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# BELT AND ROAD:
# HOW CAN PPPs HELP?

**– THOUGHT LEADERSHIP**

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The Belt and Road initiative seeks to restore China's old trade routes into other parts of Asia, Europe and Africa, while boosting economic activity and connectivity within a vast region encompassing more than 74 countries, two thirds of the world's population and one third of global GDP.

While Chinese investment along the Belt and Road is likely to take a number of different forms, in this paper we set out the reasons why the public private partnership (PPP) model could perform a central role in the delivery of infrastructure projects in Belt and Road countries. We also identify the conditions to be addressed for the successful use of the PPP model.

PPPs present a unique opportunity for China and other countries along the Belt and Road to procure infrastructure in a manner which reduces the burden on government budgets, may secure host government 'buy-in' and accountability for projects, and provides a pathway for Chinese specialist skills, goods and services, while creating a long-term platform for the development of local private sector skills in Belt and Road countries.

## What is PPP?

The term public-private partnership has been in general use since the 1990s. However, there is no widely agreed definition or model of a PPP. It has been used to refer to a range of different structures where the private sector delivers a public infrastructure project or service. This is reflected in alternative definitions adopted by public and private bodies:

- The European Union: "…the term refers to forms of co-operation between public authorities and the world of business which aim to ensure the funding, construction, renovation, management and maintenance of an infrastructure or the provision of a service."
- Standard & Poor's: "…any medium-to-long term relationship between the public and private sectors, involving the sharing of risks and rewards of multi-sector skills, expertise and finance to deliver desired policy outcomes."
- The International Monetary Fund: "arrangements where the private sector supplies infrastructure assets and services that traditionally have been provided by the government."

At its core, therefore, PPP involves the provision by the private sector of services for which the public sector would otherwise be responsible.

## Distinct from traditional procurement

Where traditional infrastructure procurement involves the public sector (a) procuring assets, not services, from the private sector, (b) carrying out design prior to procurement and (c) managing projects, including the risk of successfully integrating multiple works contracts, the PPP model transfers much of this responsibility to the private sector, while linking private sector returns to service outcomes and performance. More broadly, the key characteristics of PPPs include:

- relatively long relationships, involving co-operation between the public partner and the private partner on different aspects of a planned and clearly defined project;

- the private sector playing an important role at each stage of the project (design, completion, implementation and financing);
- the public partner concentrating on defining the objectives to be attained and performance standards to be met, and how projects will be funded by the taxpayer or end-user over the term of the PPP;
- the distribution of risks between the public partner and the private partner based upon a contractual relationship that is limited in time;
- and, in the case of BOO/BOT and concession models (see 'Types of PPP model' below), financing structures that often combine both private sector financing and public sector capital, with a clear separation between the public sector and the private sector borrower.

## Types of PPP model

- **Service/management contracts:** a government department or governmental agency (Authority) engages a private sector entity to carry out one or more specified tasks or the management of an entire public service (e.g. management of rail rolling stock) for a contractual period (typically one to five years) for a specified fee which is not dependent on demand for the task or service. The Authority will establish service standards and run a competitive bidding process to award the contracts to the private sector.
- **Lease contracts:** the Authority grants a lease to a private partner which is then responsible for a service in its entirety over a longer period (often ten to 20 years). The private partner undertakes to meet quality and service standards established by the Authority and to pay a fixed rent to the Authority in exchange for the right to receive a customer revenue stream (e.g. revenues from operating an airport or port terminal).
- **Build-operate-transfer (BOT) arrangements (and variations):** the Authority runs a competitive bid process which ends with a private entity or consortium winning the right to finance and develop a new infrastructure project (or refurbish existing facilities) in accordance with service/performance standards set by the Authority. The private partner is considered to 'own' the facility being developed until ownership transfers to the public partner as further described below.

  Typically, the Authority (a) pays the private entity or consortium periodic 'availability' payments once the asset/facility is completed and available for use, (b) retains the risk of demand shortfalls (meaning that the private partner's revenue will not vary with usage) and (c) assumes ownership of the asset/facility at the end of the contract term. If ownership is transferred to the public sector immediately following construction, the model is referred to as 'BTO' (build-transfer-operate). If no such transfer is required, the structure is referred to as 'BOO' (build-own-operate).
- **Concessions:** The private sector operator (concessionaire) is responsible for (a) the full delivery of services in a specified area, including operation, maintenance, collection, management and rehabilitation of the asset, in each case based on quality and service standards established by the Authority and (b) the financing and management of all capital investment required. Private sector returns are dependent on the tariff or fee collected from users of the service.
- **Joint ventures:** BOT/BTO projects and concessions can also be delivered as joint ventures, where the public and private partners assume joint ownership of the entity responsible for delivering the service.

| Key features of the prevalent PPP models | | | | |
|---|---|---|---|---|
| | Service/Management Contracts | Lease Contracts | Concessions | BOT/BTO/BOO |
| Scope | Service Contracts: Multiple contracts for a variety of State support services such as IT, billing etc<br>Management Contracts: Management of entire State operation or a major component of it | Responsibility for management, operations, and specific renewals | Responsibility for all operations and for financing and execution of specific improvement or rehabilitation works | Investment in and operation of a specific major component, such as a treatment plant |
| Asset Ownership | Public | Public | Public/Private | Public/Private |
| Duration | 1-5 years | 10-15 years | 25-30 years | Varies |
| Operations/ management Responsibility | Services Contracts: Public<br>Management Contracts: Public/ private | Private | Private | Private |
| Capital Investment | Public | Public | Private | Private |
| Development Risk | Public | Public | Private | Private |
| Demand risk | Public | Public/Private | Private | Public |
| Overall Level of Risk Assumed by Private Sector | Minimal/moderate | Moderate | High | High |
| Typical Compensation Terms | Unit prices or fixed fee | Portion of tariff revenues | All or part of tariff revenues | Mostly fixed, part variable related to performance |

## Choosing a PPP model for a project

As these differing models demonstrate, PPP can be deployed in a number of ways in order to fit the objectives of China as the sponsor of the Belt and Road Initiative, and of host governments and market participants including equity investors, financiers and contractors, and to accommodate operational and strategic priorities in the relevant sector. It is not "one-size-fits-all." For example, if the intention is to reduce the burden on government budgets by attracting private capital (a central driver for PPP roll out in the UK), then a BOT or BTO or BOO model may be preferable to a simple service contract (where capital investment remains the responsibility of the public sector). If risk transfer is the primary motivation, a concession PPP model, used in a number of Australian toll road projects, may be more appropriate. If, however, the host government seeks to maintain overall control over the service or asset, or re-evaluate and re-let private sector arrangements every few years, a service/management contract or lease arrangement may be more suitable.

The joint venture model is increasingly used in established PPP markets to accommodate a desire for the public partner to have greater transparency over the delivery of the project. In the context of Belt and Road, this model may provide an alternative mode of investment for China while also mitigating any concerns over the credit worthiness of a host government and therefore being a catalyst for the participation of third party equity investors (whether from China or elsewhere) who may be encouraged to invest alongside a prominent Chinese entity.

## Role of host governments and Bilateral Investment Treaties

The common element across each of these PPP models is the central role played not only by the private sector participant, but also the Authority which is letting the service/management contract or procuring the BOT or concession. An additional element is added to that role if the Authority or host government establishes a joint venture in order to take an equity stake in the project.

Notwithstanding that China is the overall sponsor of Belt and Road, the use of PPPs in countries along the Belt and Road will require the active participation of relevant agencies of the host governments, including in particular the Ministry of Finance/Treasury which will be responsible for funding host government payments to the private sector partner. The 'partnership' element of PPP is therefore given broader meaning in the context of Belt and Road to encompass the partnership between China and the relevant host government, as well as that between the relevant host government agency and the appointed private sector partner. We explore this further below.

To secure the co-operation and active participation of host governments, the progress China has been making in respect of Bilateral Investment Treaties is significant. Ensuring that such treaties accommodate (or evolve to accommodate) the breadth and scale of proposed Belt and Road initiatives is in the interests of all parties.

## PPP model across asset classes

The PPP model has been used in a number of asset classes throughout the world. These include economic infrastructure such as roads, bridges, tunnels, rail, ports, airports and broadband services, and social/public infrastructure such as social housing, schools, hospitals, prisons, water, waste and defence facilities. To an extent, PPP models used across these sectors are self-selective: lease contracts and concessions are more easily used for economic infrastructure which attracts a specific user payment (e.g. ports/airports and toll roads), whereas service/management contracts and BOT arrangements (in any form) can be procured across a broader range of economic and social assets.

As is clear from the above, however, contractual settings in individual projects can be adapted to meet the particular requirements of China, the relevant host government and the private sector.

## Benefits of PPP

In the context of the Belt and Road, the PPP model offers a number of benefits when compared with traditional procurement models backed by government-to-government grants extended by China.

## Reduce budget burden Use of private sector capital

Regardless of whether the capital cost of a project is significant, attracting investment from the private sector both limits the capital commitment from China and/or a host government, and facilitates the provision of financing from the commercial debt markets. While these benefits are most apparent in a BOT or concession PPP which facilitates the private sector meeting the high initial cost of development, the procurement of services via a service/management contract or a lease arrangement can also facilitate management of a host government's operating budget by freeing working capital and providing cost certainty for services.

China's investment in Belt and Road, while vast, could be made to go further in this manner by (a) attracting private sector investment and (b) moving a substantial part of the funding burden to the host government which, under a service/management contract or BOT model, will be responsible for making payments to the private sector for the provision of the relevant service.

The use of private capital in this manner will also deepen the financial markets in the host country over the longer term.

## Private sector discipline

The benefit of private sector capital is not restricted to the simple availability of money. The participation of external financiers will likely result in the development of a robust contractual structure which focuses on ensuring (a) the delivery of the relevant infrastructure on time, to budget and to specification, and (b) the optimal operation thereof, strict due diligence during procurement and timely delivery of information during

the term of the project. The incentives on private debt and equity financiers to succeed in delivering the PPP align the interests of such financiers with those of China and its Belt and Road partners.

## Host government creditworthiness

Given that a number of Belt and Road countries are developing economies, the creditworthiness of host governments may be a challenge for private sector participants and their financiers. The PPP model introduces a partial mitigant by allocating the host government's payment obligations over the period of the relevant contract. China may also be able to provide guarantees or other credit enhancements to further mitigate these barriers to private sector investment in Belt and Road countries.

Multilateral financial institutions have been particularly active in helping manage these risks in developing economies by offering credit enhancement and insurance products and by creating project structuring units to assist host governments with preparing their procurements in a manner which is bankable/investable from a private sector perspective. China could take a similar approach, including via the Asian Infrastructure Investment Bank which, although not formally part of Belt and Road, could play a key role in the successful execution of Belt and Road projects.

## China's role

Reducing the reliance on China's Belt and Road budget could also diversify the way in which China and Chinese companies contribute to projects. A government-to-government grant puts China in the role of project sponsor, with broad exposure to the risks of the venture. If, under a PPP, any initial capital costs are met by the private sector and the host government is primarily responsible for ongoing service payments, China can choose to provide commercial debt or equity directly to the project, provide credit enhancement or structuring support as described above or limit itself to procuring roles on the project for Chinese contractors. In this manner, the PPP model can generate trade and capital investment and open up pathways for Chinese productive capacity, while expanding the footprint of China's Belt and Road capital budget by leveraging it to access private sector capital and long-term revenue streams from host governments.

## Efficiency in risk allocation

PPPs are designed so that design, construction, completion and operational risks are allocated to the party which is best able to manage them. In developing Belt and Road countries, in particular, where host government bodies may not have the necessary long-term project skills and which private sector parties (whether local, Chinese or from a third nation) do, it follows that the risks associated with project delivery should be transferred to the private sector. In so doing, China and its Belt and Road partners should obtain best value because those with the greatest and most relevant expertise will be best able to manage or absorb the risks, thereby pricing them more economically and minimising cost.

The whole-life analysis central to a PPP project at the pre-financing stage also encourages a comprehensive and holistic approach to finding solutions to technical and commercial risks from the outset in a way that is satisfactory to all participants and which will inevitably serve to reduce overall project costs.

## Host government buy-in and accountability

The patronage and commitment of host governments is essential to the success of Belt and Road, whatever the procurement model used. Each PPP model, however, enhances the prospects of such co-operative 'buy-in' by requiring the procuring Authority to prioritise, and take ownership of, the service output required. The Authority sets the service specifications and performance standards, and then is in a position to evaluate the capacity of competing private sector parties to meet those requirements in a bidding process. Changes can also be made to such requirements once private sector feedback is collected.

Once the contract is awarded, the Authority is given the contractual tools to enforce its requirements (including via the levying of liquidated damages or payment deductions). As a consequence, the Authority is accountable for the specifications and standards imposed (and their enforcement), the choice of private sector partner and payment for services provided.

With its vast experience of managing large projects, China can consult with host governments to bring robustness to this process, particularly for developing Belt and Road countries. This will also provide a platform for the coordination of policy, political co-operation and the connectivity of people and facilities, each a central tenet of Belt and Road.

## Exports

By broadening China's role beyond the contribution of money to fund Belt and Road projects, the PPP model generates a pathway for China to contribute:

- its know-how and experience of managing large projects in the procurement, delivery and operational phases for Belt and Road countries;
- goods and services, including as a supplier of commodities and equipment to projects; and
- most importantly, specialist skills, particularly via Chinese entities which may become contractors on such projects.

In addition to diversifying China's exports and providing an outlet for Chinese productive capacity and enterprise, this will accelerate China's transition from an economy based on manufacturing to one based on services.

## Private sector skills

At its core, the PPP model seeks to maximise the use of private sector skills. This will be important for Belt and Road countries, not only to ensure community buy-in to projects but also to secure the economic multiplier effects which come with local resources being used and rewarded. China would be well placed to fill any skills gaps in host countries by exporting the specialist skills it has in abundance, while building the basis for long term consultation and cooperation.

## Foreign ownership

One practical constraint on direct Chinese investment into projects is the foreign ownership restrictions which apply in a number of Belt and Road countries. The platform which the PPP model provides for China to vary the nature of its contribution to such projects may mitigate this concern, while absolving host governments of the need to make a difficult choice between attracting Chinese patronage and relaxing long-established foreign ownership laws.

## Flexibility

As described above, the PPP model offers a range of options for capital investment, risk allocation, compensation of the private sector and for the role China takes on a project. This flexibility is amongst the key strengths of a PPP.

## Standardisation

In the medium to long term, the PPP model offers a platform for the standardisation of procurement models, risk allocation, public sector funding models, private sector financing structures, security arrangements, documentation and dispute resolution within Belt and Road countries and more broadly throughout Belt and Road corridors. This standardisation process has occurred to a significant degree in mature PPP markets such as the UK and Australia and has driven cost and time efficiency in the delivery of projects. In the same way, deployment of the PPP model can accelerate the realisation of the ambitions of China and host governments for Belt and Road.

## Success factors for PPP

For the potential benefits of the PPP model to be delivered, China and its Belt and Road partners will need to work together to ensure that the key conditions for the successful deployment of PPPs are put in place. While the specific structures to be put in place and challenges to be overcome will vary from country to country and by reference to asset class, the key success factors for PPPs generally are as follows:

**Appropriate countries, sectors and projects:** To ensure that the momentum of Belt and Road is maintained, the countries, sectors and projects for PPPs will need careful consideration. If there is no lengthy track record of successful PPP procurement in a Belt and Road country, the selection of a simple PPP project which has broad local public support is preferable to struggling with a more complex project. It will also help gently ease the host government, local private sector parties, and Chinese government agencies into the PPP process so that a level of familiarity and proficiency is developed before embarking on more complex PPP projects. In formative procurements, building credibility is key.

**Appropriate PPP model**: The success of any given PPP project will largely depend upon the selection of a PPP model. Flexibility must be built into the decision-making process so that no single PPP model is necessarily preferred over another, and that the objectives for the procurement are revisited over time to ensure that any changes are reflected in the choice of PPP model.

- **Clarity of objectives**: Time should be taken to establish the parameters, specifications and standards for a project and success should only ever be measured against the same. A misguided evaluation of one project in a country or sector will adversely affect each project that follows.
- **Reasonable risk allocation**: The well-established principle that, in a PPP structure, the risks should be allocated to the party best able to manage those risks, needs to be respected. Inappropriate transfer of risk will likely result in consequential pricing by the private sector, which may adversely affect the PPP's value for money proposition. It may also increase the risk of private sector default and termination of the project. Ultimately, if the project fails as a result of the private sector's inability to manage the relevant risk, all participants will suffer reputational damage, wherever the fault may lie under the contractual documents.
- **Legal and regulatory factors**: Relevant considerations for the Belt and Road countries include:

**Land rights** – the relevance of land rights will depend on whether the project is land intensive and the PPP model being used. For lease-type arrangements, BOT/BTO/BOO procurements and concessions, private sector contractors and their financiers will need comfort that land access and use rights are (a) broad, (b) not capable of being summarily withdrawn and (c) where relevant, capable of being assigned to subcontractors and financiers.

**Security over assets** – in order to attract finance on competitive terms,the private sector will need to be able to give its financiers comfort that appropriate security and credit support can be granted to financiers, including security (or analogous rights) over land, and over interests in relevant project entities and project assets. Financiers will also need comfort that (a) their priority over unsecured or lower ranking claims is maintained, (b) security can be enforced upon default and (c) judgments obtained in recognised foreign jurisdictions will be enforced.

**Lender step-in** – local laws and project documentation will need to accommodate lender step-in rights in order to permit lenders to protect their investment prior to any project termination right arising.

**Termination compensation/ government guarantees** – in order for projects to be commercially bankable/ investable, the host government will likely need to agree to pay compensation to the private partner upon termination in certain circumstances or provide guarantees. Local laws in some jurisdictions prohibit such arrangements, necessitating amendments to the law to accommodate PPPs (or appropriate alternative solutions to be put in place).

**Dispute resolution** – local law must accommodate a recognised dispute resolution regime. Often, this requires the inclusion and enforcement of 'agreement to arbitrate' provisions in project contracts, and the acceptance of arbitration in an established foreign jurisdiction such as the UK. The ability to enforce such arbitral awards in the host jurisdiction will also be a key consideration for financiers and contractors.

**PPP unit** – although not a pre-requisite, establishing a PPP unit within host governments to control PPP procurement may provide consistency of approach and build greater certainty of execution, while giving China a focus for its consultation and policy coordination activities. In time, such a PPP unit could develop a clear process for procurement and drive the standardisation process to achieve efficiency.

**Experienced advisors:** The successful implementation of a PPP may, depending on location and asset class, require specialist technical, financial, insurance and legal advice. The availability and participation of such advisors will usually be a prerequisite for attracting private sector financing on competitive terms. Until expertise is developed locally, China and other more advanced economies will be vital sources of such expertise. Host governments will need to recognise their importance and limit barriers to their participation (including visa and working rules)

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