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The Role and Importance of Independent Advisors in PPP Transactions

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About the Authors

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Abstract
As governments transition from their role of monopoly provider of infrastructure services to setting the framework for private provision of infrastructure services, independent "third party" advisory assistance is essential to making these public-private partnerships successful. In this article, IFC Senior Investment Officers Jumoke Jagun and Isabel Marques de Sa lay out the key roles and responsibilities of PPP transaction advisors.

Introduction
"Complicated reforms require specialists in order to succeed… Independent Advisers can provide the requisite expertise and experience to ensure the success of the reform process, and have the necessary independence to advice on the appropriate path"[i]

With the global increase in the development of PPPs over the last 15 years, the role of Governments in the provision of public infrastructure and services has gradually evolved from (a) governments being the monopoly provider of infrastructure and public services to (b) governments setting the framework for private provision of public infrastructure and services and monitoring the contractual arrangements under which the responsibility of the service provision is made (concession contracts, lease agreements, sale of shares, etc). This is by no means an easy transition for Governments to make, and Governments need independent "third party" advisory assistance to make this transition successfully.

Due to the typically long-term nature of infrastructure investments, the transfer of investment and operational responsibility from the public sector to the private sector is generally made under long term contracts with specific assignment of risks between the parties. A credible Independent Adviser will advise Government that a robust (and investment-friendly) legal and regulatory framework is critical to the successful structuring of PPPs. This framework must remove the previous public monopoly in the provision of public infrastructure and/or services and should also include the principles of economic regulation that guarantee the financial and economic equilibrium of the PPP projects.

IFC's views on Independent Advisers in PPP Transactions

IFC's Advisory Services Department specializes in advising in the structuring of PPPs in emerging countries, particularly frontier countries or the so called "frontier sectors" in middle-income countries. This involves integrating strategic and transaction advice, and structuring market-based financing and public sector risk mitigation strategies to enable us deliver an integrated solution to the infrastructure financing needs of our client countries.

Independent Advisers to Governments for the structuring of PPP transactions should have the following attributes:

1. Balancing Private and Public Sector Interests – In the pursuit of sustainable economic and social benefits, the Independent Adviser must have the ability to design PPP transactions that guarantee long lasting social benefits for the population (through improved service quality and long-term sector sustainability) – instead of achieving only short-term benefits. This includes advising governments on the legal and regulatory framework to allow for efficient PPPs, as well as assistance in the design and drafting of new laws and regulatory institutions. Safeguarding the interests of the government and the population in the achievement of a successful PPP should be the Independent Adviser's top priority. The Independent Adviser's work must not be driven by considerations of remuneration, but by the need to provide advice that effectively reconciles public concerns and desire for improved service quality and long-term sector sustainability with the conditions necessary to attract private investment.

2. Transparency and Investor Confidence – Reputation as a neutral partner, an honest broker, who is absolutely committed to the principles of transparency and fair play. The Independent Adviser's involvement should bring the assurance needed to attract competent strategic partners and investors, with the necessary technical and financial resources, to the deal. In addition, assurance of neutrality and transparency will also be important in gaining consensus among the various stakeholders in the country.

3. Multi-Skilled and Experienced Team – The team should have extensive direct experience in infrastructure project financing and investment as well as infrastructure reform and development. This multi-faceted experience allows the Independent Adviser to address all aspects of the mandate; understanding and addressing both Government's and the private sector's legitimate concerns.

4. Direct Experience in the relevant sector and market – Ideally have direct experience as an investor and lender to private sector investors, but critically, must have previous direct experience in structuring PPP transactions and must understand the pressures of the public sector. The Independent Adviser must understand the different specific sets of issues and opportunities that exist in the relevant sector(s) and markets (emerging versus developing), the harnessing of which requires specialized skills and experience.

5. Ties with the Global Investment Community – The Independent Adviser must be able to attract renowned and well-established private investors, who have extensive experience in the provision of infrastructure services.

The Adviser's transaction responsibilities will include (but not be limited to) the following:

- Assisting in building public support for the proposed PPP transaction by ensuring that: (a) the transaction structures are suitable for the country's particular conditions; (b) Government's objectives and rationale are well-articulated, and transmitted to the public through a well coordinated public information and education campaign; (c) the bidding process is objective and transparent; (d) the service provision standards and targets are well defined; and (e) a smooth transition for the labor force has been well-defined and articulated;

- Helping Government to achieve appropriate risk distribution between the private and public sectors, facilitating the future mobilization of financing, and ensuring that the relevant contractual provisions are attractive to potential investors while optimizing sustainable long-term benefits to the consumers and the economy;

- Assisting Government in ensuring that regulatory provisions are defined and implemented in conformity with the regulatory framework, and that these are sufficient to attract and retain potential investors;

- Promoting the transaction as broadly as possible to potential investors (local and international), to foster competition for the investment opportunity, ensuring that investors have equal access to complete data, in a well-structured transaction process; and

- Implementing the bidding process with maximum transparency in accordance with the rules and procedures defined with Government and in accordance with best international practice.

Key responsibilities of Independent Advisers which deserve some further discussion are:

1. Long Term sustainability of a PPP transaction

The long-term sustainability of a PPP is certainly the most daunting and important objective to achieve. Sustainability requires that the partnership needs to address: (i) often conflicting objectives of Governments, (ii) social needs and increasing sense of ownership from the general public of their right to public services at affordable prices – especially once a private operator is in place, and (iii) investor's requirements, in terms of acceptable level of risks, profitability and bankability. Failure to properly address any of the parties' requirements greatly increases the probability that the PPP Transaction will malfunction and/or will be terminated with consequent high political costs and further degradation of the already poor levels of service. In this regard, an independent advisor with a clear understanding of the balance to be obtained between the three main constituencies through the structuring of a transaction can definitively contribute to improving the long term sustainability of a public private partnership.

Conflicting Government Objectives

Governments have competing and conflicting objectives and priorities, with short tem financial objectives often prevailing over long term objectives It is critical that the Independent Adviser understands the competing and conflicting pressures on Government (financial and political), and is prepared and able to assist Government in the definition of appropriate transaction objectives which take account of project and consumer needs and private sector risk appetite, in order to achieve a successful transaction.

Budgetary constraints (financial) and the desire not to be perceived as "giving away the family silver" (political) often lead Governments to identify financial maximization as the main objective of a PPP, either (i) through maximizing upfront or annual concession fees with maintenance or reduction of the tariff in real terms, or (ii) through minimizing financial contribution in the case of a negative concession. This objective is often stated by Governments, even when significant levels of capital investment are required going forward, to achieve acceptable levels and standards of service to the population.

Governments do not intrinsically understand the private sector analysis of returns on investment (or capital employed), and it is the responsibility of the Independent Adviser to demonstrate to

Government that financial maximization of proceeds in such an instance, will likely only be achieved through the setting of inappropriately low levels and standards of service, resulting in reduced capital investments over the term. This explanation must highlight the fact that such an approach would mainly impact the poorest segments of the population that will remain outside the perimeters of the project or, if included, will remain underserved, as these marginal segments of the market often require high levels of investments and rarely procure any return.

The unsatisfactory levels of service resulting from any underinvestment will quickly generate popular dissatisfaction, which is the last thing that most Governments want or need. The rising sense of ownership and increased awareness of their social and economic rights by the populations served by private operators is easily captured by the political opposition to the ruling party. The political cost of such struggles can be extremely high, eventually leading to social unrest and/or political instability.

When the financial and economic equilibrium of PPPs requires that Governments the provide guarantees for the public sector's contractual obligations, the political sensitivity of the transaction increases with a corresponding increase in project stress. In extreme cases, where significant public sector capital investments or revenue subsidies are required upfront or over the life of the concession, Governments have in fact been accused by the opposition parties of "*giving away the family silver*" – a difficult political situation for the ruling party to be in.

Affordability and Consumer Rights

In some cases, financial and economic equilibrium of the PPP transaction can only be achieved through the provision of certain subsidies. Typically, there is a strong correlation between PPP projects requiring subsidies and poor socio-economic conditions in the country. These subsidies can either be provided internally through allowed transfers between classes of consumers and/or regions, or, directly to the end consumer.

In a number of countries, the inclusion of the poorest segments of the population in the design of a concession is critical to its long-term political sustainability. A credible Independent Adviser will advise clients on the best way to do this if direct subsides are not available; and if they are, an efficient use of the subsidy will be an important element of the overall transaction design.

> ***Box 1: Social and Political realities of serving the poor and underserved***
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> *In the water transaction in the Municipality of Petrolina, about 40,000 of the total population of about 200,000 reside in the rural, semi-arid area of Northeast Brazil. This population has limited water sources and is only randomly supplied potable water by water trucks. The regular provision of quality treated water together with the delivery of a cistern was included as a private sector obligation at the cost of reducing the net proceeds from the transaction. Although investors considered that the inclusion of rural service had a negative financial impact on the concession, they very quickly realized the social and, fundamentally, political importance of serving this particular needy population. This aspect will become more critical as more sub-sovereign (e.g. municipal) concessions in basic and essential public services like water are structured.*

If the Governments' objectives are re-defined as "*the maximization of financial proceeds while ensuring the quality of service and the long term sustainability of the PPP*", an Independent Advisor shall as it should, give particular attention to risk allocation and consistency between investment and required levels and standards of service.

2. Appropriate Risk Allocation

It is clear that in the structuring of PPPs, an honest broker is needed to create a proper balance between risk and reward for all parties. The Independent Adviser has the crucial responsibility to: recommend, structure and implement a sustainable (financially and politically), bankable transaction which achieves appropriate risk allocation between the public and private sectors, with relevant provisions that are attractive to potential investors, fulfill Government objectives and satisfy the ultimate consumer needs.

> ***Box 2: External support of public sector obligations can improve market appetite***
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> *A recent example is the privatization of a power distribution company in Romania, where the required IRR was reduced from 15% (which was not accepted by the market) to 12% by the fact that the regulatory risk was covered by a World Bank guarantee. Subsequent transactions used this IRR landmark without any guarantees. External support of public sector obligations can also be extended to termination payment risks and others.*

To achieve the above, the Independent Advisor will ensure that Governments understand the following:

- When Governments enters into a PPPs, they should act as commercial entities assuming the risks they are better positioned to control (in spite of the prerogatives granted to Governments in Civil Code countries);
- Proper risk allocation translates into lowering the cost of capital and ultimately impacts the level of required tariffs and/or the financial proceeds**.** Obviously risk allocation also depends on the country's investment environment, legal stability and track record;
- A proper allocation of risks between the parties supported by executable guarantees against possible defaults can substantially enhance the attractiveness of a PPP; and
- Particular products like guarantees on the Governments' contractual obligations further increase the stability and predictability of the partnership and therefore the Government's financial return if a partnership is to be granted in competition.

> ***Box 3: Tensions between investment requirements and operational efficiency***
>
> *In many PPPs, we observe that Governments have a clear incentive to require unrealistically high levels of investment, instead of requiring appropriate investment with improved operational efficiency. Political pressures – high levels of investment are quicker and easier to measure than efficiency (and make good political "sound bites") – together with the type of "new PPP actors", often subsidiaries of construction companies that see PPP transactions as a growth market, further reinforce the focus on high levels of investment instead of levels of service. Governments often try to impose obligations regarding the amount of investments required from concessionaire without full consideration of increasing operational efficiencies through reduction of losses etc, or the elasticity of demand upon introduction of modern technology and appropriate pricing in the billing and collection areas.*
>
> *Such over-investment will necessarily result in a need to renegotiate tariffs upwards or decrease the standard of service increasing the risk of consumer*

> *dissatisfaction. It is critical that the Independent Adviser accurately analyze this tension and, explain to and convince Government of appropriate action.*

In our experience, a thorough consideration of the type and amount of investments required to provide a satisfactory quality of service at affordable tariff levels is critical to the long term sustainability of a PPP. This is an area where the role and quality of the Independent Adviser is key, as it requires that

(a) the contractual documentation governing the PPP properly handles the inherent conflict between efficiency and investment; and

(b) the Advisor is independent enough to manage Governments' often unrealistic expectations of high levels of investment.

3. Investor's requirements

Finally, investor's requirements mainly relate to acceptable level of risks, profitability and bankability. Bankability is achieved through a proper allocation of risks and the willingness of Governments to allow the transfer of certain rights from the private sector partners to lenders, in order to obtain a satisfactory risk profile to banks. Unbalanced concession contracts with unrealistic allocation of risks may find aggressive sponsors but will ultimately fail to mobilize appropriate financing, adding financial stress to the concession. This is a final key area where the quality and experience of the Independent Adviser is critical to the success of the transaction. A successful PPP project is one that strikes the "*right balance*" between the risks transferred to the private sector and those retained by the public sector.

> ***Box 4: Polynesian Blue – A Model PPP Transaction***
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> *Background*: Polynesian Airlines, the national carrier of Samoa was inefficient and loss-making. Total Government subsidy was over US$76mm between 1994 and 2003. Government subsidy in 2004 budget was over half of budget deficit.
>
> *Government of Samoa (GoS) Objective*: Introduce PPP to eliminate burden on treasury, increase access to Samoa and assist in Samoa tourism development.
>
> *Solution*:
> - A new JV airline - Polynesian Blue - to take-over the loss-making long-haul routes using Virgin Blue (Australia)'s low-cost model.
> - Shareholding is GoS 49%; Aggie Greys Hotel 2% and Virgin Blue 49%.
> - Polynesian Blue to operate on commercial basis – with each party taking on the risks that it can best handle.
>
> *Results*:
> - New Equity investment of which 49% is FDI
> - Annual budgetary savings of approx US$3.8mm
> - Substantial reduction (over 35%) in air fares
> - Efficient, reliable and competitive air transport access to Samoa without the financial burden of running an unprofitable airline
> - Increased penetration in the tourist markets of Australia and New Zealand – the future of Samoan tourism.
> - The first time ever a low cost airline will participate in a PPP – a credit to the Government for being open to new transaction structures

Conclusion

The critical question for Governments is: Will increasing the role of the private sector in the provision of public infrastructure and services benefit our country? The answer to which is an overwhelming "YES".

Given the overwhelming response to that question, it is imperative that the Government hires credible Independent Advisers for the reform process as the PPP process is complex and, in order to create these benefits, requires a certain expertise.

Government use of Independent Advisers in the structuring of PPPs has a number of advantages:

- It allows the public sector to access global and technical expertise that does not exist within the government.
- It can prevent the government from making costly mistakes.
- It facilitates the transfer of knowledge from the private sector to the public sector; and
- It brings legitimacy to the PPP process – often placing an external stamp of endorsement on the government's proposals, thereby increasing investor and public confidence.

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[i] Toolkit for Hiring and Managing Advisors – http://rru.worldbank.org/