

2. Identifying the stages of PPI – what is PPI?

Outline of this Module

What this Module does:

This Module describes the different stages of a standard PPI process, beginning with the appraisal of different policy options, and continuing through to contract management. The purpose is to help readers understand the role of advisors at different stages in the process.

Who should read this Module:

All those who require an overview of the PPI process and, particularly, government officials involved in hiring and managing advisors should read this Module. This includes procurement officials in the ministry or privatization unit and their immediate superiors.

This Module presents and discusses the four main stages of a typical PPI reform program. It discusses each stage and provides an indicative timescale for each of the different forms of PPI. Figure 2-1 provides a general overview of a standard PPI program. The four stages are:

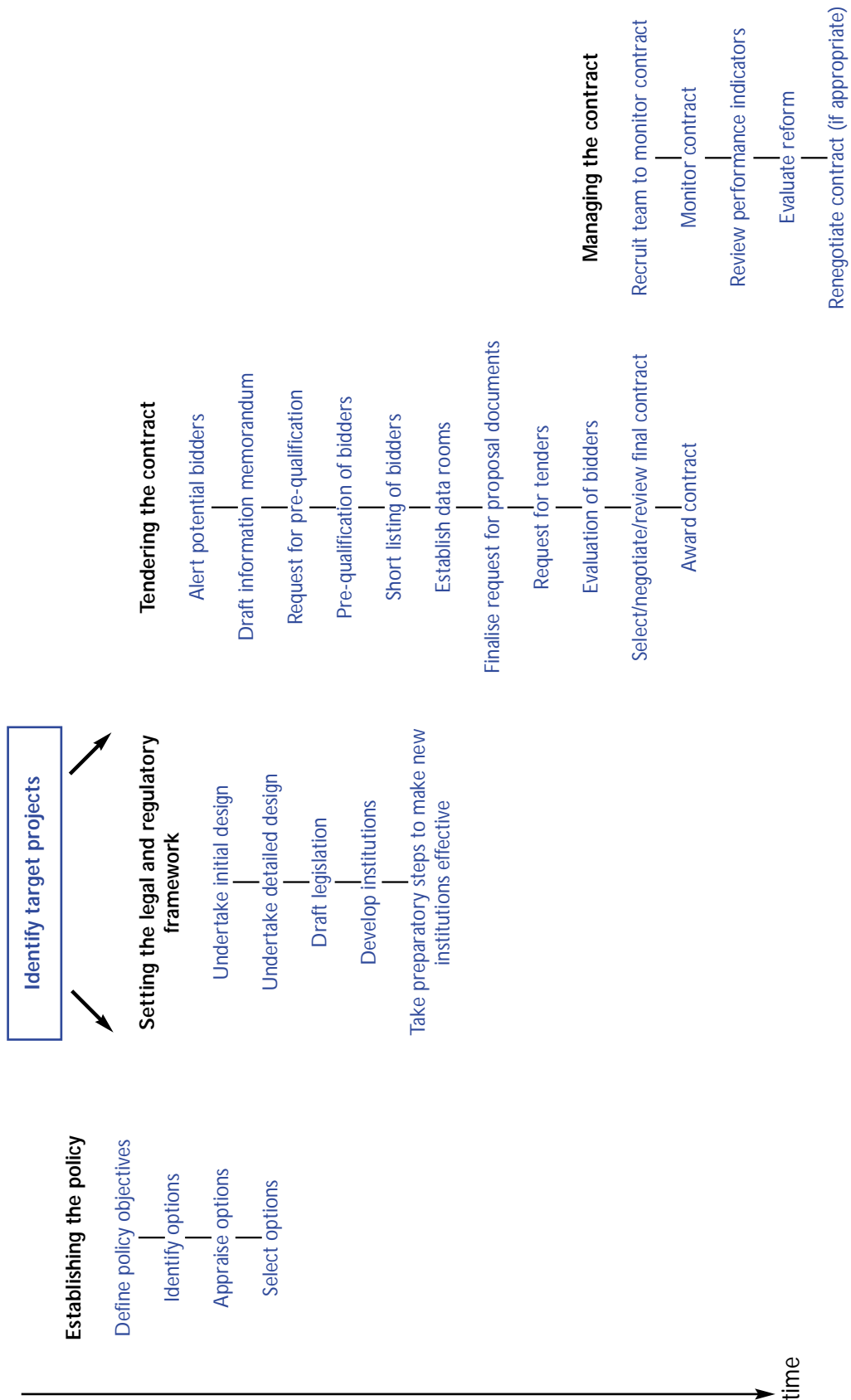
- formulating policy;
- establishing the legal and regulatory framework;
- tendering the contract; and
- managing the contract.

At some point in the PPI reform program, there will be a need to identify appropriate projects in which involvement of the private sector might be sought. The exact point in the process at which this occurs will differ from case to case. Indeed, interest in pursuing a particular project sometimes drives the larger reform process. Therefore, the figures represent this task in a floating box located between the end of stage one and stage three.

Each of the stages of the PPI process varies in importance depending on the form of PPI.

This Toolkit focuses on the hiring of advisors. Therefore, the descriptions of the PPI process are brief, generalized and intended to clarify the role of advisors throughout the process. In practice, advisors should be asked to provide a much more detailed outline of the stages for a particular project when preparing the approach section of their technical proposals. This work plan can be refined once again when the advisor has begun working for the government.

Figure 2-1
Stages of the PPI process



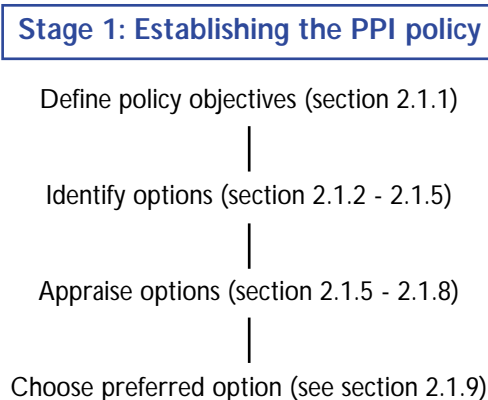
2.1 Stage 1: Formulating policy

The broad policy framework needs to be established before steps are taken to introduce private sector participation. The basic structure to this decision-making process is straightforward. The government:

- defines policy objectives;
- identifies options for meeting them;
- appraises the options; and
- selects its preferred option.

Figure 2-2 illustrates the sequencing of these tasks. This section discusses what they entail in practice.

Figure 2-2
Establishing the policy



2.1.1 Clear objectives are key to the success of policy reform

Successful PPI programs are characterized by a constant referral back to a clear set of objectives that have been agreed by all key government officials and their advisors. Less successful programs fail to ensure that the reforms are developed in line with the objectives, or they have vague and undefined objectives, or different objectives depending on who is consulted.

Having varied or conflicting objectives will create problems. It may create problems when bidders submit their tenders. For example, some government agencies, typically Ministries of Finance and State Property Funds, may favor awarding a tender that meets the objective of revenue maximization; other government agencies, such as line industries or regulators, may favor a tender that minimizes tariff impacts. Discussion on the actual objectives should take place well before transaction documents are prepared. It is essential that objectives are defined at the start, written down in simple summary, and that they form the basis of all decisions.

Objectives will vary. However, most PPI programs have two shared objectives:

- to increase the efficiency of infrastructure industries, by transferring risk from the public to the private sector and through the introduction of competition; and
- to transfer investment responsibility from the public sector to the private sector.

Governments may also pursue a range of other objectives through PPI programs.

These include:

- improving the quality of service delivered;
- expanding service provision to certain geographic areas or to particular sections of the population;
- developing emerging capital markets;
- redefining the role of the public sector;
- focusing on development in a particular part of the country; and
- raising revenue.

Governments have even entered into PPI initiatives in order to slow degradation of the environment. This is common where governments are not capable of financing or operating investments in newer technologies such as desalination projects for bulk water supply, cleaner burning power plants for electricity generation, and more stringent dredging standards for port access channels.

The nature of the government's objectives will have a direct bearing on the alternative form of PPI and the process pursued. Unless objectives are clearly defined and prioritized, there will be no basis for making consistent choices. This will lead to major difficulties with the selection of advisors and the PPI process as a whole. The first step is therefore to prepare a concise written statement of objectives, and to ensure that this forms the basis of subsequent decisions. One common practice is to ensure that all documents produced by the team working on the PPI program start with a short restatement of the agreed objectives. An indicative Statement of Objectives for a PPI initiative is presented below.

Indicative statement of objectives for a port PPI program

The primary objective of this initiative is to increase handling efficiencies in the major general cargo and container terminals of the country, to unblock bottlenecks to trade, and to lower the costs of delivered goods.

This Statement of Objectives emphasizes efficiency gains that can lead to easier trade, and eventual cost savings for consumers. It does not emphasize, for example, the development of capital markets or the importance of raising revenues for the Treasury. As a result, advisors working from this simple Statement of Objectives will focus on approaches to PPI that are intended to increase operating efficiency at the port facilities—through competitive tenders for multiple terminal operators or through performance targets and incentives placed in the bidding documents, for example. The advisor will not seek to structure the process in such a way that it necessarily leads to locally traded shares or to a large cash payment to the government at the time of privatization.

What the Statement of Objectives contains, and what it does not contain, will affect the entire PPI process and approach to advisory services. The relationship between these objectives and the potential for transferring risk is examined in detail in section 2.1.7.

Recommendation 2.1: The government officials responsible for overseeing a PPI program should articulate a clear set of objectives at the outset of an initiative and ensure that all affected government agencies are in agreement on the set of objectives. These objectives should be communicated to advisors at the earliest possible opportunity and should be referred to throughout the process when alternative approaches to PPI and processes for implementation are being considered.

2.1.2 Broad options for meeting the objectives should be identified

Once a decision has been made to go ahead with PPI, and there is a clear view of the objectives that can realistically be achieved, the government will have to consider the main options for PPI. This will be a major and complex decision because the government will also need to decide on the following issues:

- the degree of risk transfer;
- the mechanism for protecting consumer interests – market, contract or regulation; and
- the structure of the industry.

The options for feasible private sector involvement will also vary among projects.

In addition, all elements of the reform program must be consistent. For example, an option that seeks to transfer substantial risk to the private sector should not be combined with a highly prescriptive contract that limits the ability of the new owners to manage that risk; and an option that relies on competition to protect consumer interests should not be combined with an industry structure that gives too much market power to one participant.

2.1.3 Risks should be allocated between government and the private sector

The degree of risk transfer will be reflected in the form of the program. This should be based on analysis of the desirable and feasible level of risk transfer. The forms of PPI range from, at one extreme, service contracts, through, at the other extreme, the sale of assets. Figure 2-1 illustrates the spectrum of approaches.

The main options are:

- **Service contracts (2–5 years)** Private companies are employed for certain narrowly defined and specified tasks (e.g., billing services). The responsibility of the private company is limited to the specified service. The service contract is paid for in a fixed fee by the public authority. The degree of risk transferred to the private sector is limited to the service task.
- **Management contracts (3–5 years)** Management contracts extend a service contract to include the management of the company as a whole, so that management risk is transferred to the private sector. Payment is usually a fixed fee, though a portion of the total value may be covered by a bonus.⁴

⁴ See survey by Shirley and Xu "The Empirical Effects of Performance Contracts" World Bank, Policy Research Working Paper 1919, 1998.

- **Leases (10–12 years)** The private sector operates the system for a given period, but assets remain state-owned. The public sector generally remains responsible for financing new investment, and the private company for working capital and maintenance. The private sector is also responsible for collecting revenue, that it uses to fund its operations, while more risk is allocated to the private sector.
- **Concessions (15–30 years)** The private sector both operates the system and is responsible for new investment for a period of time defined in the concession agreement. At the end of the contract, the concessionaire hands over the system and is paid the residual value of the existing assets. Depending on the existence of government guarantees, the operational, financial and investment risk transferred to the private sector may be commensurate with an asset sale.
- **Greenfield contracts (10 years to indefinite)** Greenfield investment refers to the construction (and potentially operation) of a new project (e.g., a new power plant on a site, a greenfield, that had not previously had any generating facilities on it). When greenfield investment is required a series of other arrangements allows the government to transfer the risk of construction and operation to the private sector. These arrangements are summarized below.

Types of Greenfield investment

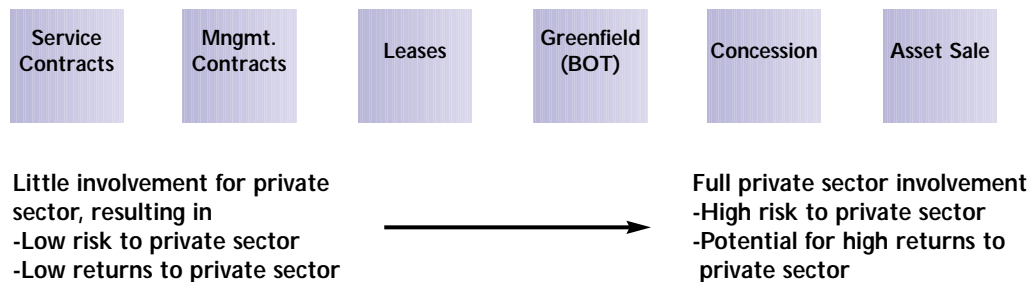
The jargon can be confusing! This is a list of the more common abbreviations to describe greenfield investment structures and their allocation of responsibilities.

| | |
|------|---|
| BOT | Build, operate and transfer |
| BOO | Build, own and operate |
| BOLT | Build, operate, lease and transfer |
| BLOT | Build, lease, operate and transfer |
| DBFO | Design, build, finance and operate |
| ROT | Rehabilitate, operate and transfer ⁵ |

⁵ ROT is not a greenfield project but is included in the list because the form of contracts and risks transferred are similar to the other forms of contracts.

- **Asset transfer (indefinite) - trade sale or flotation:** A full asset transfer, whether sold to individual companies or floated on the stock exchange, results in the private sector purchasing the existing facilities. The private sector then has full control over the ownership and operation of existing assets and the construction of new assets without any future obligation to return those assets to the government, or any other party. At the same time, the assets are freely transferable to other private sector institutions.⁶

Figure 2-3
The risk spectrum of PPI options⁷



The degree of risk transfer needs to be consistent both with the objectives and with the overall approach to private sector participation. Where consumer interests can be protected indefinitely through competition, solutions with a high degree of risk transfer may be appropriate. Where the government wants to maintain a loss-making service, a lower degree of risk transfer will be appropriate because the service would simply stop if the private sector fully assumed the risks, unless the operator is subsidized by the public sector.

Recommendation 2.2: The government should structure the contract for sale or services based on an allocation of risks that is consistent with its objectives, and with the overall approach to private sector participation.

2.1.4 It needs to be clear how consumer interests are protected

While government provides infrastructure services, consumers are protected – with varying effectiveness - through the normal processes of government. Private providers will have a strong incentive to maximize profits from infrastructure provision. It needs to be clear how consumer interests will be protected in this new environment.

The simplest and most effective way of protecting consumer interests is through a competitive market. If suppliers fail to meet consumer needs, they will also fail commercially. Many governments have withdrawn from direct provision, and now rely on competition. **Where it is feasible, reliance on a competitive market is by far the best solution.**

⁶ In practice there are many forms of asset sale. Under some conditions the government retains a golden share which allows it to veto certain decisions (e.g., the sale of the assets to another party). This option may be selected either because the government wants to prevent sensitive assets from being sold to particular parties (e.g., foreign ownership of a port also used by the navy) or to prevent potentially anti-competitive activities (e.g., a generation company owning the transmission network).

⁷ This spectrum provides only an indication of the relative allocation of risk; actual project details will affect the true allocation. For example, a concession agreement may result in greater transfer of risk to the private sector than an asset sale if the sale is accompanied by government guarantees for minimum price, revenue or volume of business.

Infrastructure services have often been thought of as natural monopolies. In other words, it is inefficient for several companies to provide a service because of the high fixed costs. This makes competition difficult. The transmission and distribution networks are typically natural monopolies. Both bulk suppliers and retailers need to access them if they are to supply final consumers and it is inefficient to have numerous, overlapping networks. Where one source of bulk supply dominates – the main water catchment, a gas field with substantially lower costs, or a large power station that dominates the market – this also reduces the scope for competition. In transport, regions that have only enough traffic to support one highway or one port terminal must contend with the monopolistic traits of infrastructure, although competition between modes of transport may still be possible.

Where private sector participation is sought in areas of natural monopoly, governments have often relied on regulatory solutions to prevent an abuse of monopoly power. This allows the outright sale of these assets, but makes it clear that their prices will be regulated indefinitely. Typically, the regulator's objectives are set in legislation, but the regulator is given independence and discretion in meeting them. The overall objective – from the investor's viewpoint – is to maximize profit subject to constraints imposed by the regulator, consumers and others.

Regulatory solutions create higher risks than competitive solutions. Investors will be concerned that there will be political pressure on the regulator. Even if there is no direct pressure, regulators may be concerned to protect consumer interests and reluctant to recognize the substantial risks attached to investment. **As a result, regulatory solutions need strong attention to the independence and competence of the regulators.** This is discussed in section 2.2.

A third option is to protect consumer interests through contract. This may be an appropriate option under three circumstances:

- as an evolutionary stage, before regulatory institutions are fully formulated and operational;
- in sectors characterized by short-term, rather than indefinite, operation of infrastructure (e.g., solid waste collection);
- for management contracts where the government is unable to create a suitable regulatory structure.

Contractual solutions may appear to create fewer risks than regulatory solutions because contract law is largely well established, while regulatory law and practice are relatively untried. However, contracts are less flexible than regulatory tools. The longer the contract period, the greater the likelihood that contract management will increasingly adopt similar features to a regulator. The contract's effectiveness breaks down when it is unable to absorb new information, and use that information to reset prices and the obligations of providers.

Where contractual solutions are adopted, performance audit will be an important component of contract management. This will involve establishing realistic but challenging performance targets for the private sector operator and then monitoring the operator's performance to ensure these targets are met.

2.1.5 Industry structure needs to fit with the approach taken

The success of any PPI process depends on selecting the appropriate industry structure. For example, solutions based on competition require that multiple companies supply a service. They also require that the monopoly networks be separated from potentially competitive parts of the industry. Creating multiple companies at one level – e.g., several generation companies or individual airports – is known as horizontal separation. Vertical separation refers to the break between levels - e.g., separating generation from transmission, or airport terminals from runways.

Contractual solutions may have fewer requirements for changes to industry structure. For example, a number of countries have franchised out operation of the power or water sectors as a whole. Public transport may be franchised with the network and the services integrated.

Recommendation 2.3: The approach taken to industry structure should be consistent with the overall objectives, with the degree of risk transfer and with the mechanism used to protect consumer interests.

2.1.6 The options should be appraised against the objectives

Once the options have been identified, they need to be assessed against the objectives. This process is known as appraisal.

The form appraisal takes depends on the objectives. Table 2-1 illustrates a possible appraisal of options for risk transfer, assessed against four objectives. The assessment makes it clear that if the government's main objectives are to improve efficiency and to finance investment, they should seek high degrees of risk transfer. If their main objective is to maintain control of the level of provision – perhaps for political or national security reasons – they may aim for lower levels of risk transfer.

The table is only illustrative. It shows that appraisal requires analysis of how well different options meet objectives, so that the government can choose among them. It is also important that the appraisal takes account of the likely level of market interest: a reform that appears well designed, but which seeks to transfer risks the private sector is unwilling to accept, will not be successful.

Table 2-1
Objectives met by different forms of PPI

| Government objective | Service contract | Management contract | Leasing | Green-field | Concessions | Divestiture |
|--|------------------|---------------------|---------|-------------|-------------|-------------|
| Improve efficiency | ✓ | ✓ | ✓ | ✓✓✓ | ✓✓✓ | ✓✓✓ |
| Transferring investment risk | X | X | X | ✓ or ✓✓✓ | ✓✓✓ | ✓✓✓ |
| Improving quality of service ⁸ | ✓ | ✓ | ✓✓✓ | ✓✓✓ | ✓✓✓ | ✓✓✓ |
| Maintaining control of the service provision | ✓✓✓ | ✓✓✓ | ✓ | X | ✓ | X |

Key: ✓✓✓ to a large extent; ✓ to a small extent; X not usually.

2.1.7 Governments also have transitional objectives...

Governments are likely to have transitional, as well as long-term, objectives. They may need to complete a transaction within a particular timetable – for example, to fit in with the electoral cycle. They will need the objectives to fit within a budget. They are likely to have concerns over regional impacts and the impact on the labor force, even if these are temporary rather than long-term concerns.

The appraisal should also reflect these transitional objectives. Reforms need to be politically acceptable and achievable.

2.1.8 ...and will need to gauge stakeholder support

The successful implementation of PPI programs will require the support of a wide range of stakeholders, from employees through consumers to potential investors.

Assessing investor interest

The government and/or its financial advisors should fully assess the degree of investor interest in a project.

A large element of basic infrastructure is unattractive to private investors. This does not preclude the use of the private sector to improve efficiency in specific areas. An example in the ports sector is a container terminal located at a site suitable as a potential hub port for liner services, but which requires basic infrastructure that does not exist. Bids are sought from international consortia in the (mistaken) belief that an efficient container terminal operation can bear the costs of breakwaters, dredging and reclamation, to provide a navigable harbor and shipping channel. The project fails without securing a deal, after much effort and money have been expended. In such circumstances some degree of public subsidy will be required.

⁸ There is a difference between improving efficiency and improving service quality. Efficiency is defined as the ratio of inputs to outputs. This ratio can remain the same even though the quality of the service changes.

Consequently, an important part of the appraisal will entail assessing the extent to which each of the PPI options will attract support from investors, from the public, and from the government.

Once this has been assessed, the government will need to identify those stakeholder groups whose legitimate interests will be affected by the reform and to establish ways of resolving related conflicts. The government may also need to consider how to build a better understanding of the reform issues (including a willingness to adapt in the face of legitimate stakeholder concerns) and to build support for each of the reform options.

2.1.9 Based on this analysis, the government needs to choose the form of PPI

The appraisal should lead to an approach that meets the government's objectives. Before starting work on the legal framework and the transaction, the government needs to decide the preferred option.

Figure 2-4 presents an illustrative flow chart that outlines the steps leading to the choice of the form of PPI. In essence, the flow chart summarizes the implications of the differing constraints, described in Section 2.1.6, on the choice of PPI.

Each form of PPI is a means to an end and not the end itself. Therefore, the answer to each of the questions depends on two main factors:

- the government's objectives; and
- the characteristics of the assets and sector in question (i.e., the constraints).

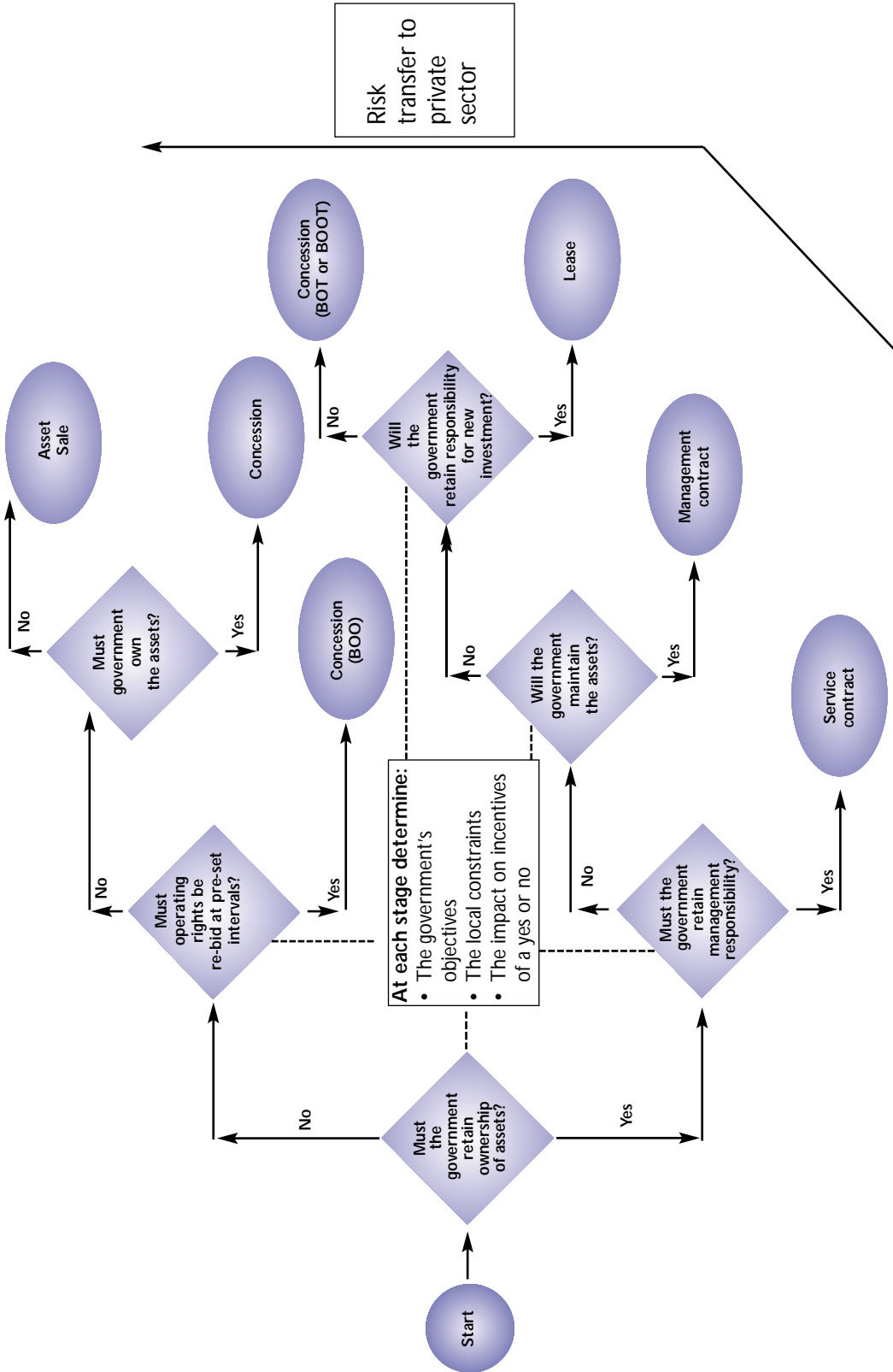
Each country or region will have characteristics that will determine the answers to the questions posed in the flow chart.

The importance of managerial control

Whenever the private sector is asked to incur the operational risk of a company, one of the most important factors potential bidders take into account is the degree to which they will have effective control over the employees. All of these approaches transfer responsibility for company performance to the private sector. However, private operators will only accept this responsibility if they think they have sufficient control in order to meet the requirements set out in the contract or to ensure a return in the case of an equity sale. The most important form of control is often control over employees.

Whether or not each of these forms of PPI is compatible with transferring power over employees depends on the legal and administrative structure of the country in question. For example, in India, where several states have embarked on private participation in the power sector, the current employment contracts in the government-owned companies contain clauses that make it difficult to transfer control over the employees to a private company that does not *own* the assets. Consequently, the ability to use management contracts, leases and concessions to create efficiency gains (and even to attract the private sector) is severely limited. Therefore, states that are currently reforming their power sectors are choosing to go down the route of an equity sale.

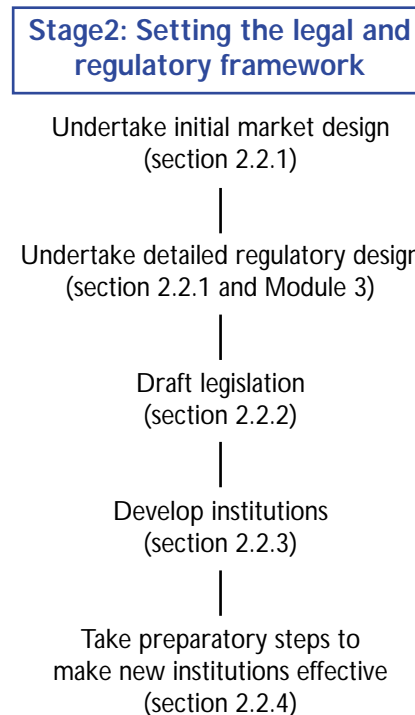
Figure 2-4
Choosing the appropriate form of PPI



2.2 Stage 2: Setting the legal and regulatory framework

Stage 1 is concerned with choosing the form of PPI. Once this is complete, Stage 2 is concerned with establishing the appropriate legal and regulatory framework for the chosen form of PPI. This involves building on the preliminary analysis undertaken in Stage 1 as part of option appraisal. Figure 2-5 outlines the steps in this stage.

Figure 2-5
Setting the legal and regulatory framework



2.2.1 *The market structure and regulatory framework need to be designed*

Once the policy work has identified a preferred option at a broad level, it becomes necessary to design the appropriate market and regulatory framework. There should be a gradual progression from initial design to detailed design, which can form the basis of legal drafting.

For example, the policy work may have identified a need for privatization of gas transmission, against long-term regulation. Initial design now needs to consider in greater detail which services and assets are regulated: whether prices, revenue or a mix of the two are regulated, on which basis regulated revenues or prices are reset and how frequently, and a series of other decisions.

Similarly, policy analysis may have concluded that there should be a competitive market for wholesale electricity. Market design will now need to consider, for example, whether this applies to all generators, or only to those above a certain size; whether all energy is traded through the pool, or only at the margin; whether there are separate markets for energy and capacity, or whether these are integrated; whether all generators receive the system marginal price, or whether they are paid their own bid price.

During the design stage, advisory inputs need to start with high-level conceptual design before moving towards detailed technical design which can be incorporated in documentation. Module 3 describes the role of advisors in that progression.

2.2.2 Legislation and subsidiary legal instruments are needed

Where assets are being sold into a fully competitive market, there may be little need for specific legislation. General legislation governing consumer protection, property rights and competition law may be sufficient. This will be the case, for example, where a government sells an airline or bus company that is subject to strong competition.

Infrastructure will rarely be as straightforward. Even where competitive solutions are adopted, they will usually rely on specific legislation to establish the market. Where regulation is needed, it may need to be underpinned by legislation.

Once detailed design is completed, work should start on drafting legislation and other legal instruments. The documents required will vary from case to case, but might include:

- the legislation itself;
- licenses, which impose obligations on market participants;
- a code that describes the functioning of the market; and
- a variety of quasi-legal documents establishing the approach to regulation.

Contracts for private sector participation are likely to have fewer requirements for legislation. Contract law will govern the contract itself. The policy objectives of the government can be embodied in the contract.

2.2.3 The main institutions need to be established and developed

It is important that progress is made on the key institutions before a transaction is completed. Private investors will be exposed to decisions made by these institutions and will want to examine their independence, their competence and the extent of their powers. It is far easier to examine these issues once the key personnel are in place and operational practices established.

In establishing a regulator, decisions will be needed on:

- how the regulator's independence is safeguarded – this is likely to be reflected in legislation;
- whether there is a single regulator, or separate regulators for different sectors; and
- whether regulators have national or regional coverage.

Regulators tend to have wide discretionary powers. It is therefore important to balance the regulator's accountability against the discretion it requires.

Contractual solutions may have less need for new and autonomous institutions.

However, an individual or department within government will have to monitor the contract and be the first point of contact for the contracted party.

These institutions will need capable staff. Some can be recruited. A number of countries have attracted nationals working abroad or ex-patriots working in the country to fill regulatory positions. However, most staff will need to be trained and developed.

2.2.4 Preparatory steps should be taken to make these bodies effective

The preparatory steps needed to make these new institutions effective can proceed at the same time as other steps already underway to attract private sector participation.

In many cases asset valuations will be needed

The financial valuation of existing assets is important for the government when PPI occurs through leases, concessions or asset sales. Although the private sector will undertake this on its own account, the government is also likely to undertake the task in order to provide an appropriate benchmark for the sale price, and to form the basis of any regulated tariffs.

The valuation will involve three main steps: first, preparation of an asset register, which simply lists the assets; second, a review of the condition of the assets; and third, valuation of the assets.

The economic value of any asset is the value of the future net cash flows earned by that asset, discounted by an appropriate cost of capital (discount rate).

In practice, valuation can be complex. The estimation of discounted cash flows requires details of:

- estimates of future sales;
- prices and collection efficiency;
- estimates of future operating efficiency and performance;
- estimates of future operating costs;
- estimates of future capital expenditure and sources of financing;
- current levels of debt and debt service costs;
- taxes payable; and
- choice of an appropriate cost of capital.

Asset bases may be valued for accounting purposes in a number of ways. The asset base is often reported in historic cost terms (i.e., the cost of the assets when they were originally installed), in current cost terms (i.e., the cost of replacing the asset base with the same assets today), or in terms of modern equivalent assets (i.e., the cost of replacing the asset base with different, modern assets that perform the same service). The choice of the methodology for valuing assets in different sectors will vary on a case-by-case basis. The results of the various valuations are generally made available to potential investors in a data room (see Module 3).

The private sector will use the information on the various valuations when preparing bids for the concession or assets. In any initial valuation, government officials, with their advisors, will need to assess:

- the current level and standards of service;
- the potential level and standards of service;
- the location and quality of the assets;
- the likely level of demand in the future; and
- the likely level of required investment.

The interaction between the newly valued asset base and the regulatory regime's revenue control has important implications for the provision of incentives to private companies. The design of both the form of PPI and the specific contract in question must incorporate these effects.

Regulatory duties need to be defined

The range of duties the economic regulator will be required to undertake will vary according to the form of PPI introduced. In general, however, the main tasks could include:

- **Price or revenue regulation** This can be achieved through a spectrum of approaches, from price-caps to rate of return to sliding scale regulation.
- **Quality of service regulation** Some form of performance monitoring, as well as price-monitoring, will be required to ensure that standards of service are maintained. Examples of performance indicators include measures of supply interruption for water, gas and electricity; connection time for telecommunications services; and regularity of service for transport.
- **Ensuring security of supply of services** Services provided by energy, water, transport, waste and telecommunications companies are all necessities to some degree. While major consumers may negotiate security of supply, most consumers are exposed to a common quality. The regulator needs to set this.

There may be a need to design tariffs

Where government is entering a contract, it needs to design a tariff for the services it is purchasing. For example, a contract for a water supply plant will need to determine the tariff against which the operator is paid. Where government is supporting a loss-making service – for example, a public transport franchise – it will need to determine the tariff that applies to final consumers.

In many cases, tariffs can also be set through a competitive bidding process. For example, a public transport franchise could define the quality of service required and seek bids for the lowest tariff required. Alternatively, bids can be let on the basis of the lowest subsidy required to supply services at a given tariff. Even then, some room should be left for innovation, and for the introduction of tariffs that may give consumers new options.

The appropriate structure of tariffs will need to reflect:

- the degree to which tariffs require regulatory oversight;
- the extent to which it is both desirable and appropriate to charge customers differently;
- the desire to meet wider social policy concerns through tariff design; and
- the extent to which prices should provide incentives to both consumers and suppliers.

Where tariffs are regulated, the form of regulation needs to be clear

In addition to the tariff design, decisions must be taken on how tariffs will be regulated. This is particularly important in the context of full or partial divestiture of assets. Options for regulating prices range from rate of return regulation to price cap regulation.

Under rate of return regulation, the regulator places a limit on the returns earned by invested capital and may also place restrictions on the dividends payable to share holders and on accumulated capital reserves. Under price cap regulation, the regulator limits price increases, often by a certain amount below inflation over the regulatory period⁹. This approach entails the regulator assessing, on a forward looking basis, the likely levels of capital and operating expenditure over time, and potential efficiency increases.

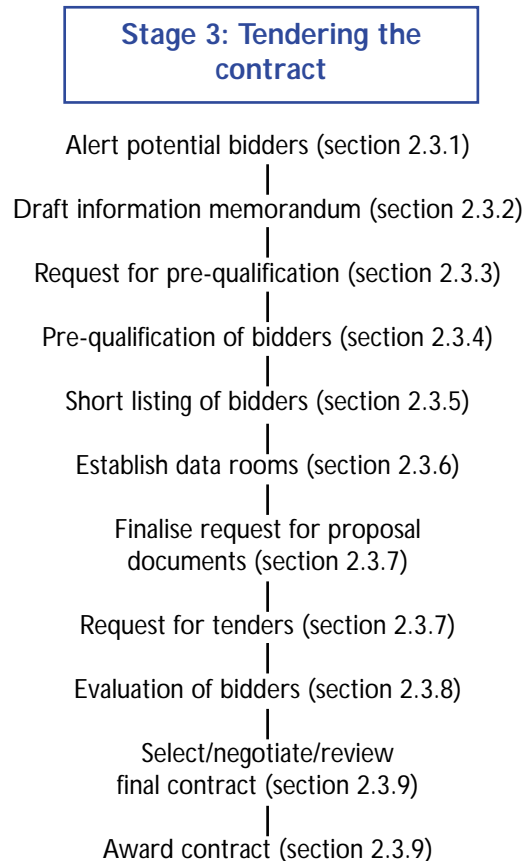
Recommendation 2.4: Government officials should prepare drafts of the documentation required to establish the legal and regulatory framework required before the transaction. These drafts should be sufficiently advanced to convince potential investors that they will be implemented.

⁹ See Further Reading, Vickers and Yarrow (1998), at the end of this Module for a full description.

2.3 Stage 3: Tendering the contract

The third stage of the PPI process should end with the government selecting a private sector partner. As illustrated in Figure 2-4 a successful transaction depends on a number of intermediate steps.

Figure 2-6
Tendering the contract



The timetable for these steps will vary according to the form of PPI chosen. The award of a management contract should be completed over a relatively short period compared to the award of a 20-30 year concession. Figure 2-7 illustrates some indicative time profiles for the implementation of different forms of PPI (see Module 4 for more detail). The profiles are only intended as a guide to the time required to agree and implement a contract. The exact time needed will vary by country and by sector. A country that has all the relevant legal and regulatory frameworks needed for a successful divestiture in place will require less time to flotation than a country with no such structures in place. The valuation of assets or design of tariffs may take longer in some sectors than in others. As a country introduces more private sector participation, the time taken to complete transactions is likely to fall.

Asset valuation in the water industry

One difficulty with valuing assets in the water industry is that much of the distribution infrastructure – trunk mains and local pipe networks – is old and underground. This can make it very difficult to locate, let alone value, the assets. Past hyperinflations and currency devaluations will also impact on valuations. Various methodologies are available, including sampling techniques and leakage estimation, to estimate both the extent and condition of the network. Even so, asset valuation in the water industry can take considerably longer and is subject to greater uncertainty than in other infrastructure industries. This uncertainty could have implications for the length of time required to implement a PPI transaction.

Figure 2-7

Indicative timetable for reform

| Form of PPI | Months | | | | |
|---------------------|-----------------------------------|------|-------|-------|---------|
| | 1-6 | 6-12 | 12-18 | 18-24 | over 24 |
| Service contract | [Bar extending to 6 months] | | | | |
| Management contract | [Bar extending to 12 months] | | | | |
| Lease | [Bar extending to 18 months] | | | | |
| Greenfield contract | [Bar extending to over 24 months] | | | | |
| Concession | [Bar extending to over 24 months] | | | | |
| Divestiture | [Bar extending to over 24 months] | | | | |

Note: See Module 4 for more detail

2.3.1 Potential bidders need to be alerted to the opportunity

As part of the appraisal of options, government officials or their advisors will have undertaken a preliminary survey of potential investors, which will have raised investor awareness of the proposed reform. However, a more extensive promotion is needed as the transaction draws near.

Before starting the bidding process, informal discussions may be useful to determine whether the investors invited to participate in the pre-qualification stage are the most appropriate ones. Pre-bid discussions can also provide useful information on what can be done to attract favorable bids.

Information can be disseminated through pre-bid conferences and the international and national media. In all cases, all potential bidders should receive the same data and material, so that no potential bidder has additional information that may help it win the contract.

Finally, large PPI transactions frequently include international roadshows to ensure investor interest. The role of public relations consultants in this process is discussed in Module 3.

2.3.2 An information memorandum should give bidders detailed information – and drafting should start early

The information memorandum will set out what the government hopes to achieve and how, the scope of the proposed project and what is to be delivered. The better the information made available to bidders, the higher the bid quality. Given the importance of the information memorandum, drafting the relevant documents should begin early in the PPI process.

This requires an upfront decision on the allocation of risks between the government (or the public representatives) and the private sector. This decision partly depends on the PPI option chosen and partly on the specific risks associated with the project in question. Table 2.2 outlines these risks in more detail. The table should only be treated as a guide: whether risks can be transferred, and whether it is appropriate to transfer them, will depend on specific project circumstances. In all of these areas there are international examples which can be adapted and from which lessons can be learned. However, there are no off-the-shelf solutions. As a result, progress towards detailed design will need to draw on both international experience and analysis of the situation within the country concerned.

An information memorandum is a much more in-depth description of the company to be privatized or PPI project than that provided in the request for proposals¹⁰. Because financial advisors are usually hired to market a particular transaction, they are often responsible for preparing the more detailed document and for presenting the transaction in the most favorable light (see Module 3 for details on financial advisors). The information memorandum does not only report facts; it also analyzes them and presents the various possible scenarios. In other words, financial advisors complete some of the due diligence most of the serious bidders will do themselves, thereby increasing the chances of attracting high quality bidders.

Lexicon of bidding terminology for investment

Advisors – individuals, companies or consortia assisting the government with the PPI process. Bidders may also seek assistance from outside advisors.

Bids – the price and detailed documentation that each bidder submits in response to a request for proposals

Bidders – individuals, companies or consortia competing for the PPI contract

Contractors – usually, those companies providing building or construction services

Consultants – see Advisors

Data room - a single location containing commercially confidential information that bidders may need in the course of preparing their bids

Financial close – Point at which all the conditions of the financing agreements have been met, all the finance is available and the contract becomes effective

Financiers – all lenders or potential lenders providing debt for a project

Information memorandum – document provided to shortlisted potential investors covering relevant financial, legal and technical information

Investors – entities or individuals participating in the equity and/or subordinated debt of project companies set up to implement projects

Offering memorandum – documents that provide details of assets to be sold to investors

Preferred bidder – sole bidder selected after the bid evaluation process to commence negotiations aimed at concluding a signed contract

Roadshow – series of meetings held in different locations aimed at promoting an investment opportunity to potential investors

Strategic investor – an investor with operating experience in the sector who intends to purchase a large or controlling share in the equity of the project company for a substantial period of time

Special Purpose Vehicle (SPV) – project company set up to implement projects

Suppliers – companies or individuals providing goods or raw materials

Tenders – see bids

¹⁰ Also known as the requests for tenders or the invitation to tender documents.

Table 2-2
Risk identification and allocation in project financing

| Risk | Nature | Allocation | Mitigation |
|--|---|---|--|
| Design risk | | | |
| Design mis-specification (I) | Design does not meet request for proposal (RFP) specifications | Construction company | Construction company has responsibility for designing and building contract to specifications. |
| Design mis-specification (II) | Design fault in tender specification | Public sector | Public sector bears any resulting cost increases |
| Construction risk | | | |
| Construction cost overruns | Due to actions within construction company's control (e.g., wastage) | Construction company | Fixed-price contract and use of liquidated damages (LDs) payable by construction company |
| Completion delay | Due to actions within construction company's control (e.g., lack of co-ordination of sub-contractors) | Construction company | Use of LDs payable by construction company |
| Failure to meet performance criteria at completion | Quality shortfall, defects in construction and other faults | Construction company | Use of LDs payable by construction company. Once exhausted, project company bears costs |
| Operating risk | | | |
| Operating cost overruns | Change in operating practices at request of project operator | Project company | Project company returns eroded |
| Changes in price of inputs | Increased prices for fuel supplies, labor and other inputs | Party best able to control or bear risk | Use of hedging at supplier or project company's expense, pass-through to consumers |

Table 2-2: (continued)

Risk identification and allocation in project financing

| Risk | Nature | Allocation | Mitigation |
|------------------------|--|--|--|
| Non-delivery of inputs | Failure to supply fuel and other inputs of sufficient quality or quantity | Supplier | Supplier pays costs of sourcing alternative supplies and any compensation due to consumers |
| Demand (I) | Variation of demand from forecast levels, for reasons beyond control of government | Project company exposed to both increases and decreases in demand. | Risk spread among financiers; investment in a range of project diversifies risk. |
| Demand (II) | Failure of predicted demand to emerge for reasons within control of government | Public sector | Contractual protection against interventions which reduce demand |
| Commercial risk | | | |
| Tariff changes (I) | Changes in market prices | Project company | Project company returns eroded |
| Tariff changes (II) | Failure to implement contractual changes in tariffs | Public sector | Public sector compensates project company for deviation from contracted levels |
| Tariff changes (III) | Change in demand arising from tariff adjustment by company | Project company | Must analyze revenue changes from impact of tariff changes on demand |

Source: Frontier Economics and Submission and Evaluation of Proposals for Private Power Generation Projects in Developing Countries, IEN Occasional Paper # 2, World Bank and USAID, 1994.

2.3.3 Bidders may be asked to prequalify

Request for proposal documents should be disseminated to enough suitably qualified potential investors to ensure sufficient competition, but not so many that it is difficult to evaluate all the proposals. One way of ensuring this is through the process of pre-qualification, beginning with requests for Expressions of Interest (EoI).

One method of requesting expression of interests is by placing advertisements in appropriate trade journals or other publications. Placing advertisements on the Internet may also be an option. The advertisements should contain a description of the potential investment opportunity. They should also invite potential bidders to make themselves known with evidence of their suitability by a certain date.

2.3.4 Only well qualified bidders should be let through

The potential investors or operators who have expressed interest in the project and provided the requested information should be evaluated against the minimum standards set for technical capability, financial and economic standing and ability. Officials can devise tests aimed at profiling suitable bidders and assessing their financial strength and/or technical capabilities.

The purpose of this stage is to assess whether bidders are capable of submitting a bid, and whether risks to government, including financial risks, can be adequately managed. It is not intended to substitute for detailed financial proposals for the particular project.

There is an argument that pre-qualification and the derivation of a shortlist may not be necessary. This argument suggests that in general, potential investors will only bid if the investment is worth their while and therefore will not submit bids if they are unable to carry out the necessary functions. However, in practice, governments often want to ensure that bidders have minimal technical competence and use shortlists to eliminate firms without the required technical abilities or financial strength. Pre-qualification also provides a mechanism for screening out speculative bidders, that would, if their proposals were taken further, waste time and money.

To maintain the integrity of the process, these tests, once passed, should not be revisited. Officials should not re-evaluate the shortlist unless new information emerges that casts doubt on the original assessment.

By evaluating the information supplied and applying a minimum standard to all respondents, officials will arrive at a list of bidders who qualify for consideration in the next stage of the process. Shortlisting will result in a list of companies that are invited to submit formal bids (possibly after further data-gathering). If no shortlisting takes place, all respondents are free to submit a final bid.

2.3.5 If there are enough bidders, a short list of qualified bidders can be prepared

A pre-qualification exercise will produce a list of qualified candidates who pass the minimum standards. In some cases, officials will wish to invite all of these bidders to take part in the competition.

However, in other cases, the list of pre-qualified bidders will contain more parties than can be sensibly accommodated in the subsequent tender process. Officials may

streamline the list if they are in a position to score the relative merits of the bidders' competence, and so rank them and select the required number from the resulting list. If they follow this route, officials should institute an objective and fair scoring system based on the published criteria. They should also inform any bidders not taken forward why they were not selected. Providing a limited short list may also increase the interest of those shortlisted because it increases their chances of winning.

2.3.6 Data rooms should give all bidders access to sensitive information

The purpose of the data room is to make available to potential bidders commercially confidential information that they need to draw up their bids.

What is a data room?

A data room is a single restricted-access location, usually in the country where the investments will be made, containing commercially confidential information that bidders may need to prepare their bids. The types of information the data room contains will include the results of technical audits and evaluations, financial information, environmental and ground studies, traffic or other nuisance studies, land ownership details, current relevant laws, and information on human resource issues.

The data room will need to be staffed to ensure security. Visits should be by appointment only to preserve the confidentiality of interested bidders. The legal advisor can organize this process.

Given the difficulties of collecting data relating to assets in some infrastructure industries, it is worthwhile starting this process as early as possible in the PPI program.

2.3.7 Final request for proposals should be sought

The documentation requesting final proposals must be clear and informative. It should outline the minimum information required for any assessment of the potential bidder's economic and financial standing and technical capacity, and the criteria for award. The information memorandum or the letter accompanying the request for proposals should include the full information requirements needed for the assessment.

In addition, bidders may need further access to the data room and may be expected to conduct more detailed due diligence at this stage.

In some cases potential bidders have been required to purchase the request for proposal documents. This can be used to demonstrate the seriousness of the potential bidder and to cover a portion of the costs of the PPI process.

2.3.8 Bidders should be evaluated

Officials will need to evaluate the bids received in accordance with the principles and criteria set out in the invitation to tender documents. It may be necessary to prepare questionnaires for each evaluator to use as a basis for marking the proposals. The project team will need to establish procedures for transparent communications with bidders and document control in order to maintain the integrity of the evaluation process.

The following issues must be addressed prior to the evaluation of the bids (i.e., when the bidding process is being developed).

- Are both technical and financial bids required (and, if so, how should they be weighted?) or only financial bids?
- Is a technical benchmark to be used with all of those who clear it evaluated solely on a financial basis?
- How are technical or financial bids that are innovative and meet the government's objectives but do not comply with the original invitation to tender to be evaluated?
- If multiple contracts or equity participation are being bid, how are multiple bids to be evaluated?

2.3.9 Contract award and post-evaluation negotiations

There will be a few remaining tasks to be completed after the contract has been awarded.

Government officials will need to negotiate and, depending on the form of PPI, sign a series of contracts with the project participants. Detailed schedules on the project documentation will need to be completed, drafting issues resolved and financing documentation put in place. Various government guarantees, such as the guaranteed availability of foreign exchange, may be required.

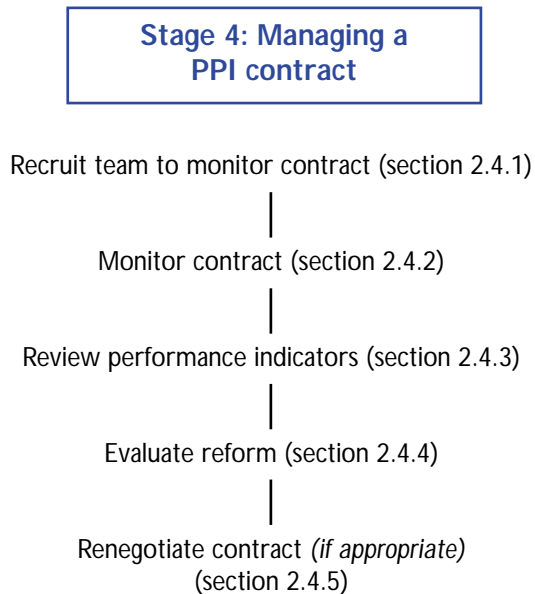
These post-bid processes can be lengthy and sufficient time must be allocated for them. Detailed contract negotiation is also the stage at which the security arrangements for the government, embodied in the contract, become clear. For this reason, it may be necessary to negotiate contracts with several bidders until there is confidence that an adequate contract can be agreed with the preferred bidder. However, this is unpopular with companies because it increases the cost of their bid.

Recommendation 2.5: The government should manage the transaction stage and the bid criteria transparently, to avoid the possibility of decisions being challenged at a later date.

2.4 Stage 4: Managing a PPI contract

When a government enters into a contract, whether this is a concession, a BOT or a lease, it will require active contract management. Transactions that rely on competitive markets or an independent regulator will have less need of government involvement in management once the transaction is complete.

Figure 2-8
Managing a PPI contract



Contract management involves ensuring that the respective roles and responsibilities set out in the contract are fully understood and met to the standards laid out in the contract, in order to fulfil the government's overall objectives. Part of the contract management process will involve establishing procedures and the institutional units to monitor the contract, and taking appropriate action where contractual obligations are not met.

The exact range of tasks in stage 4 of the PPI process will depend on the form of PPI chosen (e.g., if divestiture has been chosen these steps do not apply). It will also depend on whether there is an independent regulator and, if there is, the exact range of tasks allocated to it.

2.4.1 Establish contract management team

Irrespective of the final terms and conditions included in the contract, some form of contract monitoring will be required to assess whether the private sector provider is providing the appropriate range of services to the agreed standard. This may involve the appointment of an auditor to verify company records and accounts or to monitor and test operational performance.

To ensure continuity, some of the government officials who worked on the early stages of the PPI process should continue to monitor the performance of the private sector provider. This may involve a transfer of staff from the sponsoring department

to the independent regulator. Where this occurs, it may be appropriate for some officials to be retained within the sponsor department to liaise with, or shadow, the regulatory agency.

2.4.2 Monitor contract

In some circumstances, the contract will specify the relevant performance indicators against which the contractor will be judged. However, it may be necessary for the contract management team to develop these indicators to ensure that the contractor meets its contractual obligations fully.

2.4.3 Review measures

During the course of the contract there should be a review of the key performance indicators. A common problem with the use of performance indicators is that they can provide incentives for the company to distort its behavior and it may be important to evaluate whether this is taking place.

The problem of distorted incentives

A common performance indicator included in a service contract for the provision of customer services for a utility is the proportion of customer telephone calls answered within a minute. But this may provide incentives for the operator to answer calls quickly but to put customers on hold before he or she has dealt with the query. Similarly, performance measures established for train operators such as the number of trains running an hour or more behind schedule could provide incentives for train operators to cancel certain services altogether.

While the use of good performance indicators should circumvent these problems, no set of performance indicators, however comprehensive, will be able to overcome the phenomenon completely. Contract monitoring must therefore include an awareness of the potential for the provider to game the established performance criteria.

2.4.4 Evaluate contract

Once the contract has come to an end, an evaluation of the reform should assess whether it has been successful in reaching the government's objectives, as defined in stage 1. Independent auditors may have a role to play, by assessing the extent to which the private sector provider has adhered to levels of service and quality obligations.

2.4.5 Renegotiate contract

Once the contract is close to completion, the government will need to consider the process of re-appointing private sector providers unless it decides to take the asset back into state ownership. Contract re-negotiation may also be required in the event of pre-determined or agreed changes in circumstances other than that of the contract running its course.

Recommendation 2.6: Governments should set aside significant resources for successful contract management, particularly where it is required to replace or complement independent regulation.

2.5 Variations from the standard PPI process

Figure 2-1 and the discussion in Sections 2.1 to 2.4 provided a general overview of the different steps that contribute to each of the stages in the PPI process and an indication of the sequencing of these steps within each stage. However there are a number of circumstances in which variations to the standard PPI process might occur.

2.5.1 Due to the form of PPI selected

Figure 2-9

Variations from the standard PPI process

| Establish legal and regulatory framework | Service | Mgmt | Lease | Green | Concess | Divest |
|---|----------|------|----------|-------|----------|----------|
| Undertake initial and detailed design | Required | | | | | |
| Draft legislation and other legal instruments | Not nec | | Required | | | |
| Develop institutions | Maybe | | | | | Required |
| Preparatory steps | Required | | | | | |
| - Tariff design | Required | | | | | |
| - Value current assets | Not nec | | Required | | | |
| - Define regulatory duties | Not nec | | Maybe | | Required | |
| - Draft regulations | Required | | | | | |
| Key | Not nec | | Maybe | | Required | |

Depending upon the form of PPI selected the overall timing of the process, beginning with the policy formulation and ending with contract management, will vary. A service contract will be relatively easy and quick to introduce, whereas a full-scale privatization through asset sale may take many years to complete (see Figure 2-7).

The form of PPI will also have an impact on the steps within each stage, because not all the steps will be equally relevant. The introduction of a service contract will rarely require the government to pay significant attention to the issue of the state of the assets, compared with, for example, a transaction leading to privatization through a concession or sale of assets. In particular, the importance of the tasks in stages 2 and 3 depend on the form of PPI under consideration. Figure 2-9 illustrates the extent to which the specific tasks might be needed under different models of PPI.

2.5.2 Sector specific considerations

The specific form of the PPI process will also vary according to the sector under consideration. For those officials seeking sectoral information related to market structure, regulation and the role of the private sector, the sector specialist in the donor agencies working in a given country will be able to provide them with relevant material. One starting point for background information and contacts would be the web-sites of the donor agencies identified in Module 6.

Alternatively, Toolkits and Guides have been developed in recent months to cover the sector-specific processes for PPI in several infrastructure sectors (water, solid waste, ports, and highways). A brief description of those Toolkits, including contact and ordering information follows:

Toolkit for the Private Participation in Water and Sanitation

The World Bank's Toolkit on Private Sector Participation in Water and Sanitation is designed to assist policymakers with three key sets of issues:

- how to choose a private sector participation option;
- how to design the process for refining and implementing the chosen option;
- how to ensure that contracts for private participation in the sector (specifically, management contracts, BOTs and concessions) cover all the relevant issues.

Details on how to order hard copies of the Toolkit from the World Bank bookstore can be found at: (<http://www.worldbank.org/html/extpb/howtoorder.htm>)

The Toolkit can also be viewed on-line at:
(<http://www.worldbank.org/html/fpd/wstoolkits/>)

Guidance Pack on Private Sector Participation in Municipal Solid Waste Management

This publication is designed for municipal officials who are using, or considering using, private companies or commercialized municipal organizations to provide solid waste services.

The *Pack* comprises five separate booklets:

- *Executive Overview*
- *Part II*: description of potential benefits and implementation issues arising from a privatization process.
- *Part III*: overview of the various arrangements for involving the private sector, including checklists, forms, and terms of reference.
- *Part IV*: comprehensive definitions and explanations of specialized terms that are used in Parts II and III.
- *Part V (electronic format)*: sample contracts for both collection and disposal, and select tools from Part III.

This publication has been prepared with the support of the Swiss Agency for Development and Co-operation and The World Bank. It costs £18.50 Sterling plus postage and is available from:

Intermediate Technology Publications Ltd.

email: orders@itpubs.org.uk

Tel: 44-171-436-9761; or Fax: 44-171-436-2013

Toolkit for Private Participation in Highways

This Toolkit, currently under preparation, is expected to guide policy makers through the process of assessing and electing specific public/private partnership options for delivering essential road and highway development-related functions and for assuring the safe, efficient and high quality delivery of services that are responsive to user needs.

In this regard, the Toolkit will:

- Illustrate available reform alternatives.
- Delineate the core and value adding services which modern highway authorities offer.
- Analyze the different possible forms of private sector involvement in the delivery of each type of service.

Particular attention will be paid to ensuring that appropriate economic incentives and regulatory constraints exist to maximize social welfare.

For information on how to obtain the Toolkit, please contact PPIAF (www.ppiaf.org).

Ports Reform Toolkit

The purpose of the Port Reform Toolkit is to provide policy makers with effective decision support in undertaking sustainable and well considered reforms to public institutions which provide, direct and regulate port services in developing countries. In particular the purpose of the Toolkit is to provide public officials with support in:

- understanding the needs, challenges and risks for sector reform and institutional redesign which are emerging from the changing business environment surrounding port operations;
- choosing among options for private sector participation and analyzing their implications for redefining interdependent operational, regulatory and legal relationships between public and private parties;
- preparing legislation, contracts and institutional charters to govern private sector participation;
- managing the transition to increased private sector involvement.

The Port Reform Toolkit will be available on the World Bank Internet site, under the Transport webpage, in March 2001. A CD-Rom is expected to be available by September 2001. Information for ordering the Port Reform Toolkit CD-Rom will be available on the World Bank Transport homepage:
<http://www.worldbank.org/html/fpd/transport/>.

For specific questions on the Port Reform Toolkit, please email Marc Juhel of the World Bank's Transport Division at Mjuhel@worldbank.org.

2.5.3 Sole-sourcing may be appropriate under limited circumstances

Sole-sourcing provides investors with incentives to approach the government with innovative ideas. It is less expensive and much quicker to implement than a competitive tendering process. It may also be an appropriate option where there are relatively few companies operating in a particular market and their track records are well known.

However, sole-sourcing of infrastructure projects also has substantial disadvantages. Sole-sourced projects do not provide the government with an opportunity to evaluate the technical or financial merits of alternative bids. They therefore leave the government exposed to costly mistakes and criticisms of non transparency. Even if the government manages to extract all possible cost savings from its sole-source contractor,¹¹ the lack of transparency may result in a perception that this is not the case. This may lead to court challenges, and opposition from other politicians and the public, all of which could delay the project and increase its cost.

¹¹ A doubtful proposition since the company to whom the work will be sole-sourced is likely to be better informed about the true cost of the project than the government.

Finally, sole-sourced contracts create wide scope for corrupt practices and are consequently regarded with suspicion by most donors, governments, companies and other industry participants.

When deciding whether sole-sourcing is an appropriate way forward, government officials will need to balance the costs and benefits of doing so on a case-by-case basis.

Unsuccessful sole-sourced projects

Maharashtra, India

In the early 1990s an agreement to build a 2000 MW power plant was signed with a private developer on a sole-source basis after the government decided to forgo international competitive bidding. However, in the following elections, opposition parties criticized the scheme based upon the fact that the process was not transparent. Whether or not the scheme did provide value for money became a secondary issue. Instead, all sides were able to level numerous accusations that resulted in the project being tied up in the courts for years.

2.5.4 Unsolicited bids can be incorporated into the PPI process

Because of the reasons outlined, a purely sole-sourced approach is useful only in very limited conditions. In general, pure sole-sourcing may be useful if the project is small and follows previous good experience with the company or individual concerned, and/or the timetable for reform is tight.

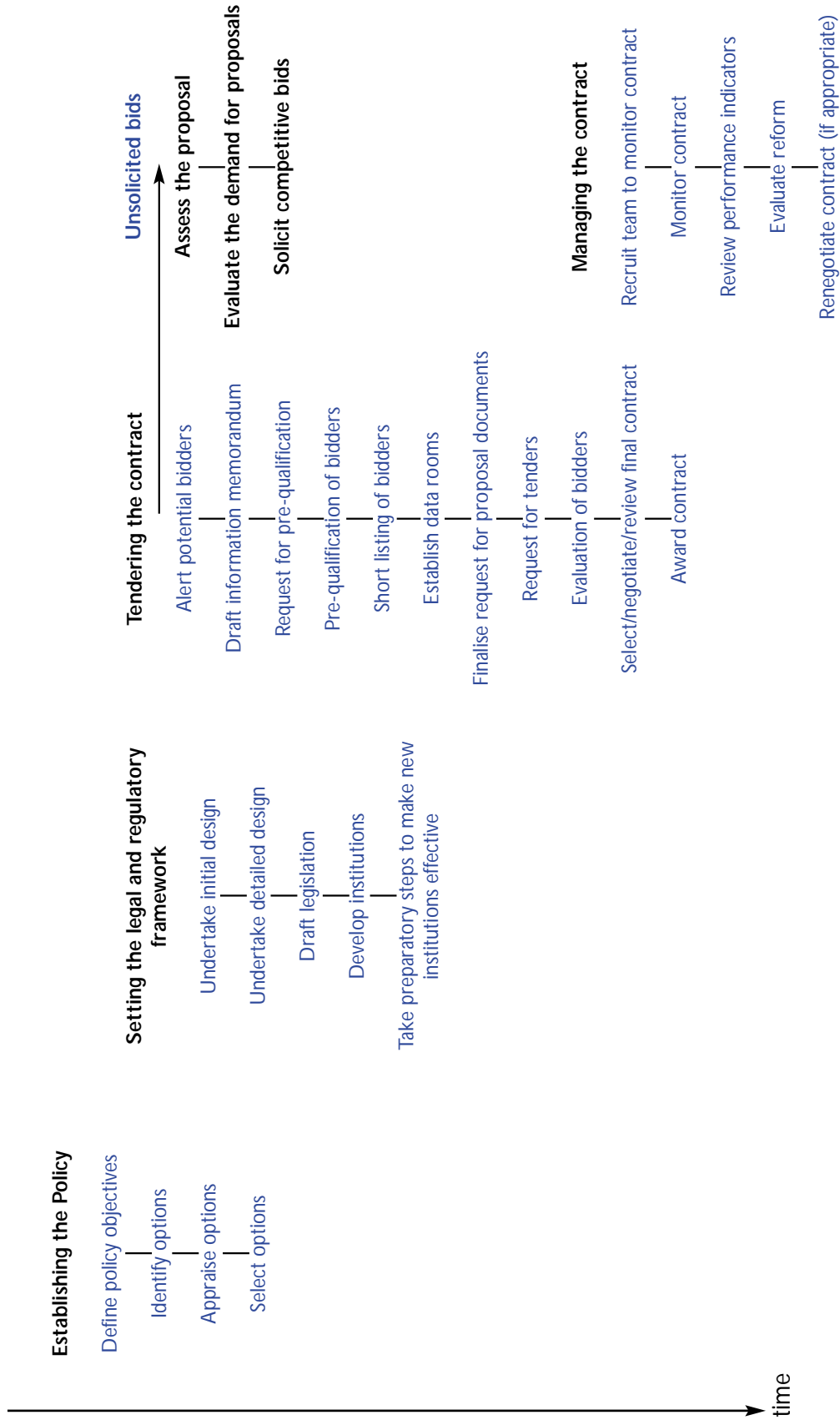
However, if the government does not acknowledge suggestions for new projects arising in the private sector, then it risks losing one of the most important functions of PPI—its ability to generate new ideas. If companies are not rewarded for bringing new ideas to the government (i.e., if the government simply implements its standard competitive bidding procedure when a company approaches it with a new idea) then there are few incentives for companies to suggest new ideas. Consequently, a number of countries have implemented competitive bidding schemes that reward the company originating the idea. Figure 2-10 illustrates how unsolicited bids are incorporated into the PPI process.

2.5.4.1 The Swiss Challenge system

The Swiss Challenge system is designed to attract new ideas from the private sector while ensuring that they are priced at appropriate levels. A generic outline of the steps involved in this process follows.

- (1) **Bid receipt** A government committee first reviews any suggestions for a new PPI project. It determines whether the initiative has merits worth pursuing and, whether the proponent has the technical and financial capacity to provide the service. If it does, the government may enter into negotiations with the party that suggested the new services.
- (2) **Negotiations** The negotiations have two main aims: first, to outline a concrete proposal, with clear outputs and a timetable, and to find a price initially acceptable to both parties. The outcome of this process should be a clear proposal outlining exactly what is to be done and at what price. The negotiations themselves should be subject to a pre-set timetable; lengthy negotiations would be costly for all the involved parties.

Figure 2-10
 Incorporating unsolicited bids into the PPI process



- (3) **Advertising** Once the negotiations for the services are completed, the government publishes the details in a government procurement publication, on the government website, in local or international newspapers, and/or in other appropriate media. In general, the advertisement should include a clear outline of the services along with the final negotiated price.
- (4) **Swiss Challenge** Following the advertisement any other company is invited to submit a proposal, prior to a deadline that provides companies with adequate time to respond.
- (5) **Resolution** If none of the new bids scores higher than the original bid (or if no bids are received) then the contract is awarded to the original party. If one or more of the new bids is judged to be better than the original bid, the original team has a pre-determined period in which to respond. Its response must be based purely on reducing the price they offered. If it manages to meet or better the best of the new bids, then the contract goes to the original bid; otherwise, it goes to the best scoring new bid.

This system provides companies with considerable incentives to propose new ideas. If they are able to propose a sufficiently innovative idea, it is unlikely that other companies will be able to submit a better proposal. At the same time, it protects the government from making expensive mistakes if the idea is not specific to the originating company and other companies are able to provide the services at a lower price.

An example of Swiss Challenge

In 1997 the Philippines government approved an unsolicited BOT proposal for a new international terminal at the main international airport in Manila. After approving the idea in principle and negotiating a price, the government put the proposal to a Swiss Challenge. Following advertising, a new consortium submitted a proposal that provided the government with more revenue from the terminal than the original proposal. Consequently, the new bid was awarded the project.

Note: This is also a cautionary tale because the original proponents stalled the project's implementation by taking the government to court, claiming that the winning bid, while providing more revenue to the government, does so only by changing the technical specifications of the project. This is why it is important that challenges only be allowed to challenge on the basis of price. Technical bids must be comparable.

Source: World Bank,

2.5.4.2 The Chilean Bonus system

Chile has implemented extensive PPI programs, from private toll roads dating back to the 1960s to restructuring and privatizing its power sector - one of the first countries in the world to do so. Consequently, it was quick to recognize that the private sector could be a useful source of ideas, while also understanding the benefits of competition. Therefore, the government developed a system that rewards the company that proposes a new idea while maintaining the competitive process in the award of the contract. The process is outlined below.

- (1) **Suggestion:** Any company wishing to submit a proposal for a new project must complete a government form in which it outlines the general concept of the services without providing specific details.

- (2) **Preliminary evaluation** The relevant ministry (in Chile, the Ministry of Public Works) then evaluates the suggestion. If it is rejected, the proponent is free to re-submit a modified bid. If it is accepted, the proponent must submit a more formal application within a specified deadline.
- (3) **Detailed submission** The detailed submission must fully identify the company or companies proposing to undertake the work, a justification for the services and full details of how it will be undertaken.
- (4) **Secondary evaluation** The same ministry then has a specified length of time (in Chile, one year) to evaluate the detailed proposal. If the proposal is rejected, the consortium retains intellectual rights over the idea for the next three years in order to ensure that the government does not simply reject good ideas and then implement them itself. If the idea is accepted then it is put to a formal competitive bidding process.
- (5) **Competitive submission** The proposed services are advertised and any interested parties—including the original proponent—are invited to bid for it. The government rewards the original company for the idea with bonus points. (In Chile it was originally rewarded a 20% bonus, subsequently reduced to 10%.) If the original proponent either loses the bid or decides not to participate, the winning bidder must compensate it for the cost of developing the original idea. The amount of the compensation is specified in the bidding documents.

Unlike the Swiss Challenge system, the Chilean Bonus system forces all companies to go through a formal competitive process, including the original proponent. However, to provide incentives for companies to come up with new ideas it awards the proponent with a bonus. It also has a mechanism to ensure that the government does not simply steal good ideas, by guaranteeing intellectual rights if the idea is rejected before the competitive bidding phase.

Successful Chilean Bonuses

By the end of 1998, three of the five contracts for private sector operation of Chilean airports had been awarded through this mechanism. In each case it was the private sector that approached the government with the suggestion for the project. In these cases, the competitive process was based on the departure fee charged to each passenger using the airport. The companies that suggested the projects were to be awarded the contracts if their departure fee was within the bonus range (i.e., 20% or 10%, depending on the airport) of the lowest competitive bid. In two of the three cases the original proponent received the contract, while in the third one of the competitive bidders was awarded the project.

Source: World Bank

Useful reading

Vickers, J. and A. Yarrow, *Privatization: An Economic Analysis*, MIT Press, 1998.
 Meyer, C and J. Vickers, "Profit Sharing Regulation: An Economic Appraisal" in *Fiscal Studies* (1996), vol. 17, no. 1 pp. 83–101.
 Shirley and Xu, *The Empirical Effects of Performance Contracts*, World Bank, Policy Research Working Paper 1919, 1998.