

FEMIP
Study on
PPP Legal & Financial Frameworks
in the Mediterranean Partner Countries

Volume 1 – A Regional Approach

Operational since October 2002, the Facility for Euro-Mediterranean Investment and Partnership (FEMIP) brings together the whole range of services provided by the European Investment Bank in the Mediterranean partner countries (Algeria, Egypt, Gaza/West Bank, Israel, Jordan, Lebanon, Morocco, Syria and Tunisia).

The study is financed under the FEMIP Trust Fund. This Fund, which was established in 2004 and has been financed – to date – by 15 EU Member States and the European Commission, is intended to support the development of the private sector via the financing of studies and technical assistance measures and the provision of private equity.

The contents of this Volume have been prepared by external consultants. The opinions expressed are those of the consultants and do not necessarily reflect the view of the European Investment Bank.

This Volume is not designed to be professional advice in respect of any particular matter and should not be relied upon in the making of any legal, commercial or financial decision.

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¹ Please note: This Volume is part of a three-volume Report: "Volume 1 – A Regional Approach", "Volume 2 - Country Analysis" and "Volume 3 - Best Practices and Lessons Learned – Selected Experiences from Other Countries". See Introduction below for further detail.

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Lebanon

- Takla, Trad, Daouk Law Firm
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Morocco

- UGGC & Associés Law Firm
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Syria

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- Mazars (UAE)

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Comparator countries:

France

- Salans
- Mazars France

Mexico

- COMAD, S.C.
- Mazars Mexico

Poland

- Salans
- Mazars Poland

South Africa

- Webber Wentzel
- Mazars South Africa

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GLOSSARY

BEA: bail emphytéotique administrative (France)	GDP: Gross Domestic Product	PFMA: Public Finance Management Act 1999 (South Africa)
BEE: Black Economic Empowerment	GMWDA: Greater Manchester Waste Disposal Authority (England)	PFS: Partnerships for schools (England)
BSF: Building Schools for the Future (England)	ICC: International Chamber of Commerce	PFU: Private Finance Unit (England)
CBT: Central Bank of Tunisia	ICE: In-Country Experts	PLN: Polish Zloty
Comparative Assessment: the comparison of PPP frameworks in the Mediterranean partner countries with the PPP frameworks in the comparator countries as set out in this Volume 1 of the Report	IFI: International Financial Institution	PPO: Public Procurement Office (Poland)
Comparator countries: England, France, Mexico, Poland and South Africa	IPP: Independent Power Plant/Project	PPP: Public Private Partnerships
Consortium: the consortium of Pinsent Masons LLP, Mott MacDonald Limited, Mazars LLP and Salans LLP appointed by the EIB to carry out the Study and the Report	IT: Information Technology	PRG: Project Review Group (England)
Cross Country Assessment: the assessment of PPP frameworks in the Mediterranean partner countries	IU: Investment Unit (Mexico)	Project SPV: Project Special Purpose Vehicle
EC: European Commission	IUK: Infrastructure UK (England)	PUK: Partnerships UK
ECA: Export Credit Agency	JV: Joint venture	Regulations: The Public Contracts Regulations (SI 2006/5) and The Utilities Contracts Regulations (SI 2006/6) (England)
EIB: European Investment Bank	LCIA: London Court of International Arbitration	Report: A report comprising three volumes titled "Volume 1 – A Regional Approach", "Volume 2 – Country Analysis" and "Volume 3 – Best Practices and Lessons Learned – Selected Experiences from Other Countries"; this being Volume 1
EPC: Engineering Procurement and Construction	MAPPP: Mission d'Appui à la Réalisation des Contrats de Partenariat (France)	RFP: Request for Proposals
EU: European Union	MEAT: Most economically advantageous tender	SoPC4: Standardisation of PFI Contracts version 4 (England)
EUR: Euro	Mediterranean partner countries: Algeria, Egypt, Israel, Jordan, Lebanon, Morocco, Syria, Tunisia and the West Bank	TIFU: Treasury Infrastructure Finance Unit (England)
FARAC: Fideicomiso de Apoyo al Rescate de Autopistas (Commission for Financial Assistance to Rescue Highways)	MOD: Ministry of Defence (England)	UK: United Kingdom
FDI: Foreign Direct Investment	MXN: Mexican Peso	UNCITRAL: United Nations Commission on International Trade Law
FEMIP: Facility for Euro-Mediterranean Investment and Partnership	NHS: National Health Service (England)	US: United States
FONADIN: Fondo Nacional de Infraestructura (Mexico)	NIP: National Infrastructure Plan (Mexico)	USD: United States Dollar
	OECD: Organisation for Economic Co-operation and Development	ZAR: South African Rand
	OGC: Office of Government Commerce (England)	
	OJEU: Official Journal of the European Union	
	PFI: Private Finance Initiative (England)	

EXECUTIVE SUMMARY

PURPOSE AND STRUCTURE OF THE REPORT

This is Volume 1 of the Report which is the product of a FEMIP (Facility for Euro-Mediterranean Investment and Partnership) Trust Fund Study analysing the legal and financial frameworks for Public Private Partnerships (PPP) in each of the Mediterranean partner countries. The definition of PPP for the purposes of the Report is a partnership between the public and private sectors pursuant to a long term contractual agreement and covering the design, construction, financing and ongoing operation and maintenance of an infrastructure asset. These projects are project financed, i.e. lenders take project risk and are mostly concerned with cashflows generated by the project for the payment of the loan applied to construction of the asset and with the assets of the project, rather than relying primarily on the general creditworthiness of the private sector sponsors.

PPP IS A VIABLE OPTION FOR THE MEDITERRANEAN PARTNER COUNTRIES....

It is clear from the Study that PPP can provide, in many of the Mediterranean partner countries and sectors, a cost-efficient means of delivering infrastructure projects, with appropriate risk transfer for the benefit of the public sector. A key advantage of well structured project financed PPPs, as opposed to traditional procurement methods², is the project discipline they create. Most Mediterranean partner countries already have had some success with PPPs and others are preparing to introduce structural reforms necessary for PPPs to work. There are, however, a number of conditions which need to be satisfied and PPP is not suitable for all projects. Careful selection and delivery of projects in the context of a well understood and appropriate legal and regulatory and financial environment is essential.

.... AND THEIR PROGRESS ALONG THE PPP MATURITY CURVE IS VARIED.

Historically **Algeria** has developed a successful PPP model for water desalination and has a track-record in IPP procurement. However, relying on its hydrocarbon income, the country currently has a policy of procuring infrastructure through alternatives to PPP. Whilst Algeria is preparing to implement a major and sustained investment programme, it does not currently actively encourage international participation.

The successful close of the New Cairo Waste Water project (NCWW) in **Egypt** indicates the potential for future PPP procurement. Whilst the capacity of domestic banks to fund PPPs is limited, government support and a PPP enabling environment (including a recently enacted PPP Law), make Egypt a potentially vibrant PPP market, capable of attracting foreign investment in sectors such as waste water, transport and healthcare.

Israel has a successful track record of PPP projects developed across a number of sectors by various procuring authorities. Projects have been implemented in the roads, light rail and desalination sectors. This, combined with a sophisticated domestic banking sector with a track-record in PPP lending and the capacity of the Israeli government to commit to PPP payments, make Israel a mature PPP market.

Successful procurements and project financings of recent high profile projects in **Jordan** (such as the Queen Alia Airport project) have demonstrated the potential for future market development. Jordan has established PPP-specific central government institutions and is in the process of enacting a PPP law. Projects are currently under procurement in the power, roads and rail sectors. A test for the new institutional framework will be how successfully it selects and scopes future projects.

Lebanon has adopted elements of a pro-PPP policy at official level with attempts to enact a PPP law to institutionalise PPP as a procurement option. Lebanese banks could have PPP lending capacity but they as well as government institutions, lack experience of PPP. This is because there is no PPP project precedents to date in Lebanon to draw upon.

Morocco has a track-record in delivering concession based projects where the user/demand risk is carried by the private sector. The procurement of availability-based PPPs has built on that existing track-record and has successfully maintained the interest of local and international investors. Although additional support is provided by several infrastructure funds, the market would benefit from a more unified approach at an official policy and institutional level (particularly with regard to a central PPP unit and PPP specific legislation).

Syria³ has taken initial steps to create a PPP friendly environment. However, there is as yet no practical PPP experience in Syria. So far only two foreign currency earning privately operated port projects have been developed and no PPP (or concession-based) project experience which includes the financing of construction currently exists in Syria. The country has recently tendered its first PPP in the power sector (Al Nasserieh), and has prequalified 16 bidders which is a sign of success. Without sufficient local bank capacity, the initial phase of Syria's PPP programme is likely to be debt funded in foreign currency primarily through IFIs and Export Credit Agencies (ECAs).

Tunisia has a history of user based concession projects and a potentially attractive environment for PPP investment. Whilst the domestic banking sector has limited capacity, long-term foreign currency funding may be a viable option for funding the projects currently being proposed in the water and electricity sectors. A stronger strategic direction with the role of PPP placed in the context of wider infrastructure priorities would benefit the development of the market in Tunisia.

The **West Bank** has no project financed PPP experience or programme, as infrastructure development relies predominantly on grant-funding. Although there are some positive signs of private-sector participation in the procurement of infrastructure, political stability and institutional development are pre-requisites to the development of a PPP market.

The political developments in 2011, affecting a number of Mediterranean partner countries, are likely to cause investors to be cautious regarding PPP opportunities in those countries, pending clarification of their outcome. These political aspects and their consequences are outside the scope of the Report. This Volume discusses how the PPP frameworks in the

² "Traditional procurement" includes, for instance, projects in which there is no long term partnership between the public and private sector and where the assets are not financed through project finance (e.g. the procurement of the construction of an asset, where financing is assumed by the public sector procuring entity).

³ The Report is accurate as at 1 October 2010 and does not take into account the recent political events taking place in the country since March 2011. These events are likely to cause investors to be cautious regarding PPP opportunities in the country, pending clarification of their outcome. These political aspects and their consequences are outside the scope of this report.

Mediterranean partner countries could be further developed to meet infrastructure needs and facilitate increased use of the PPP model where appropriate for the country to do so.

PPP MAKES NEW DEMANDS ON THE PUBLIC SECTOR....

The selection of appropriate projects for development as PPPs requires an understanding of the features of, and environment required for, a successful PPP project. This may be based on experience gained within a country, but also from wider experience in other countries. Volume 3 looks at the PPP experience in England, France, Mexico, Poland and South Africa (the comparator countries). A common feature for all countries is that PPPs make new demands on public servants, as skills are needed to specify outputs, to understand complex financial structures and to allocate and manage risks in the most efficient manner. In most comparator countries this has been, or is being achieved, by the creation of a central PPP advisory unit which draws on that experience and understanding of best practice. The Report draws upon such track record and provides concrete recommendations for such units to be established and appropriately resourced.

.... WITH PARTICULAR CHALLENGES IN PROCUREMENT....

Experience in different countries demonstrates that PPP procurements must be structured so as to:

- clearly identify the output required by the authority;
- be transparent;
- rely on evaluation criteria which recognise the complexity of the authority's requirements.

Such an approach should encourage greater competition amongst a wider range of suppliers and should therefore help improve quality and deliver competitive prices. Whilst principles of good procurement practice apply equally in 'traditional' procurement, they are still more important in a PPP. The procurement of a PPP project draws together the skills of designing, financing, constructing, operating and maintaining complex infrastructure assets. Private sector providers take the risk of not being paid until an asset is ready (and reduced revenues if there is a shortfall in performance). For this reason, issues often left open in 'traditional' procurements need to be finalised before PPP contract signature. Box 1 below left identifies some different procurement practices in Mediterranean partner countries.

Box 1: Bidding processes in the Mediterranean partner countries

To enable the procuring authority to achieve a specification at the desired price, it may be appropriate in some instances (for complex projects or projects in which there is no established track record of similar transactions) to enter into discussions with the bidders. This is in contrast to procedures whereby bidders are requested simply to bid against pre-determined contracts. The process of discussing solutions during a procurement process helps the authority to fine-tune its requirements and identify the solution that presents the best value for money.

Amongst the Mediterranean partner countries, there is varied practice in the approach to bidder participation during the procurement process.

In Algeria and Morocco, the procurement procedures do not permit the procuring authority to hold structured discussions simultaneously with rival bidders. By contrast, discussions with bidders are permitted in Israel and Egypt. In new areas / sectors of PPP, the ability to discuss project specific issues with the bidders will help the public sector to learn from the expertise of the contracting community. On the other hand, a restricted approach (where there is no active discussion) may be more appropriate where PPPs are relatively developed in a sector, contracts are standardised and issues are understood by all parties.

Tender evaluation approaches will also impact value for money that is derived by the procuring authority from PPP procurement and again, there is varying practice amongst the Mediterranean partner countries. In general, a two-stage process is adopted whereby technical submissions are evaluated first and if they pass, the financial offer will be considered and the lowest price will win. This could distort the evaluation process by making the technical offer a mere filter. It is therefore important that the pass criteria are carefully considered and sufficiently robust. An alternative approach could be to evaluate the bids on the basis of the "most economically advantageous tender" (or similar) which relies on allocating weightings to different aspects of the bid, thus enabling authorities to place emphasis where required for the project in question.

....AND ALSO CHALLENGES CAPACITY IN THE PRIVATE SECTOR.

The development of skills within the private sector – amongst sponsors, contractors and banks – will also be important. Where international organisations are participating in a PPP programme, there may be natural transfer of skills but formal training programmes should be introduced to ensure understanding of the project finance discipline within the private sector and to ensure that the public sector takes due account of market capacity, appetite and concerns. Market soundings are needed at an early stage after project identification and project pipelines/programmes should be designed with a view to attracting both domestic and international bidders and investors, to stimulate competition and improve value for money or cost-efficiency of the project.

LEGAL CHANGE WILL OFTEN BE REQUIRED....

The complexity of PPP projects, the interface requirements and the entrusting of private sector organisations to help deliver a public service have meant that most, if not all, countries which have successfully developed PPP programmes have changed their law to help achieve this. Whilst it has been the practice of some countries to develop PPP projects on the basis of pre-existing laws (usually concession laws), experience in the comparator countries suggests that a PPP programme will greatly benefit from the introduction of clear laws which enable PPP contracts to be entered into which are effective in delivering the expectations of the market and are flexible to accommodate changes in market practice. Box 2 provides some examples of Mediterranean partner countries who have changed or are changing their law.

Box 2: PPP laws in the Mediterranean partner countries

The majority of the Mediterranean partner countries are civil law jurisdictions. Israel is not an exclusively civil law country and has no specific PPP law but PPP procurement is relatively advanced and has not been hindered by the absence of PPP

specific legislation. The other countries, where the legal tradition is to rely on written laws, would benefit from a specific PPP law if PPP procurement is a priority. The recent enactment of a PPP specific law in Egypt and initiatives to introduce PPP laws in Jordan, Lebanon and Syria reflect this approach. PPP laws should address key issues such as procurement processes and the ability to issue sovereign guarantees if/when needed, to cover the contracting authority's payment obligations, and further detailed regulation can be in the form of secondary regulation (for example, implementing decrees to detail procurement procedure stages and time periods), but laws should not "over-legislate" by providing the detail of matters that are typically set out in PPP contracts where they can be more finely attuned to the particular transaction.

Morocco and Tunisia have "concession laws", but their applicability to PPP projects where the private sector does not take demand risk lacks the certainty which international funders are, as a rule, likely to seek. Should these countries wish to continue pursuing alternative PPP models (i.e. those based on availability payments), introducing clear laws applicable to these structures will benefit investment as they will provide greater certainty as to the ability of the public sector to make payments during the operational phase of a project.

Given the relatively early stages of PPP in the region overall, the enactment of PPP laws can be a means of demonstrating political commitment to PPPs. However, this is not essential where the current legal framework is clear and comprehensive and has proven itself to work in practice (as is the case in Israel, for example).

... DISPUTE RESOLUTION MECHANISMS MUST BE FAIR....

Furthermore, any legal system should provide an effective, transparent and impartial forum for the resolution of disputes with the experience of resolving complex commercial differences. In many cases the preferred forum will be arbitration operating under international rules although in some comparator countries, arbitration under local rules (England) or Court decision (France) are the norm.

Box 3: Dispute resolution in Mediterranean partner countries

In the Mediterranean partner countries, contracting authorities should consider using international arbitration as this is likely to be a key requirement for foreign investors and lenders. They will seek to be satisfied that the ultimate dispute resolution forum is able to deal with the complexities of PPP contracts.

To date, project contracts in Algeria, Morocco, Jordan and Tunisia have selected international arbitration (under rules such as International Chamber of Commerce (ICC), London Court of International Arbitration (LCIA) or United Nations Commission on International Trade Law (UNCITRAL)). This has encouraged international private sector sponsors, contributing to increased competition during bidding. In Israel and Egypt, the more common approach is to make disputes subject to domestic arbitration. In Syria, international arbitration has been identified as the preferred final resort of dispute resolution. If PPPs are to be pursued in Lebanon and the West Bank, it is recommended that international arbitration rules apply to the contracts.

... AND LENDERS' LEGITIMATE REQUIREMENTS RECOGNISED.

Experience of both successful and unsuccessful projects in the comparator countries and some of the Mediterranean partner countries shows that there are certain key features of a PPP contract which the legal framework should permit. These include:

- absolute clarity as to an authority's legal power to enter into the contract;
- the ability of the Project SPV to grant effective security over its assets, shares and revenue streams;
- the ability of funders to step into the project and rescue it;
- payment of appropriate compensation on termination;
- the ability of the State to guarantee the contractual obligations of a contracting authority, should this authority not have sufficient creditworthiness on a standalone basis;
- certainty as to contractual rights (including liquidated damages and termination rights).

The appropriate laws exist in most of the Mediterranean partner countries although developing standard contract approaches would improve a country's ability to achieve required objectives.

RISK ALLOCATION IS CENTRAL TO PPP...

Any contract must allocate risk and experience demonstrates that the temptation to allocate too much risk to either the private or public sectors, when they cannot properly manage those risks, will not provide best value for money or cost-efficiency and may lead to project failure. Worldwide, the project finance PPP market is well enough established for there to be a good deal of certainty about how key risks are allocated in successful PPP projects. These international norms should be applied in the Mediterranean partner countries in order for successful PPP programmes to be established and maintained.

... WITH A FOCUS ON THE MANAGEMENT OF RISKS BY THOSE BEST PLACED TO DO SO.

Not all risks the private sector partner cannot control should be allocated to the public sector. Thus, where an event occurs outside the private sector's control, it could be fairly compensated (in time and money), by defining principles such as "relief events" or "compensation events" in the contract or identifying relief which the parties agree should be available in the event of the application of the civil law concept of "imprévision" (economic rebalance). The private sector partner can often manage its risks through insurance – for this reason, the availability of insurance on commercial terms is a key requirement for an active PPP market. Related to this, the public sector should take great care before conceding unnecessarily wide definitions of force majeure in PPP contracts – again, international standards and norms are a useful guideline here but specific regard should be had to insurability.

THE PAYMENT MECHANISM UNDERPINS RISK TRANSFER....

Whilst all PPP projects place the risk of performance largely on the private sector partner, the allocation of demand risks and the payment mechanisms to remunerate the delivery of an output or service vary. There are two basic types of payment mechanisms: availability based and demand based. The availability based mechanism has been used in the comparator countries in many sectors. In this system, the public sector

authority only pays for the services or output provided and the payment is subject to deductions for unavailability or poor performance in accordance with the pre-set formula. Thus the private sector partner takes risk in the construction and ongoing operation of the infrastructure asset but does not take volume or usage risk. Under a demand risk scenario, the private sector assumes the market risk. The willingness of the private sector to accept such risks will depend upon its analysis of market forecasts.

.... AND THERE MAY BE IMPORTANT SECTORAL DIFFERENCES IN WHAT IS APPROPRIATE.

It is more common for demand risk to be taken in the transport sector although in many cases the authority provides a minimum payment guarantee thus absorbing all or some of the demand risk. Most of the Mediterranean partner countries have experience of procuring independent power projects using capacity/availability payments where output is purchased at a specified tariff per unit with long term purchase agreements to provide security of revenue flow. Availability payments have also been usual in a number of Mediterranean partner countries, notably in the water treatment and desalination projects in Algeria, Egypt and Israel.

HOW PROJECTS ARE FUNDED WILL ALSO IMPACT ON RISK ALLOCATIONS...

The capacity and depth of capital markets in most of the comparator countries permit projects to be funded in local currency (with the exception of Polish projects which tend to be funded in Euros (EUR) and the earlier Mexican projects which were funded in United States Dollars (USD)). However, in the majority of the Mediterranean partner countries (other than Algeria and Israel) local currency capital markets are not sufficiently deep to fund a substantial portion of potential PPP programmes. As a result, in most cases and especially for larger projects, PPPs in the Mediterranean partner countries are likely to have to be funded predominantly in foreign currency, with the procuring authority absorbing exchange rate risk. This is mainly due to the difficulty for the private sector to hedge this risk in the market at a reasonable price. However, having foreign currency denominated debt, such as in EUR or USD, interest rate risk can be transferred to the Project SPV which can hedge this risk in the market. Domestic inflation risk (on

Box 4: Exchange rate risk allocation in PPP – general principles:

To the extent that a project has raised debt or equity funding in foreign currency, the authority is likely to have to bear exchange rate risk in the payment mechanism in order to maximise cost-efficiency of the project. In such cases, project payments (other than to cover any local currency costs or local currency funding share) need to be adjusted for exchange rate variations, either by denominating project payments directly in foreign currency, or through indexation of payments in local currency. In all Mediterranean partner countries, there is no market in which the Project SPV can hedge local currency exchange rate risk for the duration of the project. Bidders and lenders will see this risk as outside their control, being a largely macroeconomic or policy determined variable, particularly when exchange rates are centrally managed or controlled, as is the case of many Mediterranean partner countries.

the domestic cost element of delivering the services during operations) is likely also to remain with the authority, since bidders and investors see this risk being outside their control, being primarily a macroeconomic or policy-determined variable.

....WITH USE OF INTERNATIONAL FUNDING SOURCES (ESPECIALLY FROM INTERNATIONAL FINANCIAL INSTITUTIONS (IFIs)) BRINGING BENEFIT OF KNOWHOW.

The international project finance community has considerable experience which can be applied to assist in developing optimal funding structures and risk allocations, and in transferring know-how to domestic financial institutions. IFIs and ECAs act as important catalysts for attracting other funders to support projects, since their rigorous requirements regarding open procurement, economic viability and risk evaluation, help create confidence in the creditworthiness and robustness of the projects.

AND IT IS CLEAR THAT SOME CHANGES WILL BE NEEDED TO MAKE PPP AN EFFECTIVE DELIVERY METHOD.

The viability of PPP in many Mediterranean partner countries can be enhanced so as to improve the delivery of infrastructure to meet social and economic needs by concentrating on relatively few key requirements. These would most notably include:

- the development of local financial markets so that local funding is sustainable (alongside foreign currency lending);
- the establishment of clear PPP laws which meet international norms;
- the establishment of institutions to develop best practice, ensure consistency and ensure a pipeline of projects as part of a sustained programme;
- the development of an approach to risk allocation which ensures value for money for the public sector by allocating to the private sector only those risks which it is best able to manage;
- addressing lenders' requirements for security packages and protection of their investments, for example by permitting and recognising lenders' step-in rights and providing sovereign guarantees of authority obligations when there are concerns regarding the latter's creditworthiness.

The key to an effective PPP project is partnership, in which both the public and private sectors recognise their shared interests. A well-designed, comprehensive project that is part of a wider country strategy; transparent and competitive procurement; and balanced contract risk allocation are all crucial factors for a successful PPP project.

INTRODUCTION

BACKGROUND AND OBJECTIVES

The European Investment Bank (EIB) has commissioned a review of the Private Public Partnership Legal & Financial Frameworks in the Facility for Euro-Mediterranean Investment and Partnership (FEMIP) Region (the Study). The Study was carried out by Pinsent Masons LLP, Mazars LLP and Salans LLP.

The Study is financed under the Facility for Euro-Mediterranean Investment and Partnership (FEMIP) Trust Fund. This Fund, which was established in 2004 and has been financed to date by 15 European Union (EU) Member States and the European Commission (EC), intends to support the development of the private sector via the financing of studies, technical assistance measures and the provision of private equity.⁴

The objective of the Study is to assess and promote the prospects for successful PPP programmes in the Mediterranean partner countries. The Report involves a detailed Cross Country Assessment of the legal and financial frameworks, and readiness, for Public Private Partnership (PPP) projects of each of the Mediterranean partner countries (Algeria, Egypt, Israel, Jordan, Lebanon, Morocco, Syria, Tunisia and the West Bank) and a Comparative Assessment of the legal and financial frameworks in the Mediterranean partner countries against good practice in five comparator countries (England, France, Mexico, Poland, South Africa).

STRUCTURE OF THE REPORT

The Report comprises three Volumes:

Volume 1: A Regional Approach (the present Volume)

This Volume presents a detailed analysis of the financial and legal issues affecting PPP in the Mediterranean partner countries and compares them with key aspects of the experience in the comparator countries.

Volume 2: Country Analysis

Volume 2 reports on the key elements of the legal and financial framework of each of the nine Mediterranean partner countries.

Volume 3: Best Practices and Lessons Learned – Selected Experiences from Other Countries

Volume 3 summarises key elements of the legal and financial frameworks of the five comparator countries, explaining why these countries were selected and the financial and legal issues identified from their experience.

METHODOLOGY

The Consortium surveyed five comparator countries outside the Mediterranean partner countries. These countries were chosen on the basis of their successful PPP environment, their unique experience of PPP and/or the lessons learned from their experiences that could inform good practice in less developed markets. The purpose of the research was to highlight the typical characteristics of PPP in the five comparator countries and to identify the reasons for the successes in their PPP regimes, as well as any shortcomings that have arisen.

The survey of the comparator countries identified key issues under seven main headings:

- funding capacity and availability;
- institutional issues;
- the legal and regulatory framework;
- bidding process;
- contract design and risk allocation;
- financial risks and payment terms;
- PPP/project finance investment readiness for lenders and investors.

The Consortium also undertook a detailed analysis of the Mediterranean partner countries (the Cross Country Assessment), organised in terms of each of these headings. This was based on information derived from a standard questionnaire devised by the Consortium. The responses, together with interviews held with key contacts in each Mediterranean partner country, formed the basis of the analysis undertaken by the Consortium. This process lasted approximately eight months (from February to September 2010) and produced detailed country reports that will be delivered to the nine Mediterranean partner countries individually. The executive summaries of the nine individual country reports form Volume 2 of the Report.

The Mediterranean partner countries and the comparator countries were then compared. The features of a successful PPP regime in relation to each issue were identified and recommendations have been made in relation to improvements to the legal and financial frameworks of the Mediterranean partner countries based on successful practice and lessons learned in the comparator countries.

The Report identifies success factors and makes initial recommendations in respect of introducing or developing a PPP programme in each of the Mediterranean partner countries. In each case this is concurrent with international best practice whilst taking into account specific issues affecting their country such as the relative stage of development of PPPs and particular country context.

The Report and all references in it are accurate as at 1 October 2010, unless otherwise stated. Whilst the potential for significant political change will impact upon the appetite of the international community to invest in PPP projects, it has been assumed that there will be no substantial change to the key requirements for a successful PPP programme. These political aspects are outside the scope of the Report and the Consortium believes that the description of the legal and financial environment and recommendations remain valid subject to resolution of political issues.

SCOPE OF PROJECTS COVERED IN THE REPORT AND THE USAGE OF THE TERM “PPP”

There are a number of procurement and service delivery structures which are commonly labelled PPP. The Report is concerned primarily with project financed infrastructure projects. The definition of PPP for the purposes of the Report is a partnership between the public and private sectors pursuant to a long term contractual agreement and covering, in most instances, the design, construction, financing and ongoing operation and maintenance of an infrastructure asset.

⁴ Further information about the FEMIP Trust Fund is available at www.eib.org/ftf

In a PPP the public sector usually establishes the service and output requirements (quality/quantity), and enters into contractual arrangements that ensure these requirements are respected. This is based on the principle that payment to the private partner is related to success in meeting the service and output requirements of the project. The long term agreements also include obligations on the part of the public contracting authority.

Project financing is a method of structuring debt finance for capital intensive projects. In such structures lenders are primarily concerned with the cashflows to be generated by the project for the repayment of the loan and with the assets of the project including rights arising under the project contracts (most particularly revenue flows). Accordingly, lenders look to these cashflows, project receivables and assets, rather than primarily to the general creditworthiness of the private sector sponsors, as collateral for the loan. Lenders' involvement in project structuring creates a discipline that is often beneficial for the project, as it creates the appropriate incentives for the private sector to deliver on time and within budget.

Examples of PPPs covered by the Report include:

- power and water treatment projects;
- roads and other transport projects;
- social infrastructure projects such as schools or hospitals.

In each case, payment to the private partner is related to meeting the project's output specification. However, this may be defined in terms of either:

- Availability – in other words, making the services of the asset available for use (this would be typical in a school project, for example, where the authority agrees to pay for the school to be appropriately maintained and serviced over the contract length);
- Demand – for example, where a concessionaire relies entirely on fees from users such as a toll road or an airport; or
- Availability and demand – for example, where a public authority agrees to pay a service fee for the development and maintenance of a road based on the road being available but there is also an element of demand fees (related to toll payments).

Projects often described as 'concessions', under which the private sector receives end user payments and takes demand risk, are addressed in the Report where they involve project financing structures.

Traditional procurement and privatisation are not within the scope of the Report. The Report does not focus on projects where the authority has procured an asset independently from its operation or a service independently from the construction of the asset (often referred to as 'traditional' procurement) or where the private entity provides the service independently of the public authority subject only to the general law or regulation rather than contract (for example, privatised utilities). Excluding such projects from the ambit of the Report is not to suggest they are not suitable methods of procurement. On the contrary, some projects (for example those involving the use of particularly innovative or complex technology for which the private sector may not be ready or capable of assuming the risk) may represent better value if procured wholly by the

public sector. Part of the process of successful project selection/procurement is to ensure that the most appropriate method of procurement is utilised.

COMPARATIVE ASSESSMENT

The Comparative Assessment at sections 1 to 7 below of this Volume 1 presents a detailed comparative analysis of PPP legal and financial frameworks in the Mediterranean partner countries and the five comparator countries. It also identifies the most significant lessons learned from the review of the comparator countries and the 'best practice' implications for the Mediterranean partners.

The key issues from the study of the comparators can be classified under seven broad headings. Each, in turn, has been broken down into the most important questions or issues which appear to determine the success, or failure, of PPP programmes. These are:

Funding capacity and funding availability – how countries can secure finance for infrastructure investment

- How attractive is a country and its PPP programme to (domestic and foreign) investors and lenders?
- Is a country's lending capacity sufficient to finance its long term PPP programme?
- Does a country's financial sector have sufficient expertise to structure complex PPP transactions and if not, how can it be improved?

Institutional issues – how countries establish the right policy framework for PPP

- Does the government have a clear policy which identifies PPP as an important tool for the procurement and development of infrastructure?
- Which bodies are involved in project identification and how is project identification linked to budgets? Is there a clear process for allocating budgets for PPP project development and ongoing operational payments?
- Has the government taken steps to support the PPP path by the creation of specialist institutions and advisory units with sufficient financial and human resource?
- Are different levels of government (local and municipal as well as national) involved in PPP procurement or is there potential for this?
- Are PPP candidate projects thoroughly researched and assessed for feasibility prior to their launch to the market?
- How can projects be implemented and monitored effectively?

Legal and regulatory framework – the legal prerequisites for effective PPP programmes

- Why should a country build a sound and attractive PPP legal framework?
- Does the legal framework sufficiently define the roles and powers of awarding authorities?
- Would lenders and investors be comfortable with the country's law governing project and finance documents?
- Would lenders and investors be comfortable with the judicial system and commercial dispute resolution system in the country?

Bidding process – the role of procurement in ensuring competition and best value for money

- Does the law set out clear procurement processes which are suitable for PPP structures?
- Is the procurement process structured to reflect the complexity of the project?
- Does the procurement procedure respect the key principles of fairness, transparency and equality?
- Are unsuccessful bidders duly notified and do they have rights of challenge?
- Is the public sector accountable for its decisions?

Contract design and risk allocation – securing optimal risk allocation specifically in relation to:

- Design and construction and technical specification risk
- Planning and approvals
- Extensions of time and compensation events
- Operational performance
- Change in law
- Termination and compensation on termination

Financial risks and payment terms

- How do authorities create the right incentives for the private sector to deliver a service or output at the least cost to the authority whilst ensuring the project is bankable?
- Are macroeconomic risks of inflation, exchange rate and interest rate allocated efficiently?

PPP/Project finance readiness for lenders and investors – the incentives and protections needed by lenders and investors

- What are the key incentives and restrictions to foreign investment?
- Are appropriate guarantees provided when necessary?
- Is there a robust security package?
- How do tax and accounting issues affect the affordability of PPPs?
- Are there any general business regulations or practices which might affect the smooth implementation of a PPP?

The questions are answered in respect of those comparator countries whose experience is most relevant and in respect of each Mediterranean partner country. Preliminary recommendations and identification of success factors are set out in boxes at the end of each section.

1. FUNDING CAPACITY AND AVAILABILITY

The macroeconomic condition of a country, its investment climate, lending capacity, as well as institutional and financial expertise, are crucial elements to attract and sustain long term infrastructure investment. These factors impact a government's capacity to sustain a Public Private Partnership (PPP) programme and the domestic and international financial markets' ability to finance it.

It is clear that some countries have funded and may continue to fund projects entirely or primarily domestically. Based on the analysis shown in this section, it is to be expected that in many cases expansion of a PPP programme (or any infrastructure programme) will require greater demand for finance from the international community in addition to financing and project delivery expertise from within the country. This section looks at the issues affecting both domestic and international funding.

This section addresses the following issues, in order to examine the sustainability and bankability of a PPP programme:

- How attractive is a country and its PPP programme to (domestic and foreign) investors and lenders?
- Is a country's lending capacity sufficient to finance its long term PPP programme?
- Does a country's financial sector have sufficient expertise to structure complex PPP transactions and if not, how can it be improved?

How attractive is a country and its PPP programme to (domestic and foreign) investors and lenders?

Comparator countries

Stable macroeconomic conditions and investment-grade credit ratings have enabled comparator countries to access domestic and foreign capital markets. France and the United Kingdom (UK), both with AAA sovereign credit ratings, have readily attracted debt and equity investors for their multi-billion Euro (EUR) PPP programmes. Mexico, with a BBB credit rating and member of the Organisation for Economic Co-operation and Development (OECD), has now successfully implemented PPPs in a number of sectors, including roads, energy, airports, healthcare, education and water infrastructure. For example, a substantial toll road investment programme was successfully carried out following a need to rescue failed toll road projects in the 1990s. South Africa (rated BBB+) has succeeded in using domestic private commercial banks for smaller PPP projects and has required international commercial bank funding backed by export credit agency guarantees for large power project financings. Similarly, Poland (A- rated), has financed its limited PPP programme predominantly through a mix of commercial banks, International Financial Institutions (IFIs) and Export Credit Agencies (ECAs). See Table 1 below for a detailed list of credit ratings in comparator countries.

Comparator countries have designed specific PPP programmes to attract a sufficient number of investors that are now strategically committed to them. In most of the comparator countries this has been a two-way process in which: the government first designed a PPP programme to attract investors; the success of pilot projects then attracted further

fundors, which widened private sector competition for PPP projects and improved pricing and terms for public authorities. The UK and France, for example, whose PPP programmes have been at the vanguard of developing PPP markets and expertise in Europe, demonstrate the importance of having a significant pipeline of projects without being overly ambitious either in scale or project complexity. Project bidders and investors will be attracted to a country's PPP programme if they see that there is a potential to recoup their investment (in terms of time and money) from a losing bid in future bids for similar projects.

The early PPP programmes in some countries such as England and France were partly motivated by governments to secure funding for infrastructure projects that would not be included in public sector debt statistics. It was initially argued that because construction and operational risks had been transferred to the private sector, financial obligations of the government in respect of PPP projects should not be capitalised and added as assets and liabilities to the public sector balance sheet. There have since been discussions and clarifications of the accounting treatment which has led to some projects being reclassified as on-balance sheet for the public sector (i.e. the capital component of the PPP payments is counted as public debt). Whether or not the project is considered to be off- or on- balance sheet should not be the determinant of whether to structure it as a PPP. The key issue is to determine that payments for PPP contracts are affordable and are justified economically by delivering sufficient economic returns and social benefits to offset their costs, irrespective of their accounting treatment.

Table 1: Sovereign credit ratings, 3 February 2011⁵

Country	Credit Rating	Rated by
France	Aaa/AAA	Moody's/Fitch/S&P
United Kingdom	Aaa/AAA	Moody's/Fitch/S&P
Israel	A1/A	Moody's
Poland	A2/A-	Moody's/Fitch/S&P
South Africa	A3/BBB+	Moody's/Fitch/S&P
Tunisia	Baa3/ BBB	Moody's/Fitch/S&P
Mexico	Baa1/BBB	Moody's/Fitch/S&P
Morocco	Ba1/BBB-	Fitch/S&P
Egypt	Ba2/ BB	Moody's/Fitch/S&P
Jordan	Ba2/BB	Moody's/ S&P
Lebanon	B1/B	Moody's/Fitch/S&P
Algeria	n.a.	Not rated
Syria	n.a.	Not rated
West Bank	n.a.	Not rated

Most comparator countries have succeeded in creating a credible PPP programme by first embarking on relatively straightforward projects before applying that experience to more contractually complex projects. This is the case, for example, in Mexico where the contractually more complicated social infrastructure PPP programmes such as hospitals and universities were only introduced after the country had successfully launched PPP programmes in internationally well understood sectors (e.g. roads and power generation). Poland's PPP transactions to date are limited – most of them are

renewable energy projects with elements of PPP (see report on Poland in Volume 3) but not fully fledged PPPs as understood in the Report. Table 2 below provides an overview of the PPP projects closed since 2006 in the comparator countries.

Table 2: Project finance lending to PPPs in the comparator countries, January 2006–November 2010 (EUR)⁶

	COMPARATOR COUNTRIES				
	France	Mexico	Poland	South Africa	UK
Total lending volume (EUR million)	7,093	7,214	1,069	1,264	32,363
Of which; power projects including renewable (EUR million)	Not included in PPP	1,674	547	829	Not included in PPP
Number of transactions	59	32	13	8	286
Of which; power projects including renewable (number of transactions)	Not included in PPP	7	10	3	Not included in PPP

Mediterranean partner countries

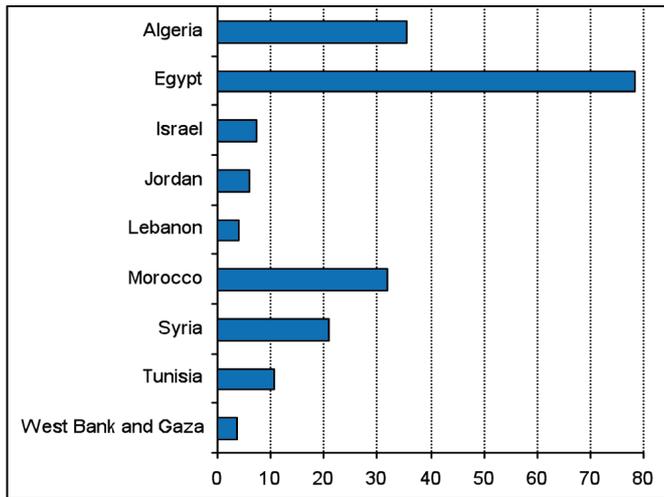
Relatively strong real GDP growth rates and improving fiscal discipline in many Mediterranean partner countries, have contributed to increased access to funding for infrastructure investments over recent years. This trend can be seen in Figure 1 which illustrates that most Mediterranean partner countries have succeeded in maintaining economic growth while reducing government borrowing; slight deteriorations in the public finances of certain Mediterranean partner countries in 2008 and 2009 generally reflect fiscal stimuli as a result of the financial crisis.

Six out of the nine Mediterranean partner countries are externally rated by well-known international rating agencies and three of them are investment grade; improving or establishing international credit ratings would contribute to increasing investor appetite. Table 1 provides a summary of the international credit ratings by country as at February 2011. As the rating opinion encapsulates a combination of financial, economic, political and institutional risk factors, it is a significant indicator of a country's relative ability to honour its obligations. Of the Mediterranean partner countries, Israel, Tunisia and Morocco are investment grade, thereby providing comfort to potential bidders and lenders. Egypt, Jordan and Lebanon are all rated below investment grade. Algeria, Syria and the West Bank are not externally rated. In the case of Algeria and Syria, the relatively low levels of public debt provide a certain degree of comfort on the sovereign's ability to repay its loans, despite the absence of a rating. However, obtaining positive credit ratings would be of great benefit in attracting funders to their PPP programmes, as the ratings factor in a number of considerations affecting a country's creditworthiness.

⁶ Source: *Infrastructure Journal* online database

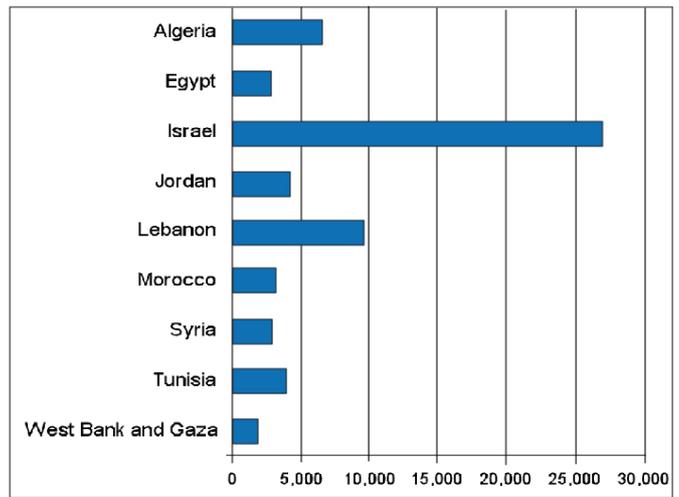
Figure 1: Mediterranean partner countries – selected economic comparisons

Population (millions, 2010 estimates)



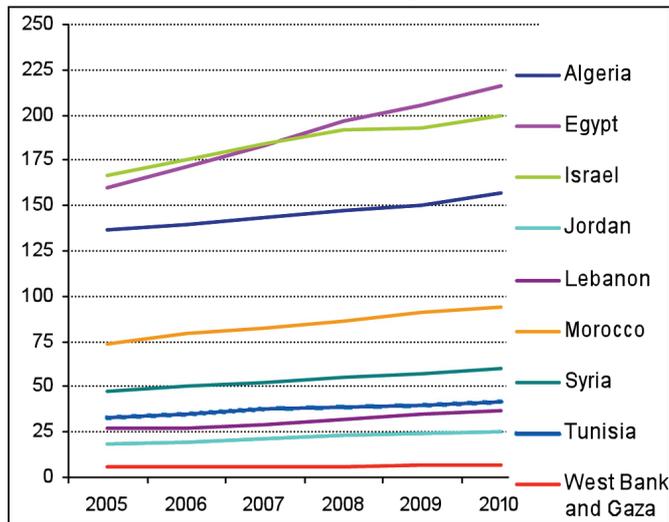
Source: IMF estimates for 2010 except for West Bank: IMF estimate for 2008

GDP/capita (US Dollars, 2010)



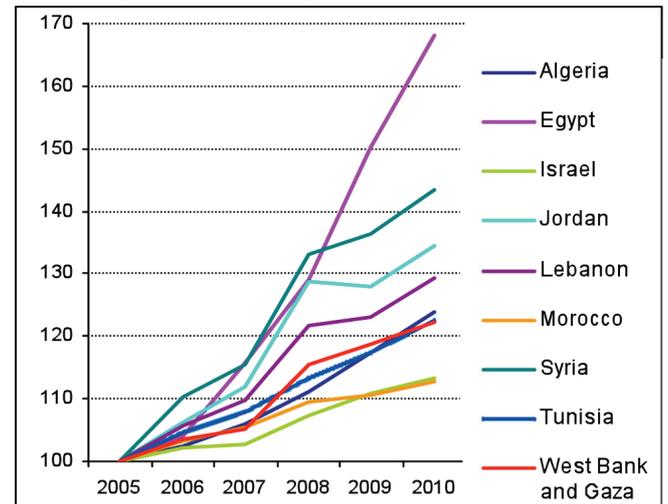
Source: IMF estimates

Real GDP (USD billions at 2010 exchange rates)



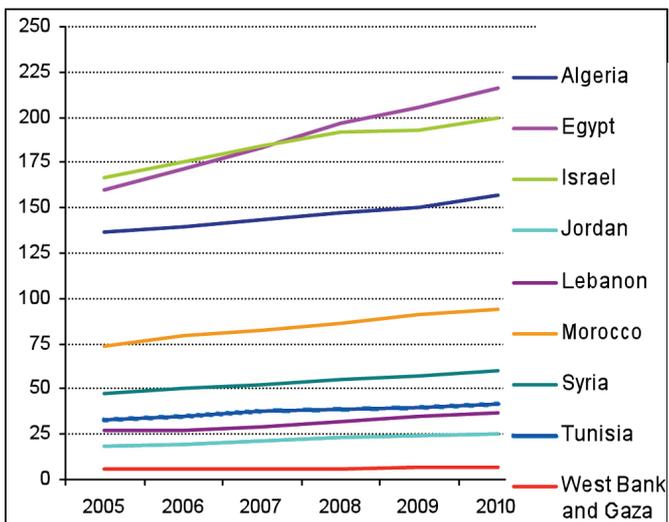
Source: IMF estimates for 2010 GDP in current prices discounted by real growth figures

Consumer price indices (2005 = 100)



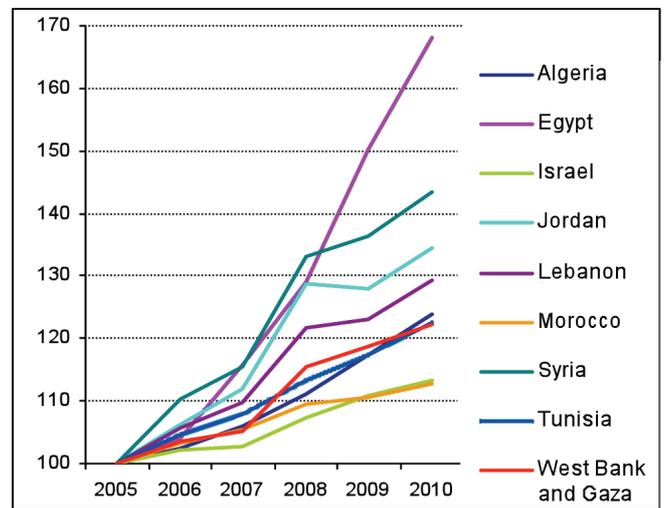
Source: IMF data

Government Debt Total/GDP



Source: Central Bank or Ministry of Finance data of each country

Government Foreign Debt/GDP



Source: Central Bank or Ministry of Finance data of each country

Political stability and strong civil institutional frameworks are essential preconditions for attracting long term investment to PPPs. In some Mediterranean partner countries, notably the West Bank and, to a lesser extent Lebanon, PPP prospects are affected by the political situation. The political developments of early 2011 in a number of Mediterranean partner countries are likely to cause investors to be cautious regarding PPP opportunities in those countries, pending clarification of their outcome. This is a consequence of increased uncertainty and instability. Moments of political change can also represent an opportunity to reinforce or improve already existing institutional frameworks. Although under different circumstances, two comparator countries, Poland and South Africa, underwent major political change during the 1990s, and effectively maintained and reinforced the institutional framework for investment.

The strength of underlying civil institutions helps determine long term investment attractiveness, depending on the degree to which they withstand and are restored following political crises. Analysis of political risk in particular countries is outside the scope of this study. Investors' perception of political risk is a complex judgement of whether, in their view, they will be permitted to earn a reasonable investment return over the long term without arbitrary interference or confiscation by governments (in whatever form) or by excessive bureaucracy or corruption; and whether an institutional framework exists to protect such rights. Physical security for personnel and assets are, naturally, also essential.

The Mediterranean partner countries have designed different PPP programmes to attract investors, although the number of PPP projects closed to date is relatively low. As shown in Table 3, which provides a list of project financed PPPs closed in the region, Israel and Egypt are the countries with larger lending volumes, reflecting the relative maturity of their PPP markets. The total number of deals for the whole region (21 projects between 2006 and 2010) is however low. Prior to establishing a formal PPP policy, the majority of the Mediterranean partner countries gained experience in PPP techniques through independent power projects (IPPs), ports and airport concessions. For example, Israel has developed PPP programmes in the transport, water desalination, sewage treatment and energy sectors, with a mixed track record: some transport projects have taken a long time to reach financial close, while the water desalination projects have been procured efficiently, applying standardised terms and correct risk allocation, and have therefore attracted domestic and international (IFI and commercial) funding. In 2010, Egypt signed its first PPP outside of the ports and power sector: the New Cairo Wastewater (NCWW) treatment plant and enacted its PPP law. Following the success of the NCWW project, using accepted PPP practices and working with international advisers, Egypt has attracted a large number of expressions of interest in the PPPs it has announced in the water, roads and power sectors. Countries like Morocco, Tunisia and Algeria have a history of concession projects used in sectors such as water treatment and transport. A significant number of foreign investors responded favourably to Algeria's first PPPs for desalination projects in 2003-2004, as the government announced a considerable pipeline of projects. This trend might be reversed in the coming years, as Algeria has recently introduced laws (Complementary Finance Law 2009, confirmed in 2010) that may deter foreign sponsors and lenders from being active in its PPP programme. Tunisia's cancellation of an IPP procurement in 2010, in favour of traditional procurement

and after receipt of priced bids, is likely to deter future PPP bidders until such time as a clear policy commitment to PPP is finalised. Syria, Lebanon and the West Bank have not closed any project financed PPPs to date, although Syria and Lebanon are taking important steps to create an attractive PPP framework and programme.

Table 3: Project finance lending to PPPs in Mediterranean partner countries, January 2006 – November 2010 (EUR million)

Country	Total lending volume (EUR million)	Number of transactions
Algeria	830	5
Egypt	1,369	5
Israel	1,089	5
Jordan	440	4
Lebanon	0	0
Morocco	108	1
Syria	0	0
Tunisia	446	1
West Bank	0	0

Source: *Infrastructure Journal* online. Excludes telecoms sector financings.

In seeking to attract investors to PPP programmes, the Mediterranean partner countries need to ensure that announced programmes are followed through consistently and transparently. This consistency of approach creates a core of expertise amongst early entrants to the market. Their success then attracts further funders, which widens private sector competition for PPP projects and improves pricing and terms for public authorities. Whether they are domestic or foreign entities, debt or equity providers, funders need to be convinced of the long term investment potential and economic viability of the country's PPP programme, otherwise they will not invest the human and financial resources to bid for and finance projects.

Is a country's lending capacity sufficient to finance its long term PPP programme?

Comparator countries

Comparator countries' access to efficient and liquid capital markets has ensured the bankability of well structured projects. Well-functioning capital markets are characterised by a diversity of financial institutions (domestic and foreign owned) active in private sector lending (including large syndicated loans), bond markets in which the government and major corporations can raise long term debt and an active equity market. Within the European Union (EU), financial markets are highly integrated so that, for example, Polish PPP projects obtain finance from a wide range of EU-based banks in addition to Polish banks. Large long term bond markets in EUR and Sterling (GBP) enable active long term interest rate swap markets in these currencies, so that Project Special Purpose Vehicles (Project SPVs) can hedge their interest rate risk. Mexican PPPs have benefitted

from the strengthening of its domestic debt markets since its financial crisis in the early 1990s. South Africa can also raise funds domestically for all but its largest projects. However, during the recent financial crisis, the comparator countries encountered major difficulties in financing infrastructure due to unavailability of finance: bank liquidity dried up when the securitisation markets (into which they packaged and sold loan portfolios) collapsed, forcing banks to reduce the size of their balance sheets through reduced lending (see Box 5 below).

To ensure that financing is available for a project, the comparator countries often require bidders to provide strong evidence of funders' support when submitting bids. Such support can be in the form of a conditional commitment letter from the banks, indicating that if the bidder is selected they will provide funding on the terms indicated, subject to satisfactory conclusion of due diligence on the project. Whilst such letters also have other “escape clauses”, such as no material changes in market conditions, they provide reassurance to procuring authorities that the project is financeable. This process requires that there are sufficient banks to support different bids exclusively and to avoid conflicts of interest arising.

The depth of their financial markets allows most of the comparator countries to provide long term funding in their local currency. France and the UK respectively have readily attracted EUR and GBP denominated debt and equity for their multi-billion EUR PPP programmes. Mexico, with a BBB credit rating and a member of OECD, increasingly funds its PPP projects in Mexican Pesos (MXN) rather than in United States Dollars (USD), and has required less IFI funding, ECA guarantees or commercial international banks requiring political risk insurance. The Mexican financial markets have also allowed for Mexican PPPs to be financed in MXN and USD denominated bonds. South Africa (rated BBB+) has seen most of its PPP programme to date (other than large power projects) financed by domestic private commercial banks in South African Rand (ZAR). Despite its high rating (A-), Poland's PPP programme has been predominantly funded in Euro, through a mix of commercial banks, IFIs and ECAs, due to relatively limited liquidity in the Polish Zloty's (PLN) long term credit markets.

The long maturities of PPP project loans in most comparator countries have made projects more readily affordable. Debt service and investor returns are modelled to be spread over as much of the project's economic life as possible, reducing the annual capital charge to be recovered from the authority through the project payments. In the UK and France, PPP loan maturities for projects are regularly in the region of 25 years, albeit shorter for power projects. Mexican toll roads currently are often financed through short term mini perm loans – seven to ten year bank loans with limited repayment, so that full debt pay-out assumes refinancing and repayment over a longer term. Mexican IPPs are typically financed through loans with tenors of around 15 years. Polish and domestically funded South African PPPs have typically obtained long commercial bank loan repayment periods of around 20 years (over 80% of the concession period). For large-scale power projects, South Africa has relied on ECA guaranteed funding with slightly shorter repayment periods, reflecting difficult market conditions. Some large-scale IFI and ECA-backed loans to Polish road projects have obtained up to 30 year repayment periods.

Even when projects in the comparator countries can be funded entirely from commercial sources, IFI lending has been used to complement commercial bank financing. For example, EU PPP projects that meet the European Investment Bank's (EIB's) lending criteria can apply for an EIB loan for up to 50% of construction costs. In such cases, the EIB “co-lends” alongside commercial financiers, normally on the same risk basis and documentary terms, other than loan pricing and repayment profile. For EU PPP projects, the risk appetite of the EIB is often well understood by the commercial debt arrangers, so that the common funding package can be readily agreed.

Mediterranean partner countries

Despite being financially solvent and liquid, the domestic financial markets in most Mediterranean partner countries are constrained in the amount of PPP lending they can provide. The banking sectors tend to be small relative to the size of the economy. The exceptions are Algeria (with its large State-owned banking sector), Israel (with a well-developed local financial system) and Lebanon (with a large banking sector due to its position as a regional financial centre, but whose appetite for PPP lending is still largely untested domestically). Morocco and Israel each have two or three dominant banks that can provide relatively large loans to individual PPPs. Egypt's and Tunisia's relatively fragmented financial sectors likewise have some banks with ability to provide limited lending to PPPs, as do (but to a lesser extent) the Jordanian banks that are rated by international credit ratings agencies. Syria's small and fragmented private commercial banking sector is more constrained. Nevertheless, despite their relatively small size, banking sectors in the Mediterranean partner countries are generally financially solvent and liquid (with low loan/deposit ratios by international standards), so that banks have lending capacity up to the constraints imposed by their individual balance sheet sizes and by their national banking regulations.

As a result of the relatively small financial markets, long term funding in local currency is not prevalent in the Mediterranean partner countries. Algeria is somewhat exceptional, since its State-owned banks can fund the Algerian PPP programme as long as they remain recipients of large deposit inflows from the government and State-owned entities, generated by the country's large hydrocarbon export earnings. Countries such as Israel, Tunisia and Morocco (with investment grade ratings) and Egypt, have shown domestic currency lending capacity for relatively large PPP projects. For example, the debt financing of Israeli road PPPs to date (over EUR 1 billion) has been provided exclusively in local currency by Israeli banks. Similarly, Egypt closed its first PPP in the water sector in April 2010 raising EUR 86 million of local currency financing. Finally, Morocco has recently obtained approximately EUR 300 million of local currency commitments for a wind power project. However, capacity even in these markets may not be sufficient to fund very large individual projects or PPP programmes in local currencies.

Mediterranean partner countries will benefit from the availability of IFI or ECA guaranteed funding to supplement domestic and foreign commercial bank funding of PPPs. IFI or ECA guaranteed funding is commonly used in some countries to fill absolute gaps in funding availability, especially in countries with no investment grade credit rating. This is likely to be the case particularly in Syria, Jordan and Lebanon. Other Mediterranean partner countries such as Tunisia, Morocco, Egypt and Israel, which historically have had access to a wide range of financiers, could also benefit from IFI and/or ECA guaranteed funding for their larger projects, in particular to take advantage of the long maturities that are available from IFIs or ECA guaranteed sources.

Box 5: Effects of the financial crisis

All comparator countries were adversely affected by the financial crisis that started in 2008, although to different degrees. Mexico suffered a 6.5% fall in real GDP in 2009 due to falling oil revenues. The UK's real GDP declined by 4.9%, reflecting the large share of the financial sector in its economy. France and South Africa both underwent more moderate decreases in GDP, and Poland's real GDP, alone amongst large EU countries, grew in 2009. The drying up of credit caused sharp increases in loan pricing during the crisis, which has only partly abated and is unlikely to reduce to pre-crisis levels, as a result also of higher bank capital requirements. During late 2008 and early 2009, a number of projects were either deferred, cancelled or reduced in scope due to lack of availability of funding. At the height of the crisis, and faced with imminent large PPP deals being unable to attract funders, the UK established a Treasury Infrastructure Finance Unit (TIFU) to co-lend to projects which has in practice served to support only one project to date (the Greater Manchester Waste PFI). France introduced increased capital spending to offset the downturn, including on major infrastructure projects such as extensions to its high speed rail system. Across Europe, the European Investment Bank (EIB) stepped up the volume of its PPP lending by around 30% (EUR 15 billion) in order to offset reduced credit. Anti-crisis measures adopted by the EIB included additional support for small and medium-sized companies, comprehensive packages on energy and climate change, the automotive industry, additional support for Central and Eastern Europe and a capital increase to cope with larger lending volumes. Market conditions improved during 2010 and funding is today generally available for viable projects, albeit at higher pricing and stricter conditions compared to prior to the crisis. The overall effect has been that projects undergo far more scrutiny by authorities, bidders and lenders.

Mediterranean partner countries have fared better in the international financial crisis. Most Mediterranean partner countries experienced positive real GDP growth in 2009 (see figures below) due largely to less highly leveraged banking sectors than many more established markets, which therefore incurred lower loan losses. Also, most governments in Mediterranean partner countries had relatively controlled debt levels, so that their ability to withstand cyclical increases in fiscal deficits during the crisis has been sustainable. The crisis was transmitted to Mediterranean partner countries mostly in the form of reduced demand for exports and services, notably of gas from Algeria, tourism receipts, and reduced foreign grant support. However, one effect of the international crisis that directly affects PPP programmes has been a reduced appetite by international banks. In this situation, Mediterranean partner countries need to compete for scarce resources, thus increasing the importance of supportive regulatory, financial and legal frameworks. The situation is currently improving with international credit availability increasing, particularly as lenders and investors seek to diversify into higher growth markets.

Real GDP growth, 2009:*

Lebanon	7.6%
West Bank	3.7%
Egypt	2.7%
Morocco	2.7%
Syria	1.5%
Tunisia	2.0%
Algeria	0.5%
Jordan	0.4%
Israel	(1.4%)

* source: IMF

Does a country's financial sector have sufficient expertise to structure complex PPP transactions and if not, how can it be improved?

Comparator countries

Exchange of knowledge with the awarding authorities in different countries and replication of best practices acquired on well developed projects, creates a core of expertise within early entrants. Dialogue over standard PPP contract terms and risk allocation has produced a developing core of knowledge on the bankability of PPP deals. This is the result of strong institutional PPP policies and frameworks in the comparator countries. Lessons learned from the UK and French market helped inform the development of other PPP markets in Europe (including Poland) and elsewhere. Institutions like Partnerships UK (PUK) (now Infrastructure UK) have helped to disseminate knowledge by providing advice to different countries (including Mexico and South Africa). In South Africa, the leading domestic banks imported PPP expertise learned in other markets to their domestic market. In Mexico, the PPP programme is largely concentrated on internationally well-understood project models, such as energy projects and toll roads. As a result, its PPP programme has attracted a mix of Mexican and foreign funders, who understand both the project structure and often the country specific economic, legal, and political features.

Mediterranean partner countries

Most Mediterranean partner countries would benefit from increased PPP expertise in domestic financial institutions. Israeli banks are the exception, due to the long standing nature of their PPP programme. Large domestic banks in Egypt, Morocco and Algeria do possess some PPP arranging experience in their home markets. In addition, some of the foreign-owned banks throughout the Mediterranean partner region can access PPP expertise from their foreign parent banks, provided the parent bank is willing to lend to that country's PPP programme. A series of targeted seminars and briefings on the opportunities of the PPP market, sponsored by the country's PPP unit or nearest equivalent agency or advisers recommended by it, could serve to increase appetite for PPP lending. The government can also seek to obtain views from international banks, both IFIs and private sector, to help determine key requirements for making a PPP programme successful. As the best way to acquire PPP expertise is generally "learning by doing", co-financing by local and international lending institutions (including IFIs) could also serve to strengthen PPP expertise in the local banking sectors.

Funding capacity and availability – recommendations/success factors

- Increase attractiveness of a country's PPP programme to a wide a range of lenders and investors by establishing a pipeline and timetable of viable projects to which the government is committed to procuring.
- Encourage local currency funding if market capacity for long term loans is available, alongside foreign currency funding.
- Promote PPP expertise in the local banking sector.
- Encourage IFI participation, which will also serve to attract other sources of funding.

2. INSTITUTIONAL ISSUES

A number of features of the institutional framework contribute to the successful development of Public Private Partnership (PPP) programmes: explicit PPP policies, adequate institutional capacity, clear processes for project identification and budget allocation and sound feasibility studies of potential projects verified by unbiased and rigorous approval processes.

This section reviews the experience of both the comparator countries and the Mediterranean partner countries in establishing policies and institutions to support a PPP programme, by examining the following issues:

- Does the government have a clear policy which identifies PPP as an important tool for the procurement and development of infrastructure?
- Which bodies are involved in project identification and how is project identification linked to budgets? Is there a clear process for allocating budgets for PPP project development and ongoing operational payments?
- Has the government taken steps to support the PPP path by the creation of specialist institutions and advisory units with sufficient financial and human resource?
- Are different levels of government (local and municipal as well as national) involved in PPP procurement or is there potential for this?
- Are PPP candidate projects thoroughly researched and assessed for feasibility prior to their launch in the market?
- What are the key elements of a project assessment process?
- Which institutions are involved in the procurement process?
- How can projects be implemented and monitored effectively?

Does the government have a clear policy which identifies PPP as an important tool for the procurement and development of infrastructure?

Comparator countries

In several comparator countries, targeted policies have clarified the role of PPP within national infrastructure plans and have guided the implementation of a PPP programme. In the United Kingdom (UK) and South Africa, several government bodies (particularly the ministry of finance and the PPP unit) have issued policies that identify PPPs as a means of infrastructure procurement; describe the reasons and goals for adopting PPP schemes; provide general guidance on how PPP projects should be developed and procured by the national and local governments; and define the sectors in which PPP programmes are encouraged. Whilst compliance by relevant actors with PPP policies is generally not mandatory (unlike legislative compliance), these policies have encouraged synergies through standardising practices across sectors and through co-ordination between interested stakeholders and institutions.

Line ministries are encouraged to develop PPP programmes as part of their wider sector infrastructure development plans.

In Poland, South Africa and Mexico there is a high degree of autonomy at State and provincial level, and the degree to which PPP is taken up varies according to local interests. It is, nevertheless, common for the ministry of finance to play a key role in translating government policy into practice and guiding line ministries as to the appropriate means of identifying and procuring projects.

Mediterranean partner countries

Most Mediterranean partner countries have not consolidated PPP legislation by introducing clear guiding policies aimed at coordinating implementation of PPP programmes. In several countries, PPP laws exist or have been drafted (Egypt, Lebanon, Syria and Jordan). This indicates that PPP is recognised as an important mode of procuring projects that have been identified and prioritised for the development of national infrastructure. In other countries, PPP is practised as a regular means of delivering projects, but there are no supporting specific PPP laws (Algeria, Tunisia, Morocco and Israel, although in the case of Tunisia and Morocco concession legislation is fairly advanced). However, most countries would benefit from clearer policies describing when and in which sectors PPPs could be an efficient procurement option, as well as practitioner guidance describing how a PPP project should be implemented on a step-by-step basis (addressing, for example, project identification, appraisal and oversight). Syria, Egypt, Morocco and Israel have developed PPP as a clearly defined policy. Tunisia has established a particularly clear and advanced policy in relation to PPP in the digital economy sector and is developing PPPs in other sectors.

Box 6: The importance of a PPP policy

In many countries legislation is supplemented by policy to stimulate the growth and development of a pipeline of PPP projects. For example, whilst not having strictly 'legal' status, government bodies may issue policy in relation to the rules of tendering and the terms of contract. PPP policies serve to define PPPs in comparison to other infrastructure service procurement options; to describe the reasons and goals for adopting PPP schemes; and to provide general guidance on how PPP projects should be implemented by the national and local governments. Compliance by relevant actors with the letter of PPP policies is generally not mandatory (unlike legislative compliance). However, PPP policies can encourage good relationships by directing and co-ordinating co-operation between interested sectors and the institutions of government. PPP policies also help to define the sectors in which PPP programs are encouraged and which the government sees as a priority.

Which bodies are involved in project identification and how is project identification linked to budgets? Is there a clear process for allocating budgets for PPP project development and ongoing operational payments?

Comparator countries

In the comparator countries, infrastructure planning and project prioritisation is co-ordinated centrally. Decisions relating to which projects should be prioritised and budget allocation are determined by central government on the basis of national priorities. Responsibility for actual identification and planning of projects lies with the line ministries and local authorities. Bodies such as the Project Review Group (PRG) in England convene regularly to scrutinise projects and to decide which can go ahead.

Project identification is normally linked to multi-annual budget programmes typically set by the ministry of finance. Often the budget lines take the form of credits (which are centrally funded and are not repayable), both for project development and for the operational phase of the project. This system is used in France. In the UK and Poland, the credits are generally only extended for the operational phase of projects. Apart from requesting central government funding, procuring authorities are generally free to pursue PPP projects at any time, using their own resources. This approach is particularly prevalent in Poland and France, where there is a considerable degree of local autonomy.

Mediterranean partner countries

To enhance credibility and investor appetite, some of the Mediterranean partner countries have identified projects by developing a multi-annual infrastructure PPP plan. This can also provide a solid basis for a PPP project pipeline. Morocco provides a good example of a thorough strategic approach to planning national development needs, through the drafting of its national five-year development plan, which outlines the infrastructure developments needed to deliver the plan.

In most Mediterranean partner countries the budgetary processes are regular and institutionalised, although such practice could be strengthened across the region. Generally, line ministries bid for their budgets, which are mediated by the ministry of finance, as in the comparator countries. There is a high degree of centralised decision-making around budgeting in the Mediterranean partner countries, which enables robust control of public finances. This takes two forms: (i) regular annual budgets for line ministries; and (ii) special budgets for large projects of strategic national importance. The pursuit of individual projects is particularly prevalent in Jordan, which until early 2011 had a government ministry specifically established for that purpose (the Ministry of Mega Projects). This has benefits in terms of focusing effort and resources on strategic projects, but can lead to overlap of responsibilities and possible duplication of work with other PPP stakeholders. In Lebanon, the annual budgeting process is difficult to determine, due to a backlog of parliamentary procedures and the practice of rolling forward the previous year's budget until this can be resolved.

Line ministries normally identify and provide their own resources to fund PPP projects. In cases where the project proposal has been originated from another source, for example a municipality, the line ministry is usually required to co-sponsor the project. Projects that originate from a region or municipality may be supported by local initiatives to the extent that there is some fiscal autonomy at local level, as well as being funded from ministerial budgets.

The regular planning and announcement of national budgets do not necessarily emphasise PPP or ring-fence funds for PPP projects, except where it is an explicit part of government infrastructure funding policy, for example in Morocco and Syria, where PPP is integral to the national infrastructure plan. In some cases, where there is a strong track-record of a particular ministry in PPP project procurement, a budgeted programme of PPP projects will be clearly identified, for example for water projects in Algeria and power projects in Egypt.

In all Mediterranean partner countries, the ministry of finance has a vital role to play in approving budgets for PPP projects.

To the extent that PPP projects commit the country to long term payments, they may be considered as adding to the national debt. Therefore it is important that proposed project costs are accurately calculated in order to enable appropriate budget-setting and approval by government agencies.

The process of planning and budgeting for individual PPP projects needs to improve in most Mediterranean partner countries. This can be enabled through the careful preparation of detailed business cases based on accurate assessments of costs, benefits and risks. Equally there is a case for encouraging a specific PPP budget to support projects, allocated either as a central pool for all sectors in the ministry of finance, or delegated to individual line ministries, as in the case of the comparator countries. In order to bring greater certainty as to the availability of resource, management of budget and a uniform process to encourage bids by procuring authorities, the Mediterranean partner countries may wish to introduce a PPP credit system which would be funded centrally and be overseen by the ministry of finance.

Has the government taken steps to support the PPP path by the creation of specialist institutions and advisory units with sufficient financial and human resource?

Comparator countries

Governments have often created central PPP units to drive forward their PPP policy and programme. All comparator countries except Poland have central PPP units (or PPP centres of expertise). These have proved valuable in standardising practice and in encouraging the development of PPP.

Practice of the comparator countries in establishing specialist PPP advisory functions (such as central PPP units) ensures cross-sector coordination and efficiency in the procurement process. Such technical advisory bodies can help to ensure that project preparation is well co-ordinated and that the government's approach to contract design and risk allocation is consistent across sectors, save for in relation to sector specific and project specific issues. This will contribute to making the project procurement process more efficient.

Box 7: The benefits and role of a PPP unit

- PPP policy-making and dissemination of best practice.
- Project identification.
- PPP project/programme planning and prioritisation.
- Provision of guidance / support to procuring / contracting authorities.
- Central repository of knowledge.

Procuring authorities normally benefit from support and guidance from the PPP units or other centralised centres of expertise when embarking upon PPP procurements. Usually this will be in the form of manuals, training activities, electronic information on websites (such as in Mexico where a website has been established to disseminate project information) and help-desk support. Infrastructure UK in England is also active in providing guidance for projects.

Countries that have reached an advanced stage of development in PPP implementation have often established sectoral PPP units within procuring authorities.

There is often a need to adapt central guidance to reflect particular technical, legal, institutional and social aspects of the sector. This gives a significant degree of comfort to project investors, funders and operators that their concerns will be reflected in the particular sector PPP documentation and procedures. Examples include the health and education sectors in England, and the university sector in France.

PPP units are not usually directly involved in project procurement, monitoring and management, which is the responsibility of line ministries or local authorities. This practice encourages participation by line ministries and local authorities producing greater local accountability and dissemination of knowledge and good practice. PPP units maintain a general overview and scrutiny function. For example, in Mexico, the Federal States must submit their projects to the investment unit for technical review before they can be approved by central government. In some exceptional and strategic sectors, PPP units may become involved in procurement (such as large defence projects in the UK advised by Partnerships UK (PUK), now Infrastructure UK (IUK)). Generally, monitoring and management of completed projects during the operational phase is left to the procuring authorities, although they may have access to PPP unit support on an ad-hoc advisory basis, for example through help-desks and interactive websites.

Mediterranean partner countries

An institutional entity has been created to support the implementation of PPP programmes where government has supported the use of PPP as an alternative procurement option.

Usually this is a PPP unit or its equivalent that advises line ministries and local authorities on the various technical aspects of PPP project identification, appraisal and procurement. There are examples of this in Egypt (the PPP Central Unit) and more recently, Syria (the Central PPP Unit which will become the PPP Bureau under the new PPP law). Tunisia has established a Concessions Unit which, however, has not yet participated actively in PPP development. Jordan has a PPP advisory unit combined in the Executive Privatization Commission and the Privatization Council. These bodies, considered to be an important repository of expertise, play a key role in project initiation and procurement. As such, they have in some cases led the tendering of projects instead of the relevant line ministry. This was the case, for example, in the Queen Alia International Airport project. Morocco is taking a positive step towards the creation of institutional expertise as it has recently announced that it will be establishing a PPP unit using advisory services of the World Bank and IUK.

The core role of PPP units in the region has been modelled on those of comparator countries, in terms of project approval, involvement in the definition of PPP programmes, and dissemination of good practice.

In many cases, there is also very strong involvement by the PPP unit in actual advisory work and the procurement of projects (for example, in Jordan as described above). In these cases, it is important that such bodies have a clear understanding of sector specific issues, but these can alternatively be addressed by establishing specialist PPP advisory units in the line ministries that are heavily involved in PPP programmes. Knowledge sharing between line

ministries can then be fostered through coordination by the Central PPP Unit. In some countries, including Algeria, Egypt and Jordan, several line ministries have already developed significant procurement experience and are relatively self-sufficient. However, when capacity is scarce, care should be taken to avoid atomising expertise. In these cases, involving staff from line ministers in centres of expertise could be more appropriate to facilitate knowledge exchange.

Central PPP advisory bodies tend to have limited human and financial resources, and would benefit from increased capacity.

There is clearly a role for investment by the government, in association with International Financial Institutions (IFIs), to build institutional capacity. In some cases, this is already underway with multilateral or bilateral financial support, for example in Morocco, as mentioned above. In Egypt, it is proposed that successful PPP projects should be charged a levy to enable funding of future capacity development.

In several countries, more than one advisory body has been given a significant role in the implementation of PPP programmes.

There are bodies with overlapping roles in Jordan, Lebanon, Morocco and Israel. It is recommended that there is a clearly defined institutional landscape to enable projects to be managed effectively, and for one PPP advisory body to take a clear lead in the whole advisory process.

Some line ministries have a more independent approach toward PPP project implementation whereas in other cases the central government, as a whole plays a larger role.

Some line ministries have experience in procuring PPP projects in their particular sectors, such as water supply (Algeria), transport (Jordan) and power generation (Algeria, Egypt and Tunisia). In such cases, there are often sector specific PPP laws or regulations to enable the respective line ministry to operate. In these cases, the line ministry will also have developed the organisational capacity to handle a pipeline of projects. In other cases, where PPP is being introduced into new sectors or is a new policy for the country, central government may encourage participation of line ministries by creating satellite PPP units in those ministries, for example in Egypt and Syria. In Egypt a satellite PPP unit has been set up in conjunction with a university to work on health projects; whilst in Syria, nodal PPP units are being established in several line ministries, including the ministries responsible for transport and energy.

Are different levels of government (local and municipal as well as national) involved in PPP procurement or is there potential for this?

Comparator countries

Local authorities or municipalities often have a high degree of autonomy to initiate PPP projects, while central government remains involved for strategic projects. This is particularly the case in countries such as Poland, Mexico and France that constitutionally have always encouraged localised decision-making. In all comparator countries, projects are frequently initiated by local authorities and municipalities. In some countries organisations exist to share local authority experience and to disseminate good practice – for example Local Partnerships in the UK. This is a joint venture between IUK and the local authorities themselves to provide guidance and technical assistance to authorities wishing to procure PPP projects in a wide range of sectors. Similar initiatives exist in

Poland and France. As a result, PPP programmes in the comparator countries demonstrate a healthy mix of PPP projects originating partly from the local level and partly from central government. The central government projects are usually of a strategic nature, such as major transport links or defence projects. Local authority projects tend to be those of a more social character, such as health, education and waste management projects.

Mediterranean partner countries

In most Mediterranean partner countries, central government drives PPP programmes and project implementation. The political importance of PPP is recognised through the creation of high-level inter-ministerial committees to review projects that have been submitted for approval by the line ministries. The committees will typically consist of representatives of all the key ministries with an interest in project development, including finance, sector interests (such as transport, water and telecoms) and the interior ministry. The inter-ministerial committee is a political high level filter. In countries where PPP is already well-established (such as Morocco, Lebanon, Jordan, Egypt and Israel), the PPP committee will report directly to the Prime Minister's office. In the case of Syria, which is developing a new programme, the PPP organisational body reports to the office of the Deputy Prime Minister (DPM). The Syrian Draft PPP Law states that the Economic Committee (comprised of the DPM and several other ministers) will have direct control over the PPP programme acting as the PPP Council in Syria. Generally, a key function of the PPP committees in Mediterranean partner countries is to approve projects. They also require progress reports on projects that are in construction or operation.

The involvement of local authorities at the early stage of project development has proven to be useful in facilitating project implementation. Although local authorities may lack fiscal autonomy and technical capacity and have limited delegated powers, they have an important role in representing the interests of local communities. There is scope to educate and involve local authorities about PPP opportunities, as has been done effectively in the comparator countries. There may also be scope to set up organisations amongst local authorities and municipalities to enable participation in PPP initiatives originating from central government, and to encourage the transmission of local views and priorities to central government decision-makers. In this way, a constructive dialogue will evolve that can inform both PPP policy and practice. Exceptions to this state of affairs apply only to the largest municipalities, for example the Greater Amman Authority in Jordan. For the most part, even where powers exist for local authorities to become involved, there appears to be little participation in most cases. Exceptions are Syria and Algeria, where there are some signs of significant local authority interest.

Are PPP candidate projects thoroughly researched and assessed for feasibility prior to their launch to the market?

Comparator countries

Before a project is presented to the market, procuring authorities prepare a business case which is refined during project development phase and reviewed at various stages. The business case is normally presented in an outline version and submitted for review to external bodies for appraisal (see

below for the appraisal process); it is then complemented with further detailed information and resubmitted for further assessments. A number of features are common across the comparator countries: (i) technical feasibility, including availability of land for development, with initial environmental and planning approvals; (ii) economic feasibility, often with a cost-benefit analysis indicating what economic and social benefits will be secured against the necessary costs; (iii) risk analysis, including risks to be transferred to the private sector, and outline contractual terms; (iv) financial appraisal, including affordability to the authority, calculation of any required operational subsidies and the preparation of a public sector comparator to justify the choice of PPP as against other means of procuring the project; and (v) legal analysis, ensuring that the necessary approvals are in place and that there are no legal impediments to the project. These features are summarised in Box 8 below. Detailed business cases may include a shadow bid model, evidence of bankability and expected accounting treatment of the resulting PPP.

Box 8: Key elements of a sound feasibility study/business case

- Technical feasibility – outline plans, site preparation and environmental approvals.
- Economic feasibility – cost/benefit analysis.
- Risk analysis – allocation of risks between public and private parties.
- Financial appraisal – affordability, bankability, tax and accounting issues.
- Legal analysis.

Detailed standardised procedures to develop business cases enable efficient project appraisal and provide comfort to potential bidders. If the project development phase is not undertaken in sufficient detail, there is a risk that the project will be delayed or may even have to be cancelled during the bidding process. In addition, private sector bidders derive comfort from well-prepared projects as it reduces their bidding costs and ensures that there is less time and lower costs needed to get to preferred bidder stage, for due diligence and then financial close.

Several comparator countries test and inform the market through the preparation of project information memoranda and the organisation of “bidders’ days”. The information memorandum sets out the scope of the project and its outline business case. Potential bidders for the project can then express their interest and raise any issues that the procuring authority might need to consider in advance of going to market through the formal procedures. A data room is established containing all of the support documentation for the procurement, such as title to land, environmental and technical studies. Also, documentation (such as standard contracts) are made readily available on the internet. This approach is used routinely in the comparator countries and is particularly valuable when the project is technically complex or contains unusual and innovative features that need to be explained to potential bidders.

Mediterranean partner countries

Often projects have not been well prepared and have required restructuring or cancellation at the bidding stage, generating delays and discomfort in the market. In several cases, large and politically high-profile projects have been cancelled during procurement, due to insufficient preparation. An example is the Egyptian schools project originally launched in 2007, which was withdrawn as being too large and ambitious for the current stage of market development and is now being redefined to a more manageable size.

Institutional capacity for effective project preparation is often not sufficiently developed and needs to be strengthened in order to attract investors and avoid renegotiations at the operational stage. Institutional capacity can be reinforced through advisory services and technical assistance, with the support of IFIs and donor funding. However, in order to ensure that capacity and expertise is maintained, it is necessary to mobilise sufficient recurrent funding over the long term. This can be done through an annual contribution from the central government or from ministerial budgets. An alternative mechanism being considered (for example in Egypt and Syria) is a levy on project transactions to offset the government’s costs of project preparation. In addition, knowledge exchange programmes in the region may also contribute to establish best practices and lessons learned.

Lack of standard practices and documentation has often been the cause of time consuming project development processes and weak business cases. In some cases, this may be partly due to the fact that PPP markets are at an embryonic stage, with a lack of capacity and resources in the procuring authorities and line ministries. For example, few countries seem to have established a standard discount rate for economic appraisal (and comparison among bidders). Some countries use public sector comparators (Egypt and Israel) which are helpful to benchmark and cost projects; while in others there is little evidence of this practice.

Where there is a good level of experience of project development and procurement in certain sectors, best practice should be institutionalised and transferred to other sectors. This is the case, for example, in Algerian desalination projects where the line ministry has developed almost a routine process and has a high degree of autonomy. Expertise has also been developed by line ministries responsible for the energy sector in Jordan and Egypt. It would be beneficial to the country’s PPP programme as a whole if a centre of expertise established itself as a repository of knowledge acquired, which it could then use to disseminate to other projects or sectors. Projects also need to be scheduled so that there are synergies within and between sectors, and to ensure that there is sufficient institutional capacity to handle the deal-flow and sufficient market capacity and interest to respond to tenders.

Experience has shown that where PPP is being introduced in a new country or sector, projects which are not overly complex are most successful. It is often productive to develop expertise and a good market reputation in a particular sector. Ambitious, excessively large projects can be difficult to achieve until institutional capacity and expertise has been developed. Some large projects have been withdrawn from the market in recent years in several countries (for example, Egypt, Jordan and Tunisia) due to size and complexity.

What are the key elements of a project assessment process?

Comparator countries

Project assessment is normally carried out through a hierarchy of institutions. This begins with the procuring authority and the responsible line ministry; followed by a gateway review by the PPP unit and the ministry of finance; and ending with formal approval by an inter-ministerial committee. In the UK, a central government committee generally relies upon the PPP unit for detailed assessment of the economic, financial, legal and technical aspects of the submission. The same function is carried out by the PPP unit in France.

Line ministries are required to follow central government guidance and procedures, and require authorisation from the ministry of finance before allowing the sponsored projects to proceed. An interesting example is Mexico, where line ministries must submit a detailed justification of the project to the Investment Unit (IU) in central government.

Line ministries and other procuring authorities must first satisfy themselves that the PPP project is robust, before submitting it for approval by central government. Normally they will do this with the assistance of their internal technical teams and ministerial PPP unit, if one exists. There is often some negotiation and redesigning of projects to accommodate ministerial views and guidance before the project is considered to be strong enough to be put forward to the central government committee for final approval.

Inter-ministerial bodies provide political support and assure coordination between agencies. Typically, a committee is established to review projects that have been submitted for approval by the line ministries. The committee will usually consist of representatives of all the key ministries with an interest in project development, including finance, sector interests (such as transport, water and telecoms) and the interior ministry. The committee will ensure that a fair and transparent review process is undertaken for each major project that it is required to scrutinise and debate. This helps to ensure that marginal projects of doubtful economic and social benefit are unlikely to be selected and that strict budgetary criteria are applied. The committee will rely on technical reports provided by the relevant line ministry and the PPP unit to help arrive at its decision in each case. Box 9 below lists the key actors typically involved in approval processes and common stages of the approvals process.

Mediterranean partner countries

Procuring authorities need to obtain technical approval from the PPP unit or its equivalent before obtaining central government approval. In most cases, there is a further stage of high level

Box 9: Approval processes

Key actors involved in approval process:

- Line minister/local government;
- PPP unit;
- ministry of finance;
- Inter-ministerial body.

Key approval processes

- Approval of the procurement option/Public Sector Comparator.
- Approval of the feasibility study/business case (financial and economic appraisal).
- Affordability test /Approval of public contribution/Approval of the accounting treatment.
- Approval by procuring entity if negotiated by a different body.
- Approval of the contract/ variations to the standard template.
- Political approval.

approval by governmental committees that report to the Prime Minister and have line ministry representation.

Approval processes need to be more rigorous. As a general observation, it seems that while the approval processes in the Mediterranean partner countries are appropriate and established, they could be more detailed and thorough in terms of the standard and comprehensiveness of documentation expected and required.

The ministry of finance has a crucial role in approving projects, and needs strong business cases to be submitted from procuring authorities. If the business case is comprehensive, detailed and well-argued, it will give the ministry of finance confidence in approving the project and will allow it to assess accurately the likely future effect on national finances.

Central PPP units are often represented in an advisory capacity on inter-ministerial approval committees. In countries such as Syria and Egypt, the PPP unit is seen as an integral part of the decision-making process. The PPP unit has a place on the inter-ministerial committee and is able to inform its deliberations. However, the role of the PPP unit as informant needs to be distinguished from the decision-making itself, which would normally not include a vote by the PPP unit.

Which institutions are involved in the procurement process?

Comparator countries

Procuring authorities lead the bidding process, normally without the support of a central PPP unit, particularly when expertise is sufficiently developed at the sector level. There is therefore a clear demarcation of responsibilities between the procurement authority and the PPP unit. The procuring authorities can be local authorities, municipalities or line ministries. The PPP unit will become involved, usually in a strategic advisory capacity, only in the largest and most strategic projects, normally in support of a line ministry.

Mediterranean partner countries

Central PPP units often take an active role in project procurement, as authorities frequently lack sufficient experience in launching a PPP project to the market. This is particularly the case where the PPP procurement method is relatively new. As the programme develops, capacity problems begin to emerge, necessitating the development of expertise in line ministries. It is interesting to note that in Syria the PPP support institutions are being designed from the outset to develop satellite PPP units in the line ministries. In this sense, Syria is benefitting from the experience of other countries and is starting its PPP programme midway up the learning curve. Care should be taken to ensure that both the central PPP unit and PPP units in the line ministries are adequately staffed.

However, in some sectors, the procurement ability of line ministries is much more developed and there is less involvement of the central PPP bodies. This is the case in Algeria, Egypt and to some extent in Jordan and Tunisia. In Egypt, the Ministry of Electricity and Energy has procured a number of projects without the involvement of the PPP Central Unit. The energy sector benefits from its own PPP procurement law and a body of experience and practice that enables the efficient procurement of new electricity generation projects.

Local authorities have a limited involvement in procurement, which could be increased to assure their support to the project and enhance the quality of stakeholder management during the operational phase. As mentioned above, there is clearly scope to develop local government capacity. While the central State authorities will still need to be involved, not least to provide sovereign payment guarantees, the involvement of local authorities will allow wide consultation and enable local political and economic support for PPP developments. This will be particularly important if local tariffs are to be used (wholly or partly) to fund projects.

How can projects be implemented and monitored effectively?

Comparator countries

Once the PPP procurement has been completed, it is common practice for procuring authorities to take full responsibility for project implementation. This will include managing the contract, ensuring that the payment mechanism is enforced and negotiating any contract variations. However, central government may still take an interest in overseeing the performance of the national portfolio of PPP projects. Often it will do this either through a sector economic regulator or through the auditing arm of government. The central PPP unit will not usually be involved in monitoring project performance after implementation. For example, an economic regulator (Monitor) oversees many large hospitals in the UK and will review the financial performance of PPP contracts where they are in place.

Contract managers are provided by the procuring authorities. Often these will be managers with a general background in administration, estate management or procurement. They do not usually receive specialist training for their posts, but can make use of guidance issued by the PPP unit or the line ministry.

Mediterranean partner countries

In common with the comparator countries, the PPP unit does not usually get involved in project implementation, as this is the responsibility of the procuring authority. However, there is a case for the PPP unit to have a monitoring role and to collate experience and lessons learned for the benefit of other authorities procuring and implementing PPP projects.

Resources will be needed in the line ministries to support project implementation and management of PPP contracts. The cost of post-completion project management should be included in the project business case and will need to be budgeted for by the line ministry. It would also be efficient to establish training programmes which could be part of the remit of the central PPP unit.

Institutional issues – recommendations/success factors**Policy**

- Issue a policy explaining the benefits of PPPs and the circumstances in which they should be used. Publicise this widely to encourage projects to be identified and developed in priority sectors.

Project life cycle

- Invest in organisation capacity and strong technical advice to ensure that projects are feasible and are adequately prepared before procurement. Feasibility agreements should be undertaken and project preparation should involve detailed output specifications, risk analysis, economic appraisal, site preparation and securing outline planning and environmental permissions for the development.
- Provide information and guidance to authorities on effective procurement, including standard contract documentation, support in appointment of advisers and examples of good practice.
- Ensure that projects are accurately budgeted at the outset, and that any financial support from central government to the procuring authority is used only for the benefit of the project.

PPP decision-making

- Establish a central government body, with ministerial representation, to review and approve projects.
- Encourage line ministries that are planning extensive PPP programmes to develop in-house capacity to develop and procure projects.
- Ensure that there is a high standard of business case development and that accurate budgets are prepared.
- Encourage local authorities to identify and promote PPP projects and to co-operate with line ministries to enable efficient procurement.

PPP units

- Establish a central PPP unit to:
 - disseminate policy and best practice;
 - review projects and support procuring authorities;
 - plan and prioritise PPP projects across sectors within the budget cycle.

3. LEGAL AND REGULATORY FRAMEWORK

Clarity and certainty of a country's legal and regulatory framework are necessary conditions for the success of a Public Private Partnership (PPP) programme. The existence of a PPP law can help to attract investors to a country by enhancing or clarifying the legal framework applicable to PPPs. This will also prevent reliance on general laws that are not specific and therefore not suited to PPPs. Investors and lenders will seek comfort that the governing law of their contracts affords them adequate protection and that disputes can be resolved impartially and efficiently.

This section sets out the legal aspects and legal basis of PPPs and examines the following questions:

- Why should a country build a sound and attractive PPP legal framework?
- Does the legal framework sufficiently define the roles and powers of awarding authorities?
- Would lenders and investors be comfortable with the country's law governing project and finance documents?
- Would lenders and investors be comfortable with the judicial system and commercial dispute resolution system in the country?

Why should a country build a sound and attractive PPP legal framework?

Comparator countries

The existence of a PPP specific law overcomes the difficulties that may be encountered when there are several laws which apply to PPPs. For example, there may be a combination of sector specific laws or the requirement for project specific laws. Differing regimes for different types of PPP models are not necessarily problematic – it must be clear which law applies to which model and leave little room for interpretation (for example, if there is a separate law on concessions, it should be clear whether that law applies to a project with even a small element of user/demand risk). A law which addresses PPP specifically has the benefit of not having to rely on uncertain interpretation of laws which regulate infrastructure procurement in general or the procurement of goods and services by public authorities. The importance of this is demonstrated by the Polish example. A PPP Act was enacted in 2009 to replace the much criticised PPP Act of 2005. A Concession Act also is in place as is a general procurement law. There is not always a clear distinction as to which law should apply to a particular project and this may create difficulties as the PPP programme develops.

Enacting specific PPP laws has facilitated the PPP development process in some of the comparator countries. Specific PPP laws have, for example, been enacted in France (the 17 June 2004 Ordinance), South Africa (Treasury Regulation 16 (issued pursuant to the Public Finance Management Act 1999 (PFMA)) and Poland (the PPP Act). In Mexico, proposals for a federal specific PPP law were introduced to the legislature in late 2009 and early 2010 and are still under discussion. In civil code countries, certainty of written laws is of paramount importance and the existence of a specific PPP law introduces the required element of certainty to the legal framework surrounding PPPs. By contrast, England does not have a specific PPP law. As a common law jurisdiction, certainty and clarity of intention of

the contracting parties is achieved by the presence of clear and comprehensive PPP contracts written under a legal system which is permissive and not prescriptive. The different approaches to PPP legislation in civil and common law jurisdictions are outlined in Box 10 below.

The enactment of specific PPP laws demonstrates political commitment towards the promotion of PPP programmes or projects. A specific PPP law can be an indication of the political will to pursue PPP and a measure to support the wider policy framework. This is particularly the case in Poland where the new PPP Act has served as a trigger for the launch of a number of PPP projects. The South African Treasury Regulation 16, together with the supporting PPP guidance available (the Treasury Practice Notes and Standardised PPP Provisions), also indicates the importance to the government of PPP as a means of delivering public infrastructure.

PPP laws can advance PPPs if they include clear and comprehensive provisions and provide overarching legislative guidance on headline issues. PPP legislation in France, Poland and South Africa, for example, identifies the scope and models of PPPs (such as concession or design, build, finance and operate structures), public authorities' obligations with regard to feasibility and consultation, procurement procedures, issues to be addressed in contractual provisions, payments, the institutional framework and the duration of projects. PPP primary legislation should be supported by necessary secondary legislation (for example regulations or implementing decrees to address detail). Secondary legislation should be implemented promptly to avoid uncertainty and a loss of momentum and reviewed regularly to ensure that changing market conditions are addressed.

Experience shows that a specific PPP law is not a pre-condition for PPP development, where clear practitioner guidelines and standard contracts are present. In the United Kingdom (UK), for example, the absence of a specific law has not resulted in the absence of a structured framework for PPPs as case law and manuals (notably Standardisation of PFI Contracts version 4 (SoPC4) contract provisions and commentary) set out comprehensive guidance for procuring authorities and provide a reference point for bidders and contractors.

Mediterranean partner countries

Recent initiatives to enact specific PPP laws in some of the Mediterranean partner countries show increasing interest in and commitment to PPPs in the region. PPP laws are in the drafting stage in Jordan, Lebanon and Syria. Jordan has the benefit of the Privatization Legislation⁷, but the intention is to improve the legal basis for PPPs in a PPP law and simplify the governing legislation since key aspects of PPP and privatisation are different. A PPP law would be a welcome introduction in Syria and Lebanon as these countries currently have limited legal basis for PPP procurement.

The new PPP Law in Egypt (enacted on 1 July 2010) demonstrates the commitment of the Egyptian government to pursue further PPPs and this should be followed up with secondary legislation as intended. Having successfully procured the New Cairo Wastewater (NCWW) project, the Egyptian government is intent on procuring further PPPs. Whilst the NCWW project was procured under the old legislative

⁷ Privatisation Law No. 25 of the year 2000 and Privatisation Regulation No. 80 of the year 2008

framework (i.e. without the benefit of a specific PPP law), the success of this pathfinder project has cemented the use of PPP as a viable option for infrastructure development. The effectiveness of the PPP law has not yet been tested, but its use is anticipated in the forthcoming projects. The Egyptian PPP law states that executive regulations, intended to add substance to the provisions of the law, will be introduced.⁸

The other Mediterranean partner countries (Morocco, Tunisia, Algeria and Israel) do not have PPP specific laws. Israel, which has foundations in the common law but with some civil law influences, does not have a PPP law and to date, this has not been a hindrance as the system of introducing project specific laws when required has provided the necessary legal authority and has worked well. In Morocco and Tunisia, concessions are specifically governed by Law 54-05 and the Tunisian Concession Law (Law no. 2008-23 of April 1 2008) respectively. Whilst these provide sufficient authority for the PPP models they govern, further specific legislation will be beneficial if availability type models are more widely procured. If the Algerian government wishes to pursue a formal PPP programme, then it would be desirable to codify all relevant legal provisions in a single PPP specific legislative text. The benefits of introducing a specific PPP law are outlined in Box 11 below.

Box 10: Civil and common law jurisdictions – two different approaches to PPP legislation

The legal tradition of a country has had an impact on the approach it takes to enacting a specific PPP law. There are two main approaches employed: (i) enactment of specific PPP legislation (favoured by civil law legal systems); and (ii) regulating PPPs on a project by project basis by contract (favoured by common law legal systems as is demonstrated by the experience of the United Kingdom).

Civil law jurisdictions rely on written laws and PPP projects rely on express legal authority. The contractual provisions entered into by the procuring authority and private sector and the interpretation of them will be derived from legislation (as opposed to, for example, the English common law principle where the intention of the contracting parties is given priority when interpreting contractual provisions).

Common law jurisdictions have a less prescriptive approach than civil law jurisdictions. The absence of a specific law does not necessarily mean an absence of a structured framework for PPPs. By regulating projects on a contractual basis there is scope and flexibility to foster contractual and financial innovation. This approach also enables the development and dissemination of good practice by developing standard contractual clauses common for similar PPP projects.

The civil law and common law distinction is apparent in the approach to PPP laws in the comparator and Mediterranean partner countries. Of the comparators, Poland and France are civil law jurisdictions that have enacted PPP legislation – the

Polish PPP Act and the Concession Act and, in France, the December 11, 2001 Law and the June 17, 2004 Ordinance. Mexico, also a civil law jurisdiction, is in the process of enacting a specific PPP law. England is a common law jurisdiction and thus, the experience to date has been to place greater emphasis on and to derive certainty from the contractual provisions. With a hybrid legal system, South Africa has the benefit of Treasury Regulation 16 but has also closely followed the English example of comprehensive guidance and contracting.

The majority of the Mediterranean partner countries are civil law jurisdictions. The foundation of the legal system in Israel is built upon the principles of both common law and civil law and so, despite the absence of a specific PPP law, PPP procurement is relatively advanced reflecting strong contractual frameworks and specific regulations introduced when necessary. The other countries, where the legal tradition is to rely on written laws, would benefit from a specific PPP law if PPP procurement is a priority. The recent enactment of a PPP specific law in Egypt and initiatives to introduce PPP laws in Jordan, Lebanon and Syria reflect this approach.

In practice, the difference of the approaches is less strict notwithstanding a country adhering to a common or civil law legal system. For example, England follows the common law approach and it has not enacted an overarching, specific PPP law, however it has enacted general pieces of legislation that impact on PPP projects and/or institutions entering into PPP contracts. By the same token, in France the presence of specific PPP regulations has not stopped contracts being as precise as possible so as to reduce reliance on the courts to address any gaps, which could create uncertainty.

⁸ The executive regulations were issued in Arabic in early 2011.

Box 11: Benefits of a specific well designed PPP law

A well designed PPP law could improve the legal framework applicable to PPPs by addressing the following essential elements:

- clear and complete procurement procedures for the award of a PPP contract (including content of the contract notice, negotiation/competitive dialogue stages, remedies available to unsuccessful bidders on a successful challenge);
- clear guidelines on the contents of tender documents;
- State support and guarantees that may be available to investors;
- a clear division of responsibilities for such matters as project planning, identifying priority sectors and conducting feasibility exercises;
- definition and safeguard of rights and responsibilities of both public and private sector bodies;
- institutionalisation of and capacity building within the government to ensure knowledgeable reference point to all stakeholders;
- clear and complete guidelines in relation to the control and supervision of procurement procedures by public authorities and of project implementation post contract award;
- establishment of a PPP institutional framework, including for example the establishment of a PPP unit.

Does the legal framework sufficiently define the roles and powers of the awarding authorities?

Comparator countries

By granting procuring authorities clear powers to enter into long term PPPs, investors will be reassured of the legality of the contract. Such powers may be derived from laws specific to PPPs (for example the 17 June 2004 Ordinance (France), the Treasury Regulation 16 issued pursuant to the PFMA (which applies to national and provincial bodies in South Africa), Municipal Systems Act 2000 and Municipal Finance Management Act 2003 (which applies to municipalities in South Africa)). Alternatively they may be derived from more general laws governing delegation of powers by public authority bodies (for example, Ley Organica de la Administración Pública Federal (Public Administration Organisation Federal Law) in Mexico, the Act of December 20 1996 on municipal management (Poland) or the Local Government (Contracts) Act 1997 (England)). The existence of clear authority for public bodies to enter into PPPs will simplify and ease the due diligence that investors and lenders and their respective advisers will undertake in this regard.

In some countries, there will be an approvals or certification process which must be completed prior to the public authority entering into the contract. This may be approvals from the ministry of finance charged with budget allocation (as in South Africa) or local assembly approvals (as in France). Parties entering into PPP contracts with public authorities will wish to ensure that these approval processes are satisfactorily complete

and may, for example, seek a warranty or a letter confirming this prior to entering into the contract.

PPPs can be procured by public authorities in sectors related to the provision of public services. In the comparator countries, the ability of public authorities to procure PPPs is generally related only to services which are provided for public needs and not in relation to purely commercial projects (for example, shopping malls). This is an important limitation and one which should be respected. As PPP payments will derive from the public purse or from user payments directly, public authorities should not be perceived to be pursuing commercial projects. In addition, areas such as defence or matters relating to security are frequently excluded from the PPP model (as is the case in Poland, for example) as they may compromise matters of confidentiality and public safety.

Scope of services may be limited to non-core services. Laws may prevent a private sector partner from providing core public services, for example teaching and healthcare. However, ancillary services, for example the provision of cleaning or catering, can be the subject of a PPP project. Such limitations are important, in particular for public perception of PPPs, as the public is unlikely to support the outsourcing of key core services to the private sector as this is seen as "privatisation". In England, for example, hospital and schools PPP projects have, until recently, been widely procured but the core services of providing healthcare and teaching have in all cases remained a government obligation.

Mediterranean partner countries

The powers of public authorities in the Mediterranean partner countries to procure projects are varied, resulting in a complex legal framework, which would benefit from simplification.

Whilst in some countries there appears to be clear authority to procure PPPs, this is not the norm. Rather, and perhaps a reflection of the relatively early stage of PPP procurement in the region, the authority to procure PPPs is not always general but achieved by ad hoc measures, such as the enactment of project specific laws. This is the case in Algeria where, for example, a motorway concession which is currently not regulated/authorised by a sector specific law would require new legislation specifically permitting such a concession. In Lebanon, the Construction Act 1989 requires the passing of a law to authorise a new concession. However, in practice, this is not always adhered to and some concessions (albeit not project financed) have been concluded through private and direct negotiation without formal tendering or authority to award. Such practices can deter potential bidders from pursuing the market if they believe that standard and transparent processes may not be followed. In Egypt there is a number of legal bases upon which to procure projects (public economic entities, public utilities legislation, sector specific laws, project specific laws and the PPP Law⁹). PPP procurement in Morocco is particularly complex. A number of laws and avenues exist (i.e. Law 54-05¹⁰ (the Concessions Law) and the Procurement Decree¹¹), but procurement by some types of public bodies is not clearly permitted in the law, notably procurement by central government departments. PPP projects which are structured in a way other than a true concession model (where the private sector takes the demand risk) is also not specifically regulated by the current laws. Similarly, in Tunisia, there is a specific legal

⁹ Law No. 67 of the year 2010

¹⁰ Enacted by Dahir No. 1-06-15 of 14 February 2010

¹¹ Decree No. 2-06-388 of 5 February 2007 in respect of procurement contracts

regime granting authority to procure concessions. However, other models are not specifically regulated. There are also some overriding sector specific laws (for example, in the energy, telecommunications and sanitation services sectors).

The benefits of streamlining the legal basis for procuring PPP projects has been recognised in Jordan. It is expected that the Draft PPP Law¹² would achieve this by specifically excluding application of the Privatization Law¹³ and the Privatization Regulation¹⁴ to PPPs, which currently empower public authorities to procure PPPs. It is intended that the PPP Law will apply to all sectors, save for national defence, police, award of justice, core areas of healthcare and education and other specific activities identified. A similar approach could have been adopted in Egypt by abolishing the application of the legislation relating to public economic utilities, public utilities and specific sectors when the PPP Law came into force.

General commercial and administrative laws govern PPPs in Israel, but the ability to introduce project specific legislation when required ensures there is sufficient legal authority to bind the public sector. In Israel, legal authority to procure a PPP is not set out in any specific legislation. Rather the general laws applicable to corporate, commercial and administrative matters apply and where sufficient legal power relating to the project is not enshrined in the existing laws, a new law will be enacted (as was the case on the cross-national toll highway project where two laws were enacted to address land acquisition and tolling). Similarly, in the West Bank there are no specific legal powers to authorise the entering into of PPPs. Any such activities would be governed by existing laws applicable to corporate, commercial and administrative matters (including the Law of Tenders for Public Works number 6 of 1999).

The lack of general cross sector PPP authorisation may not be problematic if sector specific laws, in respect of sectors where PPPs are prevalent, provide the required authorisation to outsource the relevant services. Sector specific laws feature in Algeria in the water, electricity and gas sectors; in Egypt in the electricity, ports, airports and roads sectors; and in Syria in the ports, electricity and petroleum sectors. Projects have been successfully procured in these countries on the basis of these sector specific laws.

Would lenders and investors be comfortable with the country's law governing project and finance documents?

Comparator countries

A clear underlying legal framework in the comparator countries instils confidence amongst local and foreign investors. PPP contracts in all of the comparator countries tend to be governed by the law of that country. This is a reflection of the maturity of that legal system in general.

In the case of England and France the PPP legal framework is well established and French law and English law often govern PPP financing contracts in other jurisdictions. These markets have achieved sufficient levels of maturity and created a broad

experience base such that lenders participating in PPP projects in some countries insist that their finance contracts (not the PPP contracts) are governed by these laws. Lenders insist on such choice of law as they require certainty that adequate security for their rights is available and can be enforced if required. This is particularly an issue in relation to project finance structures where lenders require a range of security to protect their rights against the Project Special Purpose Vehicle (Project SPV) (notably rights to receive payments against the loan and rights in the event of other default by the Project SPV such as insolvency or non-payment to subcontractors).

The other comparator countries also have the benefit of legal frameworks, which are well developed and are suitable to govern the PPP contract documentation. Financing contracts in Mexican and South African PPPs tend to be governed by the law of the country. In Poland, international lenders are still likely to insist on a more familiar law (such as English law) to govern their contracts. The key requirements of lenders and investors for a legal framework are set out in Box 12 below.

Mediterranean partner countries

PPP contracts in the Mediterranean partner countries will be governed by the law of the country and investors will carry out due diligence as to the suitability of the law. As PPP contracts are public contracts, this position is as one would expect. This means that equity investors will carry out thorough due diligence into the laws of the country and will work with local legal advisers in this regard. It will also mean that investors are likely to insist, in common with lenders, on the ultimate dispute resolution method being arbitration, as this may avoid recourse to the local court system, with which they are unfamiliar. Experience to date and indications in draft PPP laws demonstrate that public bodies in the region are amenable to this approach.

Financing contracts involving international funders are usually governed by the law of countries with an established body of law applicable to financing. These are more familiar to lenders and are perceived as providing stronger protection to lenders. International lenders are likely to prefer more familiar legal systems governing their contracts and frequently, English or French law is chosen. This has been reflected in practice to date in Algeria, Egypt, Israel, Jordan and Morocco. By contrast, in Tunisia, Tunisian law must govern the contract where the applicable goods are located in Tunisia. This has the effect of restricting security documentation to Tunisian law. This may be a concern for some international lenders investing in Tunisia due to the lack of familiarity with the Tunisian legal system. In jurisdictions where there has been little evidence of project financed PPPs to date, notably Syria, Lebanon and the West Bank, it would be beneficial for attracting foreign participants if the contract design and the applicable legislation permit financing contracts to be governed by a legal system which caters more thoroughly for these types of structures.

¹² Dated 1 June 2010 (a new draft law has been issued since 1 October 2010)

¹³ No. 25 of the year 2000

¹⁴ No. 80 of the year 2008

Box 12: Key elements of a legal framework

Both investors and lenders will require the following elements in the legal framework:

- Clarity of laws;
- Comprehensive laws;
- Due process and certainty of outcome; and
- Freedom to contract.

Lenders will additionally require:

- Availability and enforceability of security; and
- Certainty of the powers of the authority to enter into the contract and certainty for payment of compensation on termination.

Would lenders and investors be comfortable with the judicial system and commercial dispute resolution system in a country?

Comparator countries

The dispute resolution procedure applicable to the PPP contract and other project contracts should provide a clear, efficient and practical/commercial means of resolving disputes. To this end, it is common for PPP contracts to provide for tiered dispute resolution processes, incorporating informal methods of dispute resolution in the first instance (for example, discussion between senior representatives of the parties) and more formal next stage methods of dispute resolution, typically adjudication, expert determination (in relation to technical, non legal matters), arbitration or court proceedings.

PPP contracts may include court proceedings as the final forum for dispute resolution where the local court process is efficient and has the benefit of judges experienced in complex commercial disputes. In France, PPP disputes are in the main resolved in the courts as recourse to arbitration is generally prohibited for public entities, except where permitted by a specific law which is the case in the Ordinance on contrats de partenariat. Public authorities are likely to prefer dispute resolution in the courts as the courts are part of the institutional framework to which they belong and provide consistency as their other contracts are likely to provide for dispute resolution by the courts. Making the court process apply to PPP contracts may be beneficial from the public sector's view as a matter of policy – it will allow the courts to build up experience in such disputes. However, this may present difficulties from an investor's point of view.

Related disputes should be heard together. Where litigation is the chosen method of dispute resolution, it would be beneficial to the project from the point of view of cost-efficiencies, time efficiencies and consistency if related disputes at different levels of the supply chain were heard together. Therefore, a dispute between the public authority and the private sector partner which also impacts a subcontractor should be heard together. The Private Finance Initiative (PFI) guidance in England permits this approach. However, in some legal systems, this is not possible as different courts have jurisdiction over

public contracts (i.e. contracts to which a public authority is party) and commercial contracts (between two private entities). In France, for example, there is a jurisdictional duality such that public law contracts, such as PPP contracts, are subject to the administrative courts, whereas litigation of commercial contracts, such as a construction contract between the Project Special Purpose Vehicle (Project SPV) and its construction subcontractor, will be held before the civil courts.

Arbitration is a more viable option for final and binding dispute resolution as it is attractive to foreign investors, having been used to resolve disputes in PPP and other major infrastructure projects worldwide. Agreeing to arbitration as the final forum for dispute resolution is attractive to investors as it is not reliant on local law insofar as the applicable arbitration rules are complete, it preserves confidentiality and the more established rules have the benefit of past experience. Parties also maintain control over the arbitrator and the seat of arbitration. Choosing a foreign seat of arbitration is another way of ensuring that any gaps in the arbitration rules will be filled in by the law applicable to the seat of arbitration.

International arbitration is likely to be more appropriate than local arbitration. International contractors and lenders will prefer familiar and established rules of arbitration, such as the International Chamber of Commerce (ICC), the United Nations Commission on International Trade Law (UNCITRAL), the International Centre for Settlement of Investment Disputes (ICSID) and the London Court of International Arbitration (LCIA). However, domestic arbitration rules may be suitable where they are robust and similar to established rules. For example, this is the case in English PFI contracts, which tend to permit arbitration pursuant to domestic arbitration rules and are governed by the English Arbitration Act¹⁵.

Mediterranean partner countries

Many of the PPP contracts concluded in the Mediterranean partner countries recognise the benefits, in terms of time and cost-efficiency and in relation to the on-going partnering relationships, of tiered dispute resolution clauses. Such clauses ensure disputes are first referred to more informal processes for the resolution of disputes between the parties before reference to more formal dispute resolution procedures. Sometimes an interim measure (such as mediation) is also included. Such approaches have been seen in Algeria, Egypt, Jordan, Morocco and Israel and other countries should seek to replicate these approaches.

Enforceability of foreign arbitral awards made abroad is supported by the New York Convention. All Mediterranean partner countries, (except for the West Bank) are signatories to the New York Convention which requires signatories to recognise and enforce arbitral awards made in other signatory States. Enforcement of arbitral awards in the West Bank is likely to be difficult but court judgements made abroad may be enforceable on the basis of the Execution Law No. 24 of 2005. The preference of international project participants and lenders for arbitration over court proceedings has been recognised by procuring authorities in the Mediterranean partner countries. The default position is that disputes will be ultimately resolved by court proceedings. However, an arbitration agreement (set out in the dispute resolution provisions in the PPP contract) can alter this position.

¹⁵ Arbitration Act 1996

In Algeria, Morocco, Jordan and Tunisia, practice to date has seen the adoption of arbitration under internationally recognised rules, such as ICC, UNCITRAL or LCIA, particularly where foreign parties are involved. Continuing such practices will provide comfort to international sponsors and lenders.

In Israel and Egypt, PPP contract disputes are frequently subject to arbitration, but unlike the experience in the countries mentioned above, the arbitration is run under domestic rules. This will be a satisfactory approach to the extent that these domestic arbitration rules broadly follow the more internationally recognised procedures and this will entail some due diligence on the part of international project investors. If foreign investors and lenders increase their participation in these markets, it may be that the relevant authorities will need to review the rules of

arbitration and be more open to disputes being subject to international arbitration.

In Syria and Lebanon, it is expected that PPP contracts will provide for international arbitration. This will alleviate any concerns arising due to the early stage of the programme and concerns relating to the ability of the local courts to manage complex commercial disputes. The Syrian and Lebanese draft PPP laws recognise the benefits of and promote the use of international arbitration.

Legal and regulatory framework – recommendations/success factors

Power of public authorities to procure PPP

- Establish clear rights under law that permit public authorities to procure PPPs.
- Public authorities should obtain clear authorisation for the procurement of PPPs prior to entering into a contract.

PPP laws

- Ensure that the law governing PPPs is clear and comprehensive.
- Support primary PPP legislation with secondary legislation and comprehensive guidance.

Dispute resolution procedures

- Provide efficient and clear dispute resolution procedures for project contracts.
- Permit the use of international arbitration as a final forum for dispute resolution instead of court proceedings as this is often the preferred option for foreign investors.

4. BIDDING PROCESS

Clear procurement processes which uphold the principles of fairness and equality to all bidders and which provide transparency in the public sector's decision-making process are necessary to encourage effective competition for Public Private Partnership (PPP) projects. This not only benefits foreign investors and funders by providing comfort that their bids will be treated on merit, but also benefits the public authority by achieving better value for money, as increased competition will help drive down prices and encourage better technical solutions.

This section addresses the suitability of PPP procurement procedures and examines the following questions:

- Does the law set out clear procurement processes which are suitable for PPP structures?
- Is the procurement process structured to reflect the complexity of the project?
- Does the procurement procedure respect the key principles of fairness, transparency and equality?
- Are unsuccessful bidders duly notified and do they have rights of challenge?
- Is the public sector accountable for its decisions?

Does the law set out clear procurement processes which are suitable for PPP structures?

Comparator countries

In each of the comparator countries there are clear laws which govern the procurement of works or services to the public sector and which are suitable for PPPs. The aim of the relevant laws is to secure the best value for money for the public sector by mandating procedures that will attract a wide number of bidders and increase competition. The procurement procedures in the comparator countries apply international standards of transparency and non-bias and the procedures are clear and understood by the bidding community. In South Africa, Treasury Regulation 16 issued in 2004 requires that the PPP procurement procedure "(a) must be in accordance with a system that is fair, equitable, transparent, competitive and cost-effective; and (b) must include a preference for the protection or advancement of persons, or categories of persons, disadvantaged by unfair discrimination in compliance with relevant legislation." Similarly, there are set procurement procedures prescribed in European Union (EU) legislation (as implemented in French, English and Polish law) applicable to different types of public contracts, including PPPs. The procedures have as their aim the promotion of competition by giving bidders an equal opportunity to tender for and win public contracts on their merit. In Mexico, article 134 of the Federal Constitution sets out that procurements of services and/or public works must be through a public bid in order to ensure the best conditions for the State under the principles of efficiency, honesty, transparency and any other convenient conditions. Whilst not specific to PPPs, the Mexican procedures are well suited and have been adapted positively for PPPs.

Mediterranean partner countries

Egypt and Israel have adopted tendering procedures that have been designed specifically for use on project financed PPP projects. The new PPP Law in Egypt¹⁶ allows for dialogue and negotiations with bidders; which is more aligned to international PPP procurement practice than the general Tender Law¹⁷. The bidding procedures under the Tender Law will continue to apply where the procuring authority chooses to procure its projects under the old regimes. Therefore when choosing whether to opt to use the PPP Law, the Egyptian authorities should consider the relative advantages of the new procurement procedures in increasing competition and therefore value for money. The more simplified procedures under the Tender Law may be preferable for authorities where the projects being procured are relatively simple and where the authorities would not benefit from more involved discussions/negotiations with bidders. In Israel, the Mandatory Tenders Law¹⁸ and its implementing regulations govern procurement of PPP projects. The tenders legislation sets out defined stages in relation to the tender procedure, which are consistent with international PPP practice and if applied correctly should ensure a fair, transparent and competitive bidding process.

The procurement processes in Algeria, Morocco and Tunisia have been serviceable for certain complex projects, but the development of procedures specific to PPPs may be beneficial.

The system in current use in Algeria has been designed for the procurement of a large range of different products and services (though not PPPs specifically). In particular the procedure set out in the Algerian Procurement Code has formed the basis of internal procurement procedures for use in the energy sector (for example procurement by SONEGAS and SONATRACH). In Morocco, there are different legal procedures which can apply to PPP procurements, but application of an incorrect procedure can render the procurement susceptible to challenge and that may create a level of uncertainty which will disadvantage bidders. In Tunisia, the Concession Procurement Decree¹⁹ (secondary legislation under the Concession Law²⁰) is relatively recent and therefore its application in practice is yet to be fully tested and proven (although the project specific procedure announced for a concession involving the construction and operation of two water plants (along with the operation of three others) appears to be consistent with international practice). Given the apparent uncertainty as to the application or effectiveness of the current procedures to PPPs, it may be advantageous for changes to be considered to the procurement regime which would be specific to PPP projects and clarify the process to be applied.

The detailed procurement procedures to be followed under the new PPP laws being developed in Jordan, Syria and Lebanon are still to be defined.

The respective draft PPP laws in these countries leave the detailed procurement processes to be defined subsequently by secondary legislation. It therefore remains to be seen what stance the authorities in these countries are taking to tendering PPP projects and how they will ensure fairness, transparency and competition. After the passing of the law, the next step would be to introduce

¹⁶ Law No. 67 of the year 2010

¹⁷ Law 89 of the year 1998

¹⁸ Law No. 5752-1992

¹⁹ Decree No. 2010-1753 of 19 July 2010

²⁰ Law No. 2008-23 of April 1 2008

secondary legislation; implementing it within a short timeframe following the PPP law would enhance the law's credibility. It may also be an opportune moment for these governments to investigate other tendering procedures which are being implemented in the Mediterranean partner countries. For example, they might want to consider those procedures set out in the new PPP Law in Egypt²¹ which permits discussion in the tendering phase and does not simply demand an offer against fixed terms and conditions (restricted procedures) with a view to adopting further detailed procedures as part of a wider reform initiated by the respective PPP laws.

Is the procurement process structured to reflect the complexity of the project?

Comparator countries

Based on the experience of the comparator countries, procurement procedures are designed to reflect the scale and complexity of the project. Although each of the comparator countries has developed precise procedures with defined stages (and their own terminology), the stages set out below represent an approach that is broadly based on these countries:

- pre-procurement preparation;
- advertisement;
- pre-qualification questionnaire;
- invitation to tender;
- clarifications including discussion/negotiation;
- bid submission;
- selection of a preferred bidder;
- appeals (if any); and
- contract award.

In the comparator countries the procurement procedures that are adopted for PPPs allow a varying degree of interaction with tenderers and control over the process, generally reflecting the complexity of the project. In South Africa, for example, the procurement process set out in Module 5 of the 'National Treasury PPP Practice Notes' allows for a two-way communication process between the bidders and the authority during the initial preparation of the request for proposals documentation. Allowing feedback from all bidders prior to the issue of the bidding documents has proved useful in adding value to the bidding process; especially on complex projects. In Mexico, the public bid process allows for public question and answer clarification meetings. Similarly, EU law as applied in the domestic legislation of the United Kingdom (UK), France and Poland prescribes different processes depending on the complexity of the project. The process to be used for particularly complex projects (i.e. most PPPs) must include discussions and dialogue or negotiation with shortlisted bidders.

Pre-procurement preparation is key to successful and efficient procurements. Each of the comparator countries recognises that the authority must ensure adequate preparation prior to advertising the tender and issuing the tender documents. In the UK for example, the planning stage for PPP projects is lengthy. Before the project is advertised, the authority is required to:

- assess the business need;
- appraise the procurement options;
- discuss with the relevant governmental department;
- develop an Outline Business Case; and
- obtain approval by the relevant government body/board of the procuring organisation.

In France, a task force responsible for supporting and regulating PPP projects has been set up. *The Mission d'Appui à la Réalisation des Contrats de Partenariat* (MAPPP) is principally involved in the first part of the contrat de partenariat procedure by validating the preliminary assessment and also providing support in the preparation and negotiation of procurement and contract documents.

Mediterranean partner countries

Some of the Mediterranean partner countries may benefit from procedures that permit dialogue between the authority and pre-qualified bidders before final bid submission. In Morocco and Algeria, for example, there is no procedure which permits the authority to hold structured dialogue simultaneously with rival bidders. In contrast, individual discussions with each bidder are permitted in Israel and Egypt and are envisaged to be permitted under the Draft PPP Laws in Syria and Jordan²². If managed well, procedures which foster discussion and co-operation with bidders can be beneficial, especially in the early stages of maturity of PPP. Where complex projects are being procured, the authority may not be able to objectively define the technical solution to satisfy its needs or may be unable to identify in advance the legal or financial make-up of the project. In such circumstances, dialogue with bidders (treated equally), who have prior experience and technical know-how from similar projects may allow for refinement of the specifications and therefore result in a more robust project, which better meets the needs of the procuring authority. Further, the use of such procedures provides confidence to those financing projects that such proposals are viable and procuring authorities have made well-researched and informed decisions on the selection of contractors.

Pre-procurement preparation could be enhanced in the Mediterranean partner countries. A number of projects (both PPP and other major projects) in Jordan and Algeria, for example, have not succeeded. The projects were withdrawn from tender after selection of preferred or shortlisted bidders. This was mostly due to lack of preparation and project viability assessment in the early stages or failure to provide clear specifications or complete tender documentation (including the terms and conditions of the contract). This resulted in further bid costs, uncertainty for bidders and prolonged tender periods. Upfront investment will ensure that the process is efficiently managed and investor/bidder interest is maintained. This investment should comprise engaging expert advisers to develop appropriate tender documents and to conduct necessary technical and economic viability studies. One way of achieving this would be to establish dedicated infrastructure units to strengthen and shorten the project preparation, appraisal and implementation stages.

²¹ Law No. 67 of the year 2010

²² Syria: Draft PPP Law dated 20 April 2010. Jordan: Draft PPP Law dated 1 June 2010.

Does the procurement procedure respect the key principles of fairness, transparency and equality?

Comparator countries

The principles of fairness, transparency and equality are upheld in the comparator countries through procedures which are open and transparent and that apply equal criteria to all bidders.

For example in the UK, France, Poland and South Africa, transparency is achieved through procurement procedures that require the authority to set out clearly the way that the procurement is administered and to strictly adhere to those rules. Bidders are typically provided with:

- a clearly defined and detailed scope, including requirements, pricing and technical specifications;
- the ability to raise clarifications during the process and a clear process for how the authority will respond;
- provision of the same information to every potential bidder;
- fully disclosed selection criteria; and
- fully documented selection proceedings.

In Mexico, transparency is achieved by making the steps in the procurement process open to the public, particularly through the use of Compranet, an official government website dedicated to public procurement, administered by the Ministry of Public Function (see Box 21 below).

Transparency and fair competition is also ensured through widely advertised tenders and awards of contract. For projects procured in France, Poland and the UK, the public authorities are obliged to publish a notice in the Official Journal of the European Union (OJEU) both at the beginning and at the end of a procurement. The notices respectively advertise the intention to begin the tender procedure and notify of contract award. For public bids in Mexico, there is an open invitation to bid and question and answer clarification meetings are also events open to the public. All relevant information in respect of a bid in Mexico must be published on Compranet. In South Africa, the advertisement is placed as per the procuring authority's procurement plan. This can include notification of the project in the government tender bulletin; in prominent newspapers and journals; on the relevant authority's website; and on the national treasury's PPP website. The result of advertisement practices in the comparator countries is to increase competition between bidders, which in turn has encouraged competitive pricing, innovative solutions and improved technical proposals.

Objective and transparent award criteria are prevalent in the comparator countries and ensure high quality competition. Pre-qualification is generally used in the comparator countries to eliminate certain bidders on objective criteria such as past experience or financial and technical capacity. By reducing the number of bidders, pre-qualification may also stimulate qualified firms to prepare better quality proposals due to the imposition of shortlisted bidders which all meet the contracting authority's selection criteria. In France, for example, it is common in PPP procedures to reduce the number of bidders to four following the pre-qualification process. The invitation to pre-qualified bidders to participate in the tender are issued with objective award criteria. Comparator countries widely use criteria such as the "most economically advantageous tender"

(MEAT). This is a benchmark that considers not only the tender price of a bidder's offer but also enables the procuring authority to put a value on any risks that the bidder tries to transfer back to the authority. In Mexico, the procurement laws specify that the contract award should go to the bidder that tenders "the most advantageous conditions". Such conditions take into consideration factors such as financing terms, technical conditions and past performance on other contracts.

Mediterranean partner countries

The fundamental core principles of transparency, fairness and equality are specified in the procurement legislation of most of the Mediterranean partner countries. Each country's procedures uphold the principles to differing degrees as explained below.

All the Mediterranean partner countries generally follow the good practice of openly advertising the projects for bidding, although to differing degrees. In Algeria, for instance, there is a culture of widely publicising tender opportunities; public opening of tenders (financial offer); and contract award in public (with the media present). In Israel, under the Tenders Law and Tenders Regulations²³, tenders must be widely circulated in domestic newspapers and on the website of the Ministry of Finance. In Lebanon, project specific laws (such as Law 218 dated 13 May 1993) have previously been enacted in order to facilitate tenders. The procurement procedures used were broadly in line with practice in international PPP markets and included public advertisement of the procurement. However, developing a procurement process of general application would be more efficient and will give potential future investors more certainty. The Egyptian PPP Law²⁴ prescribes that tenders are to be advertised, but the rules for advertisement are to be set out in executive regulations to the law.

Regarding the award criteria, Mediterranean partner countries adopt a two-stage evaluation procedure where the technical and financial bids undergo separate evaluation. This process is good practice if appropriate weighting is allocated to the technical solution. In some cases, significant emphasis is placed on the price of the bid and this could have the undesired effect of reducing the technical evaluation to a mere filter for inadequate technical proposals. In Algeria, Jordan, Lebanon, Tunisia and Syria, for example, the bidder with the lowest price evaluation for the financial offer is selected if it has met the minimum technical threshold. If there is a pass/fail evaluation in relation to the technical offers followed by a lowest price evaluation for the financial offer, there is a danger that the procuring authority may not select the best technical solution to meet its needs and therefore not achieve best value for money. An alternative could be to use sophisticated award criteria which apply weightings to different components of the bid and do not rely overwhelmingly on price (see Box 13). It is essential that thought is given to specifying individual criteria, since if no criteria are specified, "lowest price" applies by default. In Morocco, for example, the most commonly used award criterion is that of "most economically advantageous tender". The Moroccan definition of "most economically advantageous tender" is broadly in line with international practice which places emphasis on the overall solution cost and not just the short term lowest cost offering. In Israel

²³ Mandatory Tenders Regulations 5753-1993

²⁴ Law No. 67 of the year 2010

procurements which are not based on lowest price consider the overall benefit of the bids to the procuring authority. There is, however, varying emphasis on financial/technical offers and scores are still weighted as much as 80% on price.

Box 13: Award criteria – lowest price or most economically advantageous tender?

The criteria on which the contract will be awarded should measure value for money. However, "value for money" cannot be an award criterion in itself. Whether the bid represents value for money is determined by the constituent parts of the bid. The applicable criteria are therefore "lowest price" or the "most economically advantageous tender" (MEAT) – that is consideration of price plus other factors, which are appropriately weighted and converted into scores for each bidder.

Lowest price

The lowest price approach does not always take into consideration differences in qualitative aspects of a bid. As such, it is generally only suitable for simple procurements for short term, low-level services or contracts of a standard specification. For complex projects procured as PPPs it would generally be more appropriate to use the MEAT criteria, subject to an assessment of the weightings to be applied.

MEAT – Balancing quality and cost

The emphasis that an authority places on price and on quality should naturally vary, depending on the available budget and the nature of the project procured. Scoring models can be devised to allocate different "weightings" to different elements of a bid. For example, a higher price weighting may be more suitable for a project with a very restricted budget combined with a clear and detailed statement of requirements, whereas quality (see below) would have the higher weighting for projects where the level of service to be delivered is key to the public body.

Quality criteria must be linked to the subject matter of the contract so that they are directly related and proportionate to the contracting authority's requirements. Some examples are:

- Aesthetic and functional characteristics;
- Capability;
- Capacity;
- Continuous improvement;
- Customer care policies;
- Delivery date or period and ability to deliver;
- Equal opportunities;
- Performance standards, quality control, self monitoring and complaints;
- Relative impact on the environment;
- Sustainability issues and environmental characteristics;
- Skills level of the workforce;
- Technical assistance;
- Technical merit.

The above has to be balanced against the need of ensuring objective comparability of different technical solutions.

In Jordan, Egypt and Israel, the publication of evaluation criteria ensures transparency. In Israel the evaluation and award criteria are, in practice, determined on a project by project basis. The evaluation criteria and methodology tend to be described in detail, for example by outlining the scoring system. The Technical Committee in Jordanian PPPs is free to decide its own evaluation criteria, although it must disclose the evaluation criteria it selects in both the announcement soliciting expressions of interest and the section on instructions to tenderers in the Request for Proposals (RFP). This is good practice that ensures fairness and transparency. The PPP Law tender procedure in Egypt provides that the bid documents prepared by the PPP Central Unit (PPPCU) in coordination with the relevant procuring public authority should include general information relating to the project, project specification and technical requirements (including evaluation criteria and methodology and instructions and timetable for bid submissions). In theory, the process is rigorous and should assure competition.

Fairness to all bidders could be enhanced in Algeria by removing the preferential treatment given to domestic bidders, as has been done in Egypt. In contrast to the Tender Law²⁵, the new PPP Law in Egypt²⁶ provides no preferential treatment to Egyptian bidders. This is presumably in recognition that under the Tender Law this was an issue for foreign investors. Foreign investors could be at a disadvantage where countries are biased towards local companies. This uncertainty may deter foreign participation in tender competitions. For instance, margins of preference applied in Algeria continue to place potential foreign investors at a disadvantage. This important issue of fairness to all bidders may need to be specifically addressed by the Algerian government if foreign investment is to be encouraged.

Are unsuccessful bidders duly notified and do they have rights of challenge?

Is the public sector accountable for its decisions?

Comparator countries

The possibility of legal challenge and accountability of the public sector to due legal process in the comparator countries ensures that the general principles of a fair and transparent procurement are upheld. In all comparator countries, non-compliance by the authority with the prescribed procurement procedure entitles the unsuccessful bidder to challenge the contract award to an independent and impartial body. Given the size of the risks, resource commitment and costs involved in participating in the bidding process, it is important that bidders are confident that the procurement procedure affords them an equal opportunity and that any rejection of the bid is based entirely on its merits. If there has been a flaw in the procurement process in the comparator countries, aggrieved bidders can raise their grievance with an independent body empowered to provide an effective recourse. This increases public sector accountability.

²⁵ Law No. 89 of the year 1998

²⁶ Law No. 67 of the year 2010

Unsuccessful candidates are informed and de-briefed on why their bids were rejected. In the UK, France and Poland for example, the procuring authority is obliged (as a result of domestic implementation of EU procurement law) to de-brief the unsuccessful bidders. This then triggers the “standstill period”, during which the contract, although technically awarded, may not actually be entered into pending a challenge from an aggrieved bidder. These periods are not very long (for example, in EU procurement it is ten days) and therefore will generally cause little difficulty for the successful bidder or the procuring authority. In Mexico, aggrieved bidders may file a bid protest or award challenge within six working days of award if it believes the procurement procedure applied does not comply with the law.

The remedies available for non-compliance are clear and effective. Recent EU legislation (implemented in England for example through the Public Contracts (Amendments) Regulations 2009) has stipulated a new remedies regime which applies greater sanctions on public authorities that have breached the procurement procedures. The legislation allows the automatic suspension of any contract award when legal proceedings are issued against the contracting authority (no separate court application is required) but an authority can apply to have the suspension set aside. Contracts that have been awarded can also be ruled ineffective (or void). The authority would therefore be required to re-procure the project. Financial penalties are also payable by procuring authorities for operating flawed procurement processes although, in practice, uncertainty continues to surround the amount of such penalty. An effective remedies regime will act as an incentive for authorities to comply with the procurement procedure and will provide investors with comfort that they will have suitable recourse if the procurement is not managed in a fair and transparent manner.

Mediterranean partner countries

There are procedures in place in all Mediterranean partner countries to deal with aggrieved bidders and to resolve complaints regarding the integrity of the bidding process. These procedures are set out in specific PPP laws (enacted or in draft where relevant), or the general law may provide for the review of public sector decisions when procurement procedures have not been followed. This is the position in Tunisia where the general law allows public sector decisions to be reviewed in cases of alleged non-compliance by the procuring authority. The PPP Law in Egypt²⁷ provides for a complaints procedure for aggrieved bidders, but is silent (and may therefore benefit from

some clarity) on the issue of the remedies and relief available for non-compliance with the procurement rules. In Israel, case law has established a set of additional general principles applicable to all public procurements, which require the procuring authority to avoid even the appearance of impropriety. A breach of the principles of equal treatment of bidders, fairness of competition, reasonableness, good faith, non-discrimination, and the avoidance of arbitrariness and conflicts of interest runs the risk of challenge in the courts but, in practice, PPP cases are rarely challenged in court. Whilst there are options for challenging procurement decisions in Syria, the effectiveness of the process is not clear and will benefit from development in the PPP context. In Morocco, one of the benefits of a new PPP law is that it could improve the PPP procurement process by addressing the remedies available to unsuccessful bidders on a successful challenge.

Bidding process – recommendations/success factors

- Set out in the law clear procurement processes which are suitable for PPP structures.
- Ensure that procurement procedures uphold the key principles of fairness, transparency and competition.
- Ensure that the procurement framework makes the public sector accountable for its decision, which must identify a winning bidder who has the ability to implement the project successfully.
- Establish a procurement process which is structured and includes procurement stages that reflect the scale and complexity of the project.
- Design a procurement procedure which includes conditions that encourage competition between bidders so as to allow public authorities to achieve better value for money.
- Advertise projects appropriately, using accessible forms of media.
- Use award criteria that are objective and transparent.
- Authorities should strictly comply with procurement procedures as this ensures certainty by removing the risk of challenge.
- Publicly advertise contract award.
- Notify unsuccessful bidders of decisions and provide an opportunity to give a debrief of their bid, setting out the reasons for elimination.
- Give unsuccessful bidders access to clear rights of challenge and effective remedies.

²⁷ Law No. 67 of the year 2010

5. CONTRACT DESIGN AND RISK ALLOCATION

A fundamental principle in project finance structures is that the economic benefit to all parties is optimised if risks are contractually allocated to the party best placed to manage the particular risk. Contract design is therefore crucial to achieving the optimal outcome for all parties.

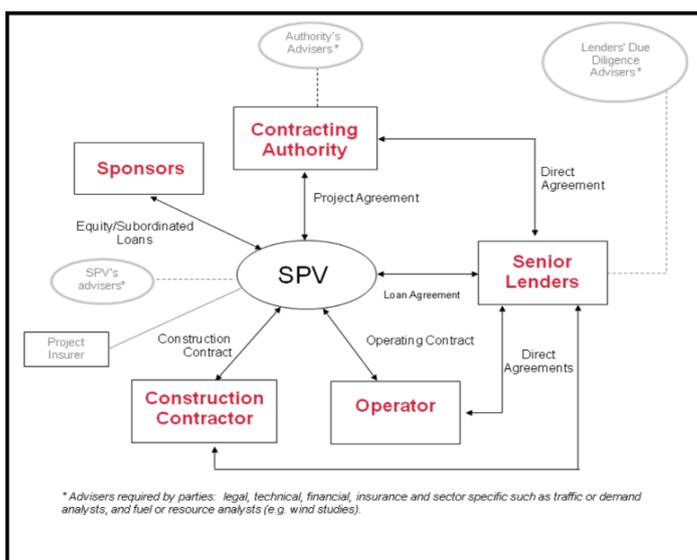
This section first sets out the key principles of risk allocation and contract structure in Public Private Partnerships (PPPs) in the comparator countries. It then deals with each significant risk issue in turn, examines key questions relating to that risk and how they are addressed in PPP contracts in the context of the comparator countries and the Mediterranean partner countries: Payment mechanism issues and financial risks are discussed in the next section.

Key general principles of risk allocation and contract structure

Comparator countries

A typical project finance structure will recognise the participation and interests of all key project parties, including the authority, Project Special Purpose Vehicle (Project SPV), sponsors, subcontractors and lenders. In the experience of the comparator countries and Mediterranean partner countries the project structure usually includes direct agreements between the public sector contracting authority and the lenders, step-in rights for lenders (for example, to replace the operator if necessary), security by assignment of project receivables as well as the key project and financing documents. Principles of risk allocation between the public sector and private sector parties depend on the country and the specific project, although certain standard principles can be observed, as described below. A typical project finance PPP structure is set out in Figure 2 below.

Figure 2: A typical project finance PPP structure
A unique feature of project financed PPP projects is that the



Project SPV is said to be 'ring-fenced'. This is a method of limiting the risk exposure of the private sector contractor/sponsors. The ring-fencing of the Project SPV will ensure the Project SPV's assets and liabilities are separated from the public authority and its sponsors. The Project SPV is set up

with the express purpose of limiting the recourse of the lenders (if the project fails) to the assets of the Project SPV. For the public authority, ring-fencing of the Project SPV represents a key benefit of PPP compared to traditional procurement, enabling capital intensive procurement to proceed with the financial risks of cost overrun, project delay and operational performance substantially transferred to the private sector.

Project finance structures can incentivise successful project implementation. A typical project finance structure, with the features described above relating to contract structure and ring-fencing and associated characteristics such as a robust security package, will incentivise all key project parties (including the public authority, Project SPV, lenders and key subcontractors) to maintain their interest in and discipline toward a successful project implementation.

Detailed risk analysis of the specific project is therefore essential. Each possible event that could lead to the project failing to perform to the original expectation needs to be identified and quantified, both as to the likelihood of its occurrence (for example frequent or rare) and its financial impact if it occurs (ranging from minor to financially catastrophic). The risks identified can then be allocated between the Project SPV and its contractual counterparties – the authority, the subcontractors, the shareholders, or otherwise allowed for in the Project SPV financial plan. This risk allocation is achieved by specific provisions in the project contracts or, in certain cases, by application of general law. In the United Kingdom (UK), in the public sector business case approval of PPPs, risk allocation is specifically analysed by means of a risk matrix identifying, for the particular project, the nature of the risk and which party is to bear it. The same risk allocation principles are then included in procurement documents, so that the private sector is clear as to the expected risk allocation.

By striking the right risk balance in the PPP contract, coupled with a competitive bidding procedure, the public sector will ensure that the private sector offers the best price thereby maximising its cost-efficiency or value for money. A cost-efficient project is one that reduces the cost of capital; facilitates the bankability of projects; limits public sector risks to the necessary; and reduces the risk premium that the public sector has to pay and therefore the cost of the infrastructure service delivery. Best value for money, on the other hand, represents the optimum combination of whole-of-life costs and quality (or fitness for purpose) of the goods or services to meet the user's requirement (definition of HM Treasury (UK)). It creates stable project cashflows that attract long term domestic and foreign lenders and investors to invest in PPPs. In effect, such investors would take a combination of project risk (supported by subcontractor guarantees as normal in project finance) and public sector credit risk – a combination which has been readily financed in a wide range of PPP markets.

A typical outcome in PPP in the comparator countries has been for the private sector to take all risks associated with delivering performance to the specification required. Fundamentally, the private sector takes the risks on its own performance. Macroeconomic risks such as exchange rates and inflation are generally allocated to the authority, unless these can be separately hedged or managed by the private sector. Changes in law and regulation require compensation by the authority or adjustment to the PPP contract terms, to keep the Project SPV

whole. Insurable events such as damage are a private sector risk for which insurance covers the costs (including lost revenues). Events outside the control of the parties – “force majeure” – are generally shared, but whether an event constitutes force majeure can vary between countries. In the comparator countries, the expected outcome is often set out in specific guidance published for the specific sector (as in the UK) or by the use of standardised documentation (as in Mexican road and power projects), with any deviations from standard or from precedent requiring central approval. Such guidance has needed only occasional updating to reflect changes in market conditions on specific issues, and has significantly assisted in shortening negotiation and procurement times for PPPs.

As a result of this risk allocation, the project parties have to keep to a clear discipline in their relationships and management of the project. The main benefit to authorities of the PPP approach is project discipline as, provided it is well structured, the private sector will have strong incentives to deliver on time and according to specifications. Consequently, the authority must carry out extensive evaluation that it is satisfied with the project design, timing and specification in advance of contract signature. After contract signature, it can request material changes only under exceptional circumstances through the contract variation procedure, to agree the price and specification of a variation. Thereafter the authority does not usually interfere in how the Project SPV delivers the project (providing it is doing so within the contract specification), but instead manages the project as a client, to ensure that the services are delivered in accordance with the contractual terms. This principle applies also where the authority or other government entity also participates in the Project SPV: such co-investment helps to foster partnership and share economic returns in the project, but does not permit the authority to seek to have the project contracts overridden. The public sector must ensure that it can properly manage the contract during the operational phase to ensure that the private sector is performing to the required standard. This is easier in projects such as power plants or toll roads, and harder in social infrastructure projects such as schools or hospitals.

The project agreement (or PPP contract) is the main agreement between the public authority and the private sector partner. This agreement regulates the partnership and risk allocation between the public and private sectors over the duration of the contract, typically long term and in the region of 25-30 years and sets out the terms of their relationship, including (without limitation): the scope of works and services; output requirements; performance standards; payment structure (including the allocation of demand and performance risk); delay events; consequences of changes in law; default events; termination rights; and dispute resolution procedures. The project agreement acts as the foundation of the project and establishes the framework for all of the other project documents.

Lenders provide financing to the Project SPV for the construction of the facility in accordance with the terms of the loan agreement and related financing documentation. The loan agreement will, inter alia, regulate terms of drawdown and repayment, events of default and lenders' monitoring rights. Other finance documents include the following: notices of assignment (an assignment of the Project SPV's rights and interests under the principal contract documents and security

over its assets); direct agreements (to create step-in rights for lenders into the various contracts to which the Project SPV has entered into and other issues that lenders may require comfort for); hedging agreements (to hedge interest rate or exchange rate movements); accounts agreements (to govern the operation of the Project SPV's bank accounts over which the senior lenders have security).

As a guide, Appendix 1 sets out a typical risk analysis of a bankable PPP project. For each risk the table in Appendix 1 includes potential mitigants and the preferred position of the lenders, sponsors and authority. The specific risks identified and their suggested mitigants and allocation are representative, in broad outline, of a range of projects that have been successfully project financed. However, specific risk analysis of each project is essential and the list in Appendix 1 is not comprehensive.

Insurance as a means of managing risk and the obstacles to the availability of suitable insurance for PPPs

Comparator countries

Obtaining satisfactory insurances at the start of projects is straightforward in normal market conditions. The main concern has been the risk of insurance becoming unavailable or unaffordable during the project term. Typically at financial close of a project, the Project SPV is able to obtain insurance for the full construction period, even if it spans several years. Thereafter, insurances are placed annually during the operating period. Insurance markets are, however, cyclical. Variations in insurance premiums depend on sector claims' histories and economic conditions (for example, UK project insurance premiums approximately trebled after 11 September 2001). At times, insurances for certain risks can become unavailable or unaffordable on commercially realistic terms. These risks are beyond the control of the Project SPV. Typically, availability based projects have high levels of debt and low cashflow surplus after operating costs. This means that significant increases in insurance premiums significantly reduce shareholder returns. To address these issues in the UK PPP market, PPP contracts include insurance benchmarking, with an adjustment to PPP payments if market insurance premiums vary beyond a threshold. Uninsurability – which typically constitutes an event of default under the project loan – is a termination event unless the authority agrees to act as insurer of last resort during the period of uninsurability.

Box 14 – Insurance packages for PPPs

Insurance standards for project financing tend to follow common key principles –

- A common insurance package is procured for the project, with all stakeholders as named insured – the Project SPV, the authority, lenders, and key sub-contractors. These parties are named insured (i.e. entitled to claim, subject to no double claiming) and the policy would typically have a “non-vitiation” clause, namely that the right of one insured party to claim will not be invalidated if one of the other insured parties invalidates the policy.
- The insurance package is comprehensive for all risks, including physical damage, theft, and third party liability, and compulsory insurances such as motor insurance and employer's insurances. Risks covered will typically include

civil unrest and terrorism, and pre-delivery marine loss cover is required in respect of delivery of critical components of the construction. In certain countries (such as for the early Mexican PPP projects), political risk insurance is needed to cover risks including but not limited to expropriation, civil unrest and exchange transfer and convertibility.

- Advance loss of profits (in respect of construction period risks) or business interruption insurance during operations is necessary to cover lost revenues following an insured event. These policy extensions are crucial for funders, to cover debt service during the period when the project facilities are being rebuilt.
- Lenders insist on taking an assignment of the insurances as security, so as to control usage of the insurance proceeds following a claim. However, this is often controlled in the project agreements, so that the banks cannot prevent insurance proceeds from being used for reinstating the project.
- Lenders typically also require that the insurances are placed with creditworthy insurers, often by specifying a minimum credit rating for insurers. Lenders and borrowers typically contract insurance advisors to agree an insurance package that is acceptable to both. This process can be lengthy, particularly in untested markets.

*Mediterranean partner countries*²⁸

The comprehensive suite of insurance cover required for PPPs is typically available in the Mediterranean partner countries.

Project agreements should therefore follow the example of the comparator countries and specify the required insurances and provide for the possibility of insurance becoming unavailable or unaffordable during the project term.

There are variations in insurance premiums between the Mediterranean partner countries. Insurance premiums in certain zones are affected by natural catastrophe risk including Algeria, northern Israel, the West Bank, Lebanon and the Syrian coast (earthquake risk), and Nile delta and Israeli coastal areas (tsunami). Terrorism cover is available in all Mediterranean partner countries (since the global premium pool for terrorism cover is very large), but at differing premium levels. Insurance premium taxes are high by international standards in Morocco (14% for construction all risks and property insurances), Tunisia (10%), Lebanon (11% including municipal taxes) and Syria (8%), which adds to the cost of projects, but is fiscally neutral for government as a whole.

Most countries require that insurances be placed in the local market, affecting insurance costs, risk of unavailability of insurance and lenders' security over project insurances.

All Mediterranean partner countries, except Israel, require that insurances of local entities (which include Project SPVs incorporated and resident in the country) are purchased from locally authorised insurers. Restricting the pool of primary insurers may cause premiums to be higher than otherwise could be the case. Local markets may be more susceptible to disruption than the global market and so the significance

of specific protection for Project SPVs in project agreements against insurances becoming unavailable or unaffordable during the project term is greater than might otherwise be the case. In certain cases (notably in non-investment grade countries) the local insurer requirement could conflict with project lenders' typical requirement that insurers have a certain minimum credit rating. However, lenders may not apply this requirement if the insurer is a subsidiary or affiliate of a major international insurance group, many of whom are represented in the majority of Mediterranean partner countries. Additionally, lenders will seek acknowledgement of security granted over the insurances from the Project SPV's primary insurers (irrespective of whether the insurers re-insure the risk domestically or abroad).

Contractual allocation of key project risks

Design and construction and technical specification risk

- Are PPP contracts designed to be output based such that the private sector assumes design and construction risk? Do payments begin on satisfactory completion of construction (i.e. no service, no fee)?
- Is the standard of works clearly defined in the PPP contract?
- Does the construction subcontractor receive appropriate incentives to deliver on time and on budget?
- Is the construction subcontractor liable for defects in the works for a defined period of time?

Are PPP contracts designed to be output based such that the private sector assumes design and construction risk? Do payments begin on satisfactory completion of construction (i.e. no service, no fee)?

Comparator countries

Established practice in the comparator countries is for the Project SPV to take construction and design risk and for it to pass all the risk down to a construction subcontractor (with appropriate warranties to the authority). By not taking construction or design risk, the public sector ensures that their concern is only that the project asset is capable of satisfying the authority's service or output requirements. PPP contracts are typically output based which means that the Project SPV is responsible for designing and constructing the facility to meet the authority's requirements. The Project SPV is not paid until completion of the facility and service commencement (i.e. 'no service, no fee'). Therefore, lenders will want to see the Project SPV passing all design and construction risk down to a construction subcontractor with sufficient financial strength and expertise in design and relevant knowledge of any technology to accept the risk under a design-build contract.

In the comparator countries, the public authority has the ability to comment on designs and require small design changes that do not significantly affect costs. However, the public sector is not expected to approve or sign off on design as this will transfer the risk back to the authority. It is standard practice for the PPP contract to include a design review procedure setting out a mechanism for submission of the design by the Project SPV, authority comment and the extent to which minor design changes are permitted before they would impact on cost.

²⁸ Information on Mediterranean partner countries collated by Willis Limited from country data sourced from AXCO Insurance Information Services and Crystal – Lloyd's Global Trading Information

By transferring both design and construction risk to the Project SPV, authorities in the comparator countries ensure that the private sector is incentivised to design and build the asset to produce best "whole life" cost. The objective of such approach is to create better quality assets because the Project SPV will need to optimise the balance between keeping capital costs low and minimising future maintenance costs which may arise over the life of contract.

Mediterranean partner countries

In the Mediterranean partner countries with some experience of PPPs, design and construction risk allocation is consistent with the approach of the comparator countries. The private sector partner will therefore be responsible for designing and constructing the project. The Project SPV will manage this risk by subcontracting it to a construction subcontractor and designer. Further, permitting formal discussions on design during the tender process will allow for a more iterative approach to the development of the authority's output requirements and will therefore encourage better design proposals for particularly complex projects. Such processes are envisaged under the Egyptian PPP Law²⁹ and are contemplated in the draft PPP laws in Jordan and Syria.

Is the standard of works clearly defined in the PPP contract?

Comparator countries

It is usual practice for the public sector to define the standard of performance of the works and include them in the bidding and contract documents. Whilst some legal systems may specify the standard of works that an employer will require from its construction contractor, the comparator countries' experience shows that standards for constructing PPP project assets should be explicitly set out in the contracts (by including detailed technical conditions that have to be met before reaching the operational phase). For example, the Polish Civil Code, PPP Act and Concession Act imply a standard of reasonable skill and care into PPP contracts, but PPP agreements in Poland additionally specify contractual provisions that create obligations for the Project SPV to comply with the authority's specifications regarding technical or functional requirements. Similarly, French law includes the notion of "fitness for purpose", but PPP contracts will include their own standards specific to the project. In Mexico, where the law is silent on standards of works, practice has developed for the most suitable standard to be defined in the bidding and contract documents. In this way the most appropriate standards of performance can be defined according to the specific needs of the project. This provides the parties with greater certainty.

Mediterranean partner countries

Practice to date in the Mediterranean partner countries follows the approach of the comparator countries by specifying in the contract the standards of works specific to each project. Norms such as "reasonable skill and care", "rules of the art" and "international standards" are frequently used.

In Tunisia, Morocco and Lebanon, although the minimum standard of works is regulated by legislation, authorities would be well advised to specify additional standards in the PPP contracts. In Tunisia, the parties are required to perform their obligations with "reasonable skill and care" and to ensure that the output of their work is "fit for purpose". The Concessions Law in Morocco³⁰ provides that public services must be delivered to minimum standards that apply even if not expressly incorporated in the contract. In practice, however, detailed standards of application will be specified in Moroccan PPP contracts. Lebanese law requires contractors to perform works with reasonable diligence and care. However, Lebanese authorities specify additional standards of performance in their construction contracts, including international specifications and benchmarking measures (such as British Standards Institution (BSI) or European Union (EU) standards when defining contractual performance standards).

In Egypt and Syria, the absence of strict legislative regulation of the standard of works means that authorities must specify their required standards in the PPP contract. This is recognised in the Syrian Draft PPP Law³¹, which provides that each PPP contract should include provisions about the conditions of delivering the service, the applicable norms and standards and the performance criteria guarantees and related penalties. The Egyptian PPP Law³² does not specify standards of performance and these should be drafted into the PPP contracts.

Does the construction subcontractor receive appropriate incentives to deliver on time and on budget?

Comparator countries

Generally, liquidated damages are payable by the construction subcontractor to the Project SPV for late completion and this acts as an incentive to complete work on time (with the exception of delays due to relief events and compensation events). The Project SPV is incentivised to complete on time because it will only start to receive the service payments upon completion of the construction (i.e. no service, no fee). The Project SPV backs off this potential loss in revenue by imposing liquidated damages on the construction subcontractor for late completion.

Both the civil and common law approaches to setting the level of liquidated damages are seen as acceptable by investors in the comparator countries. In particular, in Poland the PPP Act specifies that the PPP agreement must define the consequences of deficient performance (including liquidated damages). Although there is a broad scope to freely determine the circumstances in which liquidated damages will apply and their level, the Project SPV should carefully calibrate its losses (including in terms of increased financing charges and loss of revenue) in order to pass them down to the construction subcontractor. English case law has determined that the level of liquidated damages specified must be a genuine pre-estimate of the loss. If the level specified is excessive, they will be deemed to be a penalty and will be unenforceable. The Polish Civil Code stipulates that the level of liquidated damages may be adjusted if, in reality, the actual losses are much lower than the amount of liquidated damages, or if there has been substantial performance.

²⁹ Law No. 67 of the year 2010

³⁰ Law 54-05 enacted by Dahir No. 1-06-15 of 14 February 2006

³¹ Draft PPP Law dated 20 April 2010

³² Law No. 67 of the year 2010

Mediterranean partner countries

All Mediterranean partner countries recognise the use of liquidated damages as an incentive to complete construction on time and on budget. Consistent with international best practice, the level of liquidated damages is specified in the construction contract and is designed to compensate the Project SPV's losses (for example, increased financing costs and loss of revenue). In those Mediterranean partner countries that adopt a civil code, an emphasis is placed on the fairness of the agreed damages. The court can intervene on the application of a party and adjust the contractual level of liquidated damages if the actual loss exceeds or is lower than the contractual level. This is beneficial if such intervention is to correct manifest unfairness, but it can also introduce uncertainty. The contractual level of damages should therefore from the outset be a fair and reasonable estimate in order to prevent frequent adjustments. Certain types of liquidated damages in Lebanon may allow for what in other jurisdictions would be regarded as double-recovery. Specifically, if the liquidated damages can be characterised as a "delay penalty", the court may still make a separate award of damages resulting from the actual breach of contract. Such an approach is unusual in international PPP markets. In Israel, the law on liquidated damages follows the English common law approach and places an emphasis on the parties' estimates of foreseeable damage. Penalties (i.e. punitive sums) are not permitted.

Is the construction subcontractor liable for defects in the works for a defined period of time?

Comparator countries

The construction contract may provide for a set defects liability period during which the construction contractor will be liable for defects in the building or design. The length of such period varies depending on the nature of the works, but is typically between one and five years. The Project SPV and its lenders will want the construction contractor to be responsible for defects for as long as possible (whilst recognising that unreasonably long defects liability periods may add substantially to the price).

Defects liability periods may also be mandated under the applicable law of a country, even where the construction contract may have made alternative provision for defects. Article 1792 of the French Civil Code, for example, sets a decennial liability for defects (i.e. a ten year limitation period) in completed civil works. This will apply to the works carried out by the construction contractor. The authority will have alternative recourse for defects, through the availability and performance provisions under the PPP contract.

Mediterranean partner countries

Liability for defects is prescribed by law in the majority of the Mediterranean partner countries. Legislative provisions impose decennial liability for the private sector for defects in the design or construction of the works in Algeria, Egypt, Jordan, Morocco, Syria and Tunisia. In Israel, liability for defects due to design failure is allocated under the contract and usually falls on the Project SPV. The defects liability period under the construction contract is negotiated with the subcontractor and will vary depending on the nature of the project. Under Article 668 of the Code of Obligations and Contracts in Lebanon, the party carrying out the construction works will be liable for any

defects in the works for a period of five years from when the work is handed over.

Planning and approvals

- Will the public sector provide the land required for the project?
- Which party is responsible for obtaining consents and approvals including planning?

Will the public sector provide the land required for the project?

Comparator countries

The public sector will usually make land available for the PPP projects. This is because procuring authorities will generally either own the land in question and grant appropriate rights of use, or have the means to negotiate the purchase of the land. For PPPs in South Africa for instance, the procuring authority will grant the land and provide a number of the approvals (specifically zoning of the land and town planning approval). Additionally, many governments with established PPP programmes have the power to acquire land compulsorily if necessary, subject to the payment of appropriate compensation. However, there are usually carefully controlled circumstances permitting the use of such power of expropriation, due to the associated potentially negative political and social effects. Compulsory acquisition powers can be advantageous for PPP development but it is important that the process is managed carefully and that due regard is made to the rights to compensation of the affected persons.

Mediterranean partner countries

In the Mediterranean partner countries, PPP projects are usually established on land owned or acquired by the government. Therefore, land acquisition or ownership does not pose any practical difficulties for the Project SPV, other than the time it takes for the land to be acquired by the public authority (if not previously owned). This will be attractive to investors as the relevant governmental body will be responsible for obtaining any licences and consents directly related to obtaining the site. However, allocation of responsibility for obtaining other planning and permitting approvals for the development on the site varies between the countries.

Which party is responsible for obtaining consents and approvals including planning?

Comparator countries

Planning risks for development on the site are either allocated to the private sector or, at least, shared between the parties. Planning processes are not tailored specifically to PPP projects. Generally, the normal provisions of property/planning law in the comparator countries allow the public to object and to be heard at planning tribunals (including rights of appeal), making the process slow, with the outcome uncertain. Some projects accordingly incorporate planning controls designed to reduce such third party objection and appeal rights. Projects in certain sectors (such as transport) can take advantage of certain statutory authorisations to avoid the application of general planning law. The Crossrail transport project in England is a good example of this practice. The Crossrail Act 2008 states

that planning permission for carrying out developments in relation to the project are deemed to be granted by that act and the normal requirements for planning applications will not apply. The private sector will typically seek protection for delayed or refused planning consents and approvals particularly when it is in substantial compliance with the permit requirements. Other accepted methods of sharing planning risk include public authorities obtaining outline planning consent, with the private sector retaining the risk in obtaining detailed planning permission; and the public authority undertaking to facilitate the granting of permits.

Usually for PPPs in the comparator countries, all other final approvals will be the responsibility of the private sector (for example relevant environmental permits, building permits, water permits and other consents and approvals regarding compliance with health and safety, sanitary and fire protection requirements). The extent of the public authority's obligation is normally only to provide reasonable assistance to the Project SPV in its effort to obtain approvals. Inter-ministerial co-operation and co-operation between the public bodies involved in issuing permits is encouraged.

Mediterranean partner countries

Planning and permit risk allocation in Egypt, Jordan and Morocco most closely follows the best practice of the comparator countries of sharing the risk in such a way that sponsors and funders will not have great concern that they are allocated risks which they cannot manage. The Project SPV is responsible for obtaining any planning permission and permits required, which will vary depending on the location of the project and type of activity to be undertaken. The private sector may be contractually protected where delay in issuing permits constitutes an event of default. The New PPP Model in Egypt protects the Project SPV against unreasonable delays or abusive rejection by government departments in issuing licenses and permits by considering this as an event of default by the contracting entity. This is a favourable position as the public authority retains some of the risks associated with unreasonable delays. In Jordan, the Project SPV usually obtains any planning permissions with the assistance of the procuring authority. The Concessions Law in Morocco³³ requires the contracting authority to assist the private operator with obtaining the necessary authorisations. Here, the Project SPV is required to use its best efforts to obtain such authorisations but the private party will typically not be liable, under the project agreement, for a failure to obtain any relevant consents if it has taken all possible actions to do so. As planning powers are held at various levels of the government, the relevant planning authorities for a particular project must be made clear from the outset and lines of communication with these authorities should be open. This will mitigate the risk of delay. Often, however, outline planning permission is granted prior to financial close and therefore this issue is of less concern.

Contractually, the private sector takes the risk of obtaining the necessary permits and licences to enable construction and operation of the project in PPP projects in Algeria, Israel and Tunisia. The relevant public bodies will not guarantee that consents will be granted and so the private sector takes the risk of delays in obtaining necessary consents and the risk of failure in obtaining them. This may serve to deter foreign

investors, who may not be prepared to risk the often substantial sums incurred in preparing designs, undertaking surveys and other due diligence to take forward planning applications when there is a significant risk of delay. In practice in these countries, the risk of obtaining planning and environmental approvals is shared between the public and private sector partners to a certain extent. For example, the relevant public bodies are willing to ensure sufficient preliminary work is undertaken before bringing projects to market. Assistance is also provided in obtaining planning and other consents and, in particular, there is a willingness on the part of the administration responsible for construction permits to be flexible where the project is of public interest.

Planning risk lies with the public sector in Lebanon and Syria.

In Lebanon failure by the public sector to obtain any necessary consents that results in the project being delayed or redesigned may result in the private party being compensated. General planning laws in Syria suggest that planning permission must be obtained by the public sector who would therefore bear the risk of a failure or delay in doing so. This has been addressed in the Syrian Draft PPP Law³⁴ which recognises that this approach to risk allocation is not workable for PPP projects. The Draft PPP Law makes the Project SPV responsible for planning applications or other required permits. The public entity is required merely to assist the Project SPV in securing the process of granting the necessary permits.

Extensions of time and compensation events

Do PPP contracts make provision for the payment of compensation and/or extensions of time on the occurrence of certain events which are beyond the control of the Project SPV?

Comparator countries

It is usual practice in the comparator countries for a Project SPV to obtain relief where an event occurs that is beyond its control and it causes loss of revenue, additional capital expenditure or delay to the construction programme. From the authority's perspective, it is important that in such circumstances the continuity of public service is preserved. Granting extensions of time in such circumstances prevents the Project SPV from defaulting by failing to meet the construction longstop date. Due to the financial implications of delays to the construction programme, sponsors and funders require that PPP contracts provide for adequate relief to the Project SPV (which will be passed down to the construction subcontractor) where such delays are beyond its control. In the UK and South African PPPs, for example, the concept of "Compensation Events", "Relief Events" and "Force Majeure" are established contractual mechanisms used in PPP contracts for dealing with such circumstances.

For PPPs in the comparator countries, authorities accept that it is appropriate to pay compensation to the Project SPV where the event which causes loss or delay is within the authority's control. Taking the approach in the UK and South Africa as examples, there are three main categories of events where the authority is expected to pay compensation to the Project SPV:

³³ Law 54-05 enacted by Dahir No. 1-06-15 of 14 February 2006

³⁴ Draft PPP Law dated 20 April 2010

- breach of the authority's obligations under the contract;
- variation to the specification, initiated by the authority;
- change in law (discussed in more detail below).

Such relief is drafted into PPP contracts in the form of a Compensation Event. The general principle for Compensation Events should be to restore the economic balance of the contract. The Project SPV is therefore put in no better or worse position than had the event not occurred. As well as economic compensation, a Compensation Event will allow for an extension of time to the construction longstop date equal to any delay caused.

The concept of *Imprévision* in French law entitles the private party to contractual changes in order to restore the economic balance of the contract. Under French law (and in other civil code legal systems where this is applied), the *Imprévision* theory will apply to administrative contracts (i.e. contracts including the State). The aim of this is to preserve the continuity of public services by preventing the contractor from being in default of its obligations when unforeseeable and external events occur which change the economic balance of the contract. *Imprévision* would be likely to apply to dramatic increase in raw materials; natural disasters (earthquake, tsunami or volcanic eruption); or certain measures taken by the relevant authorities (such as price freezing). The Project SPV is then entitled to partial compensation. The parties to French PPPs ensure that PPP contracts expressly define the relevant events where *Imprévision* will apply and their consequences.

PPP contracts in the comparator countries also provide for relief to the private sector for events that are beyond the control of either party. Relief Events and Force Majeure events are explicitly defined in the PPP contract. Force Majeure events are narrowly defined in the comparator countries and are confined to events which neither party is best placed to manage and which are likely to have a long term or permanent effect on the parties' ability to perform their contractual obligations. Examples of Force Majeure events in the comparator countries' definitions are war, acts of terrorism and nuclear, chemical and biological contamination. These are usually incapable of being insured against on commercially reasonable terms. Force Majeure events are distinguished from *Imprévision* in French PPPs due to the permanent nature of the economic changes resulting from such events. Relief Events are those events beyond the parties' control which prevent performance by the Project SPV, but which can be better managed by the private sector.

Financial risk is borne by the private sector in respect of Relief Events, but is shared on the occurrence of a prolonged Force Majeure. Due to the more long term or permanent nature of Force Majeure events, typical provisions in PPP contracts in the comparator countries provide that the parties should consult to resolve the issues or amend the obligations appropriately. There is therefore some built-in flexibility in Force Majeure regimes. PPP contracts in the comparator countries provide that, ultimately, the parties can agree to terminate the contract due to a prolonged Force Majeure event. Financial risk is shared because consequential compensation on termination for Force Majeure is payable by the authority (see below). The private sector is deemed best placed to mitigate and manage against

the occurrence of Relief Events and therefore to accept the financial consequences of such events occurring. Mitigation may be through insurance or by other means such as ensuring appropriate project management or operational risk management procedures. The Project SPV is given relief from termination due to deficient performance, but will suffer any increased costs or loss in revenue, as performance deductions will continue to be applied. This incentivises the Project SPV to ensure full services are restored as quickly as possible.

Mediterranean partner countries

The regime for compensation and extensions of time is treated in a similar manner in Egypt, Morocco and Israel and broadly follows established international practice. In these countries, there are no specific legislative provisions relating to compensation payable (or extensions of time in cases of delay in the construction of the project) caused by unforeseeable events except for general concepts falling under the civil law concept of *imprévision*. In practice parties are free to contract on such issues. PPP contracts concluded in Egypt and Israel make provision for the relief available to the private sector partner for delays in performance by the contracting authority that affects performance of the contract by the Project SPV; unexpected expenses; variations initiated by the contracting authority; and other events that are outside the Project SPV's control. This treatment should satisfy lenders and investors.

In some civil code jurisdictions (including Algeria and Tunisia), the theory of *Imprévision* is applied when unforeseeable events threaten the economic viability of the Project SPV. However, even where the law provides relief it is best practice to include explicit contractual provisions relating to such events. For example, the Tunisian Concession Law³⁵ permits an extension to the overall concession period in certain circumstances, including for delay as a result of unforeseeable events or force majeure events (subject to maximum periods for extension, depending on the circumstances, before the private sector could terminate). Whilst this may seem acceptable where the private sector takes demand risk, the authority may want to consider restricting extensions to the construction period for PPPs based upon an availability model (so as to incentivise the Project SPV to complete the works). If extension of time provisions are addressed through commercial negotiations and captured in the PPP contract, a market position would be permitted to develop. Contractual drafting also tends to be more protective than case law and provides the parties with greater certainty as it provides a direct remedy for which court proceedings are not required. In Algeria and Tunisia there is no established standardised approach to the negotiation of extension of time and compensation event provisions and so it is recommended that express provisions are included in the PPP contracts to create greater certainty for all parties.

Relief due to unforeseen circumstances beyond the reasonable control of either party is provided for under the Draft PPP Law in Syria³⁶ and the Jordanian Civil Code. Article 205 of the Jordanian Civil Code makes provision for "relief events" in certain circumstances. The court is able to provide relief from contractual obligations. However, in practice the parties are free to agree contractual provisions on this issue which is preferable

³⁵ Law No. 2008-23 dated 1 April 2008

³⁶ Draft PPP Law dated 20 April 2010

as it creates more certainty. The Draft PPP Law in Syria allows for an extension of time for delays in project completion due to unforeseen circumstances beyond the reasonable control of either party. The Draft PPP Law limits the extension period of any delayed project to two years. This is presumably to account for circumstances which may cause indefinite disruption or delay; typical of Force Majeure. Of itself, two years would normally be reasonable for a construction period of three to five years. Whilst regulating the extension period through the Syrian Draft PPP Law ensures a uniform approach between authorities during the initial introduction of PPPs, it is unusual to legislate for a maximum period of extension and such matters are typically dealt with contractually, for example by having a construction longstop date relevant to the particular issues affecting a particular project.

Operational performance

Are there adequate contractual provisions to enforce performance standards during the operating phase?

Comparator countries

The contractual mechanism adopted by the comparator countries for enforcing performance standards during the operating phase is affected by whether demand risk is transferred to the private sector. Under mechanisms based on performance and availability (i.e. the public sector retains demand risk), performance is maintained and assessed on the basis of the Project SPV's compliance with output specifications, which specify the level of service required in respect of each element of the project's scope. A service payment is payable by the authority to the Project SPV on, for example, a monthly or quarterly basis and the public sector will usually enforce the standards specified in the PPP contract by making financial deductions from the contractor's payment for non-availability and poor performance. The PPP contracts aim to set a level of deductions which is relative to the seriousness of the fault and the time taken to remedy the issue. In this way, the contractor is encouraged to rectify faults quickly and efficiently. Generally, the Project SPV will be required to self monitor its performance, with the public sector having the general right to access the facility to audit performance and impose additional deductions for performance reporting failures. In Poland, for example, the PPP Act stipulates that the PPP contract must set down a detailed description of the consequences of inappropriate performance or non-performance of commitments, in particular contractual penalties or decreases in the remuneration of the private partner.

Deductions are generally the authority's sole remedy for poor operational performance, with the authority's ultimate sanction being termination of the PPP contract. Sponsors and lenders will require certainty as to the financial exposure for poor performance and so will be concerned if the authority would be able to request separate damages in addition to the stipulated contractual performance regime. For less serious faults, financial deductions may not be appropriate. Instead, the authority may impose a "performance points" system, whereby a fixed number of points will be allocated for each failure and a deduction will only be made once a certain level of aggregate points has been reached. This approach is favourable to lenders, who will want to ensure that the Project SPV's revenue stream is not disproportionately affected by minor faults.

Concession agreements will usually provide for the concessionaire to pay a fixed sum to the relevant authority for performance falling below the specified standards. Essentially, the authority will pre-estimate the "cost" of a particular event (in a road project, the road being unavailable for use for a period of time, for example) and demand that the contractor pay this money to the authority in compensation. This is also consistent with the principles adopted in civil law jurisdictions. The French Civil Code for example entitles parties to contract on a so-called "penalty clause", which has the aim of specifying a pre-estimated amount of damages to be paid on a contractual default. Such mechanisms act as an incentive on the contractor to perform its contractual obligations. In practice, the penalties will be passed down to the subcontractors who bear the relevant risks.

Mediterranean partner countries

It is generally recognised in each of the Mediterranean partner countries, as in the comparator countries, that it is important to clearly define performance requirements in the contract documents. The level of deductions tends to be proportionate to the severity and frequency of the breach. In addition, deductions may be subject to grace periods or rectification periods, to enable the Project SPV to mobilise and respond to failures effectively. This is good practice. If broader types of payment mechanisms were to be adopted in the Mediterranean partner countries, contracting authorities will need to develop alternative regimes for enforcing operational standards such as payment of damages by the Project SPV to the authority.

Change in law

How will changes in law be handled during the term of the contract – is there a mechanism for sharing change in law risk?

Comparator countries

Change in law risk is the risk that the laws effective at the time of entering into the PPP contract are changed by a governmental body during the PPP contract term and which affects operating costs. Whilst it may be possible for the private sector to price for the costs of changes in law which can be foreseen prior to contract signature, the private sector will be concerned that the effect of unforeseen changes in law (over which they have no control) may increase the project construction or operating cost, affecting profitability or the ability to service debt.

For some concession projects in the comparator countries it is possible to treat all changes in law as the private sector's risk. For example, in concessions where the costs of implementing changes in law can be passed on to the end users through price rises (such as toll roads), the private sector would be expected to bear the change in law risk. However, political difficulty can be caused by the involvement of the private sector in setting tariffs. Therefore, the private sector cannot and does not always set tariffs, and in these circumstances, will not be able to pass on the financial consequences of changes in law to the end users. In South African PPPs, for example, where tariffs may be set by the contracting authority or a third party, a risk sharing approach to change in law has resulted.

Where the main user or payer of the project is the authority, the comparator countries' approach recognises that there is a balance to be struck in the allocation of the risk. The private sector is not expected to absorb all of the costs of unforeseen changes in law which directly affect and specifically target the particular project or sector. Conversely, it is expected that project companies recognise that, in some instances of change in law, all organisations or businesses will be subject to the same changes in law and the private sector is usually best able to manage the effects of changes in law to minimise the costs to their business.

Comparator countries have developed a risk sharing approach to changes in law. In England for example, PPP contracts differentiate between (i) "General Changes in Law" that affect a wider group than the particular project or sector to which the project relates and (ii) "Specific" or "Discriminatory" Changes in Law" which specifically apply to the project or sector in question. The public sector retains all risk of Specific or Discriminatory Changes in Law (whilst receiving the full benefit of any cost savings which may arise) and the increased costs of general changes in law are shared between the parties on a progressive scale. For example, if we consider a project for the construction of a hospital in England, a change in law concerning specifications regarding surgical units equipment should be considered as a Specific Change in Law which the authority pays for, whereas a change in law concerning the number of elevators that should be provided in a public building should be considered as a General Change in Law. Risk is shared by the private sector agreeing to bear the full costs of such General Change in Law up to a certain threshold, and the authority taking increasingly more of the risk with increased expenditure required to comply with the change. In South Africa, there is also a general acceptance by authorities that unforeseeable changes in law that discriminate against the private party (either specifically or in respect of the relevant sector) should normally be at the authority's risk. Mediterranean partner countries

In Israel, Egypt, Morocco and Tunisia a similar risk sharing approach to the comparator countries in relation to change in law has been adopted. This may be a reflection of the maturity of the PPP markets in these countries. In Israel, the public sector has gone one step further in retaining discriminatory change in law risk by permitting termination of the PPP contract by the Project SPV if, within a permitted grace period, the authority does not insulate the Project SPV from the effects of a discriminatory change in law or compensate it and grant it any necessary extension of time for performance of the agreement.

In those Mediterranean partner countries which do not currently adopt a risk sharing approach to changes in law, developing such an approach could achieve better value for money. In Algeria, for example, a change in law during the term of the contract does not entitle the Project SPV to an automatic increase to its payments. Change in law is therefore currently viewed as essentially a private sector risk for which bidders should price. The risk premium allocated to change in law may decrease if the authority accepted that the private sector should be entitled to some compensation. Given the long term nature of PPP contracts, some sponsors and lenders may have some difficulty in accepting change of law risk without some risk sharing mechanism. A possible approach would be to include change in law as a limb of political force majeure. In

the case of Syria, although early in its PPP maturity, a risk sharing approach is indicated in the Draft PPP Law³⁷, such that a PPP contract can be revised at the request of the Project SPV in the case of any changes in the financial equilibrium deriving from major changes in mandatory laws which are detrimental to the Project SPV. This detrimental test is more beneficial to the private sector than the discriminatory/specific tests used in the comparator countries. Lebanon and the West Bank should adopt a risk sharing approach to change in law if their authorities enter into long term PPPs. In Jordan, change in law is a risk borne by the public sector. Whilst there may be specific cases where it would be too onerous for the private sector to accept full consequences of the change in law, Jordanian authorities should consider pursuing an approach where change in law risk is shared. Indeed, this could ease the burden on the authority in the event of a change in law with significant financial consequences.

Termination and compensation on termination

Are the termination rights clearly set out in the PPP contract?

Does each party have the right to terminate for the other's default in certain circumstances or for Force Majeure?

Does the PPP contract make clear provision for the consequences of termination, in particular compensation on termination?

Does the compensation adequately reflect the nature of the termination?

Comparator countries

As with other contractual provisions, termination rights (of both parties) are clearly defined in the PPP contract. This ensures that each party is aware of the circumstances that will give rise to termination, the process to termination (including notice provisions and remedy periods) and the consequences of termination. Even if termination is addressed in legislation (as is the case in the Polish PPP Act, which gives the public authority termination rights) the long term PPP contract should comprehensively define termination events.

Provision should be made in the PPP contract for all key modes of termination. As a minimum these should include:

- termination by the authority for a contractor default;
- termination by the contractor for authority default; and
- termination on the occurrence of a force majeure event.

PPP contracts in the comparator countries typically provide for termination in these circumstances.

Termination as a result of default of one of the parties should relate to specific significant or substantial breaches. It is good practice to define what these are (rather than simply referring to significant/substantial breaches). For example, an authority default typically comprises non-payment, and examples of contractor default are contractor insolvency, abandonment of the works and subcontracting without consent.

Parties may agree in the contract to further termination rights.

For example termination for convenience by the authority, break-point termination (at specified times during the contract term (or break points)), termination on a change in law (where

³⁷ Draft PPP Law dated 20 April 2010

the contractual obligations can no longer be performed) or termination where a risk which is usually insurable becomes uninsurable (i.e. where insurance is no longer available at all or not available on commercially acceptable terms).

Both the termination triggers and the consequences of termination should be clearly formulated in the contract.

Whilst the general law may permit the innocent party to claim damages through a court process, a more straightforward and certain approach of setting out the compensation in the contract, albeit by reference to a formula, is preferable and is standard practice in England, France and South Africa.

The measure of compensation reflects the nature of the termination event and the of risk allocation.

Thus, where the PPP contract is terminated due to an authority default or at the authority's convenience, the compensation payable to the Project SPV will comprise subcontractor and financing breakage costs, redundancy payments, loss of profits, outstanding debt service and equity returns. These elements exist in the English PFI (Private Finance Initiative) guidance and this level of compensation meets the objective that the Project SPV and its financiers are fully compensated and no worse off than if the contract had run its full course. If termination occurs due to a force majeure event (neither party's fault), financial consequences should be shared and so, the Project SPV will not normally be compensated for equity injected or returns on that equity.

Compensation on termination is offered, even where termination is for contractor default.

Whilst this may at first be seen as permitting the contractor to benefit from its own default the rational is to ensure in circumstances where one of the consequences of termination is that the project asset is handed back to the authority and the authority should not make a windfall gain (no unjust enrichment). A market value approach should be taken, so that the level of compensation is based on what a third party would pay for the contract. A market value approach does not necessarily guarantee that the lenders will be compensated in full and as such, it incentivises the lenders to step-in and rescue the project. An alternative approach in France, for example, would be for the Project SPV to be compensated in these circumstances for the level of investment made/works undertaken, subject to a cap in some cases, but not for loss of profit.

Authorities are only expected to pay a fair compensation sum.

Deductions in the calculation for compensation are made in respect of the following elements: insurance proceeds; revenue received; credit balances; costs and expenses to be incurred by the authority in rectifying defects and performing the operations.

Mediterranean partner countries

In the more developed PPP markets within the Mediterranean partner region, PPP contracts tend to clearly set out the trigger for termination and the rights of each party.

This is the case, based on practice to date, in Algeria, Egypt, Israel, Jordan, Morocco and Tunisia. In these countries, the PPP contract typically provides for termination in the following circumstances (i) authority default; (ii) contractor default; (iii) force majeure; and (iv) convenience (not typically provided for in Jordanian PPP contracts). The PPP contracts are relatively comprehensive in this regard and tend to incorporate express termination provisions which exist in law and which, for example, would be implied by the civil code.

Due to the limited experience of PPPs in Lebanon and Syria, it is unclear whether termination provisions will reflect best practice (as described above).

However, some confidence can be gained from the contracts agreed in Lebanon to date which cater for termination and in the case of Syria, the Draft PPP Law³⁸, which expressly states that contracts should include the ability to be terminated in defined circumstances (being: (i) by Sovereign decision (i.e. voluntary termination), (ii) an authority default, (iii) on contractor default and (iv) for force majeure). PPP contracts in the Mediterranean partner countries provide for compensation on termination, but there are varying approaches (as set out below). This is perhaps reflective of the limited experience of project financed structures involving international banks who are key players in more developed PPP markets.

Of the Mediterranean partner countries, Egypt, Jordan and Israel appear to have the most developed contract mechanisms for compensation on termination.

The PPP contracts agreed to date specify clear formulae for the calculation of compensation. Importantly, there is precedent for protecting senior debt and equity investment under certain circumstances. The favoured approach is for the level of compensation to vary according to the reason for termination. A contractor will therefore receive less compensation if the contract is terminated due to its own default. The availability of compensation for contractor default in these countries recognises the principle established in the comparator countries that the authority should not unaccountably benefit from the project.

In Algeria, Tunisia and Morocco, contractual provisions provide for compensation on termination, although specific acknowledgement of senior debt and equity compensation is not prevalent.

The normal approach to compensation would take account of the value of the works and loss of profit but the relevant contractual mechanism might not explicitly provide for senior debt and equity protection. To encourage lender confidence, this is a key area for development in the overall contract design.

Should a PPP programme be pursued in Lebanon, Syria and the West Bank, these countries should address compensation on termination as a key issue in the overall contract design.

This is important to new entrants in an infrastructure market who are embarking on long term contracts.

³⁸ Draft PPP Law dated 20 April 2010

Contractual allocation of project risks – recommendations/success factors**Design and construction**

- Transfer the design and construction risk to the private sector.
- The public sector should be encouraged to make payments on a "no service no fee" basis, i.e. where payments to the private sector begin only on satisfactory completion of construction or demonstration of achievement of the specified performance criteria.
- Clearly define the standard of work required in the PPP contract.
- Apply incentives (penalties/bonuses) for the private sector to perform.
- Make the construction contractor liable (either by contract or in law) for defects in the works for a defined period of time.

Planning and approvals

- The public sector would normally provide the land required for the project.
- Allocate planning risks to the private sector, but encourage the public sector to provide assistance.
- Allocate responsibility for obtaining all other approvals (for example, construction permits) to the private sector, but the public sector should provide reasonable assistance.

Change in Law

- This is best treated as a shared risk, whereby the general change in law risk is shared and change in law specific to the project is retained by the public sector.

Extensions of time and compensation

- In the PPP contract, provide for the payment of compensation to the private sector on the occurrence of certain events within the authority's control, so as to restore the economic balance of the contract.
- Clearly establish in the PPP contract the provisions for extensions of time and relief from obligations upon the occurrence of specific events that are beyond the control of either party.

Operational Performance

- Use payment mechanisms and performance/quality requirements to enforce standards during the operating phase.
- Specify the consequences of not meeting such requirements clearly in the PPP contract

Termination and Compensation on Termination

- Clearly set out termination rights in the PPP contract, including rights for each party to terminate for Force Majeure and for the other's default in certain circumstances.
- Make clear provision in the PPP contract for compensation payable by the authority on termination which adequately reflects the nature of the termination.

6. PAYMENT MECHANISM & FINANCIAL RISKS

The payment mechanism is the key mechanism for allocating economic risks between the authority or users and the Public Private Partnership (PPP) provider. It seeks to ensure that authorities pay only for services or output delivered and to ensure that providers do not have to make costly provisions in their pricing for risks which are beyond their control.

This section examines the PPP payment mechanism and in particular how the key macroeconomic financial risks of inflation and foreign exchange rates can be dealt with in the PPP contract design, by examining the following:

- How do authorities create the right incentives for the private sector to deliver a service or output at the least cost to the authority whilst ensuring the project is bankable?
- Are macroeconomic risks of inflation, exchange rate and interest rate allocated efficiently?

The payment mechanism

Comparator countries

Common principles regarding financial risk allocation in the payment mechanism for the PPP contract have been developed in PPP in the comparator countries and others where PPP programmes have been established for several years or more. These are set out in Box 15 below:

Box 15: Role of payment mechanisms in PPP

In PPP contracts, the payment mechanism is the principal tool for allocating economic risks between the authority and/or users and the Project Special Purpose Vehicle (Project SPV). In PPP, the public authority does not reimburse the Project SPV for the capital costs of the project when those costs are incurred. Instead, the Project SPV recovers the capital cost, together with financial returns and operating costs, over the operational life of the project from either regular payments from the authority, from user charges or a combination of both. The formulae for determining the payments and/or user charges and any payment adjustments are specified in the PPP contract payment mechanism. Also, the public authority typically has the right to withhold elements of the payment if the performance is sub-standard and not remediated in time (see operational performance section above).

In general, the aggregate PPP payments in a given project must comprise an “operating element” and a “financial element”.

These cover, respectively, (i) the operating costs and periodic expenditures such as life cycle maintenance, and (ii) the debt service and equity remuneration to the lenders and shareholders who funded the project’s capital costs. The split between the operating and financial elements may be explicit, for example by defining them expressly as financial and operating elements. Alternatively, the split may be implicit, with formulae in the payment or tariff mechanism reflecting the underlying split between operating and financial elements.

PPP payments may take several forms:

- If using availability payments or capacity payments, the public sector pays for the facility as long as it is available and operated in accordance with agreed performance standards, irrespective of whether it is actually using the output of that facility.
- In certain sectors, such as transport, toll or other user charges (whether paid by government or by the user or both) may be demand or volume related, if the project has required the Project SPV or concessionaire to forecast demand and take risk on the demand for the projects.

Government grants may be combined with the payment mechanism to cover some (but not all) of the capital cost. In a PPP, providing a capital grant may allow the required user charge to be kept to a level that is affordable for users. Alternatively, if the budgetary process allocates funds to authorities on a discrete capital and revenue basis, authorities may find it more efficient to use some of their capital allocation to provide a grant which reduces potential pressure on future revenue budgets from having to fund the annual PPP payment obligations. Finally, a capital grant is appropriate if the total project funding requirement is larger than the market appetite for funding projects of that nature, sector or country, (for example a number of light rail projects in the UK, the Gautrain project in South Africa). This practice has been adopted in road projects in Israel which have all included capital grants, with the aim of reducing the cost passed on to users through fares or tolls.

As an alternative to a capital grant, an annual operating subsidy can serve to reduce the cost passed onto the end user. Such payments can be performance linked like an availability payment. However, using operating subsidies rather than capital grants can increase overall project costs since the Project SPV has to fund the entire project cost.

Some projects have the potential to generate third party or ancillary revenues, the profits from which can be shared so as to reduce the annual cost of the project. These include, among others, letting of service stations on motorways, cafeteria and other ancillary services in hospitals or private residential or commercial units developed as part of the PPP development. However, experience in the largest PPP markets (such as the UK or France) indicates that few projects have the potential for a substantial cross-subsidy, and that often the sponsor selected to deliver the PPP does not necessarily have strong expertise in managing the third party income business. Exceptions arise where the project can release surplus land for redevelopment or if the project (for example, an airport) can include retail outlets. Nevertheless, if a project does have potential third party sources of income, it may be more advantageous for authorities to split the PPP from the third party opportunity, and procure them separately. This would enable the authority to use the revenue from the third party activity partly to fund its project payments.

Mediterranean partner countries

Mediterranean partner countries have adopted different PPP payment mechanisms depending on the country and sector involved. Due to relatively few PPPs having been procured to date, clear principles have not been set out for payment mechanism design, other than to follow the evolving precedent of any similar previous projects in that country, such as the desalination projects in Algeria. In the absence of available in-country precedent, countries have followed international practice. Countries with concession traditions such as Morocco, Jordan and Tunisia have generally procured projects in which the concessionaire earns regulated user-paid fees, in some cases sharing the fee revenues with the authority. On the other hand, availability payments have been the norm in a number of sectors across the Mediterranean partner countries, notably in water treatment and desalination projects in Algeria, Egypt and Israel. Power projects, such as the AES Amman East IPP in Jordan and the proposed Dairut IPP in Egypt, typically rely upon take-or-pay power purchase agreements with the tariff per unit of electricity output adjustable for any movement in underlying fuel costs.

When launching user fee based projects, the procuring authority needs to ensure that demand forecasts are robust and have been independently validated. Where investors bid for a toll charge or bid the amount of subsidy required (whether a capital or revenue subsidy), there is an inherent tension between project affordability and its bankability. This is because bidders are often selected on the basis of minimum subsidy, which requires the most aggressive traffic forecast. In turn, this would be the most difficult to obtain finance for, especially during the current credit conditions. Market studies have shown that in a majority of transport projects worldwide, actual demand fails to reach the level originally forecast. In some Mediterranean partner countries, like Syria and Jordan, which are contemplating road and light rail PPPs but which have a limited track record of comparator projects for forecasting demand, international funders will be cautious when assessing such projects. In these cases, it would be desirable to seek early feedback from the investor, market and lending community in order to design the most appropriate payment mechanism. Measures such as a minimum revenue guarantee (proposed for the Amman-Zarqa light rail project in Jordan), and a surplus profit sharing arrangement could be considered. Israel has applied minimum revenue guarantees in its road projects, as well as providing capital grants.

Increased sharing of information among Mediterranean partner countries would enable replicating payment mechanisms successfully applied elsewhere, thereby speeding up procurements. This could be in addition to learning from good practice in the international market generally. This would be particularly beneficial for instance in projects where technological measurement of performance tends to be complex but similar across countries, such as energy generation (including renewables), water and other social infrastructure projects. Greater regional knowledge sharing on how specific risks are dealt with in the payment mechanism would also attract bidding sponsors who could begin to apply resources to PPP on a whole region basis.

Macroeconomic risks

Comparator countries

Inflation risk in the comparator countries is dealt with by a combination of adjustments for general price indexation and specific cost benchmarking. PPP payments in comparator countries typically deal with operating cost inflation with one or both of (i) annual indexation of the operating element and (ii) periodic (for example every three or five years) benchmarking or market testing of the cost elements against similar services provided in the country. These mechanisms are necessary because the Project SPV is not in a position to absorb general price inflation, or real wage increases. Some concessions which rely on third party revenues provide for the operating element of unit tolls or tariffs to be increased in line with inflation and/or benchmarked cost changes. This has been the case for instance in toll roads and bridge projects in France and Mexico.

Capital markets in the comparator countries are sufficiently deep that the private sector can generally raise long term fixed rate funding in their domestic currency or hedge exchange rate risks. Other than in Poland and in some Mexican projects, the public sector in comparator countries does not usually assume exchange rate risk in the payment mechanism. In the UK, France and South Africa (other than the latter's large power projects), debt and equity markets have been able to provide sufficient funding for PPP projects. In Mexico, the bulk of recent funding of the toll road PPP programme has been in Mexican Peso (MXN). Earlier projects were typically funded in United States Dollars (USD), with payments by the public sector periodically adjusted for exchange rate movements. In the case of toll roads, Project SPVs have certain flexibility to adjust user charges but this can have an impact on demand and traffic volumes. Much of the funding for Polish PPP's is denominated in Euro (EUR) rather than in the Polish Zloty, which reflects the government's policy of adopting the Euro in the near future. As a result, Poland's position is similar to a number of the Mediterranean partner countries as regards the public sector having to bear exchange rate risk in its PPP programme.

Project affordability for the authority is adversely affected if the Project SPV has to bear risks which it cannot control or mitigate. In pricing risks such as inflation, private sector sponsors (and their lenders) are likely to assume a wider range of possible inflation scenarios than the government would and this results in increased costs for the public sector. As a result, the position taken in the comparator countries is that the public sector assumes inflation risk. Regarding the other financial risks, exchange rate and interest rate, most comparator countries have well developed financial markets in

which it is possible for the private sector to assume exchange rate risk at a reasonable cost and the depth of capital markets means that private sponsors are normally able to obtain long term fixed interest rates (or swap arrangements) on their lending. Box 15 above describes some common principles regarding financial risk allocation that have been developed in the comparator countries.

Mediterranean partner countries

Similarly to the comparator countries, inflation risk is normally assumed by the public sector in order to maximise project cost-efficiency. This risk can be covered through general indexation, benchmarking or market testing. In most Mediterranean partner countries, either price inflation has been relatively volatile (as in Egypt, Syria, and Jordan) or the published price indices are not always comprehensive or regulation and price controls (such as in Syria) are in place. In these cases, regular benchmarking or market testing would be desirable. In other cases (such as Israel and Morocco) inflation has been sufficiently low and stable to allow general indexation to apply to a substantial component of the project payments, other than in relation to specific cost elements such as specialist commodity or technical inputs. Israel has adopted highly specific indexation formulae that closely match the Project SPV's cost base, incorporating adjustments for general consumer price and sector cost indices and currency movements.

The allocation of exchange rate risks in payment mechanisms is largely determined by the depth of local capital markets.

The source of the Project SPV's funding determines the optimal allocation of these financial risks, as outlined in Box 16. Countries with local currency savings bases – Algeria, Israel, Egypt, Tunisia and Morocco – can to varying degrees obtain sufficient domestic funding for a significant portion of their PPP programmes, but for larger projects are likely to require funding from international lenders in foreign currency. In any event, even if a project is funded in domestic currency, payment mechanisms may need to include an adjustment to cover any exchange rate movements affecting the foreign currency component of construction costs, if these cannot be hedged over the full construction period. In Algeria's case, the government allocates fixed rate debt funding to the project on terms common to all bidders, which is disbursed as loans from State-owned banks, and projects therefore only require exchange rate adjustment in respect of the foreign currency element of construction costs. In Egypt, Morocco and Tunisia, there is availability of local currency funding for PPP, but not at fixed rates for the full loan period due to the absence of long term interest rate swap markets. Mediterranean partner countries with formal exchange rate pegs (such as Jordan, Lebanon and the West Bank (which does not issue its own currency)) and/or small private commercial banking sectors such as Syria, are likely to find foreign currency funding of PPPs to be more cost-efficient since the public sector is better placed to assume this risk. Requiring the private sector to assume exchange rate risk could result in the procuring authority being faced with higher payments to be made during the operational period.

Box 16: Managing exchange rate risks in PPP – general principles

To the extent that the project is funded with local currency denominated debt and equity, the authority need not bear any significant exchange rate risk. For example, if the project is funded with local currency denominated debt from local banks and local infrastructure fund equity, exchange rate risks in the project will be very limited, and project payments can be denominated in local currency without the need for significant foreign currency adjustments. Limited adjustments may be necessary for specific items, such as imported capital equipment but only for scheduled replacement, or if the construction period is longer than the tenors of the local currency forward exchange rate or currency swap markets.

To the extent that the project has foreign currency denominated debt and equity, the authority is likely to have to bear exchange rate risk in order to maximise cost-efficiency of the project. In such cases, project payments need to be adjusted for exchange rate variations, either by denominating foreign costs (including debt service) directly in foreign currency or through indexation of payments in local currency. There is no market in which the Project SPV can hedge local currency exchange rate risk for the duration of the project. Bidders and their funders will see this risk as outside their control, being a largely macroeconomic or policy determined variable, particularly when exchange rates are controlled as is the case in many of the Mediterranean partner countries. As a result, to keep the Project SPV net cashflow stable, the financial element of project payments would need to be adjusted to reflect changes in the underlying exchange rate. Where a government remains committed to the exchange rate peg, funding in foreign currency will be more cost-efficient since longer term fixed rate funding is more widely available in currencies such as the EUR or USD, than in local currency. If a country has a policy to peg or partially peg its currency, then it is better placed than the private sector to cover the risk (e.g. by currency indexation in the payment mechanism) since it is a risk controlled by the public sector.

Financial risks and payment terms – recommendations/success factors

- Design payment mechanisms in accordance with the principle that risks are allocated to the party best able to manage, control and mitigate them - typically, to ensure that the private sector takes the risks on its own performance and the authority takes macroeconomic risks unless these can be separately hedged or managed by the private sector.
- If specific elements of the Project SPV's cost base are exposed to domestic price, cost or wage inflation, allow the Project SPV to pass through cost changes to the authority via payment mechanism adjustments.
- Allow payment mechanism adjustments for exchange rate movements if the Project SPV has been funded in foreign currency, or (if funded in domestic currency) incurs capital costs in foreign currency and cannot hedge the exchange rate risk.

7. PPP / PROJECT FINANCE INVESTMENT READINESS FOR LENDERS AND INVESTORS

The success of a country's Public Private Partnership (PPP) programme depends on the quality of investors it is able to attract and the availability of finance. Development of a transparent investment regime coupled with the removal of barriers to investment (such as currency exchange controls or restrictions on repatriation of dividends) will assist in attracting potential foreign investors, which will in turn have the effect of increasing competition. A robust security package is essential for lenders (including creditworthy public sector covenants (or some form of guarantee or support of the public sector's obligations), the ability to pledge project receivables, charges/mortgages, direct agreements and step-in rights).

This section provides an analysis of the key issues that are likely to influence foreign investors in making their investment decisions, by addressing the following:

- What are the key incentives and restrictions to foreign investment?
- Are appropriate guarantees provided when necessary?
- Is a robust security package available?
- How do tax and accounting issues affect the affordability of PPPs?
- Are there any general business regulations or practices which might affect the smooth implementation of a PPP?

What are the key incentives and restrictions to foreign investment?

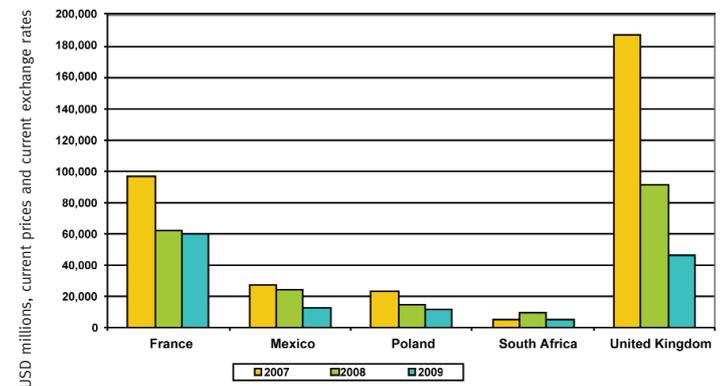
Comparator countries

All comparator countries have succeeded in attracting foreign investors to their PPP programme, although certain very specific restrictions to investment still exist in some countries. South Africa for instance still has certain controls prohibiting payments in foreign currency by local entities without the prior approval of the Exchange Control Department of the South African Reserve Bank in addition to controls regulating the receipt of foreign currency payments by local entities. These restrictions are gradually being lifted, although the global financial crisis may have recently slowed this process, as no significant progress has been made in 2010. In Mexico, the Foreign Investment Law³⁹ establishes that foreign ownership in sensitive sectors such as port services, oil, gas and electricity would be restricted to 49% (i.e. shareholding by foreign companies in the Project Special Purpose Vehicle (Project SPV) would be limited to 49%). However, in practice this restriction has not applied and no PPP activities in Mexico to date have been subject to any foreign investment restrictions.

Comparisons of foreign direct investment (FDI) volumes clearly show the benefit of improving the business climate and incentivising investments. Figure 3 shows the stock of foreign direct investment inflows for the comparator countries in 2007-2009. The United Kingdom (UK) and France have huge FDI inflows each year, reflecting the relative openness of their economies and general investment attractiveness of their markets and full integration into the European Union (EU).

The effects of the economic crisis in 2008 can be clearly seen by the decline in FDI in 2008 and 2009. Even though the FDI inflows to Mexico, Poland and South Africa are considerably lower than those to the UK or France, they each still receive considerable FDI each year.

Figure 3: Inward FDI in comparator countries



SOURCE: UNCTAD

Mediterranean partner countries

Foreign investment regulation in Egypt, Israel, Lebanon and Morocco is relatively light. There are no unique or uncommon restrictions affecting FDI that cannot be overcome in practice. In Egypt, there are no legal restrictions on the distribution of profits by joint stock companies to foreign shareholders and no consents are required or restrictions applicable on the remittance of profits outside Egypt. In Israel, current investment laws and policies facilitate PPP funding and the level of current regulatory control is conducive to the creation of healthy secondary markets in PPP projects. In Lebanon, there are no special provisions or constraints on foreign investment but restrictions do exist on the ownership of companies involved in certain sensitive sectors such as the media and land ownership. In Morocco, protection is afforded by the law to foreign investments and rights to repatriate capital and proceeds are well entrenched in both law and practice.

Recent reform of the Tunisian regulatory framework, focusing on easing the level of regulation and red tape applicable to foreign investors, has improved the country's attractiveness for investors. This has been achieved through a series of legislative enactments (such as the Code d'incitation aux investissements), which have established the principle of freedom of foreign investment in specific sectors such as communication, transport and tourism. These provisions guarantee foreign investors (whether resident or non-resident) the ability to invest in Tunisia without discrimination.

³⁹ Foreign Investment Law dated 27 December 1993

The regulation of foreign investment in Syria has improved in recent years, although further reforms of certain regulation could ensure increased attractiveness of foreign investors.

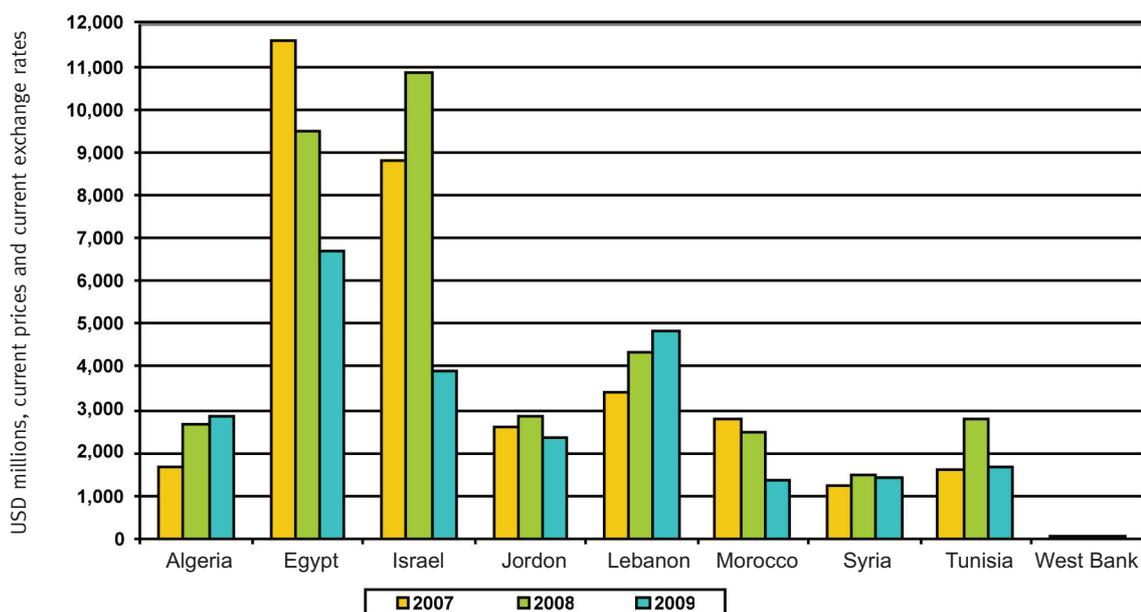
Syria maintains a currency control system, which could affect the ability of Project SPVs to repatriate certain project revenues outside Syria; money can be transferred abroad only if it was originally transferred from outside Syria to a Syrian bank account and kept in that bank in foreign currency. This could potentially cause an issue for PPPs in respect of the repatriation of payments received by the Project SPV under the project in Syria or repaying the interest of foreign loans. Further steps to improve investment appetite for PPPs are likely to be taken into account in the new PPP law, currently in draft form. It is likely that Project SPVs and financiers will be exempted from such foreign currency requirements.

In Jordan, the West Bank and Algeria, share ownership by foreign entities is restricted in certain sectors but exemptions may be granted. In Jordan, the Regulation for the Promotion of Non-Jordanian Investments no. 54 of 2000 (Investment Regulation) sets out the restrictions on foreign ownership of Jordanian companies for certain sectors and activities. In some sectors, such as construction and services related to operating subways, bridges and highways (among others), foreign ownership is restricted to 50% or 49%. Limited waivers of such

restrictions may be granted to foreign PPP investors in Jordan by the Council of Ministers, allowing them to hold a bigger share of equity than ordinarily permitted. In respect of projects in the West Bank, the Minister of National Economy can waive the restriction that a foreign entity may not own more than 49% of shares in a local company and up to 99% foreign ownership may be permitted. In Algeria, strict regulations on foreign ownership, borrowing and repatriation of earnings were introduced in 2009. Whilst it may in theory be possible for exemptions to be granted, there is no explicit guidance on when such exemptions might be permitted. Foreign investors have been active in Algerian PPPs in recent years, and in order to sustain this inflow of foreign investment, it would be beneficial if some guidance on whether and under which circumstances projects may benefit from exemptions from this legislation.

Comparisons of foreign direct investment (FDI) volumes in the Mediterranean partner region are shown in Figure 4 below. FDI has reduced in several of the Mediterranean partner countries due to the impact of the international financial crisis, which has curtailed investment in export-oriented sectors such as ports and tourism. Egypt and Israel experience the largest inflows of FDI in the region, reflecting their fairly liberalised investment regimes. Lebanon's growth reflects sustained recovery following the 2006 conflict and a booming construction and real estate sector.

Figure 4: Inward FDI in Mediterranean partner countries



Are appropriate guarantees provided when necessary?

Comparator countries

In the comparator countries, payment guarantees from the public sector (including sovereign guarantees) are available when necessary and depend on the specific circumstances of a project and the contracting authority's creditworthiness.

For PPP projects where the public sector pays availability payments and where bidders and lenders are concerned with the creditworthiness of the contracting authority, they may seek to obtain a payment guarantee from a third party, such as the sponsoring ministry. It should be noted that the guarantees being considered here are guarantees of the obligations of an authority under a payment mechanism, not direct sovereign guarantees of debt. State-backed guarantees are not permitted in Mexico for example, but PPPs are relatively established and public entities acting as contracting authorities are generally investment grade rated and there is a sustained track record of meeting payment obligations. The sponsoring ministry or government departments in South Africa and England have provided a form of guarantee of the contracting authority's payment and performance obligations in some exceptional cases, but it is not standard policy. For instance, it is recognised by the South African authorities that some form of support may need to be provided in respect of Eskom as the off-taker of the Independent Power Plant (IPP) projects, despite its investment grade rating, as a result of concerns raised by the rating agencies on Eskom's balance sheet ability to finance the huge infrastructure investment without a cost-reflective tariff. In England, the PPP obligation of NHS trusts (which are statutory corporations which manage public hospitals) are effectively guaranteed by the State.

Mediterranean partner countries

For some projects in the Mediterranean partner countries, the provision of sovereign guarantees in respect of the contracting authority's payment obligations will improve the projects' bankability. As is common practice amongst PPP investors, bidders and lenders will, as part of their diligence relating to the project, assess the overall creditworthiness of the procuring authority and their confidence in it. Where there are residual concerns with the ability of the authority to make payments, bidders and lenders will seek additional support. The extent to which sovereign guarantees or other State support are available (and the conditions of their availability) to assist with obtaining investment by foreign lenders in PPPs varies between the Mediterranean partner countries, depending largely on their credit rating or creditworthiness of the public entity.

The Israeli State does not tend to issue guarantees/securities in respect of the fulfilment by authorities of their obligations under the underlying contract. Whilst this may be acceptable to international investors in some cases, the provision of sovereign guarantees on a project specific basis could have a positive effect on financing terms and better value for money may be achieved.

In Egypt, a pragmatic approach to sovereign payment guarantees has been adopted. The availability of guarantees is largely determined on a project specific or sector specific basis

by such factors as prevailing market conditions and specific project features. This approach will be attractive to foreign sponsors and lenders, which may seek State-backed guarantees to help off-set some risks (e.g. those risks arising from poor user up-take of a facility under demand based payment mechanisms). Such guarantees can reduce capital costs of a project through improved lending terms.

In Morocco, the terms of such guarantees are negotiated on a commercial and project specific basis and come at a cost for the private sector lenders. There is some concern within the lending community regarding the cost of such securities (currently 3.5% of the loan amount). In order to evaluate whether such guarantees are beneficial to the public sector in net terms, it would be important to consider how the costs of the guarantees will be priced in by the bidders.

In Algeria sovereign guarantees are not generally provided and the attractiveness of payment guarantees has been overcome in practice by introducing a strong public sector company as off-taker. Relatively recently, procuring authorities have established State-owned entities in the sectors in which PPPs have been prevalent (water and renewable energy). The relative infancy of these entities has raised reasonable concerns amongst investors as to the creditworthiness of the procuring authority as off-taker. In one particular example, the water off-taker in the first desalination plant initially proposed was an entity established only five years previously and it was considered that the balance sheet was insufficiently robust to support the off-taker payments. This was overcome in practice by setting up a joint venture with SONATRACH. This satisfied funders but came at the cost of a prolonged negotiation process and significant revision of contractual documentation which was then applied to all subsequent desalination PPPs.

PPP investment by foreign sponsors and lenders in Jordan, Lebanon, Syria and Tunisia will be made more attractive if a clear policy on sovereign guarantees (to guarantee the procuring entity's payment obligations) were introduced. It is not usual for these governments to provide a guarantee to support the obligation of the procuring authorities to make payments. Given the early stage at which PPP currently is in Lebanon for example, the offer of such guarantees is likely to be essential to engender confidence in the private sector and mitigate some of the perceptions of country and payment related risks that are likely to influence investment decisions. In Jordan, the Draft PPP Law⁴⁰ leaves the option of providing sovereign guarantees open. The Draft PPP Law in Syria⁴¹ does not currently include any provision concerning State guarantee of payments due to the Project SPV.

The absence of sovereign guarantees in Tunisian projects is consistent with the fact that to date PPPs have principally taken the form of concessions, where the concessionaire takes demand risk and revenues are dependent on end-users (and not payments from the authority). The State does not generally offer any form of support such as minimum payment guarantees. However, in instances where there is concern about poor user uptake of a facility under a demand based scheme, the state could consider offering a guarantee as this would serve to off-set some demand risks and may have positive effects on affordability and value for money for the public sector.

⁴⁰ Draft PPP Law dated 1 June 2010

⁴¹ Draft PPP Law dated 20 April 2010

When considering whether or not to provide State guarantees, countries are also constrained by their current indebtedness. For countries with high debt/GDP levels (for example, Lebanon and Jordan), providing state guarantees for a number of large infrastructure projects may not be feasible in the near term as this would impose an unsustainable burden on their finances. In these cases, prioritisation and phasing of projects becomes crucial. In addition, a combination of availability payments and user fees in certain sectors (and if forecasting demonstrates that this is feasible) could also help reduce the public sector payment commitments.

Is a robust security package available?

Comparator countries

The legal frameworks of the comparator countries permit the standard securities usually required in international PPPs.

Lenders will expect a robust security package to protect their investments in the case of default by the borrower (the Project SPV). For PPP projects in the comparator countries, lenders require security over all the assets (including contractual rights) of the Project SPV (including assignment by way of security, charges over bank accounts and security over the shares in the Project SPV). The broad range of project finance securities available to lenders in the comparator countries include the following:

- Mortgages over any land and property held by the Project SPV;
- Fixed and floating charges over shares of the Project SPV and any plant and machinery, credit balances, book debts, intellectual property and other beneficial interests;
- Assignment of insurance policies by way of security;
- Assignment by way of security with respect to all receivables against the public authority, the subcontractors, the hedging counterparties, the insurance companies and the tax authorities and all rights in respect of any agreement to which the Project SPV is a party. In France, the Cession Dailly arrangement is a feature of lender protection, as it creates a direct relationship between the lenders and the authority, whereby lenders may request direct payments from the authority;
- Arrangements relating to the proceeds account to channel the proceeds generated by the project through a blocked account usually kept with the leading bank; these usually provide for a payment order in accordance with a cash cascade (or waterfall) clause;
- Project support agreements: completion guarantee and/or cost-overrun guarantee from the project sponsors;
- Subordination of sponsor's capital and loans to the lender's facilities;
- Interest hedge/currency hedge arrangements;
- Collateral warranties such as direct duty of care agreements from subcontractors; and
- Direct agreements, which provide step-in rights for the lenders to step-in to the project in circumstances where the Project SPV has defaulted and is in danger of its contract being terminated (for example, by replacing the constructor or operator if they are not performing during a specified period of time or by transferring the contract to a suitable substitute). Direct agreements also usually provide for the subordination of the authority's rights to those of the lenders.

Mediterranean partner countries

Israel adopts sophisticated lender security structures compliant with international practice. This includes all forms of security considered as best practice above in the comparator countries. The recognition of such security under Israeli law for the purposes of enforcement represents a crucial attraction for investors in PPP projects in Israel.

Robust security packages, generally compatible with international market practice for project financed PPPs, are also available in Egypt, Algeria, Jordan, Morocco and Tunisia, but with some exceptions that are overcome in practice. For

example, even though Egyptian law does not recognise assignment by way of security, an assignment agreement is concluded simultaneously with the facility agreement and its exercise is subject to declaration of an event of default. In Morocco, the level of protection available to funders is a matter of negotiation and generally a robust security package can be expected, including securities over assets, shares and bank accounts of the Project SPV and also direct agreements in favour of lenders. Moroccan law restricts the ability of the private sector to obtain mortgages over public sector assets in certain circumstances. While this is overcome in practice for public enterprises, who can benefit from an exception to this rule under the Concessions Law, (provided the assets revert to the public authority on the repayment of the loan)⁴², it does not apply to private sector owned SPVs. In Jordan both the lenders and the authority can be protected through a robust security package, although Jordanian law does not recognise a floating charge on assets. All secured assets therefore need to be specified with sufficient certainty and security documentation will need to be updated regularly to capture any additional assets acquired from time to time by the Project SPV. The terms of the security instruments in Tunisian concessions are in line with the international market.

Standard security instruments are available to lenders to Algerian PPPs, which are publicly owned banks. The case of Algeria is atypical in the sense that lenders to PPPs have been public sector banks. It is unclear whether lenders would be granted step-in rights, although the connection between public sector lenders and the off-taker (i.e. the public sector entity purchasing the service and/or output) may somewhat mitigate this risk.

Typical project lending securities are new concepts in Lebanon and Syria given the initial stage of their PPP programme.

Lebanon and Syria are both currently developing their PPP policies and programmes (including PPP Laws) and it is expected that standard security will be available. Until recently, both countries have generally practiced traditional, construction-based procurement. PPP project specific securities such as lender step-in and charges over all project assets will therefore need to be developed. In Syria, whilst it is common for agreements with Syrian public authorities to include the right of step-in by the authority, it is not usual for lenders to be granted rights of step-in. It may be an opportunity for appropriate precedent in respect of lender step-in rights to be set out in early project agreements procured under the new PPP law (when enacted).

⁴² Law 54-05 enacted by Dahir No. 1-06-15 of 14 February 2006 (Article 8)

How do tax and accounting issues affect the affordability of PPPs?

Comparator countries

PPP is generally “tax-neutral”, and has not required any specific tax incentives in the comparator countries. For instance in the UK, where the procurement decision rests with a “spending department” of government, that authority evaluates bids on a pre-tax basis. This is useful because in PPPs bidders price their offers so as to achieve a certain after-tax rate of return on equity. Whilst they endeavour to make the financial structure as tax-efficient as possible, in essence they include whatever taxes are payable in the project financial model, and price these into their bid. Correspondingly, in order to establish the net cost to the public sector, tax payments have to be netted out of the analysis.

Mediterranean partner countries

Likewise, Mediterranean partner countries have not introduced specific tax or accounting incentives or treatment for PPPs, so Project SPVs will follow national rules. Corporation tax rates range from 30% down to 15% – a typical range internationally – and most countries levy withholding taxes (commonly at 10%, subject to tax treaties) on interest or dividends paid to foreign entities.

Offering tax incentives for PPP investment needs to be carefully studied, since bidders include the forecast tax liabilities (however high or low) when pricing their bids. As a result, the net cost to the government or to end users (gross project payments less tax receipts from the Project SPV) will be broadly the same irrespective of tax rate or incentives offered. However, foreign currency earning and internationally competing projects, such as ports or airports, may merit specific investment incentives or tax treatment.

Consistency of tax treatment is more important for investors in PPP than absolute levels of taxation or incentives. When calculating the project payments to be paid over the entire project period, sponsors have to assume that domestic tax treatment will remain substantially unchanged during the project life, and to achieve this they will seek a degree of protection from adverse changes in tax rules through the change in law provisions in the project agreement.

Striking the right balance in tax and accounting regulation can enable authorities to maximise project cost-efficiency. When evaluating bids, in addition to the gross project

payments proposed by the bidder, the procuring authority should also consider the tax forecast to be paid (including withholding taxes) by the Project SPV over the project life. There are a number of possible tax treatments depending on the capital structure of the bidder, and so it is possible that the bid with the lowest proposed project payments is not necessarily the bid with the lowest cost after tax payments are taken into account.

A number of tax rules in some Mediterranean partner countries could potentially distort project procurement decisions, or could lead to inefficient capital structures for projects. Use of contract debtor accounting helps to reduce the cost of capital for Project SPVs, as described below. Thin capitalisation restrictions (in Egypt, Morocco, and Tunisia), intended to prevent parent companies from overloading subsidiaries with excessive inter-company debt to minimise tax liability, may restrict the amount of project debt that Project SPVs can cost-effectively raise. Since Project SPVs can generally sustain higher levels of debt than general corporate entities due to their long term contracted revenue stream, the effect of thin capitalisation restrictions can be that a higher proportion of project cost is funded by more expensive equity than is necessary, increasing the cost to the procuring authority. Also, procurement decisions may be affected if one bidder can obtain domestic debt finance which does not attract withholding tax, whilst other bidders with foreign debt funding have to assume withholding tax on interest. In such cases (ignoring any separate policy preferences for domestic funding) the authority may wish to consider netting out the withholding tax component from the project payments bid to ensure comparability of bids.

For availability-based projects, the adoption of “finance debtor” accounting⁴³ will make projects more affordable, by enabling accounting profit to match project cashflows after debt service much more closely. Finance debtor accounting for subsidiary entities such as Project SPVs is permissible under the accounting standards of all Mediterranean partnership countries except Algeria, Morocco, and Tunisia. However, finance debtor treatment for tax purposes is permitted only in Israel, Jordan, Syria, and (whilst not formally applied to date) in the West Bank. Use of finance debtor accounting is recommended by international accounting standards as it avoids many of the inefficiencies caused by fixed asset accounting in PPP projects. Without it, bidders are forced to delay dividends and pay higher taxes⁴⁴, which would encourage them to fund projects with more equity and less debt (to avoid holding distributable cash in the Project SPV for an extensive period), making their bids more expensive.

⁴³ Finance or contract debtor accounting treats the PPP concession as being an investment not in a fixed asset to be depreciated, but as a debt entitlement arising from the concession rights. The capital cost is amortised in a profile equating to the principal component of an annuity, i.e. amounts rising over time. The effect is that net revenues less amortisation and interest is much more evenly spread over the project life, and much more closely matches actual cashflows, so that the problem of accounting losses (which restricts dividend payments) does not arise. For PPP contracts where the main benefits of asset usage accrue to the public sector, finance debtor accounting is recommended by IFRIC 12 – *Service Concession Arrangements* (International Financial Reporting Interpretation Committee note no. 12, issued by the International Accounting Standards Board) and has been practiced in the UK under Financial Reporting Standard No. 5 – Application Note F: *Reporting the Substance of Transactions – PFI and Similar Contracts*, September 1998. It is also permitted in Poland and South Africa, but not in French PPPs where French accounting standards are applied to Project SPVs, and international accounting standards are applied to group consolidated accounts.

Finance or contract debtor treatment compares to the more common fixed asset treatment, where the asset is depreciated, often on a straight line basis. The combination of straight line depreciation and high interest charges in the early years of the project can give rise to accounting losses, even though the project is generating cash surpluses before finance costs.

⁴⁴ Higher aggregate income tax over the project life arises if the tax losses caused by fixed asset accounting cannot be carried forward indefinitely to be utilised to offset taxable income in later years of the project. The majority of Mediterranean partner countries have time limitations (typically 3-5 years) on the carrying forward of tax losses, which can cause carried forward tax losses to expire before they can be utilised.

Concluding remarks on the general business regulations or practices which might affect PPPs

PPPs function most efficiently when the project parties can carry out their project responsibilities without excessive regulatory restrictions. Whilst PPP laws and contracts govern how a project is to be carried out, no project can be operated in isolation from general business regulations and practice. All PPPs must adhere to local laws and regulations on matters such as employment, health and safety, tax compliance, environment, consumer protection, data protection, corporate registrations and filings. However, if such regulations are considered excessive by potential bidders and investors (especially foreign parties), they may be deterred from investing in one country in favour of a country in which it is easier to do business. Moreover, even when bidders are familiar with a country's business environment, the cost of the project will be affected by having to factor in higher administrative costs for complying with heavy regulations.

Most fundamentally, the key to success of PPPs is partnership.

A well designed, comprehensive project scope, transparent and competitive procurement and bid evaluation, and balanced contract risk allocation, are all crucial for successfully financing and signing PPPs. Thereafter, the ultimate success of the project is determined by the parties, both public and private sector (including lenders), recognising that they have a shared interest in the success of the project.

PPP/project finance investment readiness for lenders and investors – recommendations/success factors

- Minimise restrictions on investment and create incentives for foreign investment in order to increase competition.
- Sovereign guarantees should be considered in specific circumstances where there are concerns as to the creditworthiness of the procuring authority or off-taker.
- Ensure that a robust security package which meets the requirements of lenders can be created in PPP contracts. Include security over the assets of the Project SPV (including its revenue flows) and lender step-in rights as available security options.
- Throughout the life of the PPP contract, an open dialogue between the authority and private sector provider, recognising their shared interests, is key to a successful project.

..... END

APPENDIX 1

PPP PROJECT RISK ANALYSIS

Risk	Typical Solutions or Mitigants	Lender (including IFIs and ECAs) preferred position	Sponsor preferred position	Authority preferred position	Typical risk allocation
Equity Sponsor - management / technical quality Insufficient level of expertise and experience in managing similar projects, and resourcing for this project	Evidence of expertise and experience is a core pre-qualification criterion. Strong subcontractors or specific project resourcing can partly offset a weak sponsor	Key requirement, usually determined by sponsor having an established client relationship with the bank		Key requirement, established with prior knowledge of sponsor reputation and information gained in the procurement process	Satisfactory sponsor selected
Equity Sponsor - capital strength for unforeseen requirements Available resources to inject to avoid loss of equity if sponsor chooses not to “walk away” (Non-recourse nature of project finance means contingent equity is not usually committed)	General, but not legally contracted, comfort from size and reputation of sponsor, and strategic importance of project to the sponsor (for example if sponsor cannot have reputational damage of a failed project)	Project considered as strategically important so that sponsor would be reluctant to “walk away”	No formal commitment to inject equity in excess of amounts committed at financial close (otherwise it is a corporate financing rather than project financing)	Reputable sponsor with strong track record, including possible evidence of having successfully turned around projects which experienced problems	A qualitative risk, shared amongst project parties
Construction - delay risk and/or cost over-run Project not completed on time and/or budget	Separate construction Project SPV or Engineering Procurement and Construction (EPC) subcontractor (who may also be an equity sponsor) contracts on a fixed price, date certain basis with liquidated damages for delay Terminate and replace contractor if delay exceeds longstop	Fixed price contract makes capital costs certain, and liquidated damages to cover finance costs of delay	Same as lender	Cost certainty since payments to Project SPV do not start until construction complete: strong incentive to complete on time	Construction or EPC subcontractor bears risk Liquidated damages not payable to authority unless a clear economic loss from late delivery
Construction - contractor default risk Construction or EPC contractor becomes insolvent and cannot continue project	Prior assessment of contractor strength is a core pre-qualification criterion Performance bonding Payment retentions Step-in: ability to replace contractor and continue project	Ability to step-in and replace contractor without a project termination is core security for banks. Satisfactory levels of performance bonds and retentions to cover cost of disruption	Same as lender	The strong financial incentives on the Project SPV, its sponsors and lenders to save the project following contractor default generally makes giving step-in rights less costly for the authority than terminating and taking back the project	Project SPV risk, mitigated by ability to step-in and replace the defaulting contractor
Project permits and consents (planning, environmental, and other regulatory requirements) Project does not obtain permits to carry out project	Obtain permits in advance of financial close or start of construction Ensure construction and operations comply with conditions of permits	Pre-condition of committing funds. Once obtained, Project SPV obliged to comply with conditions as a loan covenant	Pre-condition of committing funds. Project SPV or sponsor is responsible for submitting applications in correct format, and cannot progress until approvals obtained	The authority or other public bodies should not obstruct or frustrate the permitting process	All parties have common interest in obtaining full consent
Technical risk - design and technology selection Project design or technology specification does not conform to legal standards or does not meet required specifications	Design is agreed in sufficient detail prior to contract award and financial close Technical due diligence for banks confirms if design is appropriate Design accepted by construction or EPC contractor	Due diligence to confirm if design is appropriate Risk passed to construction or EPC contractor	Due diligence to confirm if design is appropriate Risk passed to construction or EPC contractor	Design is fixed at financial or close: avoids risk of “gold plating” by officials, i.e. costly further amendments to design without a formal variations approval process	Construction or EPC subcontractor bears risk Important discipline for public sector: design control, cost and risk transferred

Risk	Typical Solutions or Mitigants	Lender (including IFIs and ECAs) preferred position	Sponsor preferred position	Authority preferred position	Typical risk allocation
Technical risk - defects or commissioning risk Constructed project does not meet standards on completion	Turnkey contract – non-acceptance or handover Performance damages payable to Project SPV Contractor liability, up to a cap Terminate and replace contractor to rectify	Due diligence to confirm if achievable Risk passed to construction or EPC contractor	Risk passed to construction or EPC contractor	Risk passed to Project SPV since payments do not start until completion	Construction or EPC subcontractor bears risk Liquidated damages not payable to authority unless a clear economic loss from late delivery
Technical risk - operational performance Project does not perform technically to specifications required	Once commissioned, an operator risk with claim on construction or EPC contractor for defects Project SPV's lost revenues (including authority payment deductions) are deducted from its payments to the operating subcontractor, up to a cap Terminate and replace operator if cap exceeded	Due diligence to confirm if realistic Risk passed to operator	Risk passed to operator	Risk passed to Project SPV since project payment mechanism includes deductions to reflect reduced output, availability, or performance	Operator risk
Operations - performance standards not achieved Project is not operated to standards required	Operator risk without claim on construction or EPC contractor – same mitigant as “Technical risk – operational performance”	Same as “Technical risk – operational performance”	Same as “Technical risk – operational performance”	Same as “Technical risk – operational performance”	Same as “Technical risk – operational performance”
Operations - cost over-run risk Operating costs exceed budget	Operating subcontractor's fee is fixed, subject to indexation and bench-marking or market-testing of some or all cost components	Due diligence to confirm if cost assumptions are reasonable Risk passed to operator	Risk passed to operator	Risk passed to operator; authority's costs are known in advance (from operation of payment mechanism) unless the scope of services is changed	Operator bears risk Important discipline for public sector: to achieve cost certainty, the scope of services should remain unchanged from that agreed at outset (change is subject to a formal variation process)
Operations – supply of inputs for example fuel source	Project SPV enters into a long term fuel supply agreement sufficient to achieve full output Fuel price is either fixed or the project payment mechanism (see “Revenues – price risk” below) has adjustments which match movements in fuel price Financial reserves or contingencies established for any residual risk	Fuel supplier to be reliable and creditworthy Matching fuel supply price basis to project revenue payment mechanism is crucial Highly conservative assumptions for any residual fuel price risk	Risk passed to fuel supplier	Project payments are likely to be lower if the fuel supply price basis matches the project revenue payment mechanism, than if financial reserves or contingencies are priced into the contract	Fuel supplier bears risk, and fuel price basis matches the project revenue payment mechanism (i.e. project payments adjust on a 1-for-1 basis with fuel costs)
Operations - contractor default risk Operations and maintenance contractor or service contractor becomes insolvent and cannot continue project	Prior assessment of contractor strength is a core pre-qualification criterion Step-in: ability to replace contractor and continue project	Same as for “Construction - contractor default risk”	Same as for “Construction - contractor default risk”	Same as for “Construction - contractor default risk”	Same as for “Construction - contractor default risk”
Revenues - demand risk End-user demand for project output is lower than base case original forecast	Sector specific: in many sectors the Project SPV cannot control or reliably predict end-user demand. In such cases, the PPP project payment mechanism is designed to eliminate demand risk: the authority accepts the great majority of the project's full capacity output	Generally only acceptable if end-user demand can be reliably predicted and cannot be influenced by public sector action without compensating adjustment to project payments. If accepted (for example toll roads), loan amount and cover ratios assume conservative volume of demand	Same as lender, but inclined to be more optimistic than banks when forecasting	Authority should be aware of over-optimistic bidding, where a bidder achieves lowest toll or tariff by assuming unrealistically high demand. If not achieved, project can rapidly become insolvent through inadequate revenues	Demand risk is one of the most significant risks a Project SPV can face, and increases its cost of capital significantly. If authority is in better position to assume demand risk, the reduced project payments will compensate for retaining this risk

Risk	Typical Solutions or Mitigants	Lender (including IFIs and ECAs) preferred position	Sponsor preferred position	Authority preferred position	Typical risk allocation
Revenues - output risk Project output is lower than base case original forecast for reasons other than underperformance or demand: for example due to damage or insufficient resources (for example in renewable energy projects)	For resources: detailed prior analysis of available resource, and financial protections such as reserve accounts Project SPV risk, Damage: comprehensive insurance package	Due diligence to confirm adequacy of insurances Base case forecasts to assume conservative wind or solar resource	Same as lender	Authority does not have to pay, or can make deductions, for supply or services which are not delivered	Project risks to be managed by Project SPV
Revenues - price or tariff risk Unit price or tariff is lower than base case original forecast	PPP project payment mechanism typically sets the price to cover project operating, capital, and financing costs. The mechanism typically includes indexation, cost benchmarking, and interest rate or exchange rate adjustments if the Project SPV cannot separately contractually fix or hedge these variables	Since the project cashflow is the sole source of loan repayment, the lenders require the cashflow to be as certain as possible. This is achieved by the Project SPV largely fixing its revenues and costs through the project contracts, so that cashflows are predictable as long as the project parties continue to perform and not default	Same as lenders	Authority seeks to transfer to the Project SPV those risks which it believes can be controlled or mitigated by the Project SPV and/ or its subcontractors	An equitable payment mechanism, in which the Project SPV assumes only those risks which it can manage, generally achieves the optimal and most affordable outcome for the authority. The Project SPV obtains the lowest cost of capital for the particular project, and the authority transfers the majority of project risk
Revenues - authority/off-taker payment default risk The authority or off-taker cannot pay contracted unitary charge or tariff	Lender and sponsor assessment of authority and sovereign credit risk State guarantee of contract obligations (whether in law or in the project contract)	Lender and investor confidence in the ability of State entities to meet their liabilities is essential for funding to be available	Same as lenders	A State guarantee of the contract obligations can be justifiably made if the project appraisal, procurement and approval procedures determine that the project is viable and affordable, and that a budget allocation can be made	State guarantee of the contract obligations (whether in law or in the project contract) generally provided for significant projects
Financial - interest rate exposure The Project SPV's interest costs exceed base case original forecast	Fixed rate funding or interest rate hedging if available Payment mechanism adjustment if Project SPV is funded in currency with limited long term interest rate swap or bond market	Either of the two mitigants (hedging or payment mechanism to be used) can be used	Same as lender	Separate hedging by the Project SPV is the preferred position, but payment mechanism adjustment may be necessary as a trade-off, for example to utilise local currency funding	Separate hedging by the Project SPV is applied, if available in the market
Financial - exchange rate exposure Exchange rate movements cause project costs in currency of financing to be higher than base case original forecast	Payment mechanism adjustment is required if Project SPV is funded in currency different from the currency of the project payments	Payment mechanism adjustment is required	Same as lender	If project is funded in foreign currency, the currency risk is largely unavoidable for the authority – otherwise no project	Can be authority risk if project is not funded in domestic currency, particularly if currency peg applies
Financial - liquidity Project runs out of cash due to short term problem whilst otherwise solvent	Project SPV's finance plan includes creation of cash reserve accounts, for example a debt service reserve account	To be included in project financial plan	Sponsors generally accept lenders' requirements	A Project SPV matter, though in procurement authorities should ensure the financial plan is robust	Project SPV risk
Financial - tax Project SPV's tax bill (as a proportion of profit and cashflow) higher than forecast	Depending on stability and suitability of tax regime, either acceptance of tax law as at start of project, or pre-agreed specific project treatment Payment mechanism adjustments to preserve post-tax returns on investment if change in tax law or treatment	Some exposure to general corporate tax rate changes may be acceptable, but all specific changes to taxes on project or sector must be fully adjusted for in the payment mechanism or other contract adjustment	Same as lenders. Necessary because, unlike general commercial entities, the Project SPV cannot arbitrarily raise its prices to cover increased costs	Not agreeing this would send an adverse signal as to creditworthiness and authority payment risk	As per Lender position
Insurance Project insurances not adequate to cover risks outside control of Project SPV	Comprehensive scope of insurances to be agreed between parties at start of project	Key requirement	Key requirement	Key requirement	Comprehensive insurance package obtained

Risk	Typical Solutions or Mitigants	Lender (including IFIs and ECAs) preferred position	Sponsor preferred position	Authority preferred position	Typical risk allocation
<p>Political and Legal Includes expropriation, non-convertibility or non repatriation, change in law, enforceability, civil strife, war</p>	<p>Prior assessment by lenders, International Financial Institutions (IFIs) and Export Credit Agencies (ECAs) and sponsors of their country and sovereign risk appetite</p> <p>In certain cases, political risk insurance may be available to cover certain risks for example sovereign default, expropriation, or non-convertibility</p>	<p>Lender credit appetite for country is a pre-requisite. Political risk insurance, if available, may assist in certain cases</p>	<p>Similar to lender position although sponsors with previous dealings with government may have greater confidence</p>		<p>Project contracts specify expropriation and non-convertibility as an event of default. Change in law to be dealt with through contract adjustment, and war and civil strife typically as force majeure (although in some countries government may have to retain this risk)</p>

By bringing together public and private resources, Public-Private Partnerships (PPPs) can improve the supply, provision and maintenance of infrastructure facilities and services. The potential of PPPs to address the social and economic challenges facing Mediterranean Partner Countries requires certain preconditions to be met. The purpose of this study is to assess the legal and financial frameworks that are necessary for a country to successfully select, prepare and deliver PPP projects in the region.

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