8

ONE QUESTION

EXPERTS

Some PPPs fail. That's a fact. But when the lessons these failures impart are integrated into future projects, missteps have the potential to innovate—energizing the learning cycle and setting the stage for long-term success. To gain a better understanding of how innovation in PPPs builds on genuine learning, *Handshake* reached out to PPP infrastructure experts around the world, posing the same question to each. Their honest answers redefine what works—and provide new insights into the PPP process.

> *"How can mistakes be absorbed into the learning process, and when can failure function as a step toward a PPP's long-term success?"*

ISABEL RIAL

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Isabel Rial is a senior economist of the Expenditure Policy Division in the Fiscal Affairs Department of the International Monetary Fund. She works on a range of cross country fiscal policy issues, focusing on public-private partnerships, fiscal risks management, and fiscal rules.

For centuries, PPPs have been used by governments as an alternative to traditional public procurement for the provision of public infrastructure, although results have been mixed. If properly managed, PPPs can deliver substantial benefits in terms of mobilizing private financial resources and know-how, promoting efficient use of public funds, and improving service quality. Yet in practice, PPPs have not always performed better than traditional public provision of infrastructure. The reasons for this vary across countries.

In many countries, infrastructure projects have been procured as PPPs not for efficiency reasons, but to circumvent budget constraints and postpone recording the fiscal costs of providing infrastructure services. Due to inadequate budgeting and accounting of PPPs, they can seem much more affordable, encouraging governments under short-term pressure to reduce their deficit or debt to use PPPs—even if, in the long run, they could cost more than public procurement. This has led some governments to go forward with low-quality and fiscally costly projects that would otherwise have been excluded from their public investment plans.

In some cases, PPPs have also resulted in large fiscal costs due to bad contract design and the realization of contracted risks, such as those associated with revenue guarantees. Therefore, if not properly managed, fiscal risks from PPPs can potentially have significant macroeconomic implications. They can potentially undermine efforts toward fiscal discipline by moving spending off-budget, creating firm and contingent liabilities for government.

International experience shows that there are many factors underpinning the so-called "failure to deliver" in PPP projects. This can include a weak monitoring and controlling capacity of PPPs across the public sector, but particularly in Ministries of Finance (or budgetary authorities). Second, a lack of integration of PPP projects into the budget process, medium-term fiscal frameworks, and debt sustainability analysis (given that PPPs are typically off-budget) is to blame. And third, a lack of transparency in fiscal reporting practices and quantification of fiscal risks can be at fault.

Yet governments can manage fiscal risks arising from PPPs to ensure that the potential benefits from PPPs are realized without weakening public finances or jeopardizing macroeconomic stability. Here are some ways to do that:

- Governments can pursue only "good projects" by having sound project planning, evaluation, and selection. There should be a clear investment strategy to select public investment projects on the basis of national priorities and cost-benefit analysis. Once a project is selected, the next step should be to determine whether procuring it as a PPP provides greater efficiency than public procurement.
- Governments can develop strong fiscal institutions to manage PPPs. It is essential that the Ministry of Finance manages a "gateway process" for PPPs that gives it sufficient control at each stage of the process. At any point in the process, the Ministry of Finance should be able to stop projects that are fiscally unaffordable. A dedicated PPP unit, with specialized and capable staff, can be helpful in managing this process. The Ministry of Finance can also consider establishing ceilings on both the stocks and flows of PPPs to help control fiscal risks.
- Governments can ensure a sound legal framework to manage public investment in general and PPPs in particular. This should involve a clear, fair, and predictable legal environment for the private sector. The legal framework should also clarify the roles and responsibilities of all relevant counterparts in PPP transactions.
- Governments can also implement good budgeting, fiscal accounting, and reporting for PPPs aimed at achieving full and transparent disclosure of all future budgetary costs and fiscal risks from PPPs. The impact of PPPs on future government spending should be incorporated in the debt sustainability analysis and medium-term budgetary frameworks. The use of commitment appropriations in the budgetary process, which authorize governments to commit public resources for future years, can also be helpful in drawing attention to the future costs of PPPs.

PPPs can be effective in delivering public infrastructure under certain conditions, but they also entail fiscal risks. These are manageable when officials pay close attention to models that have worked for other countries and tailor their approach accordingly.

FERNANDO CRESPO DIU

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Fernando Crespo Diu has been the Director of UTAP, the Portuguese PPP unit, since its creation in 2012. UTAP leads the appraisal, structuring and tendering of PPP projects, oversees and provides technical support to line ministries in contract management activities, supervises and reports on behalf of the Ministry of Finance the financial and fiscal performance of PPP contracts, and ensures the development of public sector know-how.

Although not a desirable outcome, failure is always the first step of the learning process toward more successful projects, in terms of implementation, value for money, and financial and fiscal sustainability. There is an enabling prerequisite for the learning process, particularly given the complexity and long duration of PPP arrangements: the establishment of institutional arrangements that provide stable, professional, and fully dedicated teams of experts within the structures of the public sector.

A central PPP unit—ideally located in the Ministry of Finance—should participate in all stages of a project lifecycle, from structuring to contract management, allowing continuous feedback and dialogue between contract management and public teams. In such an environment, the role of external advisors has to be carefully planned, as they provide key skills along the project lifecycle, but must not substitute those tasks where knowledge must be developed, stored, and used by the public sector.

In microeconomic terms, there are several key stages where public sector teams can extract valuable lessons from every project developed. During project planning, infrastructure needs across sectors must be duly appraised, ranked, and analyzed within the framework given by the long run fiscal policy objectives. During project definition and structuring, a clear and detailed risk matrix must support the analysis of risks transferred to the private partners and risks retained by the public sector, and must include as well a set of mitigation strategies for the latter. During contract management, an adequate enforcement of the contractual dispositions must be performed in a stable business environment.

Taken together, this virtually eliminates the probability of unilateral decisions by the public sector—thus maximizing predictability and minimizing the probability of contingent liabilities and the unexpected costs that damage a PPP's value for money.

DAVID BLOOMGARDEN

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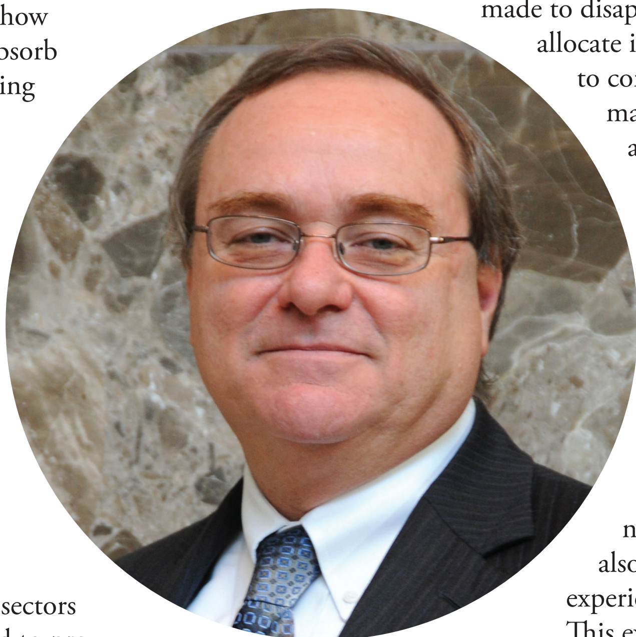
David Bloomgarden is Chief of the Basic Services and Green Growth unit of the Multilateral Investment Fund of the Inter-American Development Bank. He manages an annual $25 million technical assistance fund for early stage PPP support, climate change and adaptation/resilience programs, and private sector provision of basic services for the poor in underserved areas of Latin America and the Caribbean.

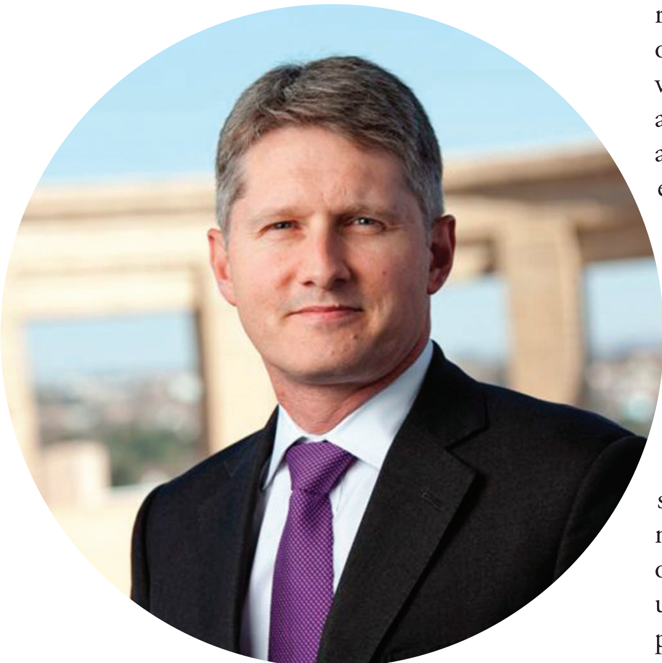


U.S. General George S. Patton famously said, "Take calculated risks. That is quite different from being rash." This quote summarizes how countries should absorb risks into the learning process of a PPP program. Governments know that complex projects never go exactly as planned. PPPs are among the most complex of all infrastructure projects, because they involve multiple stakeholders in the public and private sectors and tend to be used to procure large infrastructure. Starting a new PPP program requires that governments learn to master the regulatory, institutional, and technical challenges involved in planning, designing, and implementing a PPP. Few governments—and especially those of developing economies—can afford failure in the delivery of critical infrastructure and services given the scarce resources and enormous human needs.

To successfully launch PPP infrastructure projects, governments must develop a complete picture of the risks that flow from the scope and requirements of a project. This process begins with identifying risk for all phases of the project, from the earliest preparation stage to management of the PPP contract. This identification should list the nature of the risk, its probability of occurring, its expected impact on the project, and measures proposed to mitigate it.

Once a government has a good picture of the risk, it must allocate it. Risk cannot be made to disappear; the principle is to allocate it to the party best able to control its occurrence or manage its consequences and assess the likelihood of its occurrence. The risk of a PPP can be allocated to either the government or the PPP contractor or shared between them. The PPP contract allocates this risk and includes risk mitigation measures as needed. Governments can also manage risk by using experienced advisors.

This exercise of risk allocation is the most important step a government can take to avoid failure in the delivery of critical infrastructure. This does not mean a government can avoid mistakes or that there is a way to avoid a learning curve; it means that a government is taking a calculated risk. By carefully identifying and allocating risk, governments will climb the PPP learning curve faster. The result will be a PPP program that delivers value for money in terms of the efficient use of resources, transparency, and intended social and economic results.



RICHARD ABADIE

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Richard Abadie leads PwC's global infrastructure group, which provides services across the capital projects lifecycle. His area of expertise is infrastructure policy and financing.

Having worked in the infrastructure sector for nearly 20 years, I've had time to reflect on what success and failure look like in infrastructure PPPs. Mistakes have been, do, and will continue to be made when using PPPs. It is not perfect—nor is its application—but what in life is?

There are so many horror stories around non-PPP construction cost overruns, delays in completion, poorly specified contracts, weak tender management, corruption, failure to run transparent competitive processes, lack of project readiness, significant post-contract variations, and sporadic asset maintenance and management. PPPs eliminate many of the above structural weaknesses, which rightfully earns it its place as a challenging but effective procurement approach.

The chief criticisms of PPP—that it takes longer to procure and is less flexible than conventional procurement—have some validity. Getting price certainty does take time and requires clear contractual risk allocation through the life of the contract.

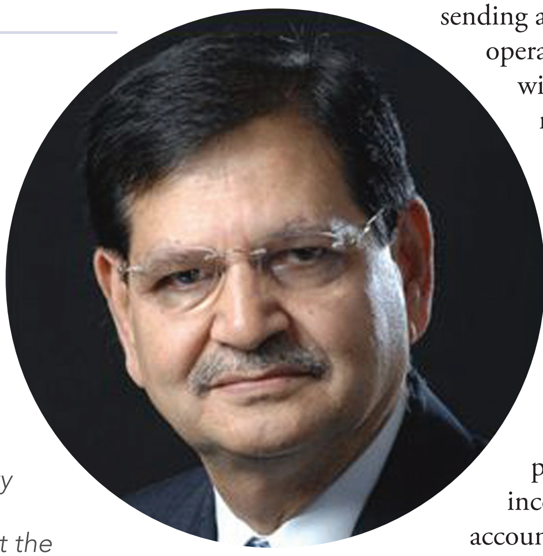
I've also seen PPP blamed for delivering services and facilities that are over-specified/not needed/unaffordable. Rarely is this the fault of one party—private or public—alone. It simply underlines the critical importance of how the private sector and public sector agencies work together to make sure the PPP is sustainable in terms of its financials and the needs it is addressing.

I've seen some questionable risk allocation to the private sector through badly structured PPPs, including:

- Major planning and approvals;
- Land expropriation and resettlement of people;
- Technology at risk of rapid obsolescence;
- Speculative demand; and
- Regulatory change.

These risks should be retained by the public sector and managed accordingly.

At the end of the day, a PPP is only one of several tools to deliver infrastructure-backed services, and "A tool is only as good as the person using it," as the saying goes. Used properly, PPPs can deliver great outcomes. Continuous learning about PPP application through codification, training, knowledge and practical experience sharing, and best practice application are critical components of successful PPPs. Industry focus should be on improving the user rather than improving the tool.



GAJENDRA HALDEA

Government of Rajasthan

Gajendra Haldea is Advisor (PPP & Infrastructure) to the Government of Rajasthan and CEO, Bureau for Partnerships in Rajasthan. He is the former Advisor to Deputy Chairman and Principal Advisor (Infrastructure) at the Planning Commission of the Government of India, as well as the author of several model PPP contracts, and the author of India's Electricity Act 2003. His most recent book is Infrastructure at Crossroads: The Challenges of Governance *(Oxford University Press).*

›› It is a truism that infrastructure projects, like much else in life, do not unfold exactly as planned. However, there is little room for failure because it would affect a large number of users for which the government would be accountable.

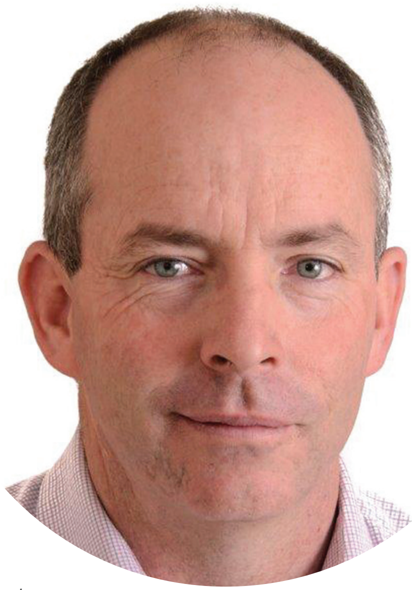
India happens to be the largest laboratory of PPP projects and offers a plethora of evidence. While most projects have succeeded, some have faced failure mainly because they were encumbered by lack of conceptual clarity in policy formulation as well as contractual framework.

Many assert that all future events cannot be predicted and a PPP contract must, therefore, be regarded as incomplete. They need to be reminded that if man could succeed in sending a satellite to space and operate it for several years without any ability to modify it, why can't this be done while launching an infrastructure project? The key lies in rigorous preparatory action. Regrettably, the structuring of infrastructure projects is often left to commercial consultants who perform with insufficient incentives, besides lack of accountability, which in turn is compounded by inadequate capacity within the government.

While it may not be possible to predict future events, it is certainly possible to identify the various categories of events and state the principles that would be followed in dealing with them. Moreover, a clear focus on outcomes, as distinct from input specifications, would allow the private entity to innovate for improving efficiencies. This implies a fairly evolved contract based on prudence and diligence, as governance by trial and error is an unacceptable proposition.

It is important to recognize that whenever a failure leads to renegotiation of a PPP contract, the users usually end up bearing the burden—either as rate payers or as taxpayers. Granting favors to private entities beyond the terms of their contract must, therefore, be avoided as far as possible.

The short answer is that it is possible to formulate PPP contracts that neither fail nor need to be renegotiated. The challenge lies in putting together the capacity and effort necessary for achieving this objective.



WILLIAM DACHS

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William Dachs is the Chief Operating Officer of the Gautrain Management Agency, charged with oversight of a $3 billion urban rail PPP. He is the former Head of the Public-Private Partnership Unit at the South African National Treasury.

The ability of a national PPP program to apply lessons learned from one project to the next is dependent on factors such as the documentation of case studies and the use of a central repository of information in a PPP unit at the national level where such lessons can be distilled and applied to the next project in that jurisdiction. There are plenty of good examples of such programs that learn from and apply lessons. But how are individual PPP projects able to absorb mistakes and still meet the original objectives of value for money for the users of the services and the taxpayers who may ultimately bear the risk of the project failing?

It is impossible to predict the range of possible risks and to allocate these with precision over 20 to 25 years in a complex and changing environment. As such, the key to achieving long-term value from a PPP does not only lie in the quality of the feasibility and procurement phases, but also in how the balance of risk and rewards is established and applied in the PPP contract so as to be able to survive significant changes over a long period of time.

The lessons that have been learned over the last 15 years are that the flexibility to amend contracts is very important but so is the need to maintain public sector oversight over that change process. This is necessary so that the public benefit, or value for money, is maintained and that the risk allocation between the parties remains consistent with that approved as part of the original PPP contract. It's also important for governments to permit PPP contracts to enter into liquidation without stepping into the contract and rescuing the shareholders.

The "let the market work" approach applies market risk in a strong but fair manner. The alternative is to renegotiate and rescue the shareholders—and in so doing, creating a strong moral hazard that will ultimately prevent any lessons from being learned and applied.

ROBERT PUENTES

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Robert Puentes is a senior fellow with the Brookings Institution's Metropolitan Policy Program, where he also directs the program's Metropolitan Infrastructure Initiative. The Initiative was established to address the pressing transportation and infrastructure challenges facing cities and suburbs in the United States and abroad.

In the U.S., one of the best learning tools for places wishing to engage in PPPs for infrastructure has been past mistakes. From the parking meter deal in Chicago, to Virginia's Pocahontas Parkway, and a handful of others, American cities and states pay close attention to one another and are loathe to repeat previous problems.

But going forward, institutionalizing such learnings requires a dedicated team. Indeed, assembling a group with the right mix of finance, legal, policy, and communications experience is critical to the success of any PPP project. Public sector agencies looking to procure a limited number of PPP projects or engaging in their first, often use outside advisors for most of these services. This can be a successful strategy as long as public sector decision makers remain in control of the process.

However, to truly embed learning, a dedicated PPP unit is necessary to increase the public sector's in-house capacity and expertise. These teams can live inside a department, such as a transportation office, or may be generalists under a mayor or governor's office. Examples of these types of PPP units can be found at both the state level, notably in Virginia, and at the city level in places like Los Angeles and Chicago. The Obama administration is also creating the Build America Transportation Investment Center, a coordination unit at the U.S. Department of Transportation that will help localities with innovative finance tools like PPPs.

While the exact mission of each of these offices varies, PPP units have five distinct roles

in the procurement process: policy formulation and coordination, quality control, technical assistance, standardization, and promotion. By bringing this expertise in-house, states and localities are able to develop both the formal and informal processes that underpin smooth transactions. Finance expertise in these units is especially important, as it decreases transaction costs over time by cutting down on the need to hire outside consultants and builds greater market certainty for leading private sector partners.

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Thomas Maier is the Managing Director for Infrastructure at the European Bank for Reconstruction and Development, overseeing EBRD's operations in the Municipal and Environmental Infrastructure and Transport sectors. He joined the EBRD as Senior Project Manager in August 1993 and later worked as Senior Banker in the Romania, Moldova, Croatia and Ukraine country team. In 1999 he moved to the Municipal and Environmental Infrastructure team as Deputy Director and became Team Director in October 2001.

For countries new to PPPs, there is no doubt a steep learning curve. Fortunately, there is also a growing body of experience that such countries can learn from—the key is to understand the essence of the lessons and then incorporate these changes into the design of government support for PPPs. Ultimately there is of course no substitute for good project preparation, local capacity, and the development of solid legal frameworks and local capital markets—we all know these are the building blocks for the long-term success of any country's PPP program.

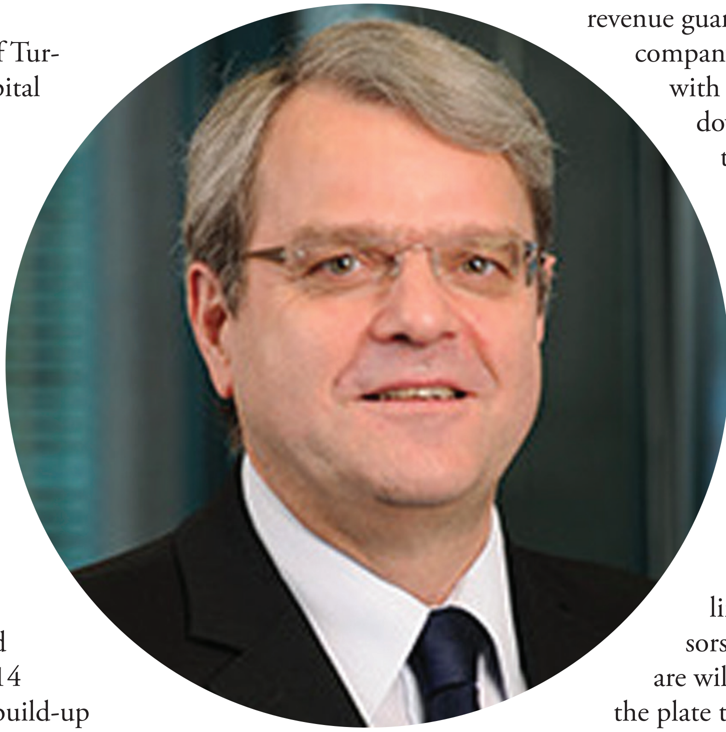
Focusing on lessons learned from EBRD's region, two current examples from Kazakhstan and Turkey come to mind.

Kazakhstan is an oil-rich country with an investment grade sovereign rating. While user charges are generally low, it is possible to structure good quality PPP projects based on the government's fiscal stance. A decade-long effort has been required to get to this point. The concession law, adopted first in July 2006 and amended in 2008, was based on best practice in the West, but apart from localized small-scale PPPs, large-scale projects have not yet been developed. In our view, the key shortcomings have included a cumbersome procurement process; the lack of an availability payment scheme; the impossibility of using international arbitration; the unwillingness to ensure creditors' step-in rights in case of default of the concessionaire; and treatment of the foreign exchange risks.

Following a few failed tenders, EBRD and IFC were engaged in 2013 to assist the government to make the necessary changes in the legislation. As a result, the law was further amended in July 2013 to allow basic yet fundamental improvements: the introduction of a two stage tendering and of the availability payment scheme as a measure of state support. In July 2014, further amendments were made to provide for step-in rights of creditors in case of default of the concessionaire, enable international arbitration, define/enable termination payments upon cancellation of a concession agreement in certain cases, and enable foreign exchange fluctuation adjustments to the state support measures provided in local currency.

Following these last amendments, EBRD and IFC have assisted the government to develop the Almaty ring road PPP based on an availability payment basis. The project, now under tender, has attracted a good level of bidder participation. Given the high profile of the Central Asian region and beyond, this project should also have a great demonstration effect.

The case of Turkey's large hospital PPP program presents another interesting set of lessons learned. While the first of what is expected to be over 30 new facilities management-based PPPs for hospitals closed in October 2014 in Adana, the build-up took over five years. This was due primarily to the need for the government to mitigate certain critical risks for the private sector before they were able to reach financial close. In 2014 the Turkish Government agreed to a set of measures and supports. First, a debt assumption by the Turkish Treasury directly covering up to 85 percent of the loan in case of default, with a cap which varies each year. Another crucial step was to provide coverage of forex risk using an indexation mechanism. In this case, the Ministry of Health agreed to a formula in the payment mechanism of the hospitals PPPs that is triggered when the Turkish lira devaluates at a higher rate than inflation. Finally, the Ministry provided a cap on performance deductions within the PPP contracts that effectively creates a revenue guarantee to the project company. This, together with the ability to pass down performance risk to services subcontractors, means a secure cash flow to service the debt.



In my view, these examples show that there are practical measures that can be taken by governments to get projects over the line, and that sponsors and their lenders are willing to step up to the plate to deliver projects when governments are willing to meet them halfway. We look forward to many more well-structured PPPs—in fact, we will be playing an active part in a global effort to accelerate infrastructure investment, using EBRD's new Infrastructure Project Preparation Facility, which launches this month. We look forward to seeing the pipeline grow.