Executive Aide-Memoire:

Public-Private Partnerships and Concessions

Disclaimer: *This document was prepared by the ISMED working group on Investment Security from the MENA-OECD Investment Programme by experts lawyers, financial and professional practitioners in public-private partnerships (PPPs) and concessions. It was written by Olivier de Saint-Lager, co-chairman of the ISMED working group and benefited from contributions of its members, principally Marc Frilet, Roger Fiszelson, Arnaud Voisin, Bertrand Marchais and Doris Chevallier; OECD experts Ihssanne Loudiyi and Hélène François and Miriana Belhadj from UNCITRAL. The views, interpretations and proposals expressed are those of the members of this working group and do not necessarily reflect the views of the OECD or the governments of its member or associated countries*.

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Intended audience of this executive aide-memoire: *this document is primarily intended for non-specialists in public-private partnerships and public service concessions who nevertheless sometimes play a key role in the decision-making process leading to the implementation of major infrastructure projects. These people may find it useful to have a short, easy-to-read document that covers the essentials of the subject. This is a wide field which uses many concepts and ideas, very diverse materials, and borrows from different cultural levels, which are sources of risk and can cause dangerous and costly confusion for the community. The authors of this paper are aware that this is a bold move, and that this summary has its limitations and dangers. Although they have tried to be as comprehensive, accurate and relevant as possible, they seek the indulgence of readers and specialists who will undoubtedly find aspects to be corrected and supplemented in this essay. Their suggestions are most welcome.*

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I. Definitions and basic concepts

- 1. Introduction: A magic formula?

Infrastructure requirements have grown considerably all over the world, especially in the Middle-East and North Africa (MENA) region. The sums needed will reach tens of trillions USD globally over the next 20 years, and hundreds of billions USD for each region. The requirements are driven by multiple causes including population growth, on-going urbanisation, changing energy usage and increased user requirements. The concomitant inability of public budgets to meet all these needs exerts a strong pressure on private resources to supplement the financial limitations and constraints on states. Using the private sector offers many advantages in the areas of financing, innovation, construction and management, but it is not free. It costs the public authorities, in terms of reimbursement and in lost earnings. It is therefore important to conduct a financial optimisation of the investment (”value for money”), including a cost-benefit calculation, incorporating multiple parameters and including a project’s contribution to economic and social development as well as its budget impact. The term “public-private partnership” (PPP) covers the association of public authorities with the private sector to implement and manage public service infrastructure. It does not mean discarding the public entity, but can be a rational choice. It offers no magic formula, no free infrastructure, equipment or public services. It only offers different ways to achieve, use and fund them. PPPs and concessions represent the two pillars of an essential formula at a time when the limitations of states are becoming apparent. They are also a source of innovation and can provide an opportunity to reduce inequalities of access and achieve more inclusive growth.

The paragraphs that follow review the main ground rules for PPPs and concessions.

- 2. Sources of complexity and difficulty: A mixture of disparate elements

If the words “complexity” and “difficulty” come up regularly in the language of PPP practitioners, it is because of the need to pay attention to the root causes of project difficulties, which have led to many disappointments. The World Bank statistics show that most PPP projects in developing countries have needed renegotiation outside the original legal framework two years after being concluded, which suggests a majority of projects have run into trouble, despite the fact that they were often the subject of lengthy negotiations leading to a contract that was intended to last for several decades. In practice, PPPs represent a complex mix of specialities. They borrow from administrative sociology, and public and private law, often mixing different types of legal principles, such as continental (Romano-Germanic or civil) law and Anglo-Saxon (common) law. The field also uses sophisticated financial concepts, making it a particularly difficult combination to master overall.

- 3. Definition issues: Overcoming difficulties and grasping the essentials

It is therefore not surprising that there are many variants of PPPs. There are convincing arguments for both wide or narrow definitions depending, for example, on whether we take our reference from the traditions of common law or civil law countries.

So as not to get caught up in a pointless dispute and get beyond these definitional contradictions, the main point to grasp is that, in both PPPs and concessions, the private sector is not just associated with design, financing and construction, but also the long-term management of the infrastructure or

public service, meeting the performance criteria specified in the contract. There are therefore two main types of PPP. There are those funded by government spending as the infrastructure or service operation progresses, for example the United Kingdom's private finance initiative (PFI), where the construction period is financed by the private sector and the operational/service phase by the public sector in the form of rent incorporating the costs of construction. Then there are those that are mainly and directly financed by user charges, i.e. concessions or leasing. Some combination of the two is also possible.

There are many other forms of private-sector involvement in the implementation of public-service infrastructures. The traditional forms are the various categories of public contracts, in which the private partner is paid in full for completing the infrastructure upon acceptance of the works, and not for the long-term management of the infrastructure or public services. Public procurement contracts can include the overall design and implementation, and operation or maintenance, but full payment takes place upon acceptance of the work.

- 4. Untangling the proliferating family of PPPs

Given this commonly accepted definition, it should be recognised from the start that a few basic realities underlie the increasingly inventive and numerous names that some practitioners use, depending on whether the private sector designs, performs, owns the property, maintains or operates the infrastructure (e.g. Build-Operate-Transfer, Build-Own-Operate, Build-Own-Operate-Transfer, Lease Operate & Transfer), with references drawn either from common law or from civil law. When setting up a project, the following two questions enable it to be quickly assigned to one of the two main categories identified above, allowing its set-up and feasibility to be assessed:

- Has responsibility for the operation of the infrastructure or public service been completely transferred to the private sector? If the answer is yes, it is indeed a PPP. Otherwise, this is a public contract, which may be more or less sophisticated.
- If it is a PPP, is the infrastructure or public service funded directly by the public authorities, for example in the form of fees largely comparable to rents, or completely (or at least mainly) by the user? In the second case, it is a concession.

- 5. The Alpha and Omega: Delivering a good project

If there is a single formula for the success of a PPP or concession, it would probably be the same as for a successful public contract: run a good project. In other words, run a project for which the internal economic calculation, combined with a rigorous analysis of its impact on externalities such as well-being, the economy and growth, and land management, demonstrates that it best meets the needs of users. This calculation is obviously complex and has to take many internal and external factors into consideration but in economic terms a project will never proceed solely because of its externalities. It has to make socio-economic sense and be able to pay back the financial investment. When there is tough competition, projects which make good economic sense but also benefit from additional external benefits will be at the top of the list.

- 6. Project life cycle

The implementation of an infrastructure project is a long procedure that has stages which together form a sequence called the "project cycle". The main stages are as follows:

- Preliminary **project identification** studies are normally the responsibility of the public authority. These state the needs to be met and form part of the framework for scheduling priority projects. They assess the services the planned infrastructure is expected to provide and its affordability in light of the capacity of users or the public finances to pay for them. These studies also select the project set-up (governance, public procurement, PPP, concession or privatisation).
- Then comes the **thorough analysis of the project** with its many pre-feasibility studies and the decision whether to continue the project on the basis of their findings. Detailed feasibility studies open the way for the implementation decision. Finally the legal and financial arrangements are prepared.
- The **invitation to tender** procedure may then be launched. This includes a public call for expressions of interest for the pre-qualification of firms. The final selection process often requires exchanges with the applicants to optimise the project, in a framework that must always remain transparent and neutral. Finally the successful tenderer is appointed and the final contract terms negotiated.

- 7. Projects need reliable studies as well as sound and experienced partners

The quality and reliability of the various studies needed (traffic or demand forecasts, technical studies, including geological ones, impact studies, and financial and legal studies) are obviously fundamental to the analysis of the project and its chances of success. These are often carried out by external consultants, and their strength and experience are equally important. Many failures are down to poorly conducted, insufficient or biased studies. Studies represent a cost and often take considerable time. At the same time, good consultants, like the right businesses, with a solid financial base and extensive experience, are rarely the cheapest. The preparation phase of a project, which determines its success, therefore requires long lead times and a sizeable budget, often greater than for work done under direct state control or through direct public procurement.

- 8. Four equal pillars of success: the state, users, private partners and financiers

In a PPP, no single partner should dominate the others. The state, users (whom the state ultimately aims to represent), private partners and funders each have their own interests and depend on each other for success. No single interest, or even two or three out of the four, can sustain the project without the others, particularly in the case of public-service concessions. The decision to go ahead can only be made jointly: it must arise from a convergence of interests. Differences will undoubtedly arise during the project, but if they are not overcome the project will be jeopardised. The recipe for a good PPP, if there is one, is to set up a process to overcome these differences through active partnership, and to prevent power struggles or an unbalanced relationship being established between some or all of the partners, both in the preparatory phase and in the contractual relationship.

- 9. Establishing constructive relationships for long-term investment

Unlike public procurement procedures, or public works contracts without public-service management, a PPP ties the private partner and the public authority together for a long time, often several decades. The requirements of the implementation and management of the public infrastructure or public service will also evolve over time. It is a heavy long-term investment for the

partners, both public and private. Managing this investment means adapting to this fundamental difference. All the tangible aspects of the project (studies, procedures, criteria, contracts, funding), as well as the content of contracts and the behaviour of each of the project partners, must take its long-term nature into account. The choice of a PPP cannot be taken lightly. It is a costly and demanding method of procurement, and sometimes restrictive, but if the project is conducted successfully, the PPP formula can be very successful. If it is widely adopted, it can increase investment opportunities.

Key points:

- ✓ *A PPP differs from a public contract in that the private-sector partner participates in the long-term operation/maintenance of the infrastructure or public service.*
- ✓ *A concession is a special form of PPP in which the private partner is paid mainly or entirely by the user.*
- ✓ *A good project is primarily a carefully prepared project, which involves high costs and long lead times. This is the price to be paid to ensure that the project is not a failure for the state and the community.*

II. The contracting public authority

- 10. Preparing the public decision-making process

The public authority's primary duty is to carry out a detailed assessment of the needs to be met, and the economic and financial analysis of whether a particular project should be carried out and how. If the financial evaluation of the investment, including the cost-benefit calculation is positive, the public authorities can then decide whether to go ahead and begin the project cycle sequence leading to the implementation of the infrastructure and its operation by the private partner, with funding through public budget resources or through the users, or a combination of both.

- 11. Taking the wider picture into account

Beyond the direct economic calculation of benefits of a project, the public authorities should consider many other external factors, which will be more or less quantifiable. These include the opinion of the future users, the social and environmental impact of the project, whether it can become sustainable and run autonomously without the costly and constant injection of public resources, and even its potential to be integrated as part of a wider network of communication or supply, for example on an urban, metropolitan, regional, national or international scale.

- 12. Navigating the possible delivery options: PPP is a middle ground between direct state control and privatisation

Public authorities have a wide variety of formulas at their disposal to implement infrastructure and operate public services. At one end of the spectrum is state control, with direct implementation by the administration. At the other end is privatisation in a liberalised framework, allowing the private sector to implement and fully operate a service without public oversight. Between these two lie a progression of alternative formulas including implementation by state enterprises or contracting with the private sector to varying degrees. Although PPP formulas and concessions lead to the operation of all or part of the public service by the private sector, it is in a form that is closely overseen by the public authorities. They will always have the right to adapt or modify and even cancel the contract or service in the general interest, without harming the private partner. It therefore offers a mixed approach, which affords the public authority far more power to drive, adapt and control the process than complete privatisation. It is up to the authority to choose the optimum formula to implement and operate the service depending on the characteristics and capabilities of the local market.

- 13. Building trust through clear determination and political commitment

Administrative supervision alone, however diligent and competent, is not enough to set in motion an operation of the magnitude usually represented by the implementation of this type of infrastructure project and the delegation of its management to the private sector.

It is difficult to find private companies willing to make risky, long-term investments in developing countries, especially for services which often require adjustments during the course of the contract. This largely explains why many projects today are not implemented and why those that are frequently fail. Confidence cannot simply be decreed but has to be won and maintained. It can falter, and then be lost. For investments of this magnitude, confidence should be built through visible state

commitments. Purely political statements, although they can be very useful, are not enough. Clear messages at the highest level and an expression of political commitment are still considered necessary prerequisites to launch such an operation. Ambiguous statements, or any reservations, would inevitably negatively affect a project and even harm it if it has already got off to a poor start. It is therefore about taking a strategic initial position. But such statements are worth nothing if actions do not follow and if state behaviour does not live up to its promises.

- 14. Creating confidence by improving the national legislative and regulatory framework and the local business climate

Having an appropriate legal and institutional framework which is clear, complete, accurate and above all effectively implemented by the political authorities and public officials, often requires profound changes and reforms to resolve the many problems that will arise during the practical implementation of these projects. Without this legal basis, there will be almost no chance of carrying out the many infrastructure and public-service projects that are a condition for attaining the United Nations' post-2015 targets for eradicating poverty. Many states have committed to comprehensive and bold reforms to create or develop the conditions which would enable these large public-service infrastructure projects to be implemented and operated with private partners.

The state and its officials must also act in a responsible, reliable and predictable way, consistent with this extensive legal framework and anchored in the prevalence of the rule of law.

Finally, a favourable business climate is needed to complement this institutional and legal framework for PPPs. The more favourable it is, the more projects can flourish.

- 15. Sub-sovereign entities

The state is not always the contracting public authority. Federated states, regions, municipalities or even public establishments may be the project owners. For such "sub-sovereign" contracting authorities, efforts must be made to find out the relevant national rules (constitutional, legislative and regulatory) combined with international law, to decide the most applicable PPP scheme. This will help identify any legal and financial peculiarities applicable to such entities and, where appropriate, plan the provisions for linking up with the national system of the country in question as early as possible. Particular attention has to be paid to any national regulatory power, particularly when the project receives public support, and to what guarantees can be conceded, as well as to the dispute settlement system applicable.

- 16. Creating and maintaining the skills of the public partner (a "PPP unit" and how to support it)

For several years, states seeking to carry out PPP projects have been advised to develop the skills and capabilities within their administration to perform the entire sequence of the project cycle, i.e. preparation, selecting private partners, monitoring performance and infrastructure operation. The most common formula involves setting up an overall dedicated administrative entity at the ministry of finance or the prime minister's office, known as a "PPP unit", possibly with ramifications in the technical departments concerned. In practice, this generic name can cover a range of bodies which have more or less extensive powers, with varying number of officials and varying capacities. Whatever its form, it acts as the representative, counterpart and key administrative contact for the private sector. It should ideally have the skills, experience and resources needed for the magnitude

of its task. This is not always the case in practice, which may lead to projects failing. Furthermore, the state must not content itself with promoting a single isolated project but develop genuine PPP expertise and policies. To do this, it needs to be able to retain PPP unit officials for long enough (several years) and understand how to motivate them so as to capitalise on their experience, and ensure the optimum rotation of staff.

- 17. Cutting red tape

Multiple administrative authorisations are generally needed to implement and operate an infrastructure development. It is extremely important to enable the private sector to work under satisfactory conditions, without having to deal with procedures that are too cumbersome, lengthy or expensive, with arbitrary decisions, and which sometimes give rise to undue demands. States thus have an incentive to take measures to simplify, streamline and accelerate access to these procedures, and sometimes centralise their processing within a special office or even the central PPP unit. There are many examples of states' efforts in this area, with results to be regularly upgraded.

- 18. Selection processes and criteria: Fostering innovation and increasing the value of the result sought

It is tempting for a contracting authority to demonstrate its expertise by producing very detailed call-for-tender specifications combined with selection criteria focused on price alone (lowest bidder for construction or best bidder in the case of royalty repayments to the project owner), which may distort the final choice. Without neglecting the conventional selection criteria, which still have a certain merit including the detection of abnormally low tenders, the contracting authority should primarily focus on defining the nature of the desired service using simple and functional criteria. This enables applicants to recommend their own solutions for the implementation of the infrastructure required to provide the service and its monitoring and adaptation, etc. This maximises the likelihood of choosing a company that has all the necessary qualities to deliver a service that is acknowledged to be of high quality and acceptable to all in the long term. Of course, the call for tenders should still retain criteria to test the reliability of the bid, and potential partners' capacity to build and operate, as well as their financial capacity.

- 19. "Off" criteria and externalities

In contrast to the case considered in the previous paragraph, the contracting authority may be required during the selection procedure to consider one or more additional criteria (political, geographical, technical and also economic and financial) that were not initially set out in the specifications. Such criteria may be legitimate and frequently recur but including them outside the official selection criteria should nevertheless be avoided because they create suspicion, increase the risk of corruption and may cause disputes and generate delays. As far as possible they must be included in the call for tenders. If by chance new criteria are to be considered lately by the contracting authority, the specifications of the call-for-tender documents should be modified to ensure all companies can compete in the selection procedure on an equal basis.

- 20. Transparency and integrity

Setting aside the legitimate ethical considerations, there is increasing awareness of the economic cost of a biased decision and the subsequent loss of credit and confidence suffered by a public entity

should it intentionally distort the conditions of an invitation to tender. Fortunately, transparency is an increasingly common working method and is relatively easy to provide in the context of a PPP. Transparency ensures that representatives of several public bodies and often very experienced international operators can collaborate, leaving little room for opportunistic behaviour. These large companies often have local partners who are aware of the realities but who are also very vigilant about specific conditions which could offer their competitors an unfair advantage. Market operating conditions thus complement and strengthen the effectiveness of local anti-corruption regulations.

- 21. Role of an independent regulatory body

The proper regulation of public services may require the state to create a regulatory administrative authority, often reporting directly to the prime minister's office or to the economic ministry. This is particularly true for countries operating within the common law tradition although it may be less important in countries with a civil law tradition and a balanced public contracts law, upheld by courts able to pass fair judgements. When an independent authority is required, they need competent, independent and experienced figureheads with the capacity to lead and co-ordinate the dialogue with the various ministries and public agencies that will play a role throughout the project. This is a necessary condition for preserving the quality of the collaboration between the public and private sector.

Key points:

- ✓ *It is strongly recommended that the public authority involve representatives of future users and civil society early on in the preparation of a PPP project, even if the former are ultimately intended to represent the interests of the latter in the contractual relationship.*
- ✓ *The state must build trust among investors by setting up an appropriate legislative and regulatory framework for PPPs and concessions, and by complying with the primacy of the rule of law, but equally through its capacity to implement these requirements diligently and effectively.*
- ✓ *Public officers act as the visible interface between the public authority and the private partner. The state must ensure that it has the staff resources, in sufficient number, skills and experience to oversee the preparation, implementation and operation of PPPs and concessions.*
- ✓ *On this basis, the state has to jump in and learn by trial and error, and regularly carry out assessments of its activity and achievements after the fact.*

III. Contractual relationships with the private sector

- 22. Knowing how to manage cases of project initiatives not requested by the state

It is not always clear how best to deal with initiatives from private project promoters which were developed without a prior request from the public administration. National institutional frameworks for project preparation are often inadequate to deal with these fairly rare scenarios. The cost of managing such an initiative may be high and it is never simple to determine whether an unsought proposal will fit well into national development schemes, particularly when it is for a major and/or complex project. Initiatives from private developers therefore remain an exception.

However, understanding how to encourage such developers is essential, because it is in the interest of the community to stimulate investment opportunities in the country. Undervaluing developers' investments deprives them of the fruit of their labours and discourages both them and other companies in a similar situation. At the same time, granting exclusive rights on the basis of a private initiative may be detrimental to the public finances and open to criticism from users and citizens. A middle way must therefore be found to deal with spontaneous offers. Special provisions are needed which take into consideration the work done by the developer but which also recognise the need for transparency and competitive tendering at an early stage. Some states have developed "right of initiative" measures that strive to combine these two competing but legitimate concerns. Other formulas consist of giving a bonus or reimbursement of expenses to the initiator of a project at the competitive tendering stage.

For these reasons the acceptance of unsought proposals will apply mainly to small projects initiated by local businesses.

- 23. Distributing the roles and responsibilities of the various private-sector partners: property developers, builders, subcontractors, managers, consultants, investors and financiers

For convenience, the term "the private sector" is used as if it consisted of a single or at least homogeneous group. This is obviously not the case, even if it is essential for the public authority to only deal with a single partner who is completely responsible for everything (design, financial and legal structuring, implementation, and public service management) and with which it must maintain a close and trusting relationship, often over very long periods.

In practice, a project will be jointly developed by many firms throughout its cycle, each with very different activities, interests and responsibilities from each other (property developer; builder; operator; technical, legal and financial adviser; credit rating companies; private bankers; insurers; maintenance companies etc.). The contracting public authority needs to keep a close eye on the distribution of roles. Although some contracts may grant everything to a single company that will design, build, maintain and operate a piece of work and the public service, this is not usually the case. Usually the contract is with a new company formed by a consortium made up of the manufacturer, operator, funders and all the other companies with the skills needed to conduct the project.

It is essential that the authority exercises its critical judgement over whether the proposed structure is actually the most effective legal and financial arrangement for the financing, construction and management of the infrastructure. There have been dreadful examples where the division of roles between the manufacturers and the operators were initially confused, which led to disaster. Care should be taken, including once the infrastructure is in use, to avoid conflicts of interest between companies taking part in the management of the public service. At the same time, the public authorities need to ensure that the consortium that submitted the successful tender and then concluded the contract will not disappear after a few years. For example, consortium members who are shareholders in the project company should not be able to sell their shares without any restriction, or prevent the project company from maintaining the partnership relationship with the public sector which might have played an important role when choosing the consortium.

- 24. An entrepreneurial adventure: Power to work locally

If the private sector were to sum up in one expression what it needs to implement and manage an infrastructure project, it would probably simply say that “it can get on with the work”, and that the general framework, any special conditions and local actions do not prevent it from doing so. Public authorities need to understand that companies with the capability to make commitments of the same level, scale and strength as a government can exercise choices within a global context.

These multinational giants choose the risks they take and will analyse the strengths and weaknesses of the projects and countries that interest them in all regions of the world. They know that this type of project is always an adventure, but its prospects must be sufficiently straightforward and profitable locally, with working conditions that are as effective as possible. This will in practice result in a thorough analysis of the so-called “investment climate”, taking into account the lessons learned from other projects. If the investment climate does not appear to be sufficiently attractive because it does not offer the required legal guarantees for the entire duration of the project, investors will turn to other projects regardless of the intrinsic quality of the project or its priority.

- 25. High costs of project preparation

Project preparation costs are expensive not only for the contracting public authority but also for the private sector. Public authorities may be able to rely on multilateral and/or bilateral technical assistance, but these resources are insufficient, scattered and uncoordinated. The international community could do much more to contribute effectively to the proper preparation of priority projects. Costs will gradually come down as best practices are developed and institutional and legal frameworks are set up which suit the particularly complex nature of these projects. The private sector rarely benefits from any public contributions, however. The costs are therefore significant for everyone. In order to give an idea of the scale, construction professionals generally say that the pre-feasibility phase may represent 0.5% to 1% of the project cost while the detailed feasibility phase may represent 2% to 3% overall (including the cost of the previous phase).

The contracting public authority therefore has a responsibility to complete the procedure at a reasonable pace, taking into account the efforts of the private sector and avoiding imposing additional costs on them. One key way it can do this is to fund high-quality studies which it then makes available to all companies competing for the contract, distorting neither the competition nor the innovation capacity of the competitors.

- **26. Answering the invitation to tender: A statement of the private sector's confidence in the state**

These high costs mean that merely by responding to the call for tenders organised by the contracting authority, companies are demonstrating a certain degree of interest in the country, a sign of confidence in its future and in the project itself. The presence of several international companies must be regarded as a great success and demonstrates the popularity of the policies of the government of that state. It is also in the interest of the state to ensure that the competition is as open as possible, so as to have a wide choice.

- 27. Contract award: A declaration of the state's confidence in the private sector

Conversely, once the company has been selected, it is the turn of the contracting public authority to make its own vote of confidence by granting the company the long-term implementation of the infrastructure and management of the public service. This transfer of responsibility for implementation to the private sector can sometimes be seen as an abdication of public responsibility. In reality, the public authority must retain and exercise significant impetus and control over these works, much more than it would have under privatisation, even if this is regulated.

- 28. Pre-established contractual or ad hoc formulas?

The proportion of pre-established legal formulas will vary depending on whether the contract is governed by civil law or common law. The concession formula is a common legal concept in continental law that has no direct equivalent in Anglo-Saxon law. The cost and time needed to finalise the contracts therefore differs significantly, as do the risks created by ad hoc clauses. It is often said that every PPP is different and that there can be no pre-established contractual formula. Those who have extensive project experience in developing countries will remember that more than 20 years ago the same arguments applied to international public procurement contracts in construction. Since then, standard invitation to tender files and a set of standard contract terms along with special project-specific conditions have gradually emerged and have become the rule for international public procurement contracts in construction.

Feedback from many projects shows that this will gradually be the case even for PPPs. In fact, several countries already offer sets of standard contract terms. This is true even for common law countries using private finance initiatives (e.g. the United Kingdom, South Africa and New Zealand), as well as for civil law countries, particularly for public-service concessions. In practice there are many sets of very similar clauses, regardless of the sector and geographical area. If stakeholders are able to share knowledge of these standards, they can greatly speed up the conclusion and facilitate the successful completion of many projects.

- 29. Financing the project with public resources or through user charges

As discussed in the first section, the main distinction between the two categories of PPP contract is whether they are financed through public budget resources, or whether they are concessions financed mainly through fees based on demand and paid by users, such as a toll in the case of transport infrastructure. The private sector will try to channel and secure all available resources to finance its investment. In some cases, in addition to a fee paid by users, the private sector may benefit from guarantees, benefits or salary supplements paid by the public contractor. These may be

essential to ensure the financial balance of the project, particularly in its initial phase ("ramp up period").

- 30. Allocating or sharing risk

The list of construction and operation risks to a project can be long, depending on the nature of the project: geological risk, construction risk, exceptional weather conditions, earthquakes, political risks, risks of political or social upheaval, war, civil war, smuggling, currency exchange risks, etc., some of which may apply to the sector or the economy as a whole. Such risks cannot entirely be offloaded onto the private partner by the public sector. Without question, risks should be allocated to the party best able to prevent them, control them or minimise their consequences. In some cases, the risks may be shared between the contracting public authority and the private company/successful bidder. They may even be shared with third parties willing to reduce the cost, such as beneficiary countries, states whose companies are involved in the implementation of the project, or multilateral or national development institutions.

It should not be forgotten that many risks can be excluded or significantly reduced through extensive prior analysis by establishing appropriate procedures with public authorities and the state. There are many examples, particularly in the concessions sector, where thorough analysis and appropriate procedures, negotiated in full transparency, can considerably reduce risks related to land management, fiscal and quasi-fiscal risks, customs, the issuance of licences, socio-environmental risks, etc.

Good quality discussion between public and private-sector organisations responsible for these areas, from the early phase of the project through to the finalisation of the contracts, will lay the foundations for balanced long-term partnership relationships, and help guarantee the future success of the project.

- 31. Legislative and fiscal stability

One recurring demand from the private sector is for predictable behaviour from the contracting authority and a stable legal and fiscal framework laid down by the state. This can be met through a “stabilisation clause”, a state commitment to legal and fiscal stabilisation by which the contract is concluded under given, understood and accepted conditions. In the event that these provisions change, something which is rarely under the control of the successful bidding company, the contracting public authority must compensate the private partner for any additional costs imposed by changes in the law or taxation affecting its accounts and the viability of the project. However, and this is a key feature of a balanced partnership, the changes must have a genuinely negative impact, beyond a certain threshold, on the economic calculations which were a decisive factor in concluding the contract.

- 32. Project modifications, evolution and fundamental change in circumstances

In addition to changes in the rules, the successful bidding company will legitimately want to guard against any new demands or changes in the specification which may impose substantial costs and delays, leading to a serious shortfall in its profits. The contracting company will try to guard against these new charges, unknown at the time of awarding the contract, without necessarily disputing the merits of any changes required by the public authorities in its sovereign role as guarantor of the

general interest. The company will also seek to receive reasonable compensation for the financial consequences of any new requirements. On the other hand, states will very rarely agree to compensate companies simply because of changes in the general economic climate or sectoral prospects which are, along with construction risks, usually left entirely at the company's door.

The most radical and sensitive situation is determining whether the contracting authority has an obligation to maintain the economic balance of the contract when there is a fundamental change in circumstances. The experience from many projects, mainly those fully delegating a public service to the private partner, is that in the event of a fundamental change in circumstances, for any reason whatsoever (other than a failure of the private partner), it is in the interest of both parties either to restore the economic equilibrium of the contract if it was upset or to terminate the contract in return for fair compensation. The courts have gradually laid down a number of principles on the right to fair compensation, such as a minimum right to compensation equal to the unamortised value of capital assets, along with compensation for a part of the shortfall when the state unilaterally terminates the contract for reasons of general interest.

Key points:

- ✓ *The private sector is a source of funding, innovation and efficient management of infrastructure and public services. Knowing how to attract it and enable it to operate locally must be a priority objective of the economic policies of states wishing to increase the number of infrastructure projects. It is also an opportunity to strengthen the fabric of local companies which have become partners of international groups.*
- ✓ *The private sector is not a single partner but a combination of companies working in various capacities. The relationships between businesses which are partners in the same project must be recorded and the public authority needs to carefully assess the sustainability of their respective commitments.*
- ✓ *Reaching a contractual balance over the long term is vital to the success of PPPs. Any serious imbalances cannot persist without damaging the interests of a partner or category of partners in the project. The contract may need to reflect this, including specific and detailed methods for calculating how to recover the financial balance or the terms of compensation in the event of termination.*
- ✓ *Contractual flexibility must be maintained to meet the changing circumstances made inevitable by the passage of time over the long term.*

IV. Project funding

- 33. A “bankable” project

In order to interest investors and lenders and convince them to contribute to financing a project, it has to offer prospects for depreciation and financial return which compare favourably with other market opportunities. Professionals are used to distinguishing between the financial internal rate of return of a project – which includes expenses and income over the term of the project – and the economic rate of return, which includes factors outside the project (”externalities”), particularly for the wider community. This broadens the calculation of the specific needs of the contracting public authority and, in addition, reinforces the relevance of the project. The internal rate of return determines the average maximum rate at which the company may borrow to fund the project – this is the first rate that is taken into account. With complex projects which take a long time to implement and are operated over a long period, this can be a tricky calculation to make.

For an operation to attract investors and lenders, the project must be “bankable”, i.e. the financial rate of return for investors must be equivalent to the average cost of the capital (weighted average cost of capital or WACC) plus a risk premium covering both the risks of the project itself and its political and economic environment, with a realistic enough degree of probability to convince them. The interest rate on the loan or loans should cover the cost of the resource raised by lenders for a given period, plus a risk premium. This risk premium will vary according to the grading of the project and how much of the risk is borne by the various categories of lenders contributing to the financing, provided satisfactory guarantee and refinancing conditions are met. It is important to note that funding has to remain “without recourse” to the parent companies of the investors: neither the shareholders, nor the subcontractors can be called on for guarantees due to the hazards and ups and downs encountered by the project.

- 34. Investors, multilateral banks and development agencies, private bankers, financial markets: The current transformation of funding sources

Raising finance for a PPP infrastructure project, for significant amounts (USD 10-100 millions or even more) over a long or very long period (often more than 15 years) is a complex, tricky and laborious operation to carry out. Typically, equity makes up a minor fraction of the financing (from business stakeholders as well as institutional and private investors). The rest of the financing will include loans from international financial institutions (World Bank, European Investment Bank, European Bank for Reconstruction and Development, African Development Bank, Islamic Development Bank, Asian Development Bank, the Inter-American Development Bank, and others) and from national development agencies (American USAID, British DFID, French AFD, German KfW, Japanese JICA, Swedish SIDA, and many others) sometimes with improved terms (called “concessional” in relation to market conditions) and loans from commercial banks. Projects may also be funded through state and European Commission subsidies (the leading world sponsor in terms of donations), under development aid. Project funding can also call on capital bond market financing.

In recent years, the international project finance market has been undergoing profound change. Despite an abundance of liquidity and low interest rates on the international market, commercial banks and the private insurers who work with them are much less present in syndicates, leaving such transactions dominated by state and multilateral agents. This lack of interest results from banks' and insurers' need to strengthen their prudential ratios, a consequence of the financial crisis of 2007/08, and their reluctance to take risks over the long term. This situation has its limits and the international financial community is busying itself looking for more diverse and competitive innovative funding approaches to respond to the large number of creditworthy needs which are currently not being met.

- 35. Developing financial innovation and securing investments

The ever-closer co-operation between the many multilateral institutions and development assistance agencies providing concessional aid has encouraged the development of mixed financing operations combining guarantees and grants, known as "blending". They allow attractive financing to be offered despite the significant decrease in commercial banks' commitments. Yet commercial banks remain essential, if only for their capacity for structuring and financial engineering, and the diversity and flexibility of the financial instruments that they can offer. These range from conventional loans (tranches of so-called "senior" loans with priority repayments, so-called "junior" loans with deferred repayments, and finally "mezzanine" loans consisting of quasi-equity) to simple overdraft facilities, for example to handle a start-up business operation with a trafficking risk.

Currently, financial security requirements are becoming more widespread as flaws in the market mechanisms are becoming apparent. The system of guarantees and insurance could be deemed to be too complex and fragmented, sometimes arbitrary, too expensive, insufficiently competitive and above all in short supply. This is mainly because of the virtual disappearance of the private insurers known as "monoliners" which specialised in project risk insurance, an activity also called "credit enhancement". Constraints on the refinancing of loans is also a major issue because the financing of infrastructure projects suffers from its need to operate over very long terms (more than 12 or 15 years). The international financial community is considering new structured formulas to revive the market and rekindle hope that commercial banks will reappear at costs that are sustainable for the public sector.

- **36. Long-term investors, alternative finance, securitisation**

Among the opportunities that have emerged to attract more capital to the infrastructure sector is the still limited but significant appearance of a new category of investors, public or private, designated long-term investors, which are able to form investment portfolios in existing projects or to invest through funds dedicated to new projects.

The Regulation (EU) of the European Parliament and the Council of 29 April 2015 established the European Long-Term Investment Fund (ELTIF) to attract savings and to transfer large amounts of capital into areas requiring long-term investment. It specified the legal framework for this new vehicle which aims to generate regular incomes for pension management agencies, pension funds, life insurance companies, foundations, sovereign wealth funds, debt funds and investors seeking long-term returns. In particular, it is intended to offer investors the opportunity to fund projects such as transport infrastructure, the production or distribution of renewable energy, social

infrastructure, and the deployment of new systems and technology that reduce the consumption of resources and energy, acting as a necessary supplement to bank financing. This new European instrument also gives retail investors access to investments linked to long-term projects which, up until now, were aimed primarily at professional investors.

Another step will be the development of massive securitised project bond funds (”project bonds”), either individually for very large projects, or in the form of a portfolio of several selected medium-size projects which have been thoroughly rated by rating agencies. Pooling these means that the risk can be reduced.

- 37. Conventional finance, Islamic finance and participatory finance

Most PPP infrastructure project finance has so far been carried out through conventional financial means. Although the financial capacity of Islamic financial institutions continues to grow, their investments remain highly concentrated around intermediate maturity periods (5-10 years) or low-risk property or industrial investments. They have invested very little on infrastructure in the MENA region despite its obvious infrastructure needs. This is due in particular to the characteristics of Islamic finance which is based on principles of Islamic business law. This promotes investment through commercial contracts involving shared profits and losses, backed by real assets. In contrast, in conventional financing, remuneration is based on a rate of interest, which is prohibited by Islamic law.

Two other alternative financial sources share similar characteristics. “participatory finance” shares risks and profits rather than remuneration based on the passage of time (the term used in some Muslim countries such as Morocco and Turkey). “Asset-based” finance, used in G20 bodies, signifies that the financing is backed by a real asset. Discussions are under way, including at the OECD, to drive change in some conventional finance instruments to enable them to accommodate funding tranches from Islamic finance more easily.

- 38. Project rating

Project risks, which are divided between the contracting authority and the successful tenderer, are commonly rated or assessed by specialised companies (Standard & Poor’s, Fitch, Moody’s, etc.) which are also active in the assessment of sovereign risk. These ratings will be used by insurers, investors and lenders to gauge the impact of all the project’s parameters on funding, establish the cost of guarantees, better assess the rate of return, and determine the interest rate for investors and various classes of lenders. This risk rating has to be paid for and adds to project costs. Moreover, it is not necessarily a guarantee of the soundness of the project as was demonstrated by the bankruptcy of the “monoliners”, all of whose projects were rated as investment grade. Conversely, a non-investment grade project is not necessarily non-bankable because it simply may not meet the specific rating criteria of the rating agencies, generating a much higher interest rate level.

- 39. Guarantees and insurance

When closing the negotiations on project financing, investors and lenders will ask the successful bidder to cover a number of risk categories. For example, it may need to take out insurance against political risks (civil unrest, expropriation, plunder, civil or foreign wars, convertibility/transfer). This cover is issued by some multilateral institutions, such as the MIGA (World Bank Group) and

specialised national agencies (export credit agencies or ECAs). It may also be asked to take out private insurance for technical or exchange risk, but rarely for general economic or trafficking risks. This market is very complex, difficult to access, and, since the financial crisis of 2007/08, lacks capacity, liquidity and genuine competition. There is undoubtedly room for development, particularly in the emergence of genuinely independent advisers over guarantees and insurance, who are involved from the earliest stage of the project.

- 40. Channelling the flow of project revenues to secure repayments to lenders

Monitoring the income flow generated by infrastructure or public services managed by a private company is one of the most critical points for lenders. These flows are needed for the normal operation of the infrastructure but also for debt servicing. Strict contractual provisions govern the monitoring and allocation of the income received by the private partner (”waterfall”), building up reserves in escrow accounts to secure repayment of loans as a priority.

- 41. Possible recourse by lenders to the project’s income and assets

In the event of a problem with debt servicing, or if a project gets into distress, additional financing contracts will seek to call on the project’s income flow directly. They can also provide lenders with various forms of recourse to the assets of the project company or the infrastructure itself, according to local law or the special contract terms. Conventional finance rarely has direct recourse to these assets, but this appears to be the rule for Islamic finance. In projects combining both conventional and Islamic finance, this situation may lead to conflicting rights. Contractual provisions need to be developed to prioritise the rights of different categories of lenders or put all financial backers on an equal footing. As for private investors, whose high returns reflect increased risk-taking, their capital must remain sufficiently at risk to be motivated to successfully complete the restructured project. The tendency to want to cover their risks, as banks do, can sometimes be counter-productive.

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Key points:

- ✓ *Multilateral financial institutions and development agencies, particularly since the financial crisis of 2007/08, dominate the financing of new infrastructure projects. Private financing has contracted accordingly, despite the over-abundance of liquidity on the markets and extremely low interest rates.*
- ✓ *However, there remains a place for private funding. It is needed for its equity, the highly diverse nature of its aid for loans, the size of its liquid assets which alone are capable of meeting the scale of needs, and its technical financial engineering.*
- ✓ *To attract back the huge quantities of capital that have been diverted from infrastructure funding, the shortcomings of the guarantees and refinancing markets have to be addressed. Participatory finance and long-term investor activity, both public and private, need to be developed, and Islamic finance attracted.*
- ✓ *The banking sector needs to create new infrastructure asset classes so that institutional investors, such as life insurers, pension funds and sovereign funds can be involved in financing infrastructure projects. The prudential rules (Basel III -CRD IV) restricting the involvement of commercial banks in the financing of concessions and other PPPs may need to be alleviated.*

V. Dispute resolution

- 42. Adopting a long-term approach to managing difficulties

The construction sector is very active in PPP operations and it is well known, rightly or wrongly, for the frequency and scale of its disputes. This tendency is reinforced by the long-term contracts characteristic of PPPs. In fact, data collected by the World Bank shows that, many PPPs are being renegotiated two years after their conclusion and a number of them are in great difficulty. While the origin of these disputes is frequently due to a defective project set-up, itself caused by inadequate contractual clauses, they are fuelled by contracts with insufficient methods to promote the prevention and resolution of disputes. This exacerbates their consequences which will not be handled in the best way. However, because disputes are almost certain to arise, they must be subject to very rigorous contingency planning. Many formulas can be used to manage a dispute satisfactorily, from its beginnings through to the most acute phases. The cost of non-resolution or late or poor resolution of a dispute is generally underestimated. It includes not only the direct cost to the operation of the infrastructure but also further damages, time spent by managers, damage to stakeholders' images, and loss of new transaction opportunities. Handling disputes right is ultimately a highly critical part of the development of the project.

- 43. Role of an independent national regulatory authority

Independent national regulatory authorities are not conflict management bodies, and can sometimes themselves be a source of disputes between the contracting public authority and the private sector responsible for the construction and its operation. However, they can play an important role in the prevention, early identification and resolution of many disputes, provided that they have the technical skills, independence from the co-contracting administration and the authority to enforce their positions within the government apparatus. Such a regulator can play a major role in facilitating relations between the contracting parties by more objectively setting out the terms of a problem that threatens to escalate into open conflict. Public administrations thus need to establish such authorities with the utmost care.

- 44. Settling disputes amicably through mediation or a disputes review board

Once a dispute is acknowledged and the negotiation phase between the parties has proved unsuccessful, it is common in major international contracts for there to be an intermediate step before legal proceedings in a local or an arbitration court. Parties retain their self-determination at this stage, compared with court decisions which are *res judicata*. Mediation is a formula by which an independent, neutral and impartial third party, albeit paid by the parties to the dispute, tries to help them resolve the dispute by encouraging the emergence of an amicable solution. It is up to the parties to accept and implement it as a contractual commitment.

A more sophisticated formula used in the United States and the United Kingdom is the disputes review board (DRB). This differs from mediation in that board is formed before the emergence of any dispute, starting to operate as soon as the contract comes into effect. The board and its members (generally between one and three people) are kept regularly informed about the project,

which serves to improve its effectiveness in the event that it is called on to intervene. The resolutions issued by this body may or may not, on an interim basis, be binding pending a judicial decision. However, they are not *res judicata* and thus remain within the contractual obligations.

In the case of both mediation and DRB, the clause that establishes these non-judicial formal dispute settlement mechanisms will lay down their rules and conditions or refer to institutional mechanisms which are generally fairly extensive.

- 45. Local court proceedings

The legal process culminates in a decision that is *res judicata,* meaning it will be binding on even the most recalcitrant parties. It is considered as a last resort in international investment agreements, where the state in the territory where the infrastructure is implemented is evading the demands of the private sector to accept an international arbitration agreement. With states which show determination to attract investors, recourse to arbitration is common but not universal, particularly in the most economically advanced countries which prefer to see their disputes settled in their own courts. However, foreign investors may fear bias or flawed judgements from host state courts.

When assessing contracts to construct and manage large infrastructure projects, the dispute resolution method will therefore be an important aspect for private-sector companies to consider. They will prefer disputes to be handled under conditions that comply with the provisions negotiated in the treaties and bilateral or multinational agreements in force for protecting foreign investments. The heterogeneity of these agreements (there are over 3 200 existing treaties) and the conditions under which they apply are regularly criticised, however, with calls for improvements to match theory and practice as much as possible and enable procedures to run smoothly.

- 46. International arbitration between states and investors

International arbitration has become the reference model for the resolution of disputes through a non-judicial process based on the consent of the parties to the dispute. Not all states readily accept arbitration; many of them, both in the North and the South, impose restrictions depending on the matter at hand, known as the “arbitrability” of the dispute. For example, disputes concerning rights which the parties do not freely have, can generally not be submitted to arbitration, so matters such as employment law and family law are very often excluded. Restrictions may also depend on the status of the parties (such as the question of the “ability to compromise” that arises particularly for public entities, states and their sub-divisions).

States may accept the use of arbitration for international contracts either through legislation, or because it has concluded/ratified a treaty or international agreement. In this alternative to a judicial decision, the arbitration court derives its legitimacy from the parties who bear the costs. It is composed of one or three arbitrators and operates under conditions set by the parties in their arbitration agreement, which often refers to a model settlement of the major international arbitration institutions (such as the International Chamber of Commerce in Paris, ICSID in Washington, or regional arbitration centres in Geneva, Brussels, Madrid, Milan, Seoul or Cairo). The arbitration convention – the arbitration clause or agreement – is the source of the jurisdictional

power of arbitrators: its effect is to give jurisdiction to an arbitration court. The arbitrator or arbitrators may continue with their task despite the existence of a dispute over the validity of the arbitration clause.

At the conclusion of its proceedings, the arbitration court makes an arbitration award to permanently resolve the dispute, which is then binding on the parties and third parties. Although the sentence has the force of *res judicata*, the arbitration court has no power to enforce it and requires an enforcement order from the competent court of the state in which it is to be applied. The arbitration courts are considered to have many merits (speed, discretion, the skill of the arbitrators appointed by the parties) but questions have also been raised over their use (unique justice, justice for the wealthy, secretive, exorbitantly costly), all accusations that have some force. Several pieces of international law relate to international commercial arbitration and investment; how binding they are depends on their type. Supranational bodies will continue to discuss and work in this area for as long as there is the will to perfect the process. By way of illustration, the latest UNCITRAL legislation to be adopted concerned arbitration between investors and states based on treaties: the Rules on Transparency and the Mauritius Convention of 10 December 2014. Arbitration cannot be totally disconnected from national judicial procedures, which should be used to regulate it and intervene *de facto*. This will enable it to operate and to avoid the risk of excesses.

- 47. Role of national courts in the control and enforcement of arbitration awards

National courts necessarily co-operate in the enforcement of arbitration awards, pursuant to the New York Convention. They also regularly facilitate the incorporation of foreign arbitration awards into the domestic legal system by exerting minimum control. The trickiest issue is the excessive heterogeneity in the interpretation of the conditions for acknowledging and enforcing arbitration awards, partly caused by the diversity of legal systems internationally. A Guide to the New York Convention prepared by UNCITRAL and intended for national courts is intended to promote a more uniform and effective application of arbitration awards.

Key points:

- ✓ *In the long term, disputes should be considered to be almost inevitable and therefore be carefully taken into account when drafting the contract. Disputes are not necessarily a sign of failure but an almost inevitable consequence of the passage of time.*
- ✓ *The utmost attention should therefore be paid to ways of managing disputes within the contractual framework, with impartiality and skill, before they escalate.*
- ✓ *The arbitration formula for settling a dispute must be understood not as a parallel justice system but allowing space for input from national courts through enforcement orders and minimum control. This trend is expected to strengthen in the future.*

VI. Conclusion

- 48. Training managers to master long-term collaboration between the public and private sectors

PPPs and concessions are a complex subject, incorporating a wide variety of content, origins and influences. They aim to combine two sectors, public and private, which are very different in nature, and to implement and manage high-stakes infrastructure projects which are politically highly critical for the states concerned. It is therefore not surprising that difficulties abound. The most difficult aspect arises from concessions and PPP operations over the long term, because these partnerships are not just a matter of public procurement or the creation of a single work site. They involve the private sector, under the supervision of the public sector, in managing a public service, which is not a natural course of action in many states. To achieve this culture change, managers will be the key players in this collaboration. They will need regular and continuous training, both in terms of the skills and behaviour of officials on both sides. This will help successfully balance public-private partnerships, which are the only feasible route for the massive investment in infrastructure which will be needed to meet the new universal goal of the United Nations for widespread eradication of poverty through access to public assets.

Key points:

- ✓ *The OECD, World Bank, IMF, United Nations Economic Commission for Europe and many other international financial organisations, such as the European Development Bank, African Development Bank and the Asian Development Bank, as well as national development organisations and agencies (AFD-CEFEB, Crown Agents) organise continuing education sessions on PPPs and concessions.*

VII. Appendices

1/ A non-exhaustive list of the main international reference texts

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2/ Selected list of national reference provisions

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