Sustainable Water Integrated Management (SWIM)

Regional Training Event

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TRAINING ON EVALUATING AND STRUCTURING PPPs IN THE WATER SECTOR

Day 1 – Session 3: Differentiation between processes for different PPP options

by

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First key, and fundamental questions

- What sector ?
- What function ?
- How to finance (equity – debt) ?
- Who pays for it (customer – tax payer) ?

Infrastructure subsectors include:

Economic infrastructure

- Transport
  - Ports
  - Roads
  - Airports
  - Rail
- Water
  - Supply & Sanitation
  - Irrigation
  - Multipurpose Dams
  - Hydropower
- Energy
- Municipal like urban drainage, solid waste
- Telecommunications

Social infrastructure

- Schools
- Hospitals
- Prisons
- Libraries

Key questions for Governments
(NG, LG, counties, municipalities)

- What problem are we trying to solve?
- **What are the implications for tariffs, and are we prepared to deal with these?**
- **Is the regulatory framework sufficient?**
- Can key stakeholders be brought on board?
- Is information about utility assets good enough to serve as a base for a long-term contract?

Selecting a "PPP"

- Define the problem before 'jumping' into a partnership
- Implement a transparent competitive process
- Consider structural options first
  - assess government/stakeholders willingness to accept the roles, duties and risks of various PPP options
- Choose the PPP option which best fits the above
- Always keep in mind that a PPP is an **instrument**, a means to an end - It is the **process** by which the objectives of the reform are achieved, that matters!

The Point

- Many different options available
- Difference is in the allocation of risks and responsibilities between the public and private partners
- There is something for every situation
- Options can build on each other

Different contracts for different objectives - 1

1. **PPPs for supporting reform and change, and/or, improve utility management performance to reform**
   -> Contracts of delegation of management (*contrats de gestion déléguée)*
   -> Concession, Lease/Affermage
   -> Management contracts

2. **PPPs for improving efficiency of operations**
   Performance based service contracts, e.g. for Non-Revenue Water (NRW) reduction (outsourcing contracts)

Different contracts for different objectives - 2

3. **PPPs to respond to specific challenges and circumstances**
   -> Small scale independent (domestic) private operators in peri-urban and low income communities

4. **PPPs for water infrastructure finance (PFI)**
   -> Build – Operate –Transfer (BOT) contracts
   -> Rehabilitate – Operate – Transfer (ROT) contracts
   -> the Design – Build – Finance (DB[X]) options

The contract should ensure a transparent and politically acceptable relation

- Mechanisms in the contract to temper high profits and heavy losses:
  - Avoid too high risk for contractor
  - Avoid too high profit for contractor

- Full and direct access by the Public Authority to all data (access to the information system; to ensure transparency and create conditions for full cooperation

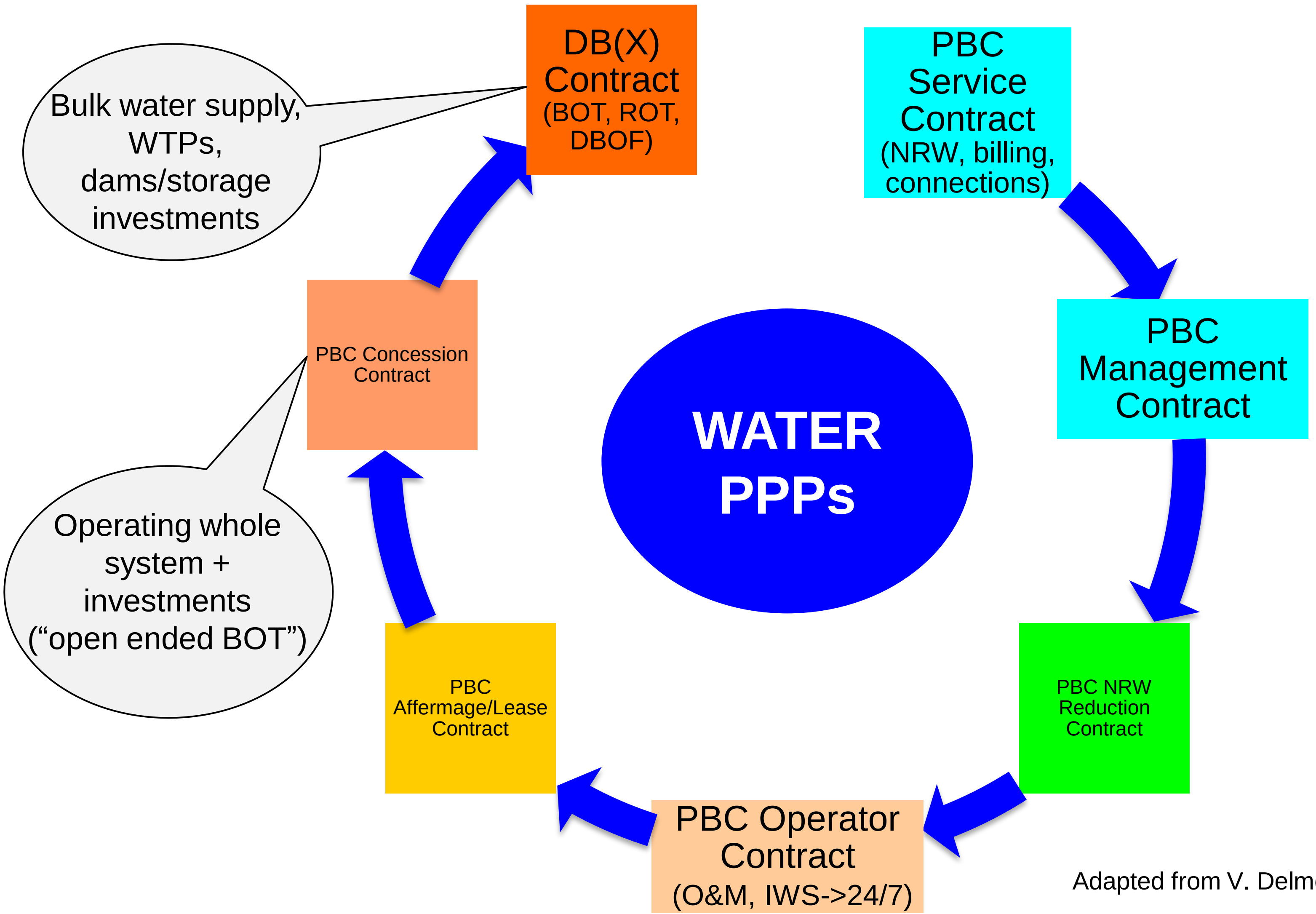
- Detailed clauses to handle the end of contract and make the whole process really sustainable

Source: Naldeo (2015)

Selected PPP option as a function of effective need & demand

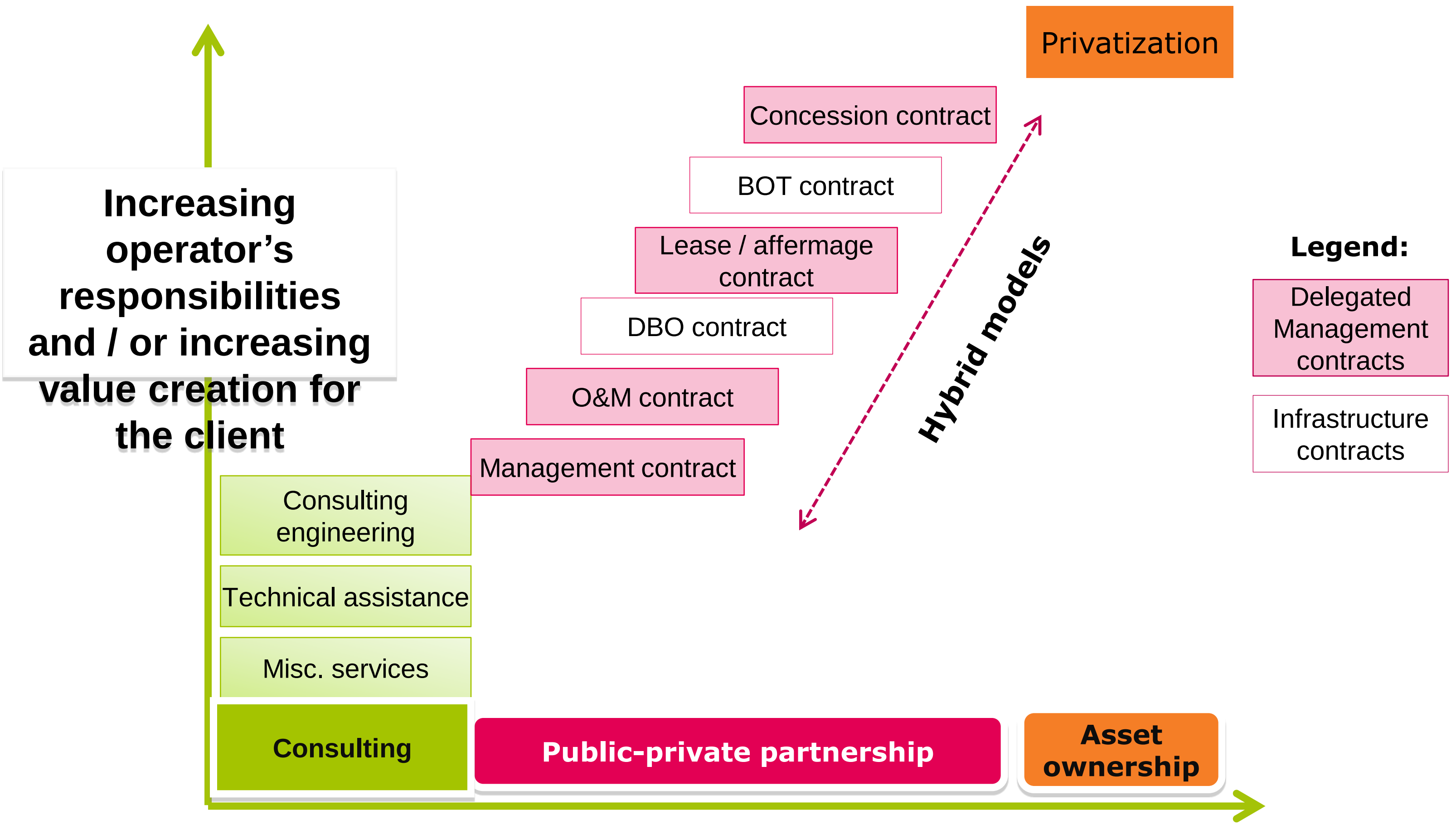
Technical Expertise	Outsourcing, Sub Contracting or Technical Assistance (WOP)
Managerial Expertise	Management Contract, Operator Contract
Performance improvement	Affermage, Lease Contract
Investments	Concession, BOT, ROT

Models of PPP in Water Sector



Adapted from V. Delmon, World Bank, 2015)

PBCs can apply for a wide variety of services and contracts



Increasing operator's time commitment and / or conducive context for PPP

Source: Suez (2014)

PBCs have the potential to be more efficient contracts than the traditional, input-based contracts

- ✓ While the contractor is required to **take more risks**, it has also **more incentives to deliver tangible results**
- ✓ For the contracting utility, a well-designed PBC is less risky since **it will pay the full price of the contract only if targeted performance improvements are achieved**
- ✓ **No staff layoff:** private partner comes for limited time to carry out additional tasks not done by the utility
- ✓ A well-designed PBC is a **win-win proposition** for both the utility and its contractor

Enabling condition for PBCs

Define and implement Long-Term sector vision

- ✓ Vision at country and utility level
- ✓ PBCs should fit into this Long-Term vision
- ✓ Financing of OPEX and continuity of CAPEX is key for Long-Term utility transformation

Fixed vs. Variable Remuneration

Most **PBCs are hybrid schemes, combining fixed payment with variable payments**

✓While a 5-10% bonus provides some incentives for performance, a “true” PBC shall aim for **at least 20 or 30%** of the remuneration paid through variable fees – so as to include not just profit but also part of contractor’s costs.

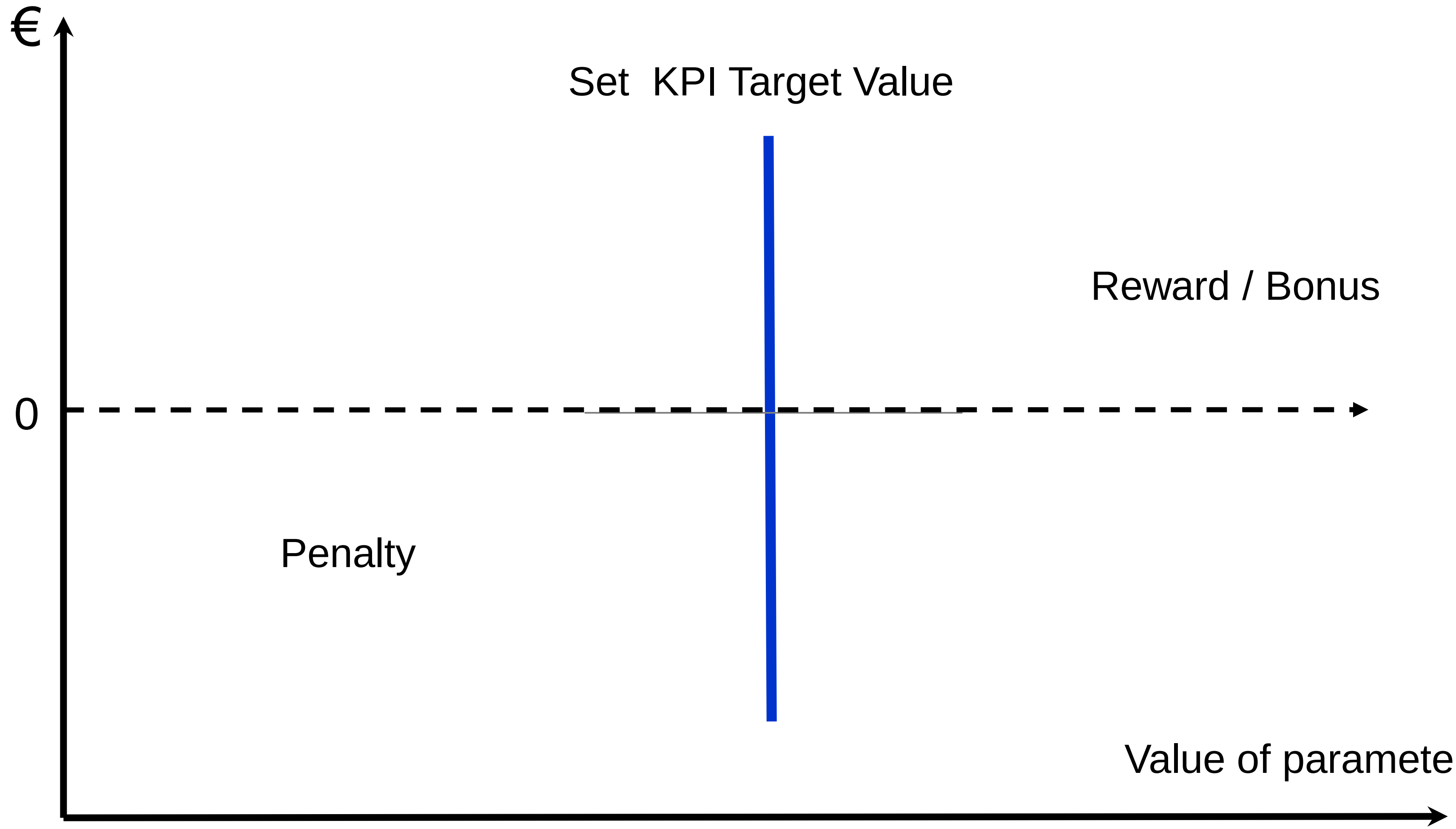
✓The feasibility of having at least 20% paid through bonus depends on local conditions and contractual design:

- Allocation of risks must be carefully thought about
- Contractual enhancements to mitigate risks
  (e.g. donors support with partial risk guarantee (PRG))

“Set – Target” Contracts

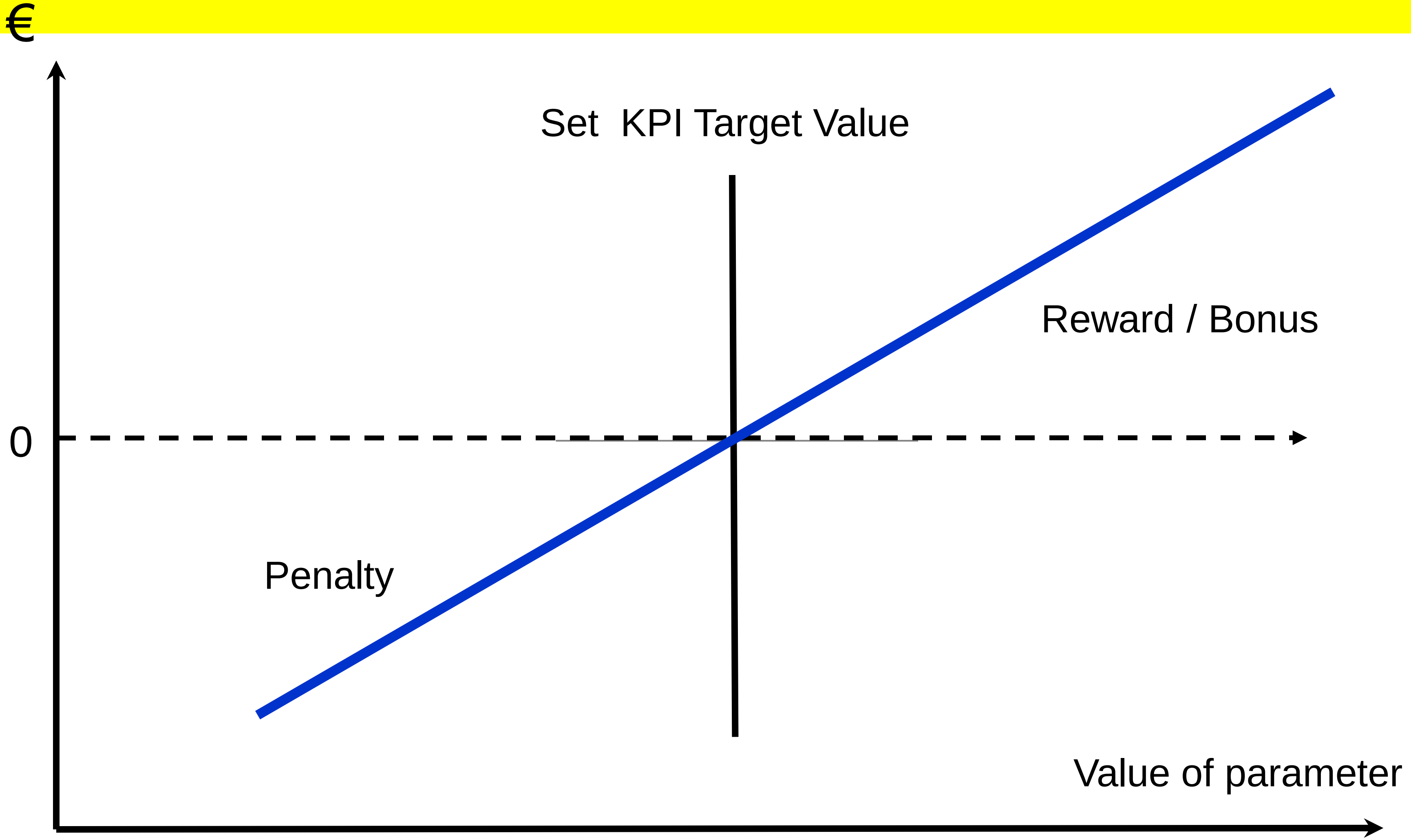
- e.g. : NRW to be reduced by a fixed or specific volume or percentage
- Penalties/bonus apply if targets missed/achieved
- No incentive to increase efficiency once target is reached – no bonus beyond target

Performance based types of contract principles – 1
Set-Target principle

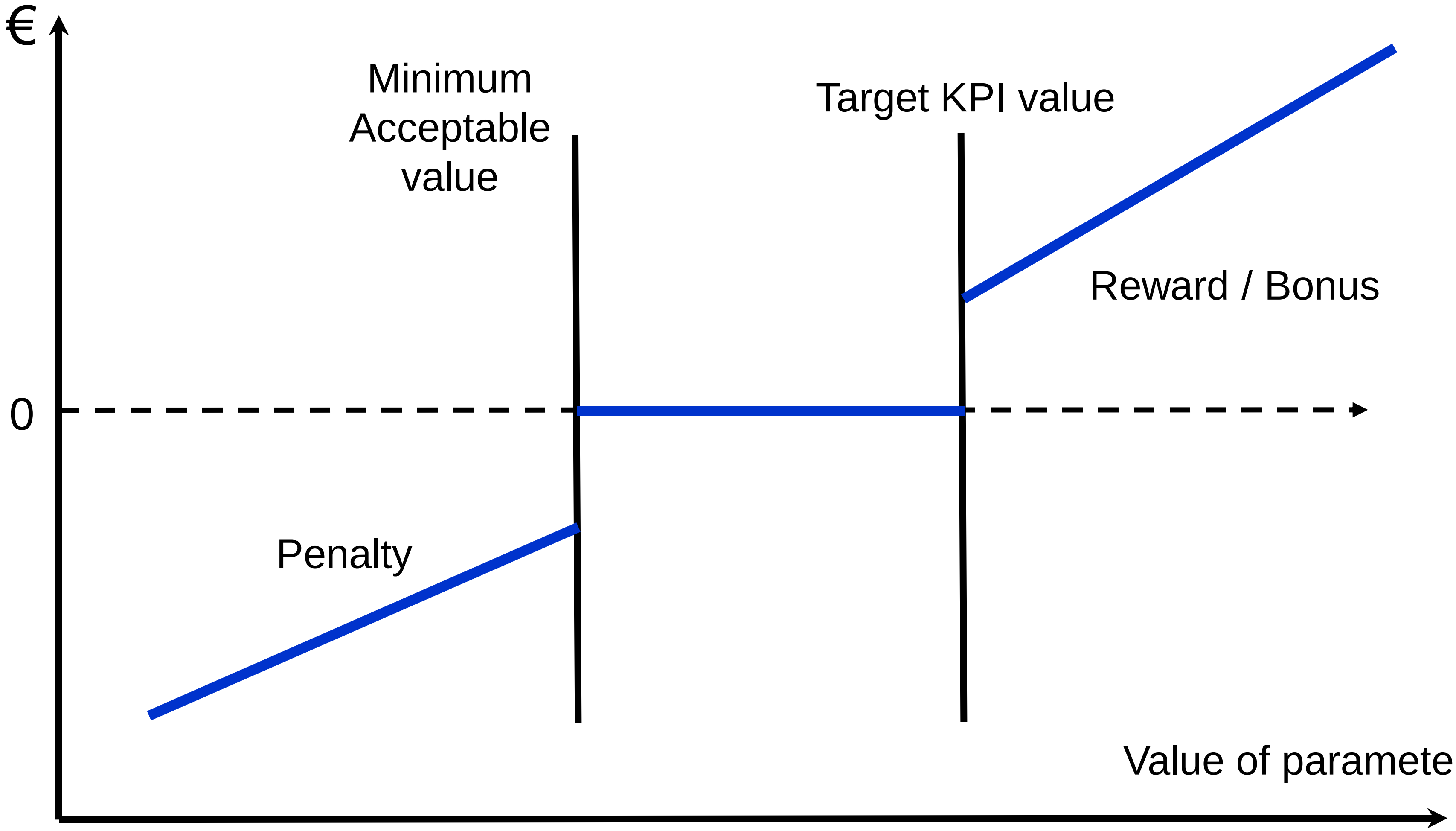


Source: Adapted from Miya (2010)

Performance based types of contract principles – 2

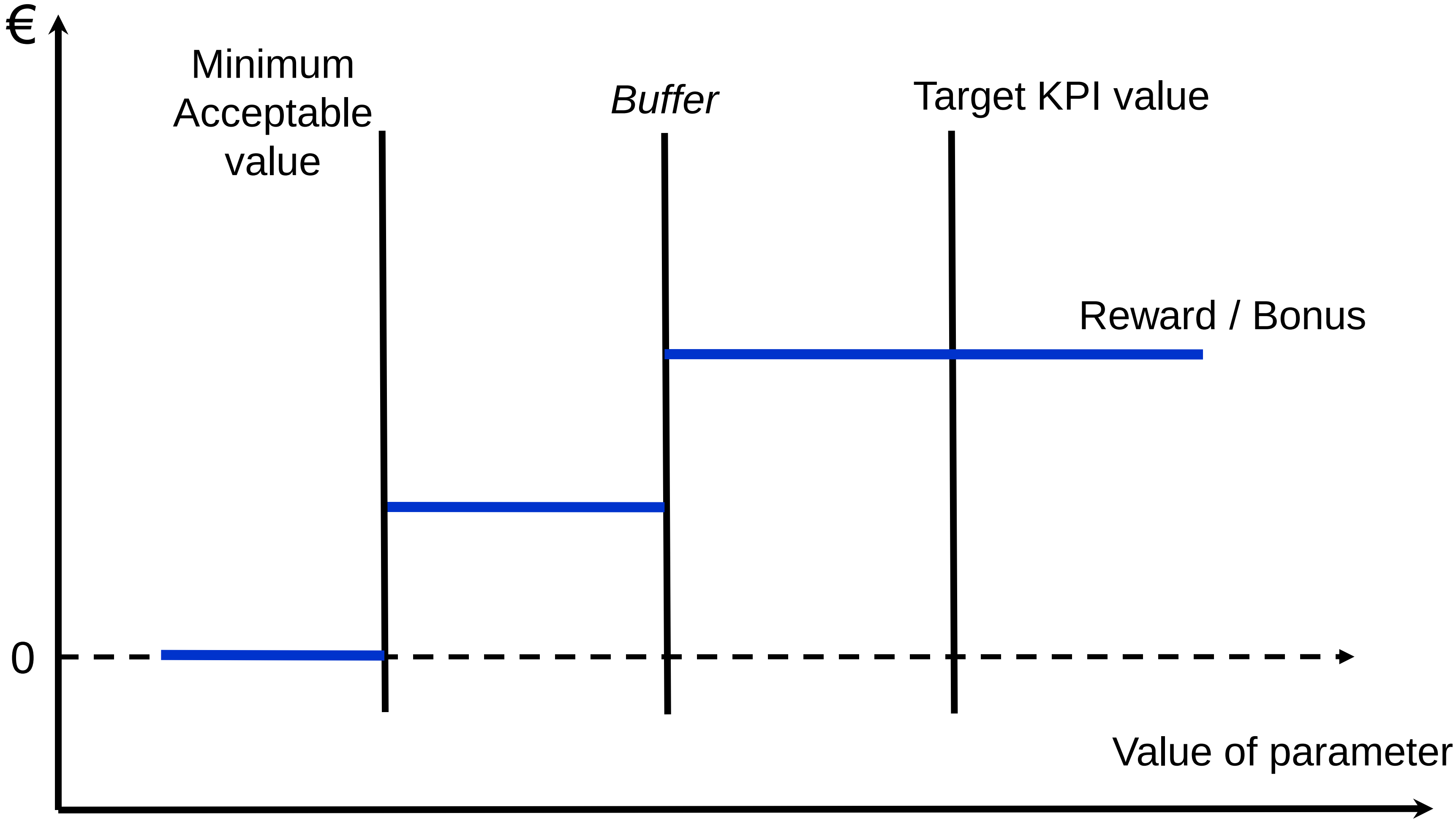


Performance based types of contract principles – 3



Performance based + Fixed Fee

Performance based types of contract principles – 4



Source: Miya (2010)

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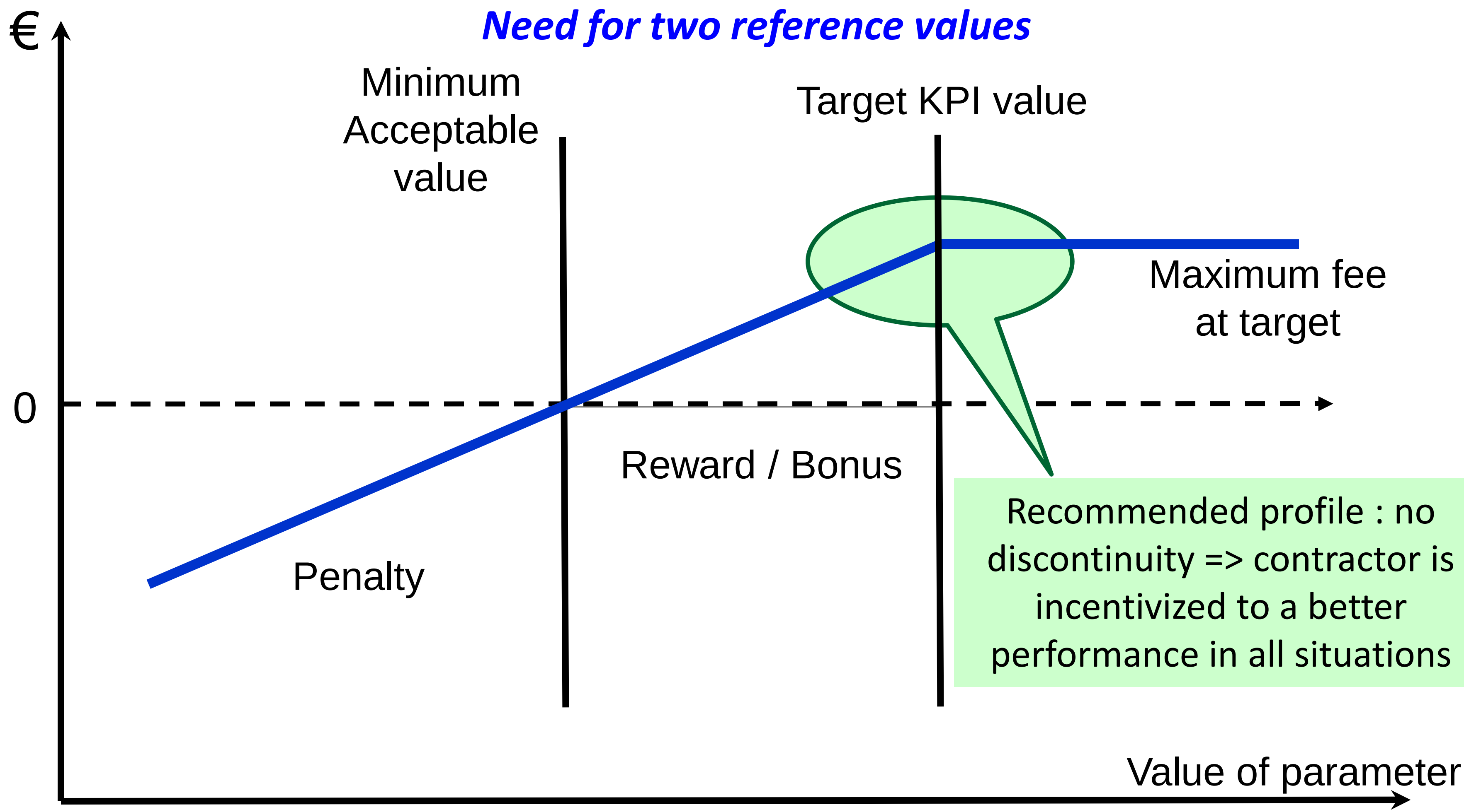
Performance based types of contract principles – 5



Source: Naldeo (2010)

Remuneration Rules

- Typical remuneration profile of a performance based contract

- Fee base on performance : typically about 30 %

  - Targets should be achievable
  - Remuneration should be progressive for each KPI (see next slide)

- Fixed fee : typically about 70 % of maximum total
  However subject to penalties

  - Penalty mechanisms should be fair
  - Fixed fee should not be the most probable total fee and include forecasted profit

Source: Naldeo (2015)

Performance Based Contracts: *challenges*

- To have a ***validated*** **base-line information** is a precondition for an effective incentive structure with realistic time-bound performance targets – *inaccuracy of base-line is an issue and a constraint*
  - Sequential, progressive PPP contracts ?
  - Evolving from a contract of means (input based) towards a contract of results (output based) ?

- Making **gains of efficiency** ***sustainable through a balanced PPP***

improving performance – building capacity & hybrid financing

A Stepwise Approach ?

- An intermediate PPP step may be needed while institutional, operational efficiency, and/or financial viability problems are tackled, to
  - Raise tariffs,
  - Build Government commitment and regulatory capacity,
  - Gain better information about the system

- **But a stepwise approach:**
  - May never go beyond the first step …
  - May involve complex re-bidding issues

A Proposed Sequential Engagement

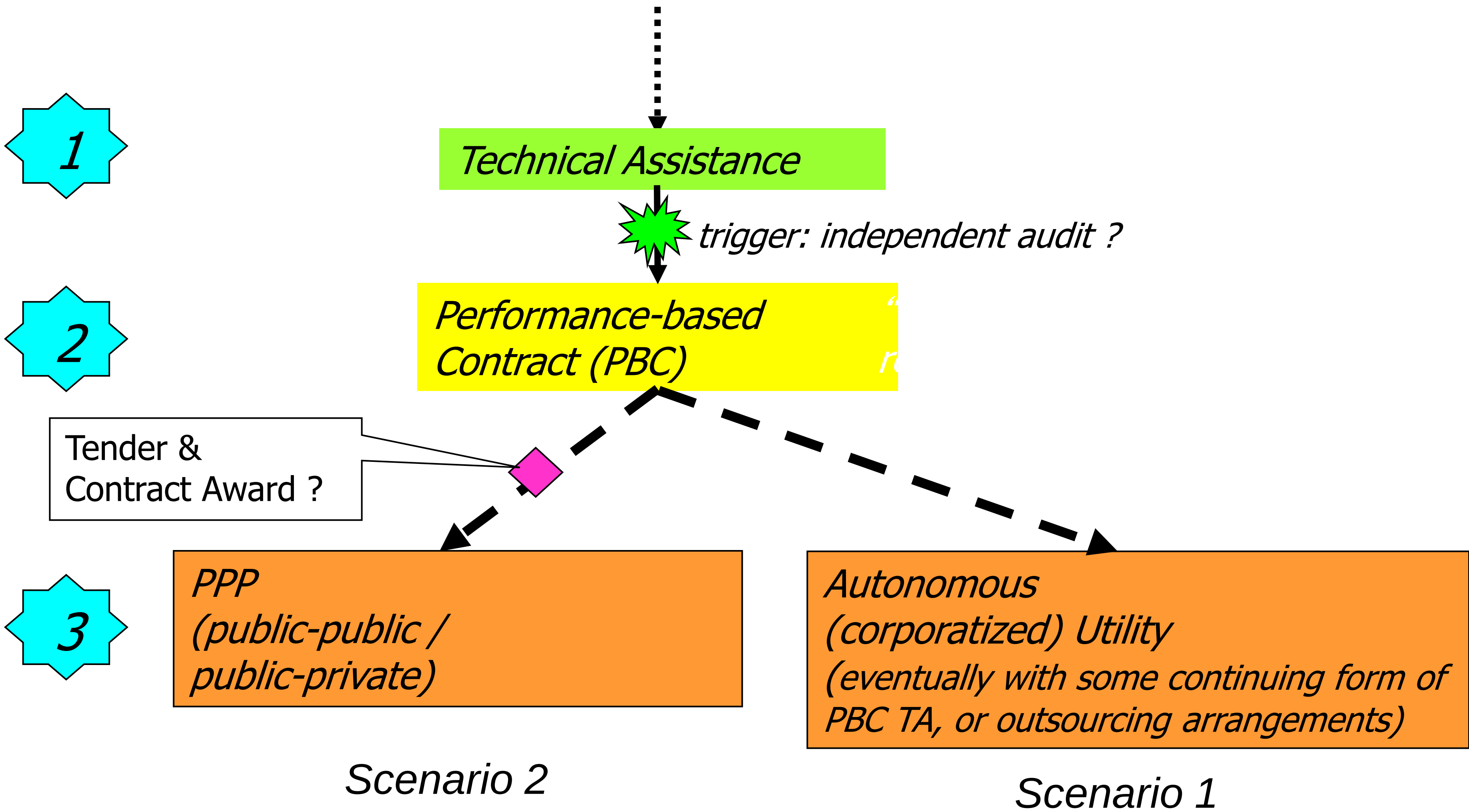
1 — *Technical Assistance* — *contract of means, input based*

trigger: independent audit ?

2 — *Performance-based Contract (PBC)* — *results contract, output based*

3 — *Next step?*

A Proposed Sequential Engagement



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In a nutshell …

a) It is increasingly important and relevant to improve utilities' efficiency and performance

b) PBCs are a good way to achieve increased performance, compared to traditional contracting

c) PBCs can apply to various type of contracts and services, and be mainstreamed, in public-private & in public-public

d) This requires to set up enabling conditions, to be implemented through IFIs, governments/municipalities, operators…

Key considerations

1. **Tendering** – differences with standard procurement selection criteria.
2. **Structuring remuneration** – most PBCs are hybrid schemes, combining fixed payment with variable payments.
3. **Financing** – PBCs require 'upfront' financing since they link remuneration to results.
4. **Allocating risk**
5. **Providing (validated) base-line data**
6. **Setting targets** – balance being achievable vs being ambitious

PPP : the « hidden » question : what's after ?

- Is it possible (in a realistic manner) to switch back to public operation after a PPP ?
  - **Three main obstacles**
    1. **Information system** not owned by utility or utility not able to manage it
    2. **Staff** : skills can go away with private operator
    3. **Procedures**, good practices and certifications (ISO 9001, etc.) can go away with private operator

- Can ***well designed contracts*** overwhelm these obstacles ?
  - Through fully addressing information system issues (ownership, etc) in contract
  - Through the capability of an early preparation of the transition (put in contract)
  - Through a "permanent control" of the private operator

Thank you