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Position Paper on Public-Private Partnerships in the Delivery of Government Services

Working Paper 8

Prepared for
Government of Palau and
Asian Development Bank

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ACRONYMS

ADB – Asian Development Bank

BOO – Build-Own-Operate

BOT – Build-Operate-Transfer

FEIM – Facility for Economic and Infrastructure Management

GOP – Government of Palau

PPP – Public-Private Partnership

PSC – Project Steering Committee

1. Executive Summary

1. This Working Paper is produced to meet the requirement for a Position Paper on Public-Private Partnerships (PPPs).

2. The narrower definition of PPPs is those arrangements where the private sector invests in needed infrastructure for the provision of agreed services, and in return the government guarantees minimum levels of revenue or use, ("take or pay"), thus making the investment worthwhile to the private sector. The private sector usually operates and maintains the facility in question, although with some PPPs relating to provision of special purpose buildings (such as schools, hospitals and prisons), this is not true, and the PPP is related only to the provision of availability of infrastructure.

3. The major benefit for government from PPPs is that it is not faced with the need to finance significant up front costs associated with new developments – say of a new landfill or water supply project. All financing is undertaken by the private sector.

4. PPPs are particularly attractive to governments that are limited in their ability to finance future capital investments, but are confident they understand usage trends and consumer willingness to pay. They provide an opportunity to replace or develop infrastructure that will bring immediate benefits to the country without the need for government to make any financial contribution of its own. They also generate some certainty that future operations, under the control of the private sector, will be efficiently managed over the "whole of life" duration of the facility – thus avoiding deferred maintenance that is sometimes a feature of government owned infrastructure.

5. Under a PPP contract a government is exposed to long-term liabilities that may not be transparently recorded. If the projections of use are unduly optimistic, then there is a long-term risk that government will have to make up any shortfalls between projections made at the time of developing the contract and actual usage/revenue.

6. In many cases, there is a lack of transparency within the national accounts as to the degree of fiscal exposure held by the government since sovereign guarantees given under a PPP do not translate into readily quantifiable outputs.

7. Other partnership models are more in the nature of contracts, and do not introduce obligations on government. Joint ventures between a government and the private sector are contractual partnerships in which the government, as well as the private sector, contributes towards the capital cost; shares responsibility for management and governance, following traditional company structures, and shares the risks associated with the venture.

8. Concessions involving another form of exclusive rights to the private sector, are again outside the narrower definition of PPP. With a concession the full risk rests with the private sector and there are no government guarantees of future revenue levels. The government's contribution is through awarding the concession and granting exclusive use of existing infrastructure in a particular location, or rights for the concessionaire to develop their own infrastructure, as described below.

9. A Build-Own-Operate (BOO) concession appears to be a more attractive modality for many of the government services likely to be required in Palau. With a BOO scheme the risk rests entirely with the private sector. If there is competitive bidding for a well structured BOO, then both development and operating costs are likely to be minimized since this is in the interests of the private sector. In contrast, a PPP with guaranteed levels of income and or usage, provides some financial performance incentives to the private sector to minimize costs and maximize revenue (within any accepted regulatory framework), but the security of the knowledge that government guarantees can be activated if certain usage hurdles are not reached. This may reduce the motivation within a PPP to make hard operating decisions, compared to a BOO concession. There is reduced incentive to maximize efficiency or increase usage through say, a planned marketing campaign that addresses a need to increase utilization or throughput of a facility.

10. Under any form of partnership it will be important for the Government of Palau (GOP) to:

- first gain a sound understanding of operational requirements and current deficiencies;
- have clearly articulated long term policies relating to Universal Service Obligations, tariff reviews and cost recovery mechanisms; and
- understand the scope for making improvements (for instance reducing water losses) and the impact this will have on the business model.

11. It will also be advisable to develop scenarios of varying levels of demand for service, so that comparisons can be made of the comparative attractiveness of different ownership and operating models such as:

- government remaining as owner/operator;
- a Joint Venture operation where risk and funding is shared between the public and private sector;
- a concession where the concessionaire uses infrastructure provided by government;
- a BOO or Build Operate Transfer (BOT) concession that can be developed to provide the same level of service, but with the private sector carrying all the risk; and
- a PPP where all investment comes from the private sector but government effectively underwrites the risk.

12. The proposed governance strategies and action plan, and the proposed assistance with development of a Business Plan for the Bureau of Public Works, will go a considerable way towards identifying performance drivers, financial breakeven points, and factors that will need to be considered in comparing different forms of service delivery for the future. The proposed strategies and action plan presented in Working Paper 7 dealing with privatization principles is a starting point. The recommendations do not include development of a more detailed comparison of the above ownership and operating models. The need for this comparison will become clearer when detailed actions to identify time bound investment programs, service requirements and resource availability have been assessed.

2. Introduction

13. This Working Paper addresses the requirement to produce a Position Paper on PPPs for the delivery of Government Services.

14. Examples of future opportunities for this modality in Palau are addressed in individual Working Papers relating to specific GOP institutions or activities.

15. The Working Paper focuses on risks and precautions that need to be considered if using this modality for the development of services and infrastructure in Palau.

3. Public Private Partnership Concepts

16. PPPs are not new, although they have experienced something of a resurgence in recent years. Much earlier examples of this development model go as far back as the days of the early introduction of railways in Europe.

17. In broad terms, PPPs are privately financed infrastructure projects with guaranteed minimum revenues for the private sector provider. The private sector either: (i) sells its services to the government, or (ii) sells its services to third parties, but with significant fiscal support in the form of sovereign guarantees from the government to ensure minimum guaranteed income streams.

18. Unlike a Joint Venture company, formed by partnership between government and the private sector and with both providing finance and sharing in the risk, a PPP is based only on sovereign guarantees from government to the private sector that certain minimum levels of revenue will be received over the life of the arrangement. The government's role in the partnership is one of guarantor, not active shareholder. The private sector investor / operator has total ownership of infrastructure and other assets (possibly excluding land), and unfettered operating rights.

19. Adoption of a PPP model means that a government can achieve additional economic benefits from investments in productive assets which are otherwise beyond its ability to finance without taking on additional loans.

20. It also means that because the private sector is intimately involved in management of new facilities, then the profit incentives associated with private sector operations ensure maximum efficiency throughout the life of the contract.

21. PPPs are based on private sector operators investing in infrastructure and asset management, with 100 percent ownership resting with the private sector, but with government providing assurances regarding projected business volumes and tariff levels.

22. The critical success factors for government are:

- gaining a sound understanding of likely operating cost structures, to be sure that the proposed venture makes financial and economic sense and provides economic benefits to the country; and

- correctly estimating the level of future revenue for the operator, so that the government is not called on to make good on its guarantees to meet any revenue shortfall.

23. The benefit is that the necessary infrastructure is provided at no cost to government.

4. Other Partnership Arrangements

24. Two other forms of partnership between government and the private sector are also common, but do not fall within the narrower definition of PPP used above, which used the test of the existence of guarantees from government to the private sector:

    - Joint Venture partnerships, in which both Government (or local government or government owned institutions) share in ownership of an institution established to provide particular services, such as electricity supply, to citizens. In a Joint Venture both contribute to the capital cost. A company, typically with limited liability, is formed. Both parties contribute to the company equity, and nominate members for the Board of Directors. The Company is responsible for operations and is expected to earn an adequate return on investment. Revenue sharing will reflect relative ownership percentages.
    - Concessions in which government, local government, or government agencies, guarantee minimum levels of income or usage to private sector providers fall within the definition of a PPP. Concessions which provide contractual rights to operate services, but no guarantees of usage, fall outside the narrow definition of PPPs, since they impose no ongoing obligations on government agencies.

25. BOO and BOT concessions also fall outside the definition of PPPs since all the risk rests with the private sector, which also funds the capital expenditure required. Government may be expected to provide indicative volume projections at the time of concession bidding. If these become contractual minimum levels, then a PPP exists and government can be called on to offset any shortfall. If the risk remains with the private sector, the relationship is contractual not partnership.

5. Public-Private Partnership Benefits

26. The major benefits from PPPs result from reduced capital investment requirements for government, enabling services to be offered earlier than might otherwise be possible using government funding.

27. Considerable financial benefits can follow from the adoption of a PPP model, in particular for a country such as Palau which is constrained in its ability to provide finance for major capital investments such as solid waste services or water supply. In particular, PPPs reduce the level of investment in capital expenditure required for major capital works by bringing in both private sector investment to cover the cost of new infrastructure, but also the necessary operational expertise, since the investor will want to have ongoing operational rights and incentives to increase profits by maximizing efficiency.

28. PPPs therefore have the potential to enhance efficiency and create fiscal savings. They allow governments to secure much needed investments in public services without having to borrow or raise taxes – an important benefit in the current circumstances in Palau. They bring in specialist private sector operators and investors, who are generally able to operate services more efficiently than equivalent organizations under direct government control.

29. Subject to economies of scale (in which Palau will rank low), any form of PPP or contractual concession can be expected to bring the benefits of competitive bidding for operating rights. The bidding may be based on royalty payments from the private sector to the government, or where operations are not likely to be profitable because of tariff constraints, subsidy payments from government to the private sector. Either scenario will introduce competitive prices.

6. Public Private Partnership Drawbacks

30. While PPPs can bring benefits by encouraging private sector investment in infrastructure and services, they also have a significant downside, which is of particular relevance to Palau. Managing the associated fiscal risks requires a strong institutional framework and understanding of the level of demand and willingness to pay for services in the selected areas. The question for decision makers is whether there is the capacity to plan for such a modality and what degree of risk government will assume. The absence of good performance indicators and measures of volumes of output and the expectations of universal service and subsidized tariffs, raise many questions about the ability of Palau to enter into PPPs.

31. However, the proposed governance strategies and action plans recommended in Working Paper 7 on corporatization and privatization are intended to strengthen the ability of officials to assess risks and to provide advice on best ways forward for the Congress.

32. In PPP models, the Government commits to purchase the output of their private partners regardless of whether or not they need those outputs. These "take or pay" contracts mean that Government effectively takes on debt-like obligations which are roughly equivalent to the cost of the investment and which remain fixed even when usage is below predicted levels.

33. PPP models thus require that the government picks up any shortfall in usage, but does not necessarily gain any benefit if usage exceeds projections. Government will also guarantee the application of agreed tariff escalation provisions.

34. One risk for government is that it is overly optimistic in its assessment of future demand and willingness to pay on the part of citizens. Another risk is that government is incurring high levels of "off the balance sheet" liabilities that disguise the true extent of indebtedness, and that the absence of sound accounting systems obscure the true extent of government liabilities. This is already demonstrated to some extent in Palau where loans for telecommunications and electricity appear against the individual Corporations, rather than as Government debt even though the ultimate risk rests with Government.

35. These risks apply within Palau. Universal Service Obligation (USO) impositions have created an expectation of service that is not financially sustainable without – in the current environment – hidden cross-subsidies that impose additional costs on other segments of the community. The reluctance to charge full cost recovery tariffs in, for instance electricity supply, mean that distorted perceptions exist on what constitute sustainable tariffs (sufficient to enable the private sector investor to recover the full costs of investment and achieve an adequate return on investment).

7. Forms of Guarantee

36. The form of guarantee from government may vary. It can be based on:

- Minimum revenue levels to be made available to the private sector partner (a common practice with toll roads);
- Volumes of use with payments following reflecting these volumes. (For instance, this approach is used for PPPs for roads where no toll applies);
- Payment based on the quality of the infrastructure – a model again used in the case of roads;
- "Availability payments" for buildings, such as schools, hospitals or prisons. In these cases the private partner usually finances, builds, and maintains the infrastructure, but does not provide the services. Operations are the responsibility of the appropriate government agencies. The payment scale in some such models reflects availability. Escalation clauses may be included in contracts to reflect higher volumes of use. As is the case in the example above, minimum maintenance standards are specified;
- "Availability (or capacity) payments" in cases of water supply and wastewater treatment.

37. PPPs are less common development instruments where volumes of use are known with reasonable accuracy. In these circumstances, alternative concession models such as BOO or BOT are preferable for government. The private sector funds all development and carries the risk. Some assurances may be required on tariff escalation clauses and timeliness of payments. The consultant is aware of a number of electricity supply agreements in India that collapsed because of excessive delays in payment from the State Government to the concessionaire.

8. Liabilities Associated with PPPs

38. Government liabilities may be explicit and relate to minimum guaranteed levels of use or minimum income streams specified by contract. Liabilities may also be implicit – for instance in cases where local government (or a local State) has entered into a PPP arrangement for services, but does not have the resources to meet a shortfall. Implicit liabilities have been invoked on a number of occasions in areas such as Eastern Europe, in cases such as electricity supply, waste water and solid waste management where quasi government agencies have miscalculated demand and failed to meet their own obligations. Other implicit liabilities have been invoked where the private sector has encountered difficulties meeting their contractual obligations and government has been forced to provide funding to the failing venture in order to ensure its completion.

9. "Good Practice" Design of PPPs

39. Successful PPPs reflect a number of characteristics. In particular:

- Define clearly the objectives to be achieved from the PPP and identify what factors influence future project performance. This requires a clear understanding of the business drivers for which the PPP is being put into place;
- Maintain a high degree of awareness of risk and the implications for government of different scenarios, such as higher or lower demand than those in the original projections that determine guarantees offered to private sector partners;
- Compare the best and worst case financial exposure under a PPP with the risks associated with a long-term concession, in order to determine which modality to pursue;
- Institute ongoing monitoring of project performance to ensure that exposure to risk is not increasing;
- Develop a reporting framework that informs all decision makers of the levels of ongoing exposure to the possibility of guarantees being invoked;
- Monitor the private sector performance especially if it involves infrastructure maintenance, to ensure compliance with contractual conditions;
- Prior to any negotiations, define limits of negotiating authority;
- Decide how to disclose in the financial reports of government the level of exposure to activation of the guarantees;
- Build the capacity to identify and manage risk;
- Complete evaluations of PPP opportunities based on whole of life costs rather than short-term considerations.

40. In terms of contract design, government objectives should be to reduce exposure to risk by transferring this as much as possible to the private sector.

10. Concession or PPP?

41. In general terms, provision of a service on behalf of government by the private sector can be undertaken on a concession basis or as a PPP. In the case of a PPP a government will not be expected to contribute financially to the cost of infrastructure development, but will guarantee the level of demand and income. Responsibility for arranging finance and for construction and operations, rests with the private sector.

42. The matrix in Table 1 compares the main features of different ownership/operating models:

Table 1. Decision Factors When Comparing Ownership and Operating Models

Model	Asset Ownership	Operating Responsibility	Benefits	Disadvantages
Government Ownership	Government	Government	• Minimum disruption to present situation	• No incentive to improve efficiency • Government covers operating losses • Bureaucracy • Risk of poor service delivery • Delayed infrastructure repairs and replacement • Need for government funded capex
Joint Venture	JV Company, including government share	JV Company, which will include private sector operator	• Some private sector expertise • Reduced capex requirements from government • Shared risk	• Still a need for capital investment from government • Government may use its influence to limit profitable operations in order to pursue social goals or meet short -term government cash flow needs
Concession	Depends on contract	Private Sector	• Private Sector Operator • No risk for government • Less likely to be deferred maintenance since this impacts efficiency • No funding requirement from government • Concessionaire may take over existing government infrastructure and be willing to invest in improvements to achieve operational efficiency • No political interference in operations	• Need for government to ensure maintenance plans are adhered to • Contract may require implementation of full cost recovery tariffs, (or ongoing subsidies from government)
BOO / BOT	Private Sector	Private Sector	• Private sector Operator • No risk for government • Less likely to be deferred maintenance, since this impacts efficiency • No funding required by government	• Dependent on operator meeting performance standards. • Contract may require implementation of full cost recovery tariffs (or ongoing subsidies from government)
PPP	Private Sector	Private Sector	• Professional Operator • Less likely to be deferred maintenance since this impacts efficiency • No funding required by government	• Government carries risk of revenue or volume guarantees • Government carries risk of making up tariff shortfalls if increases delayed • Dependent on operator meeting performance standards. • Contract may require implementation of full cost recovery tariffs