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IFC SmartLessons

real experiences, real development

Mission Difficult...but Not Impossible Making Public-Private Partnerships Work for the Poor

Public-private partnerships (PPPs) hold great promise for improving public services for the poor in emerging markets. But charting the political waters, balancing the needs of governments, consumers, investors, and lenders, and making the transaction transparent and sustainable are challenging tasks and not for the faint of heart. This SmartLesson summarizes 10 years of lessons of IFC's Infrastructure Advisory Department in its role as transaction advisor to governments on more than 100 mandates.

PPPs involve a government contracting with a private sector company for delivery of infrastructure and/or services. As transaction advisor, IFC enters into a formal transaction mandate with a government client to structure and implement a PPP-type transaction. IFC's work typically involves:

- *Analyzing the project's fundamentals;*
- *Reviewing PPP options and recommending a transaction structure;*
- *Financial modeling of the PPP project;*
- *Promoting the project to investors and getting their feedback;*
- *Preparing the PPP contract and tender procedures; and*
- *Assisting in conducting the tender and selecting the winner.*

IFC seeks to focus on first-of-a-kind transactions with high developmental impact in frontier sectors (such as health) and regions or countries that often present difficult challenges and so are of less interest to commercial advisors and investment banks.

Results

Over the past 10 years, IFC's Infrastructure Advisory Services has signed 112 advisory mandates (including 43 active mandates) and



SONEL power utility in Cameroon. Transaction closed in 2001.

successfully completed 36 mandates. Recent highlights include the Lesotho Hospital PPP, power generation and distribution PPPs in Albania, small independent power projects in rural Philippines, and a new airport terminal in Amman, Jordan. Roughly 40 percent of current advisory mandates are in International Development Association (IDA) countries.

Transactions typically take 18–24 months to complete, and IFC's success rate is about 40–50 percent (excluding active mandates still under way). Delays and failure to complete a transaction have an opportunity and morale cost on staff. So the department makes a considerable effort to glean lessons that will increase the success rate and speed up implementation.

Lessons Learned

1) Lesson 1: Politics is (and will always be) the main cause of death for transactions. It may be vested interests, who would lose from a transaction (especially a privatization), that eventually sabotage it. Or a government realizes that the project may not be acceptable to the public at the necessary tariffs. Or the transaction simply runs out of time to be completed before elections.

Political factors are the single most important impediment to success. Yet this is an area that IFC tends to pay less attention to, since most staff are primarily technicians. But ignore at your peril. Here is some practical guidance to minimize political risk:

- *Avoid taking on mandates within 12 (maybe even 18) months before elections, since most governments avoid anything potentially controversial close to elections (and some countries actually have laws that prohibit major new contractual obligations within a specified period before elections). Two of our successful mandates (Romania dialysis, Kenya telecom) completed tenders just two days before national elections. And the Moatize mining PPP was signed one month before elections. But one municipal client stopped a water project, citing concerns about water tariffs, just ahead of elections.*
- *Assess top-level political commitment before signing a mandate. Best if there is also a project champion with status and clout. Many of our successful transactions have had strong client champions and top political support, such as the Panama and Lima power privatizations, Queen Alia International Airport in Jordan, Kenya Rail, Kenya Airways, South African national parks, Polynesian Air, and our small-power projects in the Philippines. In contrast, we had a failed airline privatization and a failed airport concession transaction due to the lack of high-level political support.*
- *Identify and assess vested interests who would lose from the transaction. Several of our projects in different sectors – electricity, water, transport and health - never reached tender, primarily for this reason.*
- *Check in advance to determine whether provincial or local-level transactions need national buy-in. In one of our municipal service projects, we needed approvals at the municipal and national levels—an extremely lengthy process because governments kept changing. When we finally got approvals of the bidding documents at both levels, the municipal government got cold feet due to upcoming elections and stopped the process.*
- *Work closely with the World Bank to provide the broader necessary perspective on country politics and economics.*

2) Project fundamentals should be sound. Is the project needed (by the public), affordable (for consumers and the government), attractive (to investors), and legal (without new laws)? These questions seem obvious but can easily be

overlooked in the rush to respond to a government request. It doesn't require a huge, lengthy analysis before signing a mandate, but some quick answers can be gleaned by:

- *Checking investor (and lender) interest informally with a few local and international players.*
- *Doing quick back-of-the-envelope calculations to see the project's impact on consumer prices or the government budget. We have rejected several requests from governments for airport concession transactions due to low passenger volumes (in one case, less than 12,000 passengers annually). In two water projects in Africa and Latin America, we recommended against proceeding with the transaction after our preliminary analysis showed that the tariffs required for project viability were simply unrealistic. In two Middle East and North Africa (MENA) countries, we were asked by governments (unrealistically) to find PPP operators for new public hospitals that had been built (with external loans) but lacked funding for operations. Fortunately, we discovered this before signing a mandate and backed out gracefully.*
- *Seeing whether it can be done under existing laws. If not, try for a decree, regulation, or government decision, but don't count on new laws being passed to get it done. The absence of enabling legislation stopped our work on water PPPs in three different countries, though for different legal reasons in each case.*
- *Doing some quick analysis on whether the project (service type, level, and location) is really needed by the public. Avoid the "white elephant" syndrome, driven by politics, not need. And check for other more cost-effective measures such as improving throughput (for example, ports) or efficiency in consumption (for example, water metering) or buying the service from existing private providers (for example, hospitals).*

The scope of the PPP project is also important. In principle, the greater the risk and responsibility transferred to the private sector, the greater the potential gains in efficiency and service quality (if well-structured). Don't use PPPs solely as a financing technique to avoid public capital expenditures. But be aware that increased private sector participation



Polynesian Airlines in Samoa. Transaction closed in 2003.

and responsibility also tend to generate more opposition from public sector employees.

3) Plan and manage your team and consultants for maximum efficiency and results. Transactions typically require a diverse team of financial and transaction experts (usually IFC staff); technical and sector specialists who can best determine project need, sizing, and specifications; and transaction lawyers to vet the legal framework and put the project into proper contracts.

But getting the team in place, funded, and functioning as an efficient unit is not straightforward. Often the technical consultants and lawyers are funded in part through donor funds, which may take time to arrange. And hiring the consultants requires adherence to IFC procurement guidelines, which also takes time.

The data and information that IFC requires from its consultants for transactions are very specific and transaction-driven. So it is imperative to ask for only what is needed for the transaction analysis and contract documents. We're not here to do studies.

You can accelerate the transaction preparation and get effective results by:

- *Obtaining donor funds before signing the transaction mandate (or in parallel with mandate negotiations);*
- *Compiling available client and project data before the consultants are on board, so they don't waste time searching for it; and*
- *Having a joint kick-off session with the team, the consultants, and the client team to set everybody off on the same track.*

The global/local approach is crucial to success—both in signing transaction mandates and in successfully implementing the transactions. The Infrastructure Advisory Department was at the forefront of the global/local movement, setting up regional-based managers and local staff starting in the early 2000s. The results have been clear: many more mandates signed and better productivity (more mandates per staff). Being close to clients (in this case, governments) is absolutely essential for success. In many cases, an IFC local presence can help keep a transaction on track and moving quickly.

4) Make the contract bankable and sustainable. There are really two hurdles in this business. The first is getting to a successful transaction. The second—and more important—is having it last. In practice, this requires several things:

- *Check and recheck the risk allocation matrix with investors and lenders to get their reaction and identify any deal breakers early on. Don't stray too far from accepted international practices.*
- *Governments often have an unrealistic view of what they can get from investors and what they have to give up in return. Although it is the transaction advisor's job to communicate the concerns of investors or lenders (and identify unrealistic assumptions of the client), it helps to have investors tell the government directly.*

Nothing has the same impact as a major investor telling the government why it won't participate. The art in this business is separating the real deal breakers from the desirable-but-not-essential list. But sometimes, clients don't take our advice. In a municipal water PPP in Latin America, we experienced two failed tenders due to unrealistic expectations of the municipality about what it could get from the market.

- *Pay particular attention to the pricing and PPP payment structure and adjustment formulae. They may well be the most important element of the contract for incentivizing performance and efficiency.*
- *A balanced contract and good regulation are the most effective tools for sustainability (and yet the hardest to achieve in many client countries). If a deal is too good to be true (for one side or the other), chances are it won't last. And if it depends on big price increases for consumers, it is probably doomed to failure. A major reason for the success and sustainability of some of our power and water transactions was our ability to close the transaction with the same, or even reduced, consumer tariffs (for example, the Panama power privatization resulted in an immediate 10 percent reduction in consumer tariffs).*

5) Be sure there is transparency throughout the process.

In all these transactions, IFC's reputation is most at risk if investors or the government believe that there has been favoritism or a lack of neutrality or transparency, particularly in structuring and implementing prequalification and bidding. Such a perception can result in lawsuits, negative press, and a tarnished reputation.

Transparency sounds easy, but in fact there are decisions throughout a transaction which affect the perception of transparency. Traditionally, IFC has followed a somewhat rigid approach that favors objectivity and simplicity over subjectivity and complexity.

How does this work? Typically, where there is a prequalification process as a precursor to bidding, we favor quantifiable and verifiable technical and financial criteria, such as "at least five years' experience as an operator of a water distribution company serving at least two million customers," or "net worth of at least \$300 million as of year-end 2008." But setting these criteria necessarily involves some degree of arbitrariness and can cause complaints, generally from local firms that are not big enough to prequalify on their own. True, the decision on the precise prequalification criteria is the government's, not IFC's, but it is our job to advise the client on right-sizing the criteria for the project and on the implications of different criteria for who will prequalify and who won't.

Despite our best efforts to set quantifiable and verifiable criteria that will not be subject to dispute in interpretation, we often face interpretation disputes over such issues as accounting standards applied to financial criteria, the definition of an affiliate (and whether its experience counts), and so on. You can never completely eliminate the possibility of a complaint, but you can go a long way toward removing the possibility of interpretation disputes.



Suape Container Terminal in Brazil. Transaction closed in 2001.

In the bidding, we have tended to favor price-only bids, with sealed envelopes opened and read in a public ceremony. This means no business plans, no technical proposals, and no other documents that could be subjectively evaluated (and hence prone to disputes) or later prove to be a hollow promise.

This approach works best for straightforward projects which are not very conducive to innovative technical solutions or major differences in approaches by bidders. The possibility for complaints and corruption is minimized, but at the cost of rigidity.

Increasingly, we are faced with complex projects where bidders may have valid differences in design and approach which should be considered and cannot be readily standardized into a price-only bid. It may be for a new airport (for example, Amman) or a new hospital (for example, Lesotho). In these cases, we recommended a set of criteria for evaluating technical proposals, which may be either pass/fail or weighted with the financial proposals. It's not perfect or completely objective, but rather a recognition that some projects are just too complex or innovative to suit a price-only bid procedure.

6) Exiting—is there ever a graceful way? Our experience clearly demonstrates that the longer it takes to sign a mandate, and the longer it takes to implement a transaction once a mandate has been signed, the less likely it is that it will result in a successful transaction. And, as noted earlier, mandates that drag on will waste resources and hurt staff morale. Staff don't want to work on projects that take a long time and are not ultimately successful. But it may be hard for IFC to abandon a mandate if the government still wants to pursue it, since

the government is also a shareholder of IFC.

We have introduced three actions to address this problem:

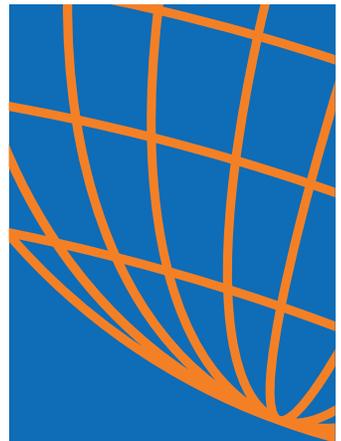
- *We spend more time on due diligence of a project's political risk and fundamentals before signing a transaction mandate. If a project has little chance of success, it is better to find out before signing the mandate (and there-*

fore not sign it).

- *We try to include additional monthly fees if the transaction goes beyond a specified timeframe (for factors beyond IFC's control). This signals at the time of mandate negotiations that time has a cost and we are not prepared to work on a transaction indefinitely.*
- *We are now including more explicit exit clauses in our transaction mandates; This allows IFC to terminate a mandate if it becomes clear that the transaction is not advancing or has little chance of success.*

Conclusion

When many of these factors go in our favor, we can have quick successes. One of our largest transactions—a \$950 million privatization of the electricity distribution company in Ceara State (Brazil)—was also one of the fastest: eight months from mandate signing to closing. Top political support, excellent counterparts, good tariff levels, and a sound legal environment all contributed. But when the negatives start piling up, mandates can drag on mercilessly for years without relief. Applying our lessons in mandate selection and execution can reduce, but probably not completely eliminate, these poor-performing mandates, and increase our overall hit rate.



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