

PUBLIC-PRIVATE PARTNERSHIP IN PAKISTAN

1. The infrastructure needs of a growing population in a developing economy like Pakistan exceed the fiscal resources available to fulfill them. For developing countries, public-private partnerships (PPP) are a well-accepted procurement and financing modality¹ to address an important portion of these infrastructure gaps. PPPs, as a tool, can be effective by:

- crowding-in private (debt and equity) capital resources in pursuit of the potential for core and non-core revenue mobilization (made available to private concessionaries through user-payer models), which in most developing countries only PPPs have been able to establish.²
- bringing cost and time efficiencies in construction of infrastructure projects and availing of other private sector expertise to manage and efficiently deliver public goods.³

2. PPPs also bring fiscal risks. These need to be mitigated and managed. To address these challenges, governments usually try to introduce PPP legal and institutional reforms to develop technically sophisticated PPP ecosystems that identify, structure and eventually only pursue PPP proposals that can maximize value-for-money (VfM) to tax-payers.⁴ These ecosystems exist to carry transactions from identification stage to execution, and ensure PPP transactions are development-relevant⁵ and fiscally-responsible. These ecosystems are as crucial for development outcomes as they are demanding in terms of technical capacity. It is the development of these PPP development frameworks that Pakistan urgently needs to pursue, which is an ongoing process, achieved to different degrees so far.

1. PPPs at the Federal level

3. In Pakistan, the power generation sector, a de-facto federal responsibility by virtue of the national integration of power transmission infrastructure, has been developed under PPP arrangements for a number of years. This has occurred under a regulatory policy that guarantees a rate of return on private partner's investments in power generation, plus an upside

¹ Technically, PPPs are a form of procurement and financing of the development and operations of infrastructure services (of public good nature), irrespective of whether the concession relies on user-payer revenue generation or not.

² Conceptually, and as it is indeed the case in many developed countries, there is not much of a "fiscal free ride" in PPPs (especially if public sector accounting is done on an accrual basis), because "Governments can also implement user charging" (see Engel, Fisher, and Galetovic (2009), *Public-Private Partnerships: When and How*. IDEAS). But actually, in most developing countries, governments can find it difficult to charge users a cost-reflective tariff for publicly-provided services (or even for services produced by assets that were provided through traditional public procurement), and PPPs have been able to overcome that political economy barrier.

³ Improving public service quality and increasing operating efficiency are also usually-emphasized objectives for pursuing fiscally-responsible PPPs, which free-up more fiscal space the more inefficient traditional public procurement (i.e. the relevant public sector comparator) is.

⁴ A PPP project yields VfM if it results in a net positive gain to society greater than that which could be achieved through any alternative procurement route. It is good practice to carry out a value for money analysis (essentially a cost-benefit analysis) as part of the initial preparation of a project, regardless of whether it is procured conventionally or as a PPP. In some countries like the UK, which have extensive PPP programmes, a PPP project is said to achieve value for money if it costs less than the best realistic public sector project alternative (often a hypothetical version of the project) which would deliver the same (or very similar) services. This public sector alternative is often referred to as the "public sector comparator" ("PSC"). Carrying out a PSC exercise should be an integral part of building the business case for a PPP project, and it is a legal requirement in many PPP programmes worldwide.

See: <http://wbi.worldbank.org/wbi/news/2013/11/04/value-money-public-private-infrastructure-projects>

⁵ The underlying projects need to have been sourced from the Government's sector or infrastructure development plan and be an integral part of development planning implementation.

to reward efficiency. In this sense, PPPs have already enabled power generation outcomes that fiscal resources would simply not have been able to reproduce, even though the levels of equity reward to independent power producers locked in the long-term power purchase agreements awarded to date can and have been questioned.

4. In other forms of infrastructure-services projects, the federal government also needs to provide support in the form of minimum revenue guarantees that can act as a safety net on the commercial risk of the project and yet create incentives for the private sector to generate core and non-core revenues from the project. The latter has to occur in order to reduce the potential fiscal burden on the public sector and maximize VfM. But there have been constraints on the ability of the federal government to provide this kind of viability gap financing to date. In addition, the Federal PPP Law is currently awaiting ratification. As such, PPP projects continue to be subject to other general and sector-specific laws, which adds a non-negligible source of legal risk to all parties in PPPs.⁶ The policy framework being developed by the Infrastructure Project Development Facility (IPDF) is also still a work-in-progress, and limited experience to date in areas such as risk-allocation means that it will be difficult to make swift progress on large-scale relevant projects anytime soon. According to the PPP Policy (2010), conditions such as VFM and viability must be met when awarding projects, but it is generally acknowledged that there is a lack of consistency and technical capacity in the application of such criteria.

5. The IPDF has been formed to act as the PPP unit and support the PPP Task Force (which advises on PPP reforms and legislation) chaired by the minister of finance. These, in combination with the Debt Policy Coordination Office and the project-specific line ministries, form the basis of the new institutional architecture for federal PPPs in the works. But it will take some time for these mechanisms to get consolidated and for now, there are important operational problems in the line departments, not least in terms of technical capacity. Possibly due to these difficulties, the IPDF is now proposing to act as transaction advisors for the PPP transactions it facilitates with the line departments. Another important challenge related to the lack of debt markets maturity, is that the availability of long-term infrastructure financing is very limited. Because only short to medium-term financing is available from commercial banks, which shortens the payback periods of commercial viability solutions that are explored, VGF becomes the crucial enabler of large-scale PPP projects.

2. Provincial PPPs

6. Recent constitutional reforms have devolved to provincial governments the main responsibility for most forms of infrastructure development. But this devolution still has to be matched with financial and technical capacity development at each provincial Government. Sindh and Punjab are the two largest provinces of Pakistan and account for roughly 77% of Pakistani population, and 85% of the country's GDP. Bankable PPPs can be implemented in these provinces, which can not only have demonstration effects on the overall PPP market in Pakistan, but also help start closing the infrastructure gap in the country. The infrastructure and social service needs of Sindh and Punjab outpace the provincial fiscal space that is currently available for new infrastructure investments. Prospects are limited for the near future development of provincial government debt issuance, or for the mainstreaming of cost-reflective user charges, by provincial governments, in current and new public sector infrastructures.

⁶ Government must follow the Public Procurement Rules (2004) and treat bidders equally. A relatively small field of bidders also limits competition. Dispute-resolution usually takes place in court; the process is lengthy (although not unfavorable towards private partners), and an Alternative Dispute Resolution Centre was recently established.

7. Traditional infrastructure procurement in Sindh has been ineffective in keeping in containing cost and time overruns. This also constrains infrastructure development in Punjab, albeit to a lesser extent. Therefore, to address the significant infrastructure requirements that are believed to constrain economic growth in Sindh and Punjab, both these provincial governments had already initiated, in the late 2000s, the design and implementation of medium-term reform agendas intended to establish mechanisms to engage the private sector through PPPs, in infrastructure and public service provision. The underlying challenges, however, remain difficult to overcome. See boxes 1 and 2 below for detailed information on those past reforms.

Box 1 – ADB’s assistance for PPP development in Sindh

Through the assistance of ADB’s Sindh Growth and Rural Revitalization Cluster Program (SGRRP), the Government of Sindh (GoS) introduced and developed a PPP policy, and a set of institutional, regulatory, financial, and concession-management frameworks for provincial PPPs. But this institutional development process remained incomplete, as the third and final subprogram of the cluster program was not processed.⁷ In its Subprogram 1, the SGRRP supported the Finance Department in producing a concept paper outlining the main steps to be undertaken in developing PPP frameworks in Sindh, as a PPP reform roadmap. Under its subprogram 2, a PPP law was drafted and enacted, and a PPP policy developed to provide operational guidance to the GoS and private sector. Guidelines for a project development facility (PDF) and a viability gap fund were also developed to support PPPs, and provincial government procurement rules were amended to include PPPs.⁸ The PPP and risk management units were also formed with support of Subprogram 2, and concrete work on appraising and developing a PPP pipeline began. But the operation of risk-management functions since then has not adhered to the originally-devised set-up. Above all, both units required further capacity development TA, and subprogram 3 was expected to support that.

Indicative triggers for subprogram 3 had been clearly defined. These included the development of a PPP pipeline based on transport sector mapping, the formal notification by the PPP Policy Board of PPP policy, project development facility (PDF) Guidelines, PPP Procurement Manual and PPP selection criteria, incorporation of Equator Principles⁹ and gender equity provisions, and the development by the Finance Department of an integrated analysis and reporting system for contingent liabilities in PPP (and non-PPP) projects. As an assurance in subprogram 2 approval, a capacity development plan was to be developed and PPP nodes were to be established at key departments. All this was supposed to be achieved by the time of subprogram 3 processing, but the latter did not materialize, and related TA was not extended. Promisingly though, the project monitoring unit of SGRRP kept reporting that all related indicative triggers for subprogram 3 in the PPP reform agenda had been achieved,¹⁰ as political will to make PPPs happen kept pushing the PPP “team” in Sindh to make progress.

It is encouraging that the agencies involved kept pursuing the objectives of this reform agenda, and to

⁷ The macroeconomic circumstances surrounding the discontinuation, in September 2011, of the \$11.3 billion Stand-By Arrangement with the International Monetary Fund (which Pakistan had entered into in 2008) made it challenging for the main international development partners to provide programmatic support to the country. Subprogram 3 was thus not processed. Subprogram 3 was thus not processed.

⁸ The policy and law incorporated environmental and social safeguards, and gender provisions, to ensure sound project design and inclusive implementation.

⁹ A risk management framework, adopted by financial institutions, for determining, assessing and managing environmental and social risk in projects, tantamount to a minimum standard for due diligence to support responsible risk decision-making.

¹⁰ With the exception of the hiring of staff qualified in environment and social management of projects.

date, of the nineteen projects referred to the PPP unit by the different departments, five have gone into execution phase, with two already in operation.¹¹ Ongoing policy dialogue between ADB and GoS since then has also emphasized that the capacity of the PPP and risk management units to appraise, manage and report on fiscal contingent liabilities remains fairly limited. The benefits to Sindh from this PPP reform agenda depend on the establishment of a proper risk management system and of a PPP pipeline development framework that is based on (i) proper economic and financial analysis, and (ii) a project prioritization that addresses Sindh's main infrastructure constraints. Implementation of these additional reforms is crucial to ensure that only PPPs that maximize value-for-money to taxpayers are pursued. In that sense technical and financial support under subprogram 3 would have been essential to ensure the requirements for such a beneficial impact.

Follow-up assistance is now crucial, as highlighted by the difficulties of the last few years:

- Because of lack of technical capacity and key institutional mechanisms, it has not been possible to develop a PPP pipeline based on strictly bankable projects with well-assessed revenue streams, or to implement a clear fiscal risk management mechanism for the PPP portfolio. This needs a gradual reform process through which P&D and line departments move towards a PPP project identification system that is linked to the province's multi-year development plan and uses bankability (potential for core and non-core revenue generation) as the crucial criteria;
- Key flaws in project finance design have led to a tendency to overcompensate in the credit risk security solution, with both the viability gap fund and the pension fund having been heavily used to cover commercial risks and provide cash collateralization of provincial credit-risk guarantees to date.
- There is no mechanism to manage the fast rising contingent liabilities and the contagion this is likely to cause in the fiscal space.

8. ADB has conducted detailed recent diagnostic exercises¹² on PPP frameworks in Punjab and Sindh, and on the current status of implementation of provincial PPP projects. Little progress has been made in Punjab since the introduction of the PPP Law and remaining guidelines, whereas Sindh has been able to, with some important lessons learnt, reach financial closure on a handful of transactions. At different stages of PPP development, both Punjab and Sindh face, with different degrees, institutional and capacity gaps that can still be clustered under three major headings:

A. PPP pipeline development. There are three major issues which stall the formation of credible provincial PPP pipelines:

- a. **Weak PPP capacity in the government.** For identification, conducting project pre-feasibility work and feasibility studies, structuring the transactions, tendering out and then managing the PPPs.¹³ Also, the right incentives are not in place for staff or government to build and retain the capacity to operationalize the PPP framework.

¹¹ The Hyderabad Mirpurkhas Dual Carriage project is in operation (construction was completed in September 2012). The four PPP projects in the execution phase are: (i) the Jhirk Mulla Katiyar Bridge project, which achieved financial closure in March 2013 and is expected to complete construction in 2014; (ii) National Institute of Child Health Security Management and Fire Safety project, expected to become operational in 2014; (iii) the Sindh Nooriabad Power projects; and (iv) the Run of the River Hydro project (in the investor solicitation stage).

¹² Diagnostic Reports by R, Wong under SC-101820 PAK: Enhancing PPPs in Punjab (Pakistan) and TA-7201 PAK: Improving PPP in Sindh (Pakistan).

¹³ Government officials lack the capacity to identify and appraise the transactions as PPPs. Sufficient skills do not exist for carrying out tasks such as forecasting use of asset, estimation of revenue/cashflows, risk allocation, calculation of rates of return and legal and corporate structuring of PPPs as independent transactions.

- b. **Weak project development.** PPPs are a very effective way of leveraging private capital and expertise for delivering public goods. However, the PPP decision process requires important investments in analytical work before transactions can be effectively executed. Governments lack funds for building capacity of their own staff (especially in provincial governments), conducting project feasibilities, financing transaction advisories, etc.
 - c. **Inherent bias/risk-aversion in the selection process of development projects.** Most of the development projects can be plotted in a biaxial space defined by public demand and commercial viability. Projects which could be high on public demand (or contain potential for non-core revenue generation) are usually those which are more commercially viable i.e. bankable for PPPs,¹⁴ and would thus require less viability-gap funding commitments. However, currently, these bankable PPP projects end up in the annual development plan (ADP) for traditional public sector infrastructure procurement and financing, as experience and planning/appraisal processes are not yet in place to ensure a high likelihood that PPP financial closure and implementation can be reached. PPPs can only be an effective element of an infrastructure development strategy if provincial governments can exercise more effective planning and gradually increase the allocation of potentially bankable projects towards the PPP route.
- B. Alignment, flexibility and capacity of procurement function.** Several policy and legislative documents (PPP Policy and Act, Provincial (Punjab/Sindh) Procurement Regulatory Authority Act and Rules) control the PPP procurement functions in the provincial governments of Sindh and Punjab. In addition, there may be sector specific requirements, such as product or service standards or schedule(s) of rates which have a bearing on the content, and mode of tendering PPP transactions. Provincial governments still find it challenging to negotiate an acceptable Request for Proposal that is in full compliance with all of these legislations, which still need to come into full alignment.
- C. Viability gap funding.** To mitigate the PFM difficulties that provincial governments in Pakistan still face in providing the necessary fiscal commitments and other guarantees of financial repercussion to PPPs, it is very important to establish well-governed off-budget facilities that can offer viability gap grants and risk-sharing solutions to make projects commercially viable for investors, while still keeping the PPP solution advantageous (versus the public sector comparator on traditional infrastructure procurement).

Box 2 – ADB’s assistance for PPP development in Punjab

Private sector participation in infrastructure and social services has also long been recognized in Punjab to be a key project development instrument going forward. With support from ADB’s Public Resource Management Program (PRMP), a Private Sector Development (PSD) Committee was created, chaired by Chairman, Planning and Development (P&D) Board to oversee the development of an action plan for implementation of a PPP roadmap (the PSD Committee was also to provide guidance to the PPP Cell that was set up in PD&D in 2008, in charge of drafting the policy and regulatory framework.

Under Subprogram 2 of the PRMP, a framework outlining the road map for PPPs was developed and a PPP Policy was approved, in 2009. The Punjab Assembly passed the PPP for Infrastructure Act on 12 July 2010 and the Planning and Development Department (P&DD) hired a manager and two professional

¹⁴ Because a large group of population could be willing to pay user fees or tolls for them.

staff for the PPP Cell. A Project Development Facility (PDF) was established, and related guidelines were approved by the provincial cabinet in 2009. A \$1 million allocation was made to this facility in the FY2010 budget, and a preliminary list of potential PPP projects was identified by P&DD. Under the PRMP, indicative actions for Subprogram 3 included the establishment of a PPP Steering Committee, chaired by the Secretary of P&DD and with representation from the local business chambers, the Government of Punjab (GoPb) and the private sector. This was established in 2010. PPP focal points were established in some line departments, and Guidelines on PPP project inception, preparation, and transaction execution were created. A risk management policy was developed, which specified criteria for risk management and defining principles in terms of project quality, legality, fiscal prudence, and financial obligations, and a PPP Risk Management Unit (RMU) was also set up in MOF. Its operationalization however has lagged behind since then, mostly due to the lack of a steady development of PPP project proposals.

The development of the PPP framework in Punjab has only been *de jure* in nature. Even though key elements of an enabling legal, institutional and financial framework for PPPs have been put in place, with the exception of viability gap, the momentum for PPP was not generated. Even though the government started establishing necessary government offices based on the PPP Law, private sector participation in education, health and infrastructure sectors did not materialize as had been originally envisaged, and the PDF was hardly tapped on. A number of reasons for this lackluster development can be identified. The PDF could have been utilized to prepare simple PPPs (service and management contracts) to facilitate learning-by-doing, and demonstration projects could have been very valuable as learning references about what needed to be done to further improve the PPP institutional, legal and regulatory framework. If PPP skills and experience had been appropriately developed, a pipeline of bankable projects could have indeed been implemented, as Punjab is known to have significant PPP potential. There have also been frequent changes of PPP Cell management and no systematic training of PPP appraisal stakeholders.

3. ADB plans going forward

9. A comprehensive capacity and institution-building response is required from development partners to address the current needs of provincial PPP development in Pakistan. With a major focus on Punjab and Sindh, the provinces that dominate the economy of Pakistan and are at more advanced stages of PPP development, and following up on past engagement with the respective provincial governments, ADB is programming a range of technical and financial assistance initiatives to help make PPPs relevant for Pakistan's development.

10. The assistance initiatives under preparation keep in view that the binding constraints of PPP development in Pakistan lay in the lack of institutional capacity across the appraisal chain through which PPP transactions are supposed to be processed, from conception to execution, i.e. within the government. In other words, both the banking industry and the State Bank of Pakistan have been forthcoming towards these project finance opportunities, and the business and financial consulting outfits established in Pakistan have linkages within their international franchises that allow those to take on transaction advisory roles of varying degrees of sophistication.

11. ADB is committing close to \$200 million of its country programming allocation to address constraints identified and discussed above.¹⁵ These resources will be pooled with institutional and financial resources from the two provincial governments, aiming to develop and implement in the next few years a pipeline of fiscally-responsible, development-relevant PPP projects. Ultimately, the expected increase in private sector participation in both infrastructure and non-infrastructure public services will help both provincial governments address a significant fraction of the infrastructure gaps that currently constrain private sector investment and job creation in Pakistan, and generate demonstration effects across the PPP market in the country.

¹⁵ ADB is currently in discussion with identified official development partners to cofinance ADB's support for PPPs.