La Lettre

ISTED

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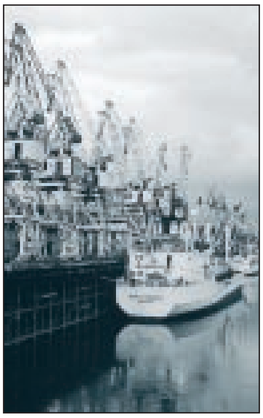
Public-private mix: risk management and distribution

Contents



Éric Maunoir - Isted

The two-way commitment made by public and private players must be based on a relationship of trust.

The increasing involvement of the private sector in the development, financing, implementation and operation of public services has been further strengthened in the past decade. Without a doubt, public-private partnerships, in varying forms, are today's key solutions for reconciling profitability requirements and the public interest.

These systems mainly concern developing and emerging countries or those in transition, where economic and financial constraints are heavy. But they are also increasingly relevant to countries applying for accession to the European Union as well as developed countries (cf. studies of the French Planning Office on the development of networked public services in France in the European context). This approach centres around the methods of sharing, management and coverage of risks described in this issue of the Lettre. Risks related to construction and operating costs must be managed and distributed among public and private partners with the help of financial agencies. Revenue-related risks which, in the case of our study on ports, depend on traffic volumes, are sensitive to the particularities of local political contexts, with a direct impact on the costs of cover.

Marked differences exist between sectors, particularly as regards the volume and economic feasibility of investments, which require appropriate involvement of the public authorities. These differences also concern the players, who include local authorities and users, particularly in the case of urban services.

But sectors have many points in common, particularly in the institutional and legal areas, as each allocation of responsibility for infrastructure or a public service requires clear identification of the players and consolidation of the relationships between them at all levels.

The partners to these contracts will all have to fulfil the requirements on which their goals depend. This particular situation of a long-term, two-way commitment between public and private partners must be based on a relationship of trust and contractual flexibility, which includes the means to settle disputes through an appropriate regulation mechanism.

Jean Smagghe,
President of Isted

Feature

Developing countries

Port concessions: risks to be shared

In developing countries, the trend is towards privatization or delegated management of public services. This is particularly so in the port sector where calls for bids are multiplying. But as a recent study[1] on public-private port concessions emphasizes, the various stakeholders have to take heavy risks.

Over the past few years, there has been a general trend towards introducing private management into ports. This mainly concerns handling and storage tasks for goods transiting through the port, and the financing and use of infrastructure and equipment for these operations. It is a development that requires a complex, multi-faceted partnership to be set up between the port authority, which is often public, and the terminal management company.

The concept of a port terminal management company covers various realities, which depend on the types of traffic handled and the amount of competition in this area of activity. This diversity determines the extent to which the company's activities have to be regulated by the port authority. In fact, regulation has major implications for the company in terms of the level of risk to be borne and the ability to manage such risk. Consequently, the principles of risk-sharing between the port authority and the company must take into account this aspect, which is critical.

To simplify in the extreme, the company bears two fundamental risks: **a cost risk,** i.e. overruns compared to initial estimations of project construction or operation costs, and **a revenue risk** or commercial risk, which depends on traffic and charges.

Regulation is essential

This is nothing out of the ordinary as any company, whatever its field of activity, has to bear such risks. But the port company carries out its business on public lands and it may draw on government investment, provide a public service and benefit from a *de facto* monopoly. Beyond the legal framework, relatively strong regulation of its activities is therefore essential. This may cover many aspects, whether technical (project definition, standards of performance, standards for maintenance of works...), economic (public service obligations, field of activity restrictions) or financial (control of charges, dues or subsidies).

What is the impact of regulation on cost and revenue risks, and how does it determine the principles of sharing these risks?

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[1] The report "Public-private port partnerships in developing countries: analysis, sharing and management of risks", drawn up by Hervé Martel, was supervised by the Isted think tank on ports, set up in January 1999. It brings together French institutional players, autonomous ports, donors, consultants and private contractors working in this sector.

Risks and constraints

The delegated management operations that are being introduced in most of the emerging countries, all emanate from the same intention on the part of governments: to marshal private resources to finance public infrastructure. They thus mainly centre on a financing technique that will determine the legal engineering to be implemented. Funding has to comply with specific constraints, particularly constraints in project structuring.

Projects are mainly financed by donors who consent to loans being repaid out of future revenues and guaranteed by the project assets. The extent of the risk they take justifies the need to make extremely precise, rigorous documentation available, which must be subject to compliance with "bankability" criteria. In essence, this documentation will include three groups of contracts covering the concession, the commercial and the financial spheres.

The concession sphere consists of contracts governing the relations between the conceding authority and the project company: concession, delegation, supply commitment… Where there is no concession contract, it may be necessary to make the information available through a specific contractual arrangement. There are four key aspects: ensure minimum revenue for the project company throughout the term of the concession, address early termination of the contract, implement a reliable system for viable operations throughout the project life span (access to land and necessary resources, obtaining approvals), ensure clear-cut, careful distribution of the force majeure risks inherent in projects.

Contracts governing the relations between the project company and the developers on the one hand, and the project company and the builders on the other hand belong to the commercial sphere. Relations between the project company and the operators are also covered by such contracts.

The financial sphere comprises the financing documentation. As negotiations with the conceding authority often begin even before the specific constraints imposed by lenders have been identified, compliance with "bankability" criteria must be a constant concern.

Emerging countries usually pose a minimum political risk that must be taken into account when structuring the financing arrangements. It is possible to involve several types of foreign participants able to assume this risk: multilateral agencies and insurance companies, export credit agencies. The building period, which is the period of maximum risk for donors, must be specifically covered.

All project assets and contracts are covered by security to the benefit of lenders – a defensive mechanism to make it easier for lenders to use of rights of intervention to replace a defaulting project company. For this reason, it is often necessary for the conceding authority to recognize lenders' rights under concession contracts or direct agreements.

(Source: Six delegated management contracts for French companies abroad: experience feedback – paper by Olivier Dauchez, Cabinet Gide Loyrette Nouel – One-day discussion conference on 23 March 2000 organized by Isted, the Ministries of Foreign Affairs (DCT) and Public Works (DAEI) and the French Development Agency)

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Éric Maunoir – Isted

A market is opening up in developing countries for "port concession" operations.

Constraints arising out of technical regulation measures have an impact on the initial estimation of project costs (investment, operation). Yet although the rules of the game are determined in advance and are clear, consistent and regularly followed, they do not affect the additional cost risk, which thus only depends on the company's ability to implement its project (except in cases of force majeure). It is consequently normal for the company to bear the full additional cost risk.

Where the additional cost results from a change in the regulatory or legal measures imposed after the contract has been signed, risk-sharing principles must depend on the nature of the activity itself. Two situations are possible:

• The service provided by the company is not considered as a public service. There is little regulation and no reason for it to change. The risk of changing the legal framework is considered by the company as a country risk, which exists for every industrial company. It results in an adjustment of the initially-expected level of profitability, and may subsequently be passed on to customers through increased charges. The company either bears this risk or abstains from becoming involved.

• The service provided by the company is a public service. The contract between the port authority and the company is similar to a public service concession. If the company agreed to assume this risk, it would increase the cost of •••

••• the service, which would be detrimental to the user. Moreover, the regulatory measures that can be imposed on port rates can prevent a company from subsequently passing them on to users. It therefore seems only fair for this risk to be shared. The apportionment principles must be clearly defined when signing the concession agreement. They can cover guarantees of stability or of appropriate tradeoffs (easing of charge constraints, offsetting benefits, compensation).

The political risk is permanent

There is always a risk for the company – a political risk of failure by the public authority to comply with the contract, or of discriminatory measures against the project. This risk can be mitigated or covered. Its assessment is a key element in the company's decision to become involved in a project.
Unlike the cost risk, imposed regulation has a direct impact on the revenue risk for the company and on its ability to manage this risk. In fact, the revenue risk is the main risk in a port project owing to the uncertainty inherent in traffic forecasts.
It is usually advisable to allocate the traffic risk to the company. This is possible and justifiable where its activities are not a public service. Profit-sharing between the port authority and the company is then feasible in some cases. It is also usually possible when these activities function in a really competitive context.

But risk-sharing is often imposed when a public service monopoly is involved. The heavy regulation then required places such constraints on the company that it does not have the means to manage the commercial risk. The port authority can then grant a guarantee of restraint on competition to the assignee, or can even guarantee a minimum level of business, through a variable subsidy paid when traffic is below target to cover the company's loss of revenue in whole or in part.

But although the company is not then fully responsible for its revenue, it must remain responsible for its costs. The regulation system must not therefore abandon the principle of assigning the project risk to the company. This is the case when the provisions of a contract guarantee a minimum level of profitability or adjust charges according to costs.

In fact, the principles of risk-sharing between the port authority and the company depend largely on the size of the public service that the national authorities include or do not include in the company's activities, and on the regulatory measures involved.

Networked public services: the end of monopolies in Europe?

In the European Union countries, the advent of competition is radically changing the profile of networked public services (energy, transport, post office, telecommunications, etc.). Integrated, competitive European markets are emerging in activities that used to be dominated by predominantly public, large national or regional monopolies.

Structural technical progress, a powerful factor of change often does better in a competitive environment than a monopoly system: an abundance of processes and services in the telecommunications sector, new production techniques without economies of scale for electricity, progress in railway interoperability, etc.). Market trends also require the inflexible limits of sectoral monopolies to be relaxed: interdependence of the electricity and gas markets, competition and complementarity between the various forms of data transmission in the postal and telecommunications services, customers' increasing interest in integrated transport and logistics services. At the same time, trade is developing on a continental and global scale. And users, who used to consider themselves as customers, now put competition to their advantage and no longer let their consumption patterns to be dictated to them.

This has induced several European countries to reform their public services. Their experience has provided input for study and debate and then for European legislation, which has given impulse to transformations throughout the Member States. The target: restrict the scope of monopolies – limit it to infrastructure – and introduce real competition into all or some of the services.


EDF

In the Bergougnoux report, a study has been made of the technical and economic features of each sector (electricity, gas, railways, post office, telecommunications).

The advent of competition will take different forms from one sector to another. But in each one, it gives an enabling impetus to industry: inter-sectoral boundaries become blurred, international strategies are deployed, mergers are formed, new value-added generating services come into being. This impetus acts mainly at European level. One of the main effects of the directives, in line with the Community authorities' aim, is to unify the European public services market.

The ultimate goals of the new regulations are to ensure fair competition, guarantee proper fulfilment of public service missions and contribute to the emergence of a European market. The State must set up strong, impartial, independent bodies to regulate each sector, in harmony with all the interests concerned. It must also develop procedures and indicators to assess progress in efficiency, quality of the public service, the results obtained by the regulators and more generally, the impact of ongoing reforms. As for the management of public corporations, this must be modernized towards an industrial governance model.

(Source: "Networked public services: competitive prospects and new regulations" – Report of the group chaired by Jean Bergougnoux – French Planning Office – April 2000 347 pages – Price FRF 105)

Report available from **La Documentation Française**
29-31, quai Voltaire – 75007 Paris – France
Tel.: 33 (0)1 40 15 70 00

D.R.

The Association of International French Contractors (SEFI) has published a complete guide to infrastructure concessions *(see page 8).*

Only regulate where it is necessary

The initial situation is often one of an oversized public sector, among whose missions those that actually form part of the public service are not clearly identified and require heavy regulation once they have been delegated or entrusted to an operator. But although there is always some form of partnership between the port authority and the company, the port terminal operator's activities do not systematically have the characteristics of a public service and thus do not always require the same amount of regulation. In fact, all regulatory measures give rise to additional costs: an additional risk cost imposed on the company resulting in a greater need for profitability, a cost of the resulting compensation, or simply a monitoring cost. It is therefore advisable to regulate if, and only if, this proves necessary. Moreover, the port company always has many partners – the port authority itself is high up on the list – which work with it to provide customers with the overall service they expect: a comprehensive port service, and even a point-to-point transport service. The port authority is consequently not only a regulatory authority, it is also the company's main partner. In this respect, this type of "horizontal" partnership is no different to a partnership between two companies. It must therefore involve mutual obligations in which the port authority not only guarantees the services it generates directly, but also those it may eventually delegate to other entities operating in the port.
The involvement of private companies in the management of ports requires a complex, multifaceted partnership to be set up with the port authority. It necessitates a clear, consistent contract framework enabling the company to assess and bear the risks it meets, based on the legal systems developed by the Anglo-Saxon countries. But the contract can never make provision for everything in advance and indexing formulae have a limited period of validity. Clauses must therefore provide for meetings and define conditions and arrangements for periodical negotiations to make the necessary adjustments. In addition to these renegotiations, periodical competitive bidding throughout the time span of the project may prove a worthwhile initiative, despite implementing difficulties. In some cases, it may be advisable to separate infrastructure and equipment management procedures from operating procedures. ●

(Source: "Public-private partnerships in the port domain in developing countries: risk analysis, sharing and management" – Hervé Martel – Isted).

Financial return and economic return: a difficult balancing act

One of the key requisites for successful port concession operations is the ability of public and private partners to assess project risks and determine the optimum allocation arrangement. The risk must be allocated to the partner best able to assume it. Once the arrangement is accepted, the private concession company aims to "quantify" and then "price" the risks – described as residual risks – that it will have to bear. The risk is evaluated by making a rating of the country and a checklist of the project. The charging system is determined by fixing a minimum threshold for the financial return to be yielded by the project, this being the threshold below which private partners will refuse to become involved. The "riskier" the project is considered to be, the greater will be the profitability requirement.

An analysis of the financial return of a project thus aims to determine the conditions in which this project can meet the financial requirements of the contract – which tend to vary over time. This is what is understood in financial jargon by the term "project bankability". The analysis then has to be compared with the analysis of the economic return of the project, in other words, the socio-economic return for the entire community.

This requires the partners to come to an agreement on the sharing of their financial commitments. The aim to achieve equitable sharing is based on a difficult compromise between the concept of the socio-economic return of a project on the one hand, and the financial return on the other hand. This exercise depends closely on the level of regulation accepted by each of the parties.

The next stage concerns financial engineering. This consists in seeking out the optimum conditions of financing and cover for the project. It thus involves structuring the capital and the financial debts, and managing "exogenous" financial risks (interest rates, exchange rates and counterparty risks) and policies. Its implementation is a sensitive, complex task. Sensitive, because the financial partners commit themselves over periods that can be very long. Complex, because of the multiplication and increasing sophistication of the financial tools on the market. For this reason, it is essential for financial engineering of a project to follow an action-oriented logic. This must be dictated by common sense and an understanding of the interests at stake, and must avoid oversophistication of the cover and financing mechanisms.

(Source: "Principles of financial modelling, engineering and analysis" – Laurent Torchet)

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Information

News

ISTED: XAVIER CREPIN REAPPOINTED AS EXECUTIVE MANAGER

At the meeting on 15 June 2000, Xavier Crépin, urban planning architect and official representative of the Ministry of Foreign Affairs, was reappointed by the Administration Board as Executive Manager of Isted for a further three-year term.

After several posts abroad as governmental adviser and urban and regional development project manager, he became responsible in the Ministry of Foreign Affairs for strengthening the involvement of non-governmental players in urban development (NGOs, decentralized development aid, companies) and launching the Municipal Development Programme (MDP) for Africa. He was subsequently in charge of geographical coordination for cooperation with Southern Africa.
In his capacity as Executive Manager of Isted since 1994, he has set up the new organization around three technical departments in the fields of transport, urban development and roads. At the same time, he has given new momentum to the information and communication activities. Since 1996, under his impetus, partnerships and networking have been developed with the Association's public and private members and correspondents. While maintaining close relations with Sub-Saharan Africa and the Mediterranean countries, Isted has enlarged its field of activity to new geographical areas, including Central and Eastern Europe, Asia and Latin America. The new orientations focus on closer involvement in the information networks and contributions to development policies and programmes.

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ISTED/WORLD BANK MEETING

As a follow up to the committee meeting of SSATP (*Sub-Saharan Africa Transport Policy Program*), a meeting between experts from the World Bank and Isted was held on 2 June 2000, at the WB headquarters in Washington. Among those present were Frannie A. Léautier, Infrastructure Group Director (Transport, Water, Urban Development and Energy), John Flora, Head of the Transport and Urban Development Division and Jean Smagghe, President of Isted, who presented the Institute's policies and activities. The theme of the meeting was public-private partnerships in the transport and urban development sectors (ports, urban transport, railways and road safety). Several collaborative projects were adopted in these fields, within the scope of the global information system developed by the World Bank.

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Xavier Crépin – Isted

In the foreground, from left to right, Frannie A. Léautier, Infrastructure Group Director (Transport, Water, Urban Development and Energy) (WB), Jean Smagghe, President of Isted and Marc Juhel, Port Advisor (WB).

ROAD AND CITIES DEPARTMENT: NEW ADDRESS

The address of the Isted "Roads" and "Cities" Department has changed.
To contact them:
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E-mail: fcroville@isted.com

THREE NEW ISTED MEMBERS

Isted has three new associate members: FORMéquip-AITPE (Association of public works engineers), ICEA (Associated consultant engineering economists) specializing in business and management consulting, and TAD Agence Consultants (Regional planning and development).

For further details on the 52 Isted members, you can consult the Institute's site at the following address: http://www.isted.com

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Events

ROADS AND TRAFFIC POLAND

The sixth international exhibition "Roads and Traffic – Poland 2000" will be held from 11 to 13 October 2000 at the Science and Culture Centre in Warsaw (Poland). The programme of this event will include: research work and projects, road building and modernization, road maintenance, traffic control systems, pavement inspection systems, road signs and marking, road safety and traffic.

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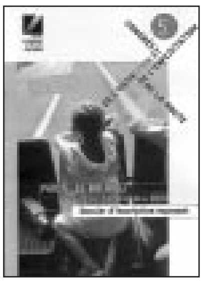
ROAD MAINTENANCE CONGRESS



The fifth edition of the Road Maintenance Congress will take place in Paris – Le Bourget (France) from 21 to 23 November 2000. At the same time, a trade exhibition will be held for all public and private bodies in charge of road network maintenance and operations in France or abroad. The congress is organized by the Directorate of Roads of the Ministry of Public Works, Transport and Housing, in partnership with Isted.

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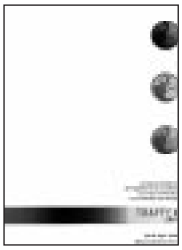
TRAFFEX 2001



Every two years, international industries concerned with traffic engineering, road safety and road maintenance meet in Birmingham (United Kingdom) for the Traffex exhibition. The next event will be held from 24 to 26 April 2001 at the National Exhibition Centre. The main categories of exhibits are: safety barriers, road markers, clothing, safety products, communication systems, comprehensive systems for traffic, design, planning and detection, environmental control systems, soil engineering, motorway and road building and maintenance, intelligent transport systems, lighting, parking, paving, site vehicles and equipment, road marking, road signs, street furniture, toll collecting, tickets, traffic control. Isted will coordinate a French Pavilion.

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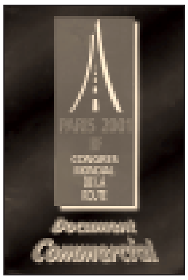
IRF 2001 ROAD WORLD CONGRESS



Paris (France) will host the XIVth World Congress of the International Road Federation (IRF) from 11 to 14 June 2001. An exhibition will accompany the congress information sessions and present a wide range of products and services for the international road and transport industry. Isted has been selected to coordinate a French pavilion that will group together companies wishing to promote their skills, around the technical services of the Ministry of Public Works.

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INTELLIGENT TRANSPORT SYSTEMS

The second European congress on intelligent transport systems, "Bilbao ITS 2001" and its exhibition, will take place from 18 to 21 June 2001 in Bilbao (Spain). The main themes are: intelligent transport systems (ITS) and their use in urban areas, interurban areas, in and around airports, in and around ports, and their links with tourism. Isted is planning to coordinate a French pavilion for the exhibition.

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Training

REGULATION AND PUBLIC-PRIVATE PARTNERSHIPS IN THE TRANSPORT SECTOR

To help all organizing authorities and regulatory bodies engaged in privatizing the transport sector, the World Bank Institute, EDI, has developed an international seminar on the theme "Regulation and public-private partnerships in the transport sector". The École Nationale des Ponts et Chaussées (ENPC) has organized French-speaking extension in partnership with the Directorate of Economic and International Affairs (DAEI) of the French Ministry of Public Works, Transport and Housing. This seminar, which was held in Paris-La Défense from 10 to 14 April 2000, brought together fifty senior policy-makers (Maghreb, Central and West Africa, Lebanon, Haiti, France). A further session of this seminar has already been scheduled for the first half year 2001.

This action aims to answer the questions arising out of the increasing role of the private sector in the supply of infrastructure and transport services (urban transport, railways, ports and airports) and the implementation of a new type of government intervention to regulate private activities. The major challenge facing the organizing authorities is that of drawing up regulations to protect users from an abuse of monopoly power and reconciling non-commercial government objectives with the need to provide a stable, potentially profitable economic environment.

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Publications

FINANCING URBANIZATION AND DECENTRALIZATION

The 47th issue of *Villes en Développement* is devoted to the financing of urbanization and decentralization. Table of contents: The road from Africities 1998 to Africities 2000 – from emergence to unification of the African municipal movement; Financing urbanization and local development; Proposals for financing urbanization in Sub-Saharan Africa, Implementation of decentralization in Central, Eastern and Baltic Europe in the 1990s. The editorial is signed by Jean-Pierre Elong M'Bassi, coordinator of the West Module of MDP (Municipal Development Programme).

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URBAN SERVICES AND SUSTAINABLE DEVELOPMENT

An analysis of six experiences of delegated management world wide

A study of six experiences of delegated management of urban services has been made by the "Urban services and sustainable development" working group led by Isted, under the direction of Dominique Lorrain: Water in Chengdu (China), waste in Hong Kong, water and electricity in Ivory Coast, electricity in Brazil, water in Buenos Aires (Argentina), and energy in Prague (Czech Republic). These experiences, carried out by French operators, have been analysed using a checklist to take into account the legal, financial and socio-economic aspects, and highlighting public-private partnerships. A comprehensive report on these six studies has just been published by the Directorate of Economic and International Affairs of the Ministry of Public Works, Transport and Housing (METL-DAEI).

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EAUDOC/SNIDE

EAUDOC/SNIDE, the first world documentation service on water, which was opened at the end of March by the International Office for Water (IOW), provides access to several specialized data bases covering all relevant institutional, administrative, scientific and technical areas of interest in France and many other countries. SNIDE also offers on-line information services such as news from the water sector, the calendar of events, a bookshop, links to sectoral water sites in France and throughout the world, and participates in international programmes: Semide for the Mediterranean Basin or Aquadoc-International for Central and Eastern Europe and Latin America.

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PRINCIPLES OF INFRASTRUCTURE CONCESSION, A PUBLIC-PRIVATE PARTNERSHIP

"A concession operation requires an overall perception of the project on the part of the private operator, which includes the design, financial arrangements, building, maintenance, management and operations". Based on this fact, the Association of International French Contractors (SEFI) has published a complete guide to infrastructure concessions. Table of contents: Definitions, general principles, award principles, design-build and operate, financing matters. The document is in French and English.

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