SADC BANKING ASSOCIATION
Transforming banking in Southern Africa

IP3
Institute for Public-Private Partnerships

PPP Skills and Competency Development

ONLINE TRAINING PROGRAMME

Module VI: PPP Contract Management, Performance Monitoring, and Price Regulation

Module Overview and Learning Objectives

This final Module of the online course provides an overview of the important "post-transaction" phase of a PPP: contract management, performance monitoring and regulation. It covers the purpose of a PPP Contract Management Plan, as well as its key elements and requirements, including the technical, human, and financial resources that the Government client needs to put in place.

In addition, this Module provides an overview of the concept of economic regulation of utilities and public services, as well as an introduction to the most common models of tariff regulation, including rate-of-return, price cap, and sliding scale regulation.

By the end of the Module participants will:

- Understand the need for a PPP Contract Management Plan;
- Have insight into the three key elements of PPP Contract Management;
- Understand the human resources required for a PPP Contract Management Team
- Understand the various phases of Contract Management and the roles and responsibilities during each phase in terms of the three elements;
- Understand the objectives of economic regulation; and
- Understand the differences between the three most common forms of economic regulation.

Introduction

Both in this online course, as well as in the real-world of implementing actual PPP projects, the great majority of attention is placed on the pre-transaction (ie before the PPP contract is signed) techniques of selecting candidate projects, conducting feasibility studies, proposing bankable risk-allocation structures including public sector supports, as well as tendering and procurement. However, perhaps the most important phase of a PPP comes *after* the PPP contract has been signed. In order for PPPs to provide the crucial benefits of expanding the quantity and the quality of infrastructure and public services, especially providing better value for the public's money, the project must perform as planned over its entire operating life (often 20 years or more). To ensure this is done, it is critical that some institution systematically monitor the performance that the PPP project is actually delivering. If necessary, this institution should be able to make deductions from the payments that PPP project receives, if it does not meet all of its contracted outputs.

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Additionally, because PPP have long contract terms, conditions are bound to change over the life of the project, in ways that neither party can foresee at the time of contract signing. Input prices (such as oil, coal, natural gas, and chemicals may change), labor prices may change, and even the scope of the PPP project may change, if requested by the client government agency. For example, the Government may request a PPP contractor to widen and expand the capacity of an existing toll road concession, or the Government may request an electricity or water distribution concessionaire to invest in a series of new connections, etc. Therefore a crucial question for the structure of the PPP contract to answer is, "how shall the tariffs or the PPP payments be adjusted given these changes in input prices or in scope?"

When initiating a PPP, Government has a key choice to make in terms of the legal and institutional method it will use to "regulate" the adjustment of PPP prices or tariffs paid to the private partner. It should be noted that the term "regulation" has two meanings. In its general use the term "regulation" refers to the entire framework of laws, their more detailed implementing rules, their specific procedures, and the relationships between the institutions that enforce the entire "regulatory framework." However, there is a more specific meaning to the term "economic regulation" referring to how public services prices will be set and adjusted in ways that are sustainable for the service provider, affordable to end-users, and that assure transparency and independence of the entire process. During the past 15 years more and more "public utility regulatory bodies" have been established throughout the developing world specifically to monitor the actual level of performance and service delivery in a given sector and to carry-out the economic regulation function for setting prices. In this Module, we will primarily be discussing techniques for the "economic regulation" of PPP prices and tariffs.

Legal and Institutional Mechanisms for PPP Contract Regulation

The two most common methods for the structuring the legal and institutional regulation of PPP contracts are regulation by contract and regulation by commission:

- Regulation by contract relies upon the PPP contract itself as the primary regulatory instrument. In this case, the rules that govern the roles and responsibilities of the parties, and especially the formulas by which any adjustments shall be made to the contract's prices or tariffs, must be clearly defined in the contract itself. Under this technique, there is generally very little discretion or judgement allowed by the contract monitoring body to make new changes to prices and payments. This tends to be applied to PPPs with a single off-taker, such as green field BOTs for Independent Power Projects (IPPs) or Private Finance Initiative (PFI) contracts, such as in the United Kingdom, where revenues come from availability payments from the client public institutions, rather than end-user fees.

- Regulation by commission entails the establishment of an independent entity charged with conducting technical and/or economic regulation of the private partner in accordance with pre-defined rules. These rules are set out in the "regulatory framework" using such instruments as laws, regulations, contracts, and licenses. Independent regulation is most commonly employed with the objective of de-politicising the setting of tariffs or user fees, and thus the form of economic regulation used is critical to the success of this approach. This tends to be applied for PPP featuring the "brown field" concessioning of existing public utility assets and networks, where revenues come from the collection of end-user fees directly from consumers. Under regulation by commission more discretion is given to the regulatory commissioners to fairly decide whether and by how much prices should be adjusted during the life of the PPP. For such a regulation by commission strategy to be acceptable to private investors and lenders, it must be an independent commission, especially independent from political pressures to simply keep tariffs as low as possible.

This Module provides an overview of both of the above legal techniques of economic regulation. It includes a discussion of contract management and monitoring, as well as an explanation of the three most common models of price regulation.

PPP contract management is the process that enables both parties to a PPP contract to meet their respective obligations. It requires building a good working relationship between government and the private sector service provider that will continue throughout the life of the agreement. It also requires anticipating future needs by managing proactively and addressing emerging problems and issues rather than merely reacting to situations after they arise.

The overarching objective of PPP contract management is for government and end users to obtain the services set forth in the output specifications of the contract and to ensure ongoing affordability, value for money, and that risks that have been transferred to the private sector *stay* transferred to the private sector. In practice, effective PPP contract management should strive to achieve continuous improvement in performance by both parties over the life of the contract.

PPP Contract Management

Contract Management:
- Enables both parties to meet obligations
- Involves building good working relationships
- Enables and assists in anticipating future needs
- Is implemented through the Contract Management Plan

The international record on PPP contract management and performance monitoring results has been a problematic one. A quantitative analysis of 1,000 different concession and PPP contracts in the Latin America and Caribbean Region determined that 30% of PPP contracts were renegotiated. More importantly the results of these renegotiations often came at the expense of the affordability, quality of service, and value for money objectives of the Government and the public (see Figure below):

Results of Concession & PPP Contract Renegotiation in LAC Region

Renegotiation Outcome	Percent of Total Renegotiations
Tariff Increases	62%
Tariff Decreases	19%
Delays in Investment Obligations	69%
Reduction in Investment Obligations	62%
Acceleration in Investments	18%
Increase in Number of Cost Components with automatic pass-through to tariff increases	59%
Extension of Concession Period	38%
Increase in Annual Fee Paid to Govt.	17%
Decrease in Annual Fee Paid to Govt.	31%
Increase in Operator's Rateable Asset Base	46%
Decrease in Operator's Rateable Asset Base	22%

Figure 1 - Source: Granting and Renegotiating Infrastructure Concessions: Doing it Right, by J. Luis Gausch, World Bank Institute, 2004

This record underscores the importance of PPP contract management. It begs the question, "what can Governments do to make sure that once PPP contracts are signed, requests for renegotiation do not result in unaffordable tariffs, delays in new service improvements, the transfer of risks back onto governments, and the erosion of the important value for money benefits that are the very foundation of the rationale for PPPs?" The answer is to carefully design and implement sound PPP contract management systems, institutions, and procedures.

In South Africa, the initial focus of the national government was to "get it right" in terms of the processes for implementing and managing a PPP. The UK PFI model and its Australian counterpart were models that were referenced in establishing the National Treasury PPP Unit and devising the careful, systematic PPP assessment processes that are in place today. As those processes were being implemented, and a growing number of PPP contracts put in place, with an even larger backlog of PPP assessments in the pipeline, it was timely for national government to enlarge its focus to encompass contract management. In 2003, the PPP Unit of South Africa's National Treasury developed and distributed its contract management guidelines. These represent best practice in that regard, particularly for countries such as South Africa, with a more developed economic and financial structure.

For More Information

The following websites provide useful information about contract monitoring and regulation:

- The African Forum for Utility Regulators: http://www.afurnet.org/
- South Asia Forum for Infrastructure Regulation: http://www.safirasia.org/default.aspx
- East Asian and Pacific Regulatory Forum: http://www.eapirf.org/

The PPP Contract Management Framework

While PPP contract management requirements will vary according to the specifics of the individual PPP agreement, there are three basic functions that need to be addressed in the management of any PPP:

- Partnership management is concerned with structures of accountability, and how government and the private sector service provider relate to each other;
- Service delivery management are the systems and procedures designed to manage risk and performance; and
- Contract administration relates to the administrative processes required to ensure that all the procedures contained in the PPP contract and all the documentation relating to it are effectively managed.

PPP Contract Management: Three Main Functions

- Partnership management
- Service delivery management
- Contract administration

To assist in addressing PPP contract management matters in a timely, systematic fashion, a contract management framework can be of valuable assistance. This framework should address the four main stages of a PPP during which the PPP contract management system is designed and implemented:

1. Procurement

2. Construction/Installation

3. Service Delivery

4. Exit

It is important to note that the overall plan for how the PPP contract will be managed, including the required performance standards, the monitoring institutions, the specific regulatory procedures, etc. must all be established *well before* the signing of the PPP contract. In fact the "PPP Business Case" (ie the detailed, proposed risk-allocation structure for the PPP) that is produced at the end of the PPP feasibility study should already provide:

- The key, general terms of the PPP contract
- The required output levels of service
- The procedures and mechanisms for measuring and verifying the levels of service being provided
- The contract payment and pricing structure
- The incentives and penalties (or payment deductions) that the private sector service faces
- Any payment escalation or cost pass-through formulas (such as for key inputs costs, like fuel)
- Procedures for handling variations in contracts, such as requested changes to agreed contract terms, agreed dispute resolution and contract termination options; and
- Other relevant mechanisms needed to enable a PPP contract to function.

These PPP contract management mechanisms are essential in allowing the contract to continue over the long-term and to respond sustainably and fairly to numerous unforeseen changes and to still continue to deliver better value for the public's money. When PPP contracts are constructed poorly, and many of these contract management mechanisms are omitted (often because of a rush to "just get the contract signed and the project started") it is much more difficult to sustain such PPPs during their long operational phases. Such contracts are more likely to encounter disputes, renegotiations, and especially early cancellations or terminations[1].

A useful tool for designing and implementing the PPP contract management is provided in the PPP Contract Management Framework Matrix in Table 6.1 below:

Table 6.1: PPP Contract Management Framework Matrix

CRITICAL STAGES OF PPP CONTRACT MANAGEMENT	KEY FUNCTIONS OF PPP CONTRACT MANAGEMENT		
	Partnership Management	Service Delivery Management	Contract Administration
Procurement	• Design the partnership management plan • Establish the contract management team • Prepare the *Contract Management Plan*	• Develop the performance management plan • Develop the risk management plan	• Develop the contract administration plan
	• Ensure a seamless transition to the new arrangements • Establish sound partnership	• Establish risk control procedures • Establish performance	• Develop financial administration, contract maintenance and variation

[1] These were the conclusions of an earlier review of nearly 2,500 major PPP contracts and the 48 contracts that were actually cancelled. Many of these cancelled PPP contracts lacked clear contract management mechanisms, and most were directly awarded (non-competitively tendered) contracts. This indicates that once the process of selecting the private partner is completed, less due diligence is done, and issues of uncertainty tend to get "pushed into the future" to be addressed during the more operational phase of a PPP contract, often unsuccessrfully. See: http://rru.worldbank.org/Documents/PublicPolicyJournal/252Harri-010303.pdf

Construction/ Installation	management systems	management systems • Monitor the development of the service towards the commencement date	management procedures • Develop the contract management manual
Operational/ Service Delivery	• Review and revise the partnership as necessary • Review and revise the *Contract Management Plan* • Commission independent reviews	• Ensure contracted services are provided in accordance with the output specification • Manage risks • Manage performance • Manage variations	• Review and revise financial administration, contract maintenance and variation management procedures • Update the contract management manual
Exit	• Organise closure event • Integrate lessons of the partnership into the work of the Institution	• Assess deliverables, value for money, quality and innovation achieved by the project • Organise post implementation review	• Implement hand back procedures • Make arrangements for the delivery of the service by the Institution or re-tendering

Government's Strategy for PPP Contract Management

It is essential that government adopt the proper overall strategy for the contract management of a PPP. Traditionally, government has been the service *provider*, in a hands-on, direct manner. A government PPP contract manager, however, must understand that she is not "the" service provider, but is the individual charged by government to ensure that the key services are, in fact, being provided. Thus, PPP contract management must be understood within the overall strategy of transforming Government's role from "rowing" to "steering."[2]

> **PPP Contract Management: Government's Approach**
>
> - Government does not *row* – government *steers*
> - Must respect transfer of responsibilities to service provider
> - Focus is on *outcomes:*
>   - Quality assurance
>   - Performance monitoring
>   - Corrective actions, where required

The Government's PPP contract management strategy, therefore, must respect the transfer of responsibilities, and commercial opportunities, to the private sector service provider. The focus must be on the service *outcomes* to be achieved, which entail quality assurance, performance monitoring and corrective action, where necessary. Effective PPP contract management requires government to move away from traditional public service delivery methods, which focused on inputs. The effective management of a PPP contract requires a range of 'soft' skills in both the government's and the private sector service provider's organisations. These important skills include communications, team building, consensus building, human resources management, dispute resolution, and strategic planning. A key element is the partnership management framework that should be contained in the Contract Management Plan and sustained after signing the PPP contract.

> **"Soft Skills" for Effective PPP Contract Management**
>
> - Communications
> - Team building
> - Consensus building
> - Human resources management
> - Strategic planning
> - Dispute resolution

The strategy the Government adopts to its contract management role will have a material effect on the success (or failure) of the PPP project. Too much government intervention usually adversely affects the relationship building with the private sector service provider, and often results in *transferring risk back to government.* Too little monitoring, on the other hand could lead to unsatisfactory service

[2] The root word "to govern" actually means "to steer" as in the "the Governor of a ship." The worldwide strategies during the past two decades to reform infrastructure sectors and public services, can be understood as changing Government's role from "rowing" (ie directly providing public services itself) to "steering": working with private sector "rowers" who will provide services, while Government returns to its core role of "steering," including monitoring and overseeing the work that private service providers do.

provision and require a significant intervention by government later on. The type of services provided, the public profile of the project and the stage of the PPP contract at any given point may, to a large extent, determine government's strategy. Thus, where the consequences of failure by the private sector service provider would be severe (for example, the failure to deliver pharmaceutical supplies to a health clinic) a rigorous PPP monitoring regime would be required. While the PPP agreement and the Contract Management Plan may include provisions for government's contract management approach, in practice, many aspects will depend upon the individual skills, judgment and creativity of the government project representative and the contract management team.

Government's PPP Contract Roles and Responsibilities

A critical aspect of effective PPP contract management for the public client Institution is to clarify the roles and responsibilities of key individuals. Ambiguity concerning the functions of important players in the contract management process could lead to unnecessary delays and disputes. The primary figures involved in contract management on government's side are the government's project representative and the project officer.

Government's PPP project representative

The government's PPP project representative is the senior official with overall responsibility for the PPP project. The role of government's project representative in PPP projects, with respect to contract management, is to:

- ✓ Mobilize support for the PPP project amongst elected officials and other key stakeholder groups;
- ✓ Appoint a PPP project officer;
- ✓ Obtain approval for the Contract Management Plan;
- ✓ Sign the PPP contract;
- ✓ Delegate necessary powers to the project officer after the PPP contract has been signed;
- ✓ Resolve any disputes which the project officer is unable to settle;
- ✓ Provide executive commitment to sound partnership management; and,
- ✓ Provide financial oversight and ensure that the PPP project continues to operate in the public interest after the contract has been signed.

Good practices indicate that the project representative be appointed as soon as government identifies a project as a candidate for PPP. This is to enable the project representative to make inputs into the output specifications and the contract, and ensure management continuity through each stage of the project. Once the PPP contract has been signed, the government's project representative should delegate the more detailed, technical responsibilities to the PPP project officer to enable her to ensure the successful day-to-day implementation of the PPP contract.

PPP Contract Management: Primary Government Persons

- Project Representative
- Project Officer

Government's PPP Project officer

The PPP project officer should be accountable to the government's project representative and must have clear delegated authority and a specific budget for carrying out her functions. The PPP project officer is required to play a central role in PPP contract management and her main responsibilities are to:

- ✓ Manage the project on behalf of government, exercising delegated authority;

- ✓ Ensure that the PPP project continues to be affordable, and provides value for money and appropriate risk transfer;
- ✓ Ensure both parties meet their contractual obligations;
- ✓ Ensure the requirements of the output specification are achieved;
- ✓ Appoint a contract management team with the necessary technical skills to administer government's obligations and protect government's rights in the contract;
- ✓ Build a strong partnership and good working relations with the private sector service provider;
- ✓ Prevent and/or resolve disputes;
- ✓ Manage risks;
- ✓ Monitor the private sector service provider's performance and take corrective action where necessary;
- ✓ Assist in the development of the Contract Management Plan;
- ✓ Implement the Contract Management Plan and related contract administration systems;
- ✓ Report on the management of the contract as required;
- ✓ Manage variations;
- ✓ Develop an effective communication framework;
- ✓ Organise contract management reviews; and
- ✓ Administer remedies in the event of contract breach.

A particular responsibility of the project officer is that of liaison officer with the private sector service provider for any dispute resolutions and to consider regular performance reports. Depending on the size of the project, the project officer may need to delegate some of these specific responsibilities to another member of the contract management team, especially dispute resolution issues. In some countries, project officers are held to a very high standard of accountability both in terms of performance and fiduciary responsibilities. In the United States, some state and federal project officers can be disciplined if their performance in contract management is seen lacking. In fact, some agencies "out-source" contract management so that accountability measures can be built into a clearer, contractual arrangement making performance, governance, and financial oversight 100% enforceable.

Government's PPP Contract Management Team

The resources to be devoted to contract management will be determined by the overall size and complexity of the project and the particular stage it has reached. In some cases it may be possible for the PPP contract management function to be carried out by a single individual. Sometimes individual contract managers may oversee multiple, smaller-sized PPP contracts simultaneously. However, larger PPPs can typically require the project officer to be supported by a team, consisting of a range of specialists and technical advisers with varying levels of involvement.

It should be the project officer's responsibility, in consultation with the government's project representative, to decide on the composition of this team, how it should be deployed, and whether and when to call on additional expertise (within the scope of the budget). The range of expertise and skills required will vary over the life of the contract.

Membership of the team will reflect the various competencies required to effectively discharge contract management responsibilities during each stage of the contract. Typical disciplines that need to be represented or be available are:

> **PPP Contract Management Team**
>
> - Provides support to Project Officer in managing Contract
> - Composition of Team varies, but may include:
>   - Technical
>   - Financial
>   - Legal
>   - Human Resources disciplines

- Expert sector knowledge in terms of the core technology of the PPP;
- Design and construction;
- Business and product assurance;
- Facilities and services management;
- Human resources;
- Information technology;
- Statutory safety and regulatory responsibilities;
- Legal matters; and
- Finance.

The main focus of the project officer and the contract management team will be to coordinate inputs from the various team members in order to ensure effective and consistent contract management.

The project officer should establish a suitable structure for the contract management team *well before* the PPP contract is signed and executed. While individuals can change, the aim should be for continuity of contract management expertise from the procurement stage onwards. To this end, knowledge management systems should be developed, and succession plans prepared for critical skill team members. The private sector service provider should be made fully aware of the contract management structures that have been established within government. Usually, the private sector service provider will appoint its own contract management team or liaison to act as its interface with government.

Where PPP contract management expertise is brought in from outside government, either on an ad hoc basis or under a long-term arrangement, it will be important to ensure that commercially confidential or proprietary information held by government and the private sector service provider is protected. The terms of reference, time scales and basis of fees for such advisers must be clearly defined so as to ensure that management of the contract rests with government. Any contract with independent professional advisers providing contract management services must contain clear arrangements for reporting results of performance monitoring to government and the private sector service provider.

Ethics should be another important consideration of the PPP project officer and the rest of the contract management team. In all their dealings with the private sector service provider, the project officer and the contract management team should be guided by the provisions of any applicable Code of Conduct, or such code should be developed by the project officer.

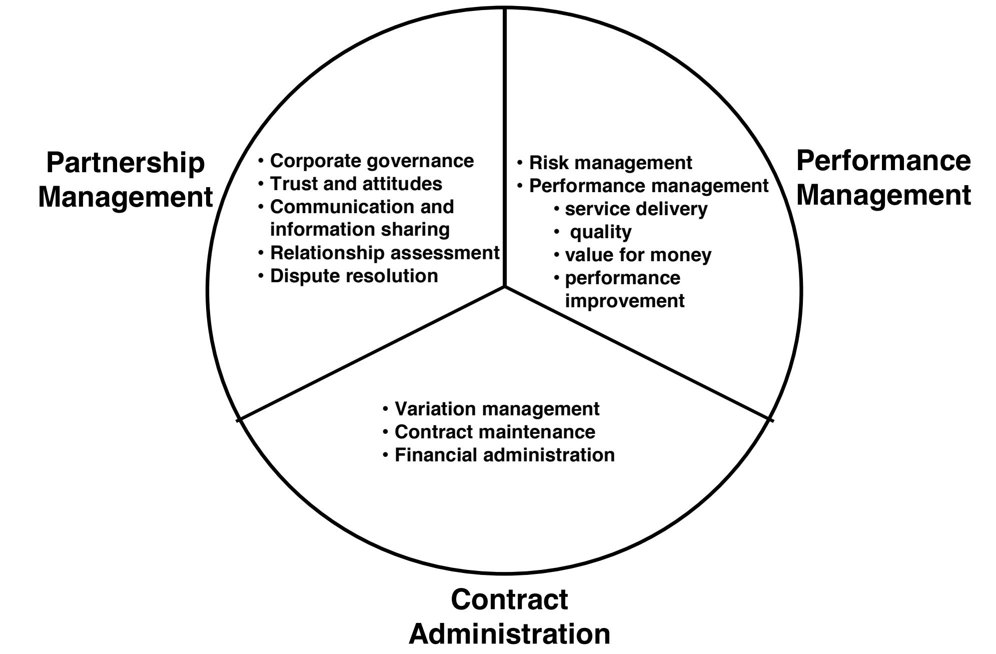
PPP Contract Management Functions

The specific tasks that need to be undertaken during PPP contract management can be broadly divided into three main functions:

- Partnership management;
- Performance (ie service delivery) management; and
- Contract administration.

These are depicted in Figure 6.1 below. In practice there will inevitably be a considerable degree of overlap between these functions and they will often need to be undertaken simultaneously during many stages of the project. Nevertheless, an understanding of the purpose of each of these functions and the competencies required to perform them effectively should help to clarify further the responsibilities of the project officer and enable him or her to assemble a team with the necessary attributes.

Figure 6.1: PPP Contract Management Functions



PPP Partnership Management

Any successful partnership must clearly "work" for both parties. For a PPP this means it must deliver the services for the Government (providing better value for the public's money) and it must allow the private partner the opportunity to earn an adequate return on its investments. The way these parties regard each other and the way in which their relationship operates is vital to making a success of the arrangement. Partnership management involves the development of processes to ensure accountability and manage the relationship between government and the private sector service provider. Some key dimensions of PPP partnership management are:

> **Partnership Management Function**
>
> Key dimensions:
>
> - Corporate governance
> - Communication and information sharing
> - Dispute resolution

- Corporate governance;

- Communication and information sharing; and
- Dispute resolution.

These issues need to be addressed in a partnership management plan that should be developed as part of the PPP Contract Management Plan.

Partnership Management: Corporate Governance

- Corporate Governance: Structures, systems, policies and mechanisms of accountability within an organisation
- South Africa has *King Code of Corporate Practices & Conduct*
  - Broadens financial focus to include environmental and social aspects
  - Applies fairness, accountability, responsibility and transparency to all activities
  - Requires accountability to the organisation and stakeholders

Corporate Governance

Corporate governance means the overall system of institutional structures, operating rules (ie bylaws), compliance mechanisms, and accountability procedures within an organisation. In South Africa the policy framework for corporate governance throughout the public and the private sector is contained in the *King Code of Corporate Practices and Conduct*, which puts forward an 'inclusive' and 'balanced scorecard' approach to corporate governance. This requires an organization's board to:

- Move from the single bottom line of financial performance to the triple bottom line, which embraces the financial, environmental and social impacts of an organization's activities;
- Apply the tests of fairness, accountability, responsibility and transparency to all acts and omissions;
- Be accountable to the shareholders (owners); and,
- Be responsive and responsible towards key stakeholders.

The *King Code* puts forward a comprehensive set of recommendations on corporate governance, covering topics such as: the role and responsibilities of company boards and directors; risk management; internal audit; integrated sustainability reporting; accounting and auditing; relations with share owners; and corporate communications.

The *King Code* applies to government institutions as well as the private sector, and is an important reference in PPP partnership management arrangements. These provisions should relate to liaison and reporting requirements and should include a governance structure that is consistent with the King Code and is headed by the government's project representative on government's side, and the Chief Executive or equivalent officer on the side of the private sector service provider.

PPP Contract Communication and Information Sharing

Effective communications are often the "make-or-break" determinant in managing a PPP partnership. Many cases of mistrust or concern over poor performance (by either party) in a PPP relationship result from a failure to communicate effectively and to understand the business goals or intentions of the other side.

Sharing information between government and the private sector service provider may raise legitimate concerns about how information will be used. Willingness to share sufficient information voluntarily depends largely on the atmosphere of trust. However, there should be a realistic balance between openness and reserving negotiating positions.

The relationship between government and the private sector service provider should operate at different organisational levels, with channels of communication running 'horizontally' between equivalent levels on both sides. A key recommendation is to first allow open communication, including recommending solutions to problems, between the lower and mid-level managers on both sides. This can be much more effective at establishing and preserving trust and cooperation compared to approaches that require that all problems, issues, and potential solutions can only be discussed during monthly or quarterly meetings between the highest level public and private officials.

Partnership Management: Communications

- Strategic Level: Government's project representative and CEO of private sector service provider
- Business Level: Project officer and the private sector service provider counterpart
- Operational Level: Government staff and private sector service delivery management

Important that communication levels be maintained when problems arise – do not "take this straight to the top"

In practice, the government's project representative and the Chief Executive of the private sector service provider should discuss corporate governance issues and provide a forum for dispute mediation if difficulties cannot be resolved at lower levels. They also promote the partnership, not least by mobilising high level political support and demonstrating commitment to the project by 'leading from the front'.

At the legal level, the contract is formally managed by government's project officer and his or her private sector service provider counterpart. Services are planned and their delivery is monitored. At the operational level, the service is delivered to the client public institution and its staff and/or the general public. Day-to-day problems in the delivery of services should first try to be resolved here; if this is not possible, they can be escalated to the project officer.

An important point is that the arrangement should be managed in such a way that these levels of communication are preserved especially when problems arise. For example, if end user departmental employees feel the service is not being delivered to the required standards, they should refer this to the PPP project officer, who will liaise with the private sector service provider counterpart. It is generally not productive to go 'straight to the top' and liaise directly with the private partner's Chief Executive; doing so would undermine the key business level management of the contract. Similarly, it would be inappropriate for service delivery management on the company side to complain about their workload to the project officer.

So a combination of 'vertical' communication between levels within each organisation and 'horizontal', peer-to-peer communication between organisations is the recommended approach. Consistent communication at each level is also important, or differences in perspective between say the government's project representative and the project officer may create difficulties in the partnership.

A mechanism that has proven to be highly effective in enhancing communication and other aspects of the partnership between government and a private sector service provider is the co-location of contract management staff from both sides in common premises. Having a base in the same building can help to build informal communication channels and trust, which can in turn help to smooth the way for more formal contractual negotiations.

PPP Dispute Resolution

To ensure they are sustainable, PPP contracts must include a clear contract dispute resolution mechanism. This procedure requires that any disputes should in the first instance be referred to the government's and private sector service provider's liaison officers (in the case of government, the PPP project officer), to enable them to try to find an agreeable solution. If they are unable to resolve the dispute within an agreed period, the dispute should be referred to the government's project representative and the Chief Executive of the private sector service provider. If agreement still cannot be reached, the matter should be referred to an independent Mediator for mediation; or to an Adjudicator to determine the outcome as part of the fast track dispute resolution procedure. Only if the informal and formal procedures of this escalation process have been exhausted should the dispute be referred to the courts through litigation.

The PPP project officer, therefore, has an important role to play in ensuring that the dispute resolution procedure is properly understood up-front by all members of the Government's contract management team. The main goal of the project officer should be to anticipate and prevent disputes from arising in the first place. When this is not possible, she should facilitate co-operation between both sides to ensure that problems are recognised and resolved as quickly and effectively as possible. If it is necessary to involve a higher level of authority, the project officer should attempt to create the best possible atmosphere for an agreement to be reached.

Partnership Management: Dispute Resolution

- Dispute Resolution processes in PPP Contract
- All disputes must follow same route from project liaison personnel on both sides to the government's project representative and private sector's CEO
- Important to:
    - Record problems as they occur
    - Notify of problems by correct route at correct level
    - Document approaches to resolving problems
    - Escalate only as per Contract

Whatever the nature of the problem, the project officer should ensure that:

- Problems are recorded as they occur;
- The Private Party is notified of problems by an appropriate route and at an appropriate level;
- Approaches to resolving problems are clear and documented; and
- The escalation procedures set out in the contract are followed.

PPP Service Delivery Management

Service delivery management in a PPP context can be divided into two principal categories:

- Risk management; and
- Performance management.

Risk management involves keeping the exposure of the project to any potential threats to an acceptable level by taking appropriate action. Performance management, on the other hand, is concerned with: ensuring that the PPP project remains affordable for government, continues to provide value for money, and the quality of service is maintained. An important point to bear in mind is that the government's performance management role in a PPP project is in many respects quite different from the performance management function that government departments normally carry out. In PPPs 'managing' the performance of the private sector service provider has more to do with regulation than management in the traditional sense.

Service Delivery Management

Two principle areas:

- Risk management
- Performance management

Risk Management

While risk management is first addressed during the earlier PPP procurement process, additional risk management procedures are required after the signing of the contract. Good practices indicate that a risk management plan addressing the risks identified during the feasibility study and reflected in the PPP contract should be included in the Contract Management Plan that was prepared prior to contract execution. Upon execution of the PPP contract, the project officer and the contract management team should elaborate on the risk management plan so developed by undertaking the following:

> **PPP Contract Management: Risk Management**
>
> Central component of contract management:
> - Contract risk allocation reflected in Contract Management Plan
> - Project Officer allocates "ownership" of each risk to member(s) of the Project Management Team
> - Risk measures determined and implemented
> - Assessment of mitigation measures is ongoing

- Establish which member of the contract management team "owns" a particular risk. All risks should be so assigned;
- Establish risk mitigation procedures indicating courses of action to be taken to mitigate each particular risk;
- As the contract proceeds, assess the adequacy of the risk mitigation measures;
- As experience dictates, adjust and amend the risk mitigation measures accordingly; and
- Amend the risk management plan going forward.

The risk management will be an iterative process, recurring numerous times throughout the life of the PPP contract.

Performance Management

Contract management requires that appropriate procedures be put in place to ensure that the goals and requirements of affordability, service delivery outputs, quality, and value for money benefits are achieved.

Good practices recommend that government include in the contract a performance monitoring methodology, comprised of three key elements: The performance management plan, the performance monitoring systems, and performance review and corrective actions systems.

- The Performance Management Plan, contained within the Contract Management Plan, ensures that the output specifications in the contract are met in terms of affordability, service delivery, quality and value for money. The performance management plan will reflect the counterpart contract provisions, and should include details of:
  - ✓ The reporting obligations of the private sector service provider in regard to self-monitoring;
  - ✓ The performance management system that will be used by government to review the private sector service provider's quality management system;
  - ✓ The mechanisms that will be established to solicit end user feedback, including a complaints procedure;
  - ✓ The government officials who will be responsible for monitoring affordability, service delivery, value for money, quality and performance improvement; and
  - ✓ An estimate of the resources that government will allocate to managing the private sector service provider's performance.

- The Performance Management Plan will describe the mechanisms that government will use to monitor the private sector service provider's performance. Performance monitoring systems should be established to enable the contract management team to:

  - ✓ Regularly check progress to ensure that project milestones are met;
  - ✓ Holding regular progress meetings with the private sector service provider to consider performance reports;
  - ✓ Conducting regular and random inspections of the supplied goods and/or services;
  - ✓ Developing effective mechanisms for obtaining feedback from end users and other key stakeholders;
  - ✓ Inspecting deliverables to ensure quality; and
  - ✓ Maintaining comprehensive performance monitoring documentation.

- Performance review and corrective action must comply with the provisions contained in the PPP contract. Effective monitoring should provide the basis for reviewing actual private sector service provider performance against the contract's required output specifications. The application of formal warnings, penalty deductions, "step-in" actions and other responses should be undertaken in a manner that is likely to achieve the best result from government's point of view. An overly rigid approach usually jeopardizes continuing service delivery, while excessive lenience could encourage further breaches.

An effective PPP performance monitoring methodology should occur at three levels:

- Systematic self-monitoring by the private sector service provider through a quality management system;
- Review of the private sector service provider's quality management system by government or an independent third party; and
- End user feedback on the quality and effectiveness of service delivery.

PPP Contract Administration

PPP Contract administration refers to the establishment of more specific administrative processes to ensure that all the procedures and documentation relating to the contract are effectively managed. Clear and practical administrative procedures can greatly help to ensure that all parties to the PPP contract understand precisely who does what, when, and how.

The PPP project officer should develop a contract administration plan that sets out:

> **PPP Contract Administration: Three Main Activities**
>
> - Variation management
> - Contract maintenance
> - Financial administration

- ✓ A summary of the proposed systems and procedures for contract maintenance, variation management and financial administration;
- ✓ The roles and responsibilities of government and the private sector service provider in relation to contract maintenance, variation management and financial administration; and
- ✓ An estimate of the resources that government will devote to contract maintenance, variation management and financial administration.

As the PPP approaches the contract's planned ending date, the PPP project officer will need to undertake those contract administration responsibilities provided by the exit provisions of the contract.

Contract administration activities can be broadly groups into three main categories:

- Variation management;
- Contract maintenance; and
- Financial administration.

Variation Management

Variation management means the creation of mechanisms to enable requested changes to the contract to be discussed and fairly agreed upon. Such changes may be necessary as a result of a change in circumstances that could not be anticipated or quantified when the contract was signed. Variations may involve changes to works, services or the form of delivery. There are four main categories of variations:

- Variations that involve no additional costs, which typically may be undertaken with notice;
- Small works variations, which may be undertaken in accordance with a low-level of notice and agreement;
- Government-instituted variations, which will typically result in a change in costs, an extension of time, or both, and which entail a more formal notice and mutual agreement process; and
- Variations instituted by the private sector service provider, which may entail a formal amendment to the PPP contract, in accordance with the provisions thereof.

The government's project representative should be notified of all proposed variations prior to their implementation. The variation procedures must be used for all changes to the contract in regard to works, services and the means of delivery.

PPP Contract Administration: Variation Management

- Few long-term PPP contracts stay the same: changes will occur
- Establish a system for administering changes:
  - "No cost" changes – do as and when necessary
  - Small works variations – approvals required, depending on level of variation
  - Government-instituted variations – formal notice & mutual agreement process
  - Private sector-instituted variations – formal amendment of PPP contract

Given the length and complexity of most large PPP agreements, it is likely that these procedures will be invoked from time to time to deal with changing project needs. Thus, variation management is a critical element of each stage of the contract administration process. It must be used effectively to ensure that other important functions, such as performance management and risk management, continue to operate in line with contractual requirements and changing service delivery imperatives. The project officer must become familiar with all the intricacies of each variation procedure and ensure that the correct steps are followed whenever the need arises.

Contract Maintenance

Contract maintenance involves the establishment of administrative procedures to ensure that the contract and related documentation are consistent, up-to-date and accessible to all the relevant parties. It also requires taking actions to allow all parties to develop a common view of contractual obligations.

Contract Financial Administration

Effective financial administration involves the development of systems and procedures to make and receive financial payments, and keep records of financial transactions in accordance with the requirements of the contract. Such requirements include making unitary and incentive payments to the private sector service provider, administering penalty deductions, calculating inflation, dealing with late payments, and receiving financial reports.

Economic Regulation of PPP Contracts

A crucial choice to be made in the design of a PPP's regulatory framework is that of the tariff regime, i.e., the rules for setting and adjusting the payments the private partner receives, whether through availability payments or end user tariffs. In developing procedures and methodologies for the regulation of tariffs to be charged for services, institutions have to balance the following (sometimes conflicting) objectives:

Objectives of PPP Economic Regulation

- Financial viability
- Dynamic efficiency
- Ease of administration
- Social policy

- Financial Viability: Payments, which cover the full cost of efficient services, are an essential component of a strategy to sustain and expand services and attract private investment finance.

- Dynamic Efficiency: PPP tariff regulation should provide incentives for ongoing technological innovation and efficient cost management. A tariff policy, which simply allows all costs to be passed on to consumers, provides no incentives for the private service provider to become efficient. The PPP's economic regulator must ensure that tariff levels make it *possible* for efficient operators to recover reasonable costs, they must not *guarantee* that the private partner will recover all of their costs.

- Ease of Administration: Tariff regulation should not impose an excessive administrative burden on consumers, the service providers or the regulatory authority. Monitoring PPP performance and regulating tariffs can take significant time and money to implement. Therefore the costs of administering economic regulation should be carefully managed.

- Social Policy: Many public services have wide-ranging social and economic impacts on the welfare of the population and on the development prospects of the state. For this reason, universal access to service is often desirable. To achieve this objective, it may be necessary to provide services at less than full-cost to low-income households, such as through lifeline tariffs.

There are two primary approaches to the regulation of tariff levels, which are in wide use: the rate-of-return methodology and the price-cap methodology. They present different advantages and disadvantages that are described in the following sections.

Rate of Return Regulation

Under the rate-of-return (ROR) approach, the private operator is guaranteed the opportunity to earn a "reasonable" rate of return on its invested capital. The regulator has some discretion in determining what a reasonable return is or, alternatively, the rate of return may be specified in the PPP contract. This approach is often attractive to private investors because their profitability is *nearly* guaranteed (provided they meet their required service delivery obligations). It can also be a very clear and effective means to incentivizing the private partner to go ahead and make new investments, such as massive new electricity or water connections. However, ROR entails a number of drawbacks. It creates few incentives for operational efficiency and often encourage excessive investments. The more investments the private partner makes, the larger its revenues will be. The timing of tariff reviews and adjustments can appear unpredictable, and the justification for tariff increases may be poorly understood by consumers, who may perceive that they are now required to pay more even if they see no material changes in the levels of service they receive.

ROR has been in use for many decades in the US and the UK, but in recent years regulators have begun to replace it with the price cap approach. It remains a valid approach for achieving adequate cost recovery in publicly operated services, which have generally been severely under-funded. It may also be the appropriate choice when the main objective of PPP is to attract private investment, because it reduces the risks on private partners associated with financing new investments.

Price-Cap Regulation

The price-cap (PC) approach is currently used for several public utility sectors in the United Kingdom, and has since gained wide acceptance elsewhere. Under price-caps, tariffs are fixed for a pre-specified period (usually five years) and increases are predictable and linked to a well-understood inflation index, such as the retail price index. If any new investments are planned (and agreed to by regulators), an additional factor is added to recover investment costs. Finally, an efficiency factor may be subtracted to keep the increase below the full inflation rate.

Typically the formula for setting tariffs under a price-cap regime is:

$$\text{Tariff Adjustment} = RPI - X + K$$

Where "RPI" is the retail price index, "X" is the efficiency factor set by the regulator, and "K" is the capital cost recovery amount allowed by the regulator. For example, if for a given 5-year review period, RPI is 10% (note that RPI can and does change from year to year), the regulator sets an "X-factor" of 4% (meaning she believes the private service provider can improve its efficiency by 4% each year) and the regulator allows a 2% annual increase in tariffs recover the costs of new investments – then the private operator will be allowed to increase its tariffs by 10% - 4% + 2% = 8% each year, at a time when inflation is at 10%.

Private operators have an incentive to improve efficiency under the Price Cap approach because they can retain any additional profits that result from their own cost-cutting. The major disadvantage of PC is that it may result in a deterioration in service quality as operators attempt to cut costs and increase profits. Service quality, and especially reliability, therefore must be monitored closely. Another disadvantage is that the high profits which may result may not be politically acceptable.

In the United Kingdom, PC has tended to move towards a return to ROR when the regulator was pressured to limit profits that private utilities were earning. For PC to work effectively, the regulator must be able to capture adequate efficiency gains for consumers (through setting meaningful "X-factors") at the five-year intervals. Despite these challenges, PC is rapidly gaining acceptance internationally, and it has been adapted to a number of PPP arrangements.

Hybrid: Sliding Scale Regulation

Sliding scale regulation is a hybrid form of economic regulation that combines features of both the Price Cap and Rate of Return approaches. Like PC, sliding scale regulation sets tariffs for a particular period and allows private operators to retain excess profits *to a point*. After the pre-determined profit ceiling is reached, a portion of the excess profits are returned to customers. Likewise, the private operator must absorb any losses *to a point* and after that point is reached, the operator is compensated.

Conclusions

Perhaps more important than the "pre-transaction" analysis and design of a PPP, are the arrangements put in place for monitoring and evaluating the performance of the private operator once it begins work under the contract. Such arrangements include the development of plans and procedures for monitoring, and institutional arrangements for managing the contract monitoring function. Where economic regulation is required, the challenge facing government is how to design a framework that is effective in balancing the often conflicting objectives of a multitude of stakeholders.

Module 6: Content Assignments

In order to successfully complete your work on the Content component of this Module, you must complete the following:

- Read the required background reading materials:

  1. "Granting and Renegotiating Infrastructure Concessions: Doing it Right," by J. Luis Gausch, World Bank Institute, 2004. http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2004/05/06/000090341_20040506150118/Rendered/PDF/288160PAPER0Granting010renegotiating.pdf

  2. "South Africa's PPP Manual – Module 6: Managing the PPP Agreement," 2006. http://www.ppp.gov.za/Documents/Manual/Module%2006.pdf

- Read this Module VI Content piece

- Answer the following question (with the answer posted to the Discussion Board of the online learning platform) relating to the Content piece:

  - First, summarize an example of a PPP from within your country (or whichever relevant country you select). Second, tell us whether it is regulated by contract or by a regulatory commission. Third, analyze the strengths and weaknesses of whichever approach has been taken and include any recommendations you have for improving the approach to PPP regulation and contract management.

- Read other participants' postings to the Discussion Board and provide substantive comments (in the Discussion Board) on two other participants' answers to the Content question.

In addition, participants may elect to read the following *optional* background reading materials for this module:

- "Outsourcing Regulation: When Does it Make Sense and How do we Best Manage It?" by Sophie Tremolet, Public-Private Infrastructure Advisory Facility (PPIAF), 2007. http://www.ppiaf.org/ppiaf/sites/ppiaf.org/files/publication/WP5-Outsourcing%20Regulation%20-%20STremolet.pdf

- "Evaluating Regulatory Decisions and Sector Outcomes from Infrastructure Industries: Results from Africa and Other Developing Countries," by Jon Stern, Public-Private Infrastructure Advisory Facility (PPIAF), 2007.

http://www.ppiaf.org/ppiaf/sites/ppiaf.org/files/publication/WP3-Evaluating%20Regulatory%20Decisions%20-%20JStern.pdf

- "Handbook for Evaluating Infrastructure Regulatory Systems," by Ashley Brown, Jon Stern, and Bernard Tenenbaum, with Defne Gencer, the World Bank, 2006 http://siteresources.worldbank.org/EXTENERGY/Resources/336805-1156971270190/HandbookForEvaluatingInfrastructureRegulation062706.pdf