



Final Report Appendix 5



Recommendations and Conclusions

Prepared as part of the

Twinning Light Project CZ/04/IB/FI/02-TL

'Assistance with the assessment of Public Private Partnership (PPP) pilot projects'



1. Introduction

The Twinning Light Project 'Assistance with the assessment of Public Private Partnership (PPP) Pilot project has commenced on 16 November 2006. Originally it was foreseen that the project would be carried out in 2005 and would precede the Twinning Project CZ 2005/IB/FI/04: Implementation of Public Private Partnership (PPP) policy in the Czech Republic. As stated in the Quarterly interim report for the Twinning Light Project¹ due to this and other factors it became clear at the start of the project that it was necessary to start the Project with clearly defining the scope and the topics that would be discussed. In cooperation with the Ministry of Finance and the Dutch and Portuguese experts connected to the project, a memo was drafted and approved by the Czech Ministry of Finance (MoF) on 13 December 2006. In this memo three topics were identified in which assistance was sought by the MoF and which have subsequently formed the basis for all the activities carried out under the Twinning Light Project. These topics are the following (divided into two components as foreseen in the TL Contract):

Component 1: PPP Pilot Projects Assessment criteria

- Identifying, managing and monitoring of fiscal risks² in PPP projects

Component 2: Fiscal and Budgetary treatment of PPP pilot projects

- Budgetary treatment of PPP Projects
- Eurostat treatment of PPP Projects

In January and February 2007³ two so called *fact finding missions* have taken place in the Czech Republic in which the Dutch and Portuguese experts have assessed the current state of affairs regarding the above mentioned topics. The purpose of these fact finding missions was to assess the current situation in the Czech Republic. These fact finding missions and desk research carried out by the MS experts resulted in two assessment reports⁴. The assessment reports contain findings and, based on these findings, recommendations made by the experts. Subsequently these recommendations were extensively discussed with the MoF and in some cases fine tuned, during two follow up missions that took place in April and May 2007⁵ and during email contacts between employees of the Czech Ministry of Finance and the experts.

This document contains the main conclusions and recommendations that have resulted from this process. It should be noted that during the course of the project a lot of information has been shared with the MoF through the provision of documents, recordings of meetings, summaries of meetings etc. These documents do not form part of this report but have been provided to the MoF separately in order to assist them in their work.

¹ This report was approved by the Steering Committee and formally submitted to CFCU on 26 March 2007.

² The term 'fiscal risk' in this context refers to potential adverse impacts on the financial position of a public entity as a result of factors that affect the performance of a PPP project.

³ Component 2: 26 January and 7 February 2007, Component 1: 8 and 9 February.

⁴ Component 1 Assessment report was approved by the TL Steering Committee on 26 March 2007, Component 2 Assessment report was approved by the TL Steering Committee on 20 April 2007.

⁵ Component 2 mission: 27 April 2007, Component 1 mission: 14 May 2007.



2. Main recommendations and Conclusions Component 1:

Results fact finding mission 26 January/7 February 2007

After the fact finding missions were completed the following recommendations were made regarding the identifying, managing and monitoring of fiscal risks in PPP projects by the MoF:

- The experts recommend that the Department for Regulation and Methodology (MoF) clearly determines the extent of its involvement in the PPP decision process, especially with regards to assessment, management and monitoring of PPP project risks not only in the preparation phase but also in the monitoring phase. Attention should also be paid to the monitoring of risks *after* the contract is closed and the level of involvement of the MoF therein. In this regard also the specific division of competences within the departments of MoF especially regarding the management of risks with a financial impact should be looked into in PPP pilot projects both during preparation stage and during the monitoring stage.
- It is important that the MoF clearly formulates the extent of the Department competences and the PPP Centrum competences. However, the MoF should not "outsource" all responsibility to the PPP Centrum. At a minimum the MoF should keep the responsibility for containing risks with a major financial impact for the budget and have the ability to verify the validity of risk assessment and to monitor what is carried out by the project management (ask the right questions). The MoF should keep control of the risk management because it is the MoF that will be held accountable. In addition a full transfer of responsibilities could lead to a potential conflict of interest as the PPP Centrum is not meant to work exclusively for the MoF and is also involved in the provision of advice and management skills to Line Ministries.
- The Control Process presented in the draft PPP Project Governance Guidance, (section 7) including six assessment gateways, should be developed, in order to specify clearly the role of each organisation (MoF, line ministries, PPP Centrum) in each phase of the project. In particular, the role of the MoF needs to be carefully presented, distinguishing the political competences (Finance Minister approval, Finance Minister veto power) from the technical competences (cost assessment, risk assessment, budgeting) that provide support to political decisions.
- The PPP Control Process (typically a gateway process) that a government adopts shall be compatible with the institutions of the country and their capabilities – different institutions, different organisational design of government and public administration, will require different control processes. But the chosen process needs to state clearly, for each gateway, which institutions will control for efficiency, affordability and sustainability.
- To be able to define the MoF involvement as suggested above and to carry out its task and guard the MoF interests in the PPP project management, the Department of Regulation and Methodology of PPP Projects will have to take steps to increase the level of knowledge and experience of its staff regarding the assessment and monitoring of risks.
- Training current and future staff may involve formal training, as well as secondments to PPP Units or similar departments in the MoF of other countries. The European PPP Expertise Centre (EPEC), currently being created by EIB with strong European Commission sponsorship, will provide a forum for debate that will help to increase the capacity of the Department for Regulation and Methodology of PPP Projects.



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- It is recommended that an organisational structure should be in place to ensure timely and continuous involvement of all the relevant MoF departments in the preparation of the MoF point of view.
- In future, the possibility to involve the audit function to improve the quality of the process should be looked into.

Results of the mission 14 May 2007

On 14 May these recommendations were discussed with the MoF, Department 114 for the Regulation and Methodology of PPP projects. This has resulted in the following main recommendations and conclusions:

- It is clear that the Department for Regulation and Methodology of PPP projects is faced with considerable capacity constraints. Although the specific roles and responsibilities of the MoF in PPP projects are recognized by MoF employees, these capacity constraints at present seriously affect the ability of the MoF to define and fulfil this necessary role in PPP projects (as defined above).
- Defining the extent to which the MoF will fulfil this role is closely connected to this capacity issue. Either the MoF will take up the responsibility itself which will necessarily mean that an increase in staff level and staff knowledge should be realized. Outsourcing of part of the MoF tasks can also be considered. The MoF will have to take a decision on this in the near future.
- Outsourcing of the drafting of methodology to the PPP Centrum is an option that is seriously being considered. Outsourcing of other activities, for example the assessing of documents (OBC) to the PPP Centrum might also be considered, although the MoF will in all cases have to be able to verify the quality of the findings delivered.
- When considering this last option one should realize that the extent to which this is possible will depend on the position and other activities of the organisation (in this case most likely the PPP Centrum) to which the tasks are outsourced. It is very important to keep in mind that the MoF interests in a PPP project differ from those of for example the Line Ministries (LM). When attracting "external" advice care should be taken that a potential conflict of interest in this respect is avoided.
- The role of the MoF and other stakeholders should be formalized in a so called *gateway* process as is stated above. A draft gateway process has already been designed by the PPP Centrum in the draft governance guidance⁶. This governance guidance will be discussed and possibly amended as part of the Twinning project Implementing Public Private Partnership (PPP) policy in the Czech Republic. It is recommended that the above mentioned recommendations will be taken into account in this process.

A considerable part of the day was spent discussing a draft Outline Business Case (OBC) for the Courthouse Usti Nad Labem. Purpose of this exercise was to assist the MoF in getting acquainted with a workable method for assessing these (often very large) documents and help them prepare the MoF opinion on this OBC. This led to the following results:

⁶ Draft governance guidance d.d. 3 March 2005, drafted by the PPP Centrum



- When assessing an OBC (or any other document that is produced during any of the stages of the preparation process of a PPP project), the MoF should clearly keep in mind the interests that it wants to safeguard and concentrate on the aspects in the document that are relevant in this respect. Considering the capacity of the MoF the MoF should rather focus on a few important aspects and ensure proper discussion on those issues than to comment on all aspects of a 200 page document.
- It is important for the MoF to “be able to ask the right questions”. It should not be the task or the responsibility of a MoF employee to check all the data that are provided in a document, this should be done by the persons drafting the document (whether that be a LM or a consultant). The MoF should scrutinize a document for inconsistencies, for matters that are unclear, for lack of proper substantiation of figures or statements etc. that might possibly effect the State finances, and comment on those.
- Questions asked by the MoF will in most cases start a discussion with the LM and/ or the consultants which have drafted the document. The MoF employees will therefore need to acquaint themselves with, and acquire a level of knowledge of, the subject of discussion that will enable them to enter into those discussions. In that respect just asking the questions will not be sufficient.
- Assessing such a document will in some cases take considerable time, depending on the document and the complexity of the issues addressed. This should be taken into account by the project management when designing a project work plan or when defining deadlines. For example in Portugal discussions on an OBC can sometimes take up to a year. This – sometimes lengthy - process is however necessary if one wants to ensure the quality of the document.

For discussion purposes the MS experts produced a document containing a significant amount of questions on the draft OBC for the Courthouse Usti Nad Labem project, which was submitted to the MoF prior to the meeting on 14 May 2007. During the discussions on 14 May 2007 the MoF employees together with the MS discussed the questions and defined a few priority questions that the MoF would put to the Ministry of Justice (MoJ). Some of these questions have already been sent to the MoJ, others will be included in the formal statement of the Minister of Finance on the OBC. The ‘flip chart notes’ on the questions are annexed to this document as Annex 1.

2. Main recommendations and Conclusions Component 2:

Results fact finding mission 26 January/7 February 2007

After the fact finding missions were completed the following recommendations were made regarding the budgetary treatment of PPP projects and application of the Eurostat ruling on PPP projects.

On the budgetary treatment of PPP projects

- Although PPP projects can provide a possibility to increase investment opportunities, it is important to ensure that PPP projects are not used (solely) with the purpose to bypass short-term budgetary pressure (EMU-deficit and/or expenditure ceilings). Therefore the total life-cycle costs of a project (traditional and PPP) should be clear and real value-for-money should be ensured.



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- Create a budgetary system that, while taking into account the different responsibilities of different stakeholders, reflects the real fiscal costs of PPP projects for the whole duration of the project. If the PPP method is chosen for a given project, make sure that these costs are reflected transparently in the public sector accounts, for example by creating a special annex to the Budget. This document should provide an overview of the total amount of liabilities regarding PPP projects that have been entered into at any given time. Therefore PPP projects that are in preparatory stages should be included in this overview as well. The extension of this disclosure scheme to sub-national governments should be addressed by the Budget Department according to EMU goals and fiscal sustainability rules.
- Use an objective method for calculating the (estimated) costs for projects that are in the preparatory stage (for example the results of the Public Sector Comparator)
- Enable the MoF to request all necessary information on PPP projects.
- Strengthen the position of the MoF in the decision process.

On the application of the Eurostat ruling on PPP projects

- Increase the level of knowledge and expertise of the Eurostat rules within the MoF and the Czech Statistical Office. In addition there should be an organisational agreement in place that involves all relevant departments and organisations, and clearly reflects the division of responsibilities in this assessment (reaching an agreement on who does what).

Results of the mission 27 April 2007

On 27 April these recommendations were discussed with the MoF, Department 114 for the Regulation and Methodology of PPP projects. This resulted in the following main recommendations and conclusions:

- *Providing transparency* on the consequences of PPP projects in the State Budget is a very important⁷ mechanism to contain PPP costs in future as it provides insight in the total amount of liabilities deriving from PPP projects and thus helps to contain risks of overruns for future budgets. This means in effect that in one way or another the budgetary information provided to the public should include the whole life cycle costs of a PPP project. However, there are less and more sophisticated methods for designing a budgetary regime for PPP projects. Considering the capacity and possibilities of the MoF at present the most important recommendation is: start with a simple system and develop the system from there. For example as a starting activity it could be considered to collect the data in the OBCs that are prepared for every PPP project and annex these figures to the table with the expected costs for each year for each project.
- As mentioned before, the budgetary information included in, or annexed to the Budget, should include projects in preparation stage and projects in execution stage. It can be considered to extend the system in future to projects that are in a planning stage.
- The structure of the existing budget tables, which are used by the MoF to gather information from the Line Ministries (LM), should be changed. The tables should be extended so that they reflect future payments for the whole duration of the project. It

⁷ See also the IMF report on Public-Private Partnerships, Government Guarantees and Fiscal Risk, IMF 2006



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can be considered (as is done in the Netherlands) to make two versions: one version in which all the data is available per project (data that should be provided by the LM) for every year of project duration for internal use within the ministry, and a more aggregated version which reflects costs for up to 10 years (and the sum of the future payments due after that) to attach to the Budget. Another option would be to fully disclose all expected payments, publishing with the Budget a table including a column for each contractual year, as is done in Portugal.

- In order for all those data to be comparable the MoF should define and publish the parameters to be considered in project assessment (e.g. real and nominal discount rates, expected long-run inflation)
- In future the possibility could be looked into to creating a database for PPP projects and possibly combine this database with the existing information system for investment schemes ISPROFIN into an integrated system which will reflect the whole life cycle costs of not only PPP projects but also of 'traditional' investment projects.
- Neither the Portuguese nor the Dutch system contains a cap to limit the amount or the volume of PPP expenditure in a given period. It is felt that such a cap will make the decision whether or not to choose the PPP method for a project, unnecessarily inflexible. Instead it is preferred to ensure complete transparency in the consequences of all projects. In case the Czech MoF should want to consider introducing a cap, the Brazilian system which establishes a cap for PPP projects (a maximum on the volume of projects measured as a percentage of the expected government revenues) might be useful to look at. It is however not recommended to introduce a cap for central government. This might however be different for sub-national governments: transparency can discipline Line Ministries' expenditure, but it might not be enough for sub-national governments (regional governments, municipalities,...), due to the possibility of free-riding behaviour, so a cap system could be designed for them.
- It is necessary for the MoF to ensure that the data provided by the Line Ministries on the expected costs of PPP projects are objective and reflect the real costs of these projects. As said, the MoF will have to stipulate the qualitative requirements that have to be fulfilled by a LM. In Portugal the data entered into the budget for projects that have not yet been tendered is related to the data in the Public Sector Comparator. The figure in the PSC will normally be entered into the Budget. In the Netherlands data from the PPC and PSC is used⁸.
- In Portugal the amount entered into the Budget PPP table is the reference value included in the tender documents. This value is the PSC or a lower value (taking into account expected efficiency gains). Those tender documents include a provision that the Government has the right to cancel the tender if bids received require government payments in excess of the reference value, so those reference values are in fact the expected upper limits for contractual budgetary costs. Contingency risks are not budgeted.
- In the Netherlands, the amount must be made available first to the cash budget of the line ministry within the multi-annual budget forecasts. At the time the PPP-contract is signed the available room in the budget (including maintenance) is converted into multi annual availability fees and the expenditure ceilings are adjusted accordingly

⁸ Public Private Comparator and Public Sector Comparator are two instruments developed by the Dutch ministry of Finance to structure the PPP process. These methodologies have been provided to the MoF as part of the Twinning Project 'Implementation of a PPP policy in the Czech Republic'.



- The MoF will need to be able to verify the data provided. It is therefore recommended to design a procedure that allows the MoF to be involved in all stages of the preparation and monitoring of a PPP project. The MoF should ensure that its specific role is recognized and formalized in this procedure. The *gateway process* that has been drafted by the PPP Centrum in the draft governance guidance⁹ can be used as a basis and might be further developed according to the wishes of the different stake holders.

It should be noted that the way the MoF role is defined in this process is very much country specific and depends on, for example, the position of the MoF and the extent to which there is the political will to comply to a strict budgetary discipline: the Dutch and Portuguese systems therefore are very different. The workings of both systems have been explained to the MoT, but the MoF will need to define its own position on the basis of the Czech context.

Whatever the *gateway process* chosen, it should keep political responsibility for the project in the Line Ministry, attributing to the MoF only the task of checking for efficiency and affordability.

- The Twinning Project 'Implementation of Public Private Partnership (PPP) policy in the Czech Republic' has addressed the further development of a gateway process in one of its components¹⁰. It is therefore recommended that the Twinning Project will take this recommendation into account.

On the application of the Eurostat ruling on PPP projects

- Although the consequences of the Eurostat assessment are very important to the budget, care should be taken that PPP projects are not designed mainly with this assessment in mind, because such a focus on the Eurostat assessment might in some cases lead to sub-optimal provisions in contracts. Rather, efficiency of a PPP project should be the main focus while designing the contract. Although the Eurostat criteria are not leading in designing the contract, these efficient projects will still very often fulfil the Eurostat criteria for 'off balance' qualification.
- On the issue of ownership of the asset in a PPP contract, which has been a discussion in the Czech Republic recently, the following can be said. It is not decisive as such whether the asset will be privately or publicly owned in the sense that a publicly owned asset will not automatically lead to the conclusion that the project should be accounted for on the balance of the State. However, when considering public ownership of the asset, the consequences of for example default, bankruptcy are vital for the Eurostat assessment. In this respect the financing arrangements, provision for penalties and specifically the provision for step-in rights should be closely looked at. In the end it comes down to the question of which party in reality bears a risk (in this case for example risk of bankruptcy) and will thus actually bear the (financial) consequences when such a risk occurs. In other words, Eurostat looks at the *economic* ownership of the asset.
- The questionnaire that is used by the Dutch Statistical Office (CBS) for the Eurostat assessment has been provided to the MoF for information purposes. This questionnaire can be used to start discussions with the Czech Statistical Office to develop a methodology that is suitable for the Czech Context. It should be noted however that the CBS does not limit itself to this questionnaire and will ask whatever questions that in their opinion are necessary for a thorough assessment. In the Netherlands the CBS is not officially involved in the preparation stages but will be

⁹ Draft governance guidance d.d. 3 March 2005, drafted by the PPP Centrum

¹⁰ Component 4: Process guidance, fact finding report, adopted on 24 April 2007



consulted informally during the different stages of preparing the contract. The CBS sends this questionnaire to the project management (LM and MoF jointly) to fill it in after the contract is signed. The result will be a 20-30 page document on which the CBS will base its judgment.

- The application of the Eurostat is very much a process of 'learning by doing'. The different institutions (LM, MoF and Statistical Office) should – while of course taking their respective responsibilities into account-, cooperate to increase the level of knowledge on this topic.

Concluding remarks:

The above mentioned advice and recommendations have been provided to the MoF to assist them in their ongoing activities on the drafting of Methodology and Legislation for PPP projects in the Czech Republic. In addition to this but not less important: the recommendations aim to assist the MoF in carrying out its task in the project management of PPP projects and to guard the long term interests of the State finances in this process.

As PPPs deal with public service, the idea that the PPP contracts may guarantee the transfer of all risks to the private partners is a fallacious one. As long as the government has an interest on the assets or on the provision of services to end-users, it will face fiscal risks on PPP contracts. Because the government will always care for the public interest and for the provision of public services, PPPs will always require a careful scrutiny of projects, a careful design of tender rules and contracts, and a careful management of those contracts. Efficient contracts and efficient contract management are the only way to induce the private partners to act according to the public interest, aligning the interest of the private partners with the interests of State and users.

The implementation of the TL results is an on-going activity. The MoF will continue to use the information and recommendations provided after the Twinning Light Project is finished. It is recommended that where relevant the outputs of the Twinning Light project will be taken into account while carrying the activities in the –closely connected- Twinning project 'Implementing Public Private Partnership (PPP) Policy in the Czech Republic' especially while drafting the manual(s) as part of the Twinning Component 1: Value for Money and 4: Process Guidance.



Annex 1: Component 1 : ' flip chart notes' on the OBC Courthouse Usti Nad Labem
14/05/2007

The remarks marked in **bold** were selected as a priority for the MoF.

4 main areas for discussion were identified, which are listed below.

- 1) Selection
 - a. **There should be a recognised alternative for which costs are realistically computed**
 - b. **PPP should deliver efficiency?**
 - Better public performance
 - Lower costs
 - Better service
 - c. **In connection to b: is there room for innovation by private partner?**
 - Who will evaluate/assess innovative proposals (legal standards)
- 2) Scheme design
 - a. Choice of services transferred; only financial motives or also other motives (Better service?)
 - b. Definition of services transferred
 - It services/information system?
 - Photocopying?
 - c. SPV will control information system – design?
 - Legal requirements?
 - Financial requirements?
 - Equity?
 - d. **More information on payment mechanism to guarantee that the incentives are there in the end**
 - Benchmark?
 - Market consultation done?
 - Review every few years?
 - e. **Availability/demand based payments, there is no division**
 - f. **Penalties – should be addressed?**
 - g. Risk Sharing
 - Construction
 - Maintenance
 - **Staff levels**
 - Lack of proper forecast**
Consequences are not addressed
No sensitivity analysis
 - ⇒ Demand + availability risk
 - ⇒ Financial/political risk
 - ⇒ Make it more flexible
 - **Risk matrix vs. main text - inconsistency?**
 - who made the matrix
 - explanation should be included
 - how is the price calculated
 - P. 87: this will cause problems in tender, should be decided in advance

3) PSC



- a. **Outsourcing is possible in both options - unbiased picture**
 - Right assumptions; what is the basis for PSC
 - b. Building costs the same?
 - c. PSC states their public partner in traditional project ca not transfer risks. Is this so?
 - d. Risks were included in PSC but there could also be risks for Government in PPP? If risks are computed in PSC, they should also be computed in PPP.
 - e. **To summarize: PROVIDE DETAILS FOR RISK SHARING AND RISK PRICING**
- 4) Institutional issues/Monitoring
- a. Governance of the court
 - Cooperation with private partner?
 - How will problems be solved (related to payment mechanism but broader)
 - System to measure performance?
 - b. **Contract management (local x MoJ)**
 - Who will monitor the contract
 - Accountable to whom?
 - Conflict of interest in legal proceedings?
 - c. Problem of operation provision replace management for period of time
 - Legal provision
 - Management team able to do it



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