

# Serving the Community By Using the Private Sector

## An Introductory Guide to Public Private Partnerships (PPPs)

March 2008  
(Second Edition)



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# EFFICIENCY UNIT VISION AND MISSION

## **V**ision Statement

To be the preferred consulting partner for all government bureaux and departments and to advance the delivery of world-class public services to the people of Hong Kong.

## **M**ission Statement

To provide strategic and implementable solutions to all our clients as they seek to deliver people-based government services. We do this by combining our extensive understanding of policies, our specialised knowledge and our broad contacts and linkages throughout the Government and the private sector. In doing this, we join our clients in contributing to the advancement of the community while also providing a fulfilling career for all members of our team.

## **Other Efficiency Unit Documents**

The Efficiency Unit (EU) has produced a number of detailed guides including on policy and practice, outsourcing and contract management. These may be found on the EU website at [www.eu.gov.hk](http://www.eu.gov.hk).

Throughout this document the term department is used to describe all government agencies.

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# FOREWORD

There has been a tremendous growth internationally in the use of the Public Private Partnership (PPP) approach to deliver large scale, long term facilities and services for the community. More and more governments, including many in Asia, have come to appreciate the improvements in service quality and value for money that well prepared PPP projects can achieve. PPPs are now an established part of public procurement in advanced and developing countries alike.

Naturally there have been challenges and many lessons have been learnt. This 2nd Edition of the PPP Guide has been prepared so that we in Hong Kong learn from the lessons and experience built up locally and overseas and ensure that our PPP projects follow up to date best practices.

It is clear that properly prepared PPPs can contribute significantly to achieving the Government's well-established policy of 'small government, big market'. PPPs encourage the creation of private sector jobs and business opportunities, whilst avoiding the unnecessary creation of civil service jobs.

The advice in this Guide has drawn heavily upon the experiences and excellent publications in Australia, especially Victoria, and the United Kingdom. The EU also wishes to acknowledge with gratitude the helpful suggestions and comments made by our colleagues in many departments and bureaux. Many Hong Kong and overseas individuals in both the public and private sectors have made valuable contributions in producing this 2nd edition. We are most grateful to them all.

The Efficiency Unit stands ready to assist departments to examine and grasp the many PPP opportunities that are now available.

**Head, Efficiency Unit**

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# INTRODUCTION

This PPP Guide is intended to help Hong Kong civil servants to develop innovative and practical ways to use PPPs to deliver public services.

Other guides published by the Efficiency Unit (EU) may be viewed at the EU website at [www.eu.gov.hk](http://www.eu.gov.hk).

**The Guide focuses principally on PPPs that involve the use of private financing of the facilities required to deliver a facility or services; this may be associated with the granting of a franchise or concession to deliver some or all of those services. It is acknowledged that many PPPs in Hong Kong will use mainly public funding, and users of the Guide should interpret the Guide appropriately when government funded models are being considered.**

The Guide introduces the use of the PPP approach to procurement in Hong Kong by posing and answering a number of questions. It has been developed mainly for use by the civil service but is made available to the private sector to enhance its understanding of the Government's approach. Users of the Guide should recognise that it is not definitive and many departments should be consulted in individual cases (see "Taking Advice and Guidance").

PPPs are used in many jurisdictions. Definitions, legal requirements and procedures, practices, terminology and acronyms etc. naturally do vary. This Guide draws on the relevant experience elsewhere that is considered most appropriate to Hong Kong's circumstances. We have used terminology etc. most familiar to Hong Kong. Some of the other terminology used overseas is cited in the Glossary of Terms.

The EU welcomes comments and feedback from users of this Guide.

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# 1 WHAT IS A PPP AND WHAT ARE THE BENEFITS?

## 1.1 What is a Public Private Partnership (PPP)?

A PPP is a contractual arrangement involving the private sector in the delivery of public services. As the name suggests, this is based on a partnership approach, where the responsibility for the delivery of services is shared between the public and private sectors, both of which bring their complementary skills to the enterprise.

PPPs bring together the public and private sectors in a long-term contractual relationship to deliver high quality public services. The private sector becomes a long-term service provider rather than a simple upfront asset builder. Departments are more involved as regulators and procurers of services rather than direct providers of services to the public.

PPPs differ from other forms of private sector involvement such as: **outsourcing**, where the public sector directly procures services through shorter-term contracts; **privatisation** where a government owned entity or asset is transferred to the private sector in perpetuity and the government's role if any is reduced to that of regulator; and **private sector provision** where the government has no involvement in the provision of a service as the demand is being adequately served by the market.

PPPs may be developed with a number of objectives in mind:

- ◆ Enhancing significantly the availability of improved public services by contributing to increases in the quality and quantity of investment in facilities and services
- ◆ Realising the full potential of public sector assets to provide greater value for money for the taxpayer and the wider community
- ◆ Removing inefficiencies and developing imaginative approaches to the delivery of public services
- ◆ Investing in high quality facilities that minimise long term maintenance and operating costs
- ◆ Managing and minimising the cost to government of risks associated with long term, complex projects
- ◆ Allowing stakeholders such as users, taxpayers, and employees to receive a fair share of the benefits of a PPP.

PPPs should not be used as a means to overcome budgetary constraints or bypass the proper fund bidding procedures, or else this will effectively be a hypothecation of revenue. Client departments should always have overriding policy justification for pursuing a project, whether by means of PPP or other approaches.

## 1.2 How do other governments view PPPs as part of their procurement strategies?

Many overseas administrations currently include PPPs within their procurement strategies, for example:

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- ◆ Partnerships Victoria policy says “where public infrastructure and ancillary services are required, the government will make no assumption that either the public or the private sector is the best provider. Consideration will be given to the whole of life costing of the infrastructure and the benefits of risk transferral in each case. If it is clear that the private sector can deliver the service more cost effectively than government, it will be invited to do so, subject to the arrangement passing a public interest test”
- ◆ The United Kingdom (UK) Government states that it “is committed to securing, over the long term, the most cost effective infrastructure for the public services. To achieve this, it seeks to ensure that investment uses the appropriate procurement option which can offer the best value for money, and that there is no inherent bias between procurement options. Consequently, its approach is based on an objective assessment of where it can offer value for money, where it can meet the government’s requirements of efficiency, equity and accountability, and where the value for money it offers is not at the cost of the terms and conditions of staff”.

There has been a significant increase in the number of countries adopting PPPs over the past decade, both in developing and developed economies, as illustrated in Figure 1.

**Figure 1: Geographic Coverage of PPPs, 1997 V 2007**



Source: “PPPs in Developing Economies: Overcoming Obstacles to Private Sector Participation” issued by DEPFA BANK in August 2007.

### 1.3 What form may a PPP take?

PPPs are not all alike; one major difference is the means by which the private partner receives a return on its investment:

- ◆ Financially free-standing projects where the services are provided for the use of the public which pays the private partner direct. These are often economic infrastructure projects, such as toll-charging road bridges and tunnels
- ◆ Projects that provide services to the public at less than cost and the payments to the private partner involve a mix of public subsidy from the government and end-user charges imposed on consumers of the services. Examples of such services are sports centres, where the consumer pays a subsidised fee for the use or hire of facilities and equipment
- ◆ Services that are provided direct to the government, which pays the private partner for those services. These are often social infrastructure projects, overseas examples of which include prisons, government office accommodation, and hospitals.

A PPP may take one of several forms including:

- ◆ Private Finance Initiatives (PFI)
- ◆ Franchises and concessions
- ◆ Joint ventures and wider market initiatives
- ◆ Partnership companies and investments.

Please refer to the “Serving the Community By Using the Private Sector - Policy and Practice” (Second Edition) published by the EU in January 2007 for elaboration on these forms.

It is important to remember that the detailed arrangements for PPPs can and should be crafted individually to suit the particular circumstances that are encountered in each instance. For example, if a new prison is required, the client department would need to consider carefully whether the private partner should be invited to provide all services - including custodial duties - or be limited to non-custodial tasks.

### **1.4 What forms of PPP are suitable for Hong Kong?**

There are a number of common contractual structures that are considered to be PPPs (see Figure 2). These are often known by acronyms such as: DBO<sup>1</sup> (Design-Build-Operate); BOOT (Build-Own-Operate-Transfer), BOT (Build-Operate-Transfer) and BOO (Build-Own-Operate) - these are all forms of DBFO (Design-Build-Finance-Operate). PPPs in Hong Kong are most likely to adopt the DBFO model or the DBO model. Under DBFO, there is a concession agreement where the public sector specifies the outputs it requires from the PPP facility, the basis for payment for those outputs, and the risk-sharing arrangements. The private sector is involved in designing, building, providing core and/or ancillary operations services, maintaining, financing and sometimes owning the PPP facilities. A DBFO scheme usually has the following characteristics:

- ◆ Long term contracts: typically 10 - 30 years; the contract length will often be for a number of years related to but usually a little shorter than the expected initial life of the facility or the main assets
- ◆ Outcome/output specifications: public service requirements would normally be framed as output specifications, instead of prescriptive input specifications and design
- ◆ A private sector legal entity, a consortium formed by multiple companies, also known as a Special Purpose Vehicle (SPV), a Project Company or a Concession Company

<sup>1</sup> A DBO contract usually involves a much shorter period of private financing, with government paying the contractor for the cost of designing and constructing facilities upon the commissioning of the facilities constructed. Government retains more risk under a DBO than a DBFO contract.

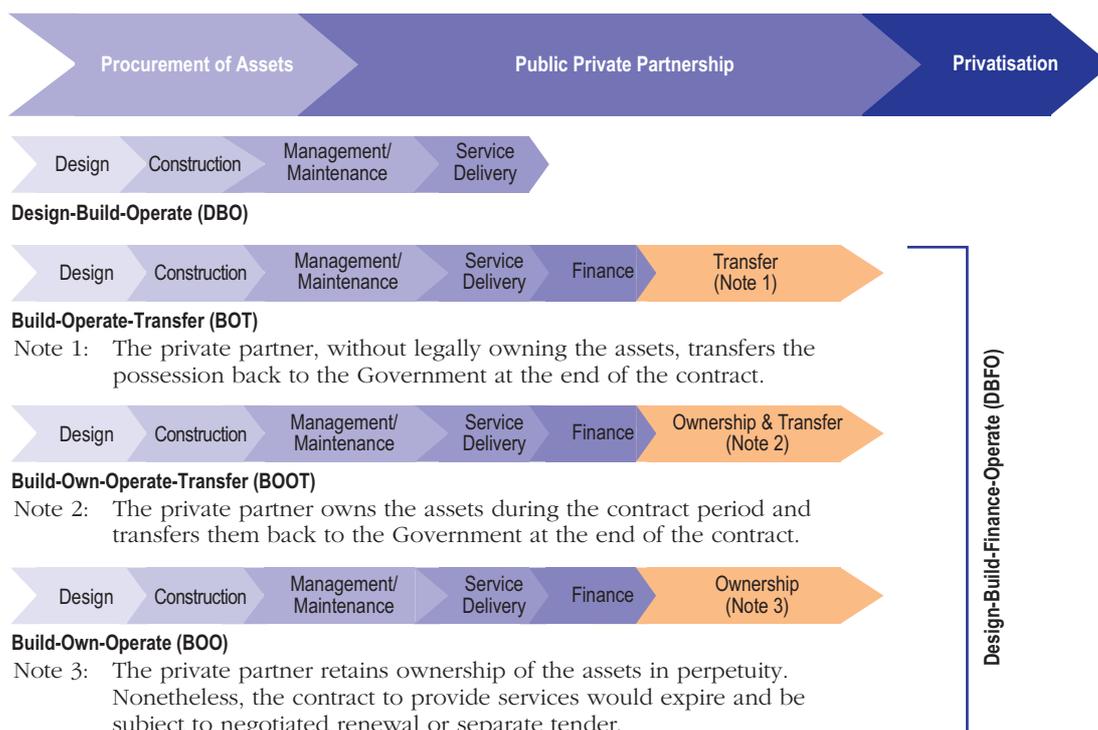
## WHAT IS A PPP AND WHAT ARE THE BENEFITS?

- ◆ Sharing of risks and responsibilities: responsibilities for those activities and outcomes that can be better controlled and managed by the private partner are transferred from government to the consortium
- ◆ Measurable performance: the outputs/outcomes are quantifiable. Agreed means of measuring these are included in the contract
- ◆ Performance based payment mechanism: the public sector pays only when measurable services/performance are delivered; and payment may be varied according to service quantity and quality
- ◆ Flexible contract with mechanisms for variations
- ◆ Private financing comprising equity and debt
- ◆ Funding: while the private sector provides the capital financing for the project, this is ultimately recovered from government, directly from members of the public, or from a combination of both.

The major difference between a DBFO and a DBO, in the Hong Kong context, is the timing and nature of the payments for the facilities associated with the project service. Under a DBO the capital costs will be paid for on commissioning and subsequent payments will only cover the recurrent costs of the service. This difference is reflected in the two most common forms of ownership structures for PPP projects:

- ◆ Contractor-owned, contractor-operated where the land and facility thereon resides with the private sector for the length of the contract
- ◆ Government-owned, contractor-operated where the private sector partner will finance and develop the facility but the public agency retains ownership of the land. The ownership of the facility and the moveable assets may be held by either the government or the private sector. The arrangements need to be made clear in the contract.

**Figure 2: Typical PPP Models**



## 1.5 What are the benefits of a PPP?

The introduction of private sector management is an effective way of bringing commercial disciplines into the provision of public services. Even where the government wishes public services to be delivered below cost, this can be achieved through using the private sector to deliver, with the government continuing to provide a subsidy. The efficiencies that will be delivered by using a PPP contract is likely, however, to reduce the level of subsidy required.

The private sector's usual incentives, coupled with the competitive pressures of the marketplace, can lead to better quality services delivered earlier and for lower cost than under traditional means of public sector procurement. The bottom line incentives that motivate the private sector are a more powerful management tool than public sector controls, irrespective of how hard the public sector tries to replicate those same incentives in its own approach.

Despite its dedication, experience and skills, the public sector is, in many circumstances, unlikely to match the innovation, creativity and efficiency of the private sector. This is often because the public sector faces constraints such as budgetary and borrowing restrictions. In some circumstances, PPPs may be attractive to governments because they can provide private funds in place of public sector capital to develop facilities and/or services. However, the principal reason that governments have pursued PPPs has been to achieve value for money. The specific benefits will depend on the specific project. Generally, benefits that may be achieved include:

### For the Public Sector:

- ◆ **Lifecycle cost management:** as the consortium has complete responsibility for the design, build, maintenance, and operation of a service, it is best placed to optimise the design for economy in construction, operations and maintenance. This optimisation is less likely to be achieved using conventional procurement approaches where design, construction, maintenance and operations are undertaken by different entities. Under a PPP, greater attention to design and quality building materials is likely to lead to higher construction costs (and reduced recurrent costs/improved operational efficiencies)
- ◆ **Construction management:** as the consortium is not being paid specifically for the construction but for the delivery of a service it is fully incentivised to achieve accelerated completion of capital works projects; and substantial improvement in the quality and durability of construction, reducing the risk of cost overruns
- ◆ **Innovative solutions:** by not specifying how a service should be delivered or how an asset has to be designed and built, but by simply spelling out the services it needs and the outputs/outcomes desired, government can engage the private sector's capacity to innovate and deliver improved value for money
- ◆ **Sharing government assets/facilities with third-party users:** sharing government facilities with other users can contain costs for government and provide public services more economically. Many government facilities/assets are capable of being shared with other users: for example, space in government buildings and government owned intellectual property such as educational material. A consortium with expertise in managing such assets will be able to optimise the use of and return on such assets
- ◆ **Sharing responsibilities with the private sector:** government's core competency should be identifying public needs and crafting public policies and objectives and, therefore, defining the service requirements and desired outcomes. The private sector is often better equipped to actually provide services - ranging from managing construction and maintenance of assets, to day-to-day operations

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- ◆ **Saving resources:** assuming that savings are achieved, in comparison with the Public Sector Comparator (PSC), there should be a freeing of resources for other public services.

### For the Private Sector:

- ◆ **Business opportunities:** being engaged to deliver a full suite of services e.g. design, construction, operations and maintenance, some of which were traditionally performed in-house by public agencies or performed by multiple private companies
- ◆ **Export opportunities:** the experience of and base provided by a continuing stream of PPP work in Hong Kong will increase the competitiveness of Hong Kong based service providers when bidding for work in the region and farther afield.

### For the Wider Community:

- ◆ **Bond markets:** the third party financing commonly associated with PPPs provides an opportunity to further strengthen Hong Kong's growing bond market
- ◆ **Regulation of service provision:** as the procurer, rather than the deliverer of the service, the government can monitor and regulate the quality of delivery and the compliance with staff, health-related, environmental, financial/tariff, legal and commercial issues with less likelihood of conflict of interest, real or perceived
- ◆ **Job creation:** the opportunity to develop and expand businesses, outside the constraints of the civil service, will encourage employment opportunities
- ◆ **Small government:** transferring the responsibility for delivery of some public services to the private sector can help constrain the size of the civil service to that required to develop policy and to deliver those services which it is considered only the public sector should provide.

## 1.6 How accurate are claims that PPPs provide good value for money?

As with all forms of procurement there are examples of good and bad performance by contractors and examples of well and poorly structured contracts. Nonetheless, there is a substantial and growing pool of data - mainly derived from reviews carried out by independent third parties, including government auditors - which leads to the conclusion that better value for money (see Question 4.3) is being achieved by using PPPs through optimal risk allocation and other efficiency measures. One review of a range of sectors in the UK found that on average cost savings of 17% were achieved compared to the public sector alternatives; another, in the Institute of Public Policy Review report 'Building Better Partnerships' published in 2002, indicated lower savings in the range of just 2% to 3%. Nonetheless, this and other studies concluded that value for money was being realised in a variety of ways. For instance, the Institute of Public Policy Review report concluded that high quality facilities were being delivered on time and on budget; innovation in design was apparent; working environments had improved; and risk transfer to the private sector had been real. A UK National Audit Office study showed that almost three times as many projects were delivered within time and budget when using PPPs than when using conventional procurement.

According to the Report on Operational PFI Projects by Partnerships UK in March 2006, 66% of public sector respondents rate the performance of their service provider as either "Very Good" or "Good" and 30% rate performance as "Satisfactory", with less than 4% rating performance as "Poor" or "Very Poor". Over 97% of public sector contract managers rate their relationships with the service provider as either "Very good", "Good" or "Satisfactory", and none rate their relationship as "Very Poor". For Hong Kong departments, the initial value for money test will be a risk adjusted comparison

between the bids actually received and the estimated whole life cost of conventional procurement and delivery (the PSC - see Chapter 4). Beyond that, client departments will need to ensure that the value for money anticipated at the time of contract letting will be delivered in practice. To do so will require careful contract management and close attention to managing the relationship with the private partner during the life of the project. Many lessons can be learned from overseas experience and departments should seek advice about precedents that have been established in their particular field.

### **1.7 In what circumstances should a PPP be considered?**

The PPP approach is an alternative to conventional methods of procuring projects and will not be suitable in every case. Care must be taken in selecting appropriate projects. Once the strategic need for a service or facility has been determined an analysis of procurement options, including PPP options, should be undertaken as part of a feasibility or business case study. Departments are encouraged to give equal weight to consideration of all forms of private sector involvement, choosing according to which will give the best value for money and the most effective means of delivering the service in question. There is a case for considering a PPP where:

- ◆ There is a major investment programme, requiring effective management of risks associated with construction and delivery; this may be a single major project or a series of replicable smaller projects
- ◆ The private sector has the expertise to deliver and there is good reason to think that it will offer value for money
- ◆ The structure of the service is appropriate, allowing the public sector to define its service needs as outputs/outcomes that can be adequately contracted for in a way that ensures effective, equitable and accountable delivery of public services in the long term
- ◆ Where risk allocation between the public and private sectors can be clearly made and enforced
- ◆ The nature of the assets and services involved are capable of being costed on a long-term, whole of life basis
- ◆ The value of the project is sufficiently large to ensure that procurement costs are not disproportionate
- ◆ The technology and other aspects are reasonably stable and not susceptible to short term fast paced changes. Where a project involves a facility (e.g. a hospital) where the equipment inside is subject to rapid technological development, arrangements separate from the PPP contract can be made
- ◆ Planning horizons are long term, with assets intended to be used over long periods.

PPP proposals should also take account of a number of public interest criteria covering: accountability; transparency; equity; public access; consumer rights; security; privacy, and the rights of affected individuals and communities, as appropriate.

On the other hand, there are circumstances that militate against using a PPP. These include:

- ◆ Projects where the client department is unable to fully and clearly specify the requirements due to uncertainty over the nature and quality of the intended service
- ◆ Difficulties in specifying requirements due to the rapid pace of technological change

## WHAT IS A PPP AND WHAT ARE THE BENEFITS?

- ◆ Difficulties in substituting suppliers due to the need to integrate proprietary technologies
- ◆ Lack of third party finance leading to the excessive reliance on corporate borrowing by the private partner and an absence of arms length due diligence
- ◆ Costs of delivering the projects being overly dominated by the annual running costs associated with delivering the service requirement, rather than being balanced by the up-front costs of investment in the project assets.

These circumstances have often appeared in Information Technology (IT) PPP projects, and less often in other PPP projects, with the result that the hoped for benefits have not always been achieved. In some jurisdictions, governments have stopped using PPPs for information and communications technology projects; in others they limit them to shorter contracts e.g. five to eight years.

### 1.8 What types of project have been completed using the PPP approach?

Hong Kong has a long history of attracting private sector investment and operating skills to deliver public services, most notably major infrastructure facilities such as the cross-harbour and other tunnels developed using the BOT approach. A number of projects are at different stages of development, or have, for example, had feasibility studies conducted on them.

Overseas, there are many successful examples, covering a wide range of economic and social infrastructure facilities built, and public services delivered, using PPP approaches. Examples from a number of overseas jurisdictions include:

<ul style="list-style-type: none"> <li>◆ Airports, airport management, and flight control</li> <li>◆ Arts and culture facilities</li> <li>◆ Court buildings and facilities, and information systems</li> <li>◆ Defence equipment, maintenance, training, and procurement support</li> <li>◆ Education (schools, police/military colleges, universities)</li> <li>◆ Fleet management services (land, sea and air, civilian and defence)</li> <li>◆ Hospitals, clinics, medical equipment</li> <li>◆ Information and communications technology services</li> <li>◆ Office new provisioning, in situ reprovisioning, and relocation</li> <li>◆ Police, fire and ambulance stations</li> <li>◆ Port facilities</li> <li>◆ Prisons and prisoner escort</li> </ul>	<ul style="list-style-type: none"> <li>◆ Railways/light rail/trams</li> <li>◆ Renewable energy</li> <li>◆ Residential accommodation for students, nurses, doctors, military personnel, etc</li> <li>◆ Scientific, and research and development facilities</li> <li>◆ Solid waste management facilities, refuse transfer, recycling, incineration, landfills</li> <li>◆ Roads/bridges/tunnels (with and without tolls)</li> <li>◆ Sports stadiums, leisure and recreation centres</li> <li>◆ Street lighting</li> <li>◆ Support services, such as laundry and food, for hospitals/prisons/elderly homes</li> <li>◆ Training-fire services, flying, etc</li> <li>◆ Urban regeneration</li> <li>◆ Water and waste water treatment plants</li> </ul>
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Figure 3 is an international comparison of the PPP experience of selected economies.

**Figure 3: International Comparison of Experience in PPPs - Selected Economies**

Country	Sector								
	Transport	Power/ Energy	Communications	Water Treatment & Distribution	Waste Management	Schools	Hospitals	Prisons	Defence
UK	●	●	●	●	●	●	●	●	●
United States	●	●	●	◐	◐	◐	○	◐	◐
Canada	●	◐	○	◐	◐	◐	●	○	●
Japan	●	●	○	●	●	●	●	◐	○
Australia	●	●	●	◐	○	◐	◐	◐	◐
Brazil	●	●	●	●	●	○	○	◐	○
Chile	●	●	○	◐	◐	○	◐	◐	○
Colombia	●	●	◐	○	◐	○	○	○	○
Mexico	●	●	○	○	◐	○	◐	○	○
Peru	●	◐	◐	○	◐	○	○	○	○
Uruguay	◐	○	○	○	○	○	○	○	○
China	◐	●	○	◐	◐	○	○	○	○
India	●	●	○	◐	◐	◐	◐	○	○
Indonesia	◐	●	○	◐	◐	○	○	○	○
Pakistan	◐	●	○	○	○	○	○	○	○
Philippines	●	●	○	◐	○	○	○	○	○
Singapore	○	●	◐	◐	◐	◐	○	○	◐
South Korea	●	◐	○	◐	◐	◐	◐	○	○
Taiwan	◐	●	○	○	○	○	○	○	○
Thailand	●	●	◐	◐	◐	○	○	○	○
Vietnam	◐	◐	○	○	○	○	○	○	○

Many years experience  
  First or few projects signed/recent experience  
  Projects in planning stage  
  No experience

Source: “PPPs in Developing Economies: Overcoming Obstacles to Private Sector Participation” issued by DEPPA BANK in August 2007.

Given the opportunity, the private sector is likely to react positively to any use of the PPP approach to undertake similar projects in Hong Kong; either through using local resources alone or combining them with overseas expertise.

## 1.9 What are the common elements found in most PPPs?

- ◆ The government has identified a value for money benefit for the specific project
- ◆ The government retains political responsibility/accountability to secure services for the community
- ◆ The government defines the timeframe in which the services must be delivered; and the quality and quantity of services needed
- ◆ The private sector delivers the services and finances or part finances the project
- ◆ A long-term relationship is established between the client department and the consortium - typically between 10 and 30 years, depending on the nature of the services, assets or facilities to be delivered

- ◆ The different functions of design, construction, maintenance and operation are integrated to release the synergies between them and discourage low-capital/high-operating expenditure solutions
- ◆ Risks are allocated and shared between the public and private sectors
- ◆ There is an emphasis on output and outcome-based specifications
- ◆ A whole life approach to cost is taken.

### **1.10 What is the government's fundamental role in PPPs?**

- ◆ Set policy, identify opportunities, and define objectives
- ◆ Ensure transparency and probity in the procurement process
- ◆ Identify and propose the allocation of risks
- ◆ Identify needs in terms of output/outcome specifications that encourage flexibility and innovation in the manner of performance
- ◆ Set and ensure the achievement of standards for health, safety, and the environment
- ◆ Establish, monitor and enforce the levels of service
- ◆ Ensure value for money is achieved
- ◆ Determine and manage reward mechanisms and tariff structures
- ◆ Provide a clear regulatory framework and perform regulatory functions
- ◆ Safeguard the interests of customers and the general public
- ◆ In some PPP projects government will still provide the front line staff.

To ensure the successful establishment and implementation of a programme of PPP projects, the government needs to foster the development of the private sector market by ensuring an adequate flow of projects and good and certain procedures for requesting and accepting proposals.

### **1.11 What is the private sector's fundamental role in PPPs?**

The private sector's role is to provide commercially effective solutions to assist government to achieve its outcomes by achieving defined levels of performance in service delivery; and providing:

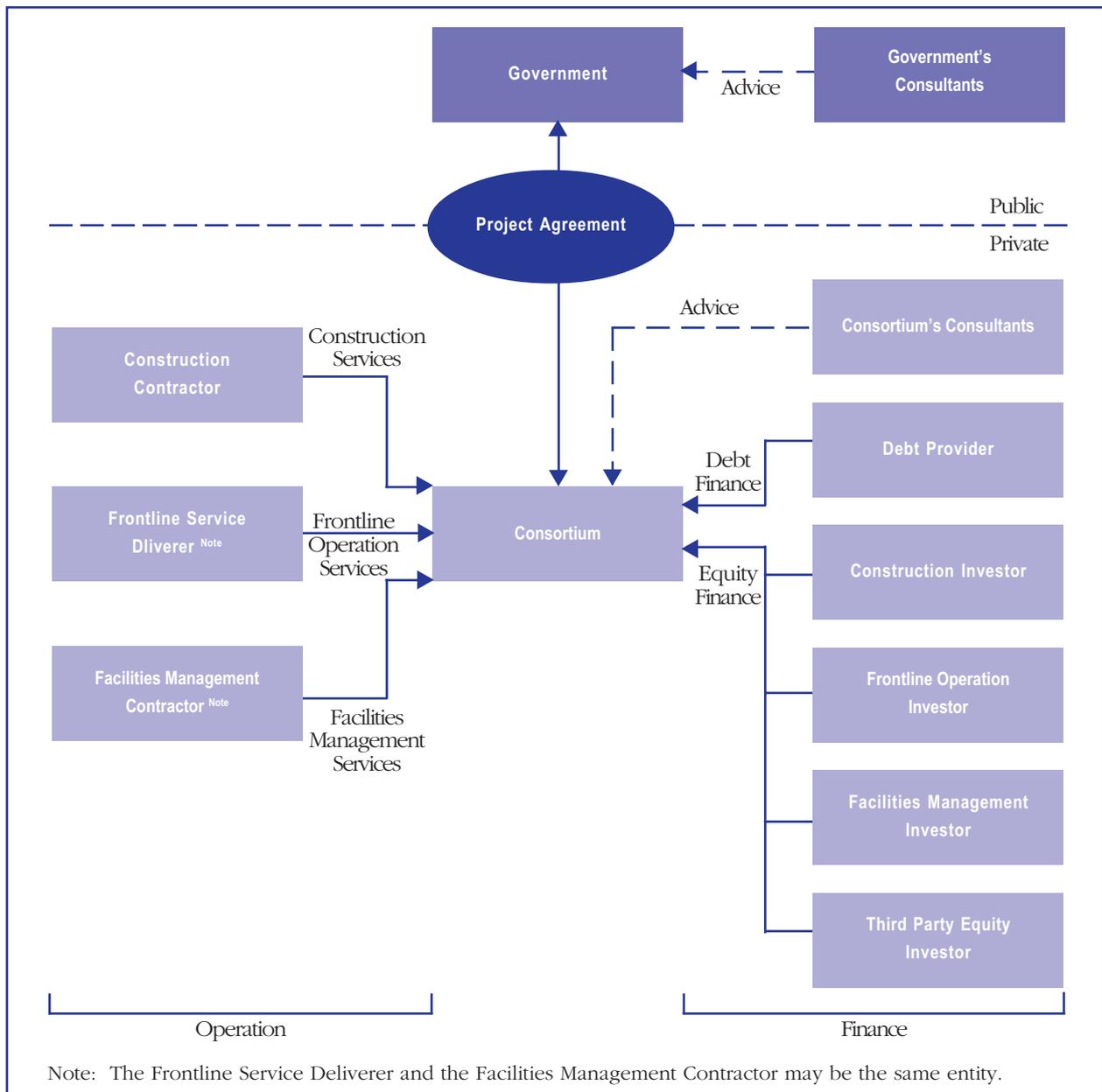
- ◆ Expertise and innovation
- ◆ Access to private financing, as appropriate
- ◆ A sufficient return to investors and other stakeholders.

The private sector will normally establish a consortium to provide the facility and deliver the service. The consortium may be able to design, build and operate the facility and provide any ancillary services. Alternatively, it may contract with appropriate third parties to deliver the relevant services.

### **1.12 How is a PPP project structured?**

A typical structure for a PPP project under the DBFO model is shown in Figure 4:

**Figure 4: Typical PPP Project Structure (DBFO Model)**



## 1.13 What other sectors have a key role in PPPs?

For many PPPs, the general public and the Legislative Council (LegCo) also have key roles to play, as follows:

- ◆ Roles of LegCo
  - To scrutinise and consider proposals
  - To reflect public views and make suggestions to the Administration
  - To approve funding proposals in accordance with the provisions of the Public Finance Ordinance (Cap 2)
  - To consider legislative proposals, including subsidiary legislation.

- ◆ Role of the general public
  - To express their views and suggestions to the Administration on proposals. This may include, for example, issues concerning location or nature of facilities, the quality and quantity of services, environmental concerns, and fees and charges.

### **1.14 Is PPP just another name for privatisation?**

No. Privatisation means the transfer of an existing government entity or asset to the private sector in perpetuity, through an asset sale, a share sale or a management buy-out. After privatisation, government's involvement is limited to a regulatory role, if required. With a PPP, government retains ultimate responsibility for the delivery of services throughout the contract.

Although some PPPs may involve existing government assets being transferred to the private partner, in Hong Kong this will normally only be for the duration of the contract, not in perpetuity. Moreover, after the expiry of the contract term the service obligation will revert to government.

On occasion, as with a privatisation, a PPP may also involve the opportunity for civil servants to transfer, permanently or temporarily, to the private sector; however, such a transfer would not be mandatory.

### **1.15 Why use a PPP instead of a trading fund or corporatisation approach?**

Under the Trading Funds Ordinance (Cap 430) the LegCo may by resolution establish a trading fund to manage and account for the operation of a government service provided to the Government, public bodies or persons other than the Government. A trading fund is expected to cover its expenditure by its revenue. LegCo prescribes the services to be provided by the trading fund. A trading fund is thus an accounting arrangement that frees a department (or part of it) from the normal appropriation procedures. A trading fund otherwise remains very much as part of the civil service, with the constraints on exploiting commercial strengths that go with it.

A corporation is established by law to carry out specified activities in accordance with established commercial principles. Whilst the government is the whole or main shareholder the corporation is not part of the civil service. The corporation is generally free to manage staff and other resources in accordance with private sector principles, to explore and exploit new commercial opportunities, and to adjust fees and charges in response to market conditions.

Departments may use a PPP approach rather than a trading fund or corporation for a variety of reasons, including:

- ◆ The time required for the drafting and enactment of legislation
- ◆ The ready availability of capable service providers in the private sector
- ◆ The services required will not generate sufficient revenue to be commercially viable, and thus require a public subsidy
- ◆ Insufficient staff/skills to provide the service in-house.

### **1.16 Can a PPP project be let by way of a land lease?**

Some PPP projects are let by way of land lease. However, in Hong Kong, the land lease tends only to commit the selected consortium to its proposal for the "hardware" (e.g. the concept plans). There is usually nothing in the lease conditions committing the consortium to honouring its proposed

plans on the management and operation of the facilities after completion of the “hardware”, although these plans formed part of the technical proposal in the tender assessment. Monitoring of the project implementation through enforcement of lease conditions may be inefficient and unsatisfactory for these projects.

If a PPP project is to be let by way of a land lease, government should attach to the land lease or include separately a management or service agreement. This is to ensure that the consortium is contractually committed to deliver its technical proposal, basing on which the project was awarded, for the future management and operation of the facilities to be developed. There should also be effective means to ensure compliance. An integrated and efficient mechanism, e.g. a multi-departmental Project Steering Committee (PSCom), should be set up to monitor the implementation of the project after it is let to ensure that the consortium makes good its proposal to meet the project objectives.

If the consortium proposes modifications to the approved plans after the award of a project, government should adopt a coordinated and objective approach to conduct an overall assessment/evaluation of the merits of such modifications. Departments concerned should make reference to the consortium’s original proposal to ensure that the proposed modifications are no less favourable to the government. Where justified, government should impose additional premiums as for lease modifications.

### **1.17 Will PPPs restrict the opportunities for local service providers?**

Local players with local knowledge, and the necessary experience and expertise, would be well placed to participate in bidding consortia, or act as sub-contractor(s). Care should be taken that this takes account of local availability, reliability, quality and pricing, and does not result in service solutions that reduce the value for money to the government, and World Trade Organisation Government Procurement Agreement (WTO GPA) provisions are not breached (See Chapter 5).

Many PPP projects will require skills and resources not available within a single company. Much will depend on the details of each individual project. Thus bidders are likely to be consortia. While small and medium enterprises are unlikely to feature as consortium members in larger projects, they will have opportunities to participate at the sub-contractor level. This is little different from the picture under conventional procurement where major construction companies would be likely to take the leading contractual roles.

### **1.18 Who ultimately will be accountable for the success of the project/service?**

There are different levels of accountability in PPP projects, as there are in other procurement methods. The client department is responsible for establishing the levels of service required, mainly by means of output/outcome specifications; for conducting a fair and transparent contracting exercise; and monitoring the performance of the selected private partner and ensuring value for money is achieved. The private partner is accountable to the client department for performing up to the standards specified in the contract. Ultimately, the project involves the delivery of public services and the government remains accountable to the public.

### **1.19 Are there good practices and lessons learnt from previous PPP projects?**

The EU has identified the following good practices and lessons learnt from local PPP experiences:

## WHAT IS A PPP AND WHAT ARE THE BENEFITS?

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### Success Factors:

- ◆ High level support
  - Obtain top level support/commitment at an early stage
- ◆ Project champion
  - Assign a project leader at sufficiently high level (preferably at directorate level) to lead the project
- ◆ Maintain momentum
  - Set a realistic project plan with appropriate milestones for different stages of the project development process
  - Adhere to the project plan (which will help maintain the enthusiasm and confidence of both the management and staff)
- ◆ Market testing
  - Conduct a market testing exercise to assess private market interest and capability as well as to solicit market feedback
- ◆ Stakeholder consultation
  - Consider staffing issues at an early stage
  - Inform staff early and regularly of developments
  - Provide opportunity for staff to contribute to the development of PPP proposals
  - Conduct public consultation at the earliest possible stage and maintain on-going dialogue throughout the preparatory and implementation phases
  - Involve all interested parties in the consultation exercise.

### Obstacles:

- ◆ Problems with land use amendments
  - Consider shifting to the PPP partner the responsibility to seek land use amendments
- ◆ Lack of confidence in the PPP approach, and insufficient experience and expertise
  - Seek assistance/advice from the EU and other experts when considering the use of PPPs
- ◆ Long contract durations
  - Put in place procedures to manage change
- ◆ Technological changes
  - Be mindful of suitability of PPPs for projects involving rapid pace of technological change
- ◆ Lack of public acceptance on the use of PPPs
  - Avoid granting disproportionate property/commercial development rights
  - Set the strategy/plan for stakeholder consultation at the very beginning
  - Consult and enlist support of the public and LegCo at the earliest possible stage
  - Put emphasis on some key messages during the stakeholder consultation exercise.

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## 2 COMPARING PPPs AND CONVENTIONAL PROCUREMENT

### 2.1 How does the PPP approach compare with conventional procurement?

Both approaches require the client department to start by:

- ◆ Establishing the need for a service, a facility or a set of facilities; in some instances ‘bundling’ a number of smaller projects may be used to secure economies of scale
- ◆ Identifying a likely location or locations for the service or facilities (this is occasionally not required for a PPP project delivering only a service, not a facility)
- ◆ Establishing whether there is general budgetary cover for any associated government expenditures, both capital and recurrent. Many projects will not be entirely self-financing
- ◆ Considering affordability and value for money issues.

Thereafter, the two approaches may diverge considerably. A PPP focuses on the procurement of a service, even though commonly associated with the construction of a facility to deliver the service. The conventional approach starts with the main focus on acquiring a facility. There are also considerable differences as to the sequence of events. Procurement activities concerning design, construction, operation and maintenance of a facility, which are generally dealt with separately under the conventional approach, tend to be grouped under the PPP approach. The PPP approach also tends to shift some responsibilities from works departments such as Architectural Services Department (Arch SD) to the client department and/or the private partner.

ETWB Technical Circular (Works) No. 4/2006 stipulates the guidelines and procedures for the delivery of projects in the Capital Works Programme (CWP). ETWB Technical Circular (Works) No. 32/2004 provides a reference guide on procurement approaches and associated project delivery techniques commonly adopted for public works.

## 2.2 How does the procurement of a facility compare?

Conventional approach	PPP approach
<ul style="list-style-type: none"> <li>◆ The client department would seek the assistance of one of the works departments in designing the facility or in the case of design and build contracts, to prepare performance specifications for the facility</li> <li>◆ The client department would form a PSCoM incorporating its own and other departmental staff, as well as outside expertise, if required, to oversee the project</li> <li>◆ Once pre-contract planning is completed and resource allocation approvals are obtained, works departments would call for tenders from private contractors to construct or to design and build the facility in accordance with its specifications (unless approval is obtained pursuant to Financial Circular No. 2/2003, tender invitation should start after funding is secured)</li> <li>◆ Following internal approval, the client department would conduct public consultation including the consultation with relevant LegCo Panels before obtaining endorsement of LegCo's Finance Committee (FC)</li> <li>◆ The successful bidder would be the one that satisfies the minimum requirements specified with respect to quality of service or product and scores the highest mark in the tender evaluation which weighs both the technical and cost aspects</li> <li>◆ Separate specialist contracts might be let to different private contractors for specialist equipment and facilities</li> <li>◆ During construction of the facility, the works department would monitor all aspects of the construction including process, quality and cost, on terms that provide best value</li> <li>◆ Upon completion of construction of the facility, the works department would inspect the works and, when appropriate, certify that the works have been completed and the final payment will be made to the contractor</li> </ul>	<ul style="list-style-type: none"> <li>◆ The fundamental approach to procuring a facility via a PPP is to define the facility in terms of the service which it is to provide</li> <li>◆ The client department would form a PSCoM incorporating its own and other departmental staff, as well as outside expertise, if required, to oversee the project (see Chapter 3)</li> <li>◆ The PSCoM would prepare documents, including output-based performance specifications, to request proposals for a private sector consortium to design, build, finance, operate and maintain the facility for a specified period, e.g. between 10-30 years</li> <li>◆ Following internal approval, the client department would seek approval of the Policy Committee before conducting consultations, including LegCo Panels, and then obtaining endorsement of the LegCo's FC</li> <li>◆ The successful consortium bidder would be the one that satisfies the mandatory requirements specified with respect to the ability of the facility to deliver the service required, the quality of design, construction and operation and on terms which provide best value for money</li> <li>◆ In assessing the conforming proposals received, the PSCoM will in most cases benchmark them against an estimate of the full lifecycle cost of the project if it was done by the conventional in-house approach</li> <li>◆ The client department and its advisors will deal solely with the consortium. The consortium bidder will manage the specialist contractors. Under a PPP, the appropriate member of the PSCoM or an independent third party will verify the facility as fit for the purpose. Only then will payment for commissioning, under a DBO, or services received, under a DBFO, be paid</li> </ul>

### 2.3 How does the procurement of a service compare?

Conventional approach	PPP approach
<ul style="list-style-type: none"> <li>◆ The service element of the project is divorced from the asset acquisition phase; any risk that the facility will not deliver the service quality required lies with the client department</li> <li>◆ The client department would make arrangements for the operational aspects of the facility. This would include cleaning and security, and the maintenance and repair of the facility. This may involve a mixture of permanent and contract staff from the client department, Electrical and Mechanical Services Department (EMSD) and works departments, and a mix of different outsourcing contracts</li> </ul>	<ul style="list-style-type: none"> <li>◆ The PPP approach requires the client department to focus on the long-term quality of the service outcomes required and structure the procurement process accordingly. Consortium bidders will be provided with targets and incentives to ensure that the outcomes are achieved</li> <li>◆ As well as defining the facility acquired in terms of service delivery, a range of further services will often be procured</li> <li>◆ Sometimes these will be the subject of a separate 'Operation and Maintenance (O&amp;M)' contract, which may include mid-life capital expenditure. Services such as operation of water supply/sewerage services, office cleaning, or road maintenance could be covered under these types of contract. Such contracts may also cover service with respect to existing assets</li> </ul>

### 2.4 How does the funding of, and payment for, a facility/service differ?

Conventional approach	PPP approach
<ul style="list-style-type: none"> <li>◆ The funding of the capital and recurrent costs would normally come from a range of different sources within the government</li> <li>◆ The costs of the preparatory design and supervisory work for the construction contracts and the capital costs of construction works would be met from the Capital Works Reserve Fund (CWRF)</li> <li>◆ Progress payments for the facility would be made upon certified completion of different stages of design and construction</li> <li>◆ The operational costs would be met from the client department's Recurrent Account</li> <li>◆ Occasional expenditure on replacement plant and equipment would come under the department's Capital Account/CWRF as appropriate</li> </ul>	<ul style="list-style-type: none"> <li>◆ The government would normally pay the winning bidder only after the facility was operational, and then payments would be only for "availability" and services provided according to the contractual specifications</li> <li>◆ Payments under a PPP will most often be combined within a unitary charge, paid at regular intervals throughout the life of the project. The unitary charge will incorporate elements of amortised capital costs paid out of the CWRF and/or recurrent costs paid out of the client department's Recurrent Account</li> <li>◆ An alternative, under a DBO, is for initial capital costs to be paid during the construction/upon commissioning of the facility, and only recurrent and capital replenishment costs to be covered by the unitary charge</li> </ul>

Conventional approach (cont'd)	PPP approach (cont'd)
<ul style="list-style-type: none"> <li>◆ Similarly, in works departments, expenditure under various departmental subheads would take place over the life of the facility</li> </ul>	<ul style="list-style-type: none"> <li>◆ Payments would be subject to satisfactory performance in the provision of services on the part of the consortium</li> <li>◆ Payments could include incentive elements where performance targets are set</li> <li>◆ If the consortium fails to meet performance standards by delivering the services as specified in the contract, or fails to rectify defects at its own expense within specified timeframes, the payments will be abated, deferred, or halted in accordance with the terms of the contract</li> </ul>

### 2.5 How in each case will the whole life costs be assessed?

Conventional approach	PPP approach
<ul style="list-style-type: none"> <li>◆ Usually only direct incremental costs are assessed</li> <li>◆ The government does not always prepare an assessment of the likely full costs of providing services over the lifecycle of a facility</li> <li>◆ The estimated cost is only an estimate, and cannot be assured unless a binding contract for its provision has been let</li> <li>◆ Subject to budgetary and management control, the costs of a new facility/service are open-ended</li> </ul>	<ul style="list-style-type: none"> <li>◆ Estimates of the whole life costs of the facility/service will be developed by the public sector, for the purpose of benchmarking bids, and by the private sector; using the same period of time to ensure a common basis for comparison</li> <li>◆ The bidder's price will normally incorporate a formula to take account of inflation/deflation</li> <li>◆ Costs are expressed on a Net Present Value (NPV) basis to enable comparison between options with different cashflow profiles</li> <li>◆ The consortium is committed to the costs it submits in its bid, which are then included in the signed contract</li> </ul>

### 2.6 Are PPPs more adversarial than conventional procurement?

PPP projects are based on long-term relationships where a successful outcome is best achieved through partnership. This should be less adversarial. If it is to be so, it is essential that departments and contractors work together closely to achieve successful outcomes. The main elements of a successful relationship between the public and private sectors are to:

- ◆ Select a consortium that shares similar attitudes and approaches to key issues
- ◆ Adopt a partnership attitude supported by the right contractual framework and a high level of detail and clarity in the definition of service level requirements and risk allocation
- ◆ Have the right skills mix present at the right time
- ◆ Have the desire to make partnership work in practice
- ◆ Maintain transparency by all parties.

A PPP contract may become adversarial if these principles are not followed. Partnership does not mean the client department accepting poor performance; it means ensuring the consortium achieves its performance goals as specified in the contract (see Chapter 8).

### **2.7 Do PPP projects take longer to get underway?**

A PPP involves one set of contracts to cover the whole lifecycle of a service; conventional procurement is more sequential, involving first a design contract, then a construction contract (or a design and build contract), and finally one or more service contracts. As a result visible progress on a conventional project is often quicker. Experience elsewhere has shown that faster construction under a PPP recovers much of the time spent on the longer preparatory period. Annex A shows a typical timeline. Australian and UK experience in deal closure has seen dramatically reduced times for finalising PPP contracts. This is largely due to the development of detailed contractual terms over time which have evolved and represent an acceptable balance of risk and reward to both the public and private sectors.

### **2.8 If a PPP proposal does not provide value for money, will this lead to delay?**

In the absence of receiving a value for money PPP bid, the department should reconsider whether to continue with the PPP approach. If so, much of the preparatory work for the PPP procurement, e.g. outcome specifications and designs submitted by PPP bidders may be used for the conventional approach. Client departments should not assume they become the owner of designs submitted in bid documents (without any contract acceptance in place). One approach is to put in PPP procurement documents a clause to the effect that the client department can use submitted architectural and other designs even though the PPP approach itself was not accepted or the bid by that particular private sector proponent was not accepted. Such a clause must be carefully drafted and both the commercial and intellectual property rights issues should be addressed.

Government must exercise good faith in this respect. Careless or reckless use of this contingency could easily damage the reputation of the Government's PPP programme in the eyes of the business community. It should be noted that in other countries, bidders sometimes submit outline designs only (because of time and cost constraints) in response to the Request for Proposal (RFP). These are then developed into detailed designs during the negotiating phase. Departments would need to ensure that the issue of liability in case of design failure is addressed.

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## 3 ESTABLISHING A PPP PROJECT

### 3.1 When does the client department decide to use the PPP approach?

Once the client department has identified a project or a service that is required, and is considered to have potential as a PPP, a feasibility study (a stage 1 business case study - see Chapter 4) should be conducted. A decision to proceed with the PPP approach would usually follow from the feasibility study recommendations which should address the following:

- ◆ Providing service specifications, which can be agreed upon by stakeholders and tested in the market
- ◆ Assessing the financial viability of the project
- ◆ Whether the client department has the necessary legal powers to let successfully a contract for the provision of the service in question and, if not, what can be done to address the absence of such powers e.g. amending existing legislation.

### 3.2 Do we need to create a Public Works Programme (PWP) item for PPP projects?

For publicly-funded PPP projects, e.g. DBO contracts it is obvious that a PWP item should be created. However, it is equally important for a number of reasons that a PWP item should be created for privately financed projects, including those that are expected to be financially free standing:

- ◆ To ensure that funding support is secured for any capital or recurrent implications arising from the project
- ◆ To enable departments to proceed with the various technical and other studies that departments need to conduct prior to the RFP using the appropriate CWRP Block Votes (not exceeding \$21M in cost) as in the conventional PWP process
- ◆ To demonstrate to potential bidders that government can procure the project in the conventional way if no value for money PPP bids are received or the PPP process does not result in a satisfactory outcome.

### 3.3 Must we decide on the PPP approach before creating a Category C PWP item?

Departments are required to prepare a Project Definition Statement (PDS) (viz. project justifications and the user requirements/service specifications) and a Technical Feasibility Statement (TFS) (mainly to establish the technical feasibility on a prima facie basis with a reasonable cost estimate) which are prerequisites for creating a Category C PWP item. It is not necessary to have decided on the PPP approach by this stage. If the department intends to pursue a PPP approach it may conduct a PPP business case study either before upgrading a Category C project to Category B, if the departmental budget has funds available. Where appropriate, the cost of such studies can be charged to the relevant CWRP block votes after the project has Category B status.

### 3.4 Is there a minimum capital cost for a PPP project?

The cost involved in procuring PPP projects dictates that it is not worthwhile to do so for small value projects. For example, the UK Treasury has indicated a minimum capital value of £20M is appropriate, whilst Singapore has set the bar at S\$50M.

As a rule of thumb, any proposed project with an expected capital cost of less than HK\$300M would likely find the traditional procurement approach more suitable.

Projects with a capital value of less than \$300M can still be pursued as PPPs if, for example, two or more similar projects can be bundled into one PPP contract. Alternatively, a series of replicable smaller projects, e.g. schools (with capital costs of about \$100M) may still be suitable as the costs of procurement will fall as more similar projects are implemented.

### 3.5 Do we need community endorsement of a project proposal?

Like any project, the ultimate success of any PPP project is due, in part, to ensuring that those individuals or bodies who are directly interested in the project are kept fully informed and properly consulted at all stages of the project. Stakeholder consultation should therefore be:

- ◆ Extensive and involve all interested parties
- ◆ Open and transparent, providing as much information as possible
- ◆ Conducted at the earliest stage possible
- ◆ On-going, maintaining effective dialogue throughout the preparatory and implementation phases
- ◆ Comprehensive, covering all aspects of the project that are of interest to stakeholders.

The Chief Executive, in his 2007 Election Platform Policy Blueprint, stated that the focus of decision making in the future Government would be public engagement. There is no hard and fast rule for conducting public engagement and bureaux/departments should tailor their engagement plans to suit individual circumstances. It is important to match different stages of the public engagement process into the development of a PPP project.

Typical stakeholders in a PPP project include:

- ◆ Relevant policy bureaux/departments
- ◆ Service users
- ◆ Staff members being affected
- ◆ Politicians, interest/pressure groups
- ◆ Local community
- ◆ General public.

The level of consultation for a PPP project may need to be greater than that for a conventional procurement. There can be considerable misunderstanding of the PPP process. The principles of transparency and accountability mean that it is important for the client department to explain the project to interested and affected parties. For example, using a PPP for the provision of a hospital may only involve the delivery of physical facilities and ancillary services, with the clinical services continuing to be publicly provided. However, the public and staff might fear that public health care was being privatised. Early and thorough communication with all stakeholders can minimise the likelihood of such misunderstandings.

The stakeholders in a prison redevelopment PPP project, for example, would include:

- ◆ Security Bureau
- ◆ Correctional Services Department
- ◆ Financial Services and the Treasury Bureau (FSTB)
- ◆ Prisoner welfare groups
- ◆ Prison visitors
- ◆ Correctional Services Department staff/staff associations
- ◆ LegCo Members
- ◆ Local communities near the prison site, e.g. relevant District Councils
- ◆ General public.

Communication will require careful handling in those cases where existing services are to be transferred from the public to the private sector.

### **3.6 Is Legislative Council (LegCo) approval of a financially free-standing project necessary?**

A financially free-standing project would not require any formal financial approvals from LegCo. However, it should be borne in mind that most PPP contracts are likely to be lengthy and of relatively high value. Departments are advised to consult the appropriate LegCo Panel in line with policies on accountability and transparency. Potential bidders, and their financiers, would take into account the degree of political support for a project when considering whether to bid, and how to price their bid. Apart from the required approval from the Executive Council (ExCo), a project where the Government intends to grant land for less than the market value would normally require consultation with the LegCo. A further consideration is whether Government retains risks that would have consequences for the public purse. Such risks would include discriminatory changes in legislation or regulation, e.g. more stringent air emission standards for an incinerator, or higher quality standards for a water treatment works. Potential bidders would also see LegCo endorsement as providing greater certainty that the project will be successfully implemented.

In privately financed projects lenders will wish to confirm as a condition precedent to the drawdown of any loans that all required approvals are in place. There should be no uncertainty surrounding the need for LegCo approval. Where a bidder requests loan guarantee or other forms of financial undertaking from Government, this requires FC's approval.

### **3.7 What funding approvals are required?**

After establishing the stage 1 business case for a project, the client department should submit via its policy bureau a bid for funds through the Resource Allocation Exercise (RAE) process. For capital costs, the bureau will need to secure capital funding under the CWRP. For other costs required during the operation phase, the bureau will need to confirm whether it can absorb the recurrent funding or whether it needs topping up from the centre.

The bureau may need to invite the Policy Committee and/or ExCo where appropriate, to approve the PPP proposal, having regard to the staff, land and financial implications. Specifically, the Policy Committee/ExCo paper will need to set out not only the costs involved but also in consultation with the Treasury Branch (TsyB) of FSTB, an assessment of whether and how the proposal will affect the budgetary expenditure guidelines, and whether revenue will be diverted to the private sector or otherwise hypothecated (see Question 7.5).

The client department would normally present the project first to the relevant LegCo Panel. Thereafter, the department will need to seek approval from the Public Works Subcommittee (PWSC) and FC for the capital works funding involved. The recurrent funding required would be examined by TsyB in the context of the PWSC submission. FC's approval is required for other forms of financial undertaking of Government, e.g. loan guarantee. A set of procedures, and a procurement flowchart are at Annexes B and C respectively.

### **3.8 Should client departments conduct technical assessments prior to inviting proposals?**

Departments will need to ensure that the relevant legislation, e.g. the Environmental Impact Assessment Ordinance (EIAO) (Cap 499), is complied with in respect of designated projects.

Departments should conduct appropriate preliminary environmental, traffic and engineering feasibility assessments, sustainability, socio-economic, heritage and regulatory/business impact studies, as part of the business case exercise, before inviting proposals in order to assess the practicability, viability and justification of the desired facility or service. The information derived from these will help potential bidders in the preparation of realistic proposals, as well as guiding the client department on the standards that can be expected of bidders. It will also give comfort to potential bidders about the risks that they will have to bear, and will tend to lead to lower bid prices if those risks are identified and capable of quantification at an early stage.

The client department will make available, with express provisions disclaiming liability, the data, information, and reports obtained from these assessments. Bidders will therefore carry the risk of making their own assessments and the time required for any studies that the successful bidder will have to conduct should be factored into the project timetable.

### **3.9 Are PPPs consistent with Government's sustainable development policy?**

Yes. The Sustainability Assessment (SA) system integrates sustainability principles into the government's decision-making process. It provides a structured framework for departments to identify the sustainability implications associated with a major proposal, including a PPP.

Departments are required to use the SA as a planning tool as they commence the planning or formulation of new proposals that may bring about significant or prolonged implications on economic, social and/or environmental conditions. Departments are required to:

- ◆ Include a paragraph in their submissions to the Policy Committee or ExCo setting out the sustainability implications
- ◆ Conduct a SA of their proposals before public consultation, and incorporate the main SA findings into relevant consultation documents
- ◆ Incorporate the requirement for SA into their business case, planning or feasibility studies

This requires prior clearance with the Sustainable Development Division (SDD). Departments are encouraged to consult the SDD as early as possible.

The Guideline on Sustainability Assessment (SA No. 1/2006) can be downloaded by departments from <http://sdu.bost.ccgo.hksarg/index.htm>.

### **3.10 Can we encourage ‘green’ or ‘sustainable’ buildings?**

Experience in numerous PPP markets demonstrates that PPPs provide a good opportunity to encourage green or sustainable buildings.

Green buildings are more environmentally friendly than the norm and, typically, will involve less wasteful construction, use less water and energy, and produce fewer polluting emissions and waste.

Sustainable buildings embrace economic and social dimensions as well as being environmentally more friendly.

Many traditionally procured buildings are neither green nor sustainable, largely because of the disconnection between designers, constructors and users. The whole of life approach used in PPPs encourages and incentivises the development of green and sustainable buildings.

The Building Environmental Assessment Method Society provides advice and assistance to both public and private sectors.

### **3.11 Are green and sustainable buildings more expensive?**

The cost of designing and building green and sustainable buildings may be higher than traditional approaches. However, the lifecycle costs will often be lower, and a building’s productivity should be higher, producing better value for money.

The greatest impact on producing green and sustainable buildings is achieved during the design stage. Over the lifetime of a typical office building the costs of running a public service constitute about 75% of the total cost, compared to less than 10% for the construction cost, including less than 1% for the design. A modest increase in upfront investment in the design can produce significant cost reductions and other benefits over the life of the facility.

Apart from environmental benefits and cost reductions, well designed buildings can improve occupant comfort which, in turn, improves productivity, and reduces staff sick leave etc.

### **3.12 Do we need to take account of the rights of minority or disadvantaged groups?**

We expect all contractors to comply with any legislative requirements. There are also requirements for contractors to avoid exploitation of non-skilled workers. Please see the EU’s Policy and Practice Guide and the User Guide to Contract Management for details. In addition, client departments will seek to get a private partner that aligns with its own values and beliefs (see Question 5.1), which should include respect for the rights and needs of all members of the community.

### **3.13 Are there any specific gender issues?**

Any department considering legislation, public policy or programmes is required to promote the elimination of discrimination against women. In the PPP context this might, for example, involve ensuring that the contractor’s female employees are given equal employment opportunities and pay. The Labour and Welfare Bureau can advise details of gender mainstreaming requirements.

### **3.14 Can the private sector propose unsolicited projects?**

The private sector may bring unsolicited ideas to the Government but, usually, a competitive bidding procedure would still be required to demonstrate value for money and to guarantee probity.

Although the risk of entering into a competitive process on the basis of a submitted idea might deter the private sector from bringing such ideas forward, only in limited circumstances would the Government grant a private party an exclusive mandate to fully develop a proposal on a non-competitive basis. Such circumstances would be rare, e.g. where the intellectual property in the proposal is of such outstanding value that a competitive market for the service would not exist. The client department would still have to satisfy itself that good value for money would be achieved and alternative means to deliver the same end result did not exist.

### **3.15 What should be the duration of a PPP contract?**

The underlying principle is that the duration selected should result in best value for money. Subject to circumstances, it is generally most efficient if the contract length is somewhere between a half and the whole of the useful life of the main assets. Factors such as service requirements of the client department and the likely terms of debt obtained by the private partner will also be relevant. A shorter contract duration might require debt to be paid off and equity returns to be earned over an artificially short period, putting upward pressure on the payments to be made by the client department. A longer duration would allow a longer debt service period.

In some overseas PPP projects, contract periods are well short of the design life of the asset, to ensure that a valuable residual interest in the asset is available to the government at the end of the contract. The transfer conditions in the contract need to be crafted to this end. A positive aspect for the financial community in this scenario is that the asset and its residual value could then be used for redevelopment.

If the client department's period of service requirement is significantly shorter than the life of the main assets, the department would be advised to reconsider the whole project, not just the PPP approach.

### **3.16 What is the Project Steering Committee (PSCom)?**

This is similar to the 'Project Steering Committee' used in the management of multi-disciplinary projects by works departments. The role of the PSCom would be to oversee the progress of the project from start to finish, give general direction of the project and make major policy decisions. The PSCom is not a contract administrator for the day-to-day contract administration.

The PSCom will either be chaired by or report to the officer in the client department with overall authority for the project. The composition of a PSCom should be limited to an optimal size for effective operation. For example, sub-groups on different expertise fields could be formed separately and only the sub-group chairman representing the interest and concerns of the corresponding sub-group members would be members of the PSCom.

The PSCom should contain the experience and expertise appropriate to its needs, and include/employ the services of an experienced Contract Manager responsible for day-to-day management and capable of ensuring adherence to the desired project timetable. In addition to members of the client department's own staff, the PSCom might include architects, engineers with various specialisations, lawyers, and financial advisors; it may contain individuals from both within and outside the government; and its composition may change according to need at different stages of the project.

Where advisors to the PSCom are employed from outside government, the client department will need to ensure against any conflict of interest arising. The client department should contractually prohibit advisors from later working on the same project for private sector bidders where this might risk the tailoring of advice or the use of inside information.

Under the conventional procurement approach the Works Branch and works departments may serve as the works agent of the client department. Under the PPP approach, the client department is responsible for forming its own PSCoM which should possess the necessary skills and knowledge to manage the contract during different stages of the project.

### **3.17 Is there a role for the works departments on the PSCoM?**

Departments should generally invite staff from works departments to join the PSCoM, where they can act as technical advisors and assist in drawing up the output/outcome specifications, setting performance standards and advising on work practices. Works departments may also assist in a regulatory and monitoring role throughout the contract period.

### **3.18 Why appoint outside advisors to the PSCoM?**

The public sector has limited experience and expertise in delivering PPP projects. External advisors can often offer a wider range of skills and commercial perspectives and experience than is available in-house, e.g. writing output/outcome specifications; negotiating complex infrastructure contracts that underpin PPP transactions; understanding the financial products that investment bankers promote to underwrite such transactions; and in contract management (see Chapter 8). Appointing the right consultants and making sensible use of them will help to address this skills deficit. Heads of Department should seek to transfer such skills to in-house staff wherever practicable, for example, by teaming up in-house staff with outside consultants. At each stage in the PPP approach, the client department should undertake a competitive tendering process to employ the necessary outside advisors. The EU will be able to provide help in assessing the need for and recruiting the necessary outside advisors.

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# 4 MAKING THE BUSINESS CASE

## 4.1 How do we make the case for a PPP?

As with any major government project that involves changing the way government business is done the first step is to ensure that there is a case (a business case) for proceeding. A business case addresses the issues that the proposal seeks to resolve. It will include the compelling case for change, in terms of the existing and future business needs; the options considered; the preferred option that represents the optimum balance of estimated expenditure and revenue, anticipated savings, expected benefits and the risks identified together with risk allocation and mitigation proposals; and an implementation plan to achieve the intended outcome.

## 4.2 How do we develop a business case?

In the early stages it might not be clear whether a PPP or another delivery option will best resolve the issues being considered. Therefore, the development of the business case for a PPP will often be done in two stages. The stage 1 business case study involves a high level selection from among the different delivery options the one that best meets the service needs. In the stage 1 business case study, the options to be evaluated should include those of the public sector (e.g. in-house provision, contracting-in, trading fund, corporatisation, etc.) and private sector (e.g. contracting-out/outsourcing, PPP, etc.). To be considered as having a prima facie case, a PPP should meet most, if not all, of the following criteria:

- ◆ There is a major investment programme, requiring effective management of risks associated with construction and delivery
- ◆ The private sector has the expertise to deliver the programme and there is good reason to think that it will offer value for money
- ◆ The structure of the service is appropriate, allowing the public sector to define its needs as service outputs that can be adequately contracted for in a way that ensures effective, equitable and accountable delivery of public services in the long term
- ◆ Risk allocation between the public and private sectors can be clearly made and enforced
- ◆ The nature of the assets and services identified as part of the project are capable of being costed on a long-term, whole of life basis
- ◆ The value of the project is sufficiently large to ensure that procurement costs are not disproportionate
- ◆ The technology and other aspects are stable and not susceptible to short-term fast paced changes
- ◆ Planning horizons are long term, with assets intended to be used over long periods.

If this exercise provides a prima facie case for a PPP, resources would then have to be invested in the stage 2 business case study. The stage 2 business case study focuses on confirming the justifications for the PPP option and setting out its details and requirements so that a final go ahead can be sought prior to the procurement. The stage 2 business case study should include a detailed analysis of the

likely costs, benefits and risks of the PPP option to the government, baseline costs, PSC, critical success factors, project management and implementation plan, procurement strategy, risk management strategy, benefits realisation plan, etc.

It should be noted that some of the issues will be covered in both stages 1 and 2 of the business case study, e.g. evaluation of options, selection of the preferred option, etc. Stage 1 addresses the issues at a higher level and in less detail. With more information available, stage 2 will review, validate and update the assumptions and estimates made earlier and map out the way forward. For example high level cost estimates gathered from a market-testing exercise might be sufficient for comparing different options in stage 1; whereas a properly prepared PSC will be required to demonstrate value for money of a PPP in stage 2.

The EU plans to issue a Government Business Case Guide in 2008 to provide more guidance on the conduct of business case studies.

### 4.3 What is value for money?

As with other procurement methods, the lowest priced option does not necessarily offer the best value for money. Value for money refers to the best available outcome taking account of all benefits, costs, and risks over the whole life of the procurement. Value for money is determined through a comparative analysis of the benefits, costs and risks of the available procurement alternatives. Assessing the value of these variables requires a degree of judgment and the use of both quantitative and qualitative analysis. Value for money combines economy, efficiency and effectiveness. It can manifest itself as:

- ◆ Delivery of a service capability at a lower cost
- ◆ Greater certainty of an expected financial outcome due to less exposure to significant risk
- ◆ Increased benefits to the end user of a service due to the public sector's focus on service delivery rather than asset procurement.

Assessment of value for money is not in itself affected by the budget impact of alternative procurement methods. The assessment should also be independent of the accounting classification of a private financing arrangement i.e. whether or not any borrowing is off the government's balance sheet. The budgetary implications of alternative procurement methods should be considered separately as part of the government resource management framework. PPP procurement inclusive of private financing should be used where it offers superior value for money compared with other procurement methods.

### 4.4 What is a Public Sector Comparator (PSC)?

A PSC is an estimated, risk-adjusted, cost of the government itself delivering the project output. The PSC is expressed in terms of the net present cost to the government of providing the output under a public procurement, using a discounted cashflow analysis that adjusts the future value of the expected cashflow to a common reference date. This enables comparison with bids and makes allowance for the imputed cost of government borrowing. The PSC has three core components:

- ◆ Raw PSC: the base cost of delivering the services specified in the project brief under the public procurement method where the underlying asset is owned by and the service delivered by the public sector
- ◆ Competitive neutrality adjustment: this removes any net advantages or disadvantages that accrue to a government run service by virtue of its public ownership, e.g. the non-payment of insurance premiums or taxes by a government run transport service

- ◆ The value of transferable risks: risks which the government would bear under a public procurement but is likely to transfer to the private sector.

A further component, the value of retained risks (risks that are likely to be retained by the government and are reflected in the Raw PSC) may be calculated and added to each private sector bid. This will be necessary if different bidders accept different levels of risk transfer.

#### **4.5 Why do we need a PSC?**

While competition encourages the private sector to submit more efficient bids, there is often a need to have a PSC to objectively compare the costs of the best PPP option against the public sector alternative.

In addition to providing the basis of comparison between the PPP and the public sector alternative, creating a PSC has the following benefits:

- ◆ Encourages the early appraisal of project risks and their allocation between the public and private sectors
- ◆ Improves bidder confidence in the tendering process and encourages bidder competition
- ◆ Encourages the closer alignment of private sector bids with government needs and risk transfer profiles, thus reducing bidding costs and timescales.

The PSC is part of a broader value assessment of bids and bidders that takes into account qualitative as well as quantitative factors.

#### **4.6 Must we always construct a PSC?**

A PSC need not be constructed where a firm decision has been made that the PPP approach is to be followed for policy or qualitative reasons, or where no public money is involved because the project is financially free-standing. Nonetheless, to establish value for money and make the business case for the project, a Raw PSC will normally be constructed, especially if there is to be some public contribution such as the creation of infrastructure, or if public land is to be provided at less than full market value. A further advantage to creating a PSC is to provide a benchmark of what the government believes is an appropriate level of investment.

It is advisable to construct an initial PSC as early as possible. This allows the client department to ascertain the expected full cost of pursuing the project by traditional means. Second, it allows the client department to inform potential private partners of the scale of the project at an early stage.

#### **4.7 How is the PSC developed?**

Annex D provides an outline of how to construct a PSC.

External help from consultants will often be required.

#### **4.8 How accurate are calculations of the PSC?**

The PSC is an estimate based on an outline Reference Project. Experience overseas indicates that the PSC cannot be calculated exactly. It should be expressed as a range of values (reflecting the accuracy and reliability of the available information) and used as only one component of the overall value assessment, not as a pass/fail test. Other components used in assessing the value for money of bids may include:

- ◆ The quality/quantity/range of service deliverables
- ◆ The operational commencement date
- ◆ Any non-quantifiable risks absorbed by the private partner
- ◆ The reputation and financial standing of the private partner.

These components may be evaluated prior to consideration of the costs.

There is a general tendency worldwide for project estimates to be over optimistic both as to cost and time to complete. The UK National Audit Office has shown that this tendency is mitigated in more than three out of four cases when using a PPP. In Hong Kong, an EU analysis has shown that the tendency to over optimistic forecasting is more prevalent with regard to time than it is to cost; in any case care needs to be taken to ensure that the PSC uses valid and carefully constructed estimates for time, cost, etc. However, it is sometimes difficult to assess the on-costs in estimating the construction costs of certain facilities due to the lack of relevant examples.

### **4.9 Is it advisable to disclose the PSC to bidders?**

The PSC will often be public knowledge by the time of the RFP as it will normally have been disclosed to LegCo's FC in the course of obtaining funding approval to proceed with the project. According to Stores and Procurement Regulations (SPR), if the estimated contract value has been disclosed to the public, departments should, in all fairness, inform bidders of the estimated contract value. However, if the information has not been disclosed publicly (e.g. in financially free-standing projects), it is not necessary to disclose the PSC. Providing the PSC to bidders will discourage them from submitting bids that are higher than what is in effect the project's financial ceiling and, provided that there is sufficient competition among bidders, it would not discourage bidders from submitting low bid prices.

### **4.10 Can the PSC be updated during the procurement process?**

Once a business case is established, it may not be worthwhile to update the PSC (except for circumstances where there is a lengthy lapse of time) unless the bidding prices are much higher than the PSC and the client department has to reassess whether to proceed with the PPP project. Current practice in the UK is not to update the PSC as it is used only to determine the case for the project to be a PPP. The competitive bidding process is used to determine what is the best value for money proposal.

### **4.11 Should the client department allow additional services to be provided under the contract?**

Departments should consider whether to seek or be prepared to accept proposals for enhanced facilities/services or other commercial facilities on the site, having due regard to their impact on the delivery of the required services. The benefits of permitting the provision of facilities/services over and above those required by the client department may include:

- ◆ Better site utilisation
- ◆ The provision of additional facilities/services for the community
- ◆ Additional revenue for the consortium/government
- ◆ Cheaper public facilities/services.

The provision of additional services/facilities might make a major contribution to the value for money and even the viability of a project. If so, bidders' proposals for and proven abilities in providing such facilities should be a key factor in proposal evaluation. If the department is prepared to accept additional services/facilities, it should ensure that any constraints are made clear to all concerned in the process of developing the project, and should be made clear in the RFP documentation. Constraints might include:

- ◆ Compatibility with the zoning on the town plan
- ◆ Restrictions on the development parameters permitted for the site such as the Gross Floor Area (GFA), plot ratio, building height and site coverage
- ◆ Sensitivities over issues such as alcohol, tobacco and gambling-related or immoral activities
- ◆ The ratio of required to additional activities
- ◆ Other policy and political considerations.

For some constraints, the department might wish to work with other government departments to minimise their effect on the project.

If the consortium is allowed to keep income from the provision of additional facilities/services, then sufficient management controls and sanctions must be in place to ensure that the consortium will not be distracted from the delivery of the required services, which may be less profitable than the additional services, e.g. the relative share of the additional services and the timing of the revenue generated. Care should be taken to avoid any hypothecation of revenue.

The client department may wish to provide sufficient flexibility for the consortium to introduce or change additional activities after the award of contract, subject to the client department's agreement where appropriate. The client department will also wish to satisfy itself concerning sharing the benefits arising from the additional services, and the fees charged to the public.

Departments will need to decide the status of additional services/facilities in the event of the termination of the PPP contract; whether at the contracted date or earlier due to the exercise of step-in rights. They should consider whether the additional services/facilities should or should not revert to the government along with the required services/facilities; and, if so, what conditions would apply and what would need to be done to manage the hand-over.

Client departments should note that insofar as land sales are concerned, there is a policy regarding an administrative ban for major modifications within five years of a land sale. These refer to modification proposals for substantial changes/relaxation in respect of the user restriction or development parameters as specified in the land sale conditions. This is to safeguard against possible criticism from other developers i.e. those who were not successful could complain that they would have put in a much higher bid for the site if they had known that the government was prepared to grant such modifications. Other developers who had not submitted any bids previously might also make similar complaints.

See also Question 7.15.

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# 5 GETTING THE RIGHT DEAL WITH THE RIGHT PRIVATE PARTNER

## 5.1 How do departments get the right private partner?

As with all private sector involvement exercises, a client department will seek to:

- ◆ Conduct market testing to discover if the private sector is willing and able to perform the required tasks
- ◆ Give potential bidders the opportunity to provide feedback on the proposed scheme
- ◆ Give sufficient publicity and time for potential bidders to prepare proposals
- ◆ Provide output/outcome performance specifications that clearly identify the service requirements
- ◆ Arrange briefings and site inspections to ensure potential bidders understand clearly the requirements before submitting their proposals
- ◆ Look for good alignment of the selected consortium with the client department's values and beliefs
- ◆ Put in place an objective and fair bid assessment process
- ◆ Conduct thorough due diligence to substantiate the preferred bidders' claims (capability, experience, expertise, financial position etc).

The Government wants to encourage the further development of high quality service providers in the market for public services. This requires that a competitive selection process be used which insists on quality services, socially-responsible terms and conditions, and high safety standards. If the Government lays down reasonable expectations, abides by them over time, and provides a level playing field, quality firms will be attracted to the market. This will make it difficult for less socially-responsible service providers to survive. Experience shows that it is competition that delivers the benefits from PPPs, not private provision per se.

## 5.2 What are the key steps to take in selecting a PPP consortium?

For most PPP projects, the following are the usual steps:

- ◆ Conduct a market testing exercise
- ◆ Issue request for Expression of Interest (EoI) from the private sector
- ◆ Pre-qualification of private sector companies including those that have submitted an EoI
- ◆ Issue RFP to pre-qualified private sector companies
- ◆ Exclude proposals not meeting mandatory essential requirements

- ◆ Conduct assessment on the proposals. Negotiate with the one or two best conforming bidders to achieve improvements to bids whilst under competitive pressure. SPR 385(e) states that negotiations shall normally be conducted with only a single tenderer. SPR 300(a)(ii) allows departments to seek the Secretary for Financial Services and the Treasury's (SFST) approval not to follow SPRs in respect of franchises, concessions etc. (most PPPs are franchises, concessions etc.) It is not normal government practice to negotiate the land premium, if any
- ◆ Select a preferred bidder or bidders to develop detailed, fully negotiated contract documents (reserve the right to revert to alternative bidders if contract negotiations break down)
- ◆ Request best and final offer
- ◆ Recommend the preferred bidder to the relevant bid evaluation committee.

### **5.3 What is the difference between market testing and Expression of Interest (EoI) exercises?**

Market testing is an exercise conducted early on, typically during the PPP business case study, where private sector companies are approached to see if the private sector is willing and able to participate in a project, and under what circumstances.

Market testing is especially useful when a particular service is being considered as a PPP for the first time. Early disclosure of government's intentions gives the private sector the necessary time to consider forming business relationships, recruiting staff, acquiring technology and so on.

An EoI takes place after policy approval for the PPP approach has been granted. In response to an invitation, companies may indicate their interest in, and ideas for, a project with a view to being invited to submit a proposal at a later stage.

### **5.4 Do we need to conduct EoI and pre-qualification exercises?**

An EoI enables client departments to gauge the extent of the available market as well as tap the experience and expertise of interested parties before finalising the scope of basic requirements and additional services/facilities. EoIs are particularly useful when the client department is proposing a PPP approach in a new area. Departments should not expect potential bidders to disclose valuable or commercially sensitive information in an EoI submission. An EoI is not usually used to establish a bidder list; if it is this should be made very clear.

A pre-qualification process can reduce the number of bidders to a manageable number. Best practice suggests that a short-list of three to four bidders is sufficient to create adequate competition and cover the risk of a party withdrawing, so long as there is adequate confidence in the capability and motivation of the bidders. A short-list of more than four is likely to lead to some bidders losing interest, as their chance of success (20% or less) may not warrant the significant investment of time and resources in preparing a bid.

The proposal and selection processes for substantial PPP projects can be very costly, both for bidders and the client department. Bidders will be sensitive to costs, and should not be compelled to incur excessive costs as a result of unnecessary bid requirements. For some projects, if it can save time and effort all round, the EoI and pre-qualification exercises may be conducted in one go. Care will need to be taken to ensure that sufficiently detailed information can be provided to bidders to achieve the purpose of the combined exercise.

The PSCom should recommend to the Head of Department, in the light of submissions received, which of those expressing an interest and/or pre-qualifying are to be invited to submit proposals.

### **5.5 What information should we give at the pre-qualification and Request for Proposal (RFP) stages?**

The objective must be to give potential partners as much accurate and pertinent information about the client department's intentions as early as possible. This is to enable potential bidders to put together coherent, sound and innovative proposals, in the full knowledge of the requirements and risks involved, and reduce the likelihood of misunderstandings, withdrawal of bids etc.

The most important document to be prepared when inviting proposals will be a properly scoped output/outcome based specification that clearly articulates the department's needs and service objectives. A clear scope will result in a better assessment of the project's feasibility and enhance the private sector's ability to identify and offer best value for money. In many cases the client department will need to undertake some early studies and/or specific site investigation in order to expedite the contracting process and remove avoidable uncertainties that would otherwise affect the costs of the project. Achieving a balance between clear specifications and scope for innovation may be challenging; whatever firm requirements are identified should be clearly identified as such for conforming bids, whilst allowing and encouraging alternative proposals also.

Information to be given to potential bidders may include:

- ◆ Carefully designed draft output/outcome-focused specifications
- ◆ A preliminary timeframe for delivery of the service/facility and whether early completion/delivery is desired or not
- ◆ Land status (i.e. ownership) of the relevant site(s)
- ◆ Where a land lease is involved, the Tender Notice and the Conditions of Sale
- ◆ Zoning on the statutory town plan(s)
- ◆ Information on whether a planning application under the Town Planning Ordinance (Cap 131) or rezoning of the site(s) is required
- ◆ Environmental, traffic, SA or other assessments required from the contractor or already done
- ◆ Draft Service Level Agreement (SLA)
- ◆ Draft contract (also see Questions 5.7-5.9)
- ◆ Proposed performance indicators
- ◆ Proposed step-in and termination provisions
- ◆ Avenues of redress/appeal on the part of the private partner
- ◆ Matrix of proposed risk allocation
- ◆ Preliminary/final Raw PSC estimate
- ◆ Affordability constraints
- ◆ Bid evaluation criteria
- ◆ Insurance cover requirements

- ◆ Whether bidders are required/encouraged to employ serving civil servants, and the terms of transfer requirements
- ◆ Whether bidders may be allowed/encouraged to provide additional services/facilities
- ◆ Whether a lump sum premium or other income/revenue is expected by the government
- ◆ Client department's proposed payment mechanism(s) (including rewards and abatements)
- ◆ What opportunity there will be for bidders to comment/suggest amendments to the payment mechanism
- ◆ Whether more than one successful bidder is envisaged or desired.

Clearly, the information to be provided at the pre-qualification stage may be less precise and comprehensive than that provided at the proposal stage. Information provided by the department must be carefully scrutinised prior to its issue. Client departments should take steps to protect themselves from liability for negligence by using appropriate disclaimer clauses.

### **5.6 What information do we want from the private sector at the pre-qualification and RFP stages?**

- ◆ Clear statements of information such as:
  - Detailed refurbishment and replacement schedules for project assets
  - What insurances will be put in place
  - The terms of employment of project staff
  - Demonstration of a commitment to ethical practices
  - Relevant experience of consortium members
  - Qualifications and experience of key staff
  - Disclosure on possible conflicts of interest and the proposed mitigation measures
  - Probity issues
  - Consortium members' financial standing
  - Record of compliance with labour ordinances
  - Delivery approach and methodologies
  - Record of innovation
  - Ideas on basis for remuneration of the consortium.

### **5.7 Why do PPPs require output/outcome performance specifications?**

Output/outcome-based performance specifications should be used in all types of private sector involvement projects. They allow the private sector as much flexibility as possible to produce innovative, cost-effective designs of services and infrastructure, on a whole-life cost basis, taking advantage of new and labour-saving technologies and techniques. For example, in a community facility project, instead of input specifications requiring the installation of permanent seating for 1 000 people, the output specifications might require that seating for 1 000 people shall be provided when required. This allows the use of temporary seating. At other times the space could be utilised for other purposes. Nonetheless, some aspects must be specified such as the means of escape and fire services requirements for the 1 000 people would have to be permanent features.

Output/outcome specifications need to be carefully drafted to drive the behaviour and performance of the consortium and its contractors throughout the life of the project. They should also avoid setting unrealistically high standards; for an existing service if standards higher than those that are currently being achieved are requested then they should be reflected in the benchmarked estimated cost of conventional procurement (the PSC).

### **5.8 When might inputs need to be defined?**

Despite the desire to maximise flexibility, it is difficult to achieve 100% use of output/outcome specifications and it will usually be necessary to use some input-based specifications or even an outline design for reference or to ensure a specific need is met, where the facility interfaces with other facilities or there is an interaction with surroundings.

Consideration should be given to the need for contracts to contain defined inputs so as to protect the Government's interests in the event of disputes. For example, an input to provide an Olympic size swimming pool could contain the usual construction schedules and contracts requiring a certain aggregate mix, sand quality and prohibited use of open bags etc. If cracks appear later in the pool walls there are likely to be arguments advanced by the consortium as to the extent of its liability (it may claim mitigation of their liability under the contract due to relief events and possibly even force majeure and compensation events - see Chapter 11). The government will wish to point to and rely upon a breach of the input requirements as to aggregate mix, sand quality and use of open bags etc.

### **5.9 What are inputs, outputs and outcomes?**

Inputs refer to the resources deployed by the contractor in the production and delivery of services. Inputs commonly include labour, physical resources, administrative services and computer systems.

A typical input specification might be "The contractor shall deploy one security guard at all times at each entrance of all buildings in the estate and security gates shall be locked between 11 pm - 6 am".

Outputs refer to the immediate result of the contractor's activities. A typical output specification might be "The contractor shall ensure that each entrance of all buildings in the estate is monitored at all times by security staff, and that they respond to requests for assistance within one minute".

Outcomes refer to the longer term impacts of the contractor's activities. A typical outcome specification might be "The contractor shall take steps to reduce the numbers of reported crimes within the estate by at least 1% each year".

Whilst the use of output/outcome specifications is strongly advocated it is acknowledged that, sometimes, it is necessary to use input specifications to ensure that the public and the department's requirements are met. For example, in a housing estate it is likely that residents will want to see the physical presence of security guards even though their safety may well be achieved satisfactorily and cost-effectively by the use of electronic and mechanical means. Departments should not lose sight of the human touch.

### **5.10 What help can be given to bidders during the bidding process?**

Whilst care must be taken to ensure against actual or perceived favouritism during the bidding process, client departments must be diligent in ensuring that bidders have sufficient access to comprehensive information to provide the best possible proposals. Clarification of requirements should be provided on demand (and shared with all bidders). So long as probity requirements, including documentation of meetings and equality of access and information, are observed, such clarifications can be face-to-face as well as in writing.

Procurement should be managed carefully with communication between bidders and the client department going through a single central point. This should help avoid ambiguity, the provision of conflicting information, and duplicate or multiple requests for similar information. Proposal evaluation criteria, for example, should be provided clearly and unambiguously so that bidders are aware of the issues that are of most importance to client departments.

At the pre-qualification and/or the initial competitive bidding stages, there may be drawbacks in providing certain information, such as a draft SLA and/or a detailed draft contract. If client departments inform bidders of the detailed contractual terms too early, the scope for negotiating will be limited; the government may be disadvantaged and may not get the best out of what is intended to be an innovative process. On the other hand nugatory work by bidders and client departments may result if bidders are not given clear indications of which items are non-negotiable. SPR 345(c) requires the tender documents to cover a number of things including general and special conditions of contracts. Departments are advised to consult the Department of Justice (DoJ) and FSTB in specific cases.

### **5.11 How is the principle of non-discrimination applied?**

All bidding exercises must be conducted in accordance with the principle of non-discrimination. The Government cannot negotiate with a non-conforming bidder with a view to modifying or waiving essential requirements. Otherwise, it would be unfair to other bidders and potential bidders.

Depending on the nature of the particular PPP in question, the rules of the WTO GPA do not apply to a concession or franchise. However, it is still necessary for the Government to act fairly. Accordingly, the Government is not free to modify or waive the essential requirements or contractual terms after the closing of the tender exercise without regard to the principle of non-discrimination. For that reason the minimum mandatory/essential requirements specified should be limited to those that are truly essential.

### **5.12 Does the World Trade Organisation Government Procurement Agreement (WTO GPA) apply to PPPs?**

Hong Kong's commitments under the WTO GPA do not cover franchise arrangements, BOT contracts and public works concession contracts. Accordingly, most PPPs complying with the recommended procedures in this Guide will not be covered by the WTO GPA. Departments may wish to check with the International Law Division of DoJ whether specific projects are covered by the WTO GPA.

The object of the WTO GPA is to provide open and fair competition amongst domestic and foreign suppliers and service providers through procedures designed to ensure that all tenderers are treated by procurement entities covered by the WTO GPA on an equal footing. It prescribes a set of requirements regarding non-discriminatory treatment of goods, services and service suppliers, qualification of suppliers, tender procedures, tender specifications and challenge procedures. The government's procurement principles of open and fair competition, transparency, value for money and public accountability are consistent with the spirit and objective of the WTO GPA.

### **5.13 How does the department negotiate a detailed contract?**

The negotiation process can involve the two parties physically meeting and negotiating face to face; it can involve the passing of draft documents backwards and forwards; or it can involve a combination of both. Passing draft documents between the two parties is the norm.

The key objective of the procurement process is to select the right consortium for the project. The bidding and negotiation process must be carefully managed. Negotiating on the detailed terms of the project will only be possible if the Government avoids setting out overly detailed terms/requirements in the procurement documents in the first place, i.e. if the Government only sets out minimum mandatory/essential requirements in the documents and leaves the detailed terms to be negotiated with the bidders. This flexible approach can encourage innovative solutions by inviting the private sector to come up with proposals but it departs from conventional practice in relation to procurement through an “invitation to tender” (ITT). For PPPs, the Government does not issue an ITT but a RFP. Accordingly, the words “tender” and “tenderers” should be avoided in the RFP documents.

The challenge is to create a bidding environment that balances on the one hand the client department’s desire for certainty, the need to maintain competitive tension, and avoid deal creep, and on the other hand the bidders’ wishes to reduce bid costs, and have clear requirements against which to provide innovative solutions. In time the development of standardised contracts, based upon local PPP experience, may assist in these objectives.

### **5.14 Can we negotiate detailed contracts with more than one bidder?**

Negotiating detailed contracts with more than one bidder is common overseas to secure the most favourable terms for government, especially where two bids are similar. Approval from SFST is required to negotiate with more than one party. The aim is to maintain the competitive environment as long as possible, to find the right pricing structures and risk allocations and therefore to achieve the best terms. From the Government’s perspective this achieves a balance between certainty and competition, though care will be needed to guard against compensation claims from losing bidders.

If detailed negotiations are conducted with more than one bidder, Government will normally negotiate with each bidder on the basis of a set of common terms. Doing so ensures greater simplicity for the client department in terms of its comparison of bids. However, it also carries some risk of loss of innovation and achieving optimum pricing proposals. Nonetheless, the client department should ensure that the RFPs provide clear, well drafted and market oriented requirements and risk allocations to reduce the probability of excessive or highly material variations between bidders. The department will normally use the same negotiating team for negotiations with different bidders and determine the baseline and the parameters before the start of the negotiation process. The department should be adequately resourced to be able to rapidly and thoroughly evaluate the variations proposed, and ensure that all material variations have been fully evaluated by the end of the negotiation phase.

It is very important that the Government communicates the process to bidders at an early stage and does not deviate from it. If Government negotiates with only one bidder it should still retain at least one bidder in reserve and not announce the existence of a preferred bidder until the completion of negotiations.

The cost of the procurement process - particularly the negotiation phase - can be extremely high, both for the private sector and the Government. If the costs are too high, taking the chance of success into account, many potential bidders will be discouraged from participation with the consequent loss of competition, innovation etc. An appropriate balance needs to be achieved. In some jurisdictions, compensation packages for short-listed bidders are set, or agreed, in advance to encourage full participation. This is not Hong Kong Government practice.

### **5.15 Who should be in the Government's negotiating team?**

One of the challenges facing departments is that few civil servants have experience in negotiating complex commercial contracts. Other jurisdictions faced similar problems when they started their PPP programmes.

Whilst there are no fixed requirements on the make-up of the Government's negotiating team there are a number of lessons learned from elsewhere:

- ◆ In the early projects senior departmental management must commit a considerable amount of their time and attention
- ◆ The lead negotiator must have the authority to negotiate (within the confines of the approved negotiating brief)
- ◆ One of the negotiating team members will often carry on as the Contract Manager (see Chapter 8) after the deal is closed, providing continuity and the institutional memory
- ◆ The lead negotiator may be brought in from either another department or the private sector if the client department does not have the experience and expertise. Departments will need to manage carefully real or potential conflict of interest.
- ◆ The negotiating team should be kept as small as possible to avoid becoming unwieldy.

### **5.16 Are bid preparation and contract management onerous and time-consuming?**

Structuring, assessing bids or, awarding and implementing a PPP contract will be a challenging process. Client departments will need a strong in-house team with appropriate external advisory support (see Chapter 8). The bidding process may involve inviting initial proposals from the private sector, evaluation of those proposals, discussion and negotiation with individual bidders in order to obtain best and final offers, and finally selection of the proposal offering the greatest value for money. Once the facility is in operation, the client department will focus on monitoring performance against defined criteria.

### **5.17 Can the client department select more than one successful bidder?**

The selection of one consortium, after a competitive bidding process, is the norm. However, there may be circumstances where the client department prefers more than one party to provide the required facilities/services. This might be to ensure that existing competition continues; to prevent the replacement of a public monopoly by a private monopoly; or to reduce the risk of service disruption in the event of staff disputes, bankruptcy etc. In such circumstances, the client department should make clear in the RFP that it is prepared to consider engaging with more than one partner; explain what those circumstances are; and request bidders to put in separate proposals for these different circumstances. Alternatively, client departments could, subject to legal clearance, break up the contract and state clearly that no bidder will be offered more than one contract. The method of determining which contract goes to whom should be clearly spelt out in the RFP document.

The successful bidders would have well-defined service areas so that they were not required to compete directly with each other after the competitive bidding process. For example, the Hong Kong Hospital Authority has replaced some of its in-house catering with PPP arrangements at two of its five geographical 'clusters' of hospitals.

### **5.18 Can a project proceed if the lowest conforming bid exceeds the PSC?**

A PSC may be a range rather than an absolute number. If, for example, the lowest conforming bid fell within the range of costs for the PSC, and there were other benefits in terms of quality of service, additional services etc, then the client department would likely feel comfortable to proceed. If the lowest price conforming bid exceeds the PSC the client department would need to ascertain whether there were any other value for money justifications, apart from the price, that would warrant the project proceeding.

### **5.19 What if the successful bid is considered too expensive?**

Any successful bid must be better value for money than the other competing bids and provide at least equal value for money as the PSC. If it passes these two tests, there is no basis for saying that it is too expensive. If, for example, the client department's expected budget is reduced it could always renegotiate the contract. But, the contractor is unlikely to drop the price without competitive pressures from other bidders and perhaps other contract conditions also being changed. For equity and probity it is important to maintain the integrity of the bidders' offer prices and terms throughout the evaluation and negotiation process. Where the successful bid exceeds the approved project estimate, departments should revert to PWSC/FC on the additional funding required or seek approval of FSTB under delegated authority (if the amount does not exceed \$15M).

### **5.20 How do we guard against artificially low bids?**

A well-constructed PPP contract will commit the successful bidder to an agreed price for the provision of specified services over a fixed time period. Resolving design flaws or poor construction will be the consortium's responsibility - at its own cost. If such problems lead to the contracted performance service standards not being met, the consortium will face deferral, withholding or abatement of payments. The consortium's ability to make claims will be very limited (unless the client department requests changes after the signing of the contract). A properly designed and executed PSC will be useful in alerting a client department to the submission of unreasonably low bids.

### **5.21 Should we impose a 'performance bond' or require other additional security?**

In some PPP projects, the Government will be contracting with a lowly capitalised consortium with its service delivery reliant on its consortium members and whose main asset will be its interest under the project documents. The Government may therefore require comfort that the consortium and its contractor(s) will be able to meet their contractual obligations. The Government will also wish to ensure that continuity of service is maintained even if a contractor becomes insolvent.

The private sector will normally use a SPV to front a consortium or joint venture of private sector participants and their respective shareholders and finance suppliers. The Government will require copper-bottomed assurances that the SPV - a 'man of straw' in view of its extremely modest share capital - has and maintains parent company guarantees, bank performance bonds and suitable backing for liquidated damages. Insurance will also be required (see Chapter 6).

It may be prudent in some circumstances to require that the consortium provides additional security, such as a fixed and floating charge over its assets. Such security will generally rank behind the security held by the financiers. The first ranking priority, however, may be negotiated for specific amounts owing to the Government, e.g. costs incurred by the Government in the exercise of step-in rights. Sponsor guarantees may also be desirable in some instances.

### **5.22 What happens at the end of the contract?**

The land and any buildings thereon will normally revert to the Government at zero value or market rate. The department will have to consider whether it wants any removable assets, e.g. equipment at the end of the contract. The contract should specify the required condition of the assets that revert to Government at the end of the contract. There should be arrangements for joint inspection of the assets, say, two years before the end of the contract, with the private partner being required to make good any deficiencies. The client department will also be entitled to require part of the payments in the final years of the contract to be put into a sinking fund in an escrow account to protect against the possibility of non-performance of the rectification works.

If a land lease is involved, the usual arrangement is that the grantee will be required to maintain all the structures and buildings on site in good and substantial repair condition with the same to be handed over to the government upon expiration of the lease term. If it is considered necessary that a vacant site must be returned to the Government, then specific provision will have to be made in the contract to oblige the consortium to demolish the facility before returning the site to the Government.

In addition to the handing back of assets, uninterrupted provision of service may be an important consideration. The outgoing consortium may be required to provide training to staff of the client department or an incoming PPP consortium before the expiration of the contract in order to ensure a smooth transition. Appropriate provisions should be incorporated in the contract.

Overseas, the assets are sometimes left with the private sector although this is unlikely to be appropriate in Hong Kong.

It must be recognised that the requirements laid down for the end of the contract will be reflected in the bid price.

The most crucial point is that the client department considers upfront what it wants at the end of the contract and includes this in the Project Agreement.

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# 6 MANAGING RISKS

## 6.1 What problems may arise in the course of a contract?

Well prepared and implemented projects will have a higher chance of avoiding and/or dealing with problems that may arise. Experience demonstrates that for both conventional and PPP procurements poor drafting of the contract/performance requirements and/or poor contract management can lead to problems downstream. Hong Kong is fortunate in being able to learn from the years of PPP experience elsewhere in order to minimise the likelihood of suffering such problems. The key in entering into contracts of all kinds is to be aware of such possibilities, take expert advice, and manage the contract letting and negotiation processes accordingly. As with any project involving investments, the due diligence, risk allocation, and negotiation processes inherent in letting a PPP contract give the opportunity for many potential problems to be identified and resolved prior to contract finalisation. Some potential problems and the means of addressing them are:

- ◆ Benefits not being shared with the Government
  - Rigorous negotiation by the Government for terms to protect the Government's interests and adequate supervision
- ◆ Bottom line considerations assuming disproportionate importance
  - Avoidance of underbidding by consortia, equitable variation conditions
- ◆ Business culture co-existing uncomfortably with public service
  - Identification of consortia with a clear commitment to public service
- ◆ Buy-out costs of replacing a poorly performing operator
  - Rigorous selection of consortia, early identification and rectification of poor performance
- ◆ Disruption to service, and costs incurred, when exercising step-in rights
  - Rigorous selection of consortia, maintenance of an appropriate level of market competition, adequate contingency arrangements
- ◆ High financing costs
  - Appropriate allocation of risk and innovative financing arrangements
- ◆ Inadequate accountability
  - Rigorous selection of consortia and adequate supervision
- ◆ Lack of competition
  - Encouragement of the market through market testing/development and well managed contracting processes
- ◆ Lack of flexibility, especially over the longer term
  - Appropriate contractual change management/variations procedures

- ◆ Liquidation and use of company structure to avoid liability
  - Rigorous selection of consortia, strong step-in rights, linking payment to performance, requirement for parent company guarantees, additional security etc.
- ◆ Lock-in to an unsatisfactory contract - leading to costs of exercising a break clause
  - Rigorous output/outcome based definition of requirements and contractor selection
- ◆ Loss of control
  - Clear service definition, effective contract management, early identification and rectification of poor performance
- ◆ Unavailability of experienced/qualified PPP contractors
  - Encouragement of the market through well managed contracting processes and a continuing deal flow
- ◆ Unmitigated risks due to inappropriate allocation
  - Management of risk allocation, drawing on expert advice
- ◆ Unreliable levels of service
  - Rigorous selection of consortia and adequate supervision.

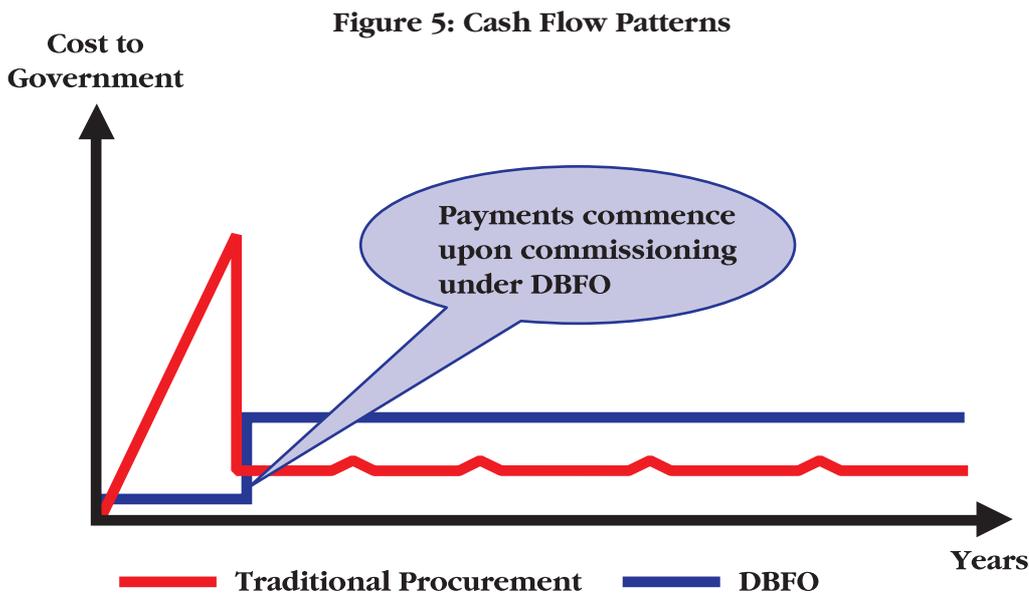
## 6.2 How does the PPP approach address the management of risks?

Risks relate to the occurrence of events whose consequences will have an effect on the outcome, either positive or negative, of a project. Exposure to risks arises in all projects, whatever the approach. PPPs provide opportunities for the better management of such risks by allocating and sharing them appropriately between the public and the private sectors. It is important that the allocation of risks is defined in a clear, unambiguous contract that sets out the risks, who takes them, and what are the consequences of and actions to be taken when the risk event actually occurs. ETWB Technical Circular (Works) No.6/2005 on systematic risk management should be used in case of PWP projects. An example of a risk matrix for a water treatment plant is given at Annex E. This shows risks many of which are specific to that project. Expert advice should be sought in developing a risk matrix. Generically the key types of risk may be classified as follows:

- ◆ Demand risks: the risk that the projected numbers of users of a service will not materialise with consequent impact on revenues; or that the number of users may be excessive with consequent impact on costs
- ◆ Design and construction risks: the risk that there will be failure to meet performance specifications; and/or there will be cost and/or time overruns
- ◆ Operating and maintenance risk: the risk that operational failures or costs and/or maintenance costs are greater than anticipated
- ◆ Technology/obsolescence risk: the risk that the assets employed in the project will cease to be the best way of delivering the required service
- ◆ Finance risk: risk associated with the cost and availability of funds for the project
- ◆ Legislative risk: the risk that changes in legislation will affect the costs/viability of the project
- ◆ Approval risks: the risk that necessary approvals are difficult to obtain or are not forthcoming
- ◆ Hazard risks: the risk of accidents or natural disasters.

### 6.3 Why transfer and share risk?

The main benefit is that by being exposed to certain risks, the consortium is incentivised to supply cost-effective and high quality services on time. Reward should always be commensurate with risk, and value for money is most likely to be achieved by allocating risk to the party best able to manage it. So, for example, the consortium only starts to receive its payments when the services start to be delivered (see Figure 5), continued payment depends on continuing service, and the level of payment is linked to meeting agreed performance criteria.

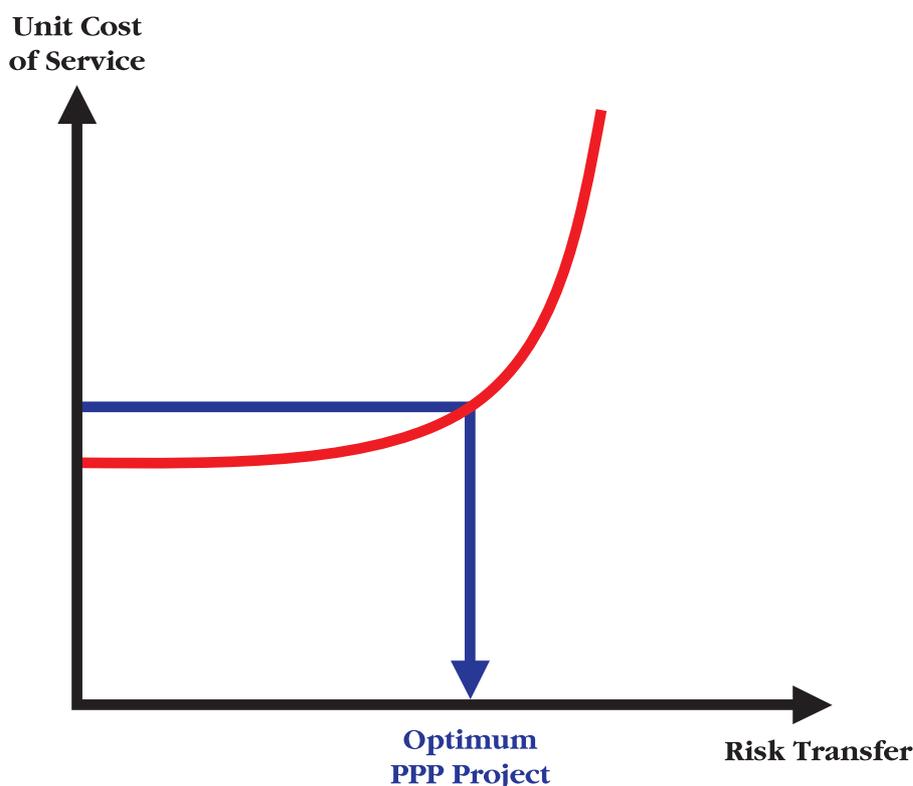


### 6.4 Which party should carry the risks associated with the project?

The theoretical golden rule is that the party best able to manage each risk should carry that risk. In practice, the allocation of risks is always subject to what could be achieved in competitive deal-making. In most projects this will mean that the client department retains some risks, the consortium carries other risks, and some risks are shared. Generally the client department would be expected to bear any risk arising from variations required by the Government, or discriminatory or specific changes in the law. The consortium would be expected to carry or share all other risks including general business risks. The willingness of a bidder to accept risks and the proposals for mitigating them can be an element in assessing and ranking bids.

### 6.5 Can all the risks be passed to the consortium?

Appropriate allocation of risk between the public and private sectors is a key requirement for the achievement of value for money. Experience elsewhere indicates that risk transfer should be optimal, not maximum (see Figure 6). If the government seeks to impose excessive risk transfer on the consortium this will result in the consortium charging an excessively high premium; simply refusing to accept the risk altogether (i.e. it will not put in a bid); or failing to meet contract obligations. Some risks are exceptionally unmanageable or unpredictable; the Government cannot simply expect to pass off such risks to the private sector without having to pay an exceptional and probably unacceptable price. It is important to identify these latter risks and to make clear to bidders that the Government will at least share them so that bid prices are not over-inflated to cover them. The Government should take into account the political risk of failure in allocating risk between the public and private sectors.

**Figure 6: Cost Effective Risk Transfer**

## 6.6 What common risk allocation mistakes are made?

A common mistake is for a department to allocate a risk to a consortium, and then de facto take back the risk by excessive interference (e.g. micromanagement) in the private sector's management of that risk.

It is legitimate and necessary for the department to monitor a consortium's performance, and to satisfy itself that the agreed outcomes/outputs are delivered, and to take necessary remedial measures (see Chapter 8). It must be remembered that in allocating a risk to a consortium, Government is paying the consortium to perform the task. There is no merit in paying someone else to do a job whilst still doing it oneself.

## 6.7 How can a monetary value be placed on risk?

Risk is a possibility, not a certainty, which makes it difficult to clearly identify and estimate its costs. Conventionally, departments have not identified or managed risks in a sophisticated way. In contrast, the private sector has long included risk considerations and costings in project work.

The appropriate method for quantifying risks will depend on the availability of relevant information. The best approach is to use empirical evidence. Analytical procedures based on expertise and experience may also be used. When neither is available, common sense estimates may be used. Some risks will be difficult to quantify. They should not, however, be ignored, but reconsidered and refined over time. The general methodological principles are:

- ◆ Assess the likelihood of a risk crystallising
- ◆ Assess the cost if it does occur

- ◆ Assess the range of cost impacts (in the form of a frequency distribution, if possible)
- ◆ Assess the expected value of the risk.

External advisors can advise departments on financial evaluation of risk.

### **6.8 Can a client department be protected from project transition risks?**

Where a PPP contract involves transition from an existing facility or service provider, whether public or private, the transition is likely to be best managed by contracting with a single party with responsibility for the migration as well as the design, construction and operation. Departments should also work out an emergency plan with the consortium in order to ensure uninterrupted provision of public service in case delayed commissioning is anticipated.

Any liquidated damages for late completion may be based upon the 'throw away' costs of the client department in preparing itself for transition, e.g. labour hire, removal costs incurred etc. In addition, the liquidated damages should compensate for the Government being delayed in providing a seamless service, including claims against the Government.

### **6.9 Can a client department minimise the interface risks regarding technical equipment?**

Systems integration and potential technological obsolescence both need careful consideration in developing the project service requirements. There will be several sets of interface risks to be managed: between existing and new equipment; and between the equipment and the physical structure and systems in the new facility. The approach likely to work best is for the department to appoint a single private party - the consortium - to manage these risks. Otherwise the client department itself will, by default, have to manage them.

The parties should identify and assess the special interface risks that may arise throughout the project and - irrespective of the underlying risk allocation position - acknowledge and agree that the provision of all services needs to be fully integrated.

### **6.10 Can insurance be used to manage risk?**

Generally, risk is best managed by a party able to influence relevant events. As mentioned above, in practice the allocation of risks is always subject to what could be achieved in competitive deal-making. Insurance may be used to mitigate a particular risk, e.g. the risk of disruption to services caused by natural events. However, the risk remains to be borne by one party or the other irrespective of insurance cover, either through the cost of the event or the cost of insurance. The difference in treatment of insurance may be one of the adjustments to be made in ensuring competitive neutrality (see Chapter 4).

The consortium can generally be expected to insure in accordance with good industry practice. The client department will generally require the consortium to take out adequate insurance to cover all types of insurable events which are considered to be 'usual' in accordance with standard commercial practice and that the Government is a co-insured for these claims. This is primarily because the client department will want to be satisfied that continuity of service supply is maintained. These required insurances usually include third-party liability claims, construction all risks, material damage claims and employer's liability insurance.

The client department should seek professional insurance advice on what requirements should be imposed on the consortium at an early stage in the procurement process and during negotiations as bidders will reflect the cost of insurance in their bids.

The contract should also address the issue of an insurable risk becoming uninsurable, or an uninsurable risk becoming insurable. In either of these circumstances the relationship between the parties to the contract may be affected; for example the extent to which the unitary charge may be adjusted to reflect insurance premiums, and the possibility of terminating the contract should a major uninsurable risk event take place.

### **6.11 What if the project asset is destroyed due to an insurable event?**

The consortium must reinstate the project facility and any insurance proceeds must be used for this purpose. However, there will be inevitable tension that arises between the external financiers and the Government in determining the extent of application of insurance proceeds for repair or reinstatement purposes.

In traditional projects, if a project is damaged, the consortium and its financiers will determine the commercial viability of reinstating the project. There is usually no compulsion on them to reinstate if they elect not to do so. However, in the case of a PPP project, the position will generally be different if an insured event occurs and the project assets require replacement or reinstatement. The Government will normally have insisted that insurance cover be taken out to permit full reinstatement in the event of damage. Furthermore, the Government may wish to oblige the consortium to negotiate insurance to reflect the fact that the Government's requirements may change after an insurance event occurs and it is possible that there will be a requirement for something other than full or exact reinstatement.

In most PPP projects, the Government will have a genuine interest to ensure that any insurance proceeds received by the consortium under the physical damage policies are applied in reinstatement of the project. The Government will also want to ensure that, upon termination of the project contracts (either by effluxion of time or early termination), it receives the benefit of any insurance proceeds so that it can continue with the reinstatement of the project.

The Government should therefore typically insist that the consortium will always be obliged to reinstate the project assets and the contracted service if an insurance event occurs.

In some PPP projects, financiers may want to impose an economic viability test to determine whether reinstatement will enable them to recover their outstanding debt in full. If this economic viability test demonstrates that this is not possible, the financiers may prefer to appropriate the insurance proceeds as secured creditors under their first ranking securities, instead of allowing reinstatement.

However, Government should accept this only in limited circumstances. The Government should argue that financiers should focus instead on ensuring that the amount insured under the advance loss of profits and business interruption insurances is sufficiently high or there is a sufficient equity buffer or other provision for contingencies in the consortium to address the financiers' concerns.

The Government should also normally argue that an economic viability test should not be necessary where there is a low risk of total destruction of the project assets (such as a large linear road or rail project, or a project comprising a large number of geographically diverse sites).

Where the risk exists (for example, in the case of a single site project), the Government may be prepared to accept an economic viability test, but only on the basis that the external financiers cannot abscond with the insurance proceeds and abandon the project if the economic viability test demonstrates that debt service is still achievable. Even then, the Government should often still insist that the consortium remain under an obligation to reinstate. If it is not financially able to do so, the consortium would be in breach of the contract and the Government could terminate for default in the usual way. The Government could then procure the rebuilding of the project assets through a new competitive tender with other interested private sector parties.

### **6.12 What is an ‘Owner Controlled Insurance Programme (OCIP)’?**

This is where the consortium takes out a single insurance contract covering all of the risks that need to be insured for one or more major construction projects. The adoption of an OCIP is advantageous to major construction projects that are being implemented in about the same time span, as different contracts relating to the projects can be insured under tailor-made insurance packages resulting in economies of scale. Apart from that, the insurance coverage can be tailor-made to suit individual project needs and avoid overlaps, gaps or conflicts between the terms of individual insurance policies.

To implement an OCIP, the owner and contractor may need to engage a consultant insurance broker to formulate strategy; design the insurance proposal; incorporate its requirements into the relevant construction contract documents; and advise on the selection of insurer and the placement of insurance. During the construction phase of the projects, the consultant broker will advise on all insurance matters.

OCIPs have been used successfully in the Airport Core Programme projects, the former Kowloon-Canton Railway Corporation’s and Mass Transit Railway Corporation Limited’s major railway projects, and for Highways Department’s major projects including Route 9, Route 10 and the Deep Bay Link.

An insurance broker may be engaged to advise the Government on the placement of necessary insurances for the projects to suit the programme of tendering. If the client department wants the private sector to follow this practice, it should be encouraged to engage an insurance broker at an early stage in the procurement process.

### **6.13 What risks cannot be transferred?**

Government cannot transfer to the private sector its fundamental responsibility and accountability to the public for the delivery of services that it is legally obliged to deliver or which it has undertaken to provide to the community. The public and politicians will always hold Government responsible for public services irrespective of the mode of delivery. A PPP can both mitigate the likelihood of risk events occurring and provide some sharing of the consequences. Nonetheless, if high risk, high visibility services are being considered for delivery using the PPP approach, particular attention must be given to:

- ◆ Maximising transparency so as to maintain public confidence, e.g. evidence of risk assessment, control and mitigation
- ◆ Risk management plans
- ◆ Contingency plans
- ◆ A shared government/consortium approach to testing, monitoring etc
- ◆ Provision for periodic re-assessment of risks

- ◆ Incorporation in the project documentation some means of ensuring the price for the services that the Government has agreed to pay in future years will not be in excess of future market prices for such services. Benchmarking or market testing may be required for this purpose
- ◆ Opportunities for public participation in the monitoring/review processes
- ◆ Effective, on-going contract management.

Some risks may not be transferable because they will make the project too commercially unattractive and financiers will be unwilling to fund the project. For example, there must be sufficient likelihood that the demand for the service (from the public or the client department) will generate sufficient income to meet the cost of provision of the service and provide a return on capital. The transfer of demand risk to the consortium may be unachievable where there is high uncertainty about the level of demand, constraints on the consortium in generating demand, or the client department is able to limit demand.

#### **6.14 How do we deal with the heightened risk from terrorism?**

There is a hardening of the international insurance markets as a consequence of the emergence of terrorist groups and the threat that they pose to infrastructure assets which are perceived to be “soft targets”. To achieve affordable insurance, there is a need to consider building design and other mechanisms which will enhance physical security of the assets in question and the possible need to deploy security personnel to undertake surveillance of the assets to mitigate terrorism risks.

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# 7 FUNDING AND PAYMENT

## 7.1 Is the private sector interested in financing PPPs?

Many PPP projects will generate strong and predictable cash flows over lengthy periods of time. This is attractive to both debt finance and equity funds seeking long term secure investments.

Even if PPP projects are unsuccessful, debt financiers and equity investors will usually be compensated for the value-added they brought to the project. It is therefore essential to keep in mind that as PPPs are often very profitable financially and a “win-win” situation for the private sector, the Government needs to keep its feet on the ground to safeguard public revenue and expenditure and ensure the wider public interest also benefits.

## 7.2 How will a PPP be paid for?

There are a number of different payment options, or combinations of options, depending on the nature of the specific project. The Government will normally propose the payment mechanism, although it is common to give bidders an opportunity to comment on the mechanism; and there should be a facility for bidders to do so in the RFP documents.

The payment stream is critical to achieving value for money from a PPP. Whilst ensuring that the consortium is only rewarded for quality service, standards must be realistically achievable. The risks associated with the flow of payments must not be so great as to prevent the consortium realising sufficient funds from financiers and investors. Higher risks will require higher rewards and so increase the cost of funding.

Payment will normally consist of a single amount, a ‘unitary charge’, e.g. monthly or annual comprising one or more of the following components:

- ◆ Amortised capital costs. The client department does not pay anything to the consortium until the construction works are certified as being completed and the service delivery commenced; at this time regular payments will start that include the amortised capital cost; payments will continue for as long as the facility/service is available, until the capital costs have been paid off. This will usually coincide with the end of the contract
- ◆ Service delivery. The contract will specify that the consortium delivers a range of services, and these will be measured by an agreed set of criteria e.g. opening hours, standards of cleanliness, lighting levels, customer service standards, and employment of appropriately qualified staff
- ◆ Headcount/shadow toll/throughput. The monthly payment could reflect the number of users of the facility, e.g. the number of swimmers using a swimming pool, or the vehicles using a bridge/tunnel
- ◆ Revenues received from users. The consortium could be paid a percentage or multiple of fees received from users. A multiple could apply where the Government intends to subsidise the service in excess of half the cost

- ◆ Retention of other revenues. The consortium may, in some circumstances identify other commercial opportunities within the site. Granting of commercial rights to perform other ancillary fee-generating services in the facility and retain the revenue so generated may be considered. However, this must not be the major incentive for the consortium to provide the facility/core service and must not undermine the normal competitive bidding procedures. Alternatively, the client department might demand a revenue/profit turnover sharing arrangement, or might require a lump sum premium.

The client department will be entitled to abate, defer, or withhold specified amounts of the payment if the consortium fails to perform as required, e.g. the roof leaks, or specified services are not performed as required. These must reflect genuine estimates of value of the services lost or the costs/damages incurred by the client department in rectifying the deficiency. This gives the consortium a powerful incentive to design and construct the facility to a high standard, to undertake repairs/maintenance quickly if problems arise, and to ensure that specified services are delivered. The abatement, deferral, or withdrawal of payments should be proportionate to the performance failure. In some cases, client departments may wish to provide for increased payments, or bonuses, for exceeding certain targets.

Different payment bases place differing degrees of risk upon the consortium. These different levels of revenue risk will be reflected in the bid prices received or, indeed, ultimately whether any bids are submitted. Allowing bidders to propose alternative payment bases to meet their various financing and investment criteria can result in significant value for the client department. If an alternative payment method is allowed, the RFP must set out clearly how different payment methods are to be compared and ranked to avoid complaint from losing bidders.

Where payments are due from Government to the contractor, or vice versa, based on turnover, throughput, or net return, such figures should be subject to audit/certification by an independent party, agreed upon in accordance with the contract.

### **7.3 What is “availability”?**

It is important to emphasise that the essential ingredient of most PPP transactions is the procurement of a service. It follows, therefore, that unavailability of the service should result in a reduced payment by the government or, in certain circumstances, no payment at all. In order to raise project finance, the amounts payable under the PPP project documentation must be predictable. A key issue for PPP projects will therefore be what constitutes “availability”.

Projects which are predicated upon availability based payments must therefore incorporate in the project documentation what is meant by “available”. The definition of availability will be more straightforward in some sectors than in others. From the consortium’s and its financier’s perspectives, this will give rise to a number of concerns which, if not addressed sensibly, may affect the bankability of the project. Departments should seek expert advice.

### **7.4 Will the Government be committed to long-term recurrent expenditure?**

Most government assets and infrastructure projects effectively commit the Government to a ‘lifetime’ of expenditure. In approaching new traditional projects, departments tend to focus on the cost of construction with less regard to lifetime expenditure implications. An important benefit of the PPP approach is that it forces client departments to adopt a strategic approach to procurement. Being long-term, PPP contracts encourage departments to carefully consider their future plans and the capital and recurrent funding requirements before making contractual commitments.

Certain elements of operational services may not be procured for the full contract term, e.g. mid-life costs associated with the replacement of key assets may be evaluated differently depending on the depreciation methods used and the timing; locking in insurance costs, for example, for lengthy periods is often problematical.

### **7.5 Can consortia keep revenue received from the use of the facility/service?**

No, except with the necessary legislative backing.

The Public Finance Ordinance (Cap 2) provides that any money raised or received for the Government shall form part of the General Revenue, unless provided for under other legislation. There should be no hypothecation of government revenue (i.e. revenues cannot be earmarked to offset particular expenditures) and no ‘netting off’ payments against revenues unless specifically provided for in legislation. The question of hypothecation can be avoided if the payment to the consortium is funded from the expenditure heads of client departments/bureaux, rather than from the revenue received from the use of the facility/service.

Monies received by consortia in their capacity as a principal, i.e. not as an agent for the Government, are not ‘public monies’ and are therefore not covered by Cap 2. The client department should seek legal advice as to whether the particular circumstances of a PPP lead to the collection of public monies by the consortia. The merits of individual cases would dictate whether it would be desirable to legislate for hypothecation or netting off.

### **7.6 Are there any standard mechanisms for revenue or profit sharing?**

Revenue and profit sharing arrangements have been used in Hong Kong, e.g. Housing Authority retail premises. Precedents are available from the Commercial Unit of DoJ. Both the UK and Australia have developed profit sharing mechanisms over time, particularly with respect to refinancing gains and the on-sale of assets acquired under a PPP.

Departments should seek guidance from their financial advisors on how to determine any re-financing gain before they embark on PPP projects. This should be reflected in the contractual documentation which should contain a detailed clause setting out the principles and mechanics by which a future gain will be measured and shared. Where there is a profit-sharing mechanism, there should be an “open book” provision in the contract, i.e. the consortium should allow Government to examine all its books and accounts in relation to the PPP project.

Departments should not seek to place unnecessarily restrictive controls on ordinary business practice, particularly in the lending market. The definition of “re-financing” should be broadly drawn to capture a broad range of transactions that could possibly result in a re-financing gain.

### **7.7 Is there any guidance on when departments should use public or private finance for a PPP project?**

Departments should always consider both options. There is growing evidence that the use of private finance generates high levels of scrutiny of a project, resulting in more certain and improved outcomes.

During the PPP feasibility/business case study, departments should explore whether the private sector is likely to be interested in financing a project incorporating the intended required facilities/services. If it appears from the business case study that there will be sufficient interest to generate

reasonable competition in the provision of project finance, that this would involve sufficient risk transfer to the private sector and a competitive deal may be obtained by the Government, the department should recommend to its bureaux/FSTB that this approach should be adopted.

If there is little interest from the private sector the department should first consider whether there are any flaws in its proposal. If the department remains satisfied that its proposal is sound and justified it should recommend to its bureaux that the project should be publicly financed and seek the necessary resources through the RAE as appropriate.

## **7.8 Where do the Government funds come from in the case of a PPP project?**

For both a PPP and the conventional approach, the capital cost of a public works project is met from the CWRF, and the recurrent costs are met either by the centre through the client department's head of expenditure or absorbed by the client department itself, the policy bureau or the lead bureau.

The client department, via its policy bureau or lead bureau, will need to secure the capital and recurrent funding via the RAE process. This will normally take place after the initial PSC (see Chapter 5) has been constructed, and before any public consultation or EoI takes place. The capital funding requirement needs to be secured from the CWRF. The relevant bureaux will need to confirm whether any other costs required for the operational phase of the project can be absorbed by the bureau or needs topping up from the centre.

The capital funding drawn from the CWRF may be paid out in regular instalments over the life of the contract (as part of the unitary charge) instead of one or more lump sums at the construction phase. It will be necessary to ensure that the capital element of payments is clearly identified so that only the construction related element is paid out of the CWRF. The CWRF must not be used to fund expenditure of a recurrent nature.

For those PPP projects that create long-term financial commitments for the Government, the proposing bureaux would need to secure approval from the PWSC and the FC for the capital funding and the recurrent funding required should be sought through the relevant RAE process. In seeking financial approvals care must be taken not to give LegCo a false impression that their future oversight of government expenditure is being circumvented. LegCo will continue to have a legitimate interest in the expenditure of public funds, and delivery of public services throughout the life of the contract.

If, as in the case of DBO, construction cost is paid upon successful commissioning of the facility, to be followed by a service charge to be paid at regular intervals, care should be taken to ensure an appropriate allocation by the consortium of the costs and charges between the capital and recurrent cost elements to avoid any back or front loading.

## **7.9 When will Public Works Subcommittee (PWSC) and Finance Committee (FC) approval be sought?**

Notwithstanding the requirements under SPR for the procuring departments to secure FC's funding approval before inviting bids for works contracts, in the interests of time and in an effort to secure the best estimates before approaching the FC, departments have increasingly been making use of the flexibility to invite proposals prior to funding being secured. There are pros and cons to both approaches. Potential bidders want assurances that the Government is committed to a PPP project before embarking on an expensive and time-consuming bidding and negotiation process. Equally, however, the FC will wish to know exactly what it is approving before agreeing to pay the bill,

remembering that different bidders could put in considerably different ideas for both required and additional services, and that negotiations with the preferred bidder could result in more changes to the details of the project. Departments should be aware of the adverse reputational issues which will confront the Government if funding is subsequently disallowed. Significant costs will normally have been incurred by the private sector bidding consortia after detailed development proposals have been sought. There is also the risk that the courts may order restitution in favour of the bidding consortia in respect of their costs and expenses incurred up to the time of discontinuance of the proposed project, if it was not made clear to the bidding consortia at the outset that finance approval had not been obtained in respect of the proposed project, and all bidding costs were to be incurred at the sole risk of the bidding consortia. Client departments and proposing bureaux will have to take a view on a case-by-case basis as to the appropriate time to seek approvals from PWSC/FC.

Whichever approach is taken, departments are advised to consult the relevant LegCo Panels, as well as other stakeholders, before seeking approval from PWSC/FC.

### **7.10 How will the consortium finance the project?**

Much will depend on the details of the project, but bidders are likely to be consortia. Whilst some equity investment in the project is likely to come from some of the major contractors in the consortia (typically 10%-30%), much of the financing is likely to be in the form of debt (typically 70%-90%), invested by third party financiers. To satisfy both their own shareholders and third party financiers, the consortium will need to demonstrate the contract's 'bankability' (i.e. the contract must be capable and likely to both repay the capital investment and provide an acceptable return over the life of the contract). Client departments should be prepared for the bidders to be aggressive in negotiating stringent commercial terms to protect their interests for both successful and unsuccessful outcomes of the PPP.

### **7.11 Are private sector borrowing costs higher than government's?**

On the face of it, government can borrow more cheaply than the private sector. Government's ability to borrow more cheaply is a function of its capacity to levy taxes to repay borrowings. Credit markets perceive this power as reducing the risk of their investment and therefore will lend to governments at lower rates. However, when it comes to raising finance for a project, it is both the country risk and the risk of the individual project that determines the real cost of finance. Private sector capital markets explicitly price in the risks of a project into its sources of finance. This is not the case in the public sector, where the risks of cost overruns, time delays or performance failures are not priced into the government borrowing rate.

### **7.12 How can PPPs be cost-effective when private sector borrowing costs are higher than government's?**

Most governments are able to borrow funds in the market at cheaper rates than the private sector. In Hong Kong's case, there are adequate funds earmarked for Government's capital works projects. It seems curious, therefore, that projects involving the provision of public services financed by the private sector can be cost effective. There are two factors that enable them to be so:

First, the inherent risk of a project is fundamentally the same irrespective of the source of funding, public or private. In the public sector, the risk of cost overruns, time delays or performance failures are not priced into the government borrowing rate. Private sector capital markets explicitly price the risk of a project into the sources of finance. The value of the transfers of risk to the private sector can offset the higher cost of borrowing.

Second, the cost difference between private and public sector borrowing is relatively small, and the cost of capital accounts on average for only 20%-25% of the full costs of a PPP project. PPPs will represent good value for money to the taxpayer if the efficiencies, productivity, and superior risk management that the private sector can achieve over the life of the project more than compensate for any higher cost of borrowing. These efficiencies may result from:

- ◆ Better management of risks
- ◆ Planning for and management of whole of life costs
- ◆ Innovative design and service provision
- ◆ Maximising asset utilisation.

### **7.13 What is the benefit of using third-party private funding?**

Projects using third-party funding, in addition to any equity injected by the consortium members, are usually subject to more intense scrutiny by the third-party financiers, which often result in the identification and resolution of potential problems prior to the letting of the contract. Third-party financiers will undertake vigorous due diligence, supported by legal, technical and insurance specialists, as they will be adopting much of the project risk. Lenders will wish to have rights to step-in and enforce security and if necessary transfer the rights under the concession to a third party if the original consortium defaults on its obligations. No-one other than the Government (e.g. a private partner creditor) can take control of the assets.

### **7.14 Should the Government use the PPP framework to pilot new financial and partnership structures?**

Since the introduction of the PPP model, the finance structures used for such projects have continued to evolve and become more sophisticated. New sources of capital have emerged e.g. private funds have been established to provide subordinated debt or additional equity. The emergence of various infrastructure investment funds has made it easier to finance viable infrastructure projects. These listed and unlisted funds have attracted investment from pension funds, large insurance companies and large international investors. The development of a secondary market in equity stakes in infrastructure projects offers institutional investors an appealing prospect; the possibility of strategic alliances between infrastructure investment and pension funds, both of which depend on stable, long-term revenue streams.

However, one feature of this development of a secondary equity market has been increased liquidity and transfer of equity soon after construction completion. In structuring long term contractual arrangements, the Government should therefore not assume that it will be dealing with the same equity investors beyond the medium term. The possible ramifications of such an outcome need to be considered for each project.

Nonetheless, it is senior debt provided by the lenders that has fuelled the PPP market overseas and contributes a substantially higher proportion of the project cost.

### **7.15 Can we finance a project by granting the successful bidder land development rights?**

If the required facilities on the site do not take up the permissible developable area and the land development rights beyond the required services cannot be tendered out separately, it may be appropriate to grant the successful bidder the right to develop compatible and agreed facilities, for

example if it produces additional facilities/services for the benefit of the community. It can also generate revenue for the successful bidder, which can help reduce the cost to the public of the required facilities.

Nonetheless, it is important that there is a direct link, throughout the life of the contract, between the performance of the private partner in respect of the required services and the revenue it receives. The latter can be payments by Government, by end-users, or a combination of both. In other words, a project should not normally be financed entirely or largely by land development rights that could be disposed of, leaving the Government without effective sanctions against poor or non-performance.

Paying for public amenities by giving land and/or development rights at less than full market value is not entirely in keeping with the spirit of the Public Finance Ordinance (Cap 2). If an amenity is desired, but is not a viable commercial proposition on a standalone basis, the amount of any shortfall should be prioritised and funded through the discipline of the annual RAE, rather than being indirectly subsidised by discounted land grants.

Land premium waiver or development rights should not be used as the major incentive for the contractor to provide a facility/service. Otherwise, the well established tender procedures/policy will be in jeopardy and the project may be criticised for bypassing the proper procedure.

Another cautionary factor is that investment in the Hong Kong property market is essentially of local interest. By financing a PPP project in this way will tend to exclude other sources of finance with consequent impacts on competition and rates of finance.

### **7.16 Can a PPP bid cost a department more, but still provide good value for money for Government?**

This is possible. For example, a department may examine whether to use a PPP approach to provide vehicular fleet services. The private sector bidder will have to include in its submission the cost of many factors that are not included in the department's budget. These include accommodation, parking spaces, vehicle first registration tax, vehicle licencing, driver licencing, fuel duty and profits tax. These and other items should be included in the 'Competitive Neutrality' calculation of the PSC (see Chapter 4).

Departments should discuss such instances and the implications on the operating expenditure allocations with the relevant resource division in FSTB after seeking endorsement from the respective policy bureau.

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# 8 MANAGING PERFORMANCE

## 8.1 Can the client department be sure that it will get value for money?

PPPs are not suitable for every project. However, projects of many types in other countries have been judged by third-party auditors to have offered better value for money than they would have done under a conventionally funded approach.

The keys to realising this potential value for money gain are:

- ◆ Ensuring that the client department and bidders have a common, comprehensive and clear understanding of the requirements and constraints of the project
- ◆ Defining output/outcome requirements in a way that gives bidders the opportunity to innovate
- ◆ Allocating project risks optimally
- ◆ Running the bid process robustly, transparently, fairly and competitively
- ◆ Providing good contract documentation
- ◆ Appropriate reporting, liaison and supervision of the contract throughout its life
- ◆ Incorporating performance measures targeted at evaluating performance throughout the contract period.

Best results are seen when contracts are managed in partnership rather than through an adversarial client-contractor approach. Nonetheless, the department must ensure that from the outset it prepares for the worst and makes plans for dispute resolution, including litigation. Among other things, this means ensuring the contract includes clear definitions of risk allocations, roles and responsibilities.

Enhanced value for money can sometimes be achieved by including within the contract escalation clauses, linked either to general price indexes or to specific indexes/benchmarks for specific areas of cost. This removes the risk of inflation from the bidder and therefore avoids the likelihood that a bidder will include pessimistic inflation forecasts into the bid price. Similarly, cost/profit-sharing clauses can allow the public sector to benefit from better than anticipated outcomes and avoid unacceptable levels of windfall gains accruing to the consortium.

## 8.2 Why is contract management important in a PPP context?

If implemented properly, effective contract management will identify, monitor and manage all risks over the life of the contract to assist in achieving project objectives. This will include:

- ◆ Identifying actual and potential risks and quantifying their likely impacts so that those risks can be managed over the life of the contract
- ◆ Developing management strategies to assume, control, mitigate or eliminate such risks.

While significant attention is given to the tender procurement, evaluation and contract negotiation phases, rather less consideration is often given to contract management issues during the service delivery phase. While performance can be driven through appropriately structured performance incentives or abatement regimes, sound contract management arrangements are required to ensure performance standards meet, and preferably exceed, expectations throughout the contract life.

It is essential that the Contract Manager has a clear understanding of the requirements of the contract and the rationale for those contractual requirements. Departments should ensure that once the PPP contract is signed, the project team does not break up; otherwise a full understanding of the contractual requirements and their underlying justifications may be lost during the remainder of the contract term.

Effective contract management supplements the allocation of project risk in project documentation. Failure to develop and implement an effective contract management strategy for the project is, in itself, a project risk that must be managed.

One useful document is “a guide to contract management for PFI and PPP projects” (2007) produced by 4ps, the UK local government’s project delivery specialist. The 4ps website is [www.4ps.gov.uk](http://www.4ps.gov.uk).

### **8.3 What is the role of the Contract Manager?**

The Contract Manager will, ideally, be involved in the early stages of developing the project proposal. He will:

- ◆ Oversee the design and construction phases
- ◆ Monitor the project once it becomes operational
- ◆ Establish and manage the day to day relationship with the consortium
- ◆ Keep abreast of developments in the field covered by the project and consider the need for change
- ◆ Manage the agreement of any changes during the life of the contract
- ◆ Monitor the achievement of key performance indicators
- ◆ Recommend and calculate payments/abatements
- ◆ Report regularly to the PSCoM
- ◆ Advise the PSCoM of any serious performance failures and the need for dispute resolution measures to be initiated.

Over the life of a project the individuals holding key posts will inevitably change. It is vital therefore that comprehensive records are maintained of all interactions and, wherever possible, new post holders are fully briefed by the departing incumbent. Particular care must be taken if there is a handover of responsibilities at the time of commissioning the project facilities.

The Contract Manager will usually need a support team. The make-up of the support team will vary at different times, and may include both civil servants and contract staff. They may not need to work full-time on a particular project.

### **8.4 What challenges do departments face in contract management?**

One of the major challenges is that using the PPP approach imposes many more demands on client departments that are not works departments. In the traditional procurement of a building or a facility, a works department takes responsibility for conducting or overseeing the design and

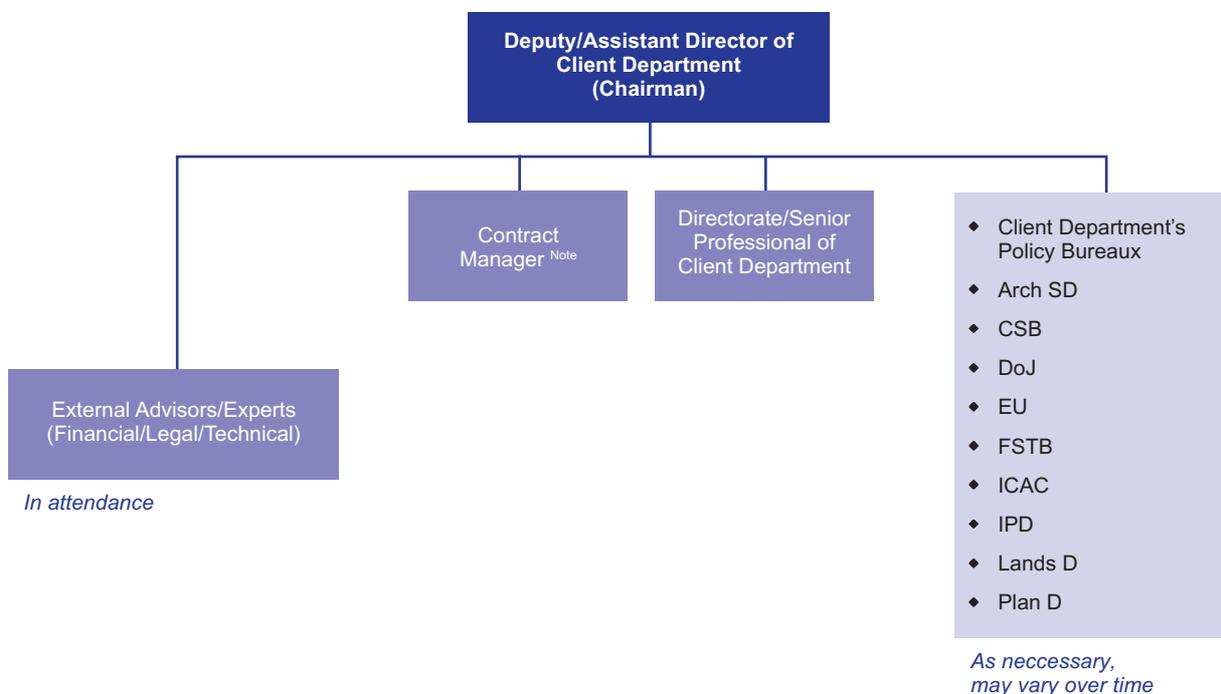
construction before handing it over to the client department upon commissioning. As a result most client departments do not possess the necessary contract management skills.

It is unreasonable to expect non-work departments staff to develop rapidly the necessary contract/project management skills to manage large, complex, high value projects. It is more sensible, practical and cost-effective to employ someone who already has those skills. This will often involve engaging non-civil servants.

### 8.5 What is the relationship between the PSCom and the Contract Manager?

The relationship between the Contract Manager, the PSCom and the consortium is shown in Figure 7.

**Figure 7: Structure of the Project Steering Committee**



Note: The Contract Manager, supported by a team of in-house/contract staff of the client department, will act as a single point of contact with the consortium in the daily operation.

### 8.6 What if the facility/service is not commissioned/commenced on time?

The consortium will face a delay in the start of its payments from the client department. In practice, this will exert strong pressure – typically stronger than under conventional contracts – for on-time completion. PPP projects that are predicated upon availability-based payments must carefully define in the project documentation what is meant by ‘available’ for this purpose.

A measure that has been adopted in some jurisdictions is to decrease the length of the operating concession and thus the amount of any availability payments in line with the length of the delay in commissioning. This has the effect of incentivising further on-time completion whilst at the same time automatically compensating the public sector for the loss of availability of the relevant service.

Where a land lease is involved, a bring-into-operation covenant will normally be included thereby imposing a positive obligation on the grantee such that the specified core facilities will be brought into operation by a specified date and on a scale and in a manner to the satisfaction of the client department.

### **8.7 Should early commissioning be allowed/encouraged?**

PPPs generally act as an incentive to complete a facility earlier than scheduled. Care should be taken that this does not cause problems for the client department if it is not able to start making early payments, or if there is no demand for early delivery of the facility's services. If early completion is not wanted, this should be clearly stated. The contract should also make clear whether early commissioning will bring forward the end date of the contract by the same period of time.

### **8.8 How can a client department ensure long-term successful performance?**

Long-term successful performance depends upon:

- ◆ Getting the contract right in the first place. Departments should properly define performance requirements, they should avoid ambiguity but not flexibility, and not seek to impose unrealistic standards
- ◆ Putting in place procedures to manage change. Service needs will inevitably change over a 10-30 year life span and the contract should contain a clear, unambiguous basis for agreeing and paying for such changes (normally such changes will not be a radical departure from the contract). If a radical departure is required consideration should be given to cancelling the existing contract with appropriate compensation and seeking new tenders for the remainder of the contract term. In the UK, the National Audit Office said that too often officials had failed to ensure value for money in dealing with changes to PFI projects and that the public sector "has allowed itself to be taken for a ride" by managers with "insufficient commercial knowledge". The HM Treasury has issued guidance to ensure that value for money is obtained in PFI projects, which can be found at [www.hm-treasury.gov.uk](http://www.hm-treasury.gov.uk)
- ◆ Departments, whilst making sure that service requirements are met, should seek to avoid an adversarial approach. They should stress the sharing of risks and rewards and establish clear lines of communication between themselves and the contractor.

### **8.9 How can the client department monitor operational performance?**

The service provisions will be based largely on output/outcome-based performance specifications contained in a SLA. Whilst client departments should avoid setting up costly and elaborate supervision of contractors, they should ensure that each project has a suitably skilled and experienced Contract Manager, with the necessary support. To facilitate the Contract Manager's work, the contract should require the production and monitoring of suitable performance indicators by the consortium, which should be provided on a regular basis to the client department and be the subject of occasional spot checks, independent review and/or audit. To this end, the contract provisions should permit the department to:

- ◆ Require regular management committee meetings between the consortium and the Contract Manager
- ◆ Have physical access to the facility at all reasonable times

- ◆ Have access to the accounts and other records of the project
- ◆ Require user-satisfaction surveys to be conducted
- ◆ Require the publication of regular reports on contractual performance
- ◆ Appoint auditors and other agents for the purpose of independent reviews or audit.

In some cases, the consortium may require licenses to operate the service. Consideration of licence applications, and their renewal/revocation may provide further opportunities to monitor operational performance.

### **8.10 Which member of the consortium should the client department approach?**

The consortium should be required to nominate one single point of contact for all dealings with the Contract Manager of the client department. This individual should have sufficient seniority and authority to make decisions and have access to, and influence over, consortium members.

### **8.11 Can the client department protect itself from serious or persistent performance failures?**

The client department, through the Contract Manager, should maintain close and regular contact with the consortium throughout the life of the contract. Potential problems should be identified early and acted upon. If problems appear to be serious and/or persistent, and if the consortium's single point of contact cannot deal with them, the issue should be elevated to a more senior level(s). If problems persist, the matter may need to be brought to the attention of the consortium's financiers.

In the majority of cases, the Government will wish to include a liquidated damages clause in the contract. Liquidated damages must be a genuine pre-estimate of the innocent party's losses. Where appropriate, the client department will be entitled to make deductions from the payments to the consortium in the event of poor performance or non-availability of the facilities. This should act as a strong incentive on the consortium to deal quickly with any shortfall in performance. Overly strict abatement regimes should however be avoided as they will make the cost of financing prohibitive and may result in a failure to let a contract.

With BOT, BOOT, etc., contracts government has in the past resisted giving charges or security over public assets such as tunnels and roads. It is normal for government to take performance bonds, parent company guarantees, liquidated damages, as well as wide restrictions on alienation and change of investor so as to drive performance.

The Government's final recourse will be the exercise of step-in rights and/or the termination of the contract. These rights would be exercised in the event of prolonged, persistent or very serious performance failures – though the consortium's financiers will normally first be given an opportunity to step in and rectify the problems. If appropriate, financiers may appoint (with the client department's consent) a substitute consortium.

When serious problems arise the client department should take the following steps:

- ◆ Request information for clarification
- ◆ Institute an investigation
- ◆ Require specific remedial measures

- ◆ Require changes in the consortium's procedures and practices
- ◆ Require changes in the consortium's management personnel or contractor(s)
- ◆ Formally warn the consortium of unsatisfactory performance
- ◆ Issue a final, public warning
- ◆ If the situation remains uncorrected, recommend step-in or termination of the contract.

Client departments should seek legal advice before acting. It is important that the Government reserves, and does not waive, its legal rights in such circumstances. There may also be confidentiality obligations under the project documents which must be observed.

### **8.12 Are there established guidelines for dispute resolution?**

The experience of other jurisdictions confirms that, as with conventional procurement contracts, there may be disputes between the client department and the consortium. Dispute resolution in PPPs takes many forms and should reflect the specific requirements of the project and the nature of the parties' relationships. The modern approach is to move to "no blame" structures with more sharing of risk. In practice, many PPPs provide for 'staged' or escalating dispute resolution procedures, e.g. starting with conciliation, which provides flexibility to the parties and respects the need to maintain their commercial relationship in the face of their dispute. Most disputes are unlikely to lead to the cancellation of the contract, but will be smaller disputes that require resolution. Appropriate models need to be considered and chosen for each type of dispute. This is particularly so in respect of technical and financial issues which need some form of resolution, e.g. expert determination that is speedy and not too confrontational.

The dispute resolution approaches to consider include:

- ◆ Benchmarking
- ◆ Conciliation/negotiation
- ◆ Expert determination
- ◆ Mediation
- ◆ Adjudication
- ◆ Arbitration
- ◆ Litigation.

Departments should choose the method(s) they want to use to resolve potential disputes, and ensure the contract is drafted to cater for such dispute resolution methods.

### **8.13 What happens if a consortium collapses?**

The consortium will typically transfer all major consortium risks to its contractors - construction, operating, maintenance and so on. This means that the consortium is unlikely to collapse just because one of its contractors comes under commercial pressure. Its financiers will in any case closely monitor its performance (operational as well as financial). If they consider one or more of the consortium members, or a contractor, is in a vulnerable state they are likely to step in and - subject to the client department's consent - replace the under performer with an alternative party better able to perform. Although this drastic step is likely to affect the delivery of services, this should only be for a limited period.

To protect against the collapse of the consortium company itself, PPP projects should be structured so that any assets would revert to the Government and the client department be able to engage an alternative service provider.

#### **8.14 What happens if one of the consortium's main contractors collapses?**

The consortium will still have the responsibility to deliver the services specified if one of its contractors collapses. It will be obliged to replace the contractor, and to absorb any additional costs that may arise. If the consortium fails to do so, it risks contract termination, with the reversion of the assets to the Government.

Before signing the PPP contract, the client department will have sought to satisfy itself - by conducting due diligence checks - about the strength and reliability of the consortium's contractors; and the financiers will insist on doing so too. Any subsequent change in a main contractor will require the client department's approval.

#### **8.15 If there is performance failure can the Government terminate the contract and/or sue for damages?**

A serious failure to perform may first lead to the exercise of step-in rights, agreed between the client department and the consortium's financiers, for the financier to rectify the problems and/or to replace all or part of the consortium. In the absence of satisfactory rectification of the situation, the Government may terminate the contract and have the consortium moved off the site. In some jurisdictions, termination compensation is not payable (especially in the road and rail sectors where the prospect of default following construction is more remote) in the event of termination due to default of the consortium. The consortium's financiers' acceptance of such an arrangement will usually require a strongly protective direct/tripartite agreement between the financiers and the Government (incorporating a generous cure regime) and a high degree of confidence on their part as to the ability of the consortium to complete the project and perform its service obligations.

However, various governments have been more sympathetic in other sectors to the application of a termination compensation regime in the case of contract default, especially where the project assets are to be transferred to the government on termination. Where the project assets are to be transferred to the government and it is considered appropriate to pay compensation, the preferred formula for compensation which appears to be emerging is:

- ◆ Where termination occurs during the construction phase, an amount sufficient to repay the consortium the amounts it has invested on completed works, adjusted for any increase in the costs to government to complete the facility, government's break costs and any liquidated or other damages payable to the government
- ◆ Where termination occurs during the operations phase, the fair market value of the asset less the government's break costs and any compensation or other amounts payable to the government (which may include additional service costs, rectification and re-tendering costs and any damages incurred as a result of the breach).

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# 9 CHANGES OF CIRCUMSTANCE

## 9.1 During the contract, can the client department change the size of facilities; the level or nature of services; or the technical standards?

Client departments should, as far as possible, structure their contracts in terms of capacity and technical standards on the basis of foreseeable, stable expectations. Ideally, changes should be avoided after finalisation of the contract. However, in the case of lengthy contracts changes in services involving both construction and operational changes are almost inevitable. The contract needs to address these issues. Measures could include:

- ◆ Formulae to take account of deflation/inflation and other price-related variables ensuring the service charges the Government has agreed to pay in future years will not be in excess of future market prices for such services
- ◆ Break clauses after a period of time
- ◆ Renegotiation clauses
- ◆ Periodic review mechanisms
- ◆ Referrals to mediation, arbitration, etc.

In particular, the contract should show whether the department or the consortium assumes the risk of certain classes of change. For example, general changes in economic conditions, costs of labour and materials, as well as taxation and changes in general law may be met by the consortium; whereas discriminatory specific legislation affecting the project may be met by the department. However, consideration should be given to managing situations where such changes fall outside of normal bounds such that the consortium does not suffer unsustainable losses or enjoys unconscionable profits.

Due to the uncertainties of inflation rates and the quantum of operating costs over a long term contract, the department will need to consider carefully the manner by which service charges are to be varied in certain specified circumstances. It would be unusual for prices to be fixed for the lengthy periods for which PPP projects are typically let. The Government should therefore only permit appropriate indexation mechanisms to be incorporated when service charges are to be reviewed. For example, choosing an index that may be short lived, or is not independently produced, is not a sensible approach. Nor is it prudent to have too narrow a focus on a particular industry or sector. There will, of course, be many other issues to consider in this context, including the circumstances where the particular index specified in the contract is no longer published or the basis upon which it is calculated is changed.

The Government should ensure that the price it has agreed to pay in future years will not be in excess of future market prices for comparable services. Some form of benchmarking or market testing may be required for this purpose. Benchmarking would typically involve the consortium comparing either its own costs or the costs of its contractor(s) against the market cost of such services. Market testing, on the other hand, might require the consortium to re-tender in the market any relevant contractor's services to test the value for money of those services.

Agreement between the department and the consortium may be required on:

- ◆ The amended method of services delivery
- ◆ The adjusted price for the services
- ◆ Whether there are capital payment implications
- ◆ Changes to the performance measurement system.

The contract should contain clear terms and conditions governing the criteria for pricing a variation in the contract; any grounds on which the consortium may refuse to implement a variation; and any remedies available to the client department in the event of such a refusal.

## **9.2 Can the client department ensure that it benefits from technical upgrades?**

The department will specify the outputs that it requires from technical equipment/facilities, and the performance standards to be met, on the basis of known technologies and established standards. These standards will be set for a period for which the department is confident that they will remain valid - for example 10 years. Successive generations of equipment are likely to be developed which produce these outputs and meet these standards more efficiently and at a lower cost. Where the consortium believes that replacing equipment will lead to lower whole life costs, it will do so. It will not replace equipment that is functioning effectively and producing the required outputs where there is no economic justification for doing so - any more than the department would replace equipment in these circumstances. The department may make it a requirement of the contract that it shares in any realised costs savings from technology changes, or savings that might reasonably be expected from upgrades, which could have been implemented but were not. Whether such a provision is appropriate will depend on the likely impact on the contract price and other value for money considerations.

## **9.3 What if the contracting department is no longer responsible for the contract?**

The Government, rather than the client department, normally enters into an agreement with the contractor. If the client department's functions are carried on by a different party within the government the contract will continue undisturbed. If the department's functions are transferred to a quasi or non-government entity it may be necessary for the Government to underwrite the credit worthiness of the successor entity with respect to the contract.

If a function were discontinued altogether, the Government would be faced with a service that it no longer needed. A break clause could be included in the contract to deal with this eventuality. If this had the effect of passing the risk of the service continuation to the consortium, it would be reflected in the contract price. In order for the contract to obtain financing, any break clause for the benefit of the Government would only be exercisable subject to compensating the consortium appropriately for the loss of the contract.

### **9.4 Can the department prevent ownership of the consortium passing into the wrong hands?**

PPP contracts typically contain provisions requiring the agreement of the client department to any changes in control of the consortium - with such agreement not to be unreasonably withheld. The approach generally adopted is that the client department should be able to prevent ownership changes that would undermine the ability of the consortium to deliver the required services reliably over the life of the contract, but not otherwise restrict the commercial freedom of the investors in the consortium company.

A right to consent to a change in control is appropriate where the department takes comfort from the original sponsors maintaining their stake throughout the life of the project. It should invariably be the case that the client department will want to prevent entities whom they regard as “undesirable” from having an economic interest in the project, e.g. entities which had previously engaged in improper dealing, which have criminal associations, or have findings of having acted with a lack of candour or in breach of trust. Such conditions should be clearly stipulated in the RFP as well as in the contract.

On the other hand, if the concern is primarily over the ability of the consortium to perform the contract after a change in its shareholding, other provisions in the contract, e.g. the payment mechanism and termination trigger, should be capable of addressing this.

In permitting any change of shareholders, it will normally be necessary to confirm the continuing strength of commitments from other shareholders and consortium members, and if there are any performance bonds or guarantors the department should appraise and review them also.

### **9.5 What if the client department is corporatised/privatised?**

Most departments are not legal entities and the PPP contract will be made with the Government. The corporatisation/privatisation of the client department may result in the assignment or novation by statute or contract of the government’s rights and obligations.

### **9.6 Will the Government be locked into using particular equipment at the end of the contract or in replacement/upgrade exercises?**

The client department can require in the output specifications that the equipment should be interoperable with other equipment meeting the prevailing industry standards. An important part of the technical assessment of bids will be to assess to what extent any proprietary systems or software are proposed. It is at this stage that the risk of any ‘lock-in’ can be mitigated. It must be recognised, however, that in some specialist areas effective technical ‘lock-in’ may have to be accepted, even under a conventional procurement.

### **9.7 What if the consortium makes ‘windfall profits’?**

Given the prolonged duration of most PPP projects, client departments will need to anticipate the possibility of the declining risk profile of the project enabling the consortium to make windfall profits. There has been public criticism in some other countries where consortia have made unanticipated profits, particularly as a result of project refinancing or the sale of project assets. Provision can be made in the contract for these gains to be shared with the Government. The Government’s share of any gain could be taken as a cash lump sum at the time of the refinancing and/or as reduced service charges. Current practice in the UK, for example, is to share windfall profits 50:50 between the government and the consortium.

## **9.8 What if there are unforeseen changes in the consortium's operating costs, e.g. change of law or insurability?**

This needs to be dealt with in the context of allocating risk. Consideration needs to be given as to what business risks should be allocated to the consortium, and what risks should be retained by the client department. For example, the effect of change of law during the life of the project. From the consortium's perspective, the risk is that change of law will increase the cost of complying with its obligations. Social infrastructure projects where the Government pays the consortium on a fixed price basis may preclude the consortium from passing on the additional cost to the Government; and economic infrastructure projects may be subject to government price controls. The issue is thus the extent to which payments to, or prices set by, the consortium should be adjusted to reflect its increased or decreased costs.

The Government's starting point should be to propose that the consortium bears the risk of all legislative changes unless they are discriminatory or specific to the project. All businesses and persons are subject to general changes of law and it is commonplace for businesses to take legislative risk. Nonetheless, to ensure that consortia are not deterred by the strict application of this approach it may be advisable to have some sharing of this risk between the Government and the consortium.

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# 10 STAFFING ISSUES

## **10.1 Do PPP projects pose industrial relations concerns to the civil service?**

Addressing the staff related issues can often be one of the most challenging tasks associated with a PPP project. Much will depend on the details of the individual PPP project, e.g. whether it affects existing services or new services. Care should be taken to draw up a manpower strategy that is most appropriate for the project in question.

For example, if the PPP project involves building a replacement facility or affects existing services, it may be possible to redeploy staff elsewhere in government, including the client department, or for some of them to be transferred to the successful bidder. In many cases, the consortium is likely to want to employ specific government personnel due to their particular knowledge and skills. Clearly, the extent to which bidders are willing to employ staff, and the terms of their employment, will be relevant to the evaluation of bids.

## **10.2 When should staff be informed/consulted?**

A comprehensive communication strategy should be drawn up from the beginning and reviewed along with the PPP process. Experience has suggested a number of useful common approaches:

- ◆ Management should consider staffing issues at an early stage
- ◆ Management should inform staff early and regularly of developments
- ◆ Staff should be offered the opportunity to contribute to the development of PPP proposals.

It is likely that staff will need to be informed and consulted on different aspects of a PPP proposal at a number of different stages. Senior management will need to carefully consider the details of these issues. Nonetheless, it goes without saying that staff should be informed of proposals before the first public airing of the subject.

## **10.3 How will staffing issues be addressed?**

In making the business case, evaluating the cost-benefit, and establishing the feasibility of a PPP project, the Government will have to take staffing issues into account, particularly those concerning serving staff.

## **10.4 Should civil servants be allowed to work for a PPP consortium?**

Any civil servant may leave the service on retirement, completion of agreement or resignation, as applicable, to work for a private company provided that they have followed prevailing rules governing post-service employment. Departments should consider whether serving civil servants should be encouraged to transfer from the civil service to the PPP consortium.

They may facilitate such transfers by requiring the consortium to employ minimum numbers of serving departmental staff, or giving bidders higher bid assessment scores for proposals involving the employment of such staff. The transfer of civil service staff can be accomplished through, for example:

- ◆ Secondment to the consortium in accordance with prevailing civil service regulations
- ◆ Offering an exit package with adequate severance terms and guaranteed employment by the consortium.

Care should be taken to ensure that those transferring were not party to, or influential in, the process of selecting the winning bidder. To prevent conflict of interest, departments should prohibit consortia from offering employment to government officers who have participated in the selection process, unless approval is obtained from Government.

### **10.5 How are staffing issues dealt with in other jurisdictions?**

In some countries, including the UK and Ireland, staffing issues have been addressed using a combination of legislation such as the Transfer of Undertakings (Protection of Employment) (TUPE) regulations and contractual assurances. The TUPE regulations have often helped to overcome staff concerns about PPPs. The TUPE regulations cover the following issues:

- ◆ Employees transfer to the new employer on the same terms and conditions
- ◆ Representatives of employees have a right to be informed about the transfer
- ◆ Protection for individuals from unfair dismissal connected with the transfer.

In other countries, such as Canada, there is no legislation covering staff transfer and such matters are handled using contractual means only. In many cases civil servants transferring to the private sector have enjoyed enhanced career prospects and the opportunity to become part of a growing business with export opportunities.

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# 11 LEGAL RIGHTS AND POWERS

## **11.1 How can Government's interests be protected in a PPP project?**

In drawing up the detailed arrangements for a PPP project, the client department will need to ensure that Government's interests are adequately protected. DoJ has conducted a review on the provisions protecting Government's interests in the various tunnel ordinances as well as the Tung Chung Cable Car Ordinance (Cap 577). These provisions cover issues such as restrictions on assignment or disposal of rights and obligations, restrictions on mortgages and charges, claiming damages to make good defects/upon the service provider's failure to perform obligations, compensation to the service provider for added value, control over change in equity ownership and shareholding etc. These provisions which the legislature has approved should normally be taken as the correct approach and standard for protecting Government's interests and be reflected in the detailed arrangements for the PPP project. DoJ can advise on the drafting of these provisions.

## **11.2 What is the legal basis for PPP approaches?**

Subject to the proper construction and interpretation of any relevant legislation in any particular situation, the Government has extensive constitutional and common law powers to make commercial contracts including PPP contracts.

Government cannot transfer to the consortium its basic accountability and responsibility to the public for the delivery of public services. In addition, Government may have a continuing, non-delegable duty of care to recipients of certain services provided by the consortium - particularly those recipients in a position of vulnerability, to whom Government owes a duty of care. This non-delegable duty of care may arise at common law or under legislation.

The existence of non-delegable duties limits the extent to which Government can transfer legal responsibility for the provision of services to the consortium. This is the case even where the financial consequences of a breach of the duty can be transferred e.g. by indemnification from the consortium, adequately supported by insurance carried by the consortium. Where Government has a non-delegable duty in delivering a service, it may remain liable for any negligence on the part of the consortium engaged to provide the services on Government's behalf. In this way, a non-delegable duty imposes a similar liability on Government for the acts of the consortium as for the acts of its own employees.

Examples of non-delegable duties include the Housing Authority's non-delegable duty to its tenants, and a school's non-delegable duty to its pupils.

## **11.3 Are Government's constitutional or common law powers qualified by legislation?**

To avoid legal complications leading to challenges and delays, it is vital before inviting bids to check the legal ability of Government to contract with the private sector in the envisaged circumstances, or to perform all of its obligations under the contract. In some circumstances, enabling or amending legislation may be required.

Some ordinances contain provisions that may enlarge or restrict 'the Authority' to do acts that would be incorporated in many PPP contracts. The client department should seek legal advice at an early stage as to whether there are any 'vires' constraints on its proposed course of action.

#### **11.4 Can Government's enforcement powers be delegated to non-public officers?**

Despite the wide constitutional and common law powers of the Government, where an ordinance confers a power or a duty on a particular public officer, he must consider the exercise of the power or performance of the duty independently and judicially to the best of his ability. In other words the policy decision of a bureau is not a substitute for the consideration of the exercise of the power or duty by the office holder concerned.

In addition, the nominated office holder must have compelling reasons not to exercise his statutory powers or duties which the legislature has expressly conferred on him. The non-exercise of any statutory power must be supported by good reasons. Whether a financial advantage by itself is sufficient is moot and depends on all the circumstances including statutory interpretation and whether the objects of the ordinance can be better attained otherwise. Everything turns on the interpretation of the particular legislation and its application to the particular facts of the case.

#### **11.5 What if enforcement powers cannot be delegated to the consortium?**

The private sector may be able to manage many government PPP facilities without the delegation of legal enforcement powers. The private sector already operates a wide range of facilities (office and shopping complexes, factories, bars and restaurants, hotels, sports and recreation facilities etc) without the benefit of public behaviour enforcement powers given to departments under many ordinances. Potential PPP bidders would consider the risks involved before submitting proposals and may wish to discuss with the Government how necessary such powers are to the successful provision of the services.

#### **11.6 Is there any general enabling legislation in Hong Kong similar to the UK?**

There is no such enabling legislation in Hong Kong. The Government's constitutional power to contract is considered to be sufficiently extensive and flexible in many cases. Client departments should always seek legal advice on whether particular legislation enhances or restricts their powers to contract.

#### **11.7 Are there any other legal constraints on a PPP?**

Each project will involve many forms of activity on the part of a consortium. Before a RFP is issued, an assessment will be needed as to whether the activities involved can be carried out - and carried out efficiently - within the framework of existing legislation. Legal advice should be sought.

#### **11.8 Can staff be required to transfer to a private employer?**

In principle, an employer has no automatic right to require an employee to work for another employer, whether permanently or temporarily, unless the terms of his contract of employment provide for this. If the contract of employment does not contain such provision, there should be mutual agreement before a transfer of employment to the consortium can occur.

### 11.9 What is the purpose of a Direct Agreement?

A Direct Agreement is one of the principal legal documents for financiers in PPP projects and is also known as:

- ◆ Tripartite Deed
- ◆ Tripartite Agreement
- ◆ Step-in Agreement
- ◆ Consent Deed.

Typically, a Direct Agreement is an agreement between the government, the consortium and the financiers funding the consortium. Under the Agreement the government usually will:

- ◆ Acknowledge that the benefit of the Project Agreement has been legally assigned to the financiers as security for the payment obligations of the consortium
- ◆ Notify the financiers of any material breach of the Project Agreement and will be obliged to send the financiers any notices it sends to the consortium at the same time, e.g. notices containing proposals for a variation to the service requirement or in connection with a deduction from the user charges or unitary payment
- ◆ Give the financiers a period of advance notice of any intended termination of the Project Agreement and offers the financiers an opportunity to:
  - Step in to remedy the position during the extended cure period
  - Take over from the consortium if the default is irremediable
  - Appoint a receiver and sell the project, including the rights and obligations of the consortium under the Project Agreement, to a substitute entity acceptable to the government in case of severe default, i.e. transfer of concession.

It should be noted that under the Direct Agreement, the rights of the government to step in under any collateral warranty agreements with the sub-contractor(s) would be suspended until the financiers make a decision regarding their position.

The consortium, its financiers and key sub-contractor(s) can also enter into a Direct Agreement, for example:

- ◆ Design & construction sub-contractor(s), project company, financiers
- ◆ Operation & management sub-contractor(s), project company, financiers.

This Agreement will provide that the key sub-contractor(s) will not exercise any rights of termination without first giving notice to the financiers and then waiting for a defined period before terminating their contracts.

### 11.10 Will there be only one contract in a PPP project?

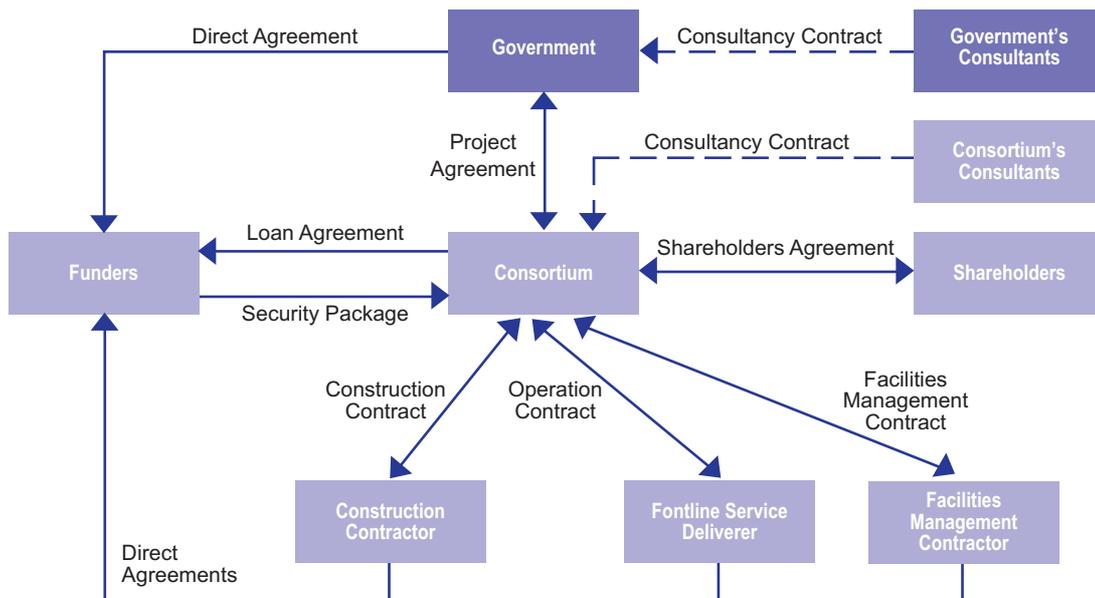
Normally there will be several contracts including:

- ◆ The Project Agreement, which is the key document between the government and the consortium
- ◆ The Direct Agreement(s)

- ◆ Sponsor arrangements (equity; equity subscription and shareholders agreements)
- ◆ Debt: subordinated loan agreements, and credit and security documentation
- ◆ Back-to-back contracts e.g. design, constructor, operation and maintenance.

See Figure 8.

**Figure 8: Key Contractual Relationships in a PPP Project (DBFO Model)**



### 11.11 Is there any ‘standardised’ contract documentation?

A number of jurisdictions, including the UK and Australia, have produced some ‘standardised’ documents. These have taken into account a considerable amount of local experience and are often credited with speeding up, and reducing the cost, of the bidding/negotiating stages.

We have not yet had sufficient local PPP projects on which to base our own ‘standardised’ documents. Nonetheless, at Annex F, is a checklist of Heads of Terms, or clauses, that departments should consider including in their Project Agreements. It must be noted that not all projects will require all of these clauses. Some projects may require clauses not included in the checklist. Question 12.5 explains what is normally included in a land lease document.

### 11.12 Can government penalize a consortium that does not meet its contractual obligations?

It is a feature of the law of contract that the courts will strike down penalty clauses. However, it is only natural that the client department would want to ensure that a consortium does perform the tasks that have been agreed and paid for. There are means acceptable to the courts that can be employed:

- ◆ Liquidated damages do not fall foul of the rule that penalty clauses are unenforceable, provided the sum fixed represents a genuine attempt to estimate in advance the loss suffered as a result of the breach

- ◆ Payment for measurable performance. The contract can be drafted so that the consortium is paid a particular fee in return for delivering a particular service. If he does not deliver satisfactorily a particular service, he does not receive the payment that goes with it.

### **11.13 What are ‘force majeure’, ‘relief events’ and ‘compensation events’?**

The consortium will be entitled to claim an extension of time to the dates in the phase-in timetable or the temporary suspension of its performance obligations relating to the provision of the service for the following three categories of delay:

- ◆ Relief Events - which arise at any stage of the contract term and for which the consortium bears the financial risk and receives no relief from liquidated damages or the performance regime, but in respect of which neither party will have rights of termination. However, the client department may require a unilateral right to terminate once a delay has persisted for a significant period. Whether a right to terminate is required and after what period it should be exercised are project specific decisions
- ◆ Compensation Events - events which arise prior to the in-service date, which are clearly the client department’s responsibility and in respect of which the consortium will be compensated
- ◆ Force Majeure Events - a narrowly defined and limited set of events which arise during the life of the contract through no fault of either party, which are best managed by the consortium (although not in its control) and in respect of which rights of termination for either party may arise after a significant delay (e.g. six months) has occurred.

Relief events need to be extremely narrowly drafted and qualified by requiring the consortium to have taken all possible steps to prevent or mitigate such an occurrence (e.g. fire, loss or damage, failure by statutory undertakings, utilities companies etc). Similarly, only general strikes of the workforce (not site or project specific) should qualify as a relief event. Compensation events apply to variations required by the government and discriminatory changes in the law. Events of force majeure should be very narrowly defined (as they usually are in these cases) and not co-extensively with uninsurable risks.

### **11.14 Can Government acquire intellectual property rights or incur any liabilities?**

If any intellectual property is created during the course of a PPP or existing rights are used in the course of the contract, express provisions for the grant of rights to the Government are strongly advised.

In the case of commissioned work, a statutory license is created with respect to copyright. The statutory license allows the use of such work by the commissioning body for purposes that could have been reasonably contemplated by the author of the work and by the commissioning body at the time the work was commissioned. Where a statutory license is not applicable, and rights are not acquired through express contractual provisions, there may nonetheless be other statutory provisions that protect the department from liability to the owners of intellectual property used under the contract. Legal advice should be sought in each case.

### 11.15 What types of intellectual property may be involved?

Specific advice should be sought with respect to each contract. However, the more common types are: copyright, trademarks, and patents.

**Copyright** protects original literary, dramatic, musical and artistic works as well as sound recordings, films, broadcast and cable programmes, and typographical arrangements of published works. Computer software, for example, is considered a literary work. See Copyright Ordinance (Cap 528).

**Trade Marks** are signs that are capable of distinguishing the goods and services of one undertaking from another undertaking, and may be registered. Common law protection may also apply to unregistered trademarks. It may be an infringement if a sign similar to a registered trademark is used without permission in the course of business. See Trade Marks Ordinance (Cap 559).

**Patents** protect new technology by giving the owner of the technology the right to prevent others from manufacturing, using, selling, or importing items using the patented technology. See Patents Ordinance (Cap 514).

### 11.16 How should the PPP contract address intellectual property?

The Government may require the transfer of ownership or the grant of a license. In particular, when the Government engages a consortium to develop new IT systems, the ownership of intellectual property will be vested in the consortium unless there are exceptional circumstances under which the Government must retain the intellectual property rights. The Government will in turn be granted a licence to use the intellectual property. See OGCIO Circular No. 1/2006 and Guidelines for Opening Up Intellectual Property Rights of New IT Systems (September 2006). Where a licence is sought, it is important to set out clearly the extent of the rights to be granted including: whether exclusive or not; whether royalty-free or not; restricted as to time, territory, purpose or manner of use; and whether transferable or sub-licensable.

The Government will usually require warranties and indemnities from the consortium with respect to any intellectual property rights used in the course of the contract. The consortium should also be required as necessary to assist in any registration procedures, the execution of any documents, or any other actions necessary to protect and indemnify the Government.

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# 12 LAND ISSUES

## 12.1 How do we deal with land issues?

Land premium waiver or development rights should not be used as the major incentive for a consortium to provide the facility/service. Otherwise, the well established tender procedure/policy will be in jeopardy and projects may be criticised for bypassing the proper procedures. Land revenue will effectively be hypothecated. That said, where there are ancillary areas not needed by the required facility and the consortium identifies some commercial opportunities within the site, granting of commercial development rights may be considered but this again, must not be the major incentive and must not undermine the normal tender procedures.

The treatment of land as an asset should be dealt with on a case-by-case basis. As a matter of principle, the disposal of land should be under a fair, transparent and competitive process. Depending on the length of tenure and nature of the service involved in a PPP project, the disposal of land can be by way of a Licence; Short Term Tenancy (STT); long lease in the form of a Private Treaty Grant (PTG) or granted by public tender; or an enabling ordinance. Client departments should consult the Lands Department (Lands D) and the DoJ at an early stage when considering a PPP. An indication of possible responses is given in the following questions and answers.

## 12.2 Can departments issue licences of land?

Land allocated to a government department under a Government Land Allocation may be made available to the department's consortium provided that:

- ◆ The department has obtained delegation from the Director of Lands under section 5 of the Land (Miscellaneous Provisions) Ordinance (Cap 28) to issue a licence of the land involved for the specific purpose and such licence is issued at the same time as the contract ('the Contract') between the department and its consortium
- ◆ The Contract is awarded through a competitive bidding process with the contract sum reflecting the full value of the rights (including the right to keep the revenue generated) and obligations attached.

Land licence fees are stipulated in the Land (Miscellaneous Provisions) Regulations (Cap 28 sub. leg. A).

An Authority under Cap 28 may delegate any of its powers and functions to any public officer or class of public officer by virtue of section 18A. However, there are a number of significant disadvantages to this approach:

- ◆ Although section 5 confers a power on the Authority to issue a licence, that will be a licence to occupy unleased land on payment of the 'prescribed fee'. **In most cases the 'prescribed fee' (in the Regulations under Cap 28) will be wholly inadequate**
- ◆ The Buildings Ordinance (Cap 123) will not apply to licences of unleased land as it exempts 'unleased land' within the meaning given by section 2 of Cap 28. In other words, although the statutory requirements of Cap 123 could be applied under the contract between the parties, enforcement would be more problematical

- ◆ It is for the potential PPP consortium to judge what length of term of a land licence is considered 'tenable' in the context of its investment sums and risks involved, and depending whether its needs legal title to the land. Cap 28 itself does not pose any restriction on the length of the term of a land licence. Licences issued by Lands D under Cap 28 are normally on a yearly basis, but can be for longer, e.g. certain utilities. Another example is that Cap 28 licences issued by EMSD for LPG filling stations are for a fixed term of 21 years.

A land licence is rarely used nowadays and should be considered only under exceptional circumstances. Solid justifications are required if a land licence is to be used.

### **12.3 Can a Short Term Tenancy (STT) be used for PPPs?**

The Government sometimes grants STT for the construction phase of a project so as to bring the Buildings Ordinance (Cap 123) into operation. The Project Agreement can be drafted to provide that upon successful completion of the construction, the Government will accept a surrender of the STT and replace it with the grant of a long lease. Basic terms (including land premium) of a long lease must be taken into account in the bidding process and incorporated into the binding Project Agreement.

### **12.4 Will a single contract cover both land and other PPP issues?**

As explained in Chapter 11 there will be more than one contract involved, involving both the government and private sector.

There are differences of opinion on whether it is best to have one unified contract, or two separate contracts that are cross-referenced to each other (one contract conferring the right to use the land/facilities and the other relating to the other PPP issues).

Those in favour of a unified document argue that there is no need for a 'separate' service agreement, and that the private sector commonly dispenses with a service agreement. The advantage of incorporating all the rights and obligations in one document is that there should be a consistency of drafting, and less chances of inconsistencies and omissions arising.

Those in favour of keeping separate documentation argue that:

- ◆ The land disposal document should be kept reasonably lean and simple, focusing on the development and use of government land, and conferring title. It is not an appropriate document for setting out detailed operational arrangement such as fees, entrance charges, opening times etc
- ◆ The commercial arrangements in a complex PPP project can be very intricate and are best dealt with independent of the land documentation. Otherwise, preparation of the land document will take much longer and will still involve more than one drafter
- ◆ Under a PPP approach, many parameters and terms and conditions are determined through negotiations with the private partner. This process is not as open and competitive as the normal tendering process for land. Hence, giving up land development rights is theoretically less efficient. As the private partners are allowed to retain the incomes arising from the commercial facilities, revenues are hypothecated.
- ◆ Modification of even minor provisions in an executed land document requires formal legal documentation, which is a lengthy, complex process that will reduce flexibility in arrangements. It may have land premium or revenue implications that may not be acceptable to the consortium

- ◆ The usual remedy under a land grant, upon breach/non-fulfilment of terms, is re-entry under the Government Rights (Re-entry and Vesting Remedies) Ordinance (Cap 126); this may not best suit the purpose of the Government operating a PPP and is in any case far less timely and direct than alternative dispute resolution processes such as abatement of charges. Cap 126 also provides a statutory right of appeal, which process could have an adverse affect on service
- ◆ PPP issues such as profit-sharing are commercially sensitive and should not be incorporated into the land grant, which will be subject to public scrutiny through the Land Registry search facilities. It should be noted, however, that in many jurisdictions, the requirements for probity and transparency dictate that copies of the project documentation be made publicly available except for only limited commercially sensitive information.

### **12.5 What terms and conditions are normally included in a land lease document?**

The lease document confers legal title to and grants possession of the land. It generally controls the permitted use, development parameters, and timely completion of development, protecting the interests of Government as the landlord including the ability to charge premium for modifications and safeguarding the reversionary interest at the expiry of the lease term.

Typically, therefore, the lease will stipulate requirements in connection with the permitted user and GFA for various purposes, building height, the period of time within which the development should be completed (the “building covenant”), compliance with ordinances, any restrictions on alienation (prior to completion and otherwise) including mortgaging, preservation of trees, provision of landscaping, and the provision of adequate car parking, loading and unloading spaces.

Other more technical requirements, such as those relating to permitted vehicular access, drainage, any related slope works and their maintenance, any Deed of Mutual Covenant for property management and reservation of any rights-of-way to others are also commonly incorporated.

Depending on the circumstances of a particular case, there may also be conditions requiring, for example, the formation of public roads and the construction of footbridges necessary to serve the new development.

### **12.6 Can PPP projects share sites with Government/Institution/Community (GIC) facilities?**

Given the shortage of land in Hong Kong, and its high value, it makes sense to maximise land utilisation. There is no general objection in principle to the sharing of land by PPP and other GIC facilities. Each case should be examined on its own merits, taking into account the zoning of the site, related restrictions on development intensity, costs to Government and/or financial benefits to the consortium, and the type(s) of user under the PPP. The usual approaches would be:

- ◆ In the case of a land licence to be granted: reservation to Government of relevant rights in the licence document for construction, use and operation of the required GIC facilities on the land (some telecommunications facilities already provide for shared use)
- ◆ In the case of a land lease to be granted: inclusion of provisions in the lease requiring the lessee (the consortium) to construct the GIC facilities, in accordance with the government specifications supplied and at a specified amount to be reimbursed, and assign them to the Financial Secretary Incorporated, or surrender the portion of the lot upon satisfactory completion.

Legal advice should always be obtained to ensure that necessary government control and/or access is maintained.

### **12.7 Who owns the land/facilities?**

There are a number of possible scenarios with ownership resting with either Government or the private sector. Depending on the intention, the Government can form wholly-owned companies to hold the land and enter into partnership with private enterprises for the delivery of service. Where a consortium has been granted a lease of land it will not only have the right to use the land/facilities for the duration of the PPP contract, but can also be said to 'own' the land. If a consortium is granted ownership of land, provision should be incorporated in the grant for reversion of the land to the Government upon expiry or early termination of the PPP contract, or in the event of cessation or diminution of purpose for which the land is granted. Consideration should be given to build into the contract provision to require the consortium to return the site free of structures (i.e. a cleared site) to the Government upon expiry or early termination. In a DBO contract the Government will usually retain ownership of the land/facilities.

### **12.8 Can the consortium dispose of land granted for a PPP?**

With respect to the land occupied for the purposes of delivering the service, client departments must ensure that the consortium is not permitted to sell, sublet or otherwise dispose of the land, or reduce its economic value without the approval of the Government. If land has been granted by means of a concessionary grant, the Government should impose a resumption provision in the grant so that the consortium will not benefit from a statutory compensation on resumption of the land.

In the case of PTG made on a concessionary basis, it is normal policy that alienation will be prohibited. On the other hand, where the land lease is disposed of through a competitive bidding process, it may be appropriate to allow alienation on the following basis:

- ◆ No alienation will be allowed before fulfilment of the building covenant and/or until the required facilities have been brought into operation in accordance with the requirements as specified in the land grant conditions
- ◆ Any alienation of the lot or any interest in the lot will not be allowed 'except as whole' i.e. no partitioning or subdivision of the lot will be allowed nor any assignment by way of undivided shares in the lot will be allowed
- ◆ Any disposal on the above basis will also be subject to the prior approval of the Government and, in the event that approval is given, the new consortium will be required to enter into a new SLA with the client department.

### **12.9 What zoning is appropriate for a PPP site?**

Most sites identified for government use are zoned GIC use on the relevant outline zoning plan. GIC use might continue to be appropriate for some PPP projects. However, in other cases the consortium might have proposed the provision of additional services on the site that are not merely 'ancillary' to the required use. It is important to check the land use zoning of the site and the provision in the 'Notes' for the respective land use zone to see if the additional services are permitted as of right or may be permitted upon application under section 16 of the Town Planning Ordinance (Cap 131) to the Town Planning Board. Otherwise a change of zoning will be necessary. Rezoning and/or planning applications may require public consultation, which may be time consuming and politically sensitive. Departments need to ensure that they have made allowance for this process.

### **12.10 Should the consortium be charged a lump sum premium?**

This will depend on the circumstances of each case. If the client department invites consortia to provide no more than the department would otherwise have provided, there is little point in charging a lump sum premium as this will artificially inflate the contract price. If however, the consortium is allowed or encouraged to provide revenue-generating services, e.g. with the grant of development right, the client department needs to consider how to ensure that the public purse receives its fair share. This might involve a lump sum premium, revenue sharing, profit sharing, or the cross-subsidy of loss making services that the consortium must provide. As a general point, these arrangements should be as transparent as possible. If there are to be cross-subsidies, for example, it should be made possible for the extent of the subsidy to be determined.

### **12.11 Should the client department prescribe the land to be used?**

If necessary to expedite the selection and negotiation phases, the RFP may prescribe the land/premises to be used. Sites may also be prescribed where the Government judges it necessary to make best use of scarce land resources within Hong Kong. Where the feasibility of the project does not depend on the location of the site concerned, bidders should be encouraged to offer innovative solutions in respect of land/premises, particularly at the EoI/pre-qualification stages.

### **12.12 Do land disposal documents allow step-in or early termination?**

Provisions can be incorporated into a land licence or land lease to enable the Government to take over the buildings erected on the land involved upon the expiry or sooner termination of the land licence/lease. The consortium is however entitled to remove his plant, equipment and facilities unless he is bound by other terms in the PPP contract.

Government step-in rights are generally found in the Project Agreement rather than land leases. A land lease document will not cover performance related to the provision of services. The usual remedy available upon breach/non-fulfilment of terms is re-entry under the Government Rights (Re-entry and Vesting Remedies) Ordinance (Cap 126), through which Government takes back the land and cancels the legal title of the grantee to the land (subject to rights of appeal to the Court or petition the Chief Executive). This can be a time-consuming process. A licence can be terminated according to its terms and Government can demand possession of the land.

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# 13 PROBITY AND CORRUPTION

## **13.1 Can Government ensure transparency and fairness in the competitive bidding process?**

The Government should ensure that the competitive bidding process is truly competitive, independent, secure, transparent and accountable, that all bidders are treated fairly, and the confidentiality of sensitive information is maintained. The PPP process should be underpinned by probity practices that ensure the procedural integrity of the process is maintained. Client departments should have in place systems, policies and procedures able to withstand public scrutiny. Please refer to Annex G on the probity principles and measures.

## **13.2 How important is avoidance of ambiguity in seeking bids?**

There is risk that Government, in seeking to maintain as strong as possible a negotiating position, allows ambiguity to be present in the bidding process. Pre-contract documentation should be carefully drafted and clearly state the actual undertakings and legal obligations required to be met. This care should extend to any documents calling for revised proposals. In all cases, there should be certainty as to the nature of the obligations owed by both parties as a result of the process. Clear and well-drafted documentation will usually avoid the risk of protracted and costly litigation.

Under the law of contract, an invitation document issued by the Government to invite persons to submit bids for a project is an “invitation to bid” and a bid submitted by a bidder is an “offer”. The Government is free to accept or reject the offer. Unless and until the Government has accepted the bid, there is no binding contract between the Government and the bidder in respect of the project. However, the mere fact that there is no binding contract, in respect of the project does not necessarily mean that there is no binding contract in respect of a different matter namely compliance with the terms of the invitation document by both Government and the bidder. It has been held by the courts that the issue of an invitation document by an inviter and the submission of a conforming bid by a bidder in response to the invitation could give rise to a binding contract pursuant to which both the inviter and the bidder agree to comply with the terms of the invitation document. Whether there is an implied term of fair dealing on the part of public bodies in conducting the bidding processes has not been settled in Hong Kong law.

## **13.3 How do we handle commercially sensitive bid information?**

While the Government is committed to an open and transparent process for PPP procurement, it is important to ensure that confidential information and intellectual property of private sector bidders is protected. Recipients of confidential information should sign a confidentiality agreement and clear security procedures should be established for handling procurement-related documents. These will be similar to existing practices that are in accordance with provisions under the SPR, Security Regulations, Financial Circulars, Independent Commission Against Corruption (ICAC) guidelines etc.

### **13.4 Can bidders' probity during the bid process be encouraged?**

Bidders should be required to act in an ethical and honest manner through the requirements of the RFP. They should be reminded of their obligations under the law. As discussed in Annex G, probity checks may be carried out on bidders during the evaluation. To focus the attention of bidders on the need to adopt ethical practices, consideration should be given to require them to demonstrate their commitment to ethical practices as part of their bid submission.

### **13.5 What are the major corruption risks?**

Many of the corruption risks for which safeguards are required will lie with the consortium for the life of the project. Nonetheless, there are still areas of concern for the civil service. At the evaluation stage, these include the handling of sensitive/confidential information, the negotiations with bidders and the selection of the winning bid. At the construction and operation stage, these include the ordering and valuation of contract variations, and monitoring the consortium's compliance with the contract requirements. To reduce these corruption risks, clear selection and assessment criteria and procedural guidelines will be needed. The Corruption Prevention Department of the ICAC can assist the departments involved to draw up these guidelines to mitigate the corruption risks. Transparent and open processes minimise the opportunity for, and the risk of, fraud and corruption.

### **13.6 Is it acceptable to negotiate with bidders?**

In many PPP projects it is necessary to negotiate before the preferred bidder is finalised in order to ensure that the client department obtains the best outcome possible both in financial and service respects. Negotiations should be used to pin down the commercial terms of the contract, with a view to ensuring that the contracted outputs will be delivered. To minimise corruption risks, any negotiation should be conducted in accordance with ICAC guidelines, the principle of non-discrimination and the provision of SPR and the WTO GPA as in the conventional procurement process.

### **13.7 Are there any 'negotiating procedures'?**

The PSCom should establish and promulgate appropriate procedures to ensure that checks and balances are in place. A negotiating brief and associated negotiation procedures approved by the appropriate bid evaluation committee will have to be prepared. Negotiating teams need a clear negotiating strategy before negotiations begin, including the intended timetable. Negotiation meetings, if any, should be fully minuted.

### **13.8 Should a contract won by corrupt means be terminated?**

Client departments should include in the RFP documentation and the contract itself clauses to the effect that contracts won by means of corruption and/or performed in a corrupt manner are liable to termination.

### **13.9 Are any staff at particular risk?**

Members of the PSCom and the bid evaluation committee should be selected with due care. As far as possible, there should be independent oversight of officers involved in critical activities such as the drawing up of the procurement documents and the criteria for evaluation, negotiation with bidders, bid assessment and monitoring the performance of the consortium.

To maintain a high standard of integrity and conduct, and avoid any perceived conflict of interest, officers should maintain an arm's-length business relationship with the bidders/consortium. Officers should avoid over-socialisation with and acceptance of excessive and lavish entertainment offered by the bidders/consortium. They should also avoid or declare any real or apparent conflict of interest that may arise or has arisen. Chapter 1A of the SPR sets out the requirements for avoidance of conflict of interest.

### **13.10 What about the consortium?**

The contracts appointing the consortium should include requirements such as on:

- ◆ Accepting advantages (because section 3 of the Prevention of Bribery Ordinance (Cap 201) does not apply to the private sector)
- ◆ Need for conducting security vetting on the consortium's personnel, in compliance with the requirement of the Personal Data (Privacy) Ordinance (Cap 486)
- ◆ Misuse of confidential, official and secret information
- ◆ Conflict of interest, and taking up outside work
- ◆ If employment of non-skilled workers is involved, the consortium is required to enter into employment contracts in the form specified by Government with each of the non-skilled workers
- ◆ Remuneration levels for non-skilled workers not below the industry average.

The Corruption Prevention Department of the ICAC also provides corruption prevention services to private sector companies and assists them in promulgating their staff code of conduct.

### **13.11 Should the consortium be subject to the Schedule to the Prevention of Bribery Ordinance (Cap 201)?**

In consultation with the Corruption Prevention Department of the ICAC and taking into account the importance of the public services to be provided, consideration should be given to including the consortium in the Schedule of Cap 201, thus designating it as a 'public body' for the purposes of the Ordinance. The Chief Executive-in-Council may by order amend the Schedule. The employee of a public body comes within stricter provisions of the Cap 201 dealing with bribery and offering, soliciting and accepting advantages.

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# ABBREVIATIONS

<b>Arch SD</b>	Architectural Services Department
<b>BOO</b>	Build-Own-Operate
<b>BOT</b>	Build-Operate-Transfer
<b>BOOT</b>	Build-Own-Operate-Transfer
<b>CSB</b>	Civil Service Bureau
<b>CWP</b>	Capital Works Programme
<b>CWRF</b>	Capital Works Reserve Fund
<b>DBO</b>	Design-Build-Operate
<b>DBFO</b>	Design-Build-Finance-Operate
<b>DoJ</b>	Department of Justice
<b>EABFU</b>	Economic Analysis and Business Facilitation Unit
<b>EIAO</b>	Environmental Impact Assessment Ordinance (Cap 499)
<b>EoI</b>	Expression of Interest
<b>EMSD</b>	Electrical and Mechanical Services Department
<b>EU</b>	Efficiency Unit
<b>ExCo</b>	Executive Council
<b>FC</b>	Finance Committee (of the Legislative Council)
<b>FSTB</b>	Financial Services and the Treasury Bureau
<b>GFA</b>	Gross Floor Area
<b>GIC</b>	Government/Institution/Community
<b>ICAC</b>	Independent Commission Against Corruption
<b>IPD</b>	Intellectual Property Department
<b>IT</b>	Information Technology
<b>ITT</b>	Invitation to Tender
<b>Lands D</b>	Lands Department
<b>LegCo</b>	Legislative Council

<b>NPV</b>	Net Present Value
<b>O&amp;M</b>	Operation and Maintenance
<b>OCIP</b>	Owner Controlled Insurance Programme
<b>OGCIO</b>	Office of the Government Chief Information Officer
<b>PDS</b>	Project Definition Statement
<b>PFI</b>	Private Finance Initiative
<b>Plan D</b>	Planning Department
<b>PPP</b>	Public Private Partnership
<b>PSC</b>	Public Sector Comparator
<b>PSCom</b>	Project Steering Committee
<b>PTG</b>	Private Treaty Grant
<b>PWP</b>	Public Works Programme
<b>PWSC</b>	Public Works Subcommittee (of the Legislative Council)
<b>RAE</b>	Resource Allocation Exercise
<b>RFP</b>	Request for Proposal
<b>SA</b>	Sustainability Assessment
<b>SDD</b>	Sustainable Development Division
<b>SFST</b>	Secretary for Financial Services and the Treasury
<b>SLA</b>	Service Level Agreement
<b>SPR</b>	Stores and Procurement Regulations
<b>SPV</b>	Special Purpose Vehicle
<b>STT</b>	Short Term Tenancy
<b>TFS</b>	Technical Feasibility Statement
<b>TsyB</b>	Treasury Branch (of Financial Services and the Treasury Bureau)
<b>TUPE</b>	Transfer of Undertakings (Protection of Employment)
<b>UK</b>	United Kingdom
<b>WTO GPA</b>	World Trade Organisation Government Procurement Agreement

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# GLOSSARY OF TERMS

<b>Benchmarking</b>	A procedure for testing whether the standard and price of services is consistent with the market standard (if any), without any formal competitive bidding.
<b>Business case</b>	<p>In the context of government projects the business case encompasses more than commercial criteria. A Government Business Case is a detailed and structured proposal for improvement in terms of costs, benefits and risks, justified for changing the way that government business is conducted.</p> <p>Departments normally develop a business case prior to the initiation of a government project or programme that requires significant commitments, including those that involve non-recurrent expenditure in procuring systems and equipment, the construction of buildings and infrastructure, and the use of the private sector in delivering public services.</p>
<b>Client department</b>	The department originating, and responsible for the intended project.
<b>Consortium</b>	In most PPP projects, the private sector partner is usually a consortium established to deliver the project. A consortium may be referred to as a Special Purpose Vehicle (SPV), a project company or concession company. The consortium will often sub-contract particular tasks to other companies/contractors.
<b>Escrow account</b>	A special trust account held in the private partner's name, in which a lawyer or escrow agent deposits money that does not belong to him or his firm to pay obligations if required.
<b>Expression of Interest (EoI)</b>	A document that the department will issue requesting information from prospective tenderers on the services they can provide and/or on the solutions available for satisfying the requirement. It is often used as a first step in the tendering process. Letters/e-mails to known interested parties, advertisements in the newspaper or an internet medium are good ways of issuing this. It is typically used in situations where the requirement cannot be adequately defined through lack of information on available solutions or when the market of service providers is not known.
<b>Gross Floor Area (GFA)</b>	The area contained within the external walls of a building measured at each floor level (including any floor below the level of the ground).
<b>Liquidated damages</b>	Stipulated amounts of money stated in the contract as compensation to the public partner under specified circumstances. The amounts should represent a genuine pre-estimate of loss suffered by the innocent party under these circumstances.
<b>Net Present Value (NPV)</b>	The present value of the expected cash flows associated with a project after discounting at a rate which reflects the value of the alternative use of the funds so as to enable comparison between options with different cashflow profiles.

<b>Market testing</b>	An exercise where private sector companies are approached to see if the private sector is willing and able to participate in a project, and under what circumstances.
<b>Novation</b>	Agreement of parties to a contract to substitute a new contract for the old one.
<b>Output-based specifications</b>	Specifications upon which bidders are invited to bid which set out the client department's requirements in non-prescriptive terms, leaving the bidders with the responsibility for determining how to deliver those requirements.
<b>Performance bond</b>	A performance bond commits the bonding company (or a bank) to step in and complete the contract if the consortium defaults on the contract. The bonding company may complete this either by performing the work itself, or by obtaining bids for the balance of the work, and then paying for the balance of the work up to the total amount of the bond.
<b>Plot ratio</b>	The ratio of the floor space of a building to its site area.
<b>Policy Committee</b>	A committee comprising Principal Officials, co-chaired by the Chief Secretary for Administration and Financial Secretary, to consider major issues requiring policy approval.
<b>Pre-qualification</b>	A process to short-list private companies that meet the requirements to be invited to submit a proposal for a project.
<b>Project Steering Committee (PSCom)</b>	A team to assist, advise and report to the Head of Department of the client department for the management of the project. The team may comprise of members from the client department, other departmental staff and private sector experts/advisors. Its composition may change according to need at different stages of the project.
<b>Public Private Partnership (PPP)</b>	An approach where the public and the private sectors both bring their complimentary skills to a project, with varying levels of involvement and responsibility.
<b>Public Sector Comparator (PSC)</b>	The risk-adjusted, estimated full lifecycle cost of a project if it was done by conventional in-house means. It is expressed in terms of Net Present Value.
<b>Request for Proposal (RFP)</b>	An invitation to (pre-qualified) private sector consortia to make an initial proposal.
<b>Required and additional facilities/services</b>	<p>Required facilities/services are those specified by the client department. Additional facilities/services are enhanced or additional features on the site, usually proposed by the consortium, bringing additional benefits, e.g. better site utilisation, revenue generation.</p> <p>Other jurisdictions use different terms and definitions. In Australia, for example, services such as teaching, health care, and dispensing justice are considered core services that must be provided by government servants. Only non-core services such as the physical provision of schools, police stations, courthouses and hospitals can be provided by the consortium.</p>

<b>Risk</b>	Risks relate to the exposure to a peril, the occurrence of events and their consequences that differ, either positively or negatively, from those that were assumed (or not, as the case may be) in establishing a project. Risks are often categorised as strategic, financial, operational and hazard risks. They arise in all projects, irrespective of the approach adopted.
<b>Risk allocation</b>	The sharing of risk between the private and the public sectors for a project so that the risks are borne by the parties best able to manage them.
<b>Service Level Agreement (SLA)</b>	An agreement setting out the standards to which the services in a contract must be delivered, often accompanied by an agreed performance monitoring regime.
<b>Shadow toll</b>	The payment of a notional toll to the consortium by the public partner for each user using the PPP facility.
<b>Sinking fund</b>	A fund into which the public partner sets aside part of the contract payment over time. The lump sum will be released to the consortium if certain requirements are met at the end of the contract.
<b>Site coverage</b>	The proportion of a site that is covered by a building.
<b>Special Purpose Vehicle (SPV)</b>	A project company established by the bidders that has as its sole purpose the delivery of a specific project, often referred to as the consortium, project company or concession company.
<b>Step-in rights</b>	<p>Rights relevant to both the private and the public sectors. In the case of the private sector, step-in rights will be a matter for the Direct Agreement between financiers, the client department and the consortium.</p> <p>Step-in rights for the public sector may be provided, entitling the client department, as a long-term or temporary 'self-help' remedy, to perform or get a third party to perform the consortium's obligations under the Project Agreement in certain circumstances.</p>
<b>Town plan</b>	A means to guide and control the development and use of land with the aim of promoting the health, safety, convenience and general welfare of the community.
<b>Whole life costs</b>	The full costs of a project including those incurred during the design, construction, operation and maintenance of the facility.

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# TAKING ADVICE AND GUIDANCE

The private sector does not generally have the experience found in the Government of large infrastructure projects involving government, public law and land, legal, policy and general administrative issues. On the other hand, the public sector is less experienced, for example, in the commercial and financial aspects of PPPs.

When establishing a PPP, a number of departments may need to be involved:

## **Arch SD**

- ◆ Provides technical advice and support, including relevant output specifications and performance standards, schedule of accommodation, preparation of the PSC, and other works practices
- ◆ Conducts technical feasibility studies and produces TFSs (prior to bidding funds from the Capital Works RAE)
- ◆ Conducts or advises on site investigations and surveys (if necessary)
- ◆ Assists in regulatory and monitoring roles throughout the contract period.

**CSB** advises on issues affecting civil service staff.

**DoJ** should be consulted on the drafting of PPP documentation, including the legal power to contract, contract terms, RFPs, output specifications and precedents for revenue and profit sharing arrangements vis-à-vis the Public Finance Ordinance (Cap 2). It can also:

- ◆ Advise on contract terms and conditions
- ◆ Draft procurement documents and contracts
- ◆ Vet procurement documents and contracts from the legal perspective.

**Economic Analysis Division of Economic Analysis and Business Facilitation Unit (EABFU)** provides advice on discount rates to be used in calculating the NPV of a PSC.

## **EMSD**

- ◆ Provides technical advice and support in respect of electrical and mechanical services
- ◆ Provides advice on specifications of electrical and mechanical maintenance services.

**EU** offers general advice on PPPs, other private sector involvement opportunities, and on external sources of advice. It can provide consultancy support by conducting business case/feasibility studies, as well as:

- ◆ Assist in preparation of procurement documents
- ◆ Organise and deliver training and seminars

- ◆ Publish guides and reference materials
- ◆ Provide help desk service (Tel: 2165 7255).

**FSTB (TsyB)** should be consulted on the funding and procedures involved in seeking FC/PWSC endorsement. It will:

- ◆ Advise on funding issues
- ◆ Vet funding applications (for both capital funding and recurrent consequences) and earmark funding for projects in RAE
- ◆ Provide support to the process of seeking funding approvals from FC
- ◆ Advise on general procurement issues.

**Labour and Welfare Bureau** advises on gender mainstreaming.

**The Corruption Prevention Department of the ICAC** should be consulted during the planning, invitation, selection, assessment, negotiation, construction, management and operation stages, to ensure that corruption prevention safeguards and mechanisms to maintain a high standard of integrity and conduct are in place. It will advise on, among others, the probity requirements, the probity plan, and the procedures to be adopted at the various stages. It may also act as an observer at bid assessment meetings. Please contact ICAC at:

Senior Staff Officer/Corruption Prevention

Telephone 2826 3198

Fax 2521 8479

Email [cpd@icac.org.hk](mailto:cpd@icac.org.hk)

Website [www.icac.org.hk](http://www.icac.org.hk).

**IPD** provides advice on protection of intellectual property rights.

**Labour Department** provides advice on pay and employment conditions as they affect private sector staff.

### **Lands D**

- ◆ Provides advice on the status of relevant site(s)
- ◆ Approves land allocations under delegated authority or advises on procedures for seeking approval from ExCo/Secretary for Development
- ◆ Determines tenure and conditions for land disposal, land premium and relevant commercial arrangements
- ◆ Provides advice on the preparation of land disposal documents.

### **OGCIO**

- ◆ Provides technical advice and support in respect of IT services
- ◆ Provides advice on specifications of IT services.

### **Plan D**

- ◆ Provides advice on land use issues
- ◆ Assists in seeking approval to rezone relevant site(s) under the Town Planning Ordinance (Cap 131) and/or in obtaining planning permission from the Town Planning Board.

**SDD** advises on SAs and vets SA paragraphs in Policy Committee and ExCo submissions.

### **Other Works Departments**

- ◆ Provide technical advice and support in relevant specialist areas.

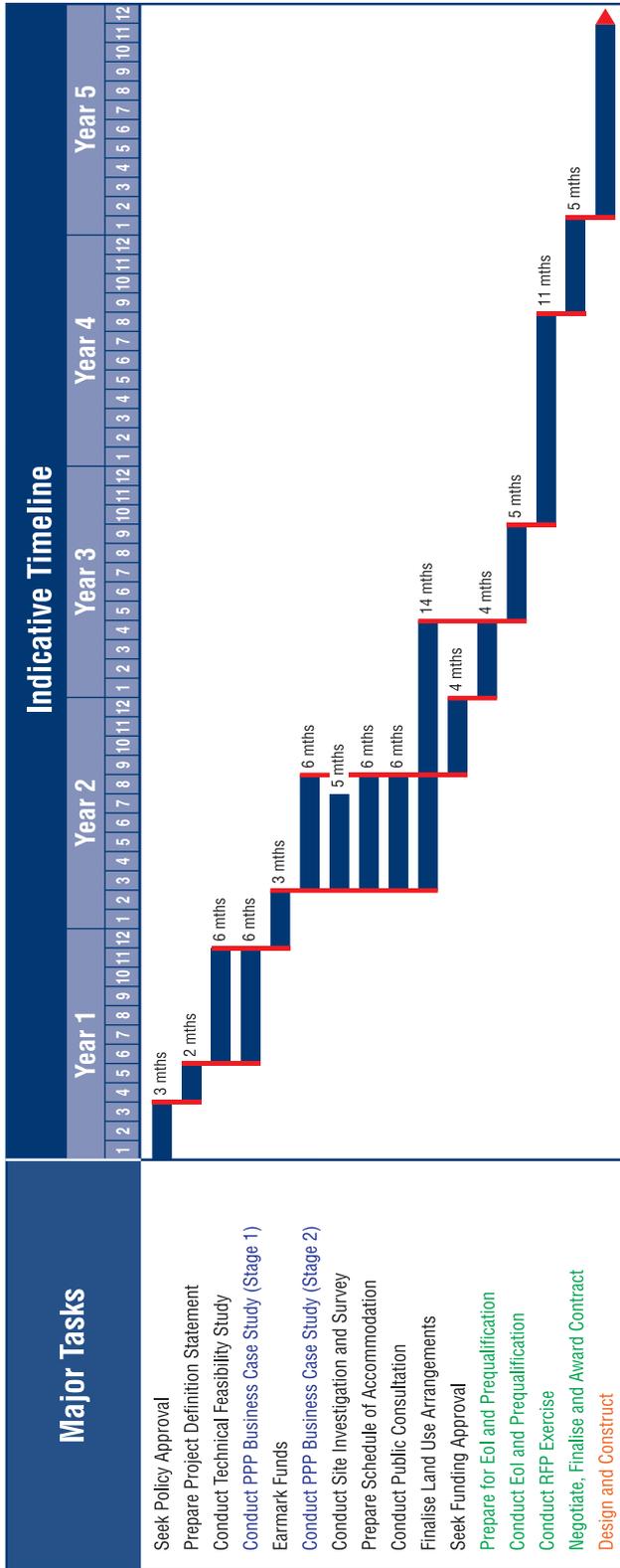
Furthermore, departments should always seek advice from their policy bureaux if they encounter problems.

### **Other Sources of Information**

There are many useful websites on the internet. The internet contains a wide range of case studies. Where these are written by parties involved in the individual projects, as opposed to independent commentators, particular care should be taken in drawing conclusions. Some of these websites and case studies may be viewed on the EU's website at *www.eu.gov.hk*.

# ANNEX A

## INDICATIVE TIMELINE



The following is assumed in the above timeline -

- (a) An appropriate site zoned GIC has been identified and earmarked.
- (b) The PPP business case studies are conducted in-house.
- (c) Invitation for EoI and prequalification of bidders are conducted in the same exercise.
- (d) Land resumption or major land clearance is not required.
- (e) Statutory and gazettement procedures are not required.

The task of “Earmark Funds” should tie in with the timing of the annual RAE exercise.

Depending on the nature of the project, public consultation may take longer time than that shown above.

Staff consultation (not shown above) should be carried out as early as possible, and in no case later than public consultation.

Environmental, traffic and engineering feasibility assessments, and socio-economic studies (not shown above) should be conducted, as appropriate, prior to Prequalification.

PPP business case studies are not required under the conventional approach.

Less time is required for tendering exercise (instead of EoI/Prequalification/RFP exercises) and negotiation of contract under the conventional approach.

More time is required for design and construction works under the conventional approach.

# ANNEX B

## ESTABLISHING A PPP - PROCEDURES<sup>1</sup>

	Action	Objectives/Controls/Approvals
<b>Step 1<sup>2</sup></b>	<b>Mobilisation and Development of a Business Case</b>	
<b>Step 1.1</b>	Conduct needs analysis, market testing and PPP feasibility study	<ul style="list-style-type: none"> <li>➤ Establish the need for the facilities/services and define service objectives</li> <li>➤ Identify appropriate location(s) for the facilities/services</li> <li>➤ Assess whether the private sector is willing and able to perform the tasks</li> <li>➤ Assess the feasibility of adopting the PPP approach</li> <li>➤ Ensure no overriding legal/statutory obstacles</li> </ul>
<b>Step 1.2</b>	Establish a PSCom comprising civil servants as well as outside expertise if required	<ul style="list-style-type: none"> <li>➤ Oversee project progress from start to completion</li> <li>➤ The PSCom is normally chaired by the Deputy/Assistant Director of the client department or a suitably senior colleague. Its composition may change at different stages of the project</li> <li>➤ Designate a Contract Manager to serve as the single point of contact with the bidders/consortium</li> </ul>
<b>Step 1.3</b>	Establish whether a site is available	<ul style="list-style-type: none"> <li>➤ Sites designated for government use are normally zoned GIC on the relevant Outline Zoning Plan</li> <li>➤ The Outline Zoning Plan Notes should be checked to see if any proposed additional facilities/services would be permitted as of right. If not submission to the Town Planning Board for planning permission or rezoning will be required</li> </ul>



<sup>1</sup> The procedures are only indicative ones for a typical PPP project. There will be variations for different projects subject to the circumstances of individual cases and the preferences of relevant bureaux/departments.

<sup>2</sup> A Category C item in the PWP project list is normally created for a PPP project during Step 1. The timing depends on the circumstances of individual projects. Please refer to Appendix I for details.

	<b>Action</b>	<b>Objectives/Controls/Approvals</b>
<b>Step 1</b>	<b>Mobilisation and Development of a Business Case (cont'd)</b>	
<b>Step 1.4</b>	Establish what facilities/services are required	<ul style="list-style-type: none"> <li>➤ Assessment is made with reference to:               <ul style="list-style-type: none"> <li>- Hong Kong Planning Standards and Guidelines</li> <li>- Requests/proposals for facilities made by relevant department(s)/organisation(s)</li> <li>- Popularity/utilisation rates of other facilities providing similar services</li> <li>- Surveys of potential users/service providers</li> <li>- Relevant population forecasts</li> </ul> </li> </ul>
<b>Step 1.5</b>	Prepare a draft Statement of Requirements	<ul style="list-style-type: none"> <li>➤ Draw up output specifications for the required facilities/services that the client department requires on the site, e.g. the outline technical specifications</li> <li>➤ The Statement of Requirements should be sufficiently flexible to solicit innovative and cost-effective proposals while ensuring that statutory requirements, e.g. fire and building safety standards, are complied with</li> </ul>
<b>Step 1.6</b>	Consider whether to accept proposals for enhanced or other additional commercial facilities/services on the site	<ul style="list-style-type: none"> <li>➤ Constraints to acceptability must be made clear to all parties concerned including the potential bidders and during public consultation</li> </ul>
<b>Step 1.7</b>	Assess risks	<ul style="list-style-type: none"> <li>➤ Assess all foreseeable risks and impacts; set out the risk matrix stipulating the appropriate parties responsible for managing and mitigating the risks</li> </ul>
<b>Step 1.8</b>	Prepare PSC with the assistance of other government departments, e.g. a works department, and seek policy endorsement	<ul style="list-style-type: none"> <li>➤ Benchmark whole life costs of required activities</li> <li>➤ PSC is expressed in net present value to enable comparison between options with different cashflow profiles</li> </ul>

(Subject to the circumstances of individual projects, e.g. availability of funding in the departmental budget, the business case can be developed at one go or in two stages. If it is conducted in two stages, the stage 2 business case study may be conducted after Step 2.)

	<b>Action</b>	<b>Objectives/Controls/Approvals</b>
	<b>Step 2<sup>3</sup> Funding</b>	
	Submit a bid via the policy bureau for funds through the RAE process	<ul style="list-style-type: none"> <li>➤ Secure capital funding under CWRP and ensure recurrent funding for the operation phase</li> </ul>
	<b>Step 3 Technical Assessments, Consultation and Land Requirements</b>	
	<b>Step 3.1</b> Conduct appropriate technical assessments and socio-economic studies	<ul style="list-style-type: none"> <li>➤ Assess the practicability, viability and justification of the facilities/services</li> <li>➤ Ensure compliance with EIAO (Cap 499)</li> <li>➤ Identify sustainability implications associated with the project</li> </ul>
	<b>Step 3.2</b> Conduct consultations	<ul style="list-style-type: none"> <li>➤ Consult relevant stakeholders of the project in an extensive, comprehensive, open and transparent manner</li> <li>➤ Ensure staff informed/consulted before public airing of the project</li> <li>➤ Obtain support/approval in principle/initial commitments from Policy Committee and appropriate LegCo Panel</li> <li>➤ Consult District Council and other statutory/non-statutory local/territory-wide bodies</li> <li>➤ Ensure on-going/regular consultation/communications with relevant stakeholders at different stages of the project</li> </ul>
	<b>Step 3.3</b> Seek necessary authorities' agreement on land use	<ul style="list-style-type: none"> <li>➤ Ensure appropriate zoning on town plan</li> <li>➤ Consider appropriate engineering conditions and/or the land allocation</li> <li>➤ Consider if the land allocation needs to be considered by ExCo or whether it can be done by Secretary for Development or Director of Lands under delegated authority</li> </ul>
	<b>Step 4 Expression of Interest Exercise</b>	
	Initiate an EoI exercise	<ul style="list-style-type: none"> <li>➤ Identify potentially interested parties</li> <li>➤ Generate ideas for inclusion in the subsequent RFP exercise</li> <li>➤ Pre-qualify companies for RFP exercise</li> </ul> <p>(Conduct EoI exercise after funding approval is obtained)</p>

<sup>3</sup> A PPP project is upgraded to a Category B PWP project during Step 2. Please refer to Appendix I for details.

	<b>Action</b>	<b>Objectives/Controls/Approvals</b>
<b>Step 5</b>	<b>Policy and Funding Approvals</b>	
<b>Step 5.1<sup>4</sup></b>	Consult and seek approvals of PWSC and FC	<ul style="list-style-type: none"> <li>➤ Justify the community need for the facilities/services</li> <li>➤ Demonstrate value for money</li> <li>➤ Seek approval for funding as appropriate (Where necessary, bureaux can approve RFP before securing FC's approval)</li> </ul>
<b>Step 5.2</b>	Determine detailed commercial arrangements	<ul style="list-style-type: none"> <li>➤ Sort out detailed funding arrangements and commercial terms. Key issues include: <ul style="list-style-type: none"> <li>- Payment mechanism</li> <li>- Contract duration</li> <li>- Land grant conditions, land premium, revenue, profit sharing</li> <li>- Principles/mechanism for measuring/sharing windfall profits e.g. refinancing gain</li> <li>- End of contract arrangements</li> </ul> </li> </ul>
<b>Step 5.3</b>	Seek draft land grant conditions	<ul style="list-style-type: none"> <li>➤ Consult Legal Advisory and Conveyancing Office of Lands D on the drafting of land grant document</li> <li>➤ Formalise land grant conditions</li> </ul>
<b>Step 6</b>	<b>Procurement and Selection</b>	
<b>Step 6.1</b>	Instruct DoJ on drafting of procurement documents/contract	<ul style="list-style-type: none"> <li>➤ Consult DoJ on the legal issues and start drafting the RFP documents, SLA, contract terms and other legal documents</li> </ul>
<b>Step 6.2<sup>5</sup></b>	Finalise procurement documents and seek approval from Central Tender Board	<ul style="list-style-type: none"> <li>➤ Draw up output-based performance specifications</li> </ul>
<b>Step 6.3</b>	Establish bid evaluation committee including the necessary departmental/technical/financial experts	<ul style="list-style-type: none"> <li>➤ Develop mechanism for evaluation of bids in a fair and objective manner</li> </ul>

<sup>4</sup> A PPP project is upgraded to a Category A PWP project during Step 5.1. Please refer to Appendix I for details.

<sup>5</sup> Departments may design and use their own non-standard contract forms to meet specific requirements of their contracts under SPR 345(b). Proposed marking schemes and tender reports require the approval of relevant tender boards.

	<b>Action</b>	<b>Objectives/Controls/Approvals</b>
<b>Step 6</b>	<b>Procurement and Selection (cont'd)</b>	
<b>Step 6.4</b>	Issue RFP	<ul style="list-style-type: none"> <li>➤ Publish notices in newspapers, government gazette, internet or invite companies/ consortia previously pre-qualified or short-listed in the EoI exercise to submit proposals</li> <li>➤ Ensure potential bidders understand clearly the requirements through briefings and site inspections</li> </ul>
<b>Step 6.5</b>	Evaluate proposals	<ul style="list-style-type: none"> <li>➤ Exclude proposals not meeting mandatory/ essential requirements</li> <li>➤ Conduct 2-envelope (technical and financial proposals) or 3-envelope (required facilities, additional facilities and financial aspects) evaluation</li> <li>➤ Compare bids with each other and with the PSC</li> <li>➤ Identify preferred bidder(s) (the best combination of technical and financial proposals)</li> </ul>
<b>Step 6.6</b>	Negotiate with bidder(s)	<ul style="list-style-type: none"> <li>➤ Consider how to maintain competitive pressure on bidders during negotiations</li> <li>➤ Prepare and seek approval of negotiating brief</li> <li>➤ Ensure the details of negotiations are fully recorded</li> <li>➤ Ensure the selection of bidders for negotiations meets the WTO GPA requirements</li> <li>➤ The process and procedures must fully comply with the provisions of relevant Financial Circulars and SPR</li> <li>➤ Ensure that necessary checks and balances (e.g. set up clear selection and assessment criteria and procedural guidelines) are in place to reduce corruption risk. Consult ICAC where and when necessary</li> <li>➤ Select from best and final offer(s)</li> </ul>

	<b>Action</b>	<b>Objectives/Controls/Approvals</b>
<b>Step 6</b>	<b>Procurement and Selection (cont'd)</b>	
<b>Step 6.7</b>	Award contract	<ul style="list-style-type: none"> <li>➤ Conduct due diligence checks to substantiate the bidder's claim of its capability, experience, expertise, financial position and reliability etc before signing the contract</li> <li>➤ Recommend the selection result to the relevant bid evaluation committee</li> <li>➤ Finalise the contract documents</li> <li>➤ Sign contract(s) on behalf of the Government, including those with third parties, e.g. financiers</li> </ul>
<b>Step 7</b>	<b>Service Commencement</b>	
<b>Step 7.1</b>	Commence construction	<ul style="list-style-type: none"> <li>➤ PSCom changes its role to monitoring and reporting the progress of the construction works of the project</li> <li>➤ PSCom should satisfy itself that standards, specifications, quality of works and the operation of the facilities meet the minimum standards agreed in the contract</li> </ul>
		
<b>Step 7.2</b>	Commissioning of facility	<ul style="list-style-type: none"> <li>➤ PSCom to facilitate commissioning</li> <li>➤ PSCom to satisfy itself that the facility, where appropriate, is able to satisfy the delivery of contracted performance</li> </ul>
<b>Step 7.3</b>	Commence service delivery	<ul style="list-style-type: none"> <li>➤ Contract Manager takes up the day-to-day monitoring role of the project once it becomes operational</li> <li>➤ Establish and maintain close and regular contact (e.g. regular liaison meeting) with the consortium to resolve problems before they become serious</li> <li>➤ Ensure comprehensive records of all interactions are kept properly</li> </ul>

<b>Action</b>	<b>Objectives/Controls/Approvals</b>
<b>Step 8 Payment and Contract Management</b>	
<b>Step 8.1</b> Make payment for the facilities/ services provided	<ul style="list-style-type: none"> <li>➤ Monitor performance regularly against defined criteria and take action to address poor performance</li> <li>➤ Re-negotiate with the consortium for changes and variations, if necessary</li> <li>➤ Payment will be made for services provided according to the contract as measured against the performance specifications</li> </ul>
<b>Step 8.2</b> Defer or reduce payment	<ul style="list-style-type: none"> <li>➤ If the consortium fails to perform, or fails to rectify defects at its own expense, payments will be reduced, deferred, or halted in accordance with the contract</li> </ul>
	
<b>Step 8.3</b> Institute investigations and issue warning	<ul style="list-style-type: none"> <li>➤ Request information for clarification, investigate the situation and require remedial measures to be taken by the consortium</li> <li>➤ If necessary, demand changes in consortium’s procedures, practices and management personnel</li> <li>➤ Issue warning and make it public when needed</li> <li>➤ Consider/initiate dispute resolution procedures</li> <li>➤ Consider private financier’s/Government’s ‘Step-in’ rights</li> <li>➤ May recommend termination of contract</li> </ul>
	
<b>Step 8.4</b> Terminate contract	<ul style="list-style-type: none"> <li>➤ Seek legal advice in case of failure of the consortium to perform up to specified performance standard</li> <li>➤ Consider: <ul style="list-style-type: none"> <li>- Resumption of sites and taking over of facilities</li> <li>- Compensation negotiation</li> <li>- Needs and procedures to replace failed consortium</li> </ul> </li> </ul>
	

<b>Action</b>	<b>Objectives/Controls/Approvals</b>
<b>Step 8</b>	<b>Payment and Contract Management (cont'd)</b>
<b>Step 8.5</b> Conduct joint inspection towards the end of the contract	<ul style="list-style-type: none"> <li>➤ Arrange for joint inspection of the assets with the consortium, e.g. two years before contract expiry, and require the consortium to make good any deficiencies</li> <li>➤ Consider establishing a sinking fund to protect against the possibility of non-performance of the rectification works</li> </ul>
<b>Step 8.6</b> Hand over facilities (at the end of the contract)	<ul style="list-style-type: none"> <li>➤ Assets revert to the Government</li> <li>➤ The contract should specify the required conditions of the assets at the end of the contract; ensure that any deficiencies are rectified by the consortium</li> <li>➤ Develop appropriate measures to ensure a smooth transition, e.g. access, training provided by the outgoing consortium to staff of the client department/the incoming consortium</li> </ul>

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# ANNEX B

## APPENDIX I: FUNDING PROCEDURES FOR PPP PROJECTS

This Appendix attempts to summarise the funding procedures to adopt for PPP projects. There is no separate PPP funding process and colleagues should familiarise themselves with the relevant Financial Circulars, Financial and Accounting Regulations and SPR.

The funding procedures for PPP projects mainly follow those for the conventional ones under the CWP, as detailed in Financial Circular No. 11/2004 and other circulars relating to the CWP. Some important issues/additional information that should be addressed/provided at different funding status (i.e. Categories C, B and A) of a PPP project are highlighted in the following paragraphs.

### Category C

A project may attain Category C status any time of the year upon submission of a PDS and a TFS approved by the Works Branch of Development Bureau. The requirements for the compilation of a PDS and TFS are set out in Financial Circular No. 11/2001.

For a PPP project, the following additional information on “Feasibility of PPP Approach” should also be provided<sup>1</sup>:

- ◆ Assessment that a PPP approach is viable and beneficial for the Government, e.g. findings/recommendations of preliminary feasibility studies
- ◆ Indications that the private sector is willing and able to take up the project, e.g. results of initial market testing exercise
- ◆ Assurance that there is no legal/statutory obstacle, or proposed measures to overcome such obstacles (if such exists).

### Category B

A Category C project will be upgraded to Category B status when funding has been approved in the Capital Works RAE and earmarked in the CWRF. The RAE submission should include the project details, estimated capital expenditure, recurrent implications, forecast cashflow requirements, implementation programme and other information as set out in the relevant circular memorandum issued by FSTB on the exercise regularly.

The construction of a PSC<sup>2</sup>, which is the estimated cost of the Government itself delivering the project output, can serve as an indication of the funding requirements of a PPP project for the bidding of resources. An itemised breakdown of the PSC components including the capital works elements (funding to be provided under the CWRF Account) and the recurrent/capital non-works elements (funding to be provided under the General Revenue Account) should be provided separately.

<sup>1</sup> Subject to the circumstances of individual projects (e.g. availability of funding for the business case studies), these information can be provided at a later stage (e.g. before the upgrading to Category B or A).

<sup>2</sup> For the purpose of resource bidding, it can be a Raw PSC, i.e. a base cost as if the project is to be funded by the Government under the conventional approach.

To substantiate the resource application, an appraisal on the recurrent consequences of a PPP project should be completed in accordance with Financial Circular No. 2/2005 in the same way as the conventional projects. These funding requirements will be scrutinised by FSTB before the submission of the project to PWSC/FC.

Once a project has attained Category B status, bureaux/departments can undertake the necessary pre-construction work to render the project ready in all respects for upgrading to Category A and commencement of work. The costs of pre-construction work will be charged to the appropriate works-related block allocations under the CWRF subject to their expenditure ceiling, as detailed in Financial Circulars No. 8/2001 and 2/2007. If the funding required is estimated to exceed \$21 million, it will be sought by upgrading part of the project to Category A.

## Category A

When all necessary pre-construction preparation, including statutory requirements and public consultation, has been completed, a Category B project will be upgraded to Category A status by seeking the endorsement of PWSC and the approval of FC. Guidelines for preparing PWSC submissions are set out in Financial Circular No. 2/2006.

For a PPP project, the following additional information should also be provided in the PWSC submission:

- ◆ Summary of the business case demonstrating how the PPP approach can achieve the best value for money
- ◆ Proposed commercial arrangements including contract duration, payment mechanism, and other partnership/financial arrangements
- ◆ Proposed allocation of responsibilities and risks between the Government and the private sector, with risk management/mitigation measures
- ◆ Results of any EoI exercise
- ◆ Staffing implications of the project and responses/comments received from staff consultation exercise(s)
- ◆ Sustainability implications of the project in accordance with the Guideline on Sustainability Assessment (SA No. 1/2006).

After FC has approved the upgrading of a project to Category A, the procedures for allocation of funds and creation of a subhead in the CWRF Estimates (before any commitment of funds can be made) are the same for PPP and conventional projects, as stipulated in Financial Circular No. 23/82.

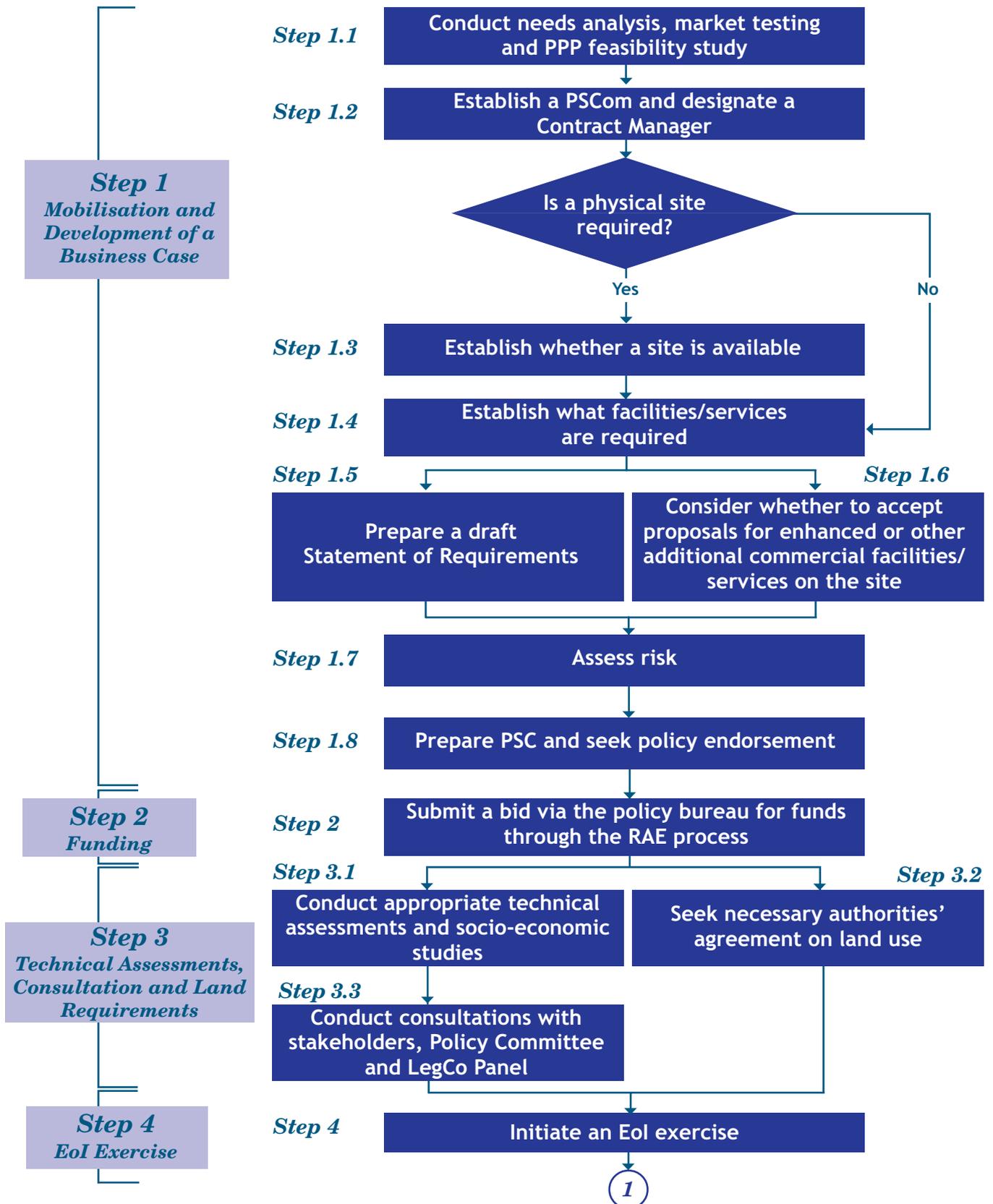
For recurrent/capital non-works funding, as most PPP contracts are likely to be lengthy and of relatively high value, FC's approval will be required before the actual allocation of the earmarked resources. Guidelines for preparing FC submissions are set out in Financial Circular No. 2/2006 and additional information should also be included similar to PWSC submissions as outlined above.

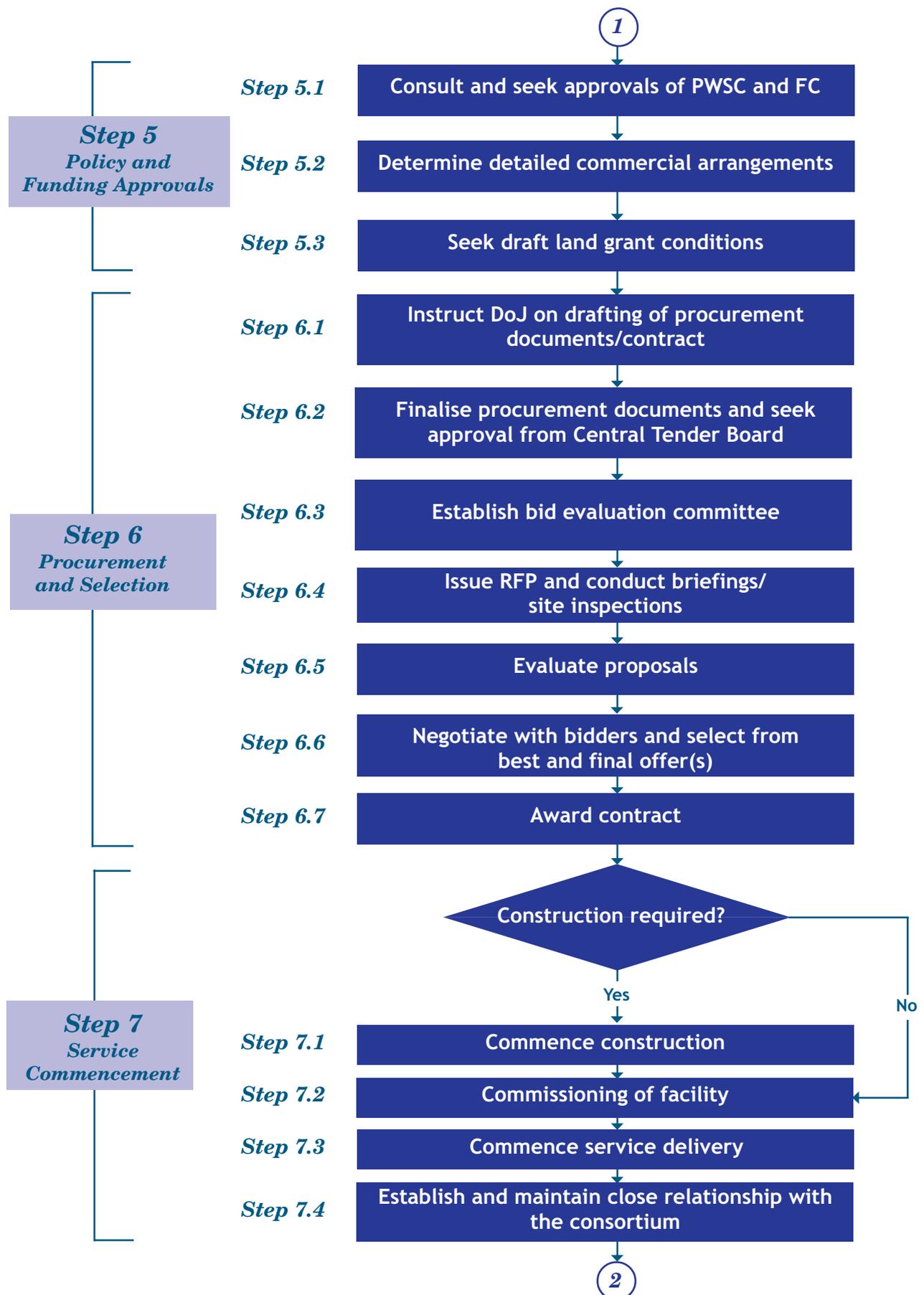
Similar to the requirements stipulated for conventional projects in Financial Circular No. 11/2004, substantial changes in a Category A PPP project, including all changes causing an increase in the approved project estimate by more than \$15 million and/or changes constituting a significant deviation from the approved project scope, require PWSC's endorsement and FC's approval. For minor changes to project scope and/or increase in approved project estimate which do not exceed \$15 million, approval will be sought from FSTB under delegated authority from FC.

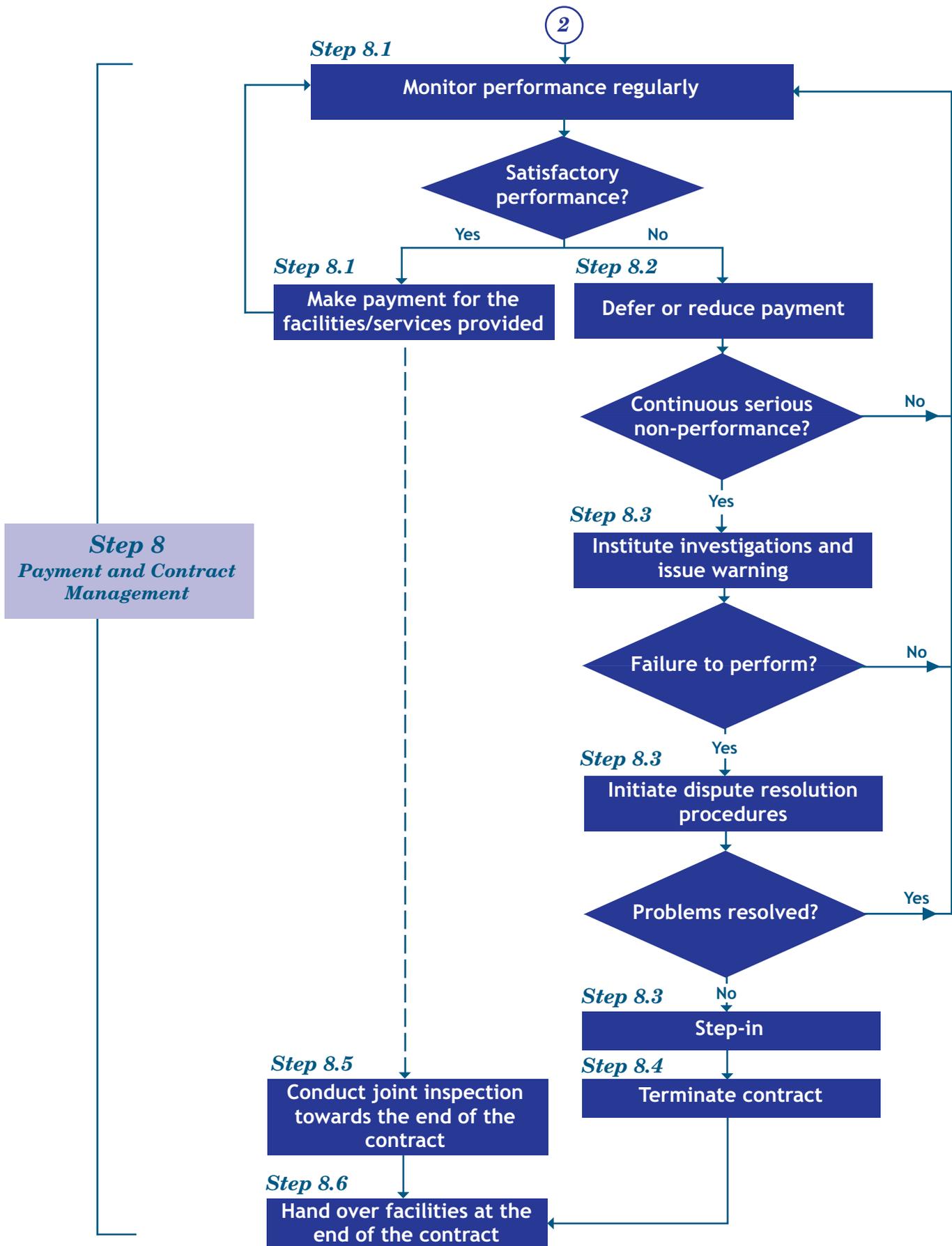
Although public funding is not required for financially free-standing PPP projects, the above procedures should still be followed, for the purpose of better project monitoring by FSTB.

# ANNEX C

## ESTABLISHING A PPP - FLOWCHART







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# ANNEX D

## CONSTRUCTING A PUBLIC SECTOR COMPARATOR (PSC)<sup>(NOTE)</sup>

The following paragraphs provide a brief outline of the key steps in constructing a PSC. A flexible approach should be adopted according to the specific characteristics and circumstances of individual projects.

### **Step 1: Formulate Output Specifications**

The output specifications set out the range of services which the Government seeks to procure and the performance levels required for each of the services.

### **Step 2: Define Reference Project**

The Reference Project should:

- ◆ Reflect the most efficient and achievable form of public sector delivery that can be employed to satisfy all elements of the output specifications, basing on current best practices
- ◆ Provide the same level and quality of services as expected to be provided by bidders to enable a like-with-like comparison
- ◆ Be framed to be a conforming bid as if it were part of the bidding process.

### **Step 3: Identify All Raw PSC Components**

The Raw PSC represents the base cost to the Government of producing and delivering the Reference Project. It comprises the following components:

- ◆ Direct costs, which are costs that can be traced or assigned to a particular service, which include:
  - Capital costs, e.g. costs for design and construction of a new facility, procurement of the required equipments and purchase/lease of land, other development costs, etc.
  - Capital receipts, e.g. as a result of upfront sale/lease/disposal of assets not involved in the provision of services (such receipts should be deducted from the cash flows of the Raw PSC, basing on their expected timing, if the same opportunity is also available to bidders)
  - Maintenance costs, e.g. costs of raw materials, tools/equipments, labour, etc. required for maintenance
  - Operating costs, e.g. costs of inputs and staff directly involved in the provision of services, insurance, etc.
- ◆ Indirect costs, which are other costs incurred that are not directly related to the provision of services, i.e. costs that contribute to the provision of a service but are not incurred exclusively for that one service, which include:
  - Capital costs, e.g. costs for partial commitment of plants/equipments, partial usage of administration buildings, etc.

- Operating costs, including corporate overheads (e.g. ancillary running costs of power, cleansing, stationery, non-core IT and equipments for administration, etc.) and administrative overheads (e.g. costs for employees not directly involved in the service provision, facilities management and project management, etc.)
- ◆ Expected third-party revenue, which over the life of the Reference Project reduces the net cost to the Government and should be deducted from the operating costs in the Raw PSC. Third-party revenue may be generated where:
  - Third-party demand exists for the infrastructure or related services
  - Service capacity exists above the government requirements
  - The Government allows third-party utilisation.

#### Step 4: Calculate Raw PSC

The Raw PSC should be calculated using the following formula:

$$\text{Raw PSC} = (\text{Capital Costs} - \text{Capital Receipts}) + \text{Maintenance Costs} + (\text{Operating Costs} - \text{Third-Party Revenue})$$

Expected cash flows of the components of the Raw PSC need to be forecast over the life of the Reference Project and should be expressed in terms of NPV using a discounted cash flow analysis that adjusts the future value of the expected cash flows to a common reference date. The following table is a simple example on the calculation of discounted cash flows (all figures are rounded to 2 decimal places).

Project Year	Cash Flow (a)	Discount Factor <sup>(1)</sup> (b)	Discounted Cash Flow (a)/(b)
1	100	1.00	100.00
2	80	1.05	76.19
3	70	1.10	63.49
4	70	1.16	60.47
5	50	1.22	41.14
6	45	1.28	35.26
7	30	1.34	22.39
8	25	1.41	17.77
9	25	1.48	16.92
10	20	1.55	12.89
NPV:			446.51

<sup>(1)</sup> Assuming a discount rate of 5% per year.

A similar approach should be adopted in calculating other components of a PSC (i.e. Competitive Neutrality, Transferable Risk and Retained Risk) to facilitate comparison of the PSC and private bids, which may have different cash flow patterns, on a common basis.

Advice should be sought from the Economic Analysis Division of EABFU on the appropriate discount rate(s) to be applied in the calculation of NPV.

### **Step 5: Calculate Competitive Neutrality Adjustments**

Competitive Neutrality removes the net competitive advantages/disadvantages which accrue to a government business by virtue of its public sector ownership. By including equivalent costs which will be incurred by bidders, it allows a fair and equitable comparison between a PSC and other private bids.

Competitive advantages from public sector ownership (amounts that should be added to a PSC) include exemption from rates, government rent, taxes, duties, fees and charges, accommodation costs, legislation/regulation, etc. which are only levied on or paid by private enterprises, while competitive disadvantages (amounts that should be deducted from a PSC) may also arise, e.g. heightened public scrutiny and reporting requirements which are not faced by private enterprises.

Competitive neutrality costs should be identified and included as NPVs of the projected cash flows over the life of the Reference Project.

### **Step 6: Identify All Material Risks**

In the context of a PSC, risks reflect the potential for additional costs above the base case assumed in the Raw PSC or for revenue below it. It is therefore necessary to include a comprehensive and realistic pricing of all quantifiable and material risks in the construction of a PSC.

For valuation purpose, a PSC only includes quantifiable and material risks. However, efforts should be made to identify and document all risks associated with the project. It should be noted that a number of similar risks, which may be immaterial by themselves, may become material when aggregated. The reasons for excluding unquantifiable risks from a PSC should also be properly recorded.

### **Step 7: Quantify Consequences of Risks**

Once all material risks have been identified, it is necessary to assess and quantify the possible consequences, both direct and indirect, of each risk eventuating, including the effect of any timing issues as different risks typically have different cost/time profiles over the term of a project.

A useful tool for identifying the consequences and financial impacts of risks is a risk matrix, which should indicate how each risk should be allocated (transferred, retained or shared), and identify the main consequences, financial impacts and potential mitigation strategies for each risk.

### **Step 8: Estimate Probabilities of Risks**

Having identified the material risks and assessed the variety of potential consequences, it is then necessary to estimate the probability of each of the consequences occurring and to consider whether the probability is expected to change over time.

There are various risk valuation techniques which can be used to provide probability estimates, ranging from simple techniques that provide a subjective estimate of probability to more advanced multivariable statistical techniques. The technique that is adopted for a particular project or a particular risk depends on the significance of the project and the complexity of the risks within it.

### **Step 9: Calculate Value of Risks**

As there is often more than one possible consequence for a particular risk, the value of each risk is then the sum of all these probability weighted consequences.

In addition, although a particular risk may be identifiable, it may be much more difficult to readily assess all the financial impacts associated with that risk. A contingency factor should therefore be included in each major risk category to account for any unobservable costs which will otherwise lead to undervaluation of the risk.

The value of each risk should be calculated individually using the following formula:

$$\text{Value of Risk} = (\text{Consequence} \times \text{Probability of Occurrence}) + \text{Contingency}$$

For example, when considering the construction risk of a new facility, the following consequences may arise:

- ◆ Increase in construction costs (cost overrun)
- ◆ Delay in construction schedule (time overrun)
- ◆ Additional costs for providing similar services during the delay period, generally from existing facilities (service maintenance).

The value of construction risk can be calculated by working out the following tables (all figures are rounded to 2 decimal places):

**Table 1: Valuation of Consequences**

Consequence	Scenario		Additional Cost (\$M)	Probability	Value (\$M)
Cost overrun <sup>(1)</sup>	Below base cost (10%)		-10	5%	-0.50
	No deviation		0	15%	0.00
	Likely	10% overrun	10	40%	4.00
	Moderate	15% overrun	15	25%	3.75
	Extreme	25% overrun	25	15%	3.75
				<b>Sub-total:</b>	<b>11.00</b>
Time overrun <sup>(2)</sup>	On Time		0	15%	0.00
	Likely	1-year delay	4	50%	2.00
	Moderate	1½-year delay	6	25%	1.50
	Extreme	2-year delay	8	10%	0.80
				<b>Sub-total:</b>	<b>4.30</b>
Service maintenance <sup>(3)</sup>	On Time		0	15%	0.00
	Likely	1-year delay	2	50%	1.00
	Moderate	1½-year delay	3	25%	0.75
	Extreme	2-year delay	4	10%	0.40
				<b>Sub-total :</b>	<b>2.15</b>
Contingency <sup>(4)</sup>	-		-	-	2.00
				<b>Total:</b>	<b>19.45</b>

<sup>(1)</sup> Assuming a total base cost of \$100 million.

<sup>(2)</sup> Assuming a cost of \$4 million per year.

<sup>(3)</sup> Assuming a cost of \$2 million per year.

<sup>(4)</sup> Assuming a factor of 2% of the total base cost.

**Table 2: Timing Weightings of Consequences**

Consequence	Year 1	Year 2	Year 3	Total
Cost overrun	70%	30%	-	100%
Time overrun	80%	20%	-	100%
Service maintenance	-	80%	20%	100%
Contingency	70%	30%	-	100%

**Table 3: Weighted Valuation of Consequences**

Consequence	Year 1 (\$M)	Year 2 (\$M)	Year 3 (\$M)	Total (\$M)
Cost overrun	7.70 (11 x 70%)	3.30 (11 x 30%)	-	11.00
Time overrun	3.44 (4.3 x 80%)	0.86 (4.3 x 20%)	-	4.30
Service maintenance	-	1.72 (2.15 x 80%)	0.43 (2.15 x 20%)	2.15
Contingency	1.40 (2 x 70%)	0.60 (2 x 30%)	-	2.00
<b>Total:</b>	<b>12.54</b>	<b>6.48</b>	<b>0.43</b>	<b>19.45</b>

**Table 4: Discounted Cash Flows of Construction Risk**

Item	Year 1 (\$M)	Year 2 (\$M)	Year 3 (\$M)	Total (\$M)
Cash flow	12.54	6.48	0.43	19.45
Discount factor <sup>(1)</sup>	1.00	1.05	1.10	-
Discounted cash flow	12.54	6.17	0.39	19.10
<b>Construction risk in NPV:</b>				<b>19.10</b>

<sup>(1)</sup> Assuming a discount rate of 5% per year.

The above process should be repeated for all the material risks which have been identified and the total value of risk is then calculated by aggregating the value of all these material risks.

### Step 10: Identify Desired Risk Allocation

It will then be necessary to classify these values into Transferable Risks, which the Government will allocate to bidders and Retained Risks, which risks the Government will bear itself, basing on an optimal level of risk transfer.

### Step 11: Calculate Transferable Risk and Retained Risk

The value of Transferable Risk measures the cost that the Government is willing to pay for those risks which it proposes to transfer to bidders.

The value of Retained Risk measures the cost of those risks which the Government proposes to bear itself. Including the cost of Retained Risk in a PSC provides a comprehensive measure of the full cost to the Government for the Reference Project, and its value can be added to each of the private bids to allow a meaningful comparison, particularly when different bidders accept different levels of risk transfer.

There may be situations where specific components of a particular risk are allocated between parties, or where an overall risk is shared. Under these circumstances, it is necessary to separate the risk into Transferable and Retained Risk components. Risk sharing may be dealt with according to an agreed formula contained in a negotiated contract.

Once all the Transferable Risks and Retained Risks have been identified, the size and timing of the expected cash flows associated with each risk needs to be expressed as a NPV over the life of the Reference Project. Each of the risks should be included as a separate cash flow item and then aggregated to form the Transferable and Retained Risk components of a PSC. This allows for a detailed analysis of the key risks and their sensitivity to the overall PSC.

### Step 12: Calculate PSC

Finally, a PSC should be calculated as the sum of the four components, in terms of NPV, as follows:

$$\text{PSC} = \text{Raw PSC} + \text{Competitive Neutrality} + \text{Transferable Risk} + \text{Retained Risk}$$

*Note: With acknowledgements to 'Partnerships Victoria Guidance Material: Public Sector Comparator - a technical note' (June 2001)*

# ANNEX E

## RISK MATRIX EXAMPLE

### Reprovisioning of a Government Water Treatment Plant under PPP Approach

No	Risk Type/ Risk Item Description	Consequence	Most Impacted Parties <sup>(Note 1)</sup>  High/ Medium/ Low Probability/ Impact	Preferred Allocation	Risk Managing Strategy: Avoid/ Minimise/ Transfer/ Allocate <sup>(Note 2)</sup>	Commercial Principle/ Contractual Terms between Government and Consortium
Notes						
<p>1. In general, Government and consumers will be impacted by delay of service commencement; while Consortium will be impacted due to possible payment reduction or abatement, or even termination</p> <p>2. Avoid - Avoid or ensure conditions that eliminate certain risks            Minimise - Minimise by reducing the likelihood or severity of certain risks            Transfer - Transfer of unavoidable risks to a third party to carry the risk            Allocate - Accept and allocate the remaining risks to the party most able to carry it at the lowest overall cost</p>						
<b>Pre-Construction</b>						
1	<b>Site</b> Site not available due to delay in granting of lease	Project delay	Consortium, Government  L/M	Government	Government to organise by commencing process well in advance of contract signing	Contract specifies clearly responsibility of Government in arranging the lease
2	<b>Site</b> Site conditions not suitable for proposed way of reprovisioning	Increased construction costs, project delay	Consortium, Government  L/H	Consortium	Consortium to minimise by expert investigation with detailed information from Government	Contract specifies Consortium's responsibility in this aspect
3	<b>Site</b> Contamination of site	Consortium needs extra costs to rectify the site	Consortium  L/M	Government	Government to minimise by expert investigation	Contract specifies Government's responsibility in this aspect

No	Risk Type/ Risk Item Description	Consequence	Most Impacted Parties <sup>(Note 1)</sup>  High/ Medium/ Low Probability/ Impact	Preferred Allocation	Risk Managing Strategy: Avoid/ Minimise/ Transfer/ Allocate <sup>(Note 2)</sup>	Commercial Principle/ Contractual Terms between Government and Consortium
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Pre-Construction (cont'd)						
4	<b>Financing</b> Consortium cannot obtain adequate financing, either equity or debt, or on the anticipated conditions	Cannot achieve financial closure, and no funding for construction	Consortium, Government  M/H	Consortium	Consortium to minimise through engaging lenders early in the bidding stage	Government will require all bidders to have fully documented financial commitments which are realistic and achievable
5	<b>Financing</b> Interest rates higher than anticipated	Higher debt servicing cost	Consortium  M/H	Consortium	Consortium to minimise through engaging lenders early in the bidding stage	Tariff payment will not be adjusted in accordance with interest rate fluctuation
6	<b>Consortium</b> Consortium becomes insolvent before completion	Reprovisioning cannot be completed	Government and lender  L/H	Government	Minimise through careful selection of Consortium	Government, Consortium and construction contractor to enter into tripartite agreement to ensure construction work can continue

No	Risk Type/ Risk Item Description	Consequence	Most Impacted Parties <sup>(Note 1)</sup>  High/ Medium/ Low Probability/ Impact	Preferred Allocation	Risk Managing Strategy: Avoid/ Minimise/ Transfer/ Allocate <sup>(Note 2)</sup>	Commercial Principle/ Contractual Terms between Government and Consortium
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Design and Construction						
7	<b>Completion and commissioning</b> Inappropriate design of plant or associated facilities	Consortium cannot deliver water at required quality or quantity	Government, consumers  L/H	Consortium	Consortium can transfer this to contractors. Government to minimise through monitoring provisions	<ol style="list-style-type: none"> <li>1. Government will only pay if outcome of audit of technical completion is satisfactory</li> <li>2. Government will require warranties from Consortium regarding suitability of the design and construction work for the intended purpose</li> <li>3. Government will approve the terms of construction contract between Consortium and the design/ construction contractor</li> <li>4. Contract will provide for Government's right in monitoring design</li> </ol>

No	Risk Type/ Risk Item Description	Consequence	Most Impacted Parties <sup>(Note 1)</sup>  High/ Medium/ Low Probability/ Impact	Preferred Allocation	Risk Managing Strategy: Avoid/ Minimise/ Transfer/ Allocate <sup>(Note 2)</sup>	Commercial Principle/ Contractual Terms between Government and Consortium
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Design and Construction (cont'd)						
8	<b>Completion and commissioning</b> Delay of construction	Reprovisioning project cannot be completed at the agreed Technical Completion Date	Government, consumers, Consortium, lender  M/H	Consortium	Consortium to minimise through proper selection of contractors and fixed term contract. Government to minimise through monitoring provisions	Contract will provide for Government's right in monitoring construction. Failure to meet the agreed Technical Completion Date will constitute default. Contractors need to provide third party performance bonds to Consortium, assignable to lenders
9	<b>Completion and commissioning</b> Cost overrun during construction	Affect Consortium's cash flow and financial viability	Consortium  M/H	Consortium	Consortium to transfer to construction contractors through fixed term, fixed price contract	Penalty provisions in Consortium's construction contract with construction contractor
10	<b>Completion and commissioning</b> Cannot complete commissioning test	Reprovisioning project cannot be completed at the agreed Technical Completion Date	Government, consumers, Consortium, lender  L/H	Consortium	Consortium to minimise by conducting relevant tasks well in advance of the commissioning date	Contract will specify all timing, scope and details of necessary audits and inspections, etc. Government will only pay if outcome of audit of technical completion is satisfactory

No	Risk Type/ Risk Item Description	Consequence	Most Impacted Parties <sup>(Note 1)</sup>  High/ Medium/ Low Probability/ Impact	Preferred Allocation	Risk Managing Strategy: Avoid/ Minimise/ Transfer/ Allocate <sup>(Note 2)</sup>	Commercial Principle/ Contractual Terms between Government and Consortium
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#### Pre-Commissioning

11	<b>Industrial relations</b> Government is unable to handle existing staff to their satisfaction	Affect transition of plant to Consortium, and project delay	Consortium and Government  M/H	Government or Shared	Government to minimise through proper consultation and communication	While Government could try to handle all existing staff on its own, it could also specify in the contract the minimum percentage of existing staff to be transferred to the Consortium under specific employment terms
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#### Pre-Commissioning and Operation

12	<b>Contract variation</b> Changes in service requirements by Government, or regulatory changes initiated by Government as a water authority	May require changes in design, additional capacity or new technology or process, which will call for additional capital investment or operating costs	Consortium  L/H	Government or Shared	Government to minimise through better planning, and adopting outcome specifications. Consortium to design facilities with scope for expansion or technology upgrade	Contract provides for tariff re-negotiation to compensate for additional capital investment or costs of Consortium
13	<b>Regulatory changes</b> General regulatory changes (including tax) applicable in general to most businesses	May result in higher capital or operating costs	Consortium  L/H	Consortium	Consortium should factor in such changes in their price estimation	Tariff payment will not be adjusted even if regulatory changes result in higher costs

No	Risk Type/ Risk Item Description	Consequence	Most Impacted Parties <sup>(Note 1)</sup>  High/ Medium/ Low Probability/ Impact	Preferred Allocation	Risk Managing Strategy: Avoid/ Minimise/ Transfer/ Allocate <sup>(Note 2)</sup>	Commercial Principle/ Contractual Terms between Government and Consortium
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Pre-Commissioning and Operation (cont'd)						
14	<b>Consortium</b> Change in Consortium's ownership structure, e.g. being acquired by a third party	Uncertain of new company's ability to execute the contract	Government and lender  L/M	Government	Minimise through appropriate provisions/restrictions in the contract	Contract provides for assignment of contract, and restrictions on changes in Consortium's equity structure
15	<b>Consortium</b> Consortium's creditworthiness	Incomplete project or suspension of treatment service	Government and lender  L/H	Government	Minimise through careful selection of Consortium	Consortium to demonstrate its credit worthiness through standby credit facilities. Lender will require assets pledge of project assets and contractual rights. Proceeds of Government payments will be deposited in an escrow account for servicing debt
16	<b>Consortium</b> Consortium lacks commitment, fails to execute contract or abandon the project	Incomplete project or suspension of treatment service	Government and lender  L/H	Consortium	Minimise through choosing appropriate PPP model	Consortium to demonstrate its commitment through certain level of equity investment. Contract provides for step in right of Government and lender, warranties, performance guarantees, indemnities and liabilities

No	Risk Type/ Risk Item Description	Consequence	Most Impacted Parties <sup>(Note 1)</sup>  High/ Medium/ Low Probability/ Impact	Preferred Allocation	Risk Managing Strategy: Avoid/ Minimise/ Transfer/ Allocate <sup>(Note 2)</sup>	Commercial Principle/ Contractual Terms between Government and Consortium
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#### Pre-Commissioning and Operation (cont'd)

17	<b>Government</b> Government terminates project or PPP agreement in accordance with changes in Government policy	Incomplete project	Consortium  L/M	Government	Minimise through appropriate provisions in the contract	Contract provides for warranties, indemnities, liabilities and compensation mechanism for early termination of contract
18	<b>Dispute</b> Dispute arising during contract period	Suspension of project or water treatment service	Government, consumers, and lender  M/H	Shared	Minimise by resolving problems before they become serious	Contract will specify dispute resolution process including escalation mechanism

#### Construction and Operation

19	<b>Financing</b> Consortium cannot secure additional financing for expansion of capacity or rebuilding due to changes in service requirements	Cannot complete further works required	Consortium  L/M	Government or Shared (depending on the contractual arrangements)	Government to minimise through better planning	Government will provide additional capital investment if changes in requirements is initiated by Government subject to funding approval of FC
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No	Risk Type/ Risk Item Description	Consequence	Most Impacted Parties <sup>(Note 1)</sup>  High/ Medium/ Low Probability/ Impact	Preferred Allocation	Risk Managing Strategy: Avoid/ Minimise/ Transfer/ Allocate <sup>(Note 2)</sup>	Commercial Principle/ Contractual Terms between Government and Consortium
<b>Operation</b>						
20	<b>Completion and commissioning</b> Failure to obtain necessary approvals and licences	Delay of commissioning leading to delay in cost recovery and debt servicing	Consortium and lender  L/H	Consortium or (if due to Government's action or inaction) Shared	Consortium to minimise by conducting relevant tasks well in advance of the commissioning date	Government will only compensate for delay in approvals under its own control
21	<b>Performance</b> Treated water output fails to meet required quantity	Shortage of treated water supply	Government, consumers  L/H	Consortium	Government to minimise through monitoring provisions	Minimum output required to be specified in the contract. Failure to meet this will constitute default. Consortium needs to provide performance bonds. Contract will provide for Government's right in monitoring
22	<b>Performance</b> Water fails to meet required quality	Health hazard	Government, consumers  L/H	Consortium	Government to minimise through monitoring provisions	Minimum quality standards specified in the contract. Failure to meet standards will constitute default. Consortium needs to provide performance bonds. Contract will provide for Government's right in monitoring
23	<b>Market/volume</b> Actual consumer demand less than anticipated	Consortium cannot recover capital investment	Consortium, Government  M/H	Government	Government to minimise through better consumption forecast	Tariff payment will comprise fixed and variable components, with the fixed one being guaranteed for payment for a minimum off take volume

No	Risk Type/ Risk Item Description	Consequence	Most Impacted Parties <sup>(Note 1)</sup>  High/ Medium/ Low Probability/ Impact	Preferred Allocation	Risk Managing Strategy: Avoid/ Minimise/ Transfer/ Allocate <sup>(Note 2)</sup>	Commercial Principle/ Contractual Terms between Government and Consortium
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Operation (cont'd)						
24	<b>Market/ volume</b> Government draws treated water from competing treatment plants leading to lower demand from reprovisioned plant	Consortium cannot recover capital investment	Consortium  L/H	Government	Government to minimise through better planning of new treatment facilities	Government will guarantee minimum volume uptake of treated water from reprovisioned plant through the off take agreement
25	<b>Market/ volume</b> Higher consumption than anticipated, calling for additional capacity	Increased capital investment	Consortium  L/L	Shared	Government to minimise through better consumption forecast	Contract provides for tariff re-negotiation to compensate for additional capital investment of Consortium
26	<b>Market/ volume</b> Dispute over volume/quality of treated water supplied to Government	Either Government overpays or the Consortium is underpaid	Government or Consortium  L/L	Shared	Avoid through specifying ways of measurement	Contract will specify the ways to measure volume/quality of treated water supplied to Government, including instrument type, method of measurement, calibration requirements, and ways to resolve disputes over measurement

No	Risk Type/ Risk Item Description	Consequence	Most Impacted Parties <sup>(Note 1)</sup>  High/ Medium/ Low Probability/ Impact	Preferred Allocation	Risk Managing Strategy: Avoid/ Minimise/ Transfer/ Allocate <sup>(Note 2)</sup>	Commercial Principle/ Contractual Terms between Government and Consortium
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Operation (cont'd)						
27	<b>Macro-economic</b> Cost variation due to inflation	Consortium cannot recover operating cost due to inflation, or Government cannot lower costs despite deflation	Consortium  M/M	Shared or Consortium	Consortium should factor in such changes in their price estimation	If risk is shared, variable part of the tariff payment will be indexed to Consumer Price Index
28	<b>Input costs</b> Cost variation due to reasons other than inflation	Consortium cannot recover operating cost if costs increase, or Government cannot benefit due to cost reduction	Consortium  M/M	Consortium or Shared	Consortium to minimise through factoring future cost increase into tariffs, and through setting up long term supply contracts	In general Consortium will bear risk of cost increase, but contract allows re-negotiation of payment if there is material changes to input costs (e.g. power costs). Contract clause to allow efficiency gain to be shared with Government
29	<b>Raw water supply</b> Fluctuation of quality of raw water	Consortium bears higher treatment cost if quality deteriorates, or Government cannot benefit cost reduction if quality improves	Consortium  M/M	Shared but with Government having sole interface with the raw water supplier	Government to minimise through quality specifications in Raw Water Purchase Agreement with raw water supplier	In the Raw Water Purchase Agreement with Consortium, Government will commit quality standards and specify consequences of not delivering quality up to standards. Contract will allow re-negotiation of tariffs if raw water quality substantially improves or deteriorates on a permanent basis

No	Risk Type/ Risk Item Description	Consequence	Most Impacted Parties <sup>(Note 1)</sup>  High/ Medium/ Low Probability/ Impact	Preferred Allocation	Risk Managing Strategy: Avoid/ Minimise/ Transfer/ Allocate <sup>(Note 2)</sup>	Commercial Principle/ Contractual Terms between Government and Consortium
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Operation (cont'd)						
30	<b>Raw water supply</b> Inadequate supply of raw water from sources	Consortium cannot deliver required treated water output	Consortium  L/M	Government	Government to minimise through long term Raw Water Purchase Agreement with raw water supplier	In the Raw Water Purchase Agreement, Government will commit volume and specify consequences of not delivering up to committed volume
31	<b>Raw water supply</b> Increase in cost of raw water	Increased production cost of treated water	Consortium  M/M	Shared but with Government having sole interface with the raw water supplier	Government to minimise through long term Raw Water Purchase Agreement with raw water supplier	Contract provides for tariff adjustment in relation to changes in raw water prices
32	<b>Maintenance</b> Technical failure due to poor maintenance	Suspension of service due to technical failure	Consortium and Government  L/H	Consortium	Consortium to transfer risk to contractor through long-term maintenance contracts. Government to minimise through monitoring provision	Consortium will secure performance bonds and warranties from contractors, which will last for a few years after completion. After that, repair risk will be borne by Consortium
33	<b>Technology</b> Technology obsolescence	Consortium cannot enjoy efficiency gain from latest technology	Consortium  L/L	Consortium	Consortium to transfer risk to contractor through long-term maintenance contracts	Output/outcome oriented service specifications will allow Consortium to upgrade technology. Contract provides for Government to share efficiency gain through technology upgrade, and provides for technology transfer to Government

No	Risk Type/ Risk Item Description	Consequence	Most Impacted Parties <sup>(Note 1)</sup>  High/ Medium/ Low Probability/ Impact	Preferred Allocation	Risk Managing Strategy: Avoid/ Minimise/ Transfer/ Allocate <sup>(Note 2)</sup>	Commercial Principle/ Contractual Terms between Government and Consortium
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Operation (cont'd)						
34	<b>Financing</b> Interest rate fluctuation	Higher debt servicing cost	Consortium  M/H	Consortium	Minimise through interest rate hedging tools	Tariff payment will not be adjusted in accordance with interest rate fluctuation
35	<b>Financing</b> Refinancing results in higher interest costs	Higher debt servicing cost	Consortium  H/M	Shared or Consortium (depending on the contractual arrange- ments)	Consortium to minimise through striving for a longer term loan, and to price the risk in through higher service fees	If shared, contract will provide for both parties to re- negotiate tariffs if interest costs change substantially due to refinancing
36	<b>Financing</b> Consortium restructure project finances	Consortium lowers its financing costs	Consortium  L/L	Shared (depending on the contractual arrange- ments)	Government to ensure the sharing of benefit through appropriate provision in the contract	Contract provides for Government right to share the benefit through re- negotiating tariffs
37	<b>Consortium</b> Consortium has short term cash flow problem	Consortium fails to service debt temporarily	Lender  L/H	Lender	Minimise through escrow account	Consortium will be required to set up an escrow account funded by proceeds from Government's payment for repaying lender
38	<b>Consortium</b> Consortium becomes insolvent during operation	Suspension of water treatment service and failure to service debt	Government and lender  L/H	Government	Minimise through careful selection of Consortium	Step in right of Government and lender in case Consortium cannot continue service

No	Risk Type/ Risk Item Description	Consequence	Most Impacted Parties <sup>(Note 1)</sup>  High/ Medium/ Low Probability/ Impact	Preferred Allocation	Risk Managing Strategy: Avoid/ Minimise/ Transfer/ Allocate <sup>(Note 2)</sup>	Commercial Principle/ Contractual Terms between Government and Consortium
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Operation (cont'd)						
39	<b>Government</b> Government fails to pay Consortium on time (Government's creditworthiness is less an issue compared with PPP projects in other developing countries)	Consortium cannot service debt	Consortium and lender  L/H	Government	Minimise through payment terms and escrow account	Contract provides for clear payment terms (including consequences for late payment), and requirement for Government to set up escrow account (with deposits from consumers' tariff payments)
40	<b>Government</b> The responsible department changes in organisation, status, e.g. become privatised	Change in Government credit rating resulting in higher interest rates	Consortium  L/M	Government	Government to minimise through appropriate provisions in the contract	Government guarantees power of department to execute contract even after changes in minimisation status
41	<b>Force majeure</b> Emergency or unforeseeable events caused by reasons of force majeure that prevent normal operation of water treatment plant	Suspension of water treatment service	Government and Consortium  L/H	Shared	Minimise through contingency plans and insurance	Consortium will not be subject to default regime provided that remedial steps are taken within an agreed timeframe. Consortium will not be paid during force majeure when water treatment service is suspended

No	Risk Type/ Risk Item Description	Consequence	Most Impacted Parties <sup>(Note 1)</sup>  High/ Medium/ Low Probability/ Impact	Preferred Allocation	Risk Managing Strategy: Avoid/ Minimise/ Transfer/ Allocate <sup>(Note 2)</sup>	Commercial Principle/ Contractual Terms between Government and Consortium
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Decommissioning						
42	<b>Asset</b> Facilities/ equipment not maintained at good conditions	Government cannot get back assets at anticipated conditions	Government  L/M	Consortium	Government to avoid through appropriate end-of-term arrangement	Contract provides for renewal at end of contract, and allows Government to recover costs from Consortium for repairing and maintaining assets not in specified conditions. This will discourage Consortium to run down assets towards end of contract

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# ANNEX F

## HEADS OF TERMS (NOTE)

### PROJECT AGREEMENT

#### Content

##### Duration of Contract

**Service Commencement**

- Government's role
- Critical dates
- Submission of designs and information to Government
- Quality management systems
- Acceptance and service commencement
- Existing services

**Protections against Late Service Commencement**

- Liquidated damages
- Performance bonds
- Parent company guarantees
- Long-stop date
- Bonus payments for early service commencement

**Supervening Events**

- Compensation events
  - Calculation
- Relief events
  - Scope
  - Consequences
- Force majeure events
  - Scope
  - Consequences
  - Relief events, force majeure events and insurance

**Information Warranties**

- Due diligence
- Government warranties
  - Exclusion
- Benefit of surveys and reports
- Latent defects risk

<b>Service Requirements and Availability</b>	Definition of unavailability
	Payment for availability and weighting of critical areas
	When does availability commence?
	When does unavailability commence?
	Rectification of unavailability
	Service unavailable but used
	Restoration of availability
	Planned maintenance
<b>Maintenance</b>	Maintenance
	Sinking fund
	Expiry of contract
	Transfer of assets at end of contract
	Surveys
<b>Performance Monitoring</b>	Setting performance level
	Monitoring
	Commencement of performance monitoring
	Replacement of sub-contractors
	Who does the monitoring?
	Who pays for the monitoring?
	Addressing qualitative factors?
	Monitoring of sub-contractors
	Report the results of performance monitoring
Consequences of poor performance	
<b>Price and Payment Mechanism</b>	Features
	Direct financial incentives
	Indirect non-financial incentives
	Structuring the Payment Mechanism
	Financeability
<b>Payments and Set-off</b>	Scope of Government's right to set off
	Timing of set-off
<b>Change in Service</b>	Government changes
	Means of payment
	Small work changes
	Contractor changes in service

<b>Change in Law</b>	<p>Allocation of risk</p> <p>Mitigation</p> <p>Discriminatory, specific and general changes in law</p> <p>General change in law at contractor's risk</p> <p>General change in law as a shared risk</p> <p>Changes in tax law</p>
<b>Price Variations</b>	<p>Indexation</p> <p>Benchmarking</p> <p>Market testing</p>
<b>Sub-contractors and Employees</b>	<p>Control over sub-contractors</p> <p>Control over employees</p>
<b>Assignment</b>	<p>Restrictions on the contractor</p> <p>Restrictions on the Government</p> <p>Restrictions on the senior lenders</p>
<b>Change of Ownership</b>	<p>Government's concerns</p> <p>Shareholders' concerns</p> <p>Exceptions to the general rule</p>
<b>Treatment of Assets on Expiry of Service Period</b>	<p>Assets where Government retains residual value on expiry</p> <p>Preserving the condition of the assets on expiry</p> <p>Handover provisions for assets which transfer to Government</p> <p>Transfer of residual value risk</p> <p>Valuation of terminal payments on expiry where residual value risk has been transferred</p>
<b>Early Termination</b>	<p>Termination on Government default</p> <ul style="list-style-type: none"> <li>- Contractor's rights to terminate for Government default</li> <li>- Compensation on termination for Government default</li> </ul> <p>Termination on contractor default</p> <ul style="list-style-type: none"> <li>- Event leading to termination</li> <li>- Termination for persistent breach by the contractor</li> <li>- Rectification</li> <li>- Compensation on termination for contractor default</li> <li>- Market value</li> <li>- Retendering election and liquid market</li> <li>- Retendering procedure</li> <li>- No retendering</li> </ul>

<b>Early Termination (cont'd)</b>	Termination on force majeure
	- Failure to agree
	- Compensation
	Termination on corrupt gifts and fraud
	Voluntary termination by Government
	- Consequences
	- Compensation
	Termination for breach of the refinancing provisions
	- Compensation
<b>Calculation and Payment of Early Termination Payments</b>	Method of payment
	Retention of assets by contractor on termination
<b>Survey on Expiry and Termination</b>	Timing
	Retention fund
	Guarantees or bonds
<b>Indemnities, Guarantees and Contractual Claims</b>	Guarantees
	Indemnities
	Collateral warranties
	Financiers' security
	Damages claims
<b>Insurance</b>	Government's requirements
	Mechanism to increase insured amounts
	Ensuring the quality of the insurances
	Changes in the terms of insurance policies
	Reinstatement and change of requirement after insured event
	Application of insurance proceeds
	Risks that become uninsurable
Control of the defence on litigation of an insured event	
<b>Information and Confidentiality</b>	Government openness
	Recommended approach
	Nature of commercially sensitive information
<b>Intellectual Property Rights</b>	Infringement by the contractor
	Infringement by the Government
	Rights on expiry or termination

<b>Dispute Resolution</b>	Dispute resolution procedure Joinder of sub-contract disputes Delays caused by disputes
<b>Government Step-in</b>	Step-in without contractor breach Step-in on contractor breach Rights of access
<b>Miscellaneous</b>	Data protection Public relations and publicity Waiver Severability Counterparts Law of the contract and jurisdiction Third party rights Contractor's records Interest on late payments Continuing obligations
<b>Direct Agreement</b>	Liability of senior lenders Recommended approach Liability for indemnity claims or claims for damages direct agreement
<b>Land and Property Interests</b>	Land/Property transfer Land/Property purchase Composite trader
<b>Alternatives to and Variants of Project Finance</b>	
<b>Due Diligence</b>	Financing documents Sub-contracts
<b>Refinancing</b>	Government consent Exemptions Method of calculating, sharing and paying benefits Audit rights and transaction costs
<b>Ethical Commitments</b>	Prevention of bribery Conflict of interest

**Note: With acknowledgements to HM Treasury's "Standardisation of PFI Contracts Version 3 (April 2004)"**

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# ANNEX G

## MANAGEMENT OF PROBITY

### Probity Principles

Probity refers to the uprightness, honesty, proper and ethical conduct and propriety in dealings. To gain the confidence of all stakeholders in the outcomes, there are several generally accepted probity principles that serve to maintain integrity of the procurement process of a PPP project, including:

- ◆ Accountability - to be able to explain and account for the practices and decisions
- ◆ Transparency and fairness - to ensure the flow of information to/from all bidders, and the treatment of all bids, is conducted in an equitable, unbiased and consistent manner
- ◆ Confidentiality - to protect the competitive position of individual bidders by ensuring confidentiality of the commercially sensitive information provided in the proposals
- ◆ Management of conflicts of interest - to ensure that no individual associated with the project is influenced, or perceived to be influenced, by self-interest or personal gain.

**Probity measures adopted in a PPP project should avoid posing additional bureaucratic procedures and should not hinder the project from developing in a smooth and efficient manner.**

### Probity Plan

A probity plan establishing the probity guidelines and procedures to be followed should be prepared prior to the commencement of the competitive bidding process of a PPP project to deal with the following issues:

- ◆ Parties/committees responsible for making decisions and communicating with bidders
- ◆ Membership of government committees and their terms of reference
- ◆ Practices regarding documentation of communications with bidders
- ◆ Procedures for responding to probity problems/queries
- ◆ Procedures for handling sensitive/confidential information
- ◆ Procedures for evaluation of bids
- ◆ Procedures for identifying and addressing conflicts of interest.

The Corruption Prevention Department of the ICAC would be pleased to assist in drawing up the probity plan.

## Probity Check on Bidders

In addition to ensuring the probity of the procurement process, the client department should also carry out probity checks on bidders, including all members of the consortium and their parent or affiliated companies, during the bid evaluation stage. The purpose is to ensure that the procuring department will not enter into a contract with a party which has a record of illegal or unethical activities. The probity check should examine the following corporate issues regarding the bidders' current and previous operations:

- ◆ Financial soundness, e.g. any records of bad debts, or bankruptcy, etc.
- ◆ Professional conduct, e.g. any records of offence/conviction of professional misconduct, or serious breach of contract, etc.
- ◆ Ethical practices, e.g. any records of unfulfilled legal obligations (such as outstanding tax payment); exploitation of non-skilled workers; or fraud/corruption, etc.

Upon selection of the successful bidder, appropriate probity measures should also be adopted on the side of the consortium. The procuring department should incorporate such requirements into the contracts to ensure the consortium's probity over the life of the project. Please refer to Question 13.10 for details.

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THE GOVERNMENT OF THE HONG KONG SPECIAL ADMINISTRATIVE REGION