Policy brief
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Comment on Proposed PPP Law

In brief

- This policy note summarizes policy lessons for Rwanda from the Chilean experience. It cautions that, contrary to intuition, PPPs do not provide additional resources.
- It suggests ways to prevent Chile's costly mistakes related to excessive contract renegotiation.
- Moreover, the experience of Chile, a country renowned for imperviousness to corruption, underscores the importance of adequate independent oversight and transparency in large transactions of PPP-financed public infrastructure.
- Chile's experience, although seen as a success, suffers from two interrelated problems: excessive contract renegotiation and high-level corruption.
- The study found five key lessons from Chile's PPP experience:
  - Institutional safeguards are critical
  - The bidding process must be carefully managed
  - Cost-benefit analyses on projects that don't pay for themselves are crucial
  - Develop institutional mechanisms to deal with lobbying
  - PPPs are not a free lunch and require sufficient revenue to pay for themselves.

This note is based on the work of Prof. Ron Fischer presented at the IGC Growth Forum in Rwanda on 17th February 2011, and his paper "The Promise and Peril of Public Private Partnerships: Lessons from the Chilean Experience".

Background

"Chile has one of the most successful PPP programs among developing countries"

The advantage of PPPs is that they bundle investment, operations and maintenance, thus reducing life-cycle costs of an infrastructure facility. In the case of highway PPPs, the main advantage is the savings that are realized through continuous maintenance.

Chile has one of the most successful PPP programs among developing countries. The program has significantly improved the country's road, airport and seaport infrastructure. Chile's total cumulative investment in 50 concessions awarded by the Ministry of Public Works since 1991 is approximately US$11.3 billion, or 5% of Chile's current GDP. The Chilean PPP Unit is within the Ministry of Public Works and has roughly 300 staff with specialized knowledge in a variety of areas. A small group within the Unit is responsible for undertaking promotional roadshows. Strategically, the PPP process in Chile is designed to avoid negotiation[1]. Instead, PPPs are awarded in competitive auctions open to any firm, national or foreign, subject to meeting technical and other requirements.

Challenges

While Chile's experience is seen as a success, the Chilean PPP programme has faced two interrelated problems – **excessive contract renegotiation and high-level corruption** – that have significantly increased the cost borne by the state.

Contract Renegotiation

In Chile, changes to the original contracts represented 24% of PPP investments (see Table 1). Since renegotiations are bilateral and without the element of competition present in the initial award of the PPP, they are expensive and can increase vulnerability to corruption. Additionally, they can reduce incentives for the public works authority to design projects correctly at the outset. Finally, renegotiation can also be a way of escaping budgetary control by loading payments on to future governments.

"The Chilean PPP programme has faced two interrelated problems – excessive contract renegotiation and high-level corruption"

In the early days of Chile's PPP program, unclear institutional arrangements forced the government to renegotiate several contracts – and these proved to be quite costly. In the case of Chile's jail PPPs, the Justice Ministry ordered modifications to the initial design and the PPP company overcharged them, leading to conflicts with the PPP Unit and enormous expenses and delays.

1. The exception is cases where PPPs must be renegotiated once awarded due to an oversight in the original project design. As renegotiation has proven costly in Chile and elsewhere, projects should be in their final design stage before being awarded.

Table 1: Endemic Contract Renegotiation	
Project Type	Renegotiation as fraction of investment
Highways	26%
Airports	12%
Jails	26%
Reservoirs	9%
Transantiago	12%
Public infrastructure	1%
Total or average	**24%**

Source: EFGH 2008

Corruption

Chile ranks among the least corrupt countries in the world, and yet their PPP programme was beset by a major corruption scandal. The corruption scandal ultimately led to the imprisonment of senior members of the PPP unit and the Minister himself. The corruption scandal led to the end of the PPP program for a number of years while reforms were carried out.

Corruption within the PPP Unit ultimately played into the numerous and costly contract renegotiations. In exchange for contracting Ministry of Public Works staff through paper companies to provide nonexistent services, the concessionaires were compensated by being allowed to overcharge in their contract renegotiations. While hiring by paper companies was used for the purpose of raising salaries in order to retain employees, the method was corruptible.

Lessons from Chile

The early Mexican PPP program represents a sobering experience. Without establishing good institutional arrangements for dealing with PPPs, Mexican taxpayers had to pay more than US$8 billion after renegotiating initial contracts for projects that were ultimately not successful

Institutional safeguards are critical – including specific legislation on PPPs and clear institutional arrangements

The legal and regulatory foundations of a country's PPP program are critical in avoiding the high costs of contract renegotiation and corruption.

One of the critical innovations of Chile's 2010 PPP law is that it regulates and limits renegotiation. Chile also addressed the problem of corruption by increasing the robustness of its institutional safeguards.

Having specific legislation in place to deal with PPP contracts also reduces setup costs of contracts and creates a framework for dealing with conflicts.

The bidding process must be carefully managed to avoid renegotiation and corruption

1. **Projects should be in final design form before being franchised**
   At the beginning of their PPP programmes, Mexico and Columbia awarded

projects as PPPs before project designs have reached their final stage. This meant that renegotiation was often required, which can be costly ($8 billion in Mexico).

2. **Separate PPP "promotion" from supervision, regulation and conflict resolution**
   While this is not yet the case in Chile, ideally the supervision and regulation of PPPs should be outside the agency charged with promoting and developing new projects. The body rewarded for promoting PPPs may be reluctant to strictly regulate and supervise existing PPP contracts for fear of making it harder to attract interest in new projects.

3. **Transparency**
   The procedure for awarding projects should be transparent and open to the public for inspection. All information should be put on the internet, including the winning and losing offers. This will attract private sector participation by signalling that the rules governing the PPP process are not discretionary.

Cost-benefit analysis on projects is crucial if they do not pay for themselves

"Cost-benefit analysis should be done by the Ministry responsible for finance, as opposed to the PPP-promotion agency"

Some PPPs generate sufficient revenue to pay for themselves through user fees, while others require subsidies. This distinction is important because it shapes the extent to which the government can rely on market competition in lieu of its own cost-benefit analysis, and it influences the type of bidding process that the government may wish to adopt. Chile's initial highway PPPs generated sufficient revenue through toll fees to pay for themselves – demand was high as Chile was growing rapidly. However, a number Chilean PPPs have required subsidies (see Annex).

Unless bankable demand predictions indicate that a project will generate sufficient user fee revenue to pay for itself, projects should be subject to cost-benefit analysis. This will ensure that there is not a more beneficial alternative use for the scarce public resources that will be used to subsidize the project via periodic payments.

Cost-benefit analysis should be done by the Ministry responsible for finance, as opposed to the PPP-promotion agency. All possible outcomes resulting from government guarantees (such as guaranteed traffic) must be simulated and included in government accounts as contingent liabilities. Given that renegotiation takes places after the initial cost-benefit analysis, renegotiation should be avoided for this reason as well.

In Chile, to ensure that the PPP program fits within the government's fiscal program, an officer from the Ministry of Finance sits within the Ministry of Public Works and has the authority to stop any project.

Be prepared to be lobbied by foreign governments

Chile has experienced political pressure from the home countries of the companies that have been awarded PPP concessions. Given that only some projects will be profitable, Rwanda should develop strong institutional mechanisms to deal with lobbying, particularly from governments that are sources of donor funding.

There is no such thing as a free lunch

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Even in the case of a PPP that is able to generate revenue through user fees to pay for itself, the government could have taken out a loan, contracted private companies to provide construction, operations and maintenance services, and collected user fees to repay the loan. Thus, no new resources are generated by the PPP.

A PPP that requires periodic government payments is no different financially from the government raising a loan to build, operate and maintain the project.

One exception is where the involvement of a multilateral development bank reduces the risk of default, and unlocks commercial lending that otherwise would not be available.

References and Further Reading

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Annex

Main Characteristics of the Chilean PPP System in 2007						
Project Type	Budgeted Cost (IF)	Total Investment (UF)	Fraction of total	Number of projects	Total renegotiated	Renegotiation as fraction of investment
Highways	185,450,742	249,737,533	88%	26	64,286,791	26%
Airports	8,798,114	10,000,162	4%	10	1,202,048	12%
Jails	7,414,824	10,076,609	4%	3	2,661,785	26%
Reservoirs	4,131,579	4,544,673	2%	2	413,094	9%
Transantiago	4,884,764	5,530,363	2%	5	645,599	12%
Public Infrastructure	4,243,082	4,267,235	2%	4	24,153	1%
Total or Average	214,923,105	284,156,575	100%	50	69,233,470	24%
Approx. US$ Equivalent		US$ 11.3 billion			US $2.7 billion	

Source: EFGH 2008. Note: Currently, 1 UF = US$43

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