Essay on Public-Private Partnerships

Introduction

Public-Private Partnership (PPP) has become an icon of any public procurement. Various countries have introduced PPP from different backgrounds of thought such as the fiscal deficit, budgetary pressure, demand-supply gap, inefficient public services to infrastructure.

Some countries choose PPP intending to gain operational efficiency, innovative technologies, and management skills, expertise from the private sector, and achieve more active involvement of private players in public service. The new government of Bangladesh has shown enough positive intent to incorporate PPP in the coming fiscal budget 2009-2010. Although late, it is a very wise decision by the Finance Minister.

Proposal type

Finance Minister AMA Muhith, for the first time, proposed an allocation of Tk 2,500 crore for the public-private partnership initiative to implement different projects in the infrastructure, health, and education sectors. The money is for ensuring government partnership in equity and loan assistance from the government to different projects such as expressways, elevated expressways, sky-trains, and underground railways for large projects. Others are for link and approach roads to bridges, flyovers, underpasses and tunnels, university residential halls, and hospitals.

Relationship

This is a special initiative from the Bangladesh government to involve private sectors in public service infrastructures. Though the concept is not new the allocation of money for PPP projects is for the first time in our budget. PPP has become mandatory in the United Kingdom since 1992. Similarly, in Singapore, the government applies PPP projects where the value of the project is likely to be more than $50 million.

It is observed that PPP is most readily applied to financially free-standing projects; generates high revenue which allows the full cover of investment, debt service, operation, and maintenance. Telecommunication, oil and gas, electricity, etc. fall into this category. These projects are profit-making and can be financially sustained. On the other side, some projects provide free services to the users. These are social projects such as schools, hospitals, water, and sanitation, etc.

Economic categories

Between these two categories, there are economic projects which generate moderate revenue. Industrial estate parks, recreation centers, hotels, and resorts fall into this category. The revenue stream is normally subject to a purchase agreement which may be guaranteed by sovereign governments as the utility’s financial strength is not sufficient enough to cover the debt repayment, operation, and maintenance service. These projects typically require large sunk investment and a longer period to recoup. Economic infrastructures are also more straightforward candidates for PPP than are social infrastructures because of the higher rate of return, favorable user charge, and better market for bundling construction with the provision of related services.

In the legal factors in PPP, an implementation agreement (IA) is signed by the government with the project company. This is a crucial agreement as it ensures what the government will provide and guarantee for implementing the project. It is executed between the project company and the government to provide sovereign support as well as credit enhancement. In the Dabhol project, India it was agreed that arbitration would take place in the London courts. The tax holiday was set for 10 years. The state government of Maharashtra, as well as the central government of India, provided payment guarantees to the project vehicle for MSEB, which was a 15 percent equity investor in the project. In the Hubco project, Pakistan a tax holiday was set for the whole life of the project. In our budget 2009-2010, the Finance Minister announced similar investment attractions like tax waivers or payment of minimum tax under PPP initiative, duty-free facilities and tax holidays, or a minimum tax on profits only for a specific period. These are the first and foremost attempts apart from establishing a comprehensive policy and regulatory framework for PPP.

Despite this, there should a handbook which provides a guideline on selecting, formulating, and executing PPP projects. The Bangladesh government should publish a guideline on PPP as like the Public-Private Partnerships Handbook by the Ministry of Finance Singapore, the Guideline for successful Public-Private Partnerships by the European Commission, Promoting PPP in Bangkok Mass Rapid Transit (BMRT) and other infrastructure, and so on.

The life span of PPP

The life of the PPP projects is normally 15-30 years. From bidding announcement to financial close takes at least 2-3 years; even the construction takes another 3-4 years. Therefore, the inception period of the PPP projects is very crucial for countries in the subcontinent like Bangladesh, India, and Pakistan as the tenure for elected governments is only 5 years. These large projects need everyone’s support.

Term and condition

Costing and pricing issues are also very crucial and sensitive in PPP projects. It requires a perfect match between assets and liabilities with cash flows. Banks usually carry short-term liabilities whereas infrastructure loans are long-term in nature, usually 10-12 years. And the leverage of PPP projects is normally 70% debt and 30% equity. Debt comes from commercial banks, international financial institutions, export credit agencies. Countries like Bangladesh, India, Pakistan depend to a large extent on foreign debt and equity due to the weak or absence of adequate local capital market and contribution of domestic loans.

Therefore, it requires the participation of Multilateral Development Banks, Bilateral Banks such as the World Bank and Asian Development Bank whose repayment tenure is relatively longer with less interest rate. In addition to that, the presence of these banks not only encourages other investors, foreign and domestic banks to provide capital – both debt and equity in the project but also enables to get government guarantees against Confiscation, Expropriation, Nationalisation, and Deprivation (SEND). This happened in Hubco Project, in Pakistan. The World Bank guarantees for this project served as a model for future guarantees in support of other BOO projects in Pakistan. Bangladesh needs to open up this avenue to get finance, assistance, and guarantees for PPP projects from these MDBs and regional development banks. Nevertheless, the Bangladesh government can also initiate bond financing either at the initial stage or after the commercial operation of PPP projects. One thing that needs to be considered is that country risk highly influences the financing of PPP projects.

This can be better perceived by Sovereign Credit Rating (SCR). Credit rating helps to understand investors on risk exposures and uncertainty, default records, and access to international bond markets for a specific country. International banks use SCR to avoid problems with home coun-try regulation through certification of their portfolios by independent raters. Legal institutional factors are the crucial determinants of sovereign credit rating. Normally projects do not receive a rating higher than the host country’s SCR. But projects may get improved ratings through creditworthy agencies, tight off-take agreements, reliable supply agreements, and setting escrow accounts. Better sovereign credit rating (SCR) helps to find a variety of options for international debt financing. The degree of government involvement has a significant impact on SCR and can influence the financial structure of a project company.

Involvement in PP

The government involvement in PPP can be direct or indirect. Non-investment grade countries like Bangladesh, India, and Pakistan require sound and strong infrastructure sector strategies, policies, reliable sponsors, sensible and trans-parent purchase agreements.

PPP projects involve a plethora of risks. A key aspect of PPP structure is its ability to help transfer risks to parties that are best suited to manage or minimize them. There is a misconception that in PPP the public sector transfers all risks to the private sector that are traditionally borne by the government. This is an incorrect view. Risks are properly allocated and distributed to parties who are experts in their specific fields on mitigating risks. Non-identification and improper allocation of risks to parties bring frustration, even breach of con-tracts. Many risks need to be borne by the government in PPP projects. Thus risk sharing is the other distinguishing characteristic of PPP; the success depends on the appropriate allocation of risks. Project risks, therefore, need to be identified very carefully and allocated to parties who are best suited to manage them at the lowest possible cost. Risks have a price and each party in a PPP project has a different perspective and approach to assess risks. Furthermore, each party makes a price for their services taking into account a profit to compensate by bearing such risk. Examples of PPP risks are as follows:

Technical risk: due to engineering and design failures.

- Construction risk: because of default in construction techniques, cost, and time overruns.
- Operation risk: due to higher operating costs and maintenance.
- Revenue risk: failure to extract resources, the fluctuation of prices, and demand for products and services.
- Financial risk: due to inadequate financial cost and hedging of revenue streams.
- Force Majeure risk: due to acts of God, war, and natural disasters.
- Regulatory/ Political risk: legal changes and lack of government support.
- Environmental risk: hazardous and adverse impacts on the environment.
- Project default: failure of the project due to a combination of any of the above factors.

Identification and assessment of risk is, therefore, not an easy task as risk is interrelated. Risk mitigation helps parties to take action:

- to reduce the likelihood of risk materializing and
- to reduce the consequences of the event.

Therefore, it is understood that precise risk estimation and allocation to parties is of immense importance; it plays an important part in the cost of financing and success of PPP projects.

Govt. contribution / investment:

The government is one of the major parties in PPP. Though it is theoretically believed that PPP should be entirely self-supporting with no recourse or guarantees from the public or private sponsors, but practical guarantees are sometimes necessary. The private sector invests only in those projects from which they can gain profit i.e. financially sound. There are projects where economic benefits are more substantial than financial gains. Governments are especially interested to invest in these projects. To attract private sectors to these projects governments need to give some support and guarantees to the private sector so that debt service obligations are made, smooth operation for revenue generation is ensured (i.e. no change in law and regulations). The private sector may also request government guarantees against market or commercial risk. The government needs to appreciate that for most PPP infrastructure projects to succeed, they must shoulder certain risks such as political risk guarantee.

Guarantee needed

One of the interesting things is that guarantees do not add any cost to a project and can be as simple as only assurance, such as no change in tax, no second facility, and so on. However, the guarantee is not without cost to a government. It makes contingent liabilities that require careful selection, monitoring, accounting, and provisions for the budget to meet future guarantee calls. In PPP infrastructure projects, some risks are still left to the government which always prefers to pass as many of the risks as possible to private parties. The most widely used major guarantees against revenue risk are off-take and supply agreements. Revenue risk includes demand and price risk. The concession period of any PPP infrastructure project is normally ten to fifteen years and more. It is very complex and needs meticulous care for analyzing demand and price upfront. Supply and off-take contracts are of central importance in this aspect. To reduce price risk, sponsors, as well as lenders, carefully examine supply contracts with the project company. Major considerations are the length of supply, availability, creditworthiness, and whether the supplies are the major component of the product produced. It is possible to link the price of supply to the price the project company receives for its product.

Two widely used supply contracts are ‘Supply and Pay’ and ‘Supply or Pay’. Supply agreements, off-take agreements reduce price risk. It reduces the demand risk as well. Two widely used off-take agreements are – “Take or Pay’ and “Take and Pay’. It is also noted that ‘Take or Pay’ arrangements are of many shades of gray and do not impose a straightforward obligation for a utility to buy the full quantity of the product. A minimum revenue can be guaranteed and the remaining part of the risk may rest with the project. In many situations, the state or a state-owned enterprise is the off-taker. The price may be controlled by concession terms or by-law establishing the framework for the industry. The investors and lenders are therefore required to understand the existing legal framework and pricing structure so that may take necessary measures against legislative changes and political risk. Government guarantee should only be used where the government has full control such as expropriation, nationalization, confiscation, and so on.

A government guarantee is also sought against state-owned enterprises or state agencies where it is the off-taker of a project. In most cases, the condition of state-owned agencies is financially unsound, and the credit-standing position on guarantees about off-take agreements does not add any value to the project. The government, therefore, requires providing counter-guarantee and backstop payment obligations in such cases.

Both features

Public-Private Partnership brings together the expertise of the government and the private sector to meet the needs of the public effectively and efficiently. If properly structured PPP will deliver public services that can better meet the needs of the public without compromising public policy goals and needs. The government has to ensure competitive bidding to meet transparency, accountability, and creditworthiness of PPP projects to the nation, particularly to the opposition party. The government should also participate in capital investment of PPP projects. The government needs to innovate investment tools such as subordinated debt under the Multi-lateral Development Banks (e.g. the World Bank) such as Private Sector Energy Development Fund (PSEDF) or Private Sector Infrastructure Fund (PSIF).

Conclusion

This debt mechanism not only relieves the investors but also attracts other off-shore and domestic lending institutions to finance. The government must also ensure performance guarantee in Put or Pay' supply contract if a state-owned enterprise (SOE) are the suppliers, and creditworthy purchase guarantees 'Take or Pay' as an off-taker for the project. The government needs to encourage Export Credit Agencies (ECAs), Multilateral Development Banks (MDBs), and insurance companies to participate in financing and/or providing political and commercial risk coverage for the project. The government needs careful selection of legal attributes for mitigating risks involved in PPP projects which will help to form financial structuring. This will enable the government to set legal strategies depending on conditions prevalent in PPP projects.