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Lessons from Public Private Partnerships in Lebanon

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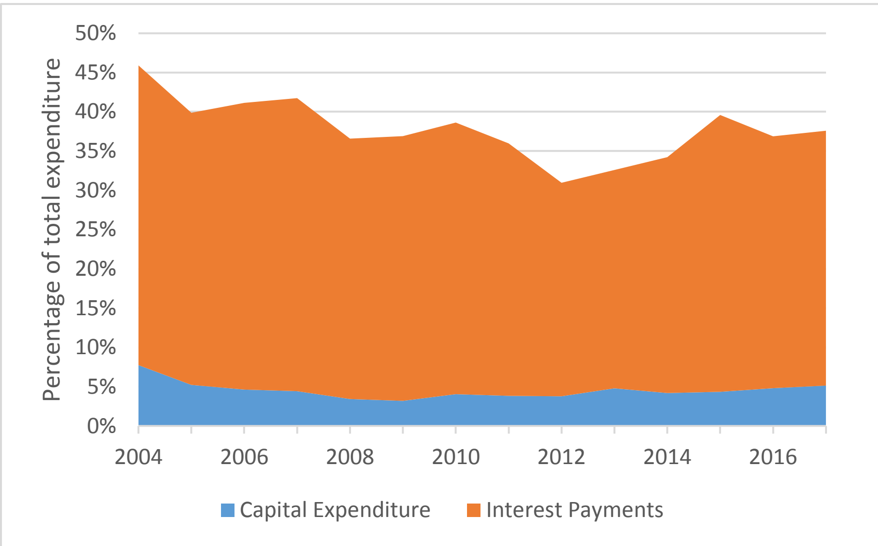
Lessons from Public Private Partnerships in Lebanon[1]

Stephan Straub

Lebanon's weak and crumbling infrastructure has put significant pressure of provision of basic services and has been an impediment for private sector development. The Ministry of Public Works and Transport estimates that only 15% of the network is in good condition, and the World Economic Forum's 2016-17 Global Competitiveness Index ranks Lebanon's quality of roads in 124th place out of 138 countries.[2] Macroeconomic imbalances, political uncertainty, and chronic fiscal deficit have contributed to low capital investment (see Figure 1 below).

In April 2018, the government of Lebanon presented its ambitious Capital Investment Program (CIP), which is mainly focused on infrastructure development and rehabilitation. The total cost of the first phase of the CIP (covering 6 years for preparatory works and implementation) is estimated at US $10.8 billion (including expropriation costs), of which around 35 % could come from private investment.[3] Therefore, the rollout of a sound and rigorous public private partnerships (PPPs) programmes are key to delivering the investment programme.

Figure- 1 Capital expenditure and interest rate payments



Source: Ministry of Finance, Lebanon

However, a look at Lebanon's recent history shows a rather uneven performance of the PPPs that have been implemented. As in many other developing and emerging countries, there were both success and failure stories. In fact, more often than not, PPPs have faced important governance and

1 We Dr. Ijaz Nabi for support and discussions during the visit in Lebanon. Rossi Abi-Rafeh and Ijaz Nabi helped improve this note with their extensive comments on the first draft. We also thank Mr. Ziad Hayek and Mrs. Maya Chamli from HCP who provided extensive material and discussion on the issues covered in this section.
2 Byblos Bank, Lebanon this week, Issue 497, June 19 - July 1, 2017, last accessed at https://applications.byblosbank.com/library/assets/Gallery/Publications/LebanonThisWeek/Lebanon%20This%20Week%20497.pdf on March. 7, 2019.
3 CEDRE Final Statèrent

political hurdles leading to inefficiencies, poor services, cost overruns, and renegotiations. This has raised doubts on the suitability of this solution with the current status quo.

In this report, we provide a review of 4 PPP projects in Lebanon drawing conclusions on why most of them were unsuccessful. We then provide a number of policy recommendations that would curb down some of the inefficiencies and bickering in the PPP process in Lebanon and re-explore the fiscal motivation behind such partnerships.

This note draws on extensive interviews conducted during a field visit in Lebanon, as well as the literature on the topic. The aim is to analyse the outcome of past Lebanese PPPs and to understand under which conditions and implementation modalities future PPPs might be successful in Lebanon. Due to the limited number of PPPs that are reviewed here and the lack of systematic data, the note is qualitative in nature

Laws on Privatization and PPP

In 2000, The Prvitization Law (law n. 228) was ratified to regulate privatization's operations and define its terms and fields of implementation. The law also established the Higher Council for Privitization (HCP) and included provisions to enhance cost-effective competition, protect consumer rights and safegaurd public funds through the evluation of the public project assets and properties, according to the international financial and economic standards.

Following this, two laws on organizing the telecommunications and electricity services sectors were adopted in 2002. The laws defined the rules for the transfer of each sector's adminstration in part or in full, to the private sector, including the role of the state in this field. The two laws also ratified the creation of regulatory authorities with the mandate of regulating and controlling the sectors in accordance with the provisions of the present law, and granted them the legal personality and technical, administrative and financial autonomy. (Article 4 in the Telecommunication Law established the Telecommunications Regulatory Authority and Article 9 in the Regulation of the Electricity Sector Law established the The Electricity Regulatory Authority).

In 2017, the Law on Regulating Public Private Partnerships (law n. 48) was ratified by the parliament. The law establishes the broad governance and institutional arrangements that can signal to the private sector that effective and transparent processes for the identification, development, negotiation, procurement, implementation and monitoring of Public Private Partnership (PPP) projects is in place (World Bank, 2018).

Review of past PPPs

Following the 1975-1991 civil war, the government sought to rehabilitate the infrastructure by a number of privatization and PPP projects. The past portfolio of PPPs in Lebanon spans a wide array of sectors; from telecom (mobile telephony), to postal services, electricity, waste management, and tourism.

Due to the history associated with privatization and PPP, the debate about these in Lebanon models has been contentious. Privatization in Lebanon have often been perceived as serving the commercial and political interests of the ruling elites of the country. Sectarian dominance and its concomitant Muhasasa (Sharing of public sector posts among political and sectarian leaders who nominate their cronies to these posts.) practices in Lebanese politics and public affairs not only consistently delayed the privatization process, but also obstructed public sector rehabilitation programs and State Owned Enterprises (SOEs) reform in all sectors. (Leenders, 2004). Moreover, most of the privatization and PPP attempts have exhibited a clear violation for the laws presented above.

Mobile Services: Global System for Mobile communication (GSM)[4]

In 1994, two Build-Operate-Transfer (BOT) contracts were granted for 10+2 years to Cellis, a joint venture involving France Telecom (66.6%) and local investors (33.3%) and Libancell, a joint venture between Telecom Finland (14%) and local investors (86%).[5] The contracts stipulated a sharing rule on gross revenues from voice calls, going from 20% in the first eight years to 40% in the next two years, and 50% beyond that. By June 2001, the two companies had a combined subscription base of over 750 thousand, covering 80% of the Lebanese territory and offering a service at one of the lowest rates in the world (Jamali, 2004). The cellular market growth had far exceeded the cap set by the government at 125,000 subscribers for each operator.

Contractual and legal conflict ensued, leading in 2001 to early termination of the contracts by the government based on claims of contract violation.[6] The Ministry of Post and Telecommunications (MPT) then created two joint stock companies to hold the assets that were reverted to the government. Until today, the mobile sector's assets are still owned the government, which has granted management contracts to Kuwait's Zain Group and Egypt's Orascom.[7]

One of the major obstacles to the sector's reaching its full potential relies in the government's policy of short-term license extensions. In fact, management contracts for the two operators are carried out on a three-month basis, a short-time frame that stands in the way of long term investment strategies (Blominvest, 2014). Moreover, a regulatory vacuum is in place as the power to regulate the sector is still in the hands of the Ministry of Telecom instead of the Telecommunication Regulatory Authority (TRA) established under the 2002/431 Telecommunications Law. In fact, the TRA's board hasn't been renewed since 2008, so the agency lacks any decision power to regulate the market. The interest of political parties in controlling this sector is the view of it being a "cash cow" for the government generating around 50% of total non-tax revenue in 2017.

As a result, several distortions plague the sector, including tariffs that have now become among the highest in the region alongside week infrastructure (see Figure 2). The poor conditions of the industry comprise the quality of network coverage, the quality of connection, the quality of data and internet services, the customer service, and the speed of technical repairs (Blominvest, 2014).

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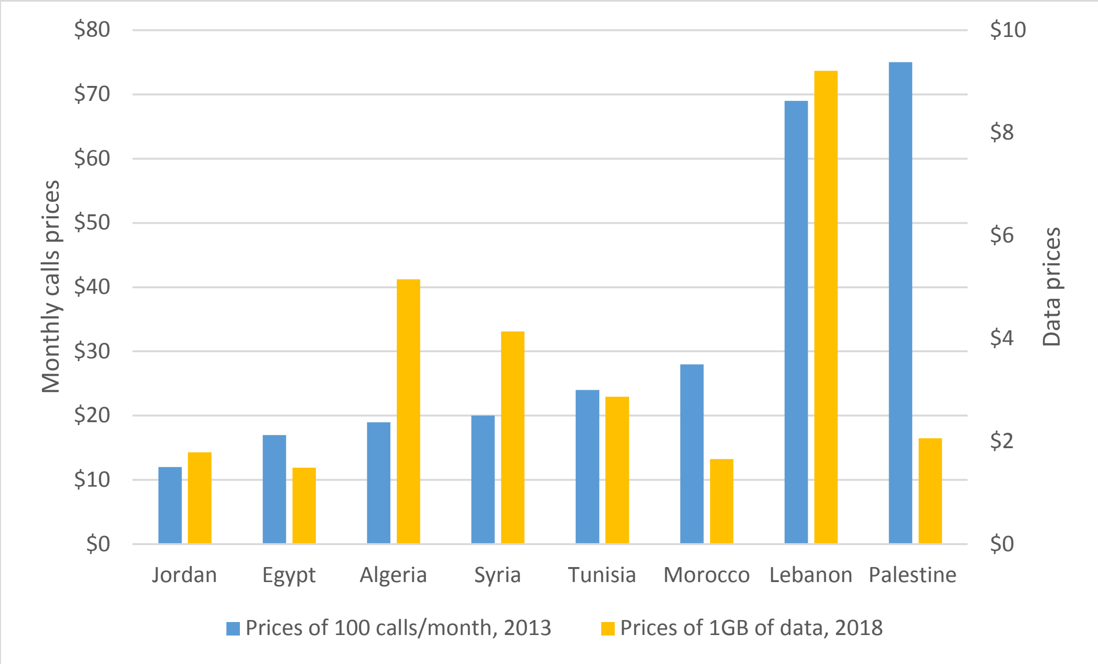
4 We thank Mr. Gilbert Najjar for extensive discussion on this issue.
5 See Jamali (2004) for a detailed description of the contracts.
6 An international arbitration process later led to the companies winning an amount of $286 million in compensation.

7 See https://hcp.gov.lb/hcp.gov.lb/au-8a16m.html#telecommunications, last accessed on April. 10, 2019.

Figure-2MobileServicesPricesinSelectCountries



Source: Telecom Regulatory Authority, Cable.co.uk

Waste Management[8]

In 2002 a 20-year BOT contract was signed between IBC and the Municipality of Saida. Under this contract, IBC would finance, build, operate and maintain a waste treatment facility capable of treating 250 tons of solid waste per day, and was granted the right to sort and sell recyclable materials contained in the solid waste. The original plan was for fresh waste would be collected, separated and downsized, subjected to anaerobic digestion, to produce methane gas and ultimately electricity, as well as organic fertilizer as a by-product of the process

Nonetheless, responsibility for solid waste collection remained with Saida Municipality. However, the biggest problem came from the fact that the waste delivery chain was not managed according to the technological requirements of the treatment plant. Indeed, the municipality insisted in maintaining garbage cans outside of houses made the collection of fresh waste for the anaerobic digestion process impossible, as the time elapsed implies that the chemical process has already started. This is incompatible with the technological design of the plant, and generated several interruption and delays, leading to the main process never being implemented.

The plant was stopped for three years and the contract renegotiated. The separation and anaerobic treatment of waste was abandoned, and an arrangement involving free transport and a fixed fee (at $95/ton) for the simple treatment was made. Under this arrangement, the plant initially designed for a local population of 300 thousand does not have the sufficient capacity to treat the waste generated by a population that has reached 550 thousand, to which must be added 150 tons shipped daily from Beirut. As a result, a mountain of waste has again been rising in the vicinity of the treatment plant. In addition, the area does not count with a wastewater treatment plant, which

[8] This section is based on extensive discussion with Mr. Hamza Moghrabi (CEO IBC)

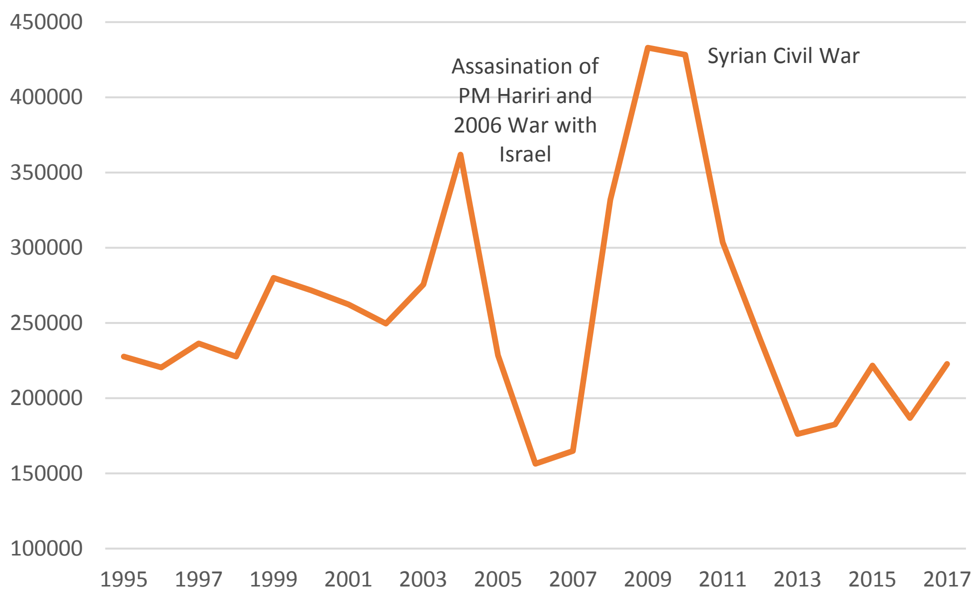
could have provided sludge to the IBC digester, leading to wastewater being discharged into the sea.

Nationwide, an estimated 51% of all municipal solid waste (MSW) is landfilled, 32 percent is dumped, and the remaining 17% is recovered through sorting and composting (SWEEP-NET, 2010).

Jeïta Grotto (Tourism)[9]

In 1993, the ministry of Tourism awarded a 30 years BOT contract to Mapas Co., for the rehabilitation and subsequent operation of the natural limestone-crystalized caves. It was the first PPP in Lebanon after the civil war. Between 1996 and 2017, there was a yearly average of around 260,000 visitors per year. However, the site has also suffered from a high volatility related to security concerns and regional turmoil, as witnessed by the steep declines in visitors after Prime minister Rafic Hariri's assassination in 2005, the 2006 Israel War, and the 2011 Syrian War, as can be seen in Figure 3. With a decline in visitor's figures, inflation and the absence of income guarantee, the site's profitability has decreased.

Figure- 3 Number of Visitors to Jeita Grotto



Source: Jeïta Grotto, MAPAS Co

Over the life of the project tensions have arisen between the operator and public counterparts. The private party mentions in particular the high turnaround of Ministers of Tourism, interferences in the hiring process of employees, and disagreements between public institutions, for example the Jeïta municipality and the central government, as reasons for this. One major point of contention has been the adjustment of the tariffs charged to visitors. While inflation and exchange rate related increases were contemplated in the contract, successive ministers have opposed such adjustments on unclear grounds. In the absence of income guarantee, this has put strong pressure on the site

9 This section is based on extensive discussion with Dr.-Eng. Nabil Haddad (Head of MAPAS Co.), as well as private communications from the company.

viability, given that over 40% of overall income is transferred to the government.[10] The concessionaire went to court and was finally granted an increase in tariff after eight years of procedure. Similarly, the site's investment capacity is heavily reliant on imported materials for caves' maintenance, but the firm was not able to obtain specific tariff reductions.

Postal Services (LibanPost)[11]

Following the civil war, the Council for Development and Reconstruction (CDR) sought the rehabilitation of postal services by bringing in private sector participation. A 1996 BOT tender based on technical scoring was won by a group composed of Canada Post Systems Management Limited (CPSML) and ProFac Management Group, leading to the signature of the 12-year contract in 1998.

The initial duty of the private operator was to invest $70 million over 12 years to re-establish the basic postal services –stamp and mail carriage services- that had been interrupted during the war period. This was achieved through a large infrastructure overhaul. The BOT stipulated revenue sharing with government according to a schedule gradually increasing from 5% to 40%.

Currently, LibanPost handles over two million transactions and 10 million pieces of delivery per year. In addition, LibanPost rapidly innovated to propose services not included in the initial contract. It now acts as an intermediary offering a host of governmental services, such as passport delivery, certification of official documents, and car plates delivery.[12] As a result, around 65% of LibanPost revenues are from non-postal services, and the operator is profitable.

The government was responsible for guaranteeing local monopoly rights, setting the tariffs and guaranteeing a minimum revenue level to mitigate demand risk. The contract was subsequently subject to several waves of amendments and renegotiations. Among the adjustments made, the investment horizon was extended, the employment obligations were made slightly more flexible, and tariff increases were planned. Over a couple of occasions there were changes in the composition of shareholders. In exchange of concessions to the operator, the government also obtained the right to audit revenues, costs, and operation figures, to extend the revenue sharing to non-postal services under certain conditions, to revise the contract every five years, and to possibly terminate it.

Over the years, the agreement proved relatively robust, despite the absence of a law and of specific provision for conflict resolution, and is often cited as the success story of Lebanese PPPs.

The persistence of contracts renegotiations

A repeated event in many of the cases we have laid out is contracts renegotiations. Due to their long-term nature, the large uncertainty about future states of the world, and the fundamental incompleteness of contracts in this context, PPP renegotiations have been pervasive across countries and sectors. Guasch, Laffont, Straub (2007, 2008) show, using data from Latin America between 1989 and 2000, that 55% of the projects in transport and 74% of those in water were renegotiated.

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10 From general income, 11 percent correspond to VAT payments, 20 percent to the ministry of tourism, while 10 percent of tickets entry fees and 5 percent of caves entry fees goes to the municipality of Jeïta.

11 This section is based on extensive discussion with Mrs. Nada Genadry (LibanPost HR Director), as well as private communications from the company and from Mrs. Maya Chamli (HCP).

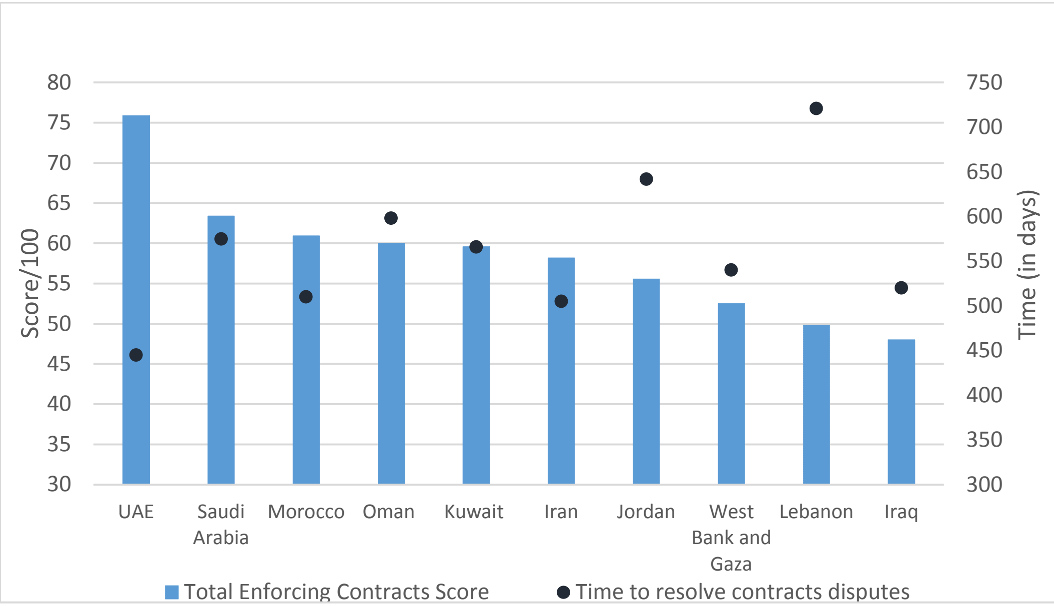
12 LibanPost's portfolio includes over 150 services. See https://www.libanpost.com/english/individuals/governmental/service-listing, last accessed on Feb. 11, 2019.

For the case of Lebanon, the high fundamental uncertainty stemming from macroeconomic fluctuations as well as patronage and corruption, PPPs are likely to require extensive and frequent adjustments. This in itself suggests a bias towards “optimal incompleteness,” in the sense that the environment calls for contracts that are as easy to adjust as possible. However, such an environment also makes awarding and contracting errors potentially more damaging to the projects. This suggests that open ended, flexible contracts will be more resilient if two additional aspects are combined:

First, important investments must be made to build regulator capacity and relative independence. Given the caveats on the possibility of de facto regulatory independence in weak governance and corrupt environments mentioned above, a basic objective should be to at least ensure they have local credibility and the ability to act as key partners to facilitate informal negotiation and mitigate tensions between the parties as the contracts face adjustments. Such an arrangement may prove more useful than exogenously imposed arbitration procedures that may end up not being respected, especially given the poor contract enforcement performance of the country (see Figure 4).

Second, given the low long-term commitment ability of authorities, low-powered incentives, where revenue sharing agreements are adjusted along the way, may prove more robust than fixed rules that lead to unexpected windfalls for the private counterpart or, on the contrary, to excessive pressures on their revenues

Figure- 4 Contract enforcements in select MENA countries, 2019



Source: World Bank Indicators

For the telecom case, contracts were hardly forward looking, and were probably too complete, as witnessed for example by clauses limiting the consumer base of the companies to 125,000. This lack of adaptability of the contractual relationship was compounded by a glaring lack of regulatory expertise and independence. As large short-term gains from expropriation were expected by the public counterpart, especially from the potential sale of licenses, the combination of complex fundamentals and flaws in the contract definition opened the road to opportunistic behaviours.

The Saida waste management project shares some of the same characteristics. It was an overly complex project, both in term of technology and because it involved several public partners with difficult coordination issues. The complexity of the project required a complete overhaul of the industrial organization of the waste management sector in the region, something that was hardly possible given the lack of regulatory expertise and the inability of local authorities to curb the opportunistic behaviour of other local operators.

The Jeïta Grotto contract also had to deal with complex institutional characteristics on the public side, in particular the need to negotiate with several, uncoordinated public partners.

Finally, the postal service initially involved a simpler, well-defined service, devoid of excessive technological complexity. In addition, the history of the project reveals a high degree of flexibility in allowing for several successive adaptations of the contract. This is supported by the view expressed by LibanPost leadership that the agreement was relatively robust, despite the absence of a specific law or of provisions for conflict resolution. The relative "incompleteness" of the contract is also illustrated by the degree of freedom awarded to the private party in developing a large number of new services. Interestingly, many of these services were targeted to easing the relationship between the public and governmental institutions, hence increasing the acceptability of this public private partnership among consumers.

Current PPP Landscape

The conclusions above shed light on the current prospects of new PPPs in Lebanon. Currently, two approaches stand out. On the one hand, the HCP has prepared a portfolio of potential projects (see HCP, 2018) and is seeking to formalize the process based on the new PPP law adopted in 2017. The most advanced project under the new legal framework is a cloud infrastructure national data centre. The framework stipulates the establishment of a PPP Project Committee, which will be in charge of the whole process, from the prequalification of bidders, to the organization of the bidding process, and the final award of the contract (see HCP, 2018, for details). This Project Committee is chaired by the HCP secretary general and is composed of representatives of the relevant ministry, the Ministry of Finance, and, where applicable, the authority regulating the relevant sector.

On the other hand, the ministry of energy and water is pushing three wind farm electricity PPP projects, largely bypassing the formal process defined in the recent PPP law. The wind farms, located in Akkar in the North of the country, should produce 200 MW, covering about one fifth of the country aggregate shortage. Following a 2013 request for proposal (RFP), and the expression of interest from three companies, the negotiation process culminated in the signing of a power purchase agreement (PPA) in 2018. This lack of institutional consensus is mostly the result of political tensions between different parts of the government and illustrates well the trade-offs regarding renegotiations in PPPs discussed above. It is difficult to predict at this stage which approach is more likely to succeed, partly because they both contain flaws of their own.

The difference in the way these two projects are managed can be related to our discussion above. The data centre project is an endeavour characterized by complex technological challenges in a fast evolving sector. It also implies the need to deal with several public entities, including some as clients. In that context, the formalized and complete contract approach undertaken under the new PPP law raises the risk of conflicts arising once the project starts operating. While it is important that the legal framework provides a positive signal of security to potential investors, especially foreign ones, it is also crucial in that context that the contract be defined in a very flexible way to allow for the adjustments that might be needed down the road.

The wind farm projects, on the other hand, exemplify an attempt to proceed under very flexible arrangements, even at the project definition stage. While the technology underlying these projects can be considered less complex than the telecom data centre case above, the complexity here stems mostly from the interactions with the public counterparts at several junctions. The promoters are betting on 'incompleteness' as a shortcut to avoid political roadblocks, potentially reducing the risk of opportunistic political interventions that would derail the projects. However, the wind farm projects raise important regulatory issues given the fact that the electricity regulator is not involved in the process and lacks independence from the line ministry. The first one is the implementation and enforcement of the long-term Power Purchase Agreement (PPA) that is crucial for the economic viability of the wind farms. Any change to these arrangements would de facto amount to expropriating the assets of the private counterparts. In addition, the PPA agreement generates long-term financial obligations for the public sector, but there is no visibility in terms of the evolution of prices paid by users. As such, there is a high risk that the wind farm operations will generate the need for extra transfers from Électricité du Liban (EDL), worsening the impact of the electricity sector on the fiscal situation. To avoid this, arrangements should be made for gradual price adjustments, given that the network price is far below the cost currently faced by users appealing to alternative self-provision arrangements. In addition, in a scenario in which end-prices increase and/or billing is improved, there is a need to develop a framework allowing for the entry of additional private generators on the side of the wind farm PPPs.

Policy Recommendations

How can policymakers make the most of the current competing approaches, and increase the likelihood of PPPs working out well in Lebanon?

- First, the legal and contractual frameworks must strike the right level of incompleteness. The objective is to ensure that there is room for high value-added technical or organizational innovations to develop new services with important benefits to the population.
- Second, a model of flexible political oversight arrangements is needed. The HCP mandate, could be extended to include approval of the projects at different stages including the final one, instead of referring to the Council of Ministers, to avoid political bargaining.[13] The composition of the project committee should also be reconsidered. In particular, it is unclear that the sector regulators should be present at the ex-ante planning, design, and delivery stages. Instead, it is desirable that their perimeter of action overlaps as little as possible with that of the PPP unit (HCP).
- Lebanon should invest heavily in the development of flexible and skilled regulatory agencies that can mediate conflicts in such cases and avoid abrupt termination. While the model of independent regulators is probably unrealistic in this case, investments in capacity are paramount.
- Finally, these arrangements for new PPPs will have to be made considering that the dark side of flexibility is the risk of corrupt deals, at the expense of the end users. The case for some type of voucher scheme involving a participation of the public in

[13] Some version of a "gateway" approval process could be implemented; see https://pppknowledgelab.org/guide/sections/31-institutional-responsibilities-review-and-approval, last accessed April, 10, 2019.

the capital of the PPP companies, with the aim of creating a popular constituency with a strong interest in the success of the projects, could also be explored.

Fiscal motivation behind PPPs

PPPs can be crucial way for Lebanon to rehabilitate its infrastructure and solve sectoral bottlenecks thus paving the way for job creation and inclusive growth. Nonetheless, a revision of the fiscal motivation of engaging in such initiatives is needed.

Long-lived infrastructure projects usually display large time mismatch between the potential cash flow that accrues over time from users and the initial investment needs for construction and the start of operation (the financing needs).[14] Cash- and credit-constrained governments often consider that PPPs help them relieve their tight budgets, as they shift the financing structure and the timing of payments. However, it is by now well-known from the academic literature that this accounting trick in no way represents a "free fiscal lunch", as there is a form of 'Ricardian Equivalence', by which the present value of investment and (foregone) revenues is strictly equivalent between public procurement and PPP.[15]

Despite this, a common and recurrent reason that pushes governments to embrace PPPs is to postpone or avoid altogether fiscal costs, as they are able to push fiscal liabilities off-balance, in the absence of reasonable fiscal accounting rules. This has clearly been one of the motivations in Lebanon, as the dire fiscal situation described in the introduction has long prevented the public sector to do large strategic investments in infrastructure.[16] An additional argument for using PPPs is that the government is current strongly credit-constraint, but would return to higher credit-worthiness a few years down the road thanks to the fiscal adjustment and debt reduction process called for in the CEDRE agreement.

While a theoretical case could be made, there are several reasons to doubt it, given the existing track record of PPPs. In particular, given the lack of integration of PPP-related debt in the public budget, this scenario is endangered by the potential realization of implicit fiscal liabilities, such as minimum income guarantees and the large tail risks falling on the public counterpart in case of project failure. This calls for a proper ex ante analysis of the fiscal implications of future PPPs, both in terms of changes in the time profile of expenditures and revenues, and in present value terms.

14 See Fay, Martimort, and Straub (2018) for a theoretical presentation of this argument.
15 See Engel, Fischer, and Galetovic (2013, 2014) for a detailed discussion. While a common argument to support PPPs is that the private sector has an efficiency advantage that might undo this equivalence at the margin, there are also reasons to think that other channels actually make PPPs costlier, including the need to provide private partners with a risk premium, and additional financing costs among others.
16 It is considered best practice to legally restrict the ability of governments to use PPPs for "debt hiding," as is done for example in France with the Spain law since 2011.

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