opposition, bulldozing people rather than really engaging them in genuine debate.”—*Janaagraha Publications: Advocacy Impact*.
- “International experience shows that privatization of ownership or management of water has led to increase in wastage, decline in water quality, increase in costs, and discontinuation of water supply when people cannot afford to pay the bills. A situation of mismanagement, underinvestment, and carelessness is wished away as a problem of regulation.”—*Times of India*.

of BWSSB and three Principal Secretaries of Urban Development (from the line ministry responsible for the project). Removal of the initial champions meant the project lost political traction over time.

Both the tumult of coalition politics and the unpredictability of bureaucratic assignments exacerbate the risk of non-completion of projects in India, despite the federal government’s growing level of PPP preparedness.

Alleviation strategies must be in place in the pre-implementation phase, including looking beyond the convenient project champion—someone who proposed the project or is not opposed to PSP in general. It is important to seek out other potential champions early on—from the technocracy, civil society, or other government ministries and departments—since they will gain greater salience during the implementation phase and ensure the delivery of a well-structured project based on consensus.

Building a phalanx of project champions allows to maintain continuity in the face of inevitable political churning, and sets in motion a consensus-building process for politically sensitive projects even before project commencement.

### *Lesson 3: Drop by drop, you fill an ocean: Focus on the promised deliverable!*

As advisors to governments, IFC and the World Bank should carefully analyze what level of PSP is adequate and feasible. In the case of GBWASP, the advisors were asked to focus on assisting the client to let a three to five-year management contract for the operation of the new periurban distribution system being built through donor funding. However, the recommendations of the advisors went beyond what was asked, and instead addressed the establishment of the PPP in the context of a 10-year vision of multistage privatization of the entire water and sanitation sector in Bangalore. This was well received, and indeed requested by senior bureaucrats and technocrats, but it was unnecessary and inappropriate in the context of the timing of the project—when suspicions about PSP in the water sector were particularly rife.

Before advisors present project structures to their clients, it would be useful to ask: Who is the audience? Not just knowing what they want to hear, but also recognizing what they can institutionally manage to implement with a view toward the securing of maximal benefits for the end user.

Advisors often face this challenge in cases where government capacity to successfully manage PPP



contracts is inadequate, or in the case of first attempts at unique project structures in unexplored sectors. However, the purpose of PPP project advisors is transaction advisory, and to simply wait around for regulatory institutions to emerge that can set the playing field right overnight is self-defeating. In the absence of enabling regulatory and institutional factors, it is important to integrate robust contract management strategies for clients with core transaction advisory work. This not only serves the sustainability of projects but also demonstrates commitment to ensuring the achievement of the longer-term development objectives that national governments and multilateral agencies have set for themselves.

#### *Lesson 4: Water, water everywhere: But which one's Indian?*

IFC was seen as an “outsider”—a fact that the various protest lobbies also exploited. As an organization with

182 shareholder member countries, IFC should strive hard to dispel the myth of its alterity and establish its identity as a multilateral organization where each member country is a stakeholder. Many saw IFC as bringing expatriates to India to advise Indians on how to better serve Indians through the managerial expertise of other expatriate firms. Small wonder that this message was then eagerly disseminated to consumers, and IFC was seen as paternalistic and in the service not of the government but rather of the of the private sector.

Under the GBWASP project structure, international PSP was proposed, which was not politically acceptable. Looking back, perhaps more time should have been invested in identifying indigenous solutions and capacities. Maybe the relevant expertise did not exist domestically, but addressing the concern of the various stakeholders was imperative, nonetheless. One could draw a lesson from Manila Water, one of the world's

Boy fetching water from a communal tap in Bangalore.



largest water privatizations, where in the absence of indigenous private sector capability, the Government of the Philippines imposed the legal requirement that the concessionaire be 60 percent owned by Filipinos. This suitably allayed stakeholder groups' concerns about a PPP not fostering technology transfer. The legal provision was designed to ensure that domestic capability would be increased as a result of the concession.

It would behoove advisors and policymakers to consider a plethora of options and configurations of potential international and domestic private sector participation. While developing potential investor lists, advisory teams could make a concerted effort to identify regional firms with niche capabilities and identify opportunities for more "South-South" collaborations.

### *Lesson 5: A ripple widening from a single stone: Think Global-Local.*

The GBWASP advisors were based out of Washington, D.C., with no continuous presence in the field. Though local consultants were appointed as well, a healthy mix of domain-knowledge experts (who could come in on an as-and-when-needed basis) and project or liaison managers in the field were needed. The best composition of a team for a project may mean that multilaterals distinguish between teams that generate mandates and teams that execute them.

IFC's decentralization initiative is well under way to counteract the perception of a distant and aloof paternalistic organization. Still, the experience of GBWASP reinforces the need to have projects managed by local teams with essential skills in the field—in project execution, client relationship management, and communications management.

### **CONCLUSION: EBB TIDE, THE RIGHT TIME TO EXIT?**

IFC Advisory support for GBWASP began in December 2004. The project closed in November 2007 without proceeding to the implementation phase. Considerable

time, effort, and money went into what has eventually morphed into a difficult legacy for IFC's Advisory Services in Public-Private Partnerships operations in India. It begs the question: When is the right time to exit, and what is the best strategy?

A high turnover rate of project champions and a tempest of angry anti-privatization voices were not healthy signs to begin with. The Delhi Jal Board project, with a similar design, had already come under severe attack, raising the question: Was this a losing battle all along?

The lesson perhaps is to consider whether multilateral agencies possess enough organizational flexibility to know when to throw in the towel.

### **ABOUT THE AUTHORS**

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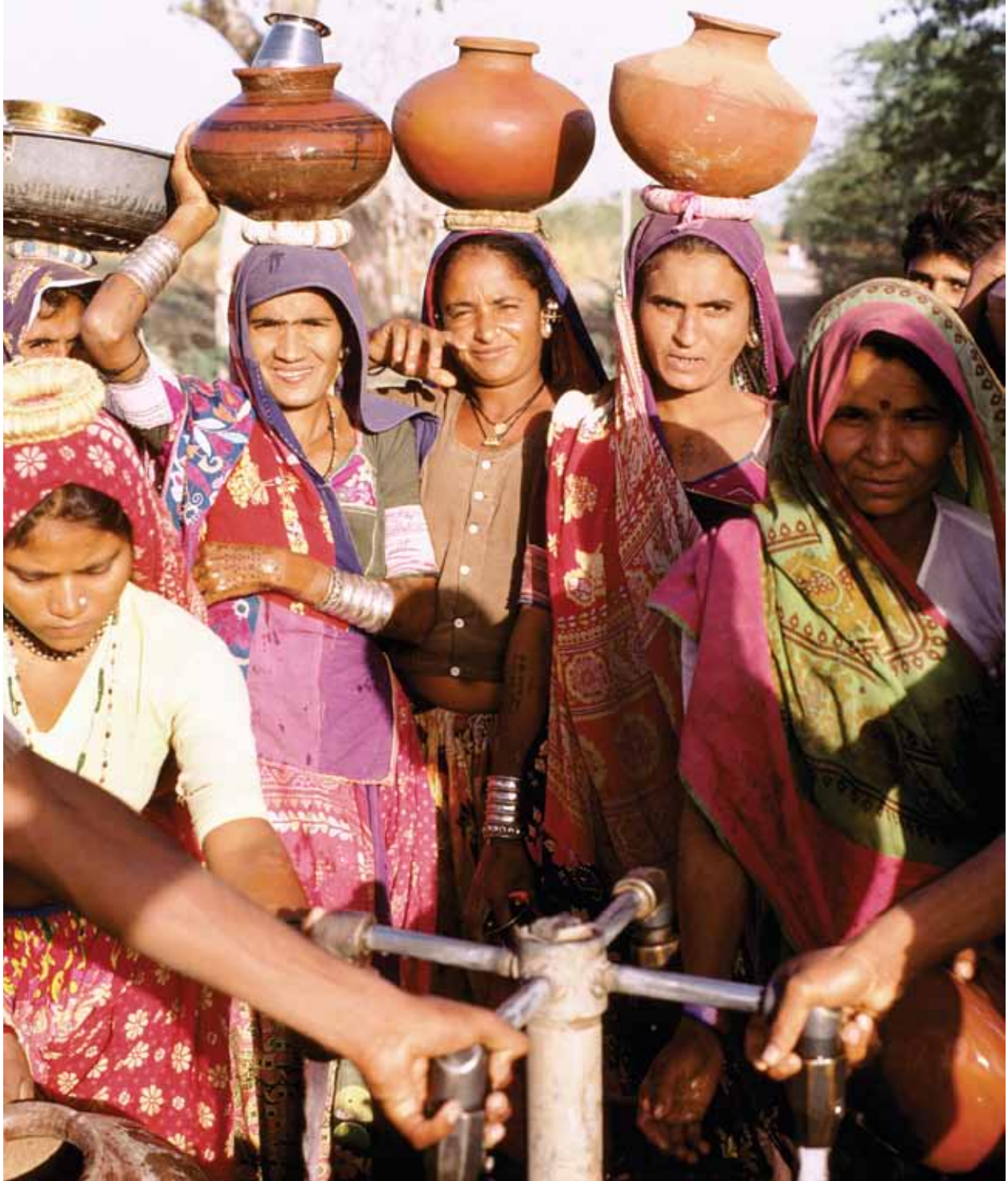
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The authors would like to thank Catherine Revels, Jerome Esmay and George Nugent for their comments and support.

May 2009





Women fetch water from a communal tap.

# Scaling Up Rural Water Supply Service in Benin: A Programmatic Approach and Budget Support

*People in rural areas of Benin have a greatly increased access to safe drinking water, thanks to government vision, donor support, and the investment and advisory assistance of the World Bank. In 2000, the government of Benin began preparing the ministries of key sectors for a shift from a project approach to a programmatic approach with enhanced budget support. The World Bank, through Budget Support Operations<sup>1</sup> and other donors, has supported Benin's reforms in budget preparation and management and in implementation of the country's Poverty Reduction Strategy Paper. The Ministry of Rural Water Supply was part of this move, and Benin is on track to meet the Millennium Development Goals (MDG) target for its rural drinking-water supply. This SmartLesson shares how the World Bank contributed to Benin's remarkable progress in this sector, and what we learned along the way.*

## BACKGROUND

Initially, the World Bank's Budget Support Operations (BSO) series was intended to support the implementation of Benin's Poverty Reduction Strategy Paper with concessional financing through the national budget processes. These operations focus on key policy and institutional reforms in priority areas and are designed to assist the government in establishing priorities and implementing a rolling core reform program. The program contained policy measures and outcome indicators for each operation. Then a gradual transition toward a consolidated programmatic approach was launched at both government and sector levels.

The first reason for including rural water supply (RWS) in the BSO was to enable the Ministry of Rural Water Supply to continue to benefit from World Bank support, since no new project could be prepared. The second reason was that all of the sector stakeholders viewed policy dialogue through the BSO as the way to improve overall planning; strengthen relationships with the

Ministry of Finance; boost reforms of a difficult sector; strengthen harmonization and alignment of donor interventions; and develop an effective monitoring and evaluation (M&E) system.

The government RWS reform program included: (i) implementing a sector-wide approach; (ii) improving budget planning, execution, and monitoring through a medium-term program budget; (iii) increasing access to a reliable, affordable, and sustainable provision of water services; and (iv) improving the governance and management practices for the small piped-water systems through a local public-private partnership (PPP) arrangement.

As a result of all these efforts, Benin is on track to meet the MDG target of a 67 percent rate of access to potable water by 2015. Since 2001, the government has made significant progress in increasing the rural population's access to potable water (from 33 percent in 2001 to 49 percent in 2008), and the sector execution capacity has been multiplied fourfold. In 2004, for the first time ever, Benin constructed more than 1,200 water points, against a target of 700; in 2008 it constructed more than 2,000. More than 500,000 people gained

<sup>1</sup> Adjustment Credit (PERAC) and Poverty Reduction Support Credit (PRSC 1–6).



access to safe water in 2008, against fewer than 100,000 in 2001—an outstanding performance in scaling up investment, since over the previous two decades no more than 500 water points were constructed annually. Also, the water-facilities functionality rate improved from 77 percent in 2003 to 87 percent in 2006, due to better post-construction follow-up (see Figure 1).

## LESSONS LEARNED

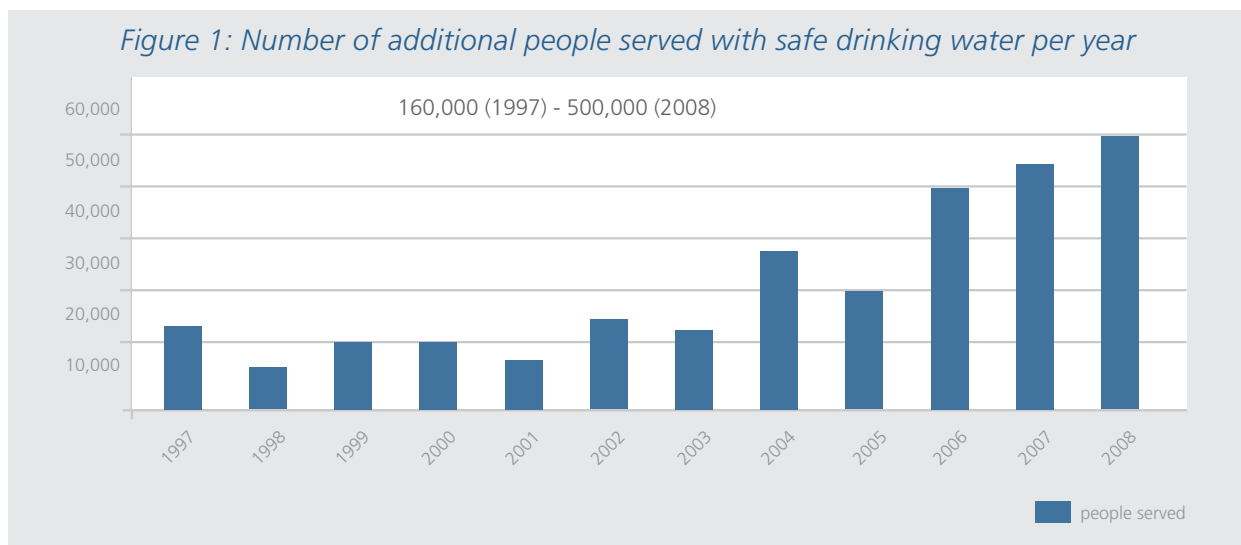
### *Lesson 1: Focus on sector planning first.*

Generally, the rural water-supply sector is heavily dependent on external financing and is supported through multiple donor projects, but coordination and planning are weak. Introducing a medium-term program budget and MDG roadmap can make a big difference. Including these new planning tools prior to the second World Bank BSO had a great impact on the sector stakeholders’ practices, and ultimately on the performance of the sector as a whole. The sector program budget was used as an inclusive planning vehicle for all stakeholders, including the Ministry of Finance. The program budget became the reference framework for strategic and operational programming and for the monitoring and evaluation of all sector activities. All projects or capacity-building activities were de-

facto included in the program budget, discussed, and validated by the Directorate of Water and the donors.

Also, we supported the development of a roadmap setting out clear annual targets for the acceleration of physical service delivery and financial investment/expenditure to achieve the MDGs in 2015. In Benin, the target was delivery of at least 1,350 new water points per year from 2005 to 2015. This roadmap provided a clear plan—a critical step toward harnessing the efforts of all sector players and promoting collective and coordinated action toward achieving the MDGs. Also, involvement of communes and regions in the formulation of investment plans and budgets has increased progressively since 2002. In addition, a procurement plan and an annual work plan were prepared along with the program budget.

Introducing a planning procedure based on objectives generates a strong dynamic of responsibility, accountability, and results. In Benin, all programs and projects were consistent and aligned with the country’s national development strategies, regardless of their modes of financing and implementation. Donor contributions to capacity building in the sector have increased. The program budget has been critical in shifting the focus from a project approach to a programmatic approach in the RWS sector. At



the same time, it has contributed considerably to improved communication and coordination among donors, predictability of funding, harmonization of donor objectives, monitoring, and alignment with country systems. And it has optimized the impact of both government and external financing.

This experience also has had a demonstration effect, with the program budget and the RWS sector roadmap being introduced in other countries: Burkina Faso, Madagascar, Mali, Mauritania, and Rwanda.

### *Lesson 2: Develop an accountability framework, including a credible M&E system and participatory reviews.*

First, to properly track physical achievement and financial disbursement, it is important to define performance indicators. But keep it simple—and make sure there are internal resources and capacity to sustain the M&E system. In 2002, the Ministry of Water put in place an M&E system in Benin which has been continually improved over time to capture the physical and financial progress made by the sector. Indicators were simple and sufficient, and the processes for gathering and storing information were clearly defined and easily implemented. The system includes a central database for water points and an information system for financial management. Annual program execution reports were improved over the period and produced in time to be presented to the Ministry of Finance and at the joint government/donors annual sector review.

Second, the participation of all stakeholders is required in reviewing the progress achieved in implementing a national program. This is an excellent way to ensure transparency and build confidence among partners, including all donors—non-governmental organizations, the private sector, and several sector ministries. In Benin, the process strengthened sector coordination and efficiency. It included three types of sector meetings: (i) a bimonthly group meeting of donors; (ii) an annual

sector review with all stakeholders, generally in May, to review progress in national program implementation against the agreed target, exchange best practices, and discuss the way forward; and (iii) another meeting organized in September by the Directorate of Water to discuss sector budget allocation and the next year's program. Those meetings have seen the involvement of all donors and have led to a greater percentage of donor funds reported in national budgets since 2005.

The Benin experience is a good example of the need for this sort of framework. Initially, the sector had four major sources of external financing: DANIDA (Danish International Development Agency), KfW (Kreditanstalt für Wiederaufbau, Germany's development bank), CTB (Coopération Technique Belge, Belgian Technical Cooperation), and JICA (Japan International Cooperation Agency). Since 2004, two more have been added: AFD (Agence Française de Développement) and AfDB (African Development Bank). Funds have been flowing more predictably (from central to local entities) since 2004, thanks to the implementation of the program budget and increased donor information and coordination. Total funding for the rural water-supply sector has increased by 214 percent over the past six years—from \$14 million to \$44 million. However, the percentage of project funds flowing through project implementation units has not gone down because donors would like to see tangible budget-support results in the field before shifting completely from the project approach to budget support.

### *Lesson 3: Be smart in using budget-support leverage.*

Generally, a ministry's operating budget is not sufficiently robust to handle pure state tasks, such as carrying out proper planning, improving national procedures, and ensuring proper post-construction activities. So, in order to ensure greater sustainability for the sector, BSO leverage is necessary to increase the operating budget and overall domestic funding—a key issue we had to address in Benin. Then, in 2001–02, the operating

budget increased from \$50,000 to \$1.5 million, and the budget for investment increased from \$1 million to \$5 million, due to intensive discussions between the Ministry of Finance and the Ministry of Rural Water. These discussions, directly facilitated by the World Bank team, constituted a critical step in helping the RWS sector adjust the amount of operational budget for the sector's needs, and these amounts have been increasing.

Another example of our having to use the leverage provided by the BSO was implementation of management reform for the rural piped-water system. Introducing a local PPP arrangement for improving the management and sustainability of the water-supply systems of small towns was one of the most difficult reforms to achieve in Benin. All of the stakeholders talked about it for years, but nothing really moved. Then, a decision to require implementation of the sector reform as a prior action for the third World Bank BSO played a key role in moving the reform process forward. As of 2008, 23 percent of the small-town water-supply systems are under PPP arrangements.

*Lesson 4: Review and address quickly the sector bottlenecks—and understand other factors beyond the sector.*

It is important to thoroughly understand the overall situation. In Benin, a public expenditures review that we conducted with DANIDA revealed a number of critical issues to be addressed. For instance, financial management systems and procurement were flagged as major areas for improvement. So we prepared an action plan that included implementation of a rigorous tracking system of all the contract procurement steps and a strong boost to the decentralization of procurement to the regions. This action definitely led to a progressive increase in sector absorption capacity.

This transition toward further decentralization of service delivery, including procurement, was facilitated by the introduction of a prior action in the fourth BSO. As a

result, 29 percent of the budget was delegated to the decentralized level for sector operational expenditures in 2007, and over 90 percent of contracts are now procured at the local level within 75 days. However, continued efforts are needed to speed up the procurement process and increase the budget execution rate.

But just fixing the sector bottlenecks is not enough. Successful implementation of the programmatic approach involves a number of other factors, such as strong government buy-in and ownership, sound budgetary reform, alignment of strategies, effective donor coordination, and a sound analytical basis. It should be noted that other reforms and prior actions included in the World Bank BSO strengthened public procurement, improved government financial management, and streamlined internal control and audit. All of these improvements had a strong positive impact and contributed to the achievement of RWS sector objectives.

*Lesson 5: If you want to go fast, go alone. If you want to go far, go together.*

Moving the reform process forward is not a one-man show! Every stakeholder has some comparative advantages, and spending time and energy to build alliances is necessary—and pays off. It is also important to understand other partners' constraints, make the best



The Small Towns Water Initiative provides potable water for 500 localities with populations of 2,000-25,000.

use of potential synergies, and look ahead. Achieving results takes time.

A good illustration of this team approach in Benin is the Small Towns Water Initiative to provide potable water for two million people living in 500 localities with populations between 2,000 and 25,000. This initiative was adopted during the 2004 government/donors joint annual sector review, and the framework agreement for it was signed by the Ministry of Finance and the donors (the European Union, DANIDA, AFD, and KfW) in February 2007. The World Bank supported the initiative process through a policy action included in the BSO. Finally, the donors' pooled fund was established and €20 million committed. Funds are disbursed based on the country system procedures and managed by national capacity. In 2008, 25 small-town water-supply systems were constructed through this initiative—a good example of working together and contributing the best each one can offer.

## CONCLUSION

Results achieved in scaling up investment and reforms in the RWS sector in Benin are due to a combination of government vision and ownership of the budgetary reform and programmatic approach, and the complementary mix of donor support and instruments used (sector investment projects, capacity building, and BSO). Donors directly contributed to building national capacity and procedures and to financing water-supply infrastructures. Also, sector prior actions and sector policy dialogue, carried out through the World Bank BSO with the Ministry of Rural Water Supply and other donors, contributed significant support to the government's efforts to implement major reforms:

- introduction of a results-oriented medium-term program budget that radically improved planning and achievements;

- management reform of small piped-water systems that introduced a new governance framework to ensure sustainable service; and
- strengthening of decentralization, with a regional program budget and procurement at the local level, to increase sector absorption capacity and empower local governments.

Government vision and ownership, planning and accountability, analytical work and a results-oriented approach, stakeholder coordination, as well as a learning-by-doing approach are key elements of this success story in Benin.

## ABOUT THE AUTHORS

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Approved by Jaime Biderman, Sector Manager, Africa Region, World Bank.

November 2009





In 2004, Benin constructed more than 1,200 water points. A water point is a borehole with a hand pump that can serve 250 people. Or it may be a small supply system with communal standpipes—the equivalent of many water points.





Lessons in Transport



# Dare to Fail: Counterintuitive Lessons from Mergers and Acquisitions Experience in the Airline Sector

Warren Buffet famously quipped that by inventing a flying machine, the Wright Brothers did the world's investors a great disservice. The only modification this SmartLesson would make is to include the world's taxpayers as well, due to the number of countries that have lost money through government-run airlines. Below are summaries of some lessons learned from airline privatization successes—and (particularly) failures.

## BACKGROUND

IFC's Advisory Services in Public-Private Partnerships provides merger and acquisition (M&A) transaction advice to clients, specifically governments wishing to transfer businesses to private sector ownership and management. Over the last 20 years, global aviation has followed this privatization path, as a consensus emerged that governments were not good at managing airlines<sup>1</sup>.

In the last 20 years, IFC has worked on nearly a dozen airline transactions. Unfortunately, many have proved to be difficult projects. However, a couple have become outstanding success stories. The Air Vanuatu transaction stumbled during the economic turmoil of 2008 (see Box 1 on the next page).

## LESSONS LEARNED

*Lesson 1: Equity investment strategy “long airlines”: Think busted flush<sup>2</sup>.*

<sup>1</sup> The theory goes that by managing airline businesses commercially the private sector creates efficiencies, saves governments money (often a huge percentage of national income), and boosts the numbers of passengers travelling.

<sup>2</sup> For those unfamiliar with gambling terminology, a busted flush refers to something that started out with great potential but ended up a disappointing failure. That is not to imply that hedge fund investment strategies bear any resemblance to poker.

A great deal has been written about the troubles of the airline sector, in particular about how bad the industry has been for investors. The reality is that, for a variety of deep-seated structural reasons, airlines have an amazing capacity to lose money. Some of the biggest problems include:

- 1. Fixed-cost structure:** Airlines tend to build up a legacy-costs base (staff and fleet) that's difficult for a new owner to manage. In addition, fuel costs are beyond management's control, and during the recent oil price spike they accounted for as much as 30 percent of the cost base.
- 2. Price-sensitive product:** Demand for travel is extremely elastic, especially in tourist markets. In recessions, people forgo vacations for other consumer goods. Conversely, price reductions increase passenger numbers dramatically (see Lesson 3).
- 3. Management speak:** The bottom line is that “cost leadership” is important—very few airlines successfully charge more for a “differentiated” product<sup>3</sup>.

<sup>3</sup> As all graduates of business school know, cost leadership and product differentiation are the two basic strategies for a business. It really is that simple, which is why all graduates of business schools know that they have absolutely no need for strategy consultants....



*Box 1: Two landmark deals—and one that didn't fly*

**Kenya Airways**

Year the deal closed	1995
Structure	Sale of 26% to strategic partner, subsequent 51% IPO on Nairobi Exchange
Bidder	KLM
Cost structure	Reduced (but full-service airline remained intact)
Results	From 1995–2001 Kenya Airways' frequencies grew by 61%, developing Nairobi into a regional hub. Tourist arrivals increased 42% over this period. A subsequent \$15 million IFC investment has funded fleet expansion. The airline has consistently been profitable.

**Poly Blue**

Year the deal closed	2005
Structure	Sale of 49% to strategic partner, 2% to local business
Bidder	Virgin Blue, Australian low-cost carrier (LCC)
Cost structure	LCC
Results	The \$7.5 million government subsidy in 2004—70% of Samoa's budget deficit—turned into \$6.6 million profit in 2007, including \$1.2 million cash dividend to government. Tourist numbers have increased 15% annually (historic trend 4%), and tourism revenue, \$83 million in 2005, reached \$113 million in 2007. Implies 2,000 new jobs created (population of Samoa: 180,000).

**Air Vanuatu**

Year the deal closed	TBD (as of 2008)
Structure	Sale of between 40% and 49% to strategic partner
Bidder	Primarily Australian airlines
Cost structure	Proposed LCC
Results	Tender held March to July 2008, over which time fuel prices rose precipitously. Investor interest dwindled; by June only one bidder remained. Terms of the offer would not meet government objectives. Recommendation: Cancel the tender and wait until market conditions improve, which may take some time.

- 4. Complicated “demand chain”:** Customers often purchase tickets through travel agents, frequently in a package with hotel accommodations. Since airlines rely on these other actors for their sales, if there are bottlenecks elsewhere the aviation sector will suffer. This is particularly true in tourism-dominated markets such as Vanuatu.
- 5. Overregulation:** Bilateral agreements between governments, still prevalent in many parts of the world, prevent competition from functioning

normally. Open skies are being adopted, but not in all countries.

- 6. The twist... leverage:** All of the above features contribute to making airlines a fairly risky business; so the last thing you'd want to do is to leverage them up like a safe, steady, predictable utility. Unfortunately, due to the massive cost of purchasing aircraft, that's exactly what happens.<sup>4</sup> Any deterioration in the operating environment and... managers are on Amazon.com ordering "Bankruptcy Legislation for Dummies."

<sup>4</sup> Some clever people figured out a way of hiding these debts off the balance sheet (through the magic of capital leases). However, the reality is that the terms of an aircraft lease are so inflexible (returning a 737 early is roughly as difficult as building one from scratch out of paper) that from a financial perspective, the business is still highly leveraged.

*Lesson 2: Airlines are a political football that politicians like to kick around.*

Unfortunately, experience has shown that in our markets, politicians are prone to protect their national flag carriers. For some reason, they are viewed as national champions, crown jewel assets that deserve special prestige and a place in a nation's heart. There are two lessons here.

First, we have to figure out the political connections within an airline's management early and determine whether there is any chance of control being relinquished. Too many times we have encountered a prime minister's nephew being the chairman of the airline's board of directors, or had our fingers burned by last-minute political decisions to pull out of a transaction—for example, with Camair (see Box 2).

These factors combine with devastating effect: Periodically the whole sector goes into meltdown, the last being after 9/11, and a current one starting in March 2008 (due to high fuel costs, later combined with softening demand). For example, in 2004, the year before we were engaged to assist with Polynesian Airlines, 70 percent of the Government of Samoa's total budget deficit was due to the losses at the airline.



*Box 2: Some of IFC's recent airline deals*

<b>Mandate</b>	<b>Country</b>	<b>Year signed</b>	<b>Result</b>	<b>Comments</b>
Air Jamaica	Jamaica	2008	Ongoing	
Air Vanuatu	Vanuatu	2007	Failed bid	Oil price increases during 2008 reduced market interest (see photo caption at left)
Rwandair	Rwanda	2005	Failed bid	Oil price increases during 2008 reduced market interest.
Camair	Cameroon	2005	Reversed	Bid won and airline awarded to SN Brussels; government then decided to cancel process.
Royal Tonga	Tonga	2003	Liquidation	IFC study showed airline was not viable; government liquidated it.
Polynesian Blue	Samoa	2003	Success	See photo caption at left.
Air Botswana	Botswana	2002	Cancelled	Lack of market interest.
Air Tanzania	Tanzania	2001	Success	Bid won by South African (\$20 million for 51%). Subsequently, airline went bankrupt and was renationalized.
Nigeria Airlines	Nigeria	1999	Cancelled	Airline eventually liquidated, replaced by Virgin Nigeria.
Kenya Airways	Kenya	1994	Success	See Box 1.

Second, the high-profile nature of airlines can sometimes work in our favor. With Kenya Airlines, for example, the original motivation for the restructuring came when then-president Daniel Arap Moi's Kenya Airways plane was grounded at Charles de Gaulle by the Accounts Receivable department of Airbus Industrie. The bankrupt airline had only forgotten to pay the installments for its aircraft. The humiliation and indignation prompted a top-level decision to put the airline on a sound financial footing—whatever it took. The Kenya Airways transaction is one of our most successful, and a poster child for airline privatization around the world.

*Lesson 3: News flash: Most people choose the cheapest flight.*

Although it sounds obvious today, the realization of just how price-sensitive the aviation sector is has taken several decades to emerge. As the first low-cost carrier (LCC), Southwest Airlines in the United States modified the traditional airline business model, which has been copied, with minor modifications, around the world. With price cuts, demand for air travel explodes (often to the chagrin of environmentalists), as has now been proven in almost every region of the globe. Empirical evidence suggests that when an LCC

starts up, prices fall by an average of 20 percent over the first four years, resulting in a traffic increase of about 50 percent over the same period. So what does this mean for our mandates?

Firstly, if our reform package is bringing competition to aviation markets, tourism numbers will grow, creating a powerful incentive for government to complete the transaction. For a mid-market destination, statistics suggest one tourism job for every four arrivals. In Samoa, for example, although several hundred jobs were lost in the restructuring of the airline, an estimated 2,000 have been created by the new arrivals—in a country with a total population of only 180,000. In three years, our transaction has taken several percentage points off the national unemployment rate—a significant impact. A key lesson from the Air Vanuatu transaction is that enlisting the support of other actors in the tourism sector (hotels, travel operators, and so on) can become an important way of mobilizing public support for our work.

The second lesson is that if we are going to advise a government to divest its national airline and encourage competition, we had better be sure that it is doing so in a way that enables the new airline to have some form of cost leadership. Otherwise, we may complete the transaction only to see the airline to go bankrupt one or more years down the track as was the case with Air Tanzania (see box on page 62).

We need to approach cost leadership creatively. Since our mandates usually take place in small, niche markets that lack economies of scale on their own, cost leadership can mean adopting the cost base of a larger regional airline. In Africa, it can mean liquidating the old airline (with its large liabilities and legacy-cost issues) and starting afresh with an international investor's business model. In other regions, a difficult but proven approach has been to create a “virtual airline” run by an LCC, as was the approach taken in Samoa and attempted with Air Vanuatu.

#### *Lesson 4: Slaying an IFC sacred cow?*<sup>5</sup>

When IFC advises a client on selling a company, there is a golden rule that we always make every effort to stick to: force the investors into bidding as part of a competitive auction. This proven classic negotiation tactic gives sellers maximum leverage over buyers, and it generally leads to the best results (on price and other terms). Typically, we manage the auction by negotiating all nonprice issues (degree of management control, service levels, brand conditions, and so on) with bidders in advance, and then hold a bid on price—and winner takes all. Basically, “Selling a Company 101” is all about getting buyers to compete with each other<sup>6</sup>.

However, in the aviation sector there may be justification for suspending this rule, for the following reasons:

- Practically speaking, actually getting two bidders prepared to compete is very difficult; depending on market conditions, it may be impossible. With Air Vanuatu we had two bidders—until about a month before the bid date when, with oil prices soaring, we suddenly found that only one remained.
- More profoundly, what are we trying to achieve? In many sectors, getting the highest price or the lowest tariff is a key objective of our transaction. But in airlines, the key objective is often simply finding an international investor that will give us access to its cost base. The terms of access to this cost base (the management fees that will be charged, what parts of the legacy business will be incorporated, and so on) are much more significant in the long run than a small nominal payment for shares.

The controversial lesson may be that a competitive bidding process brings little value to securing these

<sup>5</sup> No sacred cows were harmed during the preparation of this SmartLesson.

<sup>6</sup> This approach has also been used by IFC when exiting equity investments. A great example is the sale of 6.2 percent of the equity of Asia Commercial Bank of Vietnam, where IFC sold its stake at twice the price being publicly traded on the market. This outstanding result was achieved through a blind-auction process; JP Morgan advised IFC on this deal.



terms and conditions. If some form of competitive negotiation will secure the lowest cost base for our client, then maybe this is the process we should advise our clients to follow.

*Lesson 5: Dare to fail: A discredited theory of management finds a new home<sup>7</sup>.*

Sometimes the right advice to our clients is not to do a transaction. This can be a difficult piece of advice to give, especially when the team has worked day and night for over a year to painfully negotiate a transaction with bidders. But sometimes it is the right advice—more frequently with aviation than with our other work. These situations occur for different reasons.

For example, governments often resist our advice to allow the reformed airline to pursue a strategy of cost leadership. There can be a natural resistance to allowing a major staff restructuring to take place or to adopting a low-cost model. The danger for us is that if we recommend that the transaction be consummated on these terms, the airline will not be able to compete and will subsequently go bust in the next industry downturn (as happened with Air Tanzania), and as a development institution we are left several years down the track with an unhappy client (who also happens to be a shareholder).

Another reason is that if the industry is in the midst of a cyclical downturn, getting a good deal becomes very hard. This is what happened with Air Vanuatu. The aviation industry went into meltdown in early 2008, just as negotiations with investors were taking place. The result was that the goalposts shifted, and the broad terms of the deal that we thought were achievable suddenly moved, materially. The cost to government of gaining access to the low-cost base of a larger regional airline became prohibitively expensive, so our advice to the government was to wait. Although fairly frustrating at the time, we at least knew that we

<sup>7</sup> The Alan Latchley “Dare to Fail” philosophy was pioneered by the England football team and then adopted by a number of British industries in the period from 1950 to 1990.

had made the right recommendation to our client... But when we phoned senior management to break the news that “actually, guys, we’ve decided to call the whole thing off,” the line suddenly went dead.



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February 2009





Lessons in Health and Education

# Breaking New Ground: Lesotho Hospital Public-Private Partnership—A Model for Integrated Health Services Delivery

*For many years, Lesotho has urgently needed to replace its main public hospital, Queen Elizabeth II. In 2006, to maximize the use of limited resources and ensure long-term improvement in facilities and services, the government adopted the public-private partnership (PPP) approach for a new hospital. IFC's Advisory Services in Public-Private Partnerships advised the government in structuring a PPP for the design and construction of a new 425-bed hospital and adjacent gateway clinic, the renovation of three strategic filter clinics, and the management of facilities, equipment, and delivery of all clinical care services for 18 years. The project has a capital value of over \$100 million, and the private operator—the Tsepong consortium headed by Netcare, a leading South African health care provider—has significant local ownership: 40 percent of shares held by Lesotho-owned businesses, increasing to 55 percent during the project term. This SmartLesson describes this pioneering project, and shares some lessons we've learned from it.*

## WHAT MAKES THIS PROJECT DIFFERENT

PPPs in the health sector typically range from simple outsourcing of support services (such as catering or laundry) to the more complex design, construction, and facilities management of hospitals. To our knowledge, the Lesotho PPP structure is a first for Africa—and one of only a handful of similar projects worldwide. In addition to the design, construction, and full operation of the hospital and associated health care facilities, the Tsepong consortium will deliver all clinical services, with the objective of providing vastly improved, high-quality health care services at an affordable cost. Here are some key differences from other hospital PPPs:

### 1. Complete Health Care Services Delivery.

Tsepong is responsible for delivery of all clinical services—including recruitment of doctors, nurses, and other health professionals—and provision of all medical equipment and all pharmaceuticals necessary for clinical services delivery. In addition to the new facility,

which will operate as the national referral hospital as well as the district hospital for the greater Maseru area, Tsepong will be responsible for the refurbishment, re-equipping, and operation of three primary health care clinics at Qoaling, Mabote, and Likotsi in the greater Maseru area, allowing it to manage a mini-health care network, and filter and treat less severe cases at the clinic level, freeing up as much hospital capacity as possible.

### 2. Service Payment.

The private operator delivers budget certainty as well as patient-centered care, assuming full patient risk from project inception and agreeing to treat all patients who present at the hospital and filter clinics, regardless of the type of condition, up to a maximum of 20,000 inpatients and 310,000 outpatients per annum—with very few clinical exceptions. The government provides Tsepong an annual fixed service payment for delivery of all services, escalated only by inflation annually. We know of only one similar full PPP project in a





The 100-year-old Queen Elizabeth II Hospital, an aging facility functioning at a minimal level, will be replaced by a new hospital.

developing country, and that private operator opted for a direct-cost-plus-margin payment basis for the first few years (until patient profiles and disease patterns could be studied) before committing to a fixed cost for clinical care.

### *3. Performance Monitoring.*

The Lesotho PPP agreement includes typical performance monitoring—such as payment and penalty mechanisms related to facilities management, equipment, and other nonclinical service outcomes—as well as independent certification of delivery of facilities and equipment. But it also requires additional monitoring:

- The Lesotho agreement includes a detailed list of both clinical and facilities performance indicators that the private operator must meet in order to receive full payment from the government. Failure to meet a performance indicator will result in a severe penalty deduction (a percentage of the total service payment). The relative importance of clinical versus facilities performance indicators is reflected in the percentages deducted. For example, failure to comply with the infection-control measures (clinical indicator) draws a 1.00 percent penalty; whereas failure to comply with linen and laundry service standards (facilities indicator) brings only a 0.25 percent penalty. A ratchet mechanism for repeated

service failure for the same problem increases the penalty deduction for each repeated failure, and service failure that is not remedied can result in termination of the agreement.

- The Lesotho project has an independent monitor—a unique role specifically created for this project and jointly appointed by the government and the private operator—to perform a quarterly audit of the private operator’s performance against the contractual performance indicators (clinical and nonclinical) and, where performance has not been achieved, determine the penalty deduction that applies. The independent monitor is a consortium of companies with specialized experience in PPPs, clinical services, hospital operation and management, medical and nonmedical equipment, information management and technology, and soft and hard facilities management.
- The private operator is required to obtain and maintain accreditation from the Council for Health Services Accreditation of Southern Africa; failure to do so can result in termination of the agreement.
- The project provides for a Joint Services Committee, established by the government and the private operator, to review performance and discuss and develop mechanisms, procedures, or protocols to improve the services at the hospital and filter clinics. Given the long-term nature of the project, this committee provides a mechanism for altering the hospital’s services, by agreement, to address new disease patterns, new technologies, or new national priorities, thereby ensuring that the project remains relevant for the country.

## LESSONS LEARNED

### *Lesson 1: The baseline study is important throughout the project.*

During project preparation, IFC realized that the expectations of the government and general public were high: a new facility with better equipment and

vastly improved services. However, there were many questions as to whether the country (and the average patient) could afford new facilities and better public care. What services would be offered? Could service delivery by a private operator be affordable?

To answer these questions, IFC produced a detailed baseline study of health care costs and services at the existing Queen Elizabeth II hospital and the related filter clinics. The baseline significantly shaped the project design, helped set the performance indicators in the PPP agreement, and improved the government’s understanding of what was currently being delivered and what improvements the PPP could bring. The performance indicators are also aligned with the Millennium Development Goals (MDGs) for Lesotho. The baseline study will also be useful for IFC’s own monitoring and evaluation work on the project going forward.

### *Lesson 2: Evaluation of bids serves to enhance outcomes and affordability.*

The challenge was to come up with a bid evaluation structure to accommodate three competing objectives:

1. to procure as many services for as many people at the hospital and filter clinics as possible;
2. to improve the quality of services; and
3. to do so within the government’s affordability limit.

The best structure we could devise to balance these objectives involved dividing the technical evaluation into three areas:

**Service Coverage:** Bidders were required to confirm which services they could feasibly provide within the service payment, taking into consideration patient volumes. Services listed by the government in the bidding documents included “mandatory” and “optional.” For example, orthopedic surgery (general and trauma) was a minimum requirement, but bidders who also offered

hip-joint replacements within the service payment received additional points. Similarly, diagnostic imaging (radiology, digital X-ray, CT, mammography) was a minimum requirement, but bidders who offered magnetic resonance imaging (MRI) services received additional points. The winning bidder agreed to provide all mandatory services, plus 95 percent of all additional optional services, within the service payment.

**Patient Volumes:** The government stipulated services to a minimum of 16,500 inpatients and 258,000 outpatients at the hospital and filter clinics. Bidders had to commit to a maximum number of inpatient and outpatient visits, and the bidder offering the highest number of patients received the maximum points. The winning bidder committed to delivery of services to 20,000 inpatients and 310,000 outpatients per annum.

**Service Delivery Plan:** Bidders were evaluated on their approach to quality, effectiveness, and efficiency of the services to be provided; compliance with service standards; and how realistic their plans were. This element was evaluated by a multidisciplinary team from the Ministry of Health and Social Welfare, the Ministry of Finance and Development Planning, and IFC.

The technical and financial offers were submitted separately, with the financial offers opened only after the technical evaluation was completed.

*Lesson 3: Defining clinical services is necessary, even if it has to be a highly consultative process.*

The service coverage list developed for the bidding documents was a key element of the bid evaluation, but the definition of that list was a highly consultative process, including Ministry of Health staff, clinicians at the Queen Elizabeth II hospital, private practitioners in Lesotho, and IFC's technical experts. These discussions were complicated by the inevitable need to balance affordability and expansion of services currently not provided in Lesotho. The parties eventually reached

agreement on the minimum types of services believed to be deliverable within the affordability limit by any private operator.

To progress smoothly, such a highly visible, important national project had to be seen as having the support of all key stakeholders. Wide support would not have been possible without the consultative process. A key to getting agreement was finding a balance between services perceived to be essential versus services that would be good to have but not essential—plus a constant reference to affordability. A bidding structure that allowed bidders to include optional extras was also helpful in reaching agreement.

*Lesson 4: Integrated service delivery is essential at every level.*

Since the private operator is responsible for complete health care service delivery at the hospital and filter clinics, it was important to ensure that it could actually deliver all services—pharmaceuticals, for example. The current national referral hospital is a significant client of the National Drug Supply Organisation (NDSO), the central pharmaceutical and medical-supplies procurement entity for the government. On the one hand, if the private operator were no longer required to use NDSO as a pharmaceuticals supplier, NDSO would lose significant bargaining leverage for the country. On the other hand, if the government forced the private operator to use NDSO, and NDSO failed to deliver the right drugs on time, the private operator could claim cause for failure to treat a patient.

**Solution:** The private operator entered into a service-level agreement with NDSO, as well as a capacity-building initiative that will enhance NDSO supply and logistics capability, thereby ensuring better service delivery not only to the PPP but also to the broader public health system.

*Lesson 5: Value for money is about more than just project cost and risk transfer.*

PPPs generally focus on the concept of value for money, which typically assesses the affordability and risk transfer of a project. By this standard, the Lesotho project is affordable for the government. On an operational cost comparison, the government will not pay much more for the PPP than it currently spends on the Queen Elizabeth II, yet it will receive vastly improved facilities, medical services, and patient care. From a patient perspective, services at the new hospital and filter clinics are affordable and will cost the same as at

any other public health facility in Lesotho. The project has also ensured maximum risk transfer to the private operator, protecting the government from most of the financial, operational, and legal risks inherent in a project of this nature.

Other significant value-added elements include:

- **Development of human resources:** Lesotho, like many other developing countries, struggles to attract and retain professional health staff. In this project, the private operator is responsible for recruitment of all staff at the new hospital and filter clinics and has



The new clinics getting ready to open their doors to the public.



greater freedom to pay the staff salaries that reflect the scarcity of their skills, without being constrained by government salary policies. This project also allows the private operator to create a platform for doctors to serve both the private and public sectors in a controlled manner. The project will also create a working environment that encourages high-quality, patient-centered treatment with the use of modern equipment and greatly improved facilities—one of the key factors in retaining health sector staff.

- **Training:** The new referral hospital will be the country's main teaching hospital for physicians undergoing postgraduate training, medical students, nurses and other health professionals, and staff from other public health facilities. These students will have access to equipment and facilities not previously available in Lesotho. This training component is also expected to assist in retaining qualified health sector staff.
- **Referrals:** The government currently refers most complicated cases outside the country, since the current facilities at Queen Elizabeth II cannot accommodate them. The new hospital will address many of these cases.

Human resources (HR) and training costs are built into the financial model, and the private operator commits to spending the amounts allocated to HR and training annually—making these elements part of the overall cost of the project.

## CONCLUSION

The PPP agreement for this project was signed by the government and the private operator on October 27, 2008. Financial close occurred on March 20, 2009, and construction began on March 23, 2009. The filter clinics are expected to be operational at the end of 2009, and the new hospital in July 2011.

The Lesotho Hospital PPP has demonstrated that it is possible, in a low-income country, to embark on a very ambitious project that is affordable for the country and patients, is attractive to top-quality private

investors, expands services to more people, and has the potential to deliver high-quality health services that address MDGs and the critical shortage of health professionals—key constraints for many developing countries.

Although the project is still in its early stages and the expectation of success is high, there will certainly be challenges and obstacles for the private operator and the government to overcome. A key risk is the high probability that the hospital will reach maximum capacity very early in the project term, requiring the government to rapidly improve the service offering at other hospitals to relieve the pressure on the national referral hospital. Another risk is whether the private operator will be successful in attracting and retaining the numbers of doctors and nurses necessary to ensure effective service delivery. The key factor for the success of this project is the commitment and support of the government demonstrated throughout the project process, from procurement, during negotiations, and to financial close. The government firmly believes this project will deliver meaningful results for the country.

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July 2009

## Reappraisal of the Private Schools Support Programs in Ghana, Kenya, and Rwanda

*Private schools serve a critical role in the education system in many developing countries. However, they often remain limited in their ability to provide quality education services, due to inadequate access to finance and advisory services. In 2005, IFC piloted a model in Ghana—which it replicated in Kenya (2007) and Rwanda (2008)—that encourages local financial institutions to expand their lending to schools, with a parallel advisory program that helps schools create viable business plans and improve their operations through management/staff training and systems. This SmartLesson discusses what worked well in the program and what did not, and what can be done if IFC is to have a greater impact with the Africa Schools Program.*

### BACKGROUND

With public funds for education in Sub-Saharan Africa limited, governmental efforts alone are insufficient to meet the demand for quality education spaces. Hence, there is a need for private schools to fill the gap. Private schools, especially at the primary and junior secondary level, are essentially small and medium enterprises (SMEs) with the usual less-than-optimal formality in their operations. For this reason, few banks understand the risks involved in lending to private schools, and those that venture to do so generally lend on the short term. Thus, even if schools are able to secure bank financing, the tenor of that financing in most cases is inappropriately matched to infrastructure expansion or school modernization needs.

Managed by IFC's Private Enterprise Partnership for Africa (PEP Africa), in cooperation with IFC's Health and Education Department (CHE), the Africa Schools Program is designed to leverage IFC's experience in project financing and advisory services for SMEs. It consists of an integrated offering of access to finance and tailored business development services to schools.

IFC supports the banks by providing risk-sharing facilities and advisory services. These products simultaneously help to reduce the risk of private school loans going bad, afford bank officers the opportunity to better originate schools' loans, and ultimately enable the banks to expand their lending to the education sector. Under the risk-sharing facility, IFC shares the risk on defaulting loans on a portfolio of private schools originated by the partner bank to an expanded and defined maximum portfolio limit. IFC does this by agreeing to underwrite a percentage (40 to 60 percent) of loans in the portfolio that default and are written off (in line with local central bank requirements).

This risk is defined as junior risk, as it kicks in after the partner bank has absorbed the senior risk, or what is called the first loss: usually five to ten percent. The first loss and IFC's percentage participation are determined at appraisal and are based on the target bank's portfolio quality, including historical indicators like the nonperforming loans ratio, credit policies and procedures, and the bank's general financial health. By design, the risk-sharing facilities are unfunded, and most of the banks have come back to ask for funded lines of credit to assist them in meeting the

asset-liability mismatch for lending to schools over the medium to long term. Most of these banks typically do not have access to long-term funding—relying mostly on demand deposits—and so they are more inclined to lend on a short-term basis.

## RESULTS TO DATE

Under the risk-sharing agreements with partner banks (The Trust Bank in Ghana, KREP in Kenya, and BRD in Rwanda), a total of 75 schools and three hostels have accessed a cumulative loan total of \$12.33 million from the banks. Utilization levels of the risk-sharing facilities across the three banks are as follows:

1. Ghana: The facility has utilized about 75 percent, or \$3.45 million of the \$4.58 million (current equivalent) risk-sharing loan.
2. Rwanda: The facility has used 69 percent, or \$8.45 million of the \$12 million risk-sharing loan.
3. Kenya: The facility is at 25 percent utilization, at \$0.43 million of the \$1.7 million risk-sharing loan after the first two years of the program.

In Ghana, only one school out of the 25 schools in the portfolio has had problems with repayment. In Rwanda, the schools portfolio is the BRD bank's best, with not a single non-performing loan. In Kenya, of the 30 schools in KREP's portfolio, seven were nonperforming as of December 31, 2008. The Kenya situation was brought about by the post-election violence that rocked the country in January 2008 and resulted in some of the schools losing students and revenue, which affected their ability to repay the loans. In addition, the KREP bank faced liquidity constraints attributed to the global financial crisis, which made the situation even worse.

To support the bank in addressing this problem, the Africa Schools Kenya program conducted an audit of the nonperforming portfolio and advised the bank on how to restructure the portfolio. The portfolio is currently performing. The experience of the participating

banks, especially The Trust Bank and BRD, has proved that this is a profitable lending sector and that banks are willing to do more if the liquidity issues can be addressed.

In all countries of operation, the program also provided various advisory services to the schools, mostly focusing on delivery of business and education management workshops and developing customized business plans to access finance from the partner banks.

## LESSONS LEARNED

*Lesson 1: Private schools are not for the rich only. Therefore, we need to adjust our product to better serve low-income schools, especially in frontier markets.*

In most African countries, private-education institutions range from those serving low-income groups to those serving high-income groups. In fact, in some areas, the poor state of public schools means that the only real option for parents is the private school. However, the Africa Schools Program, as currently designed, is not able to meet the needs of schools serving low-income groups. Such schools have the following characteristics that effectively exclude them from the program:

- **Marginal profitability:** They have very low fee levels, and most of their students do not pay fees on time, if they do pay at all.



- **No security/collateral for accessing loans:** These schools are often on rented premises and in temporary structures that cannot be used as collateral (especially in the case of Kenya).
- **Lack of basic necessities:** Despite the fact that they desperately need advisory services, the schools cannot afford a contribution in time and cash, as they continuously struggle to remain afloat.

As a result, the current program has worked quite well serving mostly the middle and upper range of the private school market. If we want to expand the program’s benefits to low-income schools, we need to make several important adjustments. Specific advisory services and financial products need to be developed for the different segments.

Eligibility criteria, like a minimum number of students and 130 percent coverage ratio on loan security, should be reevaluated to maintain portfolio quality but enable low-income schools to qualify for loans under the program. IFC should also seek third-party “impact investors” to reduce the collateral requirements for schools and to reduce the pricing of the facilities to the potential partner banks. All three current partner banks have complained of the high quarterly fees charged by IFC for this unfunded risk-sharing facility as well as the level of first loss/senior risk. It is also quite telling that several other banks in Ghana, South Africa, Uganda, and other countries have rejected the facility, based mostly on the price/fees.

Profitability levels of the private schools, and hence the ability to pay off commercial loans, will vary, and IFC needs a product that recognizes this. For example, the lower-end schools could be targeted with a product that first sets out to bring them to a sustainable level—for example, loans with extended moratorium periods of up to two years. Such a product might require partnerships with other development organizations, including foundations and donor agencies that are interested in education to provide funding for advisory services not only prior to but also after

the disbursement to ensure that these schools are embracing sustainable business principles. We could also reconsider pricing levels and first-loss provisions for the partner banks that serve such schools, and leverage partnerships with development partners to provide first-loss funding.

In our experience, banks target different segments of the market. It is therefore important to engage a variety of banks (with a variety of financial products) to ensure that all market segments are reached. Otherwise, the program ends up excluding certain groups of schools that may not be part of the partner bank’s target. Low-income schools will need to be served by microfinance banks, and middle- to high-income schools need to be served by SME and larger banks, with a commensurate higher return to both IFC and the partner banks on the latter. Having more than one bank also ensures that the program does not stall if there are challenges with any of the partner banks, as was the case in Kenya with the KREP bank, and currently with The Trust Bank in Ghana.

However, getting other partner banks on board is proving to be tough, especially in view of the current global financial crisis and the pricing of IFC products. To put this in context: IFC’s Board approved the \$50 million program in June 2007. This meant that the Africa Schools Program through CHE investment officers could sign up different banks across Africa to an



Kenyan school constructed with a program loan.



aggregate total of \$50 million. So far, the aggregate of the investments in the three countries is \$3.5 million in Ghana, \$1.7 million in Kenya, and \$4.8 million in Rwanda—a total of \$10 million, or 20 percent of the original \$50 million approved. If the program is to go beyond the current 20 percent, there is a need for CHE and the Global Financial Markets Department to diversify the financial products and their pricing, as well as the levels of first loss required of partner banks, in order to attract more banks to the program. The current risk-sharing facilities require banks to use their own funding to lend, and most of the banks are asking, “When are we likely to call on IFC’s guarantee?” The terms of the agreement do not enable the banks to take on additional risky projects, so the likelihood of default is low.

In particular, Liberia and Sierra Leone represent challenges for the Africa Schools Program. Whereas demand from frontier country governments, IFC country staff, and potential private schools at all levels is high, the appetite for a low-margin investment by IFC in a local bank is almost nonexistent. We need a financial product directed at frontier markets where IFC recognizes that, due to marginal profitability but a strong social need, a suitable partner bank can be engaged on less pricey terms.

### *Lesson 2: Use local consultants for delivery of the Advisory Services Program, tailored to the needs of individual schools*

The Advisory Services component has been well attended by the targeted schools as well as by the partner banks in Ghana, Kenya, and Rwanda.

Advisory services are targeted at schools in two main ways: directly at each potential school that requests a loan, and broadly at groups of schools through workshops. IFC raises funds from donors to pay for the cost of delivering these advisory services through external consultants or firms, and the schools are obliged to cost-share at various levels of up to 40 percent, in

line with IFC’s Advisory Services pricing guidelines. Pricing is usually determined by market surveys and feedback from schools during pre-implementation workshops.

The starting point is the school’s diagnostic and business plan, delivered directly to schools through local consultants. These schools are also able to access other direct advisory services as needed. Other schools that do not access loans but meet the eligibility criteria (enrollment levels, number of years in operation, registration/licensing by the relevant authorities) can also qualify for advisory services.

Experience in delivering this program in Ghana and Kenya has shown that the direct services that include self-diagnostics and business plan development cannot be delivered as “en masse” workshops. Most schools lack a basic understanding of what a business plan entails and its usefulness. It therefore becomes critical to coach them on a step-by-step basis. This is best achieved by local consultants, who not only understand the market within which the schools operate but also are stationed in the country and therefore are able to commit ample time to the assignments.

The exit strategy is for the cost-share by IFC to decrease over the implementation period of the program and for the local consultants to be sufficiently exposed to the business opportunity to take this up on their own.



Beneficiaries of the programs in Kenya.

Ideally, IFC's continued investment engagements with local banks on private schools will create a "pull factor" for commercial and sustainable advisory services.

*Lesson 3: Carefully segment, profile, and screen the schools during pre-implementation activities.*

To be able to pitch the program at the right level, profiling and screening of schools must be part of pre-implementation activities. This can be achieved through a mini-survey or recruitment exercise to determine their broad cost structure, revenue history, and estimated recurring surplus in order to indicate realistic payback of commercial loans.

The screening and profiling should be done based on the income category of the target schools agreed on with the bank. As mentioned in the first lesson, it is necessary to design products that will specifically help low- and middle-income schools reach a sustainable level for them to benefit from this program.

We also find that preparation of the schools for advisory services can be significant, depending on their business readiness, and this takes up part of the implementation time. Pre-implementation activities should therefore be carried out over an extended period of 6 to 12 months prior to the formal program launch and the engagement of the partner bank(s). Low-income schools especially require long and heavy "hand-holding." For example, where we identify low management skills, it may be necessary to start up the advisory program about a half year before the financial program is implemented, in order to give the schools time to understand the basics of business borrowing for expansion. This also ensures that there is a pipeline of schools ready to take up loans by using prequalification criteria, once the agreement with partner banks is signed. This will also serve to attract banks to the program.

## ABOUT THE AUTHORS

Brigid Amoako, Operations Analyst in Ghana, has more than eight years of experience in business development working with IFC. Prior to joining the Africa Schools Program in November 2008, she was part of the SME Entrepreneurship Development Initiative in Accra, managing the provision of advisory services for SMEs.

Jane Onoka, Associate Operations Officer in Kenya, joined IFC in February 2007 to manage the Africa Schools Kenya program. Her role has since expanded to include managing the Africa Schools Rwanda program, as well as leading the development of new programs in other East African countries. Jane has more than 10 years of experience in education and development.

Approved by Colin Shepherd, Infrastructure and Corporate Advice Business Line Leader, Sub-Saharan Africa; and Sam Akyianu, Program Manager, Africa Schools Program.

May 2009



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## DESIGN

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## PRINTING

Ecoprint

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