

1. Principles of selection for advisory services to support PPI

Outline of this Module

What this Module does:

This Module describes the rationale for increasing private sector participation in infrastructure, and the implications for selection of advisors. It outlines the basic tenets of selection and the link between a successful Private Participation in Infrastructure (PPI) program and the proper use of advisors.

The Module provides an initial overview of PPI and the use of advisors. It does not enter into any detail about their selection or use, which is covered in later Modules.

Who should read this Module:

The Module should be read by officials from central agencies within government who are responsible for setting policy for private sector participation and the use of advisors; officials from ministries involved in the implementation of specific reforms; and the staff of financial or other agencies that handle procurement. Officials involved in implementation should use it as an introduction to the process of procuring advisors for PPI.

1.1 Private sector involvement can increase efficiency – and access new sources of finance

Over the period 1990–1998 the private sector made massive investment in infrastructure sectors in developing countries around the world. Figure 1-1 shows the investment expenditures in projects with private sector participation (PSP) by main infrastructure sector (energy, telecommunications, transport, and water and sanitation) and year.

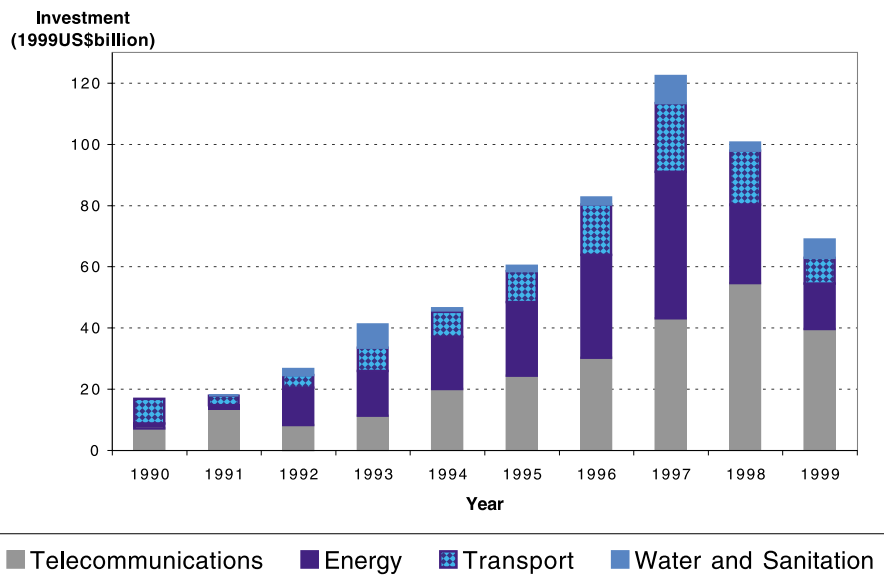
Defining the term PPI:

PPI = Private Provision of Infrastructure

PPI refers to the use of the private sector to manage, maintain, expand, operate and/or invest in infrastructure services. The areas of infrastructure covered by this toolkit include: energy, telecommunications, transport and water and sanitation.

Figure 1-1

Total investment in infrastructure in developing countries, by sector (1990–1999)

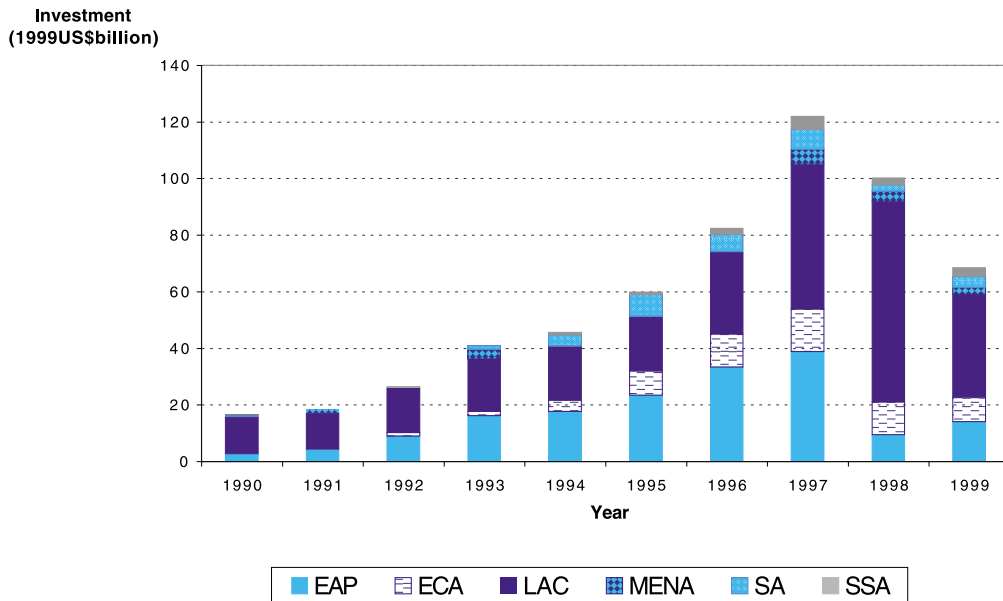


Source: World Bank, PPI Database

Note: Developing countries, defined as low and middle-income countries by the World Bank

Figure 1-2

Total investment in infrastructure in developing countries, by region (1990–1999)



Key:

EAP: East Asia and Pacific LAC: Latin America and Caribbean SA: South Asia
 ECA: Europe and Central Asia MENA: Middle East and North Africa SSA: Sub-Saharan African

Source: World Bank, PPI Database

Note: Developing countries, defined as low and middle-income countries by the World Bank

The figures show a steady rise in private participation in PPI¹ until the financial crisis that struck Southeast Asia and subsequently spread throughout the developing world. Available data indicate that investment interest is returning in response to the region's recovery.

Despite the large inflow of funds, there is significant unmet demand for PPI. As governments become increasingly comfortable with transferring risk to the private sector, and as new financial instruments and contracts are created, demand for private investment increases. There are two main reasons for the overall increase in, and demand for, PPI:

(1) Increased recognition by national, state and local governments of the ability of the private sector to assume many of the risks involved in the construction and operation of infrastructure projects.

The transfer of additional risks to the private sector provides increased incentives to manage these risks appropriately, leading to better investment decisions and more efficient service provision. While these incentives are broadly similar to those in the public sector aimed at ensuring a well-managed service, private companies, driven by the needs of shareholders and financiers, face closer scrutiny, which strengthens these incentives. These groups tend to be more demanding –

¹ PPI is a subset of private sector participation (PSP)—it is PSP in infrastructure.

and better informed – than taxpayers. Provided that PPI is well structured, this pressure should deliver the government's objectives more effectively.

(2) Decreased funds available to national, state and local governments for infrastructure investment, both when compared to total investment requirements and to many other possible uses for these funds.

Private participation does not change the need for consumers or taxpayers to pay for major investments. The government's financial position is not fundamentally changed if it pays for a service (e.g., water provision) rather than for assets (e.g., a storage dam and pipelines).

However, private participation can bring financial benefits. The costs may be lower if efficiency is increased. Major discrete financing requirements will be smoothed over a number of years. The greater clarity required for PPI also means that major investment, operational and management decisions and their financial implications will be better managed.

Restructuring may also reduce or remove the need for government financing. For example, if investments in electricity generation can be secured against future sales of electricity, the government does not need to be directly involved in financing. In theory, this is not an issue of ownership: a government-owned company could equally have secured finance against future revenue. In practice, the involvement of private companies often creates the impetus for the government to withdraw.

In recent years, governments have transferred more significant risks to the private sector for infrastructure provision. Increasingly, this has meant that private companies are not only exposed to the risk of completion on time and within budget (as happens when contractors build a runway, a bridge, or a treatment plant for a public authority); they are increasingly exposed to risks of whether a project is needed at all, whether it meets quality requirements, and whether its costs of delivery are competitive in the long term, as well as many of the environmental risks associated with infrastructure projects.

There are several entities over which the risks associated with PPI may be spread:

- government (i.e., tax payers);
- consumers;
- the project company that sponsors a project;
- the construction company that builds it;
- the financiers that back the project; and
- the operations and maintenance company.

It is the assumption of significant risk by the private sector in the provision of infrastructure that is captured under the broad term PPI. The precise risk transferred to the private sector will depend on the form of PPI (e.g., service contract, concession or equity sale) and the project in question. The link between risk and the different forms of PPI is examined in detail in Module 2. Table 2-2 presents a more detailed outline of the risks associated with PPI.

1.2 Governments still play a fundamental role

Increased PPI is often accompanied by structural changes in public sector industries. The reform model has implications for the successful structuring of PPI and also implies a number of economic and political changes that encompass:

- the current budgetary spending on infrastructure;
- government policy;
- the role of competition as the private sector is introduced;
- the government's responsibilities with the introduction of PPI; and
- the appropriate internal organization of government to implement PPI.

Budget

In most developed and developing countries, governments raise and spend directly 30–50% of GDP, using these funds to provide the framework for civil society: law and order, the justice system, defense, foreign affairs and other public goods. All too often, the definition of public goods is stretched to encompass services which could be provided efficiently without tapping to government's budget.

Defining public goods

A **public good** is one where the benefits of its provision cannot be limited only to those who pay for it, and where its use does not limit the quantity available to others. Street lighting is an example of a public good. Anyone using the street benefits from the light and the fact that one person uses it does not decrease the amount available for someone else.

In some countries, public goods are defined broadly and, as a result, significant sums are spent on welfare payments. This is almost universally true of education and health services. To varying degrees, governments also provide a much broader range of services across areas that are not strictly public goods: water and sanitation, transport, power and telecommunications. In most cases, cost recovery for these services from end users is possible and provision can be limited to those who pay for it.

Policy

Governments around the world have increasingly recognized that their role should be in setting policy for service provision, and not in providing services. This separation of policymaking from provision makes it possible to introduce the private sector, and competition, in the provision of assets and services. Along with the transfer of risk, competition is the most effective tool for increasing efficiency and reducing costs.

Competition

Increasingly, governments have also found that their policy objectives can be fully met within a competitive market. Their policy role may then be reduced to setting the framework for competitive markets (e.g., introducing competition laws to avoid abuse of market power). Over the last decade, many governments have reduced their direct involvement in many industries and have relied on the workings of the competitive market to protect consumer interests.

Recommendation 1.1: Effective PPI requires that responsibility for the provision of a service be separated from government policy-making. The structure for PPI should ensure that these responsibilities are clearly assigned and separated.

Target-setting

It is increasingly common for governments to set themselves and their representatives explicit targets for withdrawing from direct oversight of infrastructure industries. In Poland, the energy regulator has a legal obligation to withdraw from the direct oversight of the electricity generation market as soon as it is sufficiently competitive. Although this creates another set of challenges (i.e., deciding when the market is sufficiently competitive to permit withdrawal), it recognizes the ability of a competitive market to meet some of the government's objectives.

1.3 Governments can use the private sector to meet objectives more effectively

While some services can be provided through interaction between consumers and the market, there are important areas where there is less scope for government withdrawal.

The presence of natural monopolies

The first is where prices cannot be set through competition due to the existence of a natural monopoly.

This might be true of a rail line or a gas distribution system, where—it is more efficient to have a single integrated network servicing a particular area, rather than several competing networks.

What is a natural monopoly?

A **natural monopoly** exists when costs decrease as the amount produced within a single company increases. Ever-decreasing costs within the company mean that it is more efficient for a single producer to meet demand than several smaller producers.

Governments may still favor private participation in these areas but want to avoid the risk to consumers from private monopolies. One way forward is to allow a private company to own and operate the utility, but under the scrutiny of an independent government agency—a regulator.

Provision of loss-making services

A second area from which the government cannot withdraw is the provision of a necessary but loss-making service. There are many reasons why governments might want services to be provided, even at a loss. Public transport may be subsidized because the cost to society of private transport in terms of environmental degradation (from pollution) and quality of life (from traffic congestion) cannot be fully recovered from automobile drivers. Road systems are usually provided free, in part because of the difficulty of charging. Water and other services may be intentionally under-priced for reasons of public health. Postal services in rural communities are often cross-subsidized by urban populations for reasons of social equity.

It is important to note that a loss-making service does not have to be provided by a government. The private sector can be contracted to supply the service, for which it receives an explicit payment from the government, or certain consumers may be provided with a direct subsidy from the government to pay for the service. The benefits of competition can then still be realized through periodic competition for the contract.

Using competition where subsidies are required: rural-electrification in Chile
In Chile, the subsidies required for rural electrification are competitively bid. Private companies, alternative providers (e.g., NGOs, cooperatives) and communities present proposals at regular auctions for a specific amount of subsidy. The proposals are then evaluated based on a known set of criteria (e.g., amount of subsidy required, cost-benefit analysis) and the winning proposals are given funds. This process combines the need for continued government funding with the benefits of competition to minimize the public subsidy, allowing the government to serve more communities. To date the program has met its pre-set targets for rural electrification.

1.4 Effective use of the private sector requires a strong advisory team

Regardless of the intended mix between the public and private sectors in providing a particular service, the success of any PPI program depends on the organization of government and its ability to use advisory services. Before a technical assistance² project is undertaken, it is important to decide how its results will be disseminated and acted upon. In particular, it will be important to answer the following questions:

- To whom will the advisors report?
- What level of official input is required to ensure effective implementation?
- Have the relevant officials been informed about the upcoming decisions?
- Do ministers know of and support the process?
- If ministers or the head of state must take decisions, has sufficient time been set aside for them to act?
- Have the relevant resources been freed up?

Recommendation 1.2: The senior official responsible for a PPI initiative should select a strong government team. The government team should have clear responsibilities for managing the advisory team, and should establish lines of communication to all other relevant senior officials for full consideration of the advisors' recommendations.

1.5 Obtaining a strong advisory team is expensive and presents a challenge

Sections 1.1 and 1.2 described significant changes to large sections of the economy. They also described the positive impact of these changes. Since achieving these positive impacts depends on properly implementing the changes, outside expertise may be needed to:

- identify the changes required to meet the government's objectives;
- recommend the best way to implement the required changes; and
- assist in the implementation.

The expertise required for answering the questions outlined in Section 1.4 may not exist within the government. External advisors may be required.

The advice needed to implement a major reform program can be expensive. Table 1-1 provides an example of the range of fees used across a number of projects ranging from basic institutional analysis to the full range of policy, legal, technical assistance and transaction advice.

² The term "technical assistance" will be used throughout the Toolkit to refer to all services provided to governments that are in the form of advice rather than goods or works.

Table 1-1
Representative costs of hiring advisors

Country & year	Project	Type of advisors	Fee structure	Fees at time of contract
Pakistan (1985-87)	BOOT project –Lakhra power – led to Hub River Project	Financial advisors	Fixed fee	\$US 350,000 approximately
Cambodia (1996-98)	Institutional strengthening in water supply sector.	Financial, technical and legal advisors	Fixed fee	\$US 500,000
Georgia (2000)	Restructuring of Ministry of Transport and Communications as part of wider liberalization program	Technical advisors, transport planners, institutional reform experts, IT advisors and economists	Fixed fee	\$US 1 million approximately
Philippines (1995)	Water concession for Manila	Economic, accountants, lawyers and engineers. International Finance Corporation acted as lead advisor.	Mix of success and fixed fees	More than \$US 3 million
Uganda (1998–99)	Privatization of electricity industry	Strategic advisors to advise on the structural and appropriate forms of PPI for different parts of the industry, and transaction advisors for the privatization	Fixed fee	More than \$US 2 million
Brazil (1990s)	Privatization of electricity industry	Lead advisors, policy, legal, financial and other specialist advisors	Mix of fixed fee and success fees	\$US 10–12 million

Source: Frontier Economics

Governments spend such large sums on advisors because of the benefits they obtain from them, including the avoidance of costly mistakes.

However, governments face a significant challenge in managing advisors in order to obtain the best service from them. Managing advisors involves a number of steps.

- First, the government must identify the individuals or companies best placed to undertake the project .
- Second, the government must sign contracts that provide the advisors with incentives to use their expertise for the benefit of the government .
- Third, the expertise must be channeled into designing and implementing a PPI program that meets the government’s objectives.

The Toolkit outlines each of these steps.

The following Modules in *Volume I, What is PPI and how can advisors help?* :

- provide background information on PPI, outlining the different stages of the process;
- identify areas in which advisors can be used productively;
- discuss how a technical assistance project should be scoped; and
- consider issues related to the use and selection of advisors when PPI is being introduced on a small scale at the community or municipal level.

Managing a large and expensive group of advisors from differing disciplines is challenging in any country. It can be more challenging in a low-income country. The gap between host country officials and advisors may be large in terms of income, experience and understanding of the local culture.

Capable management of the advisory team is essential for three reasons:

- It is vital to the successful design and implementation of the reforms;
- Good management of advisors will reduce the need for senior officials to intervene as problem solvers; and
- Effective management of the advisory team will convey the government's competence and conviction to potential bidders for a PPI project, and may lead to greater market interest.

1.6 Governments need to purchase advisory services effectively

The first management challenge is to decide which advisory services are required and how they are to be selected. Most governments have formal rules relating to procurement. These usually vary according to the project characteristics, with the formal requirements increasing with the size of the contract. Increased formality may relate to the need for competition, the involvement of multiple parties (including agencies with specific skills in procurement) in decision-making, the types of funding, and payment arrangements. It may also relate to the process for review of the completed project.

This section describes the general characteristics of an effective selection process. It also looks at the particular characteristics of buying advisory services for PPI.

The main objective of a selection process is to hire the company or group of companies (consortium) that best meets the government's needs. This will include a focus on cost and quality, and may reflect other criteria, such as ability to deliver within a particular timeframe.

In deciding on the appropriate company or consortium, it is vital to recognize the trade-off between cost and quality. While the most expensive company or consortium will not necessarily provide the highest quality, in general it is true that the government will get what it pays for. Module 7 in *Volume III* outlines in detail approaches to ensuring the best balance between cost and quality.

Selection processes will differ from country to country and project to project. However, the process of finding the best team³ should have the following characteristics:

- **Transparency** Transparency is achieved when as much information as possible is made publicly available. A transparent process eliminates doubt about the quality of the final winning team. Furthermore, openness is a pre-requisite to the participation of most top consultancies, which may not participate in an opaque, difficult to understand process. Processes should also be open to the normal mechanisms for government review and appeal.
- **Fairness** Fairness is achieved when all parties are treated equally: when they receive the same information at the same time, and are evaluated on the same criteria.
- **Cost-effectiveness** Costs can be minimized by choosing the appropriate method for selecting service providers, e.g., the form of competitive bidding or sole-sourcing (see Module 7 in *Volume III*, How to select and manage PPI advisors). Accessing grant funds, or loans on concessional terms where available, reduces costs to government (see the Module in *Volume II*, *The role of donor agencies in PPI*).
- **Mechanisms to avoid conflicts of interest** The selection process should avoid both actual and perceived conflicts of interest. These include the participation of companies that may be involved in later stages of PPI, the participation of

³ Where a team may be a single individual, company or group of companies.

government officials who have current or recent connections to the companies involved, and the linking of rewards to anything other than performance. Conflicts of interest are discussed in more detail under areas where they most frequently occur (see Modules 3 and 4 and Module 6 in *Volume II*).

Recommendation 1.3: A government should implement a selection system that is transparent, fair and cost-effective, and which does not involve conflicts of interest. The effect of such a selection process will be to increase the likelihood of selecting the most appropriate consortium and to increase investor confidence in future PPI programs.

Selection of advisors for PPI raises three issues in addition to the general procurement principles discussed above.

Uncertainty

Purchasing advice always has an element of uncertainty: if the purchasers fully understood the advice in advance, they would not need to purchase it. This problem applies to a greater extent in PPI advisory services because of the combination of the large scale restructuring of an industry often required and the infrequency of the advice. The scale of the restructuring required increases the cost of any mistakes. The infrequency of the advice means that government officials are likely to be less able to monitor the consultants, and the consultants have fewer incentives to produce an output of the highest quality because they are less likely to be required again regardless of the outcome.

That creates a challenge in evaluating proposals. Possible solutions include:

- identifying the core skills of different types of advisors, and ensuring that these are reflected in the proposals received;
- appointing a lead advisor to assist in subsequent selection of other advisors;
- seeking out independent individuals or institutions with relevant experience to help in the evaluation and monitoring – aid donors are a possible source; and
- transferring risk so that the private company bears costs of poor performance as far as possible.

These are discussed in more detail in Module 7 in *Volume III*. (See section 7.1.)

Perception

The selection of advisors has an impact on the perception of potential investors. Well-delivered advisory services increase the credibility of the entire PPI process. Therefore the appointment is likely to have major impacts on the level of interest and the value received from any future transaction. While this does not alter selection processes, it does mean that more weight will be attached to the outcome of the advisory selection process than to a contract that has no broader ramifications for future investment.

Skill

There is a particular need to ensure the transfer of skills to local personnel. Some skills (e.g., economic regulation) will be required on an ongoing basis. Other skills will be useful to acquire for the future reform of other sectors. Several sectors may go through similar processes of reform, restructuring and inviting PPI. Attention should

be devoted to developing relevant skills within government, and among domestic advisory companies. This is discussed in more detail in Module 3.

1.7 A strong government team will reduce the concerns of potential investors

Developing country environments can be difficult for international investors. They are attracted because they see opportunities for profit, but they are deterred by risks. While commercial risks are manageable, political risks - that selection processes will be biased, that regulators will not prove fully independent or that legal remedies may prove hard to enforce - may be more challenging.

Risk and, equally importantly, the perception of risk can be reduced in three ways:

- **By demonstrating the existence of transparent and fair selection processes from an early stage.** Potential future investors will judge the government by its past actions. A selection process for advisors that is transparent, fair and cost-effective, and which does not involve conflicts of interest provides increased comfort to those contemplating the commitment of significant sums of money at a later stage.
- **By attracting advisors with a strong reputation.** Companies and individuals with excellent reputations have more to lose by making a mistake. Their willingness to see their names attached to a project or piece of advice acts as a signal that they feel it is thorough and correct. This is particularly important as the government gets close to a transaction.
- **By introducing a well-designed reform program.** Where the new industry and market structures, contractual and regulatory regime, and the legal framework are well explained and fit together logically, potential investors will be reassured that the government have designed a program that protects their interests.

Useful reading

Bouin, O., *Privatization in Developing Countries*, Policy Brief No. 3, OECD, 1992.

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