Optimising project finance solutions in the water sector

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14. IMPROVING PROCUREMENT PROPOSALS FOR PPP AGREEMENT

14.1 Introduction

A key recommendation resulting from the initial period of the PPP arrangement and the inadequacies of data mainly related to underground asset condition is the need to allow for enhanced data acquisition once the Developer has been contracted. This has been extensively discussed in the previous two chapters. Accordingly, the main recommendation resulting from Chapter 13 is the need to allow specific contractual provisions that allow for a mechanism that allows for the progressive and systematic acquisition and improvement of data and therefore the need for a Data Improvement Clause and for a Mutual Termination or Break Clause. However, although this is part of the PPP agreement, the fact that there is a data acquisition and validation period with an option for both parties to the agreement to terminate such agreement could be argued as an ‘enhanced procurement’ process. It is for this reason that I include these suggested recommendations in a chapter specifically dealing with the procurement process, as this process is in effect still part of the selection of the Developer prior to entering the longer period of the PPP agreement. Below I offer suggestions on how the Data Improvement Period can be done.

14.2 Enhanced Procurement to deal with the Data Improvement Period

Prior to the end of the initial period, a chosen regulator or expert panel will be called upon to perform an evaluation of the accuracy and reliability of the data that is available. The precise procedures regulating this review will be clearly defined in the PPP agreement in order to reduce discretion levels and potential disputes. As mentioned before, the decision of the regulator or expert panel should be binding. In addition, as this is adjudication by a third party, it is not necessary for rebidding to take place. What is critical in this process is that the review process will not consider the prices or costs bids contained in the bidder’s original proposal (the proposal on which the winning bidder was selected). The tariff review process should be based on the actual costs of the Developer over the initial period with considerations for future investments and O&M requirements, projected costs based on the Developer’s historical
costs, adjusted for future efficiency changes, and costs expected to be incurred by a hypothetically efficient company.

Responsibility for capital investments during the initial concession period

Typically under a traditional long term PPP agreement, the Developer finances capital expenditure but the Grantor has strong opinions on how the capex should be directed. Under this revised approach, the responsibility for funding capital expenditure is split between the grantor and the Developer. It is my recommendation that the Developer is granted full discretion over the investment program but the Grantor can insert provisions/constraints to assist in achieving its goals or to prevent any possible unwelcome developments that could arise if full discretion were left with the Developer, or for issues over which the Developer does not deem critical to its operations but over which the government has strong opinions. Notably, wording in PPP agreements such as “both parties to agree” and “aspects are to be coordinated” should be avoided because of their lack of specificity. The Grantor and the winning Developer, prior to signing the PPP agreement should agree upon a three-year rolling investment plan. Such approach will minimise disagreements in the first years of the contract and highlight any possible gaps or issues that had as yet not been considered. Furthermore, given that the relationship between the Grantor and the Developer is crucial to the long term success of the PPP agreement, having this initial period (of relatively low risk or at least at a lower risk than if there were no possibility for an early termination for convenience as described in the chapter above), discussions on the proposed budget will give each party experience of working alongside each other and point to any institutional personality mismatches that could hinder the relationship.

Both parties will share information on the scope of their capex responsibilities and will decide a detailed capital investment program for the forthcoming year and a conceptual program for the following two years. If no agreement can be reached, a structured process of dispute resolution stipulated and detailed in the concession contract, will be engaged. If no agreement can be reached at this stage, the independent adjudicator (detailed below) will be consulted.

Building on experience in the UK with the use of independent adjudicators, I recommend that each party agree on the appointment of this independent party at the beginning of the PPP agreement. The adjudicator would be retained throughout the entire initial period of the contract. The adjudicator will have an important role in dispute resolution, given the fact that if the Grantor and the Developer cannot reach an agreement (after a set period of time) the independent adjudicator will be authorized to make binding decisions. If the Grantor fails to comply with the adjudicator’s decisions, the Grantor will be liable to face claims for damages. The structure for making claims for damages would be detailed in the PPP agreement and the adjudicator will be encouraged to make swift and punitive decisions with little room for disputes or appeals.

14.3 Prequalification and Award Recommendations

The proposed recommendations differ from the usual criteria of other PPP agreements reviewed as part of this research in that they seek to go beyond the usual contract-based

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195 Given that this is a new way of doing things, it is highly recommended that the rules and procedures governing this process are developed thoroughly to avoid disincentivizing potential Developers. However, this process does reduce the overall risk to the Developer as it will not be held responsible for capital investments that extend beyond the review period.
criteria and develop a greater understanding and examination of potential Developers. The key point behind this approach is to view a PPP agreement as a business relationships rather than merely a contractual relationship. Therefore, my recommendation is to go beyond the regular levels of due diligence usually done by Grantors to obtain a greater understanding of the performance, management and experience profile of prospective candidates.

**Prequalification Stage Evaluation**

Conventional initial criteria are used to screen candidates – number of similar projects, specific experience, basic financial data – and those that pass the minimum thresholds go through for further evaluation.

- **Reference Case Study**: The second stage involves an in-depth examination and assessment of the candidates than that used in traditional procurement. The level of examination would be akin to the level of examination a business would do prior to engaging in a joint-venture with another business. The candidates would have to go into much greater detail about their experience levels, presenting a case study which would be evaluated by an examination committee. The committee would study the reference case study submitted and would conduct interviews with people involved with the project and could obtain further details if required from the prospective candidate. If required, a second reference case study can be requested if the first case proves insufficient.

- **Business Qualification Statement**: Similar to the review conducted by a credit rating agency, the business qualification statement would request more detailed information than in traditional procurement, eg:
  - Profile of the candidate
  - Organizational structure and management
  - Corporate strategy
  - Market standing
  - Specific markets and experience
  - Financial strengths
  - Future challenges and risks

The Business Qualification Statement would seek to go beyond the usual questions by requiring potential bidders to provide firm evidence of past experience, strategies and the thinking-processes that went behind some of the decisions made with regards to past projects. The proposed prequalification strategy places more emphasis on past deeds rather than what Developers propose they will do in their bids. In addition, a scoring process that uses judgmental criteria that differs from the usual merit-based scoring system or weighted average formulas could be used. Decisions would have to be explained using well reasoned arguments and set out in writing196.

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196 The use of judgmental criteria requires a greater amount of discretion on the part of the evaluators and less reliance on complex quantitative formula. For this reason it would be normally not as ‘clean and transparent’ as a fully quantitative process. However, my recommendation is to identify a list of the core qualities desired in the Developer. These qualities are then grouped into higher-level criteria (ie criteria which the Grantor would value more eg regional understanding, local partners etc) and would provide guidance to the evaluation committee. Sound decision making using judgmental criteria requires compartmentalizing the issues and applying discretion only to the areas that require it, and evaluators must provide sound justification for the assessments made.
**Pre-Contract Signature Assessment**

After bids have been evaluated and substantially responsive bids have been selected, it is recommended that after the price evaluation, a Pre-Contract Signature assessment be conducted for the bidder/Developer with the best bid price. This is an intensive process and if the first-ranked bidder is deemed insufficient after the evaluation, the process is conducted for the next highest price-bid. The rationale of the implementation assessment is to establish whether:

- Is the bidder technically and financially capable of executing the project to an acceptable standard?
- Are the technical, financial, scheduling proposals and assumptions realistic given the parameters of the proposed contract, the risk matrix and the operational conditions? And can realistic justifications be given for these assumptions?
- Is the bid price realistic given the technical requirements?
- Are there any identifiable risks with any aspects of the proposal?

Conducting such a thorough analysis of the bid at this stage could lead to the exposure of flaws in the bid that do not stand up to scrutiny. At the same time, it will also reveal to the Grantor which elements of the contract require greater deliberation and revision. If new risks are identified than barring any material modifications that might affect the bid price, changes to the contract can be made. The most important effect of such a rigorous evaluation would be to induce the bidders to take even greater care with the preparation of their bids.

After the evaluation is conducted and the bidder is found to be capable of adequately executing the contract, final negotiations can commence. I do recognize however that a potential flaw behind this proposed plan is the possibility that evaluators might have a bias against rejecting the highest-price bid, in which case a more impartial assessment might take place if evaluators did not the outcome of the price evaluation.

### 14.4 The Developer’s Remuneration and the Bid Price

It is recommended to use a single criterion for the evaluation of bids. These can include:

- Tariff level – lowest is best
- Subsidy level – lowest is best
- Up-front transfer payment – highest is best
- Lump sum payment linked to performance standards – highest for both is best

For the tariff and subsidy level, the Grantor would define the tariff profile over the initial period (3-5 years) and the Developer’s remuneration package would be set to incentivize improved performance. As stated earlier, during the initial period capex financing would be

Ultimately, the aim is to utilize the same rigour that Grantor’s use for the evaluation of bids, for the evaluation of short lists. The use of discretion may face critics from proponents of completely mechanical evaluation but as discussed under the section in procurement, the European experience with PPPs suggests that even a small amount of discretionary judgment can eliminate some of the issues that mechanical evaluation systems can sometimes throw up.
provided by the Grantor, therefore the incentive payments would only need to cover incremental O&M costs. The remuneration should be set to cover the optimal O&M and other costs (e.g., financing costs for working capital) for the initial period. Furthermore, the remuneration should be set at a generous level so that should adverse conditions ensue, the total expected remuneration is enough to cover the Developer’s essential costs and allow it to perform basic functions without the need for Grantor support.

Incentive payments would be based on:

- Key performance indicators that encourage Developers to increase water availability
- Discrete variables and outputs (e.g., network model, leakage detection) that earn incentive payments when delivered but these payments are decreased for every month that they are not submitted.
- Service requirements of such importance that if not met, significant liquidated damages may be claimed—e.g., wastewater quality.

For a lump sum payment linked to performance standards, the Grantor would decide upon the performance standards and calculate how the Developers’ remuneration would be calculated on the basis of attaining these performance standards—base remuneration and the incentive payments—along with what the capex budget will be. Prospective Developers will then bid in the following manner:

- Bidders bid on the lump sum payment they will make to the Grantor should they be awarded the contract. The higher the lump sum, the higher the likelihood of winning;
- If a bidder is unable to pay a lump sum, they can bid on the level of annual payment they will require from the Grantor, in addition to other remuneration. The lower the payment required, the higher the likelihood of winning.

Using a transfer payment tackles the issue of low-balling that occurs when tariff levels are used as the price criterion for decisions. Other positive benefits include:

- Regardless of the amount of lump sum bid, the Developer will receive sufficient remuneration from the tariff structure to enable it to focus on operating the concession. This lessens the requirement for the Grantor to renegotiate the terms of remuneration should the Developer suffer losses in its return on equity, not any deficits required for O&M. With this risk mitigated, Grantors can expect more serious bids from potential Developers.
14.5 Summary and Conclusions

In this chapter we part from the need to allow for enhanced data acquisition once the Developer has been contracted. Building from the conclusions of Chapter 13 introducing the need to allow for a Data Improvement Clause and for a Mutual Termination or Break Clause, I argue that the introduction of these clauses in the PPP agreement is in effect an ‘enhanced procurement’ process. It is for this reason that I make recommendations on how this process of continued selection of the developer even though a PPP agreement has been signed should be done. My main recommendations are that:

- Prior to the end of the initial period, a chosen regulator or expert panel will be called upon to perform an evaluation of the accuracy and reliability of the data that is available. With adjudication by a third party if the parties cannot agree.
- The tariff review process should be based on the actual costs of the Developer over the initial period with considerations for future investments and O&M requirements, projected costs based on the Developer’s historical costs, adjusted for future efficiency changes, and costs expected to be incurred by a hypothetically efficient company.
- Selection of a potential Developer should go beyond the usual contract-based criteria and develop a greater understanding and examination of potential Developers. The key point behind this approach is to view a concession agreement as business relationships rather than merely a contractual relationship. A scoring process that uses judgmental criteria that differs from the usual merit-based scoring system or weighted average formulas is also being proposed. Decisions would have to be explained using well reasoned arguments and set out in writing.
- After bids have been evaluated and substantially responsive bids have been selected, it is recommended that a Pre-Contract Signature assessment be conducted for the bidder/Developer with the best bid price, ultimately allowing for any final scrutiny and exposure of flaws in the bid, identification of new risks and minor modifications prior to PPP agreement effectiveness.

In this chapter I also recommend the use a single criterion for the evaluation of bids eg lowest tariff, lowest subsidy etc. Given that one of the key recommendations in this chapter is that during the initial PPP agreement period capex financing would be provided by the Grantor, incentive payments to the Developer would only need to cover incremental O&M costs. The remuneration should be set to cover the optimal O&M and other costs (eg financing costs for working capital) for the initial period. Furthermore, the remuneration should be set at a generous level so that should adverse conditions ensue, the total expected remuneration is enough to cover the Developer’s essential costs and allow it to perform basic functions without the need for Grantor support. If a lump sum payment linked to performance standards is the bidding criteria, the Grantor would decide upon the performance standards and calculate how the Developers’ remuneration would be calculated on the basis of attaining these performance standards.