



SYMBULOS

Know your options

The importance of identifying and assessing all relevant variations of private sector participation in infrastructure procurement

November 2020

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Introduction

Infrastructure procurement processes are often leading to suboptimal results for the procuring authorities. Most procurement authorities and PPP units have spent significant time and efforts on developing and running sophisticated procurement tender processes. However, they often invest less time and effort in ensuring that only the best possible procurement model is entering such a formal tender process.

Although there is a multitude of possible public-private solutions throughout the spectrum of potential cooperation between the public and the private sector, the discussion often ignores a variety of potential options as it focuses on the two most prominently used solutions. Those are traditional procurement, on the one hand, often seen as the "public" solution and Public-Private Partnership (PPP) as the "private" solution on the other hand¹. The "public" or "private" labelling mostly results from the dominant source of financing used for each respective solution, which however falls short of the true nature of those procurement models. Almost every traditionally procured and financed infrastructure project has a certain degree of private sector involvement. Private sector companies usually conduct construction works and private sector architects and engineers are often involved in early technical planning and design. Most PPP projects, on the other hand, require significant derisking by the government by way of long-term contractual support (e.g. availability payments) or other instruments.

A relatively inflexible approach focusing on traditional procurement versus commonly used PPP models can quickly result in procuring some infrastructure initiatives in the form of a PPP which for various reasons (e.g. size, no achievable risk transfer) are not suitable for private financing. At the same time, it may result in never considering other eligible projects for a broader involvement of private sector risk-takers.

¹ Privatisation is not considered as a form of cooperation between the public and the private sector, but as a transaction which sees the government removing itself entirely from the provision of goods and services that it has privatised and retaining only regulatory oversight

We recommend an approach focusing on finding the optimal level of private sector participation (PSP) in a project (and its risks) by identifying and assessing all applicable variations of PSP along the spectrum. This approach requires both advisors as well as procurement authorities to think outside the box, not to copy-paste commonly used models and to question even successfully established models of procurement and assess their potential for improvement. The process required for this is a comprehensive procurement model options analysis.

Some of the reasons why procurement authorities are not always investing the necessary time and money in conducting comprehensive options analyses include time pressure and the desire to start procuring a project as soon as possible. Also, authorities are often reluctant to spend money on advisors to reassess existing models. Copy-pasting a commonly used solution seems therefore commercially attractive at first glance. However, launching a formal tender process for a suboptimal procurement model can result in much greater cost and time delays and time and money spent on first selecting the optimal solution usually pays a dividend later.

We need to continually question the status quo of procurement models we use and find the optimal (bespoke) level of private-sector participation for each project

In an environment in which market participants are adapting to new technologies and regulations, procurement models will have to adapt and evolve as well to cope with their stakeholders' changing behaviour and goals.

Know what you are solving for

Assessing all applicable variations of PSP along the entire spectrum of potential cooperation between the public and private sector can be challenging. The varying degree of PSP in different procurement model options will not only result in different levels and terms & conditions of private-sector debt and equity financing. Each option will also differ in a

number of other characteristics, including the main stakeholders involved, the allocation of risks and responsibilities between these stakeholders, the ownership model and contractual structure, the estimated time to implementation and last but not least the required fiscal commitments and other government support as well as their resulting budget impact. How to find the one optimal combination of all those elements that maximise public value?

Agreeing on clear procurement objectives among all stakeholders first is essential for finding the optimal PSP level

The most crucial requirement for solving this problem is to set clear procurement objectives for the individual project. Procurement specialists and advisors will then be able to assess all potential variations of PSP and their resulting procurement model options against the same set of objectives. The objective setting process includes three steps:

- The first step is to identify the core objectives of the government for the specific procurement project. While setting goals first seems quite self-evident, a significant number of options analyses are undertaken or at least initiated without identifying and agreeing on clear procurement objectives first. Without such a compass procurement experts and advisors will have to make up the objectives along the way which bears significant risks of recommending a solution that is deemed optimal but which later turns out to not match with the government's real goals.
- Given the large number and nature of characteristics that describe each possible procurement option, several objectives will most likely be conflicting. For example, the aim to maximise risk transfer to the private sector conflicts with the potential goal to minimise the pricing of private sector financing. Hence identifying the core objectives won't do the job, but the government will also have to set absolute objectives and rank relative objectives in order of priority to provide clear guidance on how to solve conflicting goals.

- Last but not least, it is essential to agree on both the objectives as well as their ranking among all public stakeholders involved in the selection and approval of the final procurement model. Otherwise, a procurement option selected by one stakeholder, e.g. a sector ministry, may later be rejected by another stakeholder, e.g. the department of finance, if both stakeholders are solving for different problems.

In case the government is procuring a specific type of project for the first time, as it will likely be the case for any pilot project, the responsible stakeholders may face challenges in setting clear objectives upfront. In such a case, the options analysis should be an iterative process during which objectives are adjusted along the process, as the impact and nature of project characteristics become more transparent. Some iterations may result in the requirement to redo parts of the identification and assessment process of suitable options against the revised set of objectives.

Always question the status quo

Previously successfully used procurement model options as well as solutions commonly used in other countries can lead to suboptimal results for various reasons. On the one hand, the risk appetite of potential (financial and commercial) private sector partners is continuously adapting to regional and global events, e.g. global financial crisis, Basel Accords. On the other hand, previously defined procurement objectives of the government may be outdated due to internal (e.g. policy change) or external (e.g. oil price fluctuations, COVID 19) events. Any change in private-sector risk appetite or government objectives will require a revision of previously deemed optimal procurement models.

“Status quo, you know, is Latin for ‘the mess we’re in’” (Ronald Reagan)

How to find a new optimal or revise an existing procurement model? While comprehensive guidance on how to perform an options analysis would exceed the purpose of this paper, we will outline a few examples:

- One approach would be to take a more granular look at the risk allocation model again. Most of the commonly used risk allocation solutions in PSP models, e.g. payment mechanisms like availability payments, shadow tolls, etc., have been developed by splitting a particular project risk (e.g. revenue risk) into its respective risk elements (e.g. price, volume, available quantity, available quality, counterparty and collection risk) and allocating those to different parties. Reperforming this exercise for the various project risks will help to tailor the risk allocation model to the particular needs of the project.
- Another approach could be to question if one procurement model for the entire project is the optimal solution. Larger size projects often consist of multiple asset classes, e.g. rail projects which broadly speaking consist of rolling stock, track infrastructure and systems & signalling. Or port projects that can consist of basic infrastructure (e.g. maritime access channels, breakwaters & shore protection), operational infrastructure (e.g. inner port channels, docks), port/terminal superstructure (e.g. tank farms, silos, offices) and port/terminal equipment. Those projects may require different PSP solutions per asset class.
- Projects with a risk profile that is significantly changing throughout their lifecycle, e.g. high construction risk but lower operational risks, may benefit from a more substantial government role during the higher risk phase, i.e. different PSP solutions over time. Alternatively, such a project may also start with a traditional procurement model and later on invites the private sector to participate via an asset monetisation PPP or other forms of functional "privatisation".

In principle, it will be essential to perform any options analysis by assessing all project characteristics step by step and considering all possible variations of these structural elements. The procurement authority or its advisors should refrain from choosing from a list of existing procurement model options. Such a list would never be conclusive and would ignore any new model or model variation developed post the date of the issuance of such a list.

The dilemma of the unprecedented precedent ...

As explained above, finding the level of PSP that maximises public value, i.e. best meets the agreed government objectives, requires procurement authorities and advisors to consider all particular characteristics of a project. Even within the same industry sector, projects, and particularly their risks, can differ significantly due to local circumstances.

The requirement for a certain degree of localisation of procurement models is one of the main reasons why copy-pasting commonly used models from other countries often lead to suboptimal results. While in most European and North American countries PPP models predominantly result in "outsourcing" an established public service to private investors, the situation is entirely different in many other countries that are rolling out such services for the first time. Public transport is one good example where PPP in European markets has resulted in governments transferring existing responsibilities and risk to private sector players. On the other hand, in the Middle East, for example, numerous rail and other public transport projects and their respective infrastructure are developed for the first time. Procurement model options are different when you are free from any incumbent legal or regulatory structures as well as existing infrastructure.

The need for a bespoke procurement solution that considers local and other particularities of each project, however, creates a dilemma for advisors and procurement specialists as approving authorities will require to benchmark this solution against commonly seen procurement models in the country, region and globally. In a first step, we can solve this dilemma by benchmarking critical structural elements of a procurement model even if the combination of those elements leads to a new solution.

... will require a sounding board

More importantly, in a second step, we will need to sound potential private sector players regarding the

acceptance of the selected procurement model. Approaching the market at such an initial stage of the procurement is essential to obtain confirmation (or not) regarding crucial assumptions like terms and conditions of private-sector debt and equity financing as well as to gain valuable insights into the risk appetite and technical capabilities of potential private sector partners.

A (soft) market sounding is a unique opportunity to confirm assumptions and obtain first-hand feedback from important private-sector players

Sounding the market before obtaining the approval for the selected procurement model, and often even before announcing the project in general, also bears certain risks for the government. What if the chosen procurement model has to be changed significantly as a result of the market sounding? Will this harm the reputation of the procuring authority in the market? And how to avoid giving individual private-sector players an unintended but unfair head start by disclosing certain aspects of the envisaged project?

The procurement authority should conduct a soft market sounding with only a small number of selected private sector specialists (lenders, equity investors and contractors). It should only approach those private sector players and only disclose the level of information required to validate the assumptions and obtain the feedback needed.

Conclusion

Private-sector participation is an inherent part of (public) procurement, but procurement models differ significantly in the level and nature of PSP. Finding the optimal level of PSP for each particular procurement project often requires procurement specialists and advisors to think outside the box of commonly used PPP and traditional procurement options. They also need to consider other variations of cooperation between the public and the private sector by conducting a comprehensive options analysis.

In any case, it is crucial to carefully identify and agree on the objectives for each procurement project first so that all stakeholders involved know and agree on what they are trying to achieve. Furthermore, the procurement authority should conduct a (soft) market sounding to confirm assumptions and obtain first-hand feedback from important private-sector players.

As a prerequisite for any options analysis, a needs assessment will have to confirm the general requirement for and layout of the project - irrespective of the procurement model used later.

Only after the procurement authority has concluded a comprehensive procurement model options analysis, it should proceed with further preparing the formal tender process by developing the detailed transaction structure and business case for the selected procurement model.

Symbulos Management Consultancy

For over 20 years, Frank Beckers has supported and advised various public authorities and other clients in performing comprehensive options analysis in multiple sectors and countries. As an independent advisor, we provide impartial advice on the advantages and disadvantages of different procurement models and only focus on finding the solution that best meets our clients agreed objectives (which can also be a traditional procurement model).

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We possess the necessary knowledge and experience to provide procurement strategy advice and in particular to conduct procurement model options analyses:

- Comprehensive understanding of governments' procurement objectives and processes as well as available fiscal commitments and their budget impacts;
- Extensive knowledge of all potential private and public sector players, the broad spectrum of debt and equity financing sources and instruments as well as the risk appetite of the respective investors;
- First-hand experience in structuring and financing transactions of different size and complexity;
- Successful development and execution of multiple first-of-its-kind solutions for projects in various industry sectors.