



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

Volume 2 – Country Analysis

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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<sup>1</sup> 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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## ACKNOWLEDGEMENTS

In preparing the Report, the Consortium has been assisted by Paloma Perez de Vega, Francesco Totaro and Nicholas Jennett from the European Investment Bank, Willis Limited (in relation to insurance matters) and the following in-country experts:

Mediterranean partner countries:

### Algeria

- Ghellal & Mekerba Law Firm
- Mazars Hadj Ali

### Egypt

- Sharkawy & Sarhan Law Firm
- Mazars Mostafa Shawki

### Israel

- Glusman Shem-Tov Chowers Broid & Co – Law Offices
- MBT Consultants

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- J.C. Law Firm
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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

The Consortium is grateful for the support that has been given.

## GLOSSARY

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

## 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.<sup>2</sup>

**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 and South Africa).

### STRUCTURE OF THE REPORT

The Report comprises three Volumes:

#### **Volume 1: A Regional Approach**

Volume 1 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 (the present Volume)**

This Volume 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 this Volume 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.

<sup>2</sup> Further information about the FEMIP Trust Fund is available at [www.eib.org/ftf](http://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.

## 1. ALGERIA

### Overview

**Algeria's infrastructure sector is heavily reliant on public sector investment, which has discouraged the development of PPP initiatives.** Government agencies and state-owned corporations have sufficient funding to procure projects directly, without the need for private sector financing. Significant amounts of public investment originate in the country's significant mineral reserves, which account for a substantial percentage of the country's GDP. For instance, hydrocarbon resources (especially natural gas), represented 43% of GDP during the period 2005-2008. They have also accounted for 98% of the country's total exports during the period 2004-2010. Algeria is also the world's fourth largest producer of liquefied natural gas (LNG), supplying approximately 10% of the EU natural gas consumption.

**Regulatory restrictions imposed on private sector investments have also discouraged the development of PPP in the country.** PPP procurement and financing cannot be easily pursued in Algeria due to strict regulations introduced in 2009 on foreign ownership, foreign borrowing, and repatriation of earnings. The Complementary Financial Law of 2009 (particularly through the Ordinance no. 09-01 of 22 July 2009) introduced a number of restrictions to foreign investment, including elimination of free transfer of imports, mandating that Algerian partners must hold a majority stake (at least 51%) in any foreign investment and allowing the State the right to buy back the assets of private companies. Private investment restrictions have had a discouraging effect on the appetite of international companies to invest in Algeria thereby reducing the chances of furthering a PPP programme involving foreign investors.<sup>3</sup>

**An exception to fully public-funded infrastructure is the case of desalination plants and independent power projects, where Algeria has developed successful PPP initiatives.** The procurement and financing expertise gained from these PPP programmes is helpful in at least some sectors, should Algeria decide to further a comprehensive PPP programme in the future. The PPPs developed in the water and energy sector were successful in attracting a considerable number of international investors. Financing of these projects was provided by the public state owned banks. The Government's stated objective in developing PPPs in these sectors went beyond financial considerations and also considered benefits of transfer of technology and know-how by foreign enterprises.

**Algeria is planning to implement a major and sustained investment programme in the medium term.** The country's capacity to finance this very large infrastructure programme depends on a sustained recovery in oil and gas export earnings. Further clarity on how such a large investment programme will be carried forward and financed, the phasing of the proposed investments and how the new USD 286 billion plan interfaces with the National Territorial Development Planning Scheme would be beneficial in order to increase the investment programme's credibility.

**In order to meet some of the country's future investment needs, Algeria may find it beneficial to maintain a selective PPP programme that allows international sponsors and investors to**

**participate effectively.** Such an initiative would help preserve diversity in potential funding sources for future infrastructure development in the chosen sectors. Developing and maintaining a consistent track record in infrastructure financing could be a prudent measure that Algeria could rely on if it were to seek foreign funding for its infrastructure procurement commitments (especially during any sustained period of adverse oil and gas market conditions).

### Funding capacity and availability

**Large foreign currency reserves and minimal debt levels allow Algeria to maintain substantial investment in infrastructure, either through PPP or other means, although at the cost of sustained capital inflows from the state or state owned entities.** The main state-owned banks have approximately a 93% share of the domestic lending market. Since, under the present law, any borrowing for domestic expenditure or investment insofar as public entities are involved must be raised from local banks, PPP or other infrastructure project borrowing will continue to be provided exclusively by the five main state-owned banks. In effect, to date public banks have provided all long term PPP debt at preferential fixed interest rates equivalent to the Banque d'Algérie (Central Bank's) discount rate. The ability of these banks to fund even a small portion of Algeria's future infrastructure investment programme (whether or not procured by PPP) will require continued large net deposit flows from state-owned entities and/or the government directly.

**Public banks have provided PPP projects with preferential long-term debt with fixed interest rates, thereby the public sector has assumed the financing risk of projects.** Since the availability of preferential fixed rate funding has a major effect on the project economics, invitations to tender for PPP projects specify that such funding will be made available to the winning bid. This approach enables bidders to submit their bids on equal funding terms, so that debt terms and availability will not be competitive items between bidders. In addition, as the debt is provided by the public banks and is an element of the bid, the private sector is compensated for any changes in the financing conditions during the life of the project.

### Legal and regulatory framework

**Improved approaches to publishing case law would benefit domestic and international investors.** In Algeria, case law, or the application of law to contractual matters, is not widely published. Moreover, circulars issued at all levels of the government and which either give interpretation of laws (interpretative circulars) or issue new regulations (regulatory circulars), lack consistency in the manner of their official publication.

**A general legal framework on concessions and PPP procurement would bring certainty and predictability to potential investors.** The country's general public procurement law and the Civil Code currently take the place of a PPP law in Algeria. In the absence of a general legal framework, concessions in Algeria are regulated on a sector by sector basis or through project-specific laws. A general PPP law could bring a more uniformed implementation of procurement policies, benefiting both the government and the investors.

<sup>3</sup> We understand that, as at April 2011, legal texts regarding the new regulation are currently in the process of being drafted. These should hopefully provide greater clarity on the procedures regarding partnership.

**Arbitration is a viable alternative to court proceedings and is often available to commercial parties in Algeria.** The adoption of arbitration as the preferred dispute resolution procedure to resolve PPP project disputes could encourage PPP investment. For a valid arbitration agreement, the parties will need to agree on a seat and rules of arbitration. Algerian arbitration practices include those from the International Court of Arbitration (ICC) and the United Nations Commission on International Trade Law (UNCITRAL). Both arbitration rules are widely respected amongst the international bidding and lending community.

**Disputes resulting from a PPP contract may be subject, depending on whether a public entity is involved, to commercial or administrative law.** Cases in which a public authority is involved or where the provision of the “public service” is affected, will be heard in the administrative courts. By contrast, commercial disputes not involving the procuring authority or the provision of the public service will be subject to the jurisdiction of the civil courts.

### *Institutional issues*

**A sector specific PPP law would enhance Algeria's prospects in PPP.** PPPs have been successfully tendered and delivered in Algeria, although the contract conditions have been negotiated in the context of each project. A clear policy framework, such as the passing of a PPP law, would encourage best practice and contribute to investor and lender confidence. Such a law would be particularly important considering the recent announcement of a new five year plan heralding USD 286 billion of investment, which demonstrates a clear commitment to large-scale infrastructure expenditure by the Algerian authorities.

**In the absence of a 'PPP unit', several key actors participate in potential PPP projects in Algeria.** The Ministry of Finance grants the budgets and therefore has a crucial role in the PPP decision making process. In addition, the Commission Nationale des Marchés (National Committee of Transactions, CNM) plays an important role in the management of PPPs. The Caisse Nationale d'Équipement et de Développement (National Fund for Capital and Development) (CNED) is responsible for: increasing the efficiency of public spending; for improving the evaluation, implementation and follow up of large projects; and for diversifying the sources of financing of large projects. Whilst local entities and sector based “by services” entities (such as universities and hospitals) do have the ability to procure major projects, in practice significant projects are usually centrally procured.

**The CNED holds a powerful position in the lifecycle of major infrastructure projects and could be a useful platform on which to establish a 'PPP unit'.** The CNED has extensive experience in developing projects in a wide range of infrastructure sectors, and has credibility with the international project finance industry. This experience could be used to create a PPP Unit which could act as a centre of expertise for the structuring of project financed PPPs and, if necessary, help in steering 'pathfinder' projects to completion. Such a PPP unit could harness the existing strengths of the CNED based on the major role it plays throughout the lifecycle of traditionally financed

projects. A PPP unit could also facilitate standardisation of project planning, contractual conditions and financing. For CNED successfully to expand its already prolific role into project financed PPP, its mandate, position in the governmental hierarchy, staffing and strategy could be reviewed to examine its suitability as a cost-efficient base for a PPP unit.<sup>4</sup>

**The role of local administrative units, Wilayates and Baladiyahs, is important in promoting local projects and could be further developed to benefit an Algerian PPP programme.**

Although the Wilayates and Baladiyahs already have statutory powers to promote and execute PPP projects, their role to date has been somewhat limited. However, this role in planning and facilitating projects will become increasingly important in the context of the very ambitious five year infrastructure programme currently planned, which includes social infrastructure such as housing developments and health facilities as well as transport and utilities projects.

**Infrastructure projects are currently required to be analysed through various preparatory studies, covering both financial and technical aspects.** In the event that PPP projects are procured more frequently and across a range of sectors, a standard approach to assessing project feasibility and business case could be developed at central and local level in order to facilitate efficient administration by the responsible authorities.

### *Bidding process*

**There are various bidding processes used in Algeria for the procurement of public projects.** The central bidding process is enshrined in the Algerian Procurement Code (APC) but other sector specific bidding processes (which are largely modelled on the APC) are used by state-owned corporations such as SONELGAZ and SONATRACH. Whilst a two-stage tender process (i.e. an initial qualification stage followed by a bid submission stage with bid submission often being in two, technical and financial, stages) is available, it is not consistently used.

**The current bidding processes could be developed to include a structured phase that involves discussion and interrogation of bidders' proposals, which would be of particular benefit to complex PPP projects.** Any future reform of the APC could include amendments to the procurement procedures to ensure that a more suitable two-stage bidding be institutionalised, allowing for some measure of negotiation. Pro-active engagement of bidders has proven to be, in other markets such as the European Union, a means of fine-tuning and optimisation of solutions for the delivery of the project.

**International participants in the Algerian infrastructure sector have observed that the bidding processes could be improved by enhancing the quality of the bidding documentation available.** Due to unclear specifications and contract documentation issued in the tender phase, bidders have experienced difficulties in accurately pricing their bids. Lack of appropriate information before the initiation of procurement procedure could lead to prolonged bidding processes, potentially increasing the bid costs and even deterring future participants. In order to avoid these shortcomings, procuring

<sup>4</sup> As at April 2011, we have been informed that the creation of a centre of expertise on PPP within CNED is currently being contemplated by the Algerian government. The role of CNED vis-à-vis line ministries would be to evaluate and follow up PPP projects in which public money is mobilised to finance such projects, or to support the preparation and implementation of a PPP project if the financing is ensured by other resources different from the State budget.

authorities should develop tender documentation early in the procurement lifecycle and work with experienced, technical, financial and legal advisers to ensure that the tender documentation is clear and detailed.

**The sometimes excessive emphasis on lowest price criteria to the detriment of technical quality and the legal regulations generally favouring local participants (in the event that the bids' quality is comparable) can be factors which challenge foreign investment in Algeria.** A more balanced approach addressing technical experience and expertise could be instrumental in attracting foreign contractors to Algerian tenders and ensuring full competition, which will be beneficial for the country. One way of softening domestic preference criteria would be to allow foreign investors to incorporate a domestic entity, so that the margin preference will lose much of its significance. A good example in this direction is Egypt where, although the same margin has existed, its effect can be neutralised by incorporating a local entity.

### ***Contract design, risk allocation and financial terms***

**In Algeria, the approach to risk allocation has not yet been codified in a standard PPP contract.** However, some contracts are influenced by standard forms such as the International Federation of Consulting Engineers Contract (FIDIC) or the Cahier des Clauses Administratives Générales (General Conditions of Contracts) ('CCAG'), which is often part of the tender documents sent to bidders. The CCAG was introduced in 1964 and has been specifically applicable to contracts entered into by the Ministry of Works. In particular, the CCAG is not recommendable for PPP as it does not take account of PPP specific issues and risk allocation and partnership concepts inherent in PPP models.

**PPP contract terms could be standardised on a sector by sector basis.** An element of standardisation, at least for projects in the same sector, would serve to increase confidence amongst bidders and to incentivise investors to take a long term view of their investment in Algeria.

**Risk allocation in the Algerian PPP market follows international practices.** Design, construction, planning and delays in project delivery risks are normally absorbed by the private sector partner. Under Algerian law, the private sector is also responsible for changes in the contract that derive from a change in law and financing costs. Unforeseeable events and financial risks, such as inflation and exchange risks, are normally under the responsibility of the public sector partner.

**Some specific areas of risk allocation require further development.** In particular, the authority's position on the level of compensation paid out on early termination of contracts could be standardised and reviewed as currently most contracts do not tend to offer adequate protection of the investment made by lenders and sponsors in a termination scenario.

**In Algeria, macroeconomic risks have been reasonably well addressed, although improvements would be beneficial in order to increase the projects' value for money.** For instance, the cost of inflation could be better adjusted through regular benchmarking or market testing than a general price inflation adjustment. Two main factors explain the convenience of benchmarking. Firstly, statistical indices available in Algeria are

not sufficiently comprehensive of economy-wide measures of inflation. Secondly, price inflation is relatively volatile year-on-year in Algeria, partly due to regulation and price controls.

**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 value for money.** Best value for money represents a balance of costs, benefits and risks which is most favourable to the public sector. It creates stable project cash flows that attract long-term lenders and investors to invest in Algerian PPPs. In effect, such investors would take a combination of project risk (supported by sub-contractor or sponsor guarantees as normal in project finance) and Algerian sovereign risk – a combination which has been successfully banked in Algerian desalination projects.

### ***PPP / project finance investment readiness for lenders and investors***

**Long term PPP initiatives would benefit from a more investor-friendly legislation.** Foreign investment regulation in Algeria, particularly as enacted in the Complementary Finance Law for 2009, has institutionalised the resident national shareholding requirement, minimum levels of participation by Algerian residents and, more importantly, the requirement that debt must be sought from local banks. In order to ameliorate some of these measures, Algerian authorities could consider publishing some guidance on the circumstances in which foreign potential investors may benefit from exemptions, if any, from the effects of this legislation. If no adjustment and/or interpretation of investment rules are made by Algerian authorities, potential foreign investors will be faced with the prospect of entering into long-term partnering contracts without adequate guarantees over key decisions affecting their investments.

**The extension of state guarantees to PPP projects could attract long term investment.** Under current Algerian legislation, the state is permitted to guarantee loans taken by strategic public companies from banks and financial institutions. If the government wishes to pursue PPP initiatives, especially those of a long term nature, it should consider extending the same authorisation to private sector investors. Long-term PPP initiatives financed by private investors necessarily require significant financing from international banks, in which case state guarantees could play an important supportive role to access banking resources.

**It would also be convenient for Algerian authorities to pay careful attention to the need of a right balance between tax and accounting regulation, in order to obtain the most favourable conditions for the private sector.** Specifically, tax rules should be expressly considered when evaluating PPP tenders in order to compare bidders on the basis of their after-tax offer as well as their pre-tax offer. Similarly, the adoption of "finance debtor" accounting could help eliminate the negative impact of some tax rules and make project more affordable. Finance debtor accounting enables accounting profit to match project cash flows after debt service much more closely, avoiding many of the inefficiencies caused by fixed asset accounting in PPP projects. Finance debtor accounting is not yet allowed under Algerian accounting standards, requiring a change in tax law to be used for tax purposes.

**CONCLUSION – KEY RECOMMENDATIONS**

- Increased clarity of the legal framework applicable to PPP procurement could be achieved through the enactment of PPP specific legislation, which would cover such matters as the authority to award projects, bidding processes and required contractual provisions.
- A clearer and explicit policy framework for PPPs would facilitate financing the ambitious infrastructure development plan for 2010-2014.
- Affordability exercises and selection criteria should be improved and international best practice should be adopted when developing criteria specific to PPP procurements.
- The role of the CNED could be expanded and developed to establish a centre of expertise for the supervision of project financed PPPs. This knowledge would then be disseminated to ministries and local government.
- The Algerian Procurement Code (APC) could be supplemented to recognise and facilitate the competitive investigation and evaluation of bids for international PPP projects. New procedures should provide for improved transparent evaluation criteria that does not disadvantage foreign bidders. Procuring authorities could be strengthened so as to ensure that the standard of tender documents is improved in terms of clarity and comprehensiveness.
- The approach to risk allocation should be clarified through policy, in guidance commentary and the development of draft contractual provisions.
- Regulations on foreign direct investment could be reformed to facilitate the in-flow of foreign funds. In particular, greater clarity could be provided (for example through the issuance of official guidance) on the circumstances in which the exemptions to the Investment Legislation will apply.

## 2. EGYPT<sup>5</sup>

### Overview

**Despite recent political turmoil in Egypt, relatively solid macroeconomic conditions place the country in a favourable position to continue developing its PPP (Public Private Partnership) programme.** Sustained economic growth, a controlled fiscal position and low aggregate and foreign debt outstanding (relative to Gross Domestic Product (GDP)) will give sponsors and investors confidence in the capacity of the Egyptian government to commit to PPP concession payments for projects with a good business case. The political developments of early 2011 are likely to cause investors to be cautious due to increased uncertainty. This can be overcome by a strong commitment to developing PPPs (for those projects where it is appropriate to do so) by the new government.

**Successful experiences with PPP projects can be replicated by developing a sustainable pipeline of well-designed projects focusing on particular sectors.** Whilst government has not implemented an official policy on project prioritisation, the successful financial close of the New Cairo Wastewater (NCWW) Project demonstrates the feasibility of wastewater projects, which are expected to continue to see procurement activity. In addition, a small number of hospital and highway projects are currently in the pipeline for procurement as PPPs, as well as both conventional and renewable power projects. Building a credible pipeline of projects in particular sectors will serve to attract both local and international investors and lenders to the Egypt PPP market.

**Building on the successful implementation of the NCWW project, authorities should focus in the first instance on medium size projects or those of lesser complexity.** Particularly, wastewater projects, potable water facilities or standard power and transport projects, seem to be ideal projects to crystallize and test the capacity acquired through the implementation of successful pilot projects.

**Difficulties in developing large-scale PPP projects should be overcome by strengthening institutional capacity.** For example, particularly complex projects in the education sector, involving the procurement of 345 school buildings in various locations of the country, have been postponed or delayed. This has been partly due to the limited resources and means of the PPP Central Unit (PPPCU) to manage mega-projects, as well as lack of market appetite for projects of this sort. However, it is worth noting that the schools project has not been cancelled and that the government is likely to re-tender the project on the basis of fewer schools spread over 18 governorates. Through the effective use of advisers to successfully deliver 'pathfinder' projects, Egypt can improve the prospects of developing a good market reputation for their successful delivery. Such a reputation is important for long term investor participation in Egyptian PPPs.

### Funding capacity and availability

**Limited financial capacity of the domestic banking sector to fund small to medium sized PPP projects can be surmounted by foreign credit.** The Government's policy intention is to fund investment spending in Egyptian Pounds (EGP) where possible, to avoid exchange rate risk on foreign currency borrowing. However, if the PPP programme grows rapidly, or if large projects are undertaken, projects may have to be funded in foreign currency, with the Government underwriting the exchange rate risk in the payment mechanism. This requires the fragmented domestic banking sector to pool with International Financial Institutions (IFIs) alongside Egyptian banks (including subsidiaries of foreign banks), to boost available debt funding for Egyptian PPPs.

**Upgrading resources within the domestic banking sector could be achieved by enhancing the skills and insight of specialist PPP lending teams.** This could be brought about for instance through a series of targeted seminars and briefings on the opportunities in the PPP market. Such seminars could be sponsored by the PPCU or advisers recommended by it.

**Restricted availability of long term fixed-rate bank funding in EGP can be mitigated through contractual provisions enhancing the financial sustainability of PPP projects.** Particularly, payment mechanisms need to be adapted in the absence of financial instruments able to hedge certain macroeconomic risks such as inflation and exchange rate risks (as long term currency or inflation swaps are not available in EGP). Since these risks are macroeconomic in nature and cannot be mitigated by bidders, the procuring authority is likely to achieve the best cost effectiveness if it bears these risks in the payment mechanism.

**Relative short loan maturities available to Egyptian projects may be overcome by accessing long term commercial-bank and IFIs lending.** Short loan maturities affect project affordability because annual debt service is higher with shorter repayment periods and so project payments have to be correspondingly higher. The potential availability to PPPs of IFIs lending jointly with commercial banks for longer maturities, could encourage competition amongst commercial banks to increase the repayment periods which they offer. To date, loan repayment periods for Egyptian projects (PPP and non-PPP) have been around 15 years, compared to 25-30 year repayment periods for equivalent projects in more established PPP markets of the European Union (EU).

**Although domestic sources of infrastructure equity have been limited, international investors have substantially contributed project equity to Egyptian PPPs.** Equity for PPP projects has and will have to come from trade sponsors (i.e. the PPP subcontractors bidding for the project) and international investors such as sovereign wealth funds with appetite and knowledge of investing in Egypt. A number of sovereign wealth funds have previously invested in Egyptian projects and infrastructure.

<sup>5</sup> This section on Egypt is accurate as at 1 October 2010 and does not cover recent events in the country. The general recommendations of the report remain valid. Following recent events in early 2011, the four current PPPs in the pipeline (Rod el-Farag and 6th of October roads, the Abu Rawash wastewater scheme and the Alexandria hospital) will likely be postponed but not cancelled. In March 2011, the executive regulations governing the public-private partnership (PPP) tendering have been published in English on the PPP Central Unit's website ([www.pppcentralunit.mof.gov.eg](http://www.pppcentralunit.mof.gov.eg)).

### **Legal and regulatory framework**

**Egypt's legal system is one of the most highly developed in the Mediterranean partner region.** The legal system has foundations in the civil law tradition and distinguishes primarily between civil disputes (between exclusively commercial parties) and administrative disputes where for example, one party is a commercial party and another is an emanation or institution of the state.

**Egypt has enacted a fairly advanced PPP law, however its general legal framework for procuring infrastructure is fragmented and needs to be simplified to attract investments.** Potentially, PPP projects can be procured through the system of public economic entities, public utilities legislation and any number of sector specific or project specific laws currently in existence. The new PPP Law provides an additional channel for procurement, which was expected to replace the others. This has not happened and it seems unlikely that the government will impose the PPP law as the single framework for PPP procurement. This may have the undesired effect of hindering ministry and sector-wide support for the PPP Central Unit (PPPCU) and the New PPP Model. With the possible exception of the Ministry of Electricity and Energy which has successfully procured projects through sector specific legislation, ministries should be encouraged to procure projects under the regulations of the new PPP Law. In this regard, the PPPCU has a key role to play in raising its profile and encouraging support for and uptake of the New PPP Model. Should the government consider amending the PPP Law so that it becomes the exclusive regime for procuring PPPs, this would enhance the process of procuring projects as PPPs.

**Although Egypt boasts a modern judicial system, its complexity regarding dispute resolution may deter investors considering international arbitration a more comfortable option.** In particular, the possibility of similar disputes being heard in either the Administrative Courts (disputes between the contracting authority and the project company) or the Economic Courts (disputes between the project company and its supply chain) means that there may be a disparity in court judgments. This is not ideal where the project is inherently dependent on a number of key project parties. It is important to note, however, that the successful development of PPPs is not dependent on an extensive change to the Egyptian judicial system, as commonly PPPs do not avail themselves of the court process as they incorporate PPP specific dispute resolution mechanisms.

**The use of national arbitration by the Egyptian legal system has been positively received by local investors, although foreign investors will consider international arbitration a more viable option.** Egypt is already a signatory of the New York Convention (and therefore willing to recognise and enforce foreign arbitral awards) and, recognising that there are domestic arbitral institutions in Egypt, there remain concerns that the government's willingness to arbitrate only on the basis of local arbitral rules institutions may add to 'country risk' concerns for some potential investors. Contracting authorities should consider agreeing to international arbitration procedures, such as those under the International Chamber of Commerce (ICC) or London Court of International Arbitration (LCIA) rules, which will provide comfort to international lenders, in particular, as they are commonly adopted for PPPs in markets globally. This would also help reduce the risk margin applied by investors in their required remuneration and should

lead to lower payments by the public sector.

### **Institutional issues**

**The national PPP unit (PPPCU) has demonstrated leadership in the development of PPP programmes and projects.** Investor confidence in Egyptian public sector projects has been boosted by the creation of the PPPCU as the centre of expertise, and by giving the High Committee for Partnership Affairs (HCPA) steering and supervisory powers.

**The PPPCU should be further strengthened in order to allow it fully to capitalise on its gained experience.** The unit's reputation as the "power-engine of PPPs" in Egypt has been cemented by its institutionalisation in the PPP Law which will increase its powerful position, lend it further prestige and attract the best professionals. The PPPCU has shown its capability in its successful involvement in the NCWW project. If it follows this example and builds successfully on its existing track-record, it will contribute greatly to long term investor confidence and the success of PPPs in Egypt. Currently, the PPPCU faces a number of challenges in its development, especially if a more ambitious PPP programme were to be adopted. In particular, it is essential that funding of the PPPCU is secured for future years, for instance through a combination of donor funding and the levy of a fee on successful bidders (as provided for in the PPP Law), in order to enable the PPPCU to survive and develop its capability to select, negotiate and monitor projects.

**While keeping the PPPCU's central role, strengthening PPP expertise in line ministries will enhance project selection and preparation.** The PPPCU is integrated in the Ministry of Finance and as such is of critical importance in order to assure investors and lenders of a viable long term programme of PPP projects in Egypt. Potential PPP projects are identified by the line ministries and submitted to the PPPCU for approval. However, the lack of PPP units in individual ministries means that some projects have not been satisfactorily scoped prior to launching of procurement and as a result have been withdrawn or delayed.

**Increasing the involvement of local administrative bodies (governorates) in the procurement of local projects will contribute to public support for the projects.** Currently such bodies are involved at best in identifying infrastructure needs and lobbying central authorities for particular infrastructure requirements. By raising the profile of governorates within the matrix and thereby increasing local involvement in the PPP process, the government will not only be ensuring that projects are better suited to local requirements and therefore also be viable commercial concerns, they will also be ensuring the long term buy-in of the local end-users into the concept of PPP as a delivery model for local services.

**Expertise should be shared across the institutions involved in PPP development to enhance their synergies and accelerate PPP program implementation.** Government could foster capacity building and knowledge transfer between government bodies to ensure efficient interactions between major public-sector actors involved in the development and supervision of PPPs. The establishment of satellite PPP units may be an option to ensure line ministries develop technical expertise to procure sector specific projects successfully, when the PPP market will reach sufficient maturity.

**Processes for development of PPPs and feasibility studies should be standardised in specific guidelines to enhance expertise and consistency of procedures across sectors.** The methodology currently in use for assessing feasibility studies is not documented or crystallised in precise regulation. Government, in coordination with the PPPCU, could better define project feasibility guidelines and make them universally applicable. These guidelines would be based on international best practices and incorporate standard templates and financial model guidelines for bidding.

**The establishment of an infrastructure facility dedicated exclusively to PPPs would also bring further resources and expertise, aiding and complementing the PPPCU.** To overcome problems in project identification and scoping, the government could create an infrastructure facility, such as the Infrastructure Project Preparation Facility (IPPF) recommended by IFC. Several international financial institutions (IFIs) have fostered infrastructure facilities aiming to strengthen and shorten the project preparation stage and to facilitate appraisal and execution. The role of the facility would be to assist Egyptian public authorities in the identification, development and preparation of sustainable and bankable PPP projects. The facility, funded through donor contributions, could also cover part of the costs for necessary international advisers to be provided to the PPPCU and other government bodies.

**The success of a PPP program can be further enhanced by the implementation of an efficient gateway process.** The key role of the PPPCU both in the definition and approval of feasibility, as influential constituent member of the HCPA (which has the ultimate role under the PPP Law of approving PPP projects) could lead to assessments on individual projects lacking the level of objectivity that could be achieved where these roles were split between institutions. The effectiveness of PPPCU's analysis could be enhanced by an independent review, or gateway process, carried out by experts not involved in the preparation of the feasibility studies.

**In the interim, the existing limited resources available for PPP planning and procurement should be focused on smaller, well-defined social projects and basic infrastructure.** Care should be taken to avoid embarking on excessively large or hugely complex projects, and focus should be on medium sized projects in relatively straightforward sectors such as waste water treatment plants, conventional power plants or road projects. Once strategic PPP programmes have been successfully developed for each sector and a positive market reputation established a more ambitious deal-flow can be assured. This approach would consolidate the progress made to date in PPP.

### **Bidding process**

**The existence of multiple ways of procuring PPP projects leads to the undesired effect that other procurement procedures are often used rather than the PPP Law.** As mentioned above, the PPP Law is not the only channel for procurement, as the tender procedures under the PPP Law will co-exist with those under the Tender Law. Authorities' chosen method of procuring PPP projects will determine which bidding procedure will apply. Where the choice is to use the old framework (e.g. Public Economic Entities, Public Utilities Legislation, sector or project specific laws), the bidding procedures of the Tender Law will apply. These procedures, which have been the most commonly utilised process of tendering for infrastructure projects to date,

are "tried and tested" with a successful track record. The Tender Law, although relatively simple to apply, is not specifically tailored to major infrastructure projects. The Tender Law allows a number of tendering routes including the 'public tender' (a tender that is open to all participants) and the 'limited tender' (which is used where the nature of the work being procured requires restricting participation to certain contractors). However, these are not designed specifically to meet the requirements of tendering major infrastructure projects, as much of its provisions relate to the procurement of goods and services. Furthermore, the general nature of the provisions leaves significant scope for interpretation by those operating the tender processes, thereby reducing clarity and transparency in their application.

**A key draw-back of the Tender Law procedure from the perspective of PPPs is the absence of a structured dialogue with bidders during tendering.** Most PPPs are complex and require a 'solution-focus' that can be reached through a process of negotiations or dialogue between bidders and the procuring authority, in addition to standard question and answer sessions. The ability of the private sector to contribute its expertise to develop, jointly with the procuring authority, a viable solution in order to technically, legally and financially define a complex project, is rather restricted under the Tender Law.

**The PPP Law allows negotiation with the private sector during bidding and introduces the possibility of using competitive dialogue.** If it is to be used, the procedure for using simultaneous dialogue with competing bidders is expected to be fleshed out in executive regulations (secondary legislation) of the PPP Law. If the procedure is implemented as anticipated, it is important that it leaves little scope for subjective interpretation by those managing the bidding process and ensures transparency and fairness in the selection of the best offer. The manner of implementing this competitive dialogue can vary immensely such that it can provide real benefits, for example allowing a procuring authority to fully explore solutions being offered prior to a bidder being selected, leading potentially to a more competitive bidding resulting in better value to the authority. However it can add unreasonably to costs and also requires a high level of management input and planning in order for the process to achieve its full potential. The regulations should be introduced with the assistance of the PPPCU, who could be involved in disseminating appropriate training and guidance to procuring authorities in managing such a procedure as efficiently and fairly as possible.

### **Contract design, risk allocation and financial terms**

**The general principles of risk allocation are set out in the new PPP Law and further defined by the PPPCU, although the use of standard contracts would enhance the PPP process.** The approach to risk allocation in the new PPP Law is based on the well known principle that risks should be borne by the party best able to manage them, in accordance with international best practice. The PPPCU has identified a broad allocation of risks to be applied to all projects known as the "New PPP Model", which is based on standard PPP practice in other countries, notably the United Kingdom. However, there is no standard contract (or standard contracts by sector) for Egyptian PPP projects. Introducing these contracts and making them readily available to potential investors, for example through internet, would add considerably to transparency and can

contribute to quicker and more efficient selection procedures. The contracts would serve as a basis on which to start negotiations for a specific project.

**To date, in common with many other countries, PPP projects in Egypt have relied upon availability payments.** In this structure, the public sector pays for the use of the facility as long as it is available and operated in accordance with agreed performance or quality standards. The public sector partner has the right to withhold elements of the payment if the performance is sub-standard and not remediated in time. Following standard practice, the terms and conditions of payment and the risk distribution between public and private sectors, are included in a long term agreement between these two parties (the PPP Contract, “off-take” or “take or pay” agreement), which is the key contract in a PPP. Due to budget constraints, however, the government, in common with other countries, may eventually need to consider more innovative PPP payment mechanisms in addition to availability payments, such as introducing toll charges in road transport projects or other user fees where practicable.

**The contractual approach of the New PPP Model generally follows international practice, although certain specific financial issues would benefit from a different treatment.** Generally the risk distribution can be considered adequate. However, key issues such as certain financial and economic risks (see below) need to be addressed. Until they are adequately covered, Special Purpose Vehicles (SPVs) – created to carry the project forward- will be required to bear risks that they cannot adequately manage, and thus participants will either not tender for projects or will require a higher price, adversely affecting project affordability.

**When issuing invitations to tender, the authority should clarify its position on allocation of financial and economic risks (inflation, interest rate, and exchange rate movements).** In the absence of a hedging market and where exchange rates are partially or totally centrally managed, the public sector is best placed to compensate the private sector for the exchange rate risk in the foreign cost components. High and volatile price inflation leads to planning, pricing, and costing problems for potential sponsors and investors. This can be solved through adequate payment indexation in the long term off-take agreement. Further, specific cost inflation may need to be addressed through payment adjustments which more closely match the Project SPV’s cost base (as assessed by regular benchmarking or market testing) rather than a general price inflation adjustment. Finally, the public sector could assume interest rate risk when the only option for the bidder is local currency funding, as this is imposed by the public sector, and when the hedging market is not sufficiently well developed.

**Another issue that authorities should pay careful attention to is the need to strike the right balance in tax and accounting regulation, to obtain the most favourable conditions from the private sector.** 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. Similarly, the adoption of “finance debtor” accounting will make projects more affordable, by enabling accounting profit to match project cashflows after debt service much more closely. Finance debtor accounting is permissible under Egyptian accounting standards, but may require a change in tax law to be

used for tax purposes. Use of finance debtor accounting is typical in more established PPP markets and 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 taxes, which would encourage them to fund projects with more equity and less debt, making their bids more expensive.

**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 maximizing its cost effectiveness or value for money.** The right structure will enable a stable equity cashflow that may help to attract IFIs, sovereign wealth funds, and international infrastructure funds to invest in Egyptian project equity. In effect, investors would take a combination of project risk (supported by subcontractor or sponsor guarantees as normal in project finance) and Egyptian sovereign risk – a combination which has been successfully banked in previous Egyptian PPPs.

#### ***PPP/project finance investment readiness for lenders and investors***

**There is potentially a very comprehensive security package available to investors. This is one of the key comforts to investors in PPP projects in the Egyptian PPP market.** The availability of a security package is a key attraction for foreign investors considering Egypt as an investment prospect. The range of securities includes the typical pledges over shares, mortgages and the assignment of insurance proceeds. In addition, the government has a policy of co-signing direct agreements where appropriate with project companies and lenders whereby the Ministry of Finance will undertake to pay the Project SPV directly if the relevant contracting authority fails to do so.

**The PPP Law maintains certain restrictions that are not optimal, but that could be ultimately overcome or accepted.** The PPP Law restricts the Project SPV from assigning its rights and obligations arising from the PPP contract to third parties, except for the purposes of financing the project (and then only after the approval of the contracting authority). This is acceptable, as it does allow lenders to step-in and replace the operator and/or constructor, should there be serious project difficulties. In addition, the restriction on assignments of shares in the Project SPV is, although not ideal from an investor’s point of view, a market-accepted norm designed effectively to enable the authority to retain control at all times of the identity of the key shareholders in the Project SPV. This restriction follows the practice existing under the Old Model PPP.

**A key attraction for foreign investment in Egypt is the absence of financial and legal restrictions on foreign direct investment, including on contracts with the public sector.** However, under the Tender Law, one theoretical disadvantage to foreign companies is that the bids of domestic firms will be deemed to be of a lower price even where they in fact exceed the lowest foreign tender by up to 15%. This disadvantage is easily overcome in practice by the incorporation of an Egyptian joint stock company prior to the bidding process. No such restrictions exist under the PPP Law and therefore foreign companies investing in Egypt will be treated on an equal basis as local companies under this law. This is important as giving preference to local companies is in direct conflict with procurement guidelines of most IFIs.

**CONCLUSION – KEY RECOMMENDATIONS**

- Increased resourcing of PPP lending teams in Egyptian Banks should be encouraged.
- Where large projects are undertaken they may have to be funded in foreign currency and in that event the government would receive better cost efficiency by underwriting exchange rate risk, given the absence of a well developed exchange rate risk hedging market.
- The use of international arbitration procedure would provide comfort to lenders, in particular, as they are commonly adopted for PPPs in markets globally.
- The PPP Law could become the exclusive regime for procuring PPPs, thereby reducing uncertainty in procuring PPPs. All ministries (with the possible exception of the Ministry of Electricity and Energy which has a proven track record) should be encouraged to procure projects in all sectors under the regulations of the PPP Law.
- The PPPCU has a key role to play in raising its profile and encouraging support for and uptake of the New PPP Model.
- The government could adopt an IFC recommendation to establish an IPPF with donor support to provide for project planning, including advisers costs.
- There is a requirement for increased training and knowledge transfer between government bodies so that the supervision of PPPs is split among the major actors. The establishment of satellite PPP units is necessary to ensure line ministries develop the technical expertise to procure their projects successfully.
- Another key area for future reform would be to better define and make universally applicable a standardised project feasibility and development process that is rigorous and, for example, uses internationally recognised procedures and modelling.
- By raising the profile of governorates within the matrix and thereby increasing local involvement in the PPP process, the government will not only be ensuring that projects are better suited to local requirements and therefore also viable commercial concerns, they will also be ensuring the long term buy-in of the local end-using public into the concept of PPP as a delivery model for local services.
- Existing limited resources available for PPP planning and procurement should be focused on smaller, well-defined social projects (such as hospital projects or more waste water treatment projects) until strategic PPP programmes have been developed for each sector and a more ambitious deal-flow can be assured.

### 3. ISRAEL

#### Overview

**Stable macro-economic conditions place Israel in a favourable position to continue expanding its use of Public Private Partnership (PPP) as a procurement tool.** Israel's fiscal and debt position, sovereign credit rating<sup>6</sup> and balance of payments position give it ample capacity to maintain investment in infrastructure, whether through PPP or other means. The banking sector is healthy and sophisticated and avoided much of the solvency and liquidity pressures that occurred elsewhere during the international financial crisis. Investors have confidence in the capacity of the Israeli government to commit to PPP concession payments, or to set viable toll fee levels and in developing PPP projects with a good business case.

**A successful track-record of PPP projects is being developed across a number of sectors by various procuring authorities.** There are now signed projects in the roads, light rail and desalination sectors. As well as more transport and water projects, there are conventional and renewable power projects currently in procurement. The independent power project (IPP) procurement model offers considerable scope for application in Israel.

**Difficulties have arisen in projects where preferred bidders have been selected and contracts awarded prior to key issues being resolved.** Failed procurements such as the Tel Aviv Light Rail Project would have benefited from having more contract terms and authorisations agreed or confirmed in advance of contract award. Premature contract award typically results in bank funding support being highly conditional. It is better practice to confirm as much of the project detail as possible prior to contract award. This allows the procuring authority to require that funders provide indicative terms at final bid stage that are subject only to confirmatory due diligence, financial market conditions and credit or investment committee approval.

#### Funding capacity and availability

**The leading Israeli banks have shown their capability in PPP by underwriting large New Israeli Shekel (NIS)-denominated loans in individual transactions on keen terms.** Credit margins achieved on Israeli PPPs such as Hadera desalination plant (see Box 1) have been similar to those achieved in equivalent European PPP markets at similar times, reflecting the banks' liquidity and Israel's sovereign credit rating.

**Nevertheless, for large PPP schemes (and any substantial aggregate PPP investment programme) foreign currency funding by international banks will still be required.** Larger projects are likely to attract international bank lenders, especially where international contractors are project sponsors. However, international commercial bank appetite for Israeli PPPs has not been significantly tested since the international financial crisis. Current tenders for projects in new sectors such as Independent Power Projects (IPPs, including renewable power projects) may indicate the extent of potential international commercial bank appetite for Israeli PPPs.

**Bank capacity for Israeli PPP loans may become constrained by their maximum group credit exposure limits to key sponsors and contractors active in Israeli PPPs.** If a Project SPV is a subsidiary of a sponsor company, the project debt counts towards the bank's total group exposure to that sponsor group. If the bank has an extensive lending relationship with other parts of that sponsor group (e.g. through real estate or corporate loans), its ability to lend to that sponsor's Project Special Purpose Vehicles (Project SPVs, the project companies) will be constrained. To overcome this, Israeli corporate PPP sponsors will need to progressively form strategic alliances with financial investors, to form investment joint ventures such that project debt is not counted as group debt, and to provide a way of recycling equity capital through project equity disposals.

**Bank capacity for NIS-denominated PPP loans may also become constrained if more projects are structured without a significant proportion of government capital grants.** Some of the PPPs to date have benefited from government capital grants paid in during or at the end of construction. If fewer projects receive capital grants such that the entire project cost is to be recovered from the project operating period, the debt requirement for each project will increase. Therefore, the public sector may consider increasing the availability of capital grants.

**The domestic bond markets are sufficiently developed potentially to allow bond issuance by Project SPVs at a lower cost of funds than on bank debt.** However, careful preparation is needed if the bond finance route is to be actively considered for PPP funding.

**Expansion of PPP expertise amongst Israeli banks remains necessary, especially to ensure that banks carry out sufficient commercial due diligence when supporting bids.** This could help avoid repeat situations where projects reach preferred bidder or contract award stage and do not subsequently satisfy prior lending conditions specified by the banks. Whilst this is primarily an issue for procurers to resolve, best practice in PPP tendering requires bid-supporting banks to participate actively in the bid process. The benefit of early bank involvement is to allow them to understand and to contribute to the project negotiations. This allows banks to issue indicative lending terms and a support letter for the bid, which, although not binding, indicates that there is no undisclosed matter that would prevent them lending on the terms indicated, if subsequent due diligence was confirmatory.

**Overall, debt funding of the Israeli PPP programme is likely to continue to be provided by domestic banks, supplemented in larger projects by international financial institutions (IFIs) and foreign commercial banks.** However, availability of foreign commercial bank funding is uncertain, despite Israel's investment grade credit rating. Therefore, continuing to develop domestic bank expertise (and, in time, institutional debt capacity) in PPP is essential. A successful, well designed and managed PPPs programme offering a regular flow of projects will itself develop domestic capability, as well as attract foreign sponsors and banks to invest larger volumes in Israeli projects and assist in meeting Israel's infrastructure investment needs.

<sup>6</sup> Israel's sovereign long term credit ratings as of 1 October 2010 were (S&P) AA-/Stable (local currency) and A/Stable (foreign currency), and (Moody's) A1/stable.

### **Legal and regulatory framework**

**Israel's legal system is one of the most highly developed in the Mediterranean partner region and is capable of meeting the needs of complex PPP transactions.** The legal system has foundations in the common law but with some civil law influences. The law comprises written legislative text and caselaw. Decisions of the higher courts are binding on lower courts. The court system is divided into three general law courts (consisting of the Supreme Court, district courts and magistrates' courts) and quasi-judicial tribunals. PPP contract disputes will generally be heard in the district courts. Disputes affecting the project company or its supply chain can be heard in the same court, which will contribute to consistency and efficiency in time and cost.

**Despite the absence of a legal framework specific to PPPs in Israel, the general legal framework accommodates PPP procurements through a number of channels.** Public authorities enter into PPP contracts on the basis of Israeli administrative law, project-specific legislation, resolutions of the procuring authority and the legal framework impacting on specific issues. Since the modes of procurement accommodate the needs of PPPs, the lack of a general PPP-specific framework has not disadvantaged the procurement of PPPs in Israel.

**Project-specific laws are enacted where required to provide the legal powers for entering into contracts between the public authority and the private sector partner for the procurement of projects in a particular sector.** The general law, project specific laws and the contractual agreements will govern the relationships between the project parties.

**The enactment of a PPP-specific law, whilst not essential, could enhance PPP procurement and the government may wish to consider its benefits.** These would include, amongst other things, giving specific authority to public bodies to enter into PPP arrangements, regulating tender processes specifically for PPP and setting out key principles for the allocation of certain PPP contractual risks.

**Although Israel boasts a modern court system, as with any national court process generally, its complexity may deter investors who may see arbitration (because of its relative confidentiality and its specialist responsiveness to commercial disputes) as a more comfortable option.** PPP contracts therefore generally avoid the court system by including provisions for arbitration. Arbitrations tend to be governed by Israeli substantive and procedural law. International arbitrations are permitted and international investors who will more readily submit to international arbitration may seek assurances that the applicable law and rules are consistent with international arbitration procedures with which they are more familiar. Certainly in terms of substantive law, particularly where the lending institution is non-Israeli, there will be a preference for the substantive law governing the financing documents to be that of a country familiar to lenders (for example English law).

### **Institutional issues**

**Israel has a sophisticated approach to planning and procuring PPP projects and has developed a significant PPP programme in a variety of sectors.** There are clear and well-defined procedures for project identification and execution. These procedures (which include developing a project's business case

and examining whether PPP is in fact the most suitable mode of procurement) are based on international best-practice and include a public-sector comparator as the basis for judging the merits of projects and deciding whether they should proceed as PPPs.

### **Making institutional roles and responsibilities clearer by defining the roles of particular institutions better will prevent duplication of effort and improve pre-procurement preparation.**

The Ministry of Finance has the overall responsibility for PPP project identification and approval through the Infrastructure and Projects Division of the Office of the Accountant General. Part of the work of project execution is devolved to a government-owned company – Inbal, which co-ordinates the work of the relevant government office that is immediately responsible for the project. In the past, the roles of these institutions have overlapped. In complex PPP procurements such as those involving both line ministries and municipalities, clear demarcation of roles can bring efficiencies in procurement which can enhance investor confidence.

### **Bidding process**

**A general set of legal provisions is applicable to public procurement in general and these can be (and in the past have been) suitably adopted for PPP procurement.** PPPs are procured under the Mandatory Tenders Law 5752-1992 (the "Tenders Law"), using the procedures specified in the Mandatory Tenders Regulations 5753-1993 ("Tenders Regulations").

**The current procurement legislation allows procuring authorities to negotiate elements of the PPP contract with the bidders.** This is an appropriate framework for projects which are technically complex and which involve complex technical and legal risk allocation. The tender procedure allows for discussions to clarify elements of the procuring authority's tender requirements and to negotiate technical and legal aspects. The provision for negotiations between the procuring authority and one or more bidders, which is regularly exercised in Israeli PPPs, fosters discussion and cooperation, encouraging a solution for implementation of the project which meets the procuring authority's needs. The procurement procedure allows for competitive and transparent bidding processes with an appropriate level of objectivity when assessing bids.

**The limited number of Israeli banks active in PPP makes it impractical for bidders to seek exclusive bank support at bid stage.** In such circumstances, such bidders should seek from banks: (i) confirmation that they (the bidder) are acceptable as credit counterparties in their capacity as sponsors or contractors to the Project SPV; (ii) acceptance of key draft concession terms and risk matrix; and (iii) stipulation of core requirements, for example minimum cover ratios, maximum loan periods, or security and bonding requirements or retention of certain risks by the authority. In any event, such support letters will not be binding, since banks will not have completed due diligence on multiple bidders' proposals and will reserve the right to collaborate with various bidders, so they have greater chances of eventually financing the successful bidder. Likewise, bidders will be reluctant to divulge commercially sensitive bid details with non-exclusive banks.

### **Contract design, risk allocation and financial terms**

**Risk allocation between the public and private sector tends to follow international practice.** The PPP programme has developed sufficiently to incorporate standardised allocations of risks and market-based contractual clauses. Both the government entities and their private sector partners have become increasingly adept at managing the risks and the process of PPP procurement, meaning that standard documentation has emerged, along with market-driven contractual drafting.

**Contractual terms in Israeli PPPs have begun to standardise as procuring authorities and the market have become more adept at managing the risks common to PPP projects.** Project specific risks are subject to the negotiations permitted under the procurement legislation. In practice, risks are allocated to the parties best placed to manage them, consistent with international best practice. International contractors and their lenders will be reassured by this approach, which includes the allocation of risks such as termination being addressed appropriately (with the agreed compensation regimes) in the contract documents.

**This matching or hedging of the financial risks in the payment mechanism appears to offer the best value for money to the Israeli government.** It creates predictable cashflows, allowing banks to offer relatively low annual debt service cover ratios. It creates a stable equity cashflow that helps to attract sponsors and investors to invest in Israeli project equity. In effect, investors take a combination of project risk (supported by subcontractor or sponsor guarantees as normal in project finance) and Israeli sovereign risk. Not to offer such mechanisms would be likely to result either in funding not being available, or if available at all, the required debt service cover ratios and equity investment returns being so high as to make the project unaffordable.

**Israeli PPP payment mechanisms tend to follow best international practice.** This is beneficial as familiarity in risk allocation is likely to make it easier to foster international participation where investors are able to participate on the basis of familiar international practice. They have been flexible in relation to the indexation mechanisms applicable to offset the Project SPV's cost inflation. In general the public sector has retained such risks by including comprehensive indexation mechanisms in the payment mechanism. Interest rate risk has generally been transferred to the Project SPVs, since they can manage this risk by interest rate hedging. To the extent that projects have been funded in foreign currency, the authority has absorbed this risk through providing currency adjustments in the payment mechanism.

**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 maximizing its value for money.** Best value for money represents a balance of costs, benefits and risks which is most favourable to the public sector. It creates stable project cashflows that attract long term domestic and foreign lenders and investors to invest in Israeli PPPs. In effect, such investors would take a combination of project risk (supported by subcontractor or sponsor guarantees as normal in project finance) and Israeli sovereign risk – a combination which has been successfully banked in previous Israeli PPPs.

### **PPP/Project finance investment readiness for lenders and investors**

**Israel's tax and accounting regulations enable Project SPVs to have effective capital structures, so that project payments can be made as efficient as possible.** Nevertheless, when evaluating bids, the procuring authority evaluates not only the gross project payments proposed by the bidder, but also net out tax forecasts to be paid by the Project SPV over the life of a project. This particularly applies to the evaluation of withholding tax levied on dividends and interest.

**Project finance practices in Israel recognise the full range of securities familiar in the financing sector internationally.** For example lender securities include direct agreements with procuring authorities providing for step in rights for the authority in the underlying contract. In addition there are extensive rights to project company assets. However, in order to improve the overall security package on offer the public sector could consider the provision of state guarantees on a project-specific basis where this can be shown to improve value for money.

**A key attraction for foreign investment in Israel is the absence of financial and legal restrictions on foreign direct investment, including on contracts with the public sector.**

### **CONCLUSION – KEY RECOMMENDATIONS**

- Expansion of PPP expertise amongst Israeli banks remains necessary, both within existing PPP lenders and across more banks, to enable banks to carry out sufficient commercial due diligence when supporting bids. This could help avoid repeat situations where projects reach preferred bidder or contract award stage and do not subsequently satisfy prior lending conditions specified by the banks.
- A series of targeted seminars and briefings on the opportunities of the PPP market, sponsored by the Ministry of Finance or advisers recommended by it, would serve to increase bank appetite for PPP lending. It could also be targeted at non-bank financial institutions to examine the potential for the domestic bond market to fund PPPs.
- Whilst the current legal framework is supportive of PPPs, Israel may wish to consider whether the enactment of a specific law regulating PPPs would be beneficial. For example, a PPP-specific legal enactment could simplify the legal authority for granting PPPs, clearly setting out those sectors in which private investment is permissible and those in which it is not. This will increase investor confidence as to the legal basis for PPPs and avoid costly legal challenges as to the legitimacy of private sector participation in certain sectors.
- A clearer division of labour between those key sections of the Ministry of Finance and other government bodies involved in the procurement of PPPs is desirable. Better defined roles would improve efficiency by reducing the duplication of effort caused by overlap in roles and would also be of assistance to investors.

- A clearer and more comprehensive approach from the government though for example a comprehensive PPP strategy which demonstrates the future strategic direction of PPPs, the priority sectors and the level of financial support that sectors will attract would help to define the PPP opportunities for the market.
- Whilst procurement under the Mandatory Tenders Law (5752-1992) provides a procedure conducive to the procurement of PPPs, the enactment of a specific PPP law could also provide an opportunity to fashion a tender process specifically designed for procuring complex long term infrastructure projects.
- By reviewing the current policy of not providing state guarantees, Israel could identify circumstances in which the provision of state guarantees may have a positive effect on public sector value for money.

## 4. JORDAN

### Overview

**The World Bank classifies Jordan as a lower middle income country** with an estimated GDP of €20.6 billion (€3,448 per capita in 2009). Exports only account for 39% of foreign currency earnings. Jordan is heavily reliant on foreign transfers, specifically from Jordanians working abroad (19%), tourism & transit fees for Iraq bound goods (23%) and government grants (6%). Natural resources include potash, phosphate and relatively unexploited oil shale deposits. The population is 78% urbanised (2008), and has been increasing rapidly (6.5 million in 2010 compared to 3.2 million in 1990).

**A number of large PPPs were successfully signed over the past five years.** Examples include the AES Amman Jordan IPP (signed in March 2007), the Al Qatrana IPP (signed in October 2009), the new terminal for Amman Airport (November 2007) and the Disi Water PPP (June 2009). Total project funding for these four projects amounted to \$2.4 billion, with 30% made available by sponsors in the form of project equity plus significant support from Islamic Development Bank, KEXIM, KfW, OPIC, JBCI, and EIB in the case of Disi Water.

**Jordan has attempted a number of PPPs which were later withdrawn mainly due to limited project preparation.** For instance, the Amman-Zarqa Light Railway System project, a transport demand-based BOT, was tendered three times without success. This project was first approved in 2004 but the preferred bidder failed to raise finance and procurement was suspended in March 2009. In September 2009 IFC was appointed as consultant to this project with the purpose to review, assess and update the economic, technical, legal and environmental studies that were conducted previously for the project. Following IFC's conclusion of this preparation stage, the project has been recently put on hold for financing-specific reasons. The Aqaba New Port Development, a \$540 million project, was terminated in November 2009 and procured conventionally after the consortium selected failed to agree terms with its public sector counterpart, reflecting limited project preparation. New projects are now subject to greater pre-procurement due diligence.

**There is scope in Jordan for authorities and ministries to propose PPP projects that are smaller in scale, and simpler to implement, than its current large projects.** A suitable PPP programme with certainty of deal flow will also serve to boost foreign interest in the Jordanian PPP market. This approach would have a greater likelihood of demonstrating successful PPP procurement earlier than otherwise, as well as stimulate domestic funding markets with projects of a scale that can be absorbed by the local bank market without significant dependence on IFI and ECA funding. The experience of the projects withdrawn highlights the need for more complete pre-procurement project scoping, and for appropriate project scaling to match investor appetite for projects in an economy the size of Jordan's.

### Funding capacity and availability

**Jordan has found it difficult to attract private sector debt funding without either IFI or export credit guarantees.** A future PPP programme will need to be funded by a combination of IFI

or ECA-guaranteed debt as the domestic banking sector is small and very constrained regarding the level of support it can provide. Jordan's government debt is rated BB, and therefore does not have a long-term investment grade rating and Debt/GDP is relatively high.

**The Jordanian dinar (JOD) is pegged to the US dollar (USD) which has facilitated project funding in USD in PPPs.** The Central Bank of Jordan (CBJ) has maintained the peg since 1995 with the result that PPP projects are being funded in US dollars. Funding capability in local currency is minimal, generally available only on a floating or prime rate basis and all domestic government debt has maturity of less than 5 years. As there is no long-term interest rate swap market in JOD, PPPs generally obtain project payments denominated in foreign currency, or guarantees from the authority of the exchange rate risk in the payment mechanism, following a formal application for this risk to be covered by the Government of Jordan (GOJ).

### Legal and regulatory framework

**Jordan's legal system is based on civil law. Although a legal structure supporting current Privatization has been in existence in Jordan for several years, it is not specifically tailored for PPPs.** The provisions of the Privatization Regulation, implementing parts of the Privatization Law, have provided a legal basis for tendering and concluding PPPs since 2008. However, the current laws have not been designed specifically for PPPs but for a broader programme of private sector participation in public services. The Privatization Regulation defines PPP as *"a relatively long-term written agreement between the public and private sectors, which aims to introduce a service of a public nature, execute a project or undertake a specific business. Such project shall be financed and the risk arising from there shall be allocated pursuant to the said agreement."* The Privatization Law (Article 4) empowers government to conclude PPPs by any method as determined by the Council of Ministers. The current legislation does allow for PPPs in principle, but relevant legislation specific to PPPs is missing.

**New legislation is under consideration which will be more specifically directed to providing a stable legal framework.** The new PPP Law when enacted will become the exclusive legal regime for the procurement of PPPs in Jordan. The Draft PPP Law is expected to make the following key provisions: (a) unify the tender procedures applicable to PPPs to ensure a consistent approach is adopted across sectors and ministries; (b) develop an institutional framework through the creation of a PPP Commission to support line ministries during the procurement stage; (c) set out objectives for PPP development – including improvement of public infrastructure; mobilisation of private finance and recognition of risk allocation between state and private sector; and (d) make provision for terms that are required in PPP contracts, including duration of the contract (to not exceed more than 35 years except for specific sectors such as nuclear energy), the extent and conditions for the transfer of employees at contract commencement and finalisation, termination provisions and security arrangements. The PPP Law will thus become the exclusive legal regime for the procurement of PPPs in Jordan. The law will apply to all sectors except national defence, police, award of justice, core areas of health care (medical and diagnostic) and other activities identified by the Partnership Council.<sup>7</sup>

<sup>7</sup> Comments in the Report in respect of Jordan's draft PPP law relate to the draft current at 30 October 2010. A revised draft was published in February 2011 and is not taken into account in the Report.

**Jordan's court process offers a framework for commercial agreements although specific dispute resolution systems are typically embedded in the PPP contract.** The legal system distinguishes between civil disputes (i.e. between commercial parties or between commercial parties on the one part and the government, when dealing on a non-sovereign basis, on the other part) and administrative disputes brought before the Higher Court of Justice, which relate to challenges of decisions issued by the government or any of its agencies in their sovereign capacity. The court system has not been designed to cater for the particular needs and requirements of PPP contracts. However, the successful development of PPPs is not dependent on an extensive change to the Jordanian judicial system, as typically PPPs by-pass the legal system by the incorporation within contracts of PPP of specific dispute resolution mechanisms.

**International dispute resolution has the support of the Jordanian courts.** Jordan has in the past agreed to arbitration (domestic or international) as the contractual conflict resolution mechanism, including the adoption of recognised international arbitration under rules such as International Court of Arbitration (ICC) or International Centre for Settlement of Investment Disputes (ICSID). PPP contracts in Jordan typically provide for 'informal' methods of dispute resolution. These can take the form of tiered dispute resolution clauses where the emphasis is on resolving disputes at an early stage through director level meetings or similar measures before resorting to formal dispute resolution mechanisms.

**Jordanian law generally applies to all PPP contracts but financing contracts will be governed by English law.** Currently public and private sector organisations are free to choose the law that will govern their contracts, provided the chosen system of law does not violate mandatory rules of Jordanian law. The foreign law as the governing law of the other project documents is a valid choice of law and will be recognised by Jordanian courts. However, the new proposed PPP legislation will require that the governing law of future PPP contracts to be Jordanian law.

### ***Institutional framework***

**A number of specialist bodies exist in Jordan with a strong role in the PPP process.** The Privatization Council is a high level body chaired by the Prime Minister, set up initially as part of the general privatization drive. It has an advisory role and also approves proposals for PPP projects. Its membership comprises the Minister of Finance, the Minister of Planning, the Minister of Justice, the Governor of the Central Bank and the Chairman of the EPC. The PPP Committee was established in September 2008 pursuant to a Council of Ministers decision. Its stated role is to identify projects suitable for PPPs and to supervise feasibility studies. However, in practice it has had limited involvement in PPP projects to date. The Executive Privatisation Commission (EPC) is a public body with financial and administrative independence but reporting directly to the Prime Minister. It does not sit within any particular ministry and has an independent budget approved by the Privatization Council and by the Council of Ministers. The EPC has played a major role in projects that have been procured through PPPs, either led by the EPC or by the relevant ministries. In some cases, the EPC has taken a more minor role, for example on the Queen Alia

International Airport (QAIA) project, where the Ministry of Transport took the lead (with its advisers). There are no criteria which specify how the projects are to be allocated to the EPC or the line ministry. The EPC is a procurement vehicle, while the Projects Administration (formerly, the Mega Projects Administration) was introduced under the organizational structure of the Prime Ministry as a support to the line ministries in terms of coordination, follow-up, provision of technical and financial advice, and the packaging of mega projects. In 2010, a GOJ decision was passed requiring EPC and PA to merge; however, the decision has not yet been implemented.

**The institutional framework for delivering PPP projects in Jordan is in transition.** The Draft PPP Law prepared by EPC creates new organisations: PPP Commission and the PPP Council – to replace those currently responsible for PPP. However, the GOJ has not yet endorsed any particular institutional framework.

**Capacity needs to be enhanced to avoid over-dependence upon external advisers in project preparation and procurement.** The Jordanian PPP programme would benefit from developing a core group of financial, legal and technical experts who could assist line ministries and the EPC/PPP Commission in delivering PPP projects.

### ***Bidding process***

**The bidding process under the Privatization Law and the Privatization Regulation is broadly consistent with practices in many other PPP markets.** The process involves an expression of interest, pre-qualification, bid submission, evaluation and limited negotiation phase. A limited amount of negotiation is currently permitted after the appointment of the preferred bidder, but this is restricted to amendments which do not distort the tender documents made available to all bidders. This approach serves to uphold principles of fairness and transparency.

**The PPP Law will introduce the concept of competitive dialogue, which can provide a robust mechanism for interrogating project scope and probing value for money solutions only in some cases and only if best practice is followed.** The procedure for the operation of such dialogue is expected to be detailed in regulations (secondary legislation) of the PPP Law. Competitive dialogue should be adopted only where it is appropriate (i.e. it should not be an option for the relatively simpler projects) and should leave little scope for interpretation. It would be desirable to introduce dialogue regulations with the assistance of advisers, who could be involved in disseminating appropriate training and guidance to procuring authorities in managing such a procedure as efficiently and fairly as possible. This will serve to ensure that best practice is pursued and that the dangers inherent in such a procedure, such as increased costs for all parties, are avoided.

### ***Contract design, risk allocation and financial terms***

**Contractual design broadly follows international PPP practice with some aspects specific to Jordanian PPPs.** Whilst PPP contracts generally incorporate practice familiar in PPPs in other jurisdictions, in allocating risks such as design, standard of work and services and delay events, there are peculiarities in the Jordanian experiences. These may be project-specific such as the imposition of a public sector design and may cause

difficulties in the acceptability of risk. As far as possible contractual authorities should seek to achieve fair risk allocation which supports a PPP model and assures value for money. There is at present no standard contract, but increased procurement by PPPs in specific sectors will serve to standardise certain elements of the contract design and by-laws to the new PPP law were expected to address that.

**Payment mechanisms vary depending upon the type of PPP project being undertaken in Jordan, allowing many different types of PPP projects to be procured.** A wide variety of payment terms can be used on a project specific basis, including lump-sum payments by the procuring authority as a contribution to capital development costs, minimum revenue guarantees by the procuring authority (availability payments), regular payments of operating fees made to the government by the private sector partner and profit-sharing arrangements.

**The public sector is best placed to assume macroeconomic risks it controls and for which there are limited hedging possibilities.** When projects are funded in foreign currency, the procuring authority is likely to have to assume the exchange rate risk. This is achieved either by having the project payments denominated in foreign currency, or by having JOD-denominated payments adjustable for any exchange rate movement. Volatile price inflation presents some risks for sponsors and investors in long term PPP projects. Planning, pricing and costing risks also need to be addressed in the PPP contract payment mechanisms, for example through regular benchmarking of project costs rather than a general price inflation adjustment.

**In projects with inherent demand risk, the government should be conservative in its demand forecasts.** Transport PPP projects often use toll charges or fares to generate revenue. There is an insufficient track record and lack of comparator projects in Jordan for forecasting such demand, so international funders will be very cautious when assessing such projects for investment. Procuring such projects on an availability (or mixed availability/user fee) basis may have a greater likelihood of success and be more cost-effective.

### **PPP / project finance investment readiness for lenders and investors**

**Jordan's limited restrictions on foreign investment are a positive factor for foreign investors.** There are no restrictions on foreign companies contracting with government organisations and foreign investors are able to freely repatriate capital, profits and dividends. In addition, foreign investors are protected by law from arbitrary interference when managing and controlling their investments.

**Jordan restricts foreign ownership in key sectors but special exemptions may be given for specific PPPs.** The Council of Ministers can pass a resolution to increase the level of permitted foreign investment, but no blanket exemption will be granted to PPPs. Practice to date suggests that if there are any restrictions on foreign ownership in any sector related to the project, the EPC will liaise with the Council of Ministers at the pre-procurement stage and seek that the restrictions be waived.

**Lenders are able to obtain the necessary level of security over project assets.** Lenders are able to obtain standard lender protection, including direct agreements. However, floating charges are not legally recognised in Jordan which can be an

issue for lenders. Jordan does not automatically provide state guarantees for public sector payments to be made during the operational phase of PPP projects. The Draft PPP Law provides future flexibility but at present this is not automatically the case.

### **CONCLUSION – KEY RECOMMENDATIONS**

- The EPC or relevant procurement agency in Jordan should seek early feedback from bidders as to their funding strategies and sources of finance. If projects require IFI debt or ECA guarantees, then bidders' credentials need to be assessed as to whether they satisfy IFI or ECA criteria and whether they have previous successful experience in arranging funding for similar projects. Bidders' track record should be assessed.
- The new PPP Law should be enacted as soon as possible in order to provide clarity regarding the legal basis for procuring PPP projects.
- The roles and responsibilities of both the new organisations to be introduced by the proposed PPP Law are expected to be clarified shortly and should be clearly defined. Any required transfer of organisational capacity and staff from one organisation to another should be planned well in advance.
- New projects should be carefully scoped by the responsible public bodies and business cases should be developed that clearly set out the justification for each proposed PPP project, including realistic estimates of cost and affordability. The GOJ should prioritize among projects, and probably be guided through a "master plan" or clear sectoral guidelines that would adequately scope and prepare the projects, defining their financial costs and revenues and determining their expected horizon.
- Projects under procurement must be fully supported with information on site availability and conditions, including outline planning permission and detailed output specifications. Interfaces with other utilities and service providers must be clearly identified and defined.
- When the new PPP Law is enacted, it should ensure that the bidding process is suitable for PPP procurement and follows international practice specifically with respect to publication of tenders, tender documents, tender evaluation and contract award.
- The EPC and any successor agency should develop its expertise in running procurements and disseminate appropriate training and guidance to procuring authorities in managing bidding processes.
- Jordan's procuring authorities are likely to obtain best cost efficiency and value for money in the long term if they avoid passing risks to the private sector that the latter cannot adequately control or mitigate.
- Finance debtor accounting should be used by bidders (as permitted by Jordanian accounting standards). Tax rules could be amended to permit the use of finance debtor accounting when calculating PPP asset depreciation for tax purposes.

- To encourage interest from foreign investors each potential PPP project should be assessed for the applicability of the restrictions on foreign ownership. If necessary, a resolution of the Council of Ministers to increase the level of permitted foreign ownership should be obtained prior to the project being put up for tender.
- State-backed guarantee for payment on individual PPP projects is desirable in certain instances (for example, in the case of a weak offtaker) since it will make projects more financeable and indirectly benefit the public sector by leading to a lower overall price for the service. However, the provision of state guarantees could be determined on a case by case basis and judged against overall level of government indebtedness.

## 5. LEBANON

### Overview

**In Lebanon national political stability is an absolute precondition for the development of public-private partnerships (PPPs).** In particular, large and long term PPP projects require political stability to ensure that the rule of law will be upheld and contracts will be enforced.

**A sizeable PPP programme in Lebanon would be affordable for the public sector, provided that strong economic recovery continues and the government maintains its efforts to reduce its net public debt.** Since the war of 2006, the Lebanese economy has recovered strongly, enabling the government to run primary fiscal surpluses. Moreover, a stable monetary policy (driven by a USD fixed exchange rate) has encouraged international investment in the country's banking sector, as well as the financial and real estate markets. Nevertheless, despite significant efforts, Lebanon's public debt remains high in absolute terms. At the end of 2009, gross public debt and interest debt repayments accounted for 148 % and 11.7 % of GDP respectively.

**The government of Lebanon has taken significant steps to raise awareness about the importance of PPP for its infrastructure development, including the drafting of a new PPP law.** Recent initiatives include an awareness program that helps local banks to identify PPP opportunities, as well as a workshop designed to explain private sector engagement in water infrastructure. Complementary institutional reforms include the establishment of the Higher Council of Privatisation (HCP) and the Council for Development and Reconstruction (CDR), both created to promote efficient long-term development of infrastructure in Lebanon. The HCP is responsible for developing the PPP laws sent to the Council of Ministers in November 2010.

**The government has identified PPP as a potential tool for procuring essential infrastructure investment although a pipeline of future PPP projects has not yet been identified.** Further analysis is necessary to determine for which sectors PPP is a viable method for financing at least part of the significant reconstruction of Lebanese infrastructure currently being planned. Public sector capital expenditure is very low by international standards. With the right political and institutional conditions, Lebanon could focus its attention on key selected sectors in which to develop projects of lesser complexity, particularly those that can meet pressing socio-economic demands. Such projects if delivered successfully could play an essential role in cementing Lebanon's reputation as a destination for PPP investment.

### Funding capacity and availability

**Lebanon's economy depends on the continuing capacity of its banks to attract international deposit and investment inflows, with which the banks buy government debt.** The very high level of the debt of the public and private sectors exposes the country to any external shock which curtails deposit or portfolio investment inflows, or to any domestic event (such as a real estate price collapse) or policy which reduces confidence in the Lebanese financial system. However, the banking system appears robust financially in aggregate terms, with high reserve levels and a prudent loan/deposit ratio.

**A lighter public debt burden will free up financial liquidity for PPP investments.** If the government continues its efforts to maintain the public debt at sustainable levels, newly unrestricted public funds could be channelled to fund PPP projects. Nevertheless, due to the liability mismatch between long-term loans and shorter-term deposits, Lebanese banks might be hesitant to undertake PPP lending. Participation by International Financial Institutions (IFIs) or Export Credit Agencies (ECAs) could support the efforts of Lebanese banks to stimulate the PPP market and serve as a source of long-term funding and credit guarantees.

**Due to their limited experience with PPPs, the appetite of Lebanese banks for long-term PPP lending is presently untested.** Procuring authorities should request letters of support from funders of successful bidders in order to receive sufficient information on funding strategies and sources of finance. Although it may be impractical to require bidders to obtain exclusive commitment letters from banks prior to preferred bidder stage, a preliminary indicative feedback could assist authorities in identifying the possible funding sources.

**The Lebanese Pound (LBP) is pegged to the United States Dollar (USD). High dollarisation of bank deposits is likely to result, at least initially, in PPPs to be funded in USD.** Dollar funded PPPs will enable Project Special Purpose Vehicles (SPVs) to more easily hedge interest rate risks, allowing banks an interest rate basis for syndicated project loans. Nevertheless, procuring authorities will have to absorb exchange rate risk.

**An annual public budget should be submitted to Parliament in order to ensure the reliability of information on government expenditure.** The annual public budget has not been approved by the Parliament since 2005 due to the unfavourable political context. Private investors and lenders need credible information on government spending to boost their confidence in the ability of the government to meet its financial commitments.

### Legal and regulatory framework

**Although it is a Lebanese Constitutional requirement that concessions be granted by law, few contracts have been signed with such authorisation.** Projects involving a measure of public participation have primarily resulted from private negotiation between the State and the private investor. Other projects have been framed as alternate types of contracts and have not been subject to the stipulations of concessions. For example, the Tripoli Water project was described as a "management contract", rather than a concession. These closed-door proceedings could be challenged before the courts, increasing the amount of risk incurred by private investors.

**A Draft PPP Law, submitted for Parliamentary approval, establishes a clearer legal and institutional framework for PPP, which could be further improved through secondary regulation.** This draft law is an amended version of a previous PPP draft law which was prepared by the HCP and approved by the Council of Ministers in 2007. The Draft PPP Law grants legal powers to the HCP to develop and procure PPPs. The law applies to public authorities at the national, district, county and municipal levels. In accordance with international best practices, it also requires public authorities to treat bidders equally. The Draft PPP Law defines the roles of essential PPP institutions and the intended process for PPP project development. The implementation of detailed requirements

through decrees (at the same time or soon after the primary legislation) would create the certainty necessary for a successful PPP programme.

**Possible conflicting decisions of commercial and administrative courts make of arbitration the dispute-resolution method favoured by investors.** Disputes resulting from a PPP contract may be subject, depending on whether a public entity is involved, to commercial or administrative law. Cases in which a public authority is involved or where the provision of the “public service” is affected, will be heard in the administrative courts. By contrast, commercial disputes not involving the procuring authority or the provision of the public service will be subject to the jurisdiction of the civil courts. Considering the implications of multiple legal interpretations, investors to a PPP contract typically favour arbitration as the dispute resolution method, to avoid difficulties in the enforcement of court decisions.

**A clearer policy outlining the authorization criteria for the approval process of arbitration procedures by the Council of Ministers would increase PPP investment attractiveness and is contemplated in the current Draft PPP Law.** Lebanon’s Civil Code allows procuring authorities to enter into contractual arbitration, provided that the procedure has been approved by the Council of Ministers on the recommendation of the Minister responsible. Contractual arbitration approvals do not follow particular criteria; rather, approvals are decided at the sole discretion of the Council of Ministers. The inclusion of this method of dispute resolution in the Draft PPP Law introduces the likelihood of greater certainty and, consequently, investors’ confidence in Lebanon’s institutional framework. International arbitration is a widely embraced alternative method of dispute resolution for international investors.

### ***Institutional issues***

**The institutional framework for infrastructure is geared primarily towards traditional construction procurement supported by multilateral development funding.** This flow of funds has taken a variety of forms including direct grants and low-interest sovereign loans and has enabled a large reconstruction programme to benefit the country’s public and commercial infrastructure. The CDR has been responsible for delivering the infrastructure redevelopment programme and has become a powerful institution in Lebanon.

**In Lebanon, decision-making on infrastructure policy rests with the Parliament and line ministers.** At the top of the institutional pyramid is the Parliament, which has the power to enact specific legislation to authorise the provision of public services, either by the public or the private sectors. According to the Lebanese Constitution, the grant of rights to exploit any natural resources or public interest service needs to be provided by law. Formal decisions on the procurement of infrastructure rest within individual line ministries. The CDR (main government body for advice, expertise, and advocacy in the field of infrastructure) and the Minister of Finance have considerable influence over infrastructure procurement decisions.

**The recent openness of Lebanon to private sector participation has put the HCP at the centre of current and future PPP policies.** Established in 2000, the remit of the HCP extends to the privatisation of different sectors. The HCP is responsible for increasing the efficiency and productivity of those entities

previously under state control, as well as encouraging foreign investment in the country. If the PPP law is enacted, the HCP will become a key agency in PPP projects. Donor agencies and IFIs may wish to consider contributing to the technical resource required to upgrade the capacities of the HCP to meet the demands of the new PPP law, increase activity and become a centre for PPP expertise. A concrete application of technical assistance could come in the form of a new framework for building PPP budgets, including the respective roles and responsibilities (as applicable) of the CDR, the HCP and line ministries.

**Under the Draft PPP Law, municipalities can propose PPP projects for the consideration of the HCP.** Municipalities have not been particularly active in the promotion of infrastructure projects. Nevertheless, the Draft PPP Law presents them with significant challenges in terms of local PPP projects. In order to guarantee the technical quality and design of PPP projects, municipalities will have to be provided with capacity building opportunities and training.

In Lebanon, the implementation of the PPP law would be facilitated by the presentation of guiding policies outlining the scope and objectives of government engagement in PPPs. PPP policies could serve different purposes. First, they could help clarify the role of PPPs in comparison with other infrastructure procurement options. Secondly, they could serve to promote awareness about the advantages of PPP schemes. Finally, they could provide general guidance on how PPP projects should be implemented by the national and local governments across sectors.

### ***Bidding process***

**Lebanon’s current procurement legislation, the Public Finance Law 14969, does not provide an appropriate framework for PPP contracts.** Procedures under this framework have not been designed to procure complex project-financed partnership contracts. Therefore, its application to PPP projects has been generally avoided. In order to address these shortcomings, the government has enacted project-specific legislation to facilitate tenders. The procurement procedure selected by the government to award the provision of mobile services through concession (BOT) provides a number of lessons learned for future procurements regarding the way in which prequalification, initial offer, “best and final” offer and preferred bidder stages can be used.

**Robust feasibility study and increase transparency in the bidding process could enhance PPP investment attractiveness and competition.** Lack of sufficient competition is partly due to the limited preparation of projects. In addition, lack of transparency may also reduce competition, as in the case of two historic tourism projects based on private investor participation, where contracts were negotiated directly with Lebanese companies that did not previously enter into a formal competition. It will be beneficial for the future success of PPP projects in Lebanon to ensure that procurement procedures develop fair and transparent processes.

**Although the Draft PPP Law attempts to fill procurement gaps in Lebanon, its provisions could be completed, ultimately through secondary regulation.** Potential investors in PPP projects would be more certain about their investment prospects in Lebanon if the law could define in more detail the procurement process and procedure. In order to fill this

vacuum, Lebanese authorities could issue secondary legislation (including decrees) describing the stages of the procurement process, legal recourse and guarantees.

### **Contract design, risk allocation and financial terms**

**The introduction of private sector participation in public service delivery has provided valuable expertise regarding risk management in PPP contracts.** Until recently, the discussion on risk allocation in Lebanon was mainly based on trends and practices from government funded procurements. In the last few years, international practices are the main criteria to determine and assess risks in infrastructure contracts. The limited enforceability of land rights in Lebanon should be factored into any consideration of land permitting risk. Ownership uncertainty regarding land rights and constructors effective access to the land upon expropriation (enforcement of expropriation) may affect investment projections in PPP contracts. In order to avoid potential conflicts, government authorities could develop land management strategies (i.e. engaging communities in the provision of land permits and securing access to land).

**In order to maximize project cost efficiency, invitations to tender should clarify early in the process the allocation of risks (exchange rate and inflation).** The optimal risk allocation generates the best cost effectiveness for the authority in a PPP. Project affordability and value for money for the authority are adversely affected if the Project SPV has to bear macroeconomic which it cannot control or mitigate. In a context of macroeconomic uncertainty, a Project SPV is naturally forced to include in its pricing of the project a buffer against such risks. Moreover, if such risks are misallocated, either the necessary funding will not be available or the required debt service cover ratios and equity investment returns will be significantly high. In this scenario, the project would become unaffordable.

**The optimal allocation of exchange rate risk will depend on whether the Project SPV has obtained local or foreign currency funding, the availability of foreign currency hedging and the country's exchange rate policy.** In Lebanon, as in most Mediterranean partner countries, the ability to hedge against local currency exchange rate movements is limited by the relatively fragmented financial sector. Contractually, exchange rate risk when borne by the public sector is covered through the payment mechanism of the long term PPP contract, either by indexing local currency payments to exchange rate variations or by directly paying the foreign portion of the costs directly in foreign currency.

**Regular benchmarking, or market testing, is more suitable to address inflation costs in Lebanon than a general price inflation adjustment mechanism.** Two main factors explain this preference: (i) real wages in specific sectors can rise rapidly, usually at a higher rate than general inflation, and (ii) price inflation is volatile year-on-year.

### **PPP / project finance investment readiness for lenders and investors**

**Lebanon has a 'light-touch' regime for foreign investment and exchange controls.** There are no legal restrictions stipulating minimum use of local labour or on currency conversions and transfers. The country has also signed over 40 bilateral investment treaties with countries of the European Union and

Middle East. In addition, the government has established special bodies, such as the Investment Development Authority of Lebanon (IDAL), to promote foreign direct investment (for example, income tax exceptions, fee reductions for work permits, etc).

**The selection of the most convenient bid should consider both gross project payments and tax obligations attached to the project.** Depending on the capital structure of the bidder, different tax treatments will apply. In this context, 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. This recommendation is especially relevant for the evaluation of the withholding tax position of bidders with foreign shareholders or lenders.

**The adoption of "finance debtor" accounting and tax treatment for PPP projects could help eliminate the negative impact of some tax rules and make projects more affordable.** Finance debtor accounting enables accounting profit to match project cash flows after debt service much more closely, avoiding many of the inefficiencies caused by fixed asset accounting in PPP projects. The use of finance debtor accounting by subsidiaries (such as Project SPVs) is allowed under Lebanese accounting standards, although it would require a change in tax law to be used for tax purposes. The use of finance debtor accounting is typical of more established PPP markets and is recommended by international accounting standards.

**Lender friendly securities such as step-in rights and rights over assets are yet to achieve an optimal level of familiarity in the Lebanese market.** Due to the lack of historic PPP exposure, security arrangements available to parties to infrastructure contracts are largely those found on traditional procurement projects. Their absence is of crucial importance in any PPP procurement and particular emphasis should be placed on developing such securities to an international standard in some of the early PPP projects. This should ensure that appropriate precedence is given to project participants, so they have the comfort of knowing that investments can be secured and where necessary can be enforced.

### **CONCLUSION – KEY RECOMMENDATIONS**

- Continued national political stability and institutional development are essential pre-requisites to attracting international participation in Lebanese PPP projects.
- The successful delivery of a series of simple projects with the assistance of experienced international advisers, such as IFIs, could help establish a positive market reputation for Lebanon.
- Enacting a PPP law and the supporting regulations promptly should ensure continued momentum in interest from potential participants and investors. Constitutional requirements relating to the procurement of concessions should be observed so projects cannot be legally challenged.
- A move away from informal project awards to a regularised tender procedure based on regulations issued under an enacted PPP law will instil confidence in potential international investors. It will also assist Lebanon in obtaining the best solutions to its infrastructure needs.

- The respective roles of the different public entities involved should be defined more clearly than in the past to ensure that their roles do not overlap in the PPP procurement process.
- A significant amount of technical resource will be required to upgrade the capacities of the HCP to meet the demands of a new PPP law and increase PPP activity generally. Where possible, maximum political consensus should be achieved so that there is a high level of 'buy-in' from across the Lebanese political spectrum for institutional reforms. The HCP should be encouraged to develop a set of procedures and model documentation for efficient PPP procurements.
- Donor agencies and IFIs may wish to consider supporting the HCP to develop its role as a centre of PPP expertise.
- Budgetary procedures for PPP projects need to be clarified.
- The lack of established precedent in project securities is an essential area for further development and is crucial to investor and lender participation. Early projects can be used to set the appropriate precedent by allowing security for lenders over project assets and step-in rights and ensuring such rights are enforceable.

## 6. MOROCCO

### Overview

**Morocco's sustained economic growth and progressive structural reforms have created favourable macroeconomic conditions for PPP investment.** Morocco's fiscal deficit (4.4% of GDP) and foreign debt levels (24.5% of GDP) are moderate and sustainable despite a deterioration following the slowdown in the Euro area, which is Morocco's primary export market and main source of foreign direct investment. Nevertheless, the government has the capacity to maintain current spending levels and has a diversified range of funding sources offering long-term maturities. Morocco's investment-grade rating also implies reliable access to international capital markets at favourable rates.

**There is a growing recognition in Morocco that PPPs provide an optimal procurement method for meeting infrastructure needs in a number of sectors.** The National Development Plan has stated that the government can significantly benefit from a well-designed PPP initiative to help close Morocco's substantial infrastructure gap. Primary sectors include water, wastewater, irrigation, energy and transport. The government is pursuing policies that prioritise alternative sources of energy (e.g. wind and waste to energy) and PPP structures could be appropriate methods for realising these initiatives. Other sectors could also benefit from further PPP investment including non-commercial sectors, such as health, education and justice.

**Although a legal framework exists to support concessions, broader PPP procurement in Morocco, such as projects where payments are directly related to performance, requires the implementation of comprehensive legal and regulatory reforms coupled with institutional capacity building.** PPPs to date have been ad hoc in nature due to the absence of a single policy or procurement channel. Public bodies such as the National Office of Electricity and some state-owned entities have been active in entering into partnership contracts with the private sector in a number of sectors, including energy, water supply, and ports. These projects demonstrate that Morocco can attract high quality domestic and international bidders.

### Funding capacity and availability

**The government of Morocco has several potential sources of domestic financing for its PPP programmes, including national infrastructure funds, local banks and international investors.** A number of infrastructure funds have been established in Morocco with the specific objective of investing equity in Moroccan infrastructure projects. These funds make Moroccan PPP more attractive for bidding sponsors since co-investment by such funds enables sponsors to reduce their own equity commitments and to have potential buyers for their shareholdings at a later date. As the PPP pipeline grows, foreign banks may be attracted to lend in larger volumes to Moroccan projects, especially if international financial market conditions continue to improve.

**The domestic banking sector has capacity to fund relatively large, individual PPP projects, but could benefit from increased PPP experience.** The financial sector is solvent and liquid. Some local banks have participated in a number of PPPs/concessions signed to date in Morocco as co-financiers. Nevertheless, the

banking sector as a whole would benefit from increased specialised PPP lending expertise and resourcing, thereby enabling local banks to handle larger deal flows. Developing domestic bank expertise in PPP financing will also enable smaller PPP projects (such as social infrastructure projects in the health and education sector) to be denominated and funded in local currency thereby reducing foreign exchange risk.

**A floating rate inter-bank loan market in Moroccan dirhams enables commercial bank interest rate setting for PPP loans denominated in the local currency. However, the long-term interest rate swap market in dirhams is not fully developed.** As a result, Project Special Purpose Vehicles have difficulties at hedging local interest rate risk in the market and to the extent projects are funded by dirham-denominated debt, project payments will be required to be adjustable for interest rate movements. Although a long-term (25 years) fixed rate bond market exists in Morocco, its total size, limited issuance in longer maturities, and the small size of banks, prevents the establishment of a long-term interest rate swap market in dirhams.

**Large PPP schemes (and any substantial aggregate PPP investment programme) will likely require foreign sources of financing.** Procurers should seek early feedback from bidders as to their funding strategies and the sources of finance, to identify if there is potentially a funding gap. Larger projects are likely to attract international bank lenders, especially where international contractors are project sponsors. As a result, debt funding of the country's PPP programme will come from a combination of domestic and international bank debt, including International Financial Institution (IFI) and Export Credit Agency (ECA) funding.

### Legal and regulatory framework

**Legislation regarding the procurement of concessions is relatively well developed but further clarity on the legal framework applicable to PPPs would be beneficial.** While a legal framework exists to support concessions, there is no comprehensive legal and institutional framework applicable specifically to PPPs. The existing legal framework is relatively developed in relation to concessions procured by the municipalities or public bodies; it is governed, on the one hand, by Law 54-05 (the 'Concessions Law') for general matters of principle and, on the other hand, by sector-specific laws to regulate each sector (for example, specific laws relating to ports, water and electricity). However, specific regulations to Law 54-05 in relation to key areas such as the bidding process have not yet been implemented. Other aspects of PPP procurement and implementation are less developed. Notably, PPP procurement by central government departments is not addressed in the legal framework and the regulation of procurement of projects other than concessions does not have a clear legal basis. Furthermore, there is no clear legal basis for the procurement of broader categories of PPPs, such as direct availability based payment flows from the contracting authority to the project company (as opposed to user fees). Whilst developing these categories of PPPs using existing legislation might still be feasible, by enacting a PPP-specific law, the government could more clearly expand the type of PPP models it implements, group all PPPs under one unique "umbrella" framework and strengthen the legal basis for procurement (whether at a local, regional or national level). This would also reassure investors of the legal basis for their projects.<sup>8</sup>

<sup>8</sup> It is to be noted that the International Finance Corporation (IFC) and Infrastructure UK (IUK) are currently analysing Morocco's legal framework in relation to PPPs.

**Morocco's civil law tradition distinguishes between public and private (commercial) matters, which could result in disputes of one PPP project being heard in different courts.** Public contracts, including PPP contracts concluded between a public authority and a private sector company, are subject to the jurisdiction of the Administrative Courts. Disputes within the project company's/concessionaire's supply chain will be heard in the Commercial Courts but can be joined to proceedings in the Administrative Courts if they are related to a dispute at the public authority – project company level and this should be encouraged where possible. The possibility however of disputes at different levels within a PPP structure being heard in different courts still exists (this is the same as the French system). Where this happens, the effects could be inconsistent findings of facts by different courts on the same dispute and a duplication of efforts. The resulting disparities between outcomes can prolong and complicate disputes and increase the risk perceived in investing in PPPs in Morocco.

**PPP contract disputes in Morocco will be subject to the jurisdiction of the Moroccan courts unless a valid arbitration agreement has been reached between the parties.** The court system is adapting to deal specifically with PPP-related disputes, but costly court procedures means that commercial parties are more likely to prefer arbitration as a means of resolving differences. The use of arbitration as a means of dispute resolution in PPP projects is specifically mentioned in Law 54-05 and should be encouraged. Where disputes between parties to PPP contracts occur at different levels of the PPP supply chain, the courts could facilitate their efficient and speedy resolution by permitting, where possible, the joining of such disputes into one set of proceedings in order to foster efficiency and consistency of outcome. International arbitration (such as pursuant to the International Chamber of Commerce (ICC) or International Centre for Settlement of Investment Disputes (ICSID)) is available to international commercial parties and is foreseen in Law 54-05 for foreign direct investments.

### ***Institutional issues***

**In Morocco, the decision-making process for major infrastructure projects involves many parts of central government and can also be initiated at the municipal level.** Projects are likely to involve a wide range of stakeholders, including decision-making committees across ministries for centrally procured projects. Although there is desire and an impetus at the local level to develop PPP projects, there are some concerns as to whether municipalities have sufficient legal powers to award contracts. Legal reforms to remove ambiguities in the powers of municipalities to procure projects will enhance investor confidence and the scope of local authorities to develop projects in line with local needs.

**Capacity building and policy coordination within the Moroccan government needs to be further prioritized.** In order to address capacity constraints and ensure coherence across the government, the Ministry of Economy and Finance is creating a new PPP unit with the assistance of the International Finance Corporation (IFC) and Infrastructure UK (IUK). The role of this

unit will be to develop policy, to support the identification, structuring and implementation of projects (particularly in key service sectors such as health or education) as well as to provide guidance, oversee procurement processes, and monitor projects in the implementation and operational phases, contribute to knowledge sharing, draw up operational manuals, etc.. This new unit will need to build on the experience of the DEPP (“Direction des Etablissements et Entreprises Publiques et de la Privatisation”) and the DRSC (“Direction des Regies et des Services Concedes”) to ensure that existing PPP knowledge is mobilised and enhanced. At the same time, the new PPP unit will contribute to enhancing the capacity of both the DEPP and the DRSC in PPPs. Close partnership between the DEPP and the European Union-sponsored capacity building programme has provided a platform for the creation of a central PPP unit. Morocco’s challenge will be to develop sufficient number and quality of PPP projects and to provide the PPP unit with sufficient expertise and financial means to be able to carry out its functions.

### ***Bidding process***

**A clearer legal framework, grouping procurement of all PPPs under a single, specific PPP law, would bring benefits in the overall framework for PPP procurement.** The Concessions Law is intended to regulate the choice of the most appropriate procedure but, to date, the relevant implementing regulations have not been enacted for centrally procured PPP projects.<sup>9</sup> The government should consider their early implementation since, in the absence of specific legal regulation, bidding procedures are designed on a project by project basis and are set out in the tender document. This provides bidders with information as to how the procurement will be run but does not provide certainty that similar procedures will apply to all major project procurements. PPPs that require availability payments from the public sector and that do not fall under the ambit of the Concessions Law will, it is expected, be procured under the Procurement Decree (2-06-388). However, this governs general public procurement and not PPPs specifically. The tender processes outlined in the Procurement Decree are not appropriate for complex procurements of long term PPP contracts.

**Regulations which are introduced to govern bidding procedures would benefit from drawing on practices in PPP markets internationally.** The key to efficient procurement is to achieve competition, fairness and transparency. Provision should be made for specified stages of procurement, negotiation and (where the complexity of the project warrants it) dialogue. There should in addition be provision for evaluation criteria and the separation of technical and financial evaluation. By following recognised international practices, investors will be comforted that procuring authorities intend to run fair and transparent processes.

**The inclusion of a dialogue provides a suitable method of PPP procurement in some particularly complex projects.** Typically, a process of dialogue can be undertaken prior to the selection of a preferred bidder when the procuring authority enters into in-depth discussion simultaneously with each bidder until it has

<sup>9</sup> Concerning local authorities, for the application of Law 54-05, the Government published Decree 2-06-362 on the 9th of August 2006 relating to articles 5 and 12 of the Law.

'settled' on a solution. The benefit of this method to the procuring authority would be the ability to probe value for money solutions and the use of such a method would give comfort to investors that tender processes are solution orientated and are therefore designed to identify and develop long term and viable solutions. In considering the appropriateness of such a process, however, the public authority should consider whether it has the management in place to conduct such exercises robustly but efficiently and fairly. In Morocco, public/private consultations have taken place and are more frequent following the entry into force of Law 54-05, which does not foresee any exclusion to dialogue. Whether to use this procedure of simultaneous consultations is decided on a case-by-case basis and is common for international competitive bidding procedures.

**Morocco is adopting a gradual approach to changes in its legal and institutional changes, trying to draw lessons from experience.** Morocco's legal and financial framework allows carrying out PPPs but would benefit from a number of improvements. Particularly, creating a central PPP unit as soon as possible and developing a number of pilot PPP projects would contribute to increased PPP expertise. Morocco could also draw from experiences of PPPs in other countries and swiftly introduce certain key reforms mentioned above.

#### **Contract design, risk allocation and financial terms**

**Risk allocation between the public and private sector in PPP projects is negotiated contractually and is not currently standardised.** Generally the allocation of risk follows recognised international practice whereby the outcome of commercial negotiations results in risks being allocated to the party best able to manage them. Under the Moroccan concession model, demand risk is usually allocated to the private sector. If the government expands the use of PPP and structures projects with alternative payment models, such as an availability-based model, certain aspects of risk allocation will need to be revisited, including payment guarantees, performance standards and relief events, to ensure that the projects remain attractive to project investors and operators.

**As international lending to Moroccan projects increases, international lenders will play an increasing role in shaping risk distribution and will seek to ensure that their interest in the projects is secure.** Key provisions such as protection against unforeseeable events, dispute resolution procedures, change in law and compensation on termination will undergo close scrutiny. Lenders will negotiate provisions to ensure that the Project Special Purpose Vehicle's (SPV's) exposure is kept to a minimum, by insuring against or sub-contracting obligations and risks, so as to ensure that debt service is secured.

**When issuing invitations to tender, the authority should clarify early in the process its position on allocation of financial and economic risks.** For instance, the procuring authority is likely to achieve the cost effectiveness in the payment mechanism if it bears macroeconomic risks under its control, such as inflation and exchange rate risks. This applies particularly to availability based payment mechanisms or a combination of availability/user fee payment structures. Investors would then take a combination of project risk (supported by subcontractor or sponsor guarantees) and Moroccan sovereign risk. The

optimal allocation of interest rate risk will depend on whether the Project SPV has obtained dirham or foreign currency funding. To the extent that the project is funded with dirham, the authority is likely to have to include interest rate adjustments in the payment mechanism in order to match movements in the Project SPV's cost of senior debt. This is due to the absence of a significant long-term interest rate swap market in dirham to allow Project SVP to fix its interest rate exposure. In the case of Project SVP funded in a foreign currency and when hedging is possible, the authority does not need to bear the interest rate risk.

#### **PPP / project finance investment readiness for lenders and investors**

**The lack of specific restrictions on foreign direct investment is a significant attraction to foreign investors.** Light touch regulation for foreign investment and foreign exchange control has been implemented over the past two decades. The Investment Charter enacted by Law 18-95 (1995) provides a series of tax incentives to qualifying foreign investors. The approval of the Foreign Exchange Office (FEO) (the main regulator of foreign exchange transactions) is now only required in limited circumstances. Investments can be repatriated without major bureaucratic obstacles. The current framework in this context is encouraging however further structural reforms will be needed to enhance the ability to implement PPPs successfully in Morocco.

**Lenders can receive a full range of securities in line with those which are commonly seen on the international market.** The exception is that assets in the public domain that are owned by the public authority cannot be pledged as collateral. Article 8 of the Concessions Law allows pledges in relation to assets held by public enterprises. In order to enhance the ability of public authorities to pledge project assets without the use of public enterprises, the government could consider permitting by legislation the pledge of assets in the public domain as security. Project SPVs and other incorporations can generally operate without any special restrictions on ownership although generally when contracting with the government, an entity should be incorporated in Morocco.

**Tax and accounting may require different treatment in Moroccan PPP contracting and tender evaluation.** Some Moroccan accounting and tax rules encourage inefficient capital structures in long-term PPP projects. The treatment of tax will need to be considered in bids to ensure that the full impact on project costs is evaluated. In addition, permitting "finance debtor" accounting and tax treatment for PPP projects will help eliminate these inefficiencies. These technical changes are consistent with international project finance practice and produce a better match of project returns against tax liabilities.

#### **CONCLUSION – KEY RECOMMENDATIONS**

- For projects in procurement (and especially larger projects), the procuring authorities should seek early feedback from bidders as to their funding strategies and the sources of finance, evidenced for example by letters of support from funders. This can assist in identifying if there is a funding gap and in confirming that the project scope and risk allocation is acceptable to the market.

- The legal framework for PPPs that are not concessions should be clarified. A specific PPP law could be introduced to govern broader types of PPP. Such a law could grant authority to all types of public bodies who will be involved in PPP procurement and could give legal power to structure PPPs with different payment models, depending on the most economically feasible approach.
- The use of arbitration as a means of dispute resolution in PPP projects should be further supported.
- The new PPP unit should harness and strengthen the existing expertise of the DEPP and the DRSC and its remit should specifically include co-ordination of the PPP project pipeline, provision of advice to municipalities, development of standard contracts, guidance and standard criteria for evaluating PPP project bids.
- Municipalities would benefit from the removal of ambiguities and legal difficulties in their powers to approve the award of PPP contracts.
- In the absence of a comprehensive specific PPP law, bidding processes should continue to be under the Concessions Law and other PPP procurement routes could be strengthened by continued development so that they continue to benefit from best international practice in terms of advertisement, tender documents, evaluation and contract award.
- The current practice of structuring risks so that each party is assuming risks which it is best placed to manage should continue.
- Moroccan law does not allow lenders to secure against publicly owned property (that is owned directly by the public authority). The government should consider ways in which the pledge over public assets could be extended. This has happened with the creation of two exceptions to this rule (i) applicable to certain public bodies and (ii) under Law 15-02 to harbour projects. Further exceptions to the general rule could be considered.

## 7. SYRIA

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 the Report.

### Overview

**Syria's economy is gradually improving as a result of some structural reforms; public finances remain under control.** During the last five years, Syria has undertaken a transition from a centrally planned economy to a relatively open social market economy. Structural reforms that are being introduced include replacing inefficient and costly price subsidies with targeted cash transfers, notably on energy, oil products and agricultural input subsidies, unifying the exchange rate and easing access to convertibility and transferability of domestic currencies in order to promote foreign investments. The reforms have helped to increase Syria's non-oil economy activity and to offset the effects of a decline in domestic oil reserves. The country's real GDP per capita has grown consistently in recent years (4.7% p.a. average over the last five years) and its fiscal position is under control despite high fiscal deficits (7.7% in 2008 and 5.5% in 2009). The Syrian government follows a policy of limiting public debt to a maximum of 30% of GDP. In 2009, total Debt/GDP was 21% (including Foreign Debt which represented 10% of GDP).

**Consistent economic growth and progressive market reforms have created a reasonably favourable platform for PPP investments in Syria, although a lot still needs to be done.**

Continued reforms will enable the country to attract high quality investments and to upgrade its public infrastructure. A PPP law is currently being drafted and is under review by key stakeholders in the government and the public administration. In addition, a Central PPP Unit (CPPPU) was established in 2009 in the Office of the Deputy Prime Minister for Economic Affairs as a first step to promote and develop a pipeline of viable PPP projects.

**Syria has limited track record to date with "project financed" PPPs but is moving up the learning curve quickly by appointing transaction advisors and learning from other countries' experiences.** Two foreign currency earning privately operated port developments (Latakia and Tartous), although not strictly PPPs (as defined in the Report), possess some features of a PPP, such as a revenue-sharing payment mechanism.<sup>10</sup> The true first PPP project in Syria (as defined in the Report) is currently being tendered by the Ministry of Electricity (MoE) with International Finance Corporation (IFC) as transaction advisor. The project, an Independent Power Producer ("IPP"), consists of the design, financing, construction, operation and maintenance of a 250MW thermal power plant at Al Nasserieh.

**The experience of the projects mentioned above demonstrates the importance of comprehensive pre-procurement preparation.** For instance, the prequalification for the Al Nasserieh IPP was

launched twice with only two companies pre-qualified in the first round, compared to 16 strong and reputable consortia and companies pre-qualified in the second round, after the project had undergone thorough preparation by the MoE with the assistance of IFC. Full professional and project management advice to guide the procuring authorities has proved to be highly beneficial and this should be encouraged, especially for the initial PPP projects.

**Capacity building within institutions and personnel across government will make future delivery of PPPs more effective and efficient.** Key decision-making and executive bodies need to develop a set of skills that understand PPP requirements as distinct from those of traditional public procurement. In this sense, it will be beneficial if the knowledge of PPPs that exists in the apex institutions such as the Prime Ministry will continue to filter through to line ministries and public entities, as is currently occurring at the Ministry of Electricity. First steps in this direction have already been taken, as shown for instance by United Nations Development Programme (UNDP) sponsored training programs that are currently underway. In addition, the University of Damascus, in coordination with the Prime Ministry, companies from the private sector, as well as the UNDP, is establishing a Training Centre within the University specifically to tackle this issue.

**Project selection and preparation should reflect the early stages of PPP development in Syria.** Projects identified as potential PPPs include an airport, a metro, highways, power, and waste water treatment projects. Some of the projects being prioritised are ambitious in size, complexity and risks, and will take many years to fully implement. In a first stage, the CPPPU may wish to encourage line ministries to prioritise the smaller and relatively simple "candidate" PPP projects. Such projects would build up expertise required for the procurement of larger and more complex projects. A viable PPP programme with certainty of deal flow will attract investor interest in the Syrian PPP market.

### Funding capacity and availability

**Until further banking sector reforms are implemented, it is unlikely that there will be a significant market in Syrian Pound (SYP) denominated lending to PPPs.** The financial sector remains highly state-controlled and regulated relative to most other countries in the Facility for Euro-Mediterranean Investment and Partnership (FEMIP) region. There has been only limited and recent public debt issuance and state-owned banks control approximately 76% of the market share. The majority of the private commercial banks are subsidiaries or affiliates of Middle Eastern banks. The Government could direct state-owned banks to lend to PPPs, but at the expense of credit availability for other sectors. The private commercial banking sector is characterised by strong balance sheets and highly liquid,<sup>11</sup> and could therefore become active in lending to PPP projects. However, privately owned banks struggle to compete with state-owned banks in long-term lending in SYP as, with no public debt markets, interest rates in SYP remain regulated rather than market determined.

<sup>10</sup> Due to the absence of a PPP law as of yet, the two ports were structured within the current legal framework of Syria, but aspects of a PPP transaction are present: public and private sector sharing in the revenue as well as the risks of the project, with the port authority as a partner in the terminal operations.

<sup>11</sup> Bank loans outstanding totalled approximately 62% of GDP as of December 2009, and the aggregate loan/deposit ratio was 68%, relatively low ratios compared to typical European commercial banking sector ratios. (Data Source: Central Bank of Syria website: Monetary Statistics 2010, Tables 1 and 7)

**Consequently, in the initial stages, private sector commercial bank lending to Syrian PPP projects is likely to remain relatively small and denominated in foreign currency.** Private commercial banks located in Syria have access to foreign currency deposits, directly or via their foreign parent company. Individually they are relatively small banks, so that their ability to provide significant amounts of long-term lending for a large PPP programme is likely to be severely constrained. In addition, international private commercial bank appetite for lending to Syrian PPP projects will be reduced in the short term as a result of Syria's limited track record in international bank or bond debt markets and the absence of a widely recognised international credit rating for Syria. Possible exceptions to this position may arise in foreign currency earning projects, or where a strong international sponsor is able to attract relationship banks. The Syrian government has recently launched two rounds of bond issuances and both have been met with significant interest from both public and private banking institutions, marking the potential appetite for such instruments in the country. In this respect, further developing domestic banks' lending capacity as well as expertise in PPP is a pre-condition for a successful long term PPP programme involving the local banking sector.

**The initial phase of Syria's PPP programme is likely to be debt-funded in foreign currency, primarily by a combination of International Financial Institutions (IFIs) and Export Credit Agencies (ECA)-guaranteed lending.** IFI and ECA activity in Syria is currently relatively low though increasing. The European Investment Bank (EIB) is the largest IFI lender to Syria. In addition to lending and capacity building by the European Union Delegation to Syria, other institutions include the French AFD (Agence Française de Développement) and the German KfW (Kreditanstalt für Wiederaufbau) – KfW mostly in the water and microfinance sectors.

**Continued banking sector reforms by the Central Bank of Syria would contribute to increased funding capacity for the PPP programme.** In the past few years, the Central Bank of Syria started to reduce restrictions on foreign-currency transactions in order to facilitate foreign direct investment. In July 2008, the Central Bank issued Treasury bills on a trial basis in an attempt to gradually open the financial market. The Ministry of Finance has begun issuing Treasury bills to help to establish a local bond market, which would increase lending capacity. These measures should also help to develop and modernise the banking sector.

**Syrian Holding Companies can equally be expected to play an active role in the development of PPP in Syria.** The five existing Holding Companies<sup>12</sup> all plan to be active in bidding and developing infrastructure projects, and are likely to be major providers of project equity for Syrian PPP projects. As a result, in some procurements, the key selection of contractors and operators will be made by Holding Companies when they select partners, rather than by the procuring authority at the preferred bidder selection stage. In this way, the Holding Companies may have a quasi- authority role and the government may wish to test this approach prior to procuring some PPPs. Also, in cases where a Holding Company has already signed an early stage Memorandum of Understanding (MoU) in respect of a project or

sector, de facto control of procurement is transferred to the Holding Company. Care should be taken to ensure that the role of the Holding Company does not deter other participants and that procurements are run on a level playing field.

### *Legal and regulatory framework*

**Whilst relatively developed, certain aspects of the Syrian legal system would benefit from targeted reforms in order to increase clarity and time efficiency in legal processes.** Syria has foundations in a civil law tradition. Whilst written legislative text is available, the law is relatively untested, court processes tend to be lengthy and judges do not have specific expertise in PPP or complex procurement issues. Regarding dispute resolution procedures, as is common in most PPPs, arbitration is likely to be a more viable method of resolving PPP disputes. In Syria, parties are free to refer a matter to international arbitration under their own contractual arrangements and this is likely to be the case at least in the medium term.

**Developing the legal framework to cater more specifically for PPPs will enhance chances of success.** The current legislative framework is not well suited to PPP procurement. Whilst partnerships between the public and the private sectors have been achieved within the existing legal environment, notably in the ports sector, they have required a number of exceptions and specific ratification processes that cannot form the base for a wide and prolonged programme of infrastructure investments. Therefore, considerable development is needed (and is underway) to provide adequate comfort to private developers and lenders that their projects are supported by a sound legal framework.

**The enactment of a new PPP law, currently in draft form, is expected to considerably strengthen the PPP legal framework in Syria.** This new PPP law will address key issues, such as tendering procedures, institutional framework, dispute resolution mechanisms (including allowing international arbitration) and availability of state support. However, the right balance should be struck in the final version of the law in order to provide a degree of flexibility while at the same time spelling out key aspects of the law so as to ensure clarity and enforceability on the part of the judiciary. The new PPP law will have greater chances of success if it allows sufficient flexibility to resolve concrete issues depending upon the project and the sector, while setting a clear framework regarding general legal, procurement, contractual and institutional issues.

### *Institutional issues*

**The Draft PPP Law sets out comprehensive institutional arrangements for project identification, approval, procurement and monitoring.** A PPP Council would be established within the Prime Ministry, with representation from other ministries. Specifically, the Economic Committee comprised of the Deputy Prime Minister and several other key Ministers, will carry out the role of the PPP Council in Syria. The draft law envisages the creation of a PPP Bureau to provide technical support to the PPP Council and to the line ministries. This PPP Bureau would replace the Central PPP Unit (CPPPU) already in existence. Nodal PPP Units would also be established in the line ministries. This could be an effective approach to creating the

<sup>12</sup> The Syrian Holding Companies are: Syrian Qatari Holding (SQH); Cham Holding (currently sponsoring the training centre in coordination with the University of Damascus); Construction Products Holding Co; Kuwait Syria Holding Company; and Souria Holding.

necessary institutional infrastructure but care should be taken to avoid overlapping of responsibilities among key institutions involved in PPPs.

**A key institutional challenge for Syria will be to make this well-structured organisational system work in practice, as it is yet untested.** It is particularly important that funding should be secured to enable the technical support system to be recruited and developed to increase capacity and know-how within the key institutions. In particular, know-how must be developed across those institutions interested in pursuing PPP.

**Experience in other countries suggests that careful attention will need to be given to project selection and design.** Before going to market, projects must be supported by strong business cases and detailed documentation. Comprehensive project scoping and design will make the procurement process smoother and provide greater clarity to bidders. Transaction advisers and technical consultants appointed by the procuring authority have an important role to play and authorities should work with their advisers from an early stage in the project lifecycle. Current limited availability of funding, of both equity and debt, has to be carefully considered in the planning exercise as the size of each project and the cumulated volumes can significantly increase the risk of not reaching financial close. Furthermore, as sovereign credit support to procuring public entities is likely to be required, co-ordination at central level, with direct involvement of the Ministry of Finance, is to be encouraged.

### **Bidding process**

**The new PPP Law is expected to introduce bidding procedures specific to PPPs, overriding existing procurement legislation that is not well suited.** The various procedures under the Public Procurement Code were initially designed for the procurement of goods and are therefore not appropriate for the procurement of complex works and services contracts. The current draft PPP Law on the contrary, refers to restricted, negotiated and competitive dialogue procedures, which are commonly used in countries with developed PPP practices. The detail of these procedures will be set out in separate executive orders which will need to be carefully considered in order to ensure the core principles of competition, fairness and transparency. By issuing the executive orders at the same time or within quick succession of the new PPP Law, Syrian authorities will ensure that projects can be rapidly procured in the spirit of the new Law.

### **Contract design, risk allocation and financial terms**

**Syria has a limited track record in PPPs to date and is hiring international consultants to carry pilot project forward as well as learning from other countries' experiences.** Procuring authorities should continue to work closely with the newly established PPP units and internationally experienced advisers to formulate a basis of risk allocation. Authorities would normally aim to ensure the output or service is delivered according to specifications and the PPP contract should therefore create sufficient incentives for the private sector to deliver in a cost efficient manner. An internationally proven contractual structure that has already delivered positive results

to contracting authorities in the region will encourage top private sector companies to participate in the project tendering. 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 maximizing cost efficiency and value for money.

**When issuing invitations to tender, the authority and Government should clarify early in the process its position towards allocation macroeconomic risks such as foreign exchange rate and inflation.** The optimal risk allocation generates the best value for money for the authority in a PPP. Project affordability and cost efficiency for the authority are adversely affected if the Project Special Purpose Vehicle (SPV) has to bear macroeconomic or policy risks which it cannot appropriately control or mitigate. The private sector will not be able to cover risks of adverse movements in financial variables which it cannot hedge or pass through to contractors and will therefore include a premium against such risks in its pricing. Moreover, if such risks are misallocated, either funding will not be available, or the required debt service cover ratios and equity investment returns will be so high as to make the project unaffordable.

**The optimal allocation of the exchange rate risk depends largely on availability of foreign currency hedging and the country's exchange rate policy.** In Syria, as in most FEMIP countries, the ability to hedge against exchange rate movements is limited by the relatively small and fragmented financial sector. Furthermore, as the public sector controls the exchange rate movements to some extent, with the Syrian pound managed by the Central Bank and loosely pegged to the IMF's special drawing rights since October 2007, then from an optimal risk allocation perspective, it will be necessary and more cost efficient for the public sector to assume this risk. Contractually, exchange rate risk can be covered by the public sector in the payment mechanism (by indexing local currency payments to exchange rate variations or by directly paying the foreign portion of the costs directly in foreign currency).

**Inflation is a macroeconomic risk that is generally best covered by the public sector in the PPP contract's payment mechanism.** Consumer price inflation tends to be volatile in Syria. As it is a macroeconomic risk influenced by economic policy, inflation is more easily controlled by the public sector than private companies. Among the different strategies to address this risk, there is regular benchmarking of project costs (particularly useful when inflation is volatile) as well as general price inflation adjustments.

**In projects with demand risk authorities should be realistic in their forecasts and consider complementing user revenues with availability payments.** Transport PPP projects often use toll charges or fares to generate revenue. There is insufficient track record or comparator projects in Syria for forecasting such demand, so international funders will be very cautious when assessing such projects for investment. As it is likely that investors will not be willing in the medium term to assume traffic risks, procuring such projects on an availability basis may have a greater likelihood of success and be more cost-efficient.

When demand risk is assumed by the public sector through availability payments, it is likely that the payment obligations of the procuring authority will need to be backed by a sovereign guarantee. A government guarantee will be needed as there is no track record of independent borrowing by public sector bodies in Syria other than the state. The guarantee is necessary not only as a promise of ultimate payment, but also of timely payment: project SPVs, which have no autonomous resources other than the project assets, require timely payment to provide the services and to ensure a regular cash flow to meet their debt service obligation and to satisfy expectations of equity return.

### **PPP / project finance investment readiness for lenders and investors**

**The regulation of foreign investment in Syria has moved in recent years towards a more liberalised regime, although further reforms in key areas are still needed.** Even though regulation of foreign investments is now less stringent than in the past, current regulations do continue to pose some difficulties. Syria maintains a form of currency control system, which could affect the ability of Project SPVs to repatriate project revenues outside of 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 may cause an issue in respect of honouring debt service obligations (interest and principal) and the return on equity, both dividends and capital. In addition, the current restrictions relating to repatriation of capital, interest and profits only at annual intervals are likely to deter foreign investment from contractors or lenders, which will be needed to support Syria's ambitious PPP programme. This issue is expected to be adequately addressed in the draft PPP law in order to exempt SPVs from several of these restrictions. Particularly for repayment of loans and related interests, common practice is that transfers outside of money outside of Syria are allowed on the basis of what is stipulated in the loan agreements, so it can be quarterly or semi-annual or whatever is agreed in the respective finance contract and notified to Central Bank.

**Tax and accounting regulations can have a substantial effect on the price paid by the public sector and/or user for the service or output.** Tax incentives to investments, provided they are well targeted, can have a considerable impact on the price that investors will require the public sector to pay for the services or outputs deriving from PPP contracts; as a consequence, it is in the interests of the government to carefully compare the reduced revenue from tax incentives with the lower price they would have to pay during operational period. The Syrian draft PPP law recommends granting SPVs certain tax incentives or exemptions. Furthermore, 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.

**Improving the range of protections available to lenders, notably lenders' step-in rights, will improve the overall business environment for project financing in Syria.** It is not common in Syria for lenders to be granted a direct agreement providing step-in rights. The new PPP law is expected to specifically create the principle of step-in rights, such that banks can protect their investment by stepping into the project in the event that the Project SPV defaults. This will enable the lenders

to rescue the project and, if necessary, transfer the project to a suitable substitute constructor or operator.

**As more PPPs are procured in Syria, the security package will more closely mirror commonly used securities for PPPs.** At present, the most common method of security for Syrian financial institutions is placing a lien on property. However, the new PPP Draft law is expected to allow PPP contracts to have the following security conditions: liens and securities on the income stream (ie. on project agreements) and shares of the Project Company as well as mortgages on assets. Although mortgages on assets have been explicitly granted in the draft PPP Law, the mortgaging of government owned land in particular has been excluded.

### **CONCLUSION – KEY RECOMMENDATIONS**

- Syria has limited experience in PPPs to date (as they are defined in the Report) but has shown commitment to learn from other countries' experience and to engage experienced transaction advisors to assist developing individual projects. In this sense, Syria has started quite high in the learning curve.
- The new PPP Law is expected to comprehensively address key legal, regulatory and institutional issues relating to PPPs. The Draft PPP Law sets out comprehensive institutional arrangements for project identification, approval, procurement and monitoring. It is important however that the level of detail does not work to the detriment of a flexible project by project approach when this might be necessary.
- The scoping, economic feasibility analysis and procurement of projects needs to be carried out to the standard required by the best practice guidelines approved by IFIs and ECAs to ensure that Syrian PPPs have maximum opportunity to access these essential funding sources.
- Funding should be secured to enable the PPP Bureau and the line ministry's Nodal PPP Units to recruit experienced staff and to function effectively. Funding must also be made available to support capacity building across the institutions involved in PPP more generally.
- Careful attention should be given to (i) developing sound business cases during project preparation and (ii) detailed tenders and supporting documentation at the request for proposals stage, in order to build confidence in the developing PPP market.
- The CPPPU may wish to encourage authorities and ministries to propose PPP "candidate" projects that are relatively small in scale and simple to implement, rather than excessively large or complex projects. This would help develop a track record of successfully procured projects early in the process. One example of a project with reasonable size and complexity is the Al Nasserieh IPP currently being tendered.
- Contract structure and risk allocation should be designed so that each party is assuming risks which it can best manage. When issuing invitations to tender, the authority should clarify the risks it is prepared to assume.

- The new PPP law should specifically create the principle of step-in rights, so that banks can protect their investment by stepping into the project operations in the event that the Project SPV defaults. This will enable the lenders to rescue the project and, if necessary, transfer the project to a suitable substitute.
- Sovereign guarantees of PPP payment obligations should be considered, particularly at the beginning.
- The country is undergoing gradual liberalisation from a centrally planned economy to a social market economy. Further liberalisation of the banking sector and elimination of some remaining barriers to foreign investment will attract strong private sector companies to invest in the Syrian PPP programme. An external credit rating of the country by a well reputed rating agency would also help to attract investors and lenders to Syria's upcoming PPP projects.

## 8. TUNISIA<sup>13</sup>

### Overview

**Despite recent political turmoil, relatively stable macroeconomic conditions provide a solid platform for PPP investment in Tunisia.** The country presents a reasonable fiscal deficit (3% of gross domestic product (GDP) in 2009), a controlled external debt (17% of GDP), and consistent economic growth (4% real GDP). Moreover, Tunisia's investment grade status provides the government with access to a diversified range of domestic and foreign funding sources. All together, these conditions give the government capacity to maintain spending and to commit plausibly to PPP payments.

**In addition, Tunisia's experience with concession contracts offers a valuable foundation to develop PPP initiatives.** The concessions in Tunisia that are procured under the Concession Law can be considered as PPPs for the purposes of the Report, as they involve a partnership between the public and private sector pursuant to a long-term contractual agreement and are backed by project financing. The country has successfully implemented PPP concessions in different sectors such as water (desalination plants), electricity generation and airports.

**By leveraging current experience, the development of a formal PPP policy and the establishment of a PPP centre of expertise could assure a coordinated and effective implementation of PPP programmes.** A PPP framework including institutions has been established to manage digital economy-related PPP projects tasked with upgrading Tunisia's ICT and telecommunications infrastructure (the "Digital Economy Initiative" or DEI). Following the success of many concession projects and of the DEI, Tunisia could bring consistency and efficiency in the implementation of PPP schemes by setting policy goals and priorities regarding the desired impact of PPP at the sector and local government level. In addition, identification of priority sectors and announcing a pipeline of projects would enhance the credibility of the PPP policy. The establishment of a centre of expertise could then assure the sharing of best practices and lessons learned, as well as monitoring and support for the implementation of the set PPP policies.

### Funding capacity and availability

**The implementation of PPP programmes is constrained by the banking sector's long-term lending capacity and could therefore benefit from being complemented through IFI and ECA-backed financing.**<sup>14</sup> Despite sufficient liquidity and solvency, domestic banks lack the capital base to provide long term financing for large infrastructure projects. In this context, international financing in foreign currency, especially from IFIs and/or financing or guarantees by ECAs, emerge as critical contributors to the expansion of PPP initiatives in Tunisia, by providing long term foreign currency lending.

**PPP programmes implementation is also affected by limited expertise in PPP lending by the domestic banking sector, which could be enhanced by targeted training and co-financings with international lenders.** The Tunisian banking sector is small and fragmented relative to the size of the economy and has limited PPP experience. With the exception of local branches of international banks, the banking sector in Tunisia has not been actively engaged in PPP lending, and is therefore lacking the expertise other financial institutions have developed in promoting PPP projects. A series of targeted seminars and briefings organized, among others, by international banks or IFIs on opportunities in the PPP market, could serve to increase local understanding and appetite for PPP lending. In addition, Tunisian local banks could provide some finance for PPPs together with international financial institutions, thus gaining valuable "on the job" training.

### Legal and regulatory framework

**Tunisia follows a civil code legal system albeit one that places emphasis on court precedent as well, which serves as a general framework for concession laws.** Tunisian law comprises formal sources such as legislation, regulations and customs, and interpretive sources such as case law. Both legislative text and case law are published, widely available and in written form. A hierarchy of courts, the availability of written law and published decisions, the right to appeal and the persuasive nature of superior court judgments, are preconditions for an impartial and consistent application of the law. Within this framework, and in the absence of a specific PPP Law, the Concession Law governs procurement of all PPP concession projects in Tunisia, except where there is a sector-specific law, as in the case of energy, sanitation, telecommunications and the digital economy.

**Although the existing Concession Law is in practice applied to PPP projects, it would be beneficial to adapt the legal and institutional framework to the specificity of PPPs.** The Concession Law, despite being a successful framework for private sector engagement, does not provide a formal platform for project financed PPP where the public sector takes demand risk through the use of availability payment funding. The "unique user" interpretation of the Concession Law, through which the conceding authority pays the concessionaire directly, has allowed the adaptation of the concession model to project financed PPP. Nevertheless, investors, especially those willing to commit to long term PPP, would be reassured were such an interpretation to be formalised so that the power of public authorities to sanction and operate such projects is robust. Preferably this would be done by being enshrined in a legal instrument with preminent status in Tunisian law (such as a legislative act or decree).

**The Tunisian government prefers disputes to be resolved in the Tunisian courts but the parties may agree to international arbitration.** The ability of the court system to deal with complex PPP disputes could be strengthened but is a suitable mechanism for resolving disputes. Common practice in PPP projects is to agree the mechanism for dispute resolution in the

<sup>13</sup> Recent events in Tunisia (January 2011) have contributed to increased political instability but as at March 2011 the country maintains its investment grade rating and relative macroeconomic stability.

<sup>14</sup> IFI = International Financial Institutions; ECA = Export Credit Agencies.

long term contract between the public and private sector. Foreign arbitral awards are enforceable in Tunisia under the New York Convention on the Recognition and Enforcement of Arbitral Awards. Where arbitration or other forms of dispute resolution have not been agreed, disputes between a public authority and a project company/concessionaire will be subject to the jurisdiction of the administrative courts. This creates a potential complexity because disputes between the concessionaire and a member of its supply chain will normally be subject to the jurisdiction of the commercial courts, but if a commercial dispute has arisen in the contract of a public service by the concessionaire the commercial dispute can be also heard at the administrative courts.

### ***Institutional issues***

**The central government is highly involved in the development of PPP projects which ensures consistency but could also create capacity bottlenecks if a large PPP programme is developed.** Actors at the centre of government include the Office of the Prime Minister (key decision-making body), the Ministry of Finance (responsible for PPP procurement issues), and the Concessions Unit (regulation and supervision of concessions). Project selection is driven mostly by line ministries, although local authorities can also propose PPP projects and concessions. The assessment of projects' affordability and feasibility are normally undertaken by procuring authorities and their advisers, in particular project sponsors from the line ministries. The threshold on investment affordability by sector is set annually by the government for each line ministry, taking into consideration a five year plan. The budget is mainly allocated by the Ministry of Finance. At the local level, regional governorates and local authorities can conclude concession contracts subject to the final approval of the Minister of the Interior.

**The development of budget-linked, multi-annual infrastructure plans has improved Tunisia's PPP market, although the robustness of its project pipelines could be enhanced.** Both strategic and annual development plans have contributed to better policy formulation, and to information access by investors. Nevertheless, these initiatives have often been too broad, lacking sufficient details on funding sources and anticipated methods of procurement. Improving the quality of information provided in those instruments will have significant impact in the formulation of PPP policies and PPP market attractiveness. Investors are more likely to make a long term strategic commitment to the Tunisian PPP programme if the scale and shape of the investment programme is published.

**The development of a PPP centre of expertise would serve to provide know-how and leadership in the design and implementation of PPP programmes.** In order to maximise existing resources and increase PPP expertise, the Concession Unit could be developed into a PPP agency. By playing an active role in the procurement of projects, the Concessions Unit could develop valuable expertise in PPP procurement and implementation. However, it would be advisable that its expertise be strengthened through the recruitment of a core team of experts. Such expertise could then support the line ministries, local authorities and other state organisations involved in procurement of PPP projects. The role of any PPP centre in relation to other interested parties of government would need to be clarified.

### ***Bidding process***

**The recently issued Concession Procurement Decree has provided Tunisia with a modern procurement regime, which if applied correctly should ensure a fair, transparent, and competitive bidding process.** Among the most important provisions of Decree 2010-1753 are the establishment of a dialogue between the public authorities and bidders, the separation of technical and financial bids, and the creation of special committees responsible for different aspects of the tender process.

**A certain degree of dialogue with bidders, as is allowed in Tunisia's procurement law, can be beneficial for large PPP projects provided it is handled transparently.** The Concession Procurement Decree allows bidders to express their concerns on the contractual documents and to propose amendments. Whilst there is not an explicit reference to dialogue or negotiation during the tender phase, authorities may use this framework to promote the exchange of views and opinions among competitors and authorities that can be beneficial in helping to better define the project. As long as the dialogue does not materially increase the costs of bidding and is handled transparently (for example, by spreading information to all bidders equally), it can be a powerful tool to drive cost-efficiency, value for money and attain optimal solutions for complex projects. In other markets, such as the European Union, pro-active engagement of this type has proven to be a means of fine-tuning and optimising solutions for the delivery of the project.

**The separation of technical and financial bids by the Concession Procurement Decree could undermine technical aspects of an offer and adversely affect overall value for money.** The process of separating the evaluation of the technical from the financial offers could serve to provide a technically sound bid, which is also financially attractive. Nevertheless, there is a risk that there will be a pass/fail evaluation in relation to the technical offers, followed by a lowest price evaluation of the financial offer. Where the "lowest price" is the over-riding evaluation criteria, there is a risk that the technical evaluation becomes a mere filter with the overall result that once the technical solution has achieved the requisite score to enable the financial proposal to be considered, the financial proposal is the effective determinant. In order to prevent those unbalances, authorities should seek to ensure that appropriate objective criteria and weightings are given to different components of the technical evaluation.

### ***Contract design, risk allocation and financial terms***

**Although under the concession law "substantial" risk has to be allocated to the private sector, in current PPP transactions risk allocation has been gradually tailored to the project and risks are allocated to the parties best placed to deal with them.**

Under the concession model, demand risk has been generally allocated to the private sector as Article 4 of the Concession Law provides that the concessionaire shall bear a "substantial part of the risks" associated with performing the contract. In this context, a project-based risk allocation becomes crucial to securing investors' interest in the project.

**In the projects financed to date, allocation of the main risks has in practice followed international norms, albeit without a standard template.** Tunisian law permits extensions of time available to the construction period as well as extensions to the overall concession period although aspects of the law are very prescriptive. Termination and compensation on termination also generally follows standard practice and is regulated in each individual contract. The Concession Law does not provide for compensation, although sector specific laws in the sanitation and civil aviation sectors provide that compensation should reflect the direct and material loss suffered by the concessionaire. Liquidated damages (the standard protection against delays in construction) are permitted and as occurs in civil law jurisdictions elsewhere, the courts place an emphasis on the fairness of the agreed damages, so that the damages stipulated in the construction contract may be increased or reduced in court. The public sector has wide powers unilaterally to modify the contract in the protection of the public service and user interests. However, where this power is exercised, the concessionaire will be entitled to compensation to restore the financial balance of the contract. There is at present no standard template for Tunisian PPPs; a template with general principles would provide greater clarity on key risks which the public sector is prepared to assume at an early stage and this would lower both costs and negotiation timing.

**When issuing invitations to tender, the authority should clarify early in the process its position on allocation of macroeconomic risks (exchange rate and inflation), in order to maximise project cost-efficiency.** Project affordability and value for money for the authority are adversely affected if the Project SPV has to bear macroeconomic or policy risks which it cannot control or mitigate. In a context of macroeconomic or policy uncertainty, a Project SPV is forced to buffer against such risks in its pricing. 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. In order to maximise the value of PPPs for Tunisia, procuring authorities need to adapt risk allocation to the characteristics of each project.

**The optimal allocation of exchange rate risk will depend on whether the Project SPV has obtained Tunisian Dinars (TND) or foreign currency funding, the availability of foreign currency hedging and the country's exchange rate policy.** Rather than peg or track the TND exchange rate to foreign currencies as in some other Mediterranean partner countries, the Central Bank of Tunisia (CBT) conducts a flexible exchange policy. In Tunisia, as in most Mediterranean partner countries, the ability to hedge against TND exchange rate movements is limited, although the CBT makes a range of currency risk hedging instruments - such as futures, options and swaps - available to economic entities. This makes it difficult for foreign investors to hedge against exchange rate risk. In this event, the private sector partner (and its lenders and sponsors) generally assumes a wider range of possible risk scenarios which it prices into its offer, if it is able to provide an offer at all. It also makes sense (from an optimum risk allocation perspective) for the public sector to assume exchange rate risk where funding is obtained in foreign currency as this is not a risk that can be managed by the private sector. Contractually, exchange rate risk when borne by the public sector is covered through the payment mechanism of the long term PPP contract by indexing local currency payments to exchange rate variations or by directly paying the foreign portion of the costs directly in foreign currency.

**Relatively volatile price inflation in Tunisia presents risks for sponsors and investors, especially in long-term PPP projects and needs to be addressed through contract provisions.** Planning, pricing and costing risks need to be addressed in the PPP contract payment mechanisms. In Tunisia, when inflation risk is assumed by the public sector, this is normally covered contractually through indexation (over consumer or producer price indices, for instance). Regular benchmarking of project costs presents advantages vis-à-vis a general price inflation adjustment particularly because of the volatility of inflation rates.

#### **PPP / project finance investment readiness for lenders and investors**

**The level of regulation of foreign investment has eased considerably in recent years, providing investors with a wide range of protective measures.** The Concession Law allows foreigners to participate in concessions without restrictions, including the guarantee of repatriation of their investment (including capital, capital gains and dividends). Moreover, under the freedom of investment regime, no prior authorisation is required for foreign investors to carry out business in Tunisia. The security package available to lenders follows standard international practice and includes measures such as charges, mortgages, step-in rights, direct agreements (between the lenders and the authority), and pledges over shares and receivables.

**Although Tunisia's corporate tax regime is generally favourable for business, several tax and accounting rules discourage SPVs from having an efficient capital structure.** As a result, both the after-tax cost of capital for SPVs and the PPP concession payments become more expensive. Unless the impact of taxation is expressly considered when evaluating project bids, distorting tax rules will encourage bidders to use less debt, i.e. by using more expensive equity relative to debt, further increasing the cost of capital. Furthermore, the adoption of "finance debtor" accounting and tax treatment for PPP projects could help eliminate the negative impact of some tax rules and make project more affordable. Finance debtor accounting enables accounting profit to match project cashflows after debt service much more closely, avoiding many of the inefficiencies caused by fixed asset accounting in PPP projects. Finance debtor accounting is currently not permissible under Tunisian accounting standards, requiring a change in tax law in order to be used for PPP purposes.

#### **CONCLUSION – KEY RECOMMENDATIONS**

- Tunisia's macroeconomic stability provides an adequate platform from which to launch medium and large infrastructure projects such as PPPs.
- Tunisia's experience with concession contracts which are project financed offers valuable experience in PPP, though it would be desirable for the country to create a comprehensive PPP policy and framework.
- A central PPP unit stemming from the Concession Unit could enhance expertise in the public sector and line ministries to maximise the effectiveness of a PPP policy. A credible pipeline of PPP projects would further enhance credibility and investor appetite for these projects.

- Local financing is constrained by the fragmented financial sector and limited experience in large PPP projects. Co-financing with IFIs and targeted training sessions could contribute to increasing awareness and expertise on PPPs.
- The legal framework based on concessions has proven adequate for PPP, although a PPP Law and setting out general principles of risk allocation could contribute to lower negotiation times and greater cost effectiveness (or value for money) and create an environment more attractive to foreign investors.
- Inflation and exchange rate risks are generally better covered by the public sector, as these are not risks that can be properly managed by the private sector. If the private sector were asked to cover this risk, it would be priced into the tariff to be paid by the public sector for the service/output (making the project more expensive) and it could also potentially prevent financing.

## 9. WEST BANK<sup>15</sup>

### Overview

**An unstable political and fiscal framework puts the West Bank in a difficult position to develop Public-Private Partnership projects (PPP).** Despite investment-friendly policies implemented by the Palestinian Authority, the lack of full control by the government over some parts of the territory and the absence of fully fledged statehood coupled with restrictions on parts of its territory, make political risk the key investor concern for developing PPPs in the West Bank. In addition, its weak economy, which remains vulnerable to political developments and dependent on grants from the international community, does not provide sufficient long-term fiscal sustainability for PPP projects.

**However, in the medium to long-term, Palestinian Authority's policies, and donors' support is expected to increase and expand private participation in infrastructure (PPI).** There is potential for further private sector participation beyond the current small-scale PPI in the telecom sector. Much of this is expected to be facilitated through the Palestinian Investment Fund (PIF), particularly in key sectors, such as waste and water management and the energy sector. In the medium to long-term, the need to bridge a huge infrastructure gap and enhance infrastructure, could also lead to the development of small-scale PPP pilot projects, particularly through blending of grants and loans.

**The development of a coherent infrastructure plan could foster a clear sequencing of PPI projects.** Developing a pipeline of well-designed projects could leverage PIF and international financial institutions' funding and catalyze private investment in the medium-term, mainly through regional investment funds. The partnership of the PIF with International Financial Institutions (IFIs) in the design and implementation of such program may also strengthen the PIF's capacity and contribute to the prioritization of viable and realistically achievable projects. These could provide the basis for future PPP project development when investment conditions are met.

**PPP pilot projects could be developed if stability and investment climate improve.** Given the current political and macroeconomic context, the private sector is unable to finance, build and operate projects without IFIs and donors assuming most of (if not all) the risks (through concessional financing, for instance). Therefore projects currently undertaken in the Palestinian Territories do not fall within the definition of PPPs used in the Report. A viable sequencing of PPP investments from telecoms to energy as well as water and waste management sectors, may simultaneously allow less reliability on IFI/concessional funding and lead to a gradual transfer of risks to the private sector. In addition to improving political and macroeconomic stability, institutional strengthening, increased funding capacity and simplification of the legal framework, could lead to the development of targeted PPP projects in the medium term.

### Funding capacity and availability

**The Palestinian Authority (PA) has little if any autonomous borrowing capacity due to its dependence on the international community to sustain its fiscal stance.** Despite growth (real GDP growth of around 7% p.a. in 2009 and 2010), the economy remains weak, vulnerable to political developments and dependent on grants from the international community for its fiscal stability. The PA follows general economic policies outlined in the Palestinian Reform and Development Plan (PRDP) 2008-10 aiming, among others, at fiscal consolidation and improved infrastructure through private-sector investment. An extension of the PRDP, originally funded by pledges made at the 2008 Paris donor conference, is currently being prepared. PA's ability to progress economically however, is constrained by the political situation. The PA will continue to depend heavily on donor support in the medium term, which could be further targeted specifically to development projects.

**Commercial bank lending capacity for project financing is very limited, both from Palestinian banks and from foreign commercial banks.** All the financing currently available on the market is short term. The experience of the Wataniya Telecom financing – the nearest equivalent to PPP financing to date in the West Bank – indicates that even locally active banks require credit insurance or export credit guarantees for lending to long term projects located in the West Bank.

**Infrastructure funding in the West Bank is likely to continue to be predominantly based on grants.** In the foreseeable future, IFIs, Export Credit Agency (ECAs) and political risk insurers are likely to be the only long-term funders or collateral providers for any PPP project that may be developed in the West Bank. Commercial bank appetite for long-term lending to West Bank projects would require both a significant easing in political tensions and on restrictions on the West Bank economy. For any potential PPP projects under which payments would be made by the PA (e.g. through availability payments), the PA's fiscal sustainability would need to improve and move away from reliance on grant funding.

**The Palestinian Investment Fund (PIF) could provide equity and act as catalyst for equity investment in infrastructure including PPPs in the medium-term.** Wholly owned by the PA but independently managed, the PIF's aim is to strengthen the local economy through key strategic investments. It is currently leading an ambitious five year investment program amounting to USD 4 billion. Target projects include construction of a 140MW-200MW power plant in the northern West Bank, under an IPP scheme, with construction and commissioning expected to take between 24 and 30 months, after the required clearances have been secured. If the PIF is to become a significant source of equity for PPPs, it would need to be kept independent from specific bidders until the procuring authority selects the preferred bidder, in order to ensure a competitive and transparent procurement process.

<sup>15</sup> Note on the usage of terminology in the Report: Whilst the Report covers the West Bank (and the economic analysis throughout the Report concerns exclusively the West Bank unless otherwise stated), the terms Palestine/Palestinian refer to the territories covering Gaza and the West Bank in the context of the activities of, or the institutions operated by, the Palestinian Authorities.

### **Legal and regulatory framework**

**The lack of full territorial control by the PA affects the enforceability of its legal framework for infrastructure development.** The legal framework applicable to infrastructure and more generally, the application of Palestinian law, varies in accordance to the level of control that the PA exercises over each area. This, in addition to the lack of full PA statehood, affects the enforcement of the legal framework for infrastructure.

**Despite difficulties and the complexity of the PA's current legal framework, authorities do have powers to enter into PPP projects.** An example is the power project mentioned above that, although not a PPP in strictu sensu, it is a project led by the PA.

**The Disputes can be settled by international arbitration in the PA, although the court system is not well equipped to deal with complex PPP contracts.** Even though international arbitration is possible, arbitration awards are difficult to enforce in practice. The absence of bilateral treaties means that foreign investors have less protection against government actions.

### **Institutional capacity**

**The decision making process for infrastructure development in the PA is complex due to the political situation which inevitably leads to delays in implementation that may discourage investors.** The Presidency has been involved in the procurement of infrastructure projects (such as telecommunications) and the Ministry of Public Works plays a key role in initiating and overseeing the procurement of projects including those falling within the responsibility of local authorities (such as utilities). Given the current political circumstances, project identification within the Palestinian Territories requires coordination with the Israeli authorities and prior authorization by Israel of certain import of materials and equipment. Key actors include the Israeli Civil Administration (ICA) and the State of Israel, which affect the development of infrastructure in the Palestinian Territories.

**Weaknesses in institutional capacity for infrastructure development have been successfully tackled through technical-assistance, the level of which it would be desirable to increase.** Most infrastructure and technical assistance projects are initiated, funded and normally executed by bilateral agencies and/or multilateral financial institutions in close cooperation from the PA. Notable progress has been made under the "European Neighbourhood Policy" in public finance management and in other fields (for example with the introduction of computerised tax procedures and decentralised internal auditing); such success could be replicated in through similar initiatives to increase capacity in infrastructure development.

**The PA could benefit from closer cooperation with institutions or agencies in neighbouring FEMIP countries with experience in infrastructure and PPP development.** Knowledge exchange programmes with such institutions could have a positive effect on the PA's ability to carry out successful PPP pilot projects in the future. Lessons learned by peer countries could foster technical expertise, which could then be centralized in a specialized unit dealing with large infrastructure projects.

### **Bidding Process**

**The Tender Law permits the procurement of major infrastructure through open, restricted or negotiated procedures.** Whilst existing tender procedures are generally suitable for processing major infrastructure, because much infrastructure procurement is undertaken by foreign donors (in partnership with the PA), often the applicable procurement procedures of the donor countries are followed. In the case of bilateral aid, this means that procurement is at times subject to country of origin specifications, thus reducing international competition.

**Bidding processes and evaluation criteria broadly follow international norms.** Bids are assessed by a standing Central Tenders Committee and whilst there is no standard procedure for contesting decisions, they are susceptible to judicial review.

### **Contract design risk allocation and financial terms**

**Due largely to the political situation, the PA does not currently have experience in the field of PPP.** Except for the privatisation of the telecom sector, which may be considered similar to PPPs since it involves the financing of public infrastructure by the private sector, the PA has not engaged in a PPP that is project financed. If, after detailed analysis, PPP is viewed as the best mechanism to partially finance public infrastructure in the Palestinian Territories, a whole framework for PPPs would need to be developed. Such framework includes, among others, risk allocation mechanisms through contract design and the development of typical financial terms. This could only be achieved through strong technical assistance funded by donors.

**The general law and policy within the PA would allow for a correct allocation of risks, with the support of the donor community.** Whilst PPP have not been tested in practice, there is no reason to believe that appropriate structures and terms could not be developed in the future, after the political situation improves. The underlying issue of political risk would need to be mitigated in any event, with the support of governmental and multilateral organisations prepared to absorb substantial elements of the political risk.

### **Opportunities and expectation**

**The economic outlook of the PA will depend on easing of the political situation and continued donor support.** The ability of the PA to eventually fund some of their needed infrastructure projects using PPPs is constrained in the medium term by political instability. Economic growth will depend on improvement in the political situation and a reduction in the currently imposed trade barriers. It is likely that the PA will continue to rely heavily on donor support, which could be strengthened and targeted more directly to infrastructure development projects. In the future, increased private sector participation through PPPs or other contractual structures, will be a key element for economic growth.

**CONCLUSION – KEY RECOMMENDATIONS**

- The political situation is a key constraint to infrastructure development in the PA. Continued efforts to improve political stability, regional peace and further progress towards statehood which lead to improvements in the socio economic conditions of PA's population, would foster a more favourable climate for investments.
- Private sector involvement through PPPs for example, has the potential to improve infrastructure in the Palestinian Territories. The PA should consider the optimal institutional collaborations to achieve this.
- Continued partnerships and knowledge/skills transfer through technical assistance from neighbouring FEMIP countries and the agencies currently active in the Palestinian Territories, is likely to be of long term benefit.
- Some sources of funding for a future PPP programme have been identified. The PIF could become a major equity provider for future PPP projects. However, the PIF is to become a significant source of equity for PPPs, it would need to be kept independent from specific bidders until the procuring authority selects the preferred bidder, in order to ensure a competitive and transparent procurement process. Other sources of equity and debt are likely to be donors, IFIs and ECAs, capable of covering the political risk as well as providing funding.
- The PA's huge infrastructure needs will be continued to be covered through international support. Donor support, which is currently sustaining the PA's economy, could be further targeted to development projects. The ability of the West Bank and the PA to embark on PPPs in the medium/long term will however remain subject to substantial improvements in the political situation.

..... E N D .....

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.

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. This study is financed under the FEMIP Trust Fund.

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