

HOW TO ENSURE VALUE FOR MONEY FROM PPPs: SELECTED REVIEW OF PPP GUIDELINES

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Abstract

A distinction need to be made between the *PPP policy framework*, which defines the broader enabling environment for the development of the PPP market, and *PPP guidelines*, which provide guidance on technical project-related issues. A well-defined PPP policy framework is essential to promote value for money from individual PPP transactions. However, government officials responsible for developing PPP projects have often limited leeway to reform the PPP policy framework. In this context, PPP guidelines are often a valuable tool to leverage value for money from PPPs, and their development can partially address the inadequacy of the PPP policy framework.

After briefly discussing the most salient features of the PPP policy framework, a selected number of PPP guidelines are reviewed with the objective of (a) identifying valuable approaches for maximizing value for money from PPPs and (b) providing guidance on how to tailor PPPs to the local conditions. The note focuses on the following three steps in the PPP life cycle: (a) assessing PPP *ex-ante* value for money; (b) organizing a competitive bidding process and (c) regulating the PPP contract. The findings suggest that the following three factors need to be considered to develop PPP guidelines that are consistent with the local conditions:

- (a) the typology of PPP projects (e.g. the average project scale and complexity, the *ex-ante* availability of information on key contract parameters),
- (b) the political environment (e.g. the political willingness to establish an autonomous regulatory agency) and
- (c) the market conditions (e.g. the degree of market competition and private sector interest).

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A. INTRODUCTION

1. **PPP guidelines provide guidance on the key stages of a PPP project lifecycle.** Guidelines for Public-Private Partnerships (PPP), “PPP guidelines”, are a set of procedures aiming to assist government officials through the various stages of the PPP project lifecycle (“PPP lifecycle”), from PPP project identification to project bidding and regulation. The overall objective of PPP guidelines is to maximize value for money from PPP projects by providing clear rules of the game and enhancing the transparency and accountability of the PPP lifecycle. As PPP guidelines generally differ in their prescribed approach to PPP project development, there are several lessons to be learnt by comparing PPP guidelines across jurisdictions.

2. **A PPP policy framework needs to be established before effective PPP guidelines can be developed and successfully applied.** A distinction need to be made between the *PPP policy framework*, which defines the broader enabling environment for the development of the PPP market, and *PPP guidelines*, which provide guidance on project-related issues. The PPP policy framework affects the success of individual PPP transactions both *directly* (e.g. specific projects may benefit from dedicated financial schemes) and *indirectly* (e.g. bidding competition for a given transaction can be promoted through broad-based governance reforms). However, reforming the PPP policy framework is often outside the realm of those government officials tasked with the development of specific PPP projects. In this context, PPP guidelines provide government officials with a valuable tool to leverage value for money from PPPs, and may partially address the inadequacy of the PPP policy framework.

3. **The note provides guidance on how to ensure value for money from PPPs given local conditions.** The *first* part of the note briefly reviews aspects of the PPP policy framework that directly impacts on the success of PPP transactions. Based on a selected review of PPP guidelines, the *second* part of the note suggests a number of approaches for ensuring value for money from PPPs at the following three key stages of the PPP project life-cycle¹:

- (1) **Preparation phase** – discerning whether a PPP project represents *ex-ante* value for money (i.e. before the bidding phase);
- (2) **Bidding phase** – assuring that value for money is delivered through bidding participation and competition;
- (3) **Post-bidding phase** – ensuring effective regulation and oversight of PPP agreements (see Table 1 below).

¹ PPP guidelines from the following countries / jurisdictions have been reviewed as part of this exercise: UK, Australia states, Singapore, Ireland, Hong Kong, Germany, NEPAD (Sub-Saharan Africa) and South Africa, in addition to cross-country literature reviews on specific elements of PPP guidelines.

4. The rest of the note is organized as follows: Section B briefly discusses key aspects of the PPP policy framework, Section C reviews a number of approaches for carrying out the three stage of the PPP lifecycle outlined in Table 1; Section D concludes by summarizing key lessons for tailoring PPP guidelines to the local conditions.

Table 1: Key Stages of the PPP Life cycle

Stage 1: Preparation	Assessing <i>ex-ante</i> whether a PPP project represents value for money
Stage 2: Bidding	Securing value for money through a competitive bidding process
Stage 3: Post-bidding	Effectively regulating the PPP contract

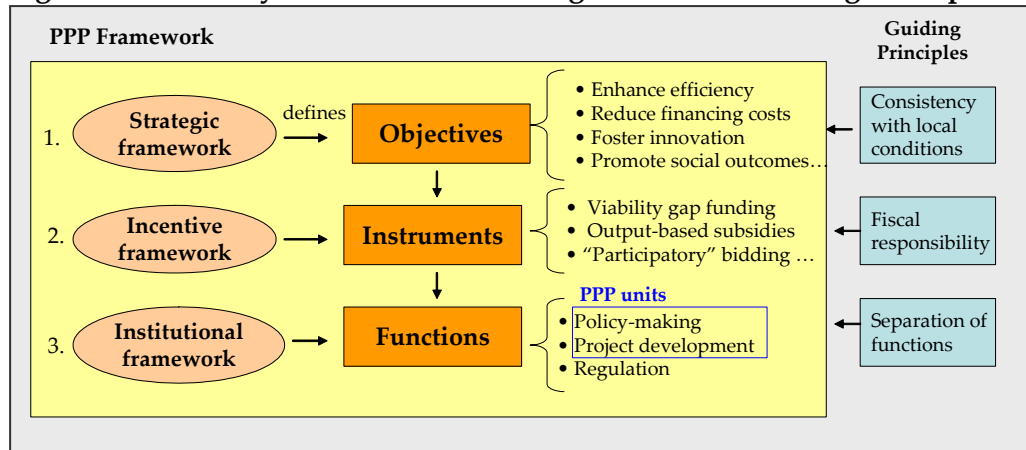
B. THE PPP POLICY FRAMEWORK

5. **The PPP policy framework defines the enabling environment for the development of the PPP program.** An effective PPP policy framework comprise the following three inter-related building blocks:

- **Strategic framework** – the high-level *strategic* framework, which defines the mandate and *objectives* of the PPP program, in line with the local conditions ;
- **Incentive framework** – the *incentive* framework which identifies the most appropriate *policy instruments* for achieving the objectives of the PPP program, within a framework of fiscal responsibility;
- **Institutional framework** – the *institutional framework*, which identifies the *functions* required to manage the PPP program and assign them to competent agencies based on the principles of separation of functions.

Figure 1 illustrates the key building blocks of the PPP policy framework and the guiding principles that should inform its development. Without aiming to conduct a comprehensive review of PPP policy-related issues, which is beyond the scope of this work, the rest of this section discusses salient features of the PPP policy framework that have a direct impact on the success of individual PPP transactions.

Figure 1: PPP Policy Framework – Building Blocks and Guiding Principles



Strategic framework – Defining PPP Objectives

6. **The PPP policy framework defines the economic rationale and strategic objectives of the PPP program.** Government officials may have a wide range of incentives for pursuing PPPs. For example, some may be primarily interested in reducing financing costs for capital-intensive projects. Others may tap the PPP market for improving the efficiency and performance of current service providers. However, government officials may also enter into PPP agreements for wrong economic and political motives – i.e. for circumventing budget constraints and pushing projects off-balance sheets, for accessing rent-seeking opportunities or gaining short-term political

momentum. Given the vast range of motives that government officials may have to pursue PPPs, building a common strategic vision on the role and objectives of the PPP program is the first essential step to ensure value for money from individual PPP transactions.

7. **The strategic vision needs to be translated into a very clear statement of what constitutes PPPs.** All jurisdictions that have built a successful PPP program have developed a clear definition of what constitutes a PPP transaction (e.g. Partnership Victoria, Australia, PFI initiative, UK). The PPP framework needs however to be flexible enough to allow modification in the allowed range of PPP transactions to respond to changes in circumstances. For example, in the wake of the East Asia financial crisis, which led to a sudden decline in private sector appetite for infrastructure projects, Korea modified its *1994 Act on Private Participation in Infrastructure* to broaden the range of allowed PPP transactions with the objective of accelerating private sector participation.²

Incentive framework – Developing the Policy Instruments

8. **The PPP framework provides the policy instruments for implementing the strategic vision of the PPP program.** Once the strategic vision has been defined, the challenge is to develop a suitable incentive framework for achieving the objectives of the PPP program, within a framework of fiscal responsibility. A wide range of policy instruments can be leveraged to provide government officials with the right incentives for pursuing PPP projects—e.g. financial instruments and bidding procedures. In particular, policy interventions may be necessary to correct market failures or achieve social objectives.

9. **In markets characterized by socio-economic externalities, policy interventions are critical to promote sustainable outcomes from PPPs.** In presence of externalities, achieving sustainable outcomes is a necessary condition for the success of the PPP program. Sustainability has a different meaning depending on the type of project undertaken and its associated externality. For example, achieving sustainable outcomes may entail devising pro-poor water delivery solutions in informal settlements as part of a PPP water concession, or reducing congestion and pollution through a PPP public transport project. The following are examples of policy instruments that have been developed to correct for socio-economic externalities in PPP projects:

- (a) output-based subsidy schemes provided to private operator for extending the water network in un-planned settlements (e.g. Casablanca, Morocco; Cameroun)
- (b) the Viability Gap Funding (VGF) capital grant schemes provided to eligible PPP projects which are not commercially viable but have high economic benefit (e.g. India and Pakistan).

² In addition to Build-Transfer-Operate (BTO) and Build-Own-Operate (BOO), the 1999 Act allowed for Build-Operate-Transfer (BOT) contracts as well as unsolicited proposals World Bank (2007).

- (c) Subsidies for regional transport projects covering more than one jurisdiction (e.g. EU capital grant to support the Perpignan-Figueras private rail concession jointly managed by Spain and France)³

10. **In contexts where social cohesion is a challenge, policy interventions may be essential to mainstream community participation into PPPs.** Depending on the nature of the PPP program, civil society and/or community participation may be essential to manage political risk and ensure the sustainability of the PPP program. When this is the case, policy instruments need to mainstream social objectives into the different stages of the PPP lifecycle. For example, in Manila the Water for Poor Communities program was launched in 1998 by MWCI, the private concessionaire in the East area of Manila, to meet its contract obligations vis-à-vis the urban poor residents. A key feature of the program is the tripartite partnership between the private operator, a community-based organization and the city government. Under this agreement, community organizations are responsible for community mobilization, routine maintenance of the facilities and bill collection.⁴ The South Africa's Black Economic Empowerment (BEE) program, which is briefly described in Box 1, provides another powerful example of how social objectives can be mainstreamed into PPPs.

Box 1: South Africa Black Economic Empowerment in PPPs

South Africa passed the Broad-Based Black Economic Empowerment [BEE] Act in 2004 to support the economic development of the local population through greater ownership and participation in businesses. The PPP program was considered an excellent instrument for mainstreaming BEE objectives given that PPPs provide significant sub-contracting opportunities and have long-term nature and well-identified risk-sharing structures, which may reduce risks for black enterprises. Based on the *Code of Good Practice for Black Economic Empowerment (BEE) in Public Private Partnerships* (Code for BEE in PPPs), government tenders for PPPs need to explicitly consider as part of their evaluation criteria the quality of the partnership arrangements the bidder has negotiated with civil society organizations. More specifically, no PPP can be issued to the market without a BEE balanced scorecard comprising a set of BEE elements (e.g. percentage of black party equity, black managerial control of private party). The Code for BEE in PPPs also mandates that the BEE elements constitute 10 percent of the bid evaluation system and bidders must achieve a minimum threshold of 60 percent of the total BEE points.

Source: South Africa National Treasury (2004b).

³ EU (2004).

⁴ United Nations (2005).

Institutional Framework - Assigning PPP Functions

11. **The PPP policy framework defines the institutional functions needed to implement the PPP program.** There are three basic PPP functions that need to be assigned to competent agencies: policy functions, regulatory functions and project development functions. As a way to minimize conflicts of interest, the institutional framework should be developed based on the principles of separation of functions. In practice, resource or political constraints often limits the scope for creating dedicate line agencies for each function. For small PPP programs, bundling some of the functions together is often the only viable solution, as it allows achieving economies of scale and reducing costs.

12. **Specialized PPP units have been established in several countries to perform a broad range of PPP functions.** Bundling PPP functions in one centralized PPP unit has become a relatively common practice in many developing countries to promote PPPs. PPP units tend to be tasked with a wide range of functions, from setting the PPP policy framework to originating and developing PPP transactions. Based on a recent World Bank review of PPP units, the most successful PPP units (e.g. South Africa PPP unit, Partnership Victoria, Australia and Partnership UK) are those created with the specific mandate to correct well-identified government failures, in particular:

- (a) lack of coordination across line ministries,
- (b) lack of incentives for procuring PPPs,
- (c) lack of appropriate skills or
- (d) information asymmetries.⁵

In parallel, the following lessons of experience can be derived from a review of underperforming PPP units:

- (a) PPP units cannot function effectively without strong political support (e.g. National Investment Bank of Jamaica – NIBJ –, Jamaica);
- (b) PPP units cannot effectively change the status quo if the procurement of capital works suffers from lacks transparency and competition (e.g. Infrastructure Investment Facilitation Center – IIFC –, Bangladesh);
- (c) PPP units cannot succeed when responsibilities are spread across agencies and coordination is weak (e.g. BOT Center, Philippines).

⁵ World Bank (2007).

C. PPP GUIDELINES – DELIVERING VALUE FOR MONEY FROM PPPs

13. **There are three essential steps that government officials ought to take to develop a PPP project**, namely assessing *ex-ante* value for money (Section C.1); developing a competitive bidding process (Section C.2) and regulating the PPP contract (Section C.3). For each of these steps, a number of methodological approaches prescribed in PPP guidelines are reviewed and guidance is provided on how to identify the approach that best suit the local conditions.

C.1 ASSESSING EX-ANTE VALUE FOR MONEY

14. **PPPs should only be pursued when they represent value for money for users and taxpayers.** Being a relative concept, value for money can only be quantified against a benchmark or alternative scenario. The methodologies prescribed in PPP guidelines for the *ex-ante* valuation of PPP projects can be broadly classified in three categories:

- (1) **the public sector comparator approach**, which relies exclusively on quantitative methods as evaluation criteria for value for money,
- (2) **the “mixed” approach**, which relies on a combination of quantitative and qualitative methods; and
- (3) **the market based approach**, which relies on market forces to determine the value for money of a PPP project.

The Public Sector Comparator approach

15. **Some jurisdictions require the identification of a Public Sector Comparator as a benchmark to assess value for money.** Based on the Public Sector Comparator (PSC) approach, PPPs can only be undertaken if they represent value for money in comparison with the most efficient form of public procurement. This approach requires estimating the risk-adjusted monetary cost of a hypothetical public project (“the public sector comparator”). The PSC test is conducted before the tendering of the PPP project to provide public authorities with sufficient certainty that value for money can be achieved *ex-post*.

16. **The PSC approach is widely used for PPP project valuation in mature economies and increasingly so in developing countries** (e.g. Australia, Canada, Germany the Netherlands, Ireland, and South Africa). Germany, for example, adopts a rigorous “three-step” PPP assessment, which includes (a) a preliminary qualitative test to ascertain the overall feasibility of the PPP project, (b) a quantitative PSC calculation and (c) an *ex-post* update of the PSC model based on actual data provided by the preferred bidder. Each of the three steps allows an exit option if the PPP project does not pass the test.⁶ In some jurisdictions, the value of the PSC is kept confidential, on the ground that public disclosure could provide bidders with an unfair advantage and

⁶ Sachs et al. (2005).

compromise the prospect for achieving value for money (e.g. Ireland).⁷ Disclosure of the value of the PSC is instead advised in some jurisdictions as a way to discourage unrealistic bids (e.g. Hong Kong).⁸

17. **The PSC approach is a useful tool for assessing the monetary benefits of PPPs.** The PSC test has the advantage of forcing government officials to think through the rationale for partnering with the private sector and encourage early appraisal of project risks. The *ex-ante* PSC test can also reduce the sunk costs associated with time-consuming and expensive procurement of commercially un-viable PPP projects. Finally, the PSC test can help government officials detect excessively aggressive bids that are unlikely to represent value for money.

18. **However, the PSC approach may presents several shortcomings, especially in the absence of reliable data.** First and foremost, its data intensity may easily lead to data inaccuracy and provide incentives for data manipulation. For example, in the case of long-term contracts (e.g. 20- or 30-year concession) it is virtually impossible to estimate the risk-adjusted cost and the efficiency gains of an alternative public project with sufficient accuracy to prove the value for money of the PPP project. These drawbacks are even more evident when the PSC test is applied to PPP projects in developing countries, where there is often no realistic public sector alternative to private financing. When this is the case, the PSC is largely irrelevant and the benchmark should be the *status quo* alternative.⁹

19. **In light of these shortcomings, the PSC has been recently subject to some criticism in Western countries.** For example, in the UK the HM Treasury came to the conclusion that the PSC approach is often unreliable due to “the demonstrated systematic tendency for appraisers to be over-optimistic about key project parameters”.¹⁰ The HM Treasury advocates that this “optimism bias” can be corrected through systematic use of project databases that can provide a reasonable estimate of how much estimated costs have diverged from actual costs in past projects. The option of conducting a “reality check” based on past project data is however often not available in less mature economies, where such databases seldom exist.

The “mixed” approach

20. **Recently, value for money methodologies that account for both financial and non-financial factors have been developed.** The growing criticism toward the PSC model is leading to a shift toward more comprehensive value for money approaches, encompassing both qualitative and quantitative methods (“mixed” approach). In the UK, the recently updated HM Treasury guidance for the Private Finance Initiative (PFI) downplayed the PSC methodology in favor of a broader Program and Project Level

⁷ Government of Ireland PPP Unit (2006).

⁸ Hong Kong Efficiency Unit (2008).

⁹ See, for example, Leigland and Shugart (2006).

¹⁰ UK Green Book (2003).

Assessment.¹¹ This broader approach has been applied for the ex-ante valuation of the London Underground PPP project, a complex and politically contentious transaction which required a comprehensive assessment based on a combination of financial and non-financial considerations (see Box 3). A “mixed” approach has also been recently recommended in the PPP guidelines drafted for the New Partnership for African Development (NEPAD).¹² The main steps of this approach are summarized in Table 2 below.

Table 2: Ex-ante PPP Value for Money Assessment – Example of a “Mixed” Approach

	Steps	Description
1	Select a few representative projects	
2	Identify <i>types</i> of projects where the private sector is most likely to bring efficiency gains based on theory and empirical evidence.	Major factors that argue in favor of PPP projects should be identified based on local parameters and international evidence, such as completeness of contracts, transaction costs, private sector expertise and competition.
3	Carry out a PSC comparison for one or a few representative projects of each type, and only if there is a realistic alternative public sector project.	The focus of the PSC analysis would be exclusively on aspects that give rise to suspicions that the PPP project might not have an advantage.
4	Develop routine-level instructions and guidance for the appraisal of individual projects of a specified type.	
5	Model the envisaged PPP project during the preparation stage	PPP modeling should be conducted not for purposes of comparison with a PSC but to better understand and improve the PPI arrangement and transaction.

Source: Shugart (2006).

The market-based approach

21. **The market-based approach emphasizes effective risk management and contract design to maximize value for money from PPPs.** The market-based approach assumes that there are always benefit from complementing private and public financing, so the focus should be The market-based approach assumes that there are always

¹¹ UK HM Treasury (2006).

¹² Shugart (2006). “Quantitative Methods for the Preparation, Appraisal, and Management of PPI Projects in Sub-Saharan Africa”. World Bank/PPIAF.

efficiency gains to be made by partnering with the private sector in delivering a specific public service. Based on this approach, there is no need to undertake data-intensive PSC modeling exercises to determine the potential value for money of a PPP project, as value for money is achieved purely by market competition. The market-based approach is currently prescribed by PPP Guidelines in Singapore, under the assumption that private financing is always desirable as it instills discipline in the use of public capital.¹³ When the cost of private financing is higher than the cost of public capital, the PPP guidelines recommends that steps be taken to reduce the private financing costs by efficiently managing the risk of the transaction and assuring the viability and bankability of the project.¹⁴ Under the market-based approach the due diligence of a PPP project is thus mainly conducted to ensure that the potential pitfalls of a PPP project are avoided through optimal contract design rather than to justify the PPP value for money relatively to a counterfactual public project.

¹³ Sachs et al.. (2005) and Singapore Ministry of Finance (2004).

¹⁴ "With appropriate risk management measures under a win-win PPP deal structure, the higher private financing costs could be offset by the efficiency gains that private financing can provide" (Singapore, PPP guidelines, p. 35).

Box 2: London Underground PPP Project – Ex-ante Value for Money Assessment

In May 1997, the UK Government started considering options for creating a PPP for the London Underground (the “Tube”). The decision was triggered by decades of under-investment and deferred maintenance of the assets with the consequent decline in train service reliability and customer satisfaction. The investment and maintenance backlog were mainly due to budgetary uncertainty and uneven grant funding which compromised the planning and execution of investments. An inter-departmental Working Group was established to identify possible business structures for the PPP deal with Price Waterhouse as the financial adviser; London Underground did not participate in the Working Group given its vested interests in the deal. The agreed-upon business model involved splitting horizontally London Underground into three private sector infrastructure companies (“Infracos”). Based on this business model, a new public sector operating company “New London Underground” would run trains and stations and determine service patterns. Responsibility for maintaining and improving the infrastructure (track, signals, and stations) and rolling stock would be transferred to the three Infracos on fixed term contracts with New London Underground.

Concurrent with the planning of the PPP, the UK Government had been preparing to devolve certain powers to a new form of metropolitan government for London, the Greater London Authority, consisting of the Mayor of London (the Mayor) and the London Assembly. Transport for London (TfL) was established under the Mayor's direction with responsibility for implementing the Mayor's transport strategy. The Department of Transport decided that London Underground would secure the PPP deal before transferring the Tube to Transport for London. However, the Mayor and TfL repeatedly objected to the PPP, creating significant political instability in the transaction.

A PSC exercise was initially conducted to assess the value for money of the proposed PPPs. Two variants of the PSC were developed. One assumed that London Underground would continue to be funded from Government grants and fares, and the second variant assumed that London Underground would issue its own bonds in the financial markets. Both the traditional and bond funded model yielded a slightly higher cost for the public sector options compared to the PPP option. However, London Underground acknowledged that both models were subject to a high degree of uncertainty and provided limited assurance about the value for money of the proposed PPP deal. The uncertainty of the models exacerbated the political instability of the transaction, as London Underground's and TfL's financial advisers made public strongly contrasting assessments of the value for money analysis of the PPP bids.

Given the uncertainty surrounding the PSC model, the National Audit Office (NAO) strongly recommended London Underground to conduct a wider and non-financial assessment of the PPP benefits and risks. In parallel, Ernst & Young was hired by the Department of Transport to conduct an independent review of the value for money assessment, taking into account non-financial considerations. Among the key non-financial factors which were considered in the assessment are risk allocation, management autonomy, the capability of bidders, working relationships, the robustness of contract, flexibility, remedies and contract enforceability.

By March 2003, the Department of Transport had awarded three 30-year concessions, two for the deep tubes and one for the sub-surface lines. All concessions are output-based and incorporate

strong performance targets (the PPP agreements deliberately do not specify the work to be undertaken and set deliverables in terms of the service provided to passengers). In July 2003, ownership of London Underground was transferred from the central government to TfL. As provider of grant of some £1 billion a year the central Government nevertheless retains a strong interest in the effectiveness of the PPP.¹

Sources: NAO (2004); Ernst & Young (2002).

Main lessons

22. **The PSC approach is a valuable decision-making tool when a PSC is a well-defined alternative, sufficient data is available and the PPP project is not politically contentious.** The optimal method for the *ex-ante* valuation of PPP projects is specific to the local socio-political conditions and to the nature of the PPP project. The PSC approach could provide government officials with a rigorous decision-making tool for the assessment of PPP projects based on hard-core empirical evidence. Two conditions need however to be met for the application of the PSC approach: (1) the availability of a reasonable and well-defined public sector alternative (e.g. bond financing) and (2) the existence of reliable databases of past projects to limit the risk of data inaccuracy and the “optimism bias”. When these two conditions are not met – i.e. public funding is not reasonable alternative and good databases are not available- “mixed” methodologies, which place higher weights on non-financial considerations, or market-based tests, are often the best available solutions to assess value for money of a PPP project. Even in mature economies, where data is unlikely to be a constraint, complex and politically contentious projects require a mixed assessment, encompassing socio-economic factors and non-financial considerations which are not easily monetized (e.g. the London Underground PPP contract). Key parameters to be considering in devising the optimal *ex-ante* valuation method of PPP projects are summarized in Table 3 below.

Table 3: Selecting PPP Value for Money Methodology– Key Parameters

Parameters	Methodology	
	PSC	Mixed/ Market based
Clear and well-defined public sector alternative	✓	
Reliable dataset of past projects available	✓	
Highly complex and politically contentious projects		✓

23. **The *ex-ante* value for money assessment is a necessary but not sufficient condition to ensure *ex-post* value for money.** The ultimate value for money test rests on the comparison of the received bids with the benchmark. There is a multiplicity of factors that influence the *ex-post* value for money, such as the competitiveness of the

market, the management of the bidding process itself and supervision of the subsequent contract.

C.2 ORGANIZING COMPETITIVE BIDDING OF A PPP PROJECT

24. **An efficient and transparent bidding process is essential to attain value for money from the PPP project.** It is therefore of paramount importance that PPP guidelines provide government officials with clear guidance on how to manage the bidding phase. Issues of bidding design that feature prominently in PPP guidelines include how to encourage bidding competition and participation, how to create a transparent and level playing field among the interested parties and how to ensure that the bidding process is adequate to the local context. This section focuses on one issue of special concern to government officials, especially in jurisdictions with limited history of PPP transactions, namely how to maximize competition among private operators at the bidding phase through bidding design and appropriate handling of unsolicited proposals.

Increasing competition through bidding design

25. **Bidding costs represent a sunk cost for bidders and may act as an impediment to market competition.** In these instances, bidding design may be used to limit bidding costs and thus increase bidding competition and participation. *First*, a sound and transparent bidding process may not be sufficient to attract a minimum number of credible bidders when bidding costs are high relative to the value of the project. To address this issue, PPP guidelines generally identify a minimum project value below which competitive tendering does not represent value for money. A two-stage bidding process which requires pre-qualification of bidders is another widely used approach to contain bidding costs. *Second*, the high cost of preparing a complaint bid for a large and complex project may deter credible private partners from bidding. When this is the case, jurisdictions may allow for the total or partial reimbursement of the costs of complaint bids. For example, London Underground took this unusual but not unprecedented step to reimburse bidding costs as a way to secure bidding competition in the face of the very high bidding costs and political risks to the project. Bid compensation should however be the exception rather than the norm and be treated as an explicit government subsidy.

26. **A less acknowledged impediment to competition is the widespread use of excessively aggressive bidding.** Aggressive bids can be mistakenly interpreted as a sign of healthy market competition while in fact the opposite is true. If selected, aggressive bids are unlikely to be honored and will set the stage for opportunistic project renegotiation. Provisions should be made in the PPP guidelines to allow government officials to disqualify excessively aggressive bids.¹⁵ Government officials are however often reluctant to reject aggressive bids for fear of being accused of corruption

¹⁵ Guash (2004).

or favoritism. In these instances, the most effective way for governments to deter aggressive bidding is to limit the scope for opportunistic re-negotiation with private firms, even if this may lead to the cancellation of some PPP projects.

27. **Innovative solutions to encourage bidding competition and participation emphasize two-way channels of communications with bidders.** For example, in Singapore the PPP guidelines require a market feedback period of 3-6 months during the issue of the Invitation to Tender. During this period, pre-qualified bidders have not only the opportunity to ask for clarifications on the tender documents, which are publicly answered, but they can also make confidential suggestions on how to improve the project specifications. The government official has the option to either discard or incorporate these suggestions in the final tender document

Dealing with unsolicited proposals

28. **When channeled into a competitive and transparent bidding process, unsolicited proposals can bring several benefits.** The benefits of unsolicited proposals are evident in jurisdictions with low technical capacity for PPP development or in markets with marginal private sector interest. However, even in jurisdictions with a long history of PPP development, unsolicited proposals can be instrumental to foster innovation in project development. The benefits of unsolicited proposals can only be realized if formal procedures are in place to handle them effectively and ensure that they deliver value for money.¹⁶ This is often not the case in most jurisdictions, where unsolicited proposals are often directly negotiated with private firms through informal procedures.¹⁷ As a minimum, unsolicited proposals should be subjected to a competitive bidding process (e.g. Queensland, Australia). Some countries have gone a step further by designing an institutional framework that incentivize private firms to come forward with innovative project proposals while assuring that such proposals are subjected to market competition through a transparent bidding process. The most common systems to incentivize unsolicited proposals through competitive bidding are (a) the bonus system, (b) the Swiss challenge system and (c) the hybrid best and final offer system (see Table 4 for a short description of these systems). Some countries have also introduced eligibility criteria for unsolicited proposals. For example, under the Philippines' BOT law unsolicited proposals can only be accepted for (a) innovative projects, (b) projects not listed as priority projects; (c) project that do not involve any direct government guarantee, subsidy or equity.

¹⁶ Hodges and Dellacha (2007).

¹⁷ Only a few countries prohibit unsolicited proposals with no exceptions (e.g. Columbia).

Table 4: Handling Unsolicited Proposals – Most Common Systems

System	Country	Main features
Bonus	Chile, South Korea	A bonus in the formalized bidding procedure is granted to the original project proponent (i.e. the original proponent's proposal is selected if it is within a stipulated percentage of the best offer). The maximum bonus is 10 percent in both countries. In Chile, the original proponent may sell the bonus to another bidder and the winner may have to reimburse project development costs to the original proponent.
Swiss challenge	Philippines, India (Andhra Pradesh and Gujarat), Italy, Taiwan, and the U.S territory of Guam	The original proponent has the right to counter-match any superior offers. If the original project proponent does not match the price, then the project is awarded to the lower price project proponent of the Swiss challenge.
Best and final offer	South Africa, Costa Rica	Recently developed hybrid model are based on a multiple rounds of tendering, in which the original proponent is given automatically the advantage of participating in the final round.

Source: Hodges and Dellacha (2007).

Main lessons

29. **Successful tendering of a PPP project requires a sound understating of the structure of the market and the scope for private sector participation.** Key parameters to be considered when designing the tendering process for a PPP project are (a) project complexity and (b) the scope for market competition. When tendering a complex project in a market characterized by a few large players (e.g. water sector), government officials need to pay special attention to the bidding phase to ensure that enough competition is generated through the tendering process. In markets characterized by limited competition, tapping the benefits of unsolicited proposals through formal mechanisms that guarantee value for money could also be warranted to encourage competition.

C.3 REGULATING PPP AGREEMENTS

30. The importance of sound regulation of PPP agreements for ensuring value for money cannot be over-emphasized. Once the PPP contract has been awarded, regulating the PPP agreement is crucial to ensure that the notional concept of value for money translates into concrete gains for consumers and taxpayers. There are three broad institutional models for regulating PPPs: (a) regulation by contract, (b) regulation by agency and (c) hybrid models characterized by a combination of regulation by contract and by agency. While this categorization is by no means exhaustive of the variety of regulatory models that can be encountered, it nevertheless helps government officials

identify the key parameters that need to be considered in designing the optimal regulatory framework for a PPP arrangement.

Regulation by contract

31. **Under this model, the regulatory contract is negotiated with the private counterpart at the outset and embedded in the PPP agreement.** As a result, all regulatory rules, such as performance standards, tariff-setting and dispute resolution mechanisms, are built in the PPP agreement (e.g. water *affermage* in Senegal, water concession in Morocco). Oversight and enforcement of the regulatory contract are the responsibility of a ministerial agency, a local government office or a PPP unit. For example, in the Manila water concession, the Metropolitan Waterworks and Sewerage System (MWSS) Regulatory Office was created by the Concession Agreement to monitor compliance with the terms of the PPP agreement, such as service obligation targets, and conduct performance evaluation. This model is best used for relatively un-contentious PPP contracts, especially if all relevant parameters are known with reasonable certainty at the time of contract negotiation. Under these conditions, the cost of establishing autonomous regulatory agencies is likely to outweigh the benefits. In practice, regulation by contract may be the only model able to attract private sector participation in jurisdictions where autonomous regulation is not a politically feasible or credible option, as complete and legally binding PPP contracts greatly reduce private sector's risk.

Regulation by agency

32. **Under this model, a specialized agency is tasked of regulating the PPP agreement.** Regulatory functions are transferred to an autonomous or quasi-autonomous agency, which periodically sets the parameters of the PPP agreement between the government and the licensed private firms (e.g. service charges or rate of return and quality of service). Given the high sunk costs of establishing an autonomous regulatory agency, this model represents a cost effective solutions for long-term concession or divestiture, especially if the PPP agreement involves assets of national strategic importance. Regulation by agency is widely used in the electricity and telecom sector and less commonly applied in the water sector, with a few notable exceptions (e.g. Ofwat in England and Wales, NWASCO in Zambia and CRA in Mozambique).

Regulation by contract and by agency (hybrid model)

33. **More recently, a hybrid model has emerged where a regulatory contract is negotiated upfront and periodically reviewed by an independent third party (e.g. an Expert Panel or Arbiter).** This model is best used when complete contracts cannot be drafted at the time of contract negotiation because a reasonable degree of contract flexibility is needed and/or some key parameters are unknown - e.g. this is often the case for long-term PPP contracts involving underground assets whose state is often unknown before the commencement of the works. Under these circumstances, relying exclusively on regulation by contract will almost certainly lead to politically costly contract re-

negotiation. One could envisage the use of this model to reinforce regulation by contract in jurisdictions with well-established regulatory agencies, where these agencies cannot operate at sufficient arm's length from the government to function as an honest broker between the government and the private operator. For example, the water concession in Bucharest calls for the appointment of an independent Expert Panel to provide its binding opinion on tariff reviews, while other regulatory tasks are performed by an autonomous regulatory agency.¹⁸ Members of the Expert Panel had to be selected by mutual agreement between the government and the private operator and could not be nationals of either Rumania or the private operator's home country. This model can also be used in contexts where regulation is necessary to supplement contract specification but too limited in scope to justify the establishment of an autonomous regulatory agency. For example, this model has recently been applied for regulating the PPP agreement for the London Underground, where regulatory standards are incorporated in the concession contract, with the exception of service charges, which are periodically set by an independent PPP Arbiter (see Box 3).

34. The main features of these three regulatory models (regulation by contract, regulation by agency and hybrid models) are summarized in Table 5 below.

¹⁸ Eberhard (2006) and ERM (2004).

Table 5: Overview of Regulatory Models for PPP Arrangements

	Models		
	Regulation by Contract	Regulation by Contract and Agency (Hybrid Model)	Regulation by Agency
Parameters of PPP agreement	<p>The parameters of the PPP agreement (e.g. service charges or rate of return and service standards) are specified in the PPP contract.</p> <p>The parameters can only be altered through re-negotiation</p>	<p>The PPP parameters are:</p> <ul style="list-style-type: none"> • initially specified in the PPP contract; • subsequently determined through Periodic Review. 	<p>The PPP parameters are determined at periodic regulatory reviews, which generally cover a period of 3-7 years.</p>
Regulatory framework	<p>No independent regulatory agency.</p> <p>Oversight functions performed by ministerial agency, local government department or PPP unit.</p>	<p>Independent third party (e.g. Arbitrator, expert panel or advisory bodies) carries out periodic reviews of the regulatory contract</p>	<p>Autonomous regulatory agency sets PPP parameters at periodic reviews.</p> <p>Best practice calls for regulatory agencies to operate at arm's length from government agencies.</p>
Examples	<p>Morocco water concession,</p> <p>Senegal water <i>affermage</i></p> <p>Manila water concession</p> <p>Gabon, electricity and water concession</p>	<p>London Underground PPPs (PPP Arbitrator)</p> <p>Bucharest water concession (Expert panel)</p> <p>Chile water privatization (Independent Arbitration Panel)</p>	<p>England and Wales water asset divestiture (Ofwat);</p> <p>Mozambique water lease and management contracts (CRA),</p> <p>Zambia water management contract (NWASCO)</p> <p><i>(Widely used in energy and telecom PPP transactions)</i></p>

Main lessons

35. **Both technical and political factors need to be carefully considered to identify the optimal regulatory framework for a PPP contract.** For complex and long-term PPP contracts involving strategic relevant assets, establishing an autonomous regulatory agency may be warranted based solely on technical considerations. However, the political readiness to create an autonomous or semi-autonomous regulatory agency needs also to be considered as a critical factor. When the institutional context is not conducive to the creation of an autonomous agency, there is a high risk of regulatory capture by vested interests that may undermine the public partnership with the private sector and ultimately set back the development of the PPP market.

Box 3: Innovative Form of PPP Regulation – London Underground and the PPP Arbiter

The three concessions for the London Underground are in the first instance regulated by the 30-year contract stipulated between the three Infracos and London Underground Limited, which retains responsibility for operating the trains. Regulation by contract was however deemed insufficient to deliver value for money given the lack of information on the conditions of some of the critical assets and the difficulty of capturing long-term efficiency potential through a competitive tender process. These considerations led to the introduction of a Periodic Review mechanism, similar to that in the UK price-regulated network industries (although at 7½, rather than 5, year intervals) to determine service charges and standards of services. In addition, provision was made for Extraordinary Reviews to allow charges to be modified within a review period if Infracos experience cost shocks outside their control.

It was considered that London Underground would have limited leeway and negotiation powers to conduct the periodic review due to its vested interest in the deal as the train operating company. Provisions were therefore made in the PPP arrangement for the appointment of an independent statutory Arbiter by the Secretary of State with responsibilities for conducting the Periodic Reviews and, if necessary, the Extraordinary Reviews. It is worth noting that the role of the PPP Arbiter is more limited than that of a regulatory agency. For example, disputes between the parties are deal by contract provisions, unless they occur during Periodic Review or Extraordinary Review.

The Arbiter is appointed as an individual, with the power to employ staff and incur expenses. Costs are met by the Secretary of State for Transport, although the Arbiter is independent of Ministers (and of the PPP Parties).

Source: Bolt (2004).

D. CONCLUSIONS

36. **A well-defined policy framework is a key determinant of the success of a PPP program.** A PPP policy framework comprises the following three inter-related building blocks, which defined the enabling environment for the PPP program: (a) strategy (b) incentives and (c) institutions. An effective PPP policy framework spells out (a) the mandate and high-level objectives of the PPP program; (b) the policy instruments for achieving the objectives of the program and (c) the institutional functions needed to implement the program. The PPP policy framework needs to be complemented by PPP guidelines, which provides technical guidance on the key stages of the PPP lifecycle.

37. **PPP guidelines provide government officials with a valuable tool for maximizing value for money at critical stages of the PPP life cycle.** PPP guidelines provide some scope for enhancing value for money from individual PPP transactions even in contexts where there is limited leeway to modify the PPP policy framework. PPP guidelines generally focus on the following three critical stages in the PPP lifecycle: (a) assessing PPP ex-ante value for money; (b) organizing a competitive bidding process and (c) regulating the PPP contract. For each stage, the note reviews a number of approaches for securing PPP value for money and identifies the key factors to be considered for tailoring these approaches to the local context. The main conclusions of the review are summarized in Figure 2 below.

38. **Local factors need to be carefully considered at each stage of the PPP life cycle to maximize value for money.** The note identifies several factors to be considered for tailoring PPP guidelines to the local conditions. These local factors can be summarized in the following three categories:

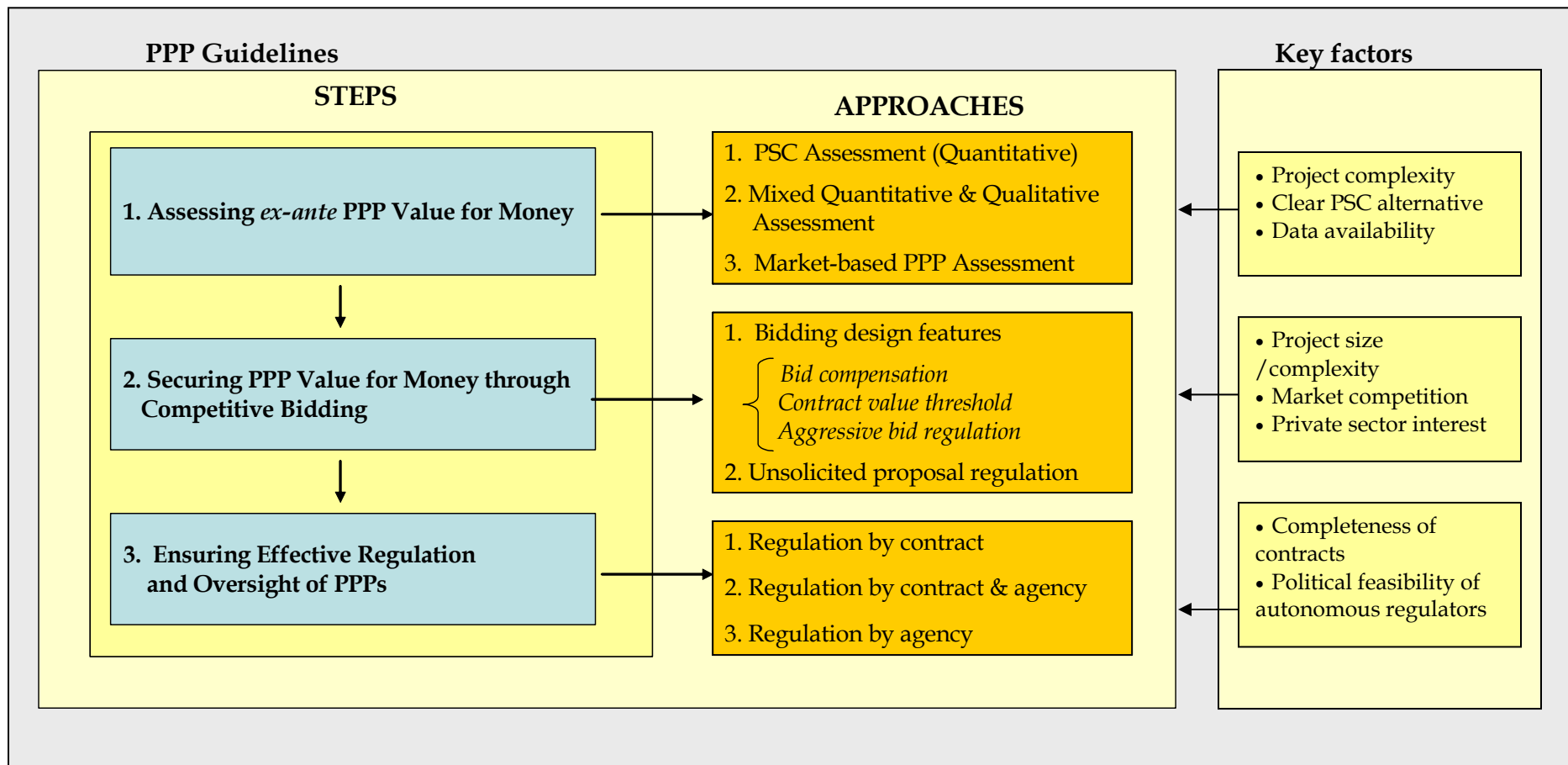
- (a) the typology of the PPP projects (e.g. the average project scale and complexity, the *ex-ante* availability of information on key contract parameters),
- (b) the local institutional environment (e.g. the political willingness to establish an autonomous regulatory agency) and
- (c) the market conditions (e.g. the degree of market competition and private sector interest).

39. **Complex projects require a different project development strategy than more conventional PPP transactions.** The note suggests some approaches that can be taken to maximize value for money at the different stages of PPP project development for the more complex PPP transactions. Complex projects can be defined based on the following parameters:

- large scale;
- political sensitivity;
- lack of information on key project parameters and
- limited private sector interest.

A comprehensive value for money assessment based on quantitative and qualitative considerations is often needed to ensure both the political acceptability and the socio-economic feasibility of complex PPP transactions. Special attention is also to be paid to the bidding phase to provide incentives for strong participation and competition when bidding costs are high and private sector interest is weak— among the options available are the reimbursement of bidding costs and the channeling of unsolicited proposals through competitive bidding system). Finally, regulating complex PPP transactions for which some of the parameters may require the establishment of a dedicated agency or at least the appointment of an arbiter for the determination of periodic charges. Despite the higher costs of agency-based regulation, this approach, if politically feasible, is likely to deliver net benefits for complex projects by avoiding politically costly contract renegotiation that would likely to occur under a regulation by contract framework.

Figure 2: PPP Guidelines - Summary of Key Steps and Options



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