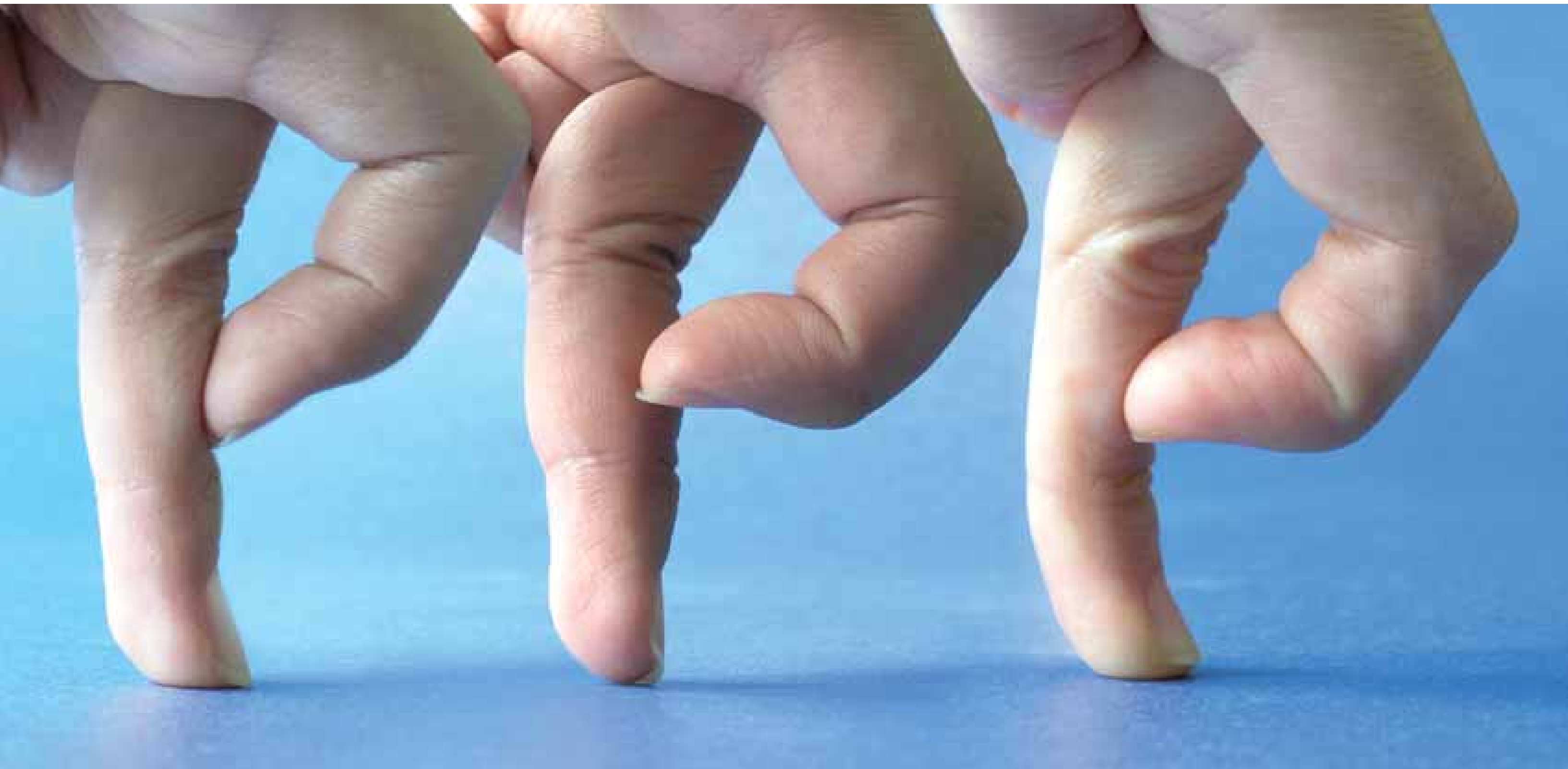

Meeting the Region's Infrastructure Needs

Guidelines for Effective Public Private Partnerships

Pacific Economic Cooperation Council
www.pecc.org

The Pacific Economic Cooperation Council (PECC) is an independent, multi-stakeholder organization committed to the promotion of cooperation and dialogue in the Asia Pacific. Founded in 1980, PECC is a network of member committees composed of individuals and institutions dedicated to this mission. The Council is one of the three official observers of the APEC process.

Currently PECC has a total of 26 member committees representing the economies of Australia, Brunei Darussalam, Canada, Chile, China, Colombia, Ecuador, Hong-Kong, China, Indonesia, Japan, Korea, Malaysia, Mexico, New Zealand, the Pacific Islands Forum, Peru, the Philippines, Singapore, Chinese Taipei, Thailand, the United States, Vietnam, France Pacific Territories and Mongolia and institutional members: the Pacific Trade and Development conference (PAFTAD) and Pacific Basin Economic Council (PBEC).

The PECC provides a forum through which its members and broader stakeholders can influence the development of policies affecting the Asia Pacific region.

These guidelines are the outcome of a three-year consultative process convened by PECC which brought together government officials, private operators, international financial institutions and non-governmental organizations to discuss trends and developments in the structuring of PPPs around the region. All of the presentations and papers from this series of seminars are available from the PECC website at: www.pecc.org/infrastructure

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Preface and Acknowledgments

The Pacific Economic Cooperation Council (PECC) was founded in 1980 to serve as a forum to discuss cooperation and policy coordination in the region. PECC is a unique tripartite partnership of senior individuals from business, government and research who work, in a non-official capacity, on practical issues to promote economic growth and development and increase economic cooperation on both sides of the Pacific Rim.

PECC is the only non-government, independent official observer organization of APEC and provides policy recommendations and analytical support to APEC. It also interacts with multilateral organizations such as the World Bank, the OECD, UNCTAD, the Asian Development Bank and the ASEAN Secretariat. PECC identifies opportunities and potential problems for member economies' businesses and governments and establishes project groups to concentrate on particular policy areas. These groups organize seminars, conduct studies and publish their conclusions and recommendations for the benefit of the Pacific community.

These guidelines follow in the tradition of PECC consensus-building on key topics including: *Encouraging International Investment in the Asia Pacific Region: A Draft Asia Pacific Investment Code* (1994 – Trade Policy Forum); *PECC Competition Principles: PECC Principles for Guiding the Development of a Competition-Driven Policy Framework for APEC Economies* (1999 – Trade Policy Forum); *Guidelines for Good Corporate Governance Practice* (2001 – Peer Assistance and Review Network (PARNet)); *Proposals for an APEC Common Understanding on RTAs* (2003 – Trade Forum and RTA Task Force)

PECC's interest in Public Private Partnerships (PPPs) came as a response to the growing demand for infrastructure in the Pacific region and the pressure to build new infrastructure with limited funds. APEC leaders have explicitly recognized the need for government and businesses to work together to address regional infrastructure needs. The *Vancouver Framework for Enhanced Public-Private Partnerships for Infrastructure Development* sets out voluntary principles which highlight the importance of sound and stable economic and legal frameworks, transparent and accountable processes, appropriate risk management, and ensuring that the infrastructure supports the achievement of economic, environmental and social goals. PECC's *Guidelines for Effective Public Private Partnerships* further develop these broad themes, and draw out a set of practical recommendations for governments, private partners and the financial sector.

This document is the culmination of an extensive process of consultation and consensus building. Together with governments, private operators, international financial institutions and non-governmental organizations PECC held three regional seminars, the first in Sydney in December 2004 addressed the development of PPPs for essential infrastructure services in Asian economies, the second in Santiago, in December 2005, was more oriented towards specific Latin America issues related to PPPs, and a concluding seminar in Sydney in November 2006, when these Guidelines were officially introduced. PPPs for Infrastructure Development were also the subject of a plenary session at the Sixteenth PECC General Meeting held in Seoul in September 2005.

With these PPP Guidelines, PECC aims to help government state, municipalities, operators and financial institutions to build the infrastructure and public services of tomorrow, and to manage them on a long-term basis. They define the function and impact of PPPs in the financing of infrastructure projects and set a framework for more transparent and efficient PPPs.

The development of the PECC Guidelines presented in this document has benefited from many contributions. There has been much enthusiasm and encouragement from within PECC and from other international organizations. In addition to this general acknowledgment of widespread assistance and support, special acknowledgement is due to the participants in the three seminars for their efforts and, especially, for their valuable insight in various stages, drafting, and assistance in hosting discussions on the PPP Guidelines.

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I Introduction and Background

Responding to infrastructure needs and seeking better public service management

Across the world, the growing population, changing lifestyles and increasing per capita needs have fuelled a growing demand for infrastructure services that is becoming increasingly difficult to meet.

For the first time in the history of mankind, the number of urban dwellers equals the rural population, the combined result of population growth and rural exodus. The urban population increases by 70 million people a year, that is, by the size of a city like Santiago de Chile or Ho Chi Minh City each month. One generation from now, two-thirds of the world's population will be living in cities, compared with only 10% a hundred years ago.

The economic, social, political, sanitary and environmental challenges from urban growth are enormous: how to cope with a global public services infrastructure gap and pressures for efficiency improvements while being exposed to budgetary constraints and "affordability" limits?

The need for external financing is tremendous. For many years, developing countries have underinvested in infrastructure projects. Financing shortfalls are a serious constraint for the development of PECC's economies. According to the Asian Development Bank (ADB) and the World Bank (*Connecting East Asia: New Framework for Infrastructure* Asian Development Bank, Japan Bank for International Cooperation, and the World Bank, 2005), from 2005 onwards the infrastructure investment requirements for developing Asia and the Pacific will exceed US$ 250 billion per year. Over the next 20 years East Asia would need US$1 trillion in infrastructure investment.

The basic services essential for a certain quality of life are roughly the same across the world. These "essential services" usually include power generation and distribution, telecommunications, ground and sea transportation, water distribution and sanitation, and waste management.

Infrastructure services involve far more than purely essential services, encompassing the building of all infrastructure including hospitals, schools, road construction, airports and ports facilities, prisons, and arts and cultural venues.

These infrastructure services have some characteristics in common: they are expensive to set-up and are consumed on a massive scale. Governments and local agencies may not be able to cope with the growing demand for infrastructure.

A widely recognized goal for state or local authorities, multilateral organizations, and public and private operators is to facilitate access to public infrastructure and services.

Public authorities must decide whether infrastructure and public services are to be managed in a fully public way or delegated to a private operator. Many local authorities in Asia and the Pacific Rim economies increasingly seek private investment through Public Private Partnerships (PPPs) in an effort to combine a public service mission with the efficiency of a private operator.

For many years, public authorities played the major role in offering aid in the design, financing and management of public facilities. However, budget pressures and growing demand for services mean that public authorities often no longer have the financial and technical capacities to meet expectations of citizens, taxpayers and consumers.

Today it is widely accepted that PPPs can address these problems. In the past 15 years more than 130 countries worldwide have adopted PPP options. Delegating the management and financing of selected infrastructure and public services to a private partner, with a clear set of obligations, allows for a better allocation of scarce public resources to meet growing demand.

PPP agreements can take several forms and play different roles. They are not simply a way to overcome a budgetary constraint to finance infrastructure projects, but can also promote long-term development.

The nature and role of Public Private Partnerships

PPPs can be defined as cooperation between public authorities and the private sector in order to ensure the financing, construction, renovation or management of infrastructure, or provision of a service.

The PPP concept remains an “umbrella notion”, in constant evolution and covering a wide range of economic activities and legal schemes. PPPs recognize that the relative advantages of public and private sectors in the performance of specific tasks differ. By allowing each sector to do what it does best, public and private operators can operate jointly and provide infrastructure services in the most efficient manner. They also provide an effective approach for infrastructure delivery and outsourcing of public services.

PPPs introduce private sector capital, bring in expertise and deliver public services more efficiently. They share investment risks, responsibilities and rewards between the public and the private sector.

In the PECC economies, tailor-made partnerships between local authorities and private operators take a number of forms: management and service contracts, lease, concessions, concessions with partial asset sales, Build-Operate-Transfer (BOT), Design-Build-Operate, and even more sophisticated forms such as joint lease / BOT contracts, divestiture, or any combination of these to fit best with the population’s needs.

The need for improved forms of governance

The flexibility of public-private partnerships is a major advantage. At a time when the need to improve governance methods is strong, PPPs have adapted to suit state and local public authorities needs and specific requirements.

Although the issue of financing is crucial for the sustainability of PPPs and for the affordability of public services, the factor limiting the emergence of projects to improve public service is rarely money. The limiting factor is more often related to governance.

Massive financing cannot be mobilized without serious guarantees that the funds will be well managed. Therefore a pre-requisite for mobilizing finance is a step forward in public service governance.

In the past decade, PPPs have expanded new kinds of governance and helped bring about more responsible management of public services.

Effective public service policy requires a clear breakdown of responsibilities between the public authorities, service operators and financing institutions. Good governance above all requires formalizing the rights and duties of the stakeholders to the PPP process. PPP operators cannot work effectively and legitimately without a strong supervising authority. Well-conceived PPPs clarify the roles of public and private entities and lead to improved performance.

PPPs, a tool to implement sustainable development policies

PPPs may also be a tool to implement sustainable development policy:

- PPPs help local authorities define a long-term vision and translate it into the day-to-day management of public services;
- PPPs also help operate existing infrastructure and provide investments in order to meet the needs of future generations. The investments made by private operators and their financial partners in the framework of a PPP demonstrate the current generation's concern for those who will follow. Efficient management of today's infrastructure is an essential requirement to ensure future generations receive high-quality services.

PPPs offer a potential solution to the challenges of growing infrastructure needs, budget constraints and pressure for improved management and delivery of public services. PPPs can be flexible enough to accommodate a range of requirements and objectives, but the roles of all parties must be clearly specified.

For these reasons, PECC believes that voluntary guidelines, supported by a best effort clause, should help PPP stakeholders to find a common understanding, leading to a more balanced and effective set of rights and obligations for the partners involved.

PECC's voluntary Guidelines for effective Public Private Partnerships

An effective PPP involves:

1) Inclusive development and affordability

- investment in infrastructure to improve the living conditions of society and access to basic services at an acceptable cost.

2) Trust and cooperation

- a clear definition of the roles of all stakeholders involved; transparency of procedures, performance evaluation criteria, and review mechanisms to take into account possible events that might impact on the contractual obligations; and a framework for the settlement of disputes. In addition, earning the trust of the population is crucial, especially when a PPP involves basic services such as water distribution.

3) Stability and predictability

- a sound social, economic and legal environment
- a clear understanding of attitudes and motivations of local governments in order to assess the viability of investment;
- a legal framework for contract enforcement and remedies;
- financially and technically credible partners with reasonable experience, particularly for complex cross-border projects; and,
- consistent enforcement of contracts, which enhance regulatory stability and predictability.

4) Accountability and risk management

- rewarding organizations that perform well for their stakeholders and conversely penalizing those that perform badly; and making risks and rewards commensurate in order to drive good performance.

5) Infrastructure financing optimization

- channeling more of the financial flows toward municipalities and promoting mature local financing markets to help overcome the budgetary constraints of local authorities, to raise funds and to optimize the financial structure of projects.

For each of these Guidelines, recommendations are made to the PPP stakeholders:

- Public authorities, including state government and regional/local authorities;
- The financial community, including public, multilateral and private financers; and
- The private sector.

The recommendations are summarized at the end of the report.

II PECC Voluntary Guidelines For Effective Public Private Partnerships

1) Inclusive development and affordability

An effective PPP will involve investment in infrastructure to improve the living conditions of society and provide access to basic services at an acceptable cost.

Inclusive development

Infrastructure fights poverty in two ways: it supports the process of growth and it helps the poor to access basic services. It draws poverty reduction, service provision and growth into a reinforcing circle.

The full impact of an infrastructure project depends not only on incomes generated but also on other dimensions of well being, such as access to basic services, and the impact not only on the direct users but also on the population.

Infrastructure is critical for realizing sustained economic growth, and has strong positive linkages with other sectors. It is required for the efficient delivery of goods, services, and information, including services to the poorest; it provides an enabling environment for private sector development and promotes broad-based growth.

Basic services infrastructure is essential for ensuring a certain quality of life. Infrastructure provides people with essential services they need in their day-to-day life: water distribution and sanitation; power for heat, cooking and light; telephones; computer access and transportation. The absence of some of these services is an important dimension of what is referred to as poverty by the World Bank.

Infrastructure is also an input to production: it connects goods to markets, workers to industry, people to services, and rural areas to high density urban centers. Infrastructure reduces costs, enlarges markets, and facilitates trade.

Delivering affordable infrastructure services – the roles of the PPP partners

Within a PPP, role sharing between the public authority and the private contractor is established under a contract. A contractual arrangement has a number of advantages. It forces a healthy clarification of the parties' roles, a precise definition of the expected results, and a focus on performance.

The role of governments

The public authorities define the service policy, decide on the targets to be met, assign the missions and degree of autonomy they want to give the private partner, and provide an incentive structure to ensure the private operator delivers the appropriate quality of service. They define the price ceiling to be met by the operators when providing full service to the poor. Governments also have to evaluate the prices proposed by the operator to ensure they are consistent with the economic and social policy of the government.

The public authorities will also determine the amount of the subsidy to the private operator. For the public authorities it may not be appropriate to select the bidder who asks for the lowest subsidy or proposes the best price. It may be preferable to choose the one which allows for better and wider access to the essential services even if the subsidy to be given to the operator is higher.

Increases in the contributions from national or local taxpayers can reduce the tariff that users will have to pay. Taxpayers' support may also be justified when a facility to be built will benefit not only to the present generation but also to the next one, or when this facility will benefit not only users but also a wider part of the community (e.g.: for the economic development of a region). Public aid can take various forms such as a capital endowment, grants for equipment purchases, repayable cash advances or preferential interest charges.

The public administration must define the procedures for selecting the partners, open invitations to tender and facilitate a negotiation process. The public partner must award the contract to the tender that offers the desired service quality at the lowest cost. This will not necessarily be the lowest cost tender.

The pre-selection process should take into account the experience and the reputation of the private operator, based on criteria such as its technical expertise and its capacity to find partners to meet the financial requirements to cover the project.

The role of the private operator

The operator brings its expertise to optimize the infrastructure and achieve the best value for money. Having a private operator involved can substantially reduce the cost of investment and operational costs.

The private service operator should optimize the use of existing infrastructure, so that it can serve more people at a better cost, reducing the need for new infrastructure investment. That would help governments to best allocate limited financial resources between competing essential services.

The private operator can help local governments to optimize their investment program, when facilities need to be upgraded, extended or refurbished, or to comply with new standards. A balance must be found between keeping down the investment cost and facing the risk of higher operating costs or accepting higher investment costs with a view to reducing operational costs. Once the trade-off has been clearly identified and measured, it should prevent the local authorities putting excessive pressure on the operator to reduce investment costs.

Cost optimization should encompass design and construction, operation, and financing. Contracts must cover a sufficient period to allow for complete optimization of the service and to generate substantial productivity gains. Too short a contract period might prevent the complete and long-term optimization of the service and infrastructure.

PPPs should help to improve the situation of disadvantaged populations while maintaining socially acceptable prices. The challenge faced by governments is to maintain cost at a level acceptable to the end user. A growing consensus is that there is a need to meet the expectations of consumers who are too poor to pay for the service. Authorities will have to evaluate the effect of the private operator's tariff structure on use of the service.

PPPs give local authorities access to high-level expertise in public services so that they can benefit from the effectiveness and know-how of an experienced operator while retaining control over strategic options and general policy. Private sector know-how can help local authorities improve public service management and achieve managed and sustainable development. PPPs will bring a transfer of know-how including training. Improving public services will not be achieved without boosting local skills.

Recommendations:

To public authorities:

- Recognizing that infrastructure is critical for achieving social and economic goals and for realizing sustained economic growth, and has strong positive linkages with other services and industry sectors; **public authorities should maintain an enabling environment for private sector by supporting policy, institutional, regulatory and judicial reforms that improve governance and provide an effective check against corruption;**

- To sustain growth and alleviate poverty, **public authorities should aim at developing essential services with support of the private sector;**

- **When determining the PPP contract terms, public authorities must find an appropriate balance between prices and/or subsidies, operating costs and investments;**

- **Public authorities should provide essential services to the poor in an effective way.**

To the private partners:

- **Private partners should aim to develop PPPs where they are most needed;**

- **Private partner involvement through PPPs could range from fairly simple levels of private sector involvement, to more complex arrangements** i.e. services contracts, management contracts, operation and maintenance contracts, lease contracts, concessions contracts, divestiture, or any combination of these;

- To meet the financial requirements of local governments, **private partners should not only create and operate new assets, they should also be involved in the renovation of existing assets;**

- **Involvement of the private sector requires close cooperation and communication with local government to:**

  - clearly understand the needs of the community;
  - offer the best essential service at a cost affordable to the end users; and,
  - strengthen the economic growth of the host economy and alleviate poverty in the developing economies.

2) Trust and cooperation

Trust and cooperation are at the heart of effective Public Private Partnerships

No long-term contract can be established and survive without trust. The relationship between the public and the private entities must endure throughout the 10, 30 or 50 year duration of the contract. Many new events may occur during such a long period, but the public-private collaboration must continue for the contract to be successful. The parties are partners in the venture and not opponents.

Trust between the local authority and the private operator is necessary but not sufficient for an effective PPP. Trust with the staff retained, with consumers and with the population is also required.

To build trust with local authorities

If there is trust, PPPs can be an efficient way to implement public service policy. Trust requires:

- a clear allocation of roles between partners involved (local authorities, constructors, lenders, operators);
- a stable regulatory framework, which makes the economic and legal environment the most predictable possible, and which reduces the risk of changes to the rules of the game;
- transparency through procedures for transferring information;
- a strict respect for the autonomy given to the private partner;

- performance evaluation criteria;
- a contract review mechanism in order to take into account new events which may modify the contractual equilibrium; and
- a clear procedure to solve potential misunderstandings.

The better the contract defines objectives and performance criteria, the less room there is for mistrust.

Trust also requires designing realistic investment programs. Dialogue between organizing authorities, local populations and operators should lead to a joint and pragmatic definition of what is possible immediately, what has to wait five years and what is reasonable in the longer term. Realistic performance targets should reflect the initial level of service and the expectations of the existing and potential consumers.

Trust should work both ways. When a local authority outsources a service, it should accept the rules of the game; reducing the degree of autonomy of the private operator contradicts the notion of outsourced management and limits the efficiency of the operator.

To build trust with the staff retained

Outsourcing an infrastructure service previously operated by a public entity to a private operator is always a sensitive issue for incumbent employees. Maintaining a climate of trust among the staff is a key factor when the public sector transfers responsibilities to the private sector. At the start of the contract, the challenge is to ensure continuity of service and maintain employees' motivation. Employees also have to be motivated to carry out the mission assigned to the private operator.

Transition from the public to private sector has a great impact on personnel and must be managed carefully. From the initial offer to the agreement, the private operator has to commit, in clear terms, to respect the conditions for retaining personnel and comply with the regulatory framework. It must observe legislative constraints, as well as the corporate and collective agreements negotiated with the trade unions representatives (salary, leave, overtime and employee profit-sharing policies, contingency funds).

Improving the quality of service and the operations' performance can only be achieved if the changes suggested are accepted and implemented by the entire personnel. The switch from public to private management needs to be meticulously managed and supported by a transition project to help employees adopt a positive attitude towards a major change.

To build trust with consumers

An effective PPP requires that customers and citizens support the decisions made by public authorities.

Information is a prerequisite for consumer trust. Without access to information, consumers cannot reach informed opinions and adhere to the policy jointly implemented by the local authority and the private operator.

Involvement of customers and citizens takes place, first of all, through their government authorities and through their elected representatives. Direct involvement of customers and the local population is also essential to build trust.

Services consumers are much more demanding of a private operator, especially a foreign one, than a public one. Consequently, a private operator has more pressure than a public operator to explain what it does, what actions it has to undertake to improve the service or to quickly restore services in case of interruption.

Clear undertakings to customers and promoting transparency through performance evaluation criteria and regular reporting on ongoing activities also facilitate the establishment of trust with consumers.

To build trust with the population

The population's trust is crucial, especially when a PPP provides basic services such as water, transportation or energy. Without the support of local populations for service policies, service levels and price levels, nothing sustainable can be built. Mutual trust has to be promoted, sometimes requiring an external mediation. A culture of mutual respect and dialogue is the basis for an effective PPP.

A transparent process that involves consultation of the population should be used when determining the type of management (direct or indirect) of the service and the level of involvement of the private sector. A high degree of transparency during the bidding process is necessary to remove any suspicion of an unfair selection between a private operator versus a public one or an unfair selection of the firm.

When outsourcing a service, public authorities retain responsibility for defining the policy and taking strategic decisions. Although authorities make the decisions and private operators have to apply them, people tend to think that the private sector involvement strips the public authorities from their responsibility. People should be informed that elected officials and public authorities establish policy and monitor performance. In some cases public authorities make policy subject to the Legislature's checks and balances.

The best way to win trust is action. Good results obtained during the first years of the PPP operation make people confident in the choice made by the local authority. Improvements which generate immediate results on strategic projects increase the support of the population for the project.

Mutual trust has to be promoted all along the PPP process, not only during the preparatory phase but also after, by a permanent dialogue between the local authority, private partner, customers and the population.

The private operator has to develop external communications to keep the general public informed about its performance and to respond to any requests.

Recommendations:

Public authorities should:

- **Design realistic investment programs and carefully estimate the needs to be satisfied to strengthen trust and cooperation.** Dialogue between the authorities in charge, local populations and operators should lead to a joint and pragmatic definition of what is possible immediately, what has to wait five years and what it is reasonable to plan in the longer term.

- **Promote transparency and consult the population during the process to determine the management of the service (direct or indirect management), service policies, service quality and price levels.** Nothing sustainable can be built without the support of local people.

- **Inform people of the role of elected officials and public authorities in shaping the service's delivery and the responsibilities that public and private partners retain.**

- **Respect the autonomy of the private operator.**

Financial community should:

- **Assess the reliability of data and viability of projects.**

Private partners should:

- Work with the public partner to ensure that the PPP leads to socially acceptable service prices to maintain trust with disadvantaged people.

- **Manage carefully the transition from public to private management,** which has a great impact on employees.

- **Issue clear undertakings to customers,** immediately **restore or improve services, and promote transparency through performance evaluation criteria and regular reporting on ongoing activities,** to establish trust with consumers.

3) Stability and predictability

Basic pre-conditions for effective PPPs include:

- a stable macro-economic environment;
- a legal framework for contracts and disputes resolution;
- an effective stance against corruption; and
- developed local financial markets.

Prior to any formal PPP agreement basic conditions should be met, with a view to ensuring transparency and legal security, creating confidence and preventing any suspicion of corruption. The public partner should:

- offer a stable and efficient regulatory framework to make the economic and legal environment the most predictable possible, and reduce the risk of changes of the rules of the game;
- open related markets to competition between private operators and set terms and conditions for access to the infrastructure;
- set up efficient regulations and comprehensive rules of procurement, recognizing the principles of open access, transparent bidding and equality of treatment.

In order to build a long-term relationship between the public authorities and their private counterparts, both contracting parties should focus on the stability of their relationship. The public sector tends to emphasize the continuity and the quality of the service provided by the private company, while the private partner may attach a great value to the stability of the legal context. On both sides, several principles should apply.

There is no single legal tool to set up a PPP relationship. Each PPP relationship is unique and the appropriate structure for a PPP should take into account the political, social and technical environment.

Nevertheless, stakeholders should aim at setting standard PPP contracts at all levels of government: national, sub-national or plurilateral, where feasible.

PPPs are not the only answer to the demand for public infrastructures and services, so the decision whether to enter a PPP should be rigorously assessed.

In most cases, the public administration must improve its traditional operating methods: adopting better negotiation strategies, monitoring the performance of the contract, and defining an efficient distribution of risks between contracting parties.

Social and economic environment of the country

A) Needs of the public authority

In most cases, the initiative for a PPP comes from public authorities. It may be based upon a contract or an institution (semi-public company). The public entity must take into consideration the nature of the public needs, the duration of the partnership and the nature and level of control or monitoring that public authorities want to exert on the project.

The public authority shall determine the main characteristics of the project: construction or operation; real estate project or outsourcing of the public utility. At this stage, the authority also has to define the level of performance of the assets, the level of quality of the service and the type of financing for the project.

A common feature of PPPs is the long duration of the partnership. It must prove durable but should also be adaptable to evolving needs. While PPP relationships are usually long term, shorter agreements, 5 to 7 years, have also been efficient, although they may not allow a full optimization of the service.

For long-term commitments, ranging from 15 to 50 years, it is essential to pre-determine the operational framework to:

- spread the impact of investments on the service price over several years, and thus moderate price increases for the services delivered; and
- ensure a reasonable return on the invested capital, recognizing the requirements of the service and investment life cycle.

Finally, the level of control has to be defined. Although the main reason to set up a PPP is because the private sector can better conduct the project, the social context can justify a high degree of control by the public entity. In any case, some control is essential to guarantee the private partner's level of performance.

B) Local market for the PPP's services

An assessment of the market should be conducted in order to check the interest of the potential operators or lenders and the ability of the final users to pay for the service.

Public authorities should:

- devote sufficient time to the preparatory phase of a project;
- design realistic investment programs;
- not focus exclusively on a financial approach but also integrate operating concerns;
- fulfill the requirements for sustainable development;
- correctly identify and price the project's risks.

If a positive market response is unlikely, it may not be worth pursuing a PPP.

C) Need for a strong legal and institutional framework

For private operators and public entities, an effective PPP will depend upon the quality of institutions and the interest and strength of financial operators.

The quality of institutions and the level of stability and predictability will determine the level of attractiveness of a country to financial operators, both foreign and domestic.

Governments have to decide whether to have a regulatory authority, and then choose between an independent or an integrated regulator, taking into account the specific political and cultural environment of the country.

Public authorities also have to identify indicators of quality and define the processes of control and mechanisms to evaluate performances.

To understand, compare and evaluate the strategies proposed by competing private operators public authorities need to identify the right level of technical sophistication of the operation of the building of the infrastructure and/or its operation. Public authorities should leave room for innovation and alternate solutions.

Competition from foreign operators would strengthen local competition, pushing domestic operators to perform better, enabling them to play a substantial role in the development of their home country.

Basic legal conditions for PPPs

A) Negotiation and dialogue between the public and private partner

The negotiation process should aim to:

- identify technical solutions able to meet the needs of the population;
- set the operating framework for the private partner and arbitrate between public needs and operational constraints of the private operator;
- identify realistic performance requirements;
- define an efficient sharing of risks between the public and the private partner according to the respective ability of the parties to assess, control and cope with them;
- set the conditions for an efficient transfer of employees from the public to the private sector according to the regulatory framework and the corporate and social context of the private operator and its constraints through collective agreements.

B) Clarity and adaptability of the contract

The principle of good governance requires a clear definition of partners' responsibilities. The clearer the objectives and performance criteria defined in the contract, the less room there is for misunderstandings.

The legal framework should offer sufficient flexibility to enable a durable relationship between the public authority and its private partners.

Given its duration a PPP contract should envisage unforeseen events. A contract with adjustment, review and step in clauses is therefore necessary to respond to major disruptions in the economic parameters of the contract.

In addition, a balanced contractual framework has to be set up with a fair evaluation of performances of the public service and a fair determination of the conditions of public payments, which may be set to provide incentives for performance.

Finally, should the contract be terminated, the public partner must specify how to:

- ensure quality and guarantee continuity of public services;
- cope with rights and obligations attached to ownership of the infrastructure; and,
- set mechanisms for settlement and conflict resolution to minimize the need for costly litigation.

Recommendations

To ensure stability and predictability of the project, public authorities should:

- **set a stable and efficient regulatory framework,** which makes the economic and legal environment the most predictable possible, **limiting the risk from changes in the rules;**

- **promote competition in related markets;**

- **aim at setting standards for PPP contracts;**

- promote procurements that recognize the principles of free access, transparent bidding and equality of treatment **to create conditions for transparency and legal security, which foster confidence and prevent corruption;**

- **define the main characteristics of the project: level of performance and quality of the service, and the type of financing for the project;**

- **choose private partners through a pre-selection process** which recognizes the experience and expertise of the bidders, based on criteria such as its technical expertise and capacity to find partners to meet the financial requirements of the project in its entirety - design, construction, operation and maintenance;

- as a common characteristic of PPP is the long duration of the partnership link, the project must adapt to evolving needs;

- **determine the level of control by the public authorities:** although the main reason to set up a PPP is because the private sector can better conduct the project, the social context can justify a high degree of control by the public entity. Some control is essential to guarantee the private partner's level of performance;

- **offer a sound contractual framework and define an efficient distribution of risks between the public and the private partner** according to the respective ability of the parties to assess, control and cope with them and try to avoid an increase of the price of services because of unexpected events;

- **set up procedures for renegotiation of the contract** when facing unforeseen situations;

- **offer dispute settlement mechanisms,** to help stakeholders in the PPP process to resolve conflicts **and avoid disruptions in the provision of the service.**

Private partners should:

- **take into account the local context, administrative procedures, social, institutional and political landscape, know-how and technical needs;**
- **comply with procedures for renegotiation of the contract** when facing unforeseen situations;
- **provide procedures for resolving users' complaints about the service;**
- **be involved in monitoring compliance of the service, in case of failure of the local administration.**

4) Accountability and risk management

One of the main difficulties to overcome with managing accountability and risk management in PPPs is the potential for misunderstanding between the parties involved. To adequately appraise the risks associated with PPPs, each party must understand the rules and principles underlying the way performance is measured.

It is widely accepted that public sector accounting and private sector accounting differ in fundamental ways, and each has limitations. Public sector accounting could be an obstacle to the fair evaluation of the performance of public services because it may not adequately deal with accountability and risk management.

There is clearly room for progress in developing a common language between the stakeholders of a PPP activity.

Accounting in the public sector

Public sector accounting is traditionally based on a budgetary concept. Receipts and expenditures are entered as a function of changes in cash position. Recognition of revenues and expenses is not linked to the provision of services or the transfer of goods. Hence, it is impossible to measure the performance of a public sector entity correctly; that is, to know the real cost of a service rendered or a good transferred. For example, the absence of a notion of inventory in public sector accounting makes it impossible to determine and control the cost of production of goods.

Public sector accounting is traditionally characterized by the absence of the balance sheet concept. There is no distinction between *expenses* (which pertain to the *activity* of a public sector entity) and *fixed assets* (which pertain to the *asset base* of a public sector entity). There is no notion of *commitments* given and received: various receivables, labor-related commitments (pensions, etc.) or financial commitments (guarantees, collateral, provisions for contingent liabilities, etc.) Therefore, public sector accounting does not give a true image of the asset base of the central or local government, and makes it impossible to project the future correctly. For example, the lack of provisions for recording customer receivables makes it impossible to take the risk of non-payment into account.

The frequent absence of a concept of depreciation in the accounting of public entities makes it impossible to relate the level of wear on an asset and the need to replace it.

There are often no clearly defined financial aggregates, no publication of a full financial statement differentiating the income statement, the asset base and the cash flow of the public sector entity. Therefore, the performance of the public sector entity cannot be measured on the basis of the operating income it generates, but only with reference to the amount allocated to it in the budget. Traditionally, the larger the allocation, the more significant the government agency.

Participation of the private sector, a means of improving evaluation of the performance of public services

Involvement of the private sector in managing infrastructure or public services through concessions or public service contracts opens the way to a "best practice" approach that makes it possible to improve efficiency and make a fair evaluation of the performance of public services.

Involvement of the private sector requires credible audit authorities to follow-up on reciprocal commitments and contractual provisions between the public and private sector, including monitoring quality control; sales price and cost of services provided; respect for fiscal rules and accounting regulations; and financial information.

Private sector accounting (*accounting for commitments*) allows for greater flexibility, better tracking of the costs of services and greater efficiency of the services provided. To achieve this goal and permit a comparison with public sector services of the same nature, the private partner should provide the public authority with all information that could bear on the quality or price of services it provides in the medium and long term.

The accounting framework has to classify costs and expenses, related to financing and operating the service into capital expenditures (CAPEX) made, and future expenditures for which provisions have been booked (replacement of infrastructure or bringing it up to standards, etc).

The accounting framework should respect the standards peculiar to the service concerned and to the applicable form of contract (inscription of capital expenditures made by the concessionaire, method of depreciation, CAPEX subsidies, provisions for major repairs, provisions for renewals, etc).

It should also respect the quality standards imposed in regulations and/or in the contract with the public authority (technical aspects, safety, health, pollution and impact on the environment, etc.).

All this information should be encompassed within the management report. It should provide the financial statements (income statement, balance sheet, cash flow table) as well as an analysis of the quality of the service provided.

IPSAS standards, a means of bringing public and private sector accounting standards together

The modernization of the accounting regimes of public sector institutions aims to provide public entities with a more effective and more harmonized accounting system, and to respond to the new financial responsibilities deriving from enhanced decentralization and new requirements in accounting and financial reporting. In this context, a process of review was begun that led to the creation of IPSAS (International Public Sector Accounting Standards, 1996).

These standards recommend adoption of accounting for commitments based on private sector accounting, especially IAS standards, and the establishment of financial statements applied to all aspects of a government. The OECD adopted them in 2000, NATO and the European Union in 2002.

IPSAS standards are a uniform accounting framework for all public sector entities. They provide a "business" view of public sector accounting, while proposing solutions that are adapted to the special characteristics of public sector organizations.

Once financial statements are set up in conformity with IPSAS standards, it is possible to:

- make the true cost of public administration more transparent;
- have more indicators for budget preparation;
- make lawmakers aware of future expenses that do not appear in a purely budgetary approach.

The adoption of these standards by government authorities, with an independent expert to audit their application, can contribute to improved efficiency and a better evaluation of the performance of public sector services.

Sustainable development, a means of bringing public and private sector perception of accountability and risk management together

According to the United Nations, *"sustainable development consists of the ability for present generations to satisfy their needs and allowing future generations to satisfy their own needs"*. It is based on three main objectives: economic development, shared social development, protection of the environment. In that regard, Agenda 21 recommends all companies contribute to sustainable development through employment, staff training, research and innovation. Today it is at the very heart of high quality management. Several countries require by law that private companies indicate in their annual report steps taken in favor of sustainable development.

The public sector has engaged in an approach driven by sustainable development, essentially to:

- provide relevant information to citizens and investors who request more transparency and responsibility from public bodies;
- establish the population's trust in the political process;
- increase the efficiency of the public sector;
- increase the synergy and cohesiveness of public policies;
- engage in a better allocation of public resources and transform risks into strategic opportunities;
- improve the image of the public sector;
- increase the involvement of the population;
- respect environmental laws and regulations.

To an increasing extent, the impact on sustainable development is used as a criterion to assess companies, especially those involved in providing public services. Private sector managers increasingly recognize that economic, social and environmental performance are the main drivers to value creation.

- A company's short and long term impact on the environment and its social performance affect its reputation, economic health and market quotation;
- Effective management of social and environmental risks increases a company's value;
- Sustainable development has a growing role in international financial funding decisions; and
- Legal requirements increase communication between all stakeholders.

Recommendations

Public enterprises are traditionally characterized by resistance to change in their operations, lack of innovation, difficulties in adapting to demand, high operating costs and inappropriate capital expenditures. The introduction of regulations and accounting standards applicable to the private sector, whether in the form of concessions or other contracts or through the evolution of public sector accounting standards (IPSAS standards), should make it possible to improve flexibility, dynamism and efficiency in management, as well as increase financial or socio-economic profitability of public services or infrastructure.

Public authorities should:

- **engage in reporting and publication that gives a true picture of the asset base of the central or local government;**
- **respect the accounting standards peculiar to the service concerned and to the applicable form of contract;**
- **respect quality standards imposed in regulations and/or in the contract with the public authority;**
- **pursue the modernization of the accounting regimes of public sector institutions,** to provide them with a more effective and harmonized accounting system and respond to new financial responsibilities deriving from enhanced decentralization and new requirements in accounting and financial reporting; and
- **engage in an approach driven by sustainable development** to give the relevant information to citizens and investors who request more and more transparency and responsibility from public bodies.

Private partners:

- in managing infrastructure or public services, **private operators should seek best practices** to improve efficiency and make a fair evaluation of their performance;
- **private sector accounting (accounting for commitments) should aim to promote greater flexibility, better understanding of the costs of services and greater efficiency of the services provided;**
- **private partners should pay more attention to sustainable development.**

5) Infrastructure financing optimization

Infrastructure needs can be met in two ways, with different financial implications:

1) the creation of completely new infrastructure, (such as highways or railroads lines in areas lacking transportation infrastructure). The project cannot usually benefit from

operating revenue during the construction phase, which makes it more costly to raise the necessary financing. The traffic or demand risks may also be higher since the assessment of future revenues is based on pure projections, not on concrete data issued from the operation of an existing infrastructure;

2) the extension of existing infrastructure to satisfy an increase in demand (e.g.: water or energy services in growing cities). In that case, the private partner is usually also in charge of operating and modernizing the former infrastructure. Investment financing is easier since cash flows coming from the existing operation revenues at the start of the project may contribute one part of the necessary funding. Lenders prefer a corporate risk approach to a project risk approach, relying on projections rather than on existing revenues.

In both cases, to attract private sector involvement (technical and financial), it is important to reduce the time frame during which the return on investment (ROI) is negative.

Avoiding the risk of unnecessary new investment

The private sector can contribute to the basic services challenge by improving the efficiency of the public service rather than being only viewed as a financial provider.

The role of a private operator is twofold: firstly it should aim, when feasible, to optimize the existing infrastructure, so that it can serve more people and produce a better quality service.

Optimizing the capabilities of existing infrastructure reduces the need for new investment and avoids the risk of unnecessary investment. It is therefore crucial to optimize the service infrastructure as a whole, in technical, organizational, financial and environmental ways. This wholesale optimization improves the quality of the service provided and releases cash flow to fund new infrastructures.

Secondly, when necessary, the private operator would build and finance new infrastructure.

The role of a private operator in investment financing

A private operator plays a pivotal role in optimizing the investment program and facilitating its financing:

- When a private operator steps in and upgrades a service, it paves the way for good use of the financing earmarked for new projects;
- If new investments are needed, the private operator brings its expertise to help the public partner optimize the investment program so that its impact on the price of service will only be felt gradually.
- Although a private operator may provide some of the financing from user charges, it primarily serves as a catalyst for raising funds from other financial partners.

- When new infrastructure needs to be built, the private operator controls the price/quality ratio of the new investment and guarantees the quality of the service provided within the framework set by the public partner.

In the context of scarce financial sources compared with massive needs, the operator, whether public or private, has a duty to use the project funds efficiently (including any taxpayer contribution), and to manage the service in the most efficient way.

Facilitating the financing of basic infrastructure

Given the need to overcome deficits and to provide the best possible financial cost/quality ratio to consumers, financial resources are to be drawn from all sources: service users; governments (through taxpayers); local financing; private operators; and international mechanisms. The financial flows should be channeled toward the contracting parties.

The challenge in improving essential services lies in attracting large scale investments for their extension and modernization. An active combination of public and private financing should be sought with a view to optimizing financial flows to the operator and to providing the best financial cost/quality ratio to consumers.

It is desirable for a mature local financing market, able to understand and to bear the sub-sovereign risk, to provide long term financing. Local long term financing increases private sector involvement in public service projects.

Using local capital and financial markets to finance basic service investment can overcome the limitations of international financing. When private financing is denominated in foreign currency, it exposes the operator and local authority to a foreign exchange risk. Local currency financing can mitigate foreign exchange risk and insulate the financial package from the adverse effects of a foreign exchange crisis.

Recommendations

To public authorities and the private sector:

- **Optimize the capabilities of existing infrastructure** to reduce the need for new investments and avoid the risk of unnecessary investment;

- **Optimize the whole service,** “everything that can be optimized”, and not only the use of existing infrastructure;

- **Systematically look for local currency financing,** in order mitigate foreign exchange risk and insulate the financial package from the adverse effects of a foreign exchange crisis, which may happen during the long duration of the contract.

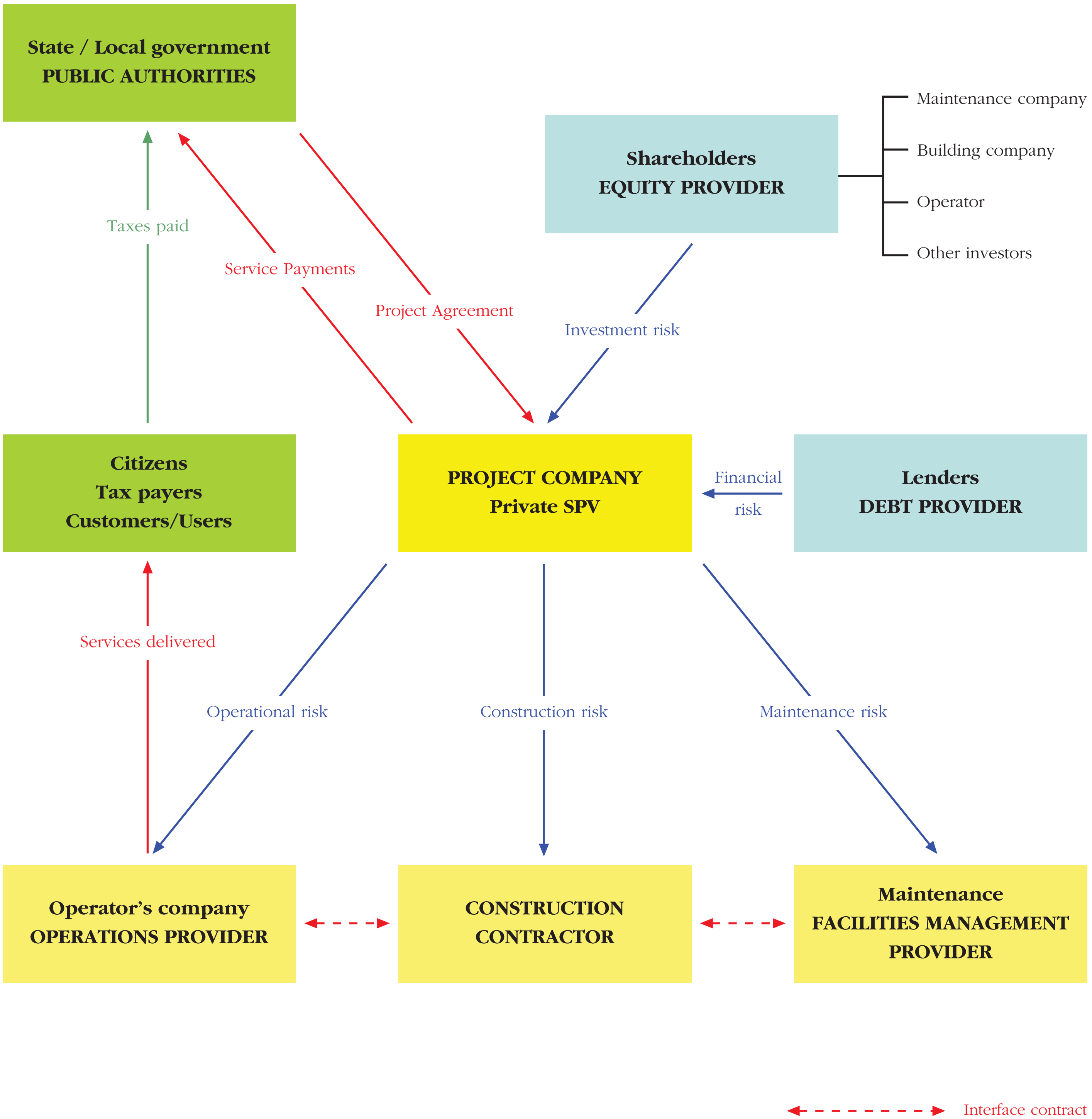
To the financial community:

- **Promote local capital and financial markets that are able to assess and bear the sub-sovereign risk, and provide long term financing for PPP projects;**

- **Channel more of the financial flows directly toward the contracting parties;**

- **Combine public and private financing to optimize financial flows and to provide the best possible financial cost / quality ratio to consumers.**

Public Private Partnership SCHEME



III A) Synthesis of recommendations
- Recommendations to stakeholders

Recommendations	Public authorities	Financial community	Private partners
Inclusive development and affordability	• Should continue to create an enabling environment for the private sector by supporting policy, institutional, regulatory and judicial reforms that improve governance and provide effective checks against corruption, which are essential for attracting private sector investments. • Should aim at developing essential services with support of the private sector. • Must find an appropriate balance between prices and/or subsidies, operating costs and investments, when determining the PPP contract terms. • Should also aim at providing the essential services to the poor to in an effective way.		• Should aim to develop PPPs where they are most needed. • Private involvement in PPPs could range from simple to complex levels of arrangements. • Should not be viewed only as for creating and operating new assets; they could also be involved in renovation of existing assets to meet the financial requirements of local governments. • Should aim at close cooperation and communication with local government: - to clearly understand the needs of the community - to offer the best essential service at a cost affordable to the end users - to strengthen the economic growth of the host economy and alleviate poverty in the developing economies
Trust and cooperation	• Design realistic investments programs and carefully estimate the demand to be satisfied. • Promote transparency and consult the population during the process to determine the management of the service (direct or indirect management), service policies, service levels and price levels.	Assess the reliability of data and viability of projects.	• Work with the public partner to ensure that PPP implementation leads to socially acceptable service prices to maintain trust with disadvantaged people. • Manage carefully the transition from public to private sector.

III A) Synthesis of recommendations
- Recommendations to stakeholders

Recommendations	Public authorities	Financial community	Private partners
	• Inform people of the role of elected officials and public authorities in shaping the service's delivery and the responsibilities that the private and public partners retain. • Respect the degree of autonomy initially allowed to the private operator.		• Issue clear undertakings to customers, and restore or improve services from the very start, and promote transparency through performance evaluation criteria and regular reporting on ongoing activities.
Stability and predictability	• Promote competitiveness and attractiveness of related markets. • Set a stable an efficient regulatory framework. • Aim at setting, with other stakeholders, standards for PPP contracts. • Promote procurement rules recognizing the principles of open access, transparent bidding and equality of treatment. • Define the main characteristics of the project: level of performance of the equipment, level of quality of the service and type of financing. • Choose private partners through a pre-selection process which would recognize the experience and expertise of the competitors, • Fix the duration of the project. • Determine the level of control by the public authorities		• Take into account the local context, administrative procedures, social, institutional and political landscape, know-how and technical needs. • Comply with procedures for renegotiation of the contract. • Provide for procedures for resolution of conflicts. • Be involved in monitoring compliance of the service. • Organize the integration of human resources.

III A) Synthesis of recommendations
- Recommendations to stakeholders

Recommendations	Public authorities	Financial community	Private partners
	• Offer a sound contractual framework and define an efficient distribution of risks between the public and the private partner. • Set up procedures for renegotiation of the contract. • Offer dispute settlement mechanisms to avoid a disruption in the provision of the service.		
Accountability and risk management	• Engage in reporting and publication to give a true picture of the asset base of the government. • Respect the accounting standards peculiar to the service concerned and to the applicable form of contract. • Respect quality standards imposed in regulations and/or in the contract with the public authority. • Pursue modernization of the accounting regimes of public sector institutions. • Engage in an approach driven by sustainable development.		• Operators should, in managing infrastructure or public services, seek best practices. • Private sector accounting (accounting for commitments) should aim at allowing for greater flexibility, better understanding of the costs of services and greater efficiency of the services provided. • Private partners should pay more attention to sustainable development, specifically for entities involved in sectors of activity where PPPs are considered an appropriate way to deliver public related services.

III A) Synthesis of recommendations
- Recommendations to stakeholders

Recommendations	Public authorities	Financial community	Private partners
Infrastructure financing optimization	• Optimize the capabilities of existing infrastructure - before building new ones. • Optimize the whole service. • Systematically look for local currency financing.	• Promote local capital and financial markets, able to understand and bear the sub-sovereign risk, and to provide long term financing for PPP projects. • Channel more of the financial flows directly toward the contracting parties. • Combine public and private financing to optimize financial flows and to provide the best possible financial cost / quality ratio to consumers.	• Optimize the capabilities of existing infrastructure before building new ones. • Optimize the whole service. • Systematically look for local currency financing.

III B) Synthesis of recommendations
- Recommendations at each stage of PPPs

	Pre-assessment	Set-up	Award	Life
Public authorities	• Design realistic investment programs and carefully estimate the demand to be satisfied. Dialogue between organizing authorities, local populations and operators should lead to a joint and pragmatic definition of what is feasible. • Set a stable and efficient regulatory framework, which makes the economic and legal environment the most predictable possible. • Promote competitiveness and attractiveness of the related market competitive to open it up to private operators and to stimulate their implication. • Establish comprehensive rules of procurement recognizing the principles of open access, transparent bidding and equality of treatment in a way to create conditions for transparency and legal security and to create confidence and prevent corruption. • Determine the level of control by the public authorities: although the private sector may have a better ability to conduct the project, the social context may justify a high degree of control by the public entity. This control is essential to guarantee the level of performance by the private partner.	• Continue to create an enabling environment for private sector by supporting policy, institutional, regulatory and judicial reforms that improve governance and provide effective checks against corruption. • Develop essential services on a broad base with support of the private sector. • Aim to provide essential services to the poor at a price they can afford. • Promote transparency and consult the population during the process to determine the type of management of the service (direct or indirect). • Inform people that elected officials and public authorities maintain complete control over service's policy and that private-sector involvement does not strip public authorities of their responsibility. • Optimize the capabilities of existing infrastructure before building new ones, since it reduces the need for new investments and avoids the risk of unnecessary investment. • Optimize the whole service. • Set up procedures for renegotiation of the contract in case of unforeseen events.	• Define the main characteristics of the project: level of performance of the assets, level of quality of the service and the type of financing. • Establish the duration of the project. The project and contract must be durable but also must be adaptable to evolving needs. • Engage in an approach driven by sustainable development. • Choose private partners through a pre-selection process which recognizes the experience and expertise of the private operator, prior to the final selection of the private partner, based on criteria such as its technical expertise, its capacity to find partners to meet the financial requirements to cover the project. • Offer a sound contractual framework which defines an efficient distribution of risks between the public and the private partner according to the respective ability of the parties to assess, control and cope with them.	• Respect the degree of autonomy given to the private operator as initially decided. • Engage in an approach driven by sustainable development. • Comply with procedures for renegotiation of the contract.

III B) Synthesis of recommendations
- Recommendations at each stage of PPPs

	Pre-assessment	Set-up	Award	Life
Financial community	• Check that the PPP's implementation leads to socially acceptable service prices to maintain trust with disadvantaged people. • Promote local capital and financial markets, able to understand and to bear the sub-sovereign risk, and to provide long term financing for PPP projects.	• Engage in reporting and publication with a view to giving a true picture of the asset base of the central or local government. • Mobilize its expertise to assess the reliability of data and viability of projects. • Channel more of the financial flows directly toward the contracting parties, since most of the basic public services are under the responsibility of sub-sovereign administrative and political entities (mainly municipalities); • Combine public and private financing to optimize financial flows and to provide the best possible financial cost / quality ratio to consumers.		• Respect the accounting standards peculiar to the service concerned and to the applicable form of contract. • Respect quality standards imposed in regulations and/or in the contract with the public authority. • Pursue the modernization of the accounting regimes of public sector institutions.

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