

SERVICE - FEE MECHANISM IN THE PPP PROJECTS

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Abstract:

Today it is clearly evident that the governments, of every level, cannot complete all the growing needs of the population for the main services, by acting alone. The need to ask for asking support from another sector, for the completions of these services constitutes the necessity for a collaboration with the private sector. The partnership of the public sector with the private one is one of the most promising forms for resolving different problems. This collaboration aims at recognizing the benefits that those two sectors can have, from the financial resources, the experience and professional knowledge per the base public services aimed for the whole citizens.

One of the most important problems of a PPP Project is the considering of service Fee mechanisms. Albania is now improving the legal frame to develop PPP projects not only from the central government but from the local Authorities too. The local Authorities have not still the capacities to solve the problems with the Fee calculating.

This Paper will consider the issues relevant to the Service-Fee mechanism:

- Scope of services
- Service-Fee payment structure
- Structuring Services Fees based on :
 - Usage/demand

These issues will help the local Authorities in Albanian to understand the difference of the calculating Fees for different projects of the PPPs.

Key Word : PPP, Soft FM, Service fee-mechanism, opex, capex

1. Introduction

This Paper considers issues relevant to the Service-Fee Mechanism:

- Scope of services (2);
- Service-Fee payment structure (3);
- Structuring Service fees based on:
 - usage/demand (4);

2. Contract Scope

A preliminary issue, before considering various Service Fee mechanisms in more detail, is what should be included within the scope of a PPP Contract anyway? There is a fundamental difference between projects such as roads, where most if not all the services (such as accident recovery, repair and maintenance) are normally included within the scope of a PPP contract, and projects such as hospitals, where there is a considerable variation in the possible scope of services (for example, it obviously makes a substantial difference to the PPP Contract whether or not medical equipment or clinical services are included). The arguments for the ‘whole-life’ benefit of an integrated approach to a PPP bid has been a lot, but questions can be raised:

- How does a Public Authority deal with the situation where a bid consortium has strong and weak members, e.g. a good Construction Subcontractor, but a poor FM services provider, or a good financial package but a poor Construction subcontract?
- should design always be left to the bidders? It is arguable that in case of a straightforward where there is a little scope for innovation, the Public Authority is in as good a position as

any bidder to prepare the design, which will make the bidding process quicker and cheaper. Bidders can of course suggest improvements. (This approach was adopted, for example, for Chilean toll roads⁷.)

- Should finance be left to the bidders? Funding competitions effectively separate finance out at the bid stage, and debt finance can even be provided by the public sector and so removed from the bid package completely - this again raises the issue of whether the role of “financial facilitators” is helpful to the PPP market.
- Should Soft FM services be included in the scope of the PPP contract ?

The most common of these “unbundling” questions probably relates to Soft FM services. Two types of services may be included within the scope of a PPP Contract - Hard FM, i.e. routine maintenance of buildings and equipment, and Soft FM, e.g. cleaning, catering, security, etc. Hard FM is an inherent part of a PPP Contract, since the whole basis of the Contract is the provision of the Facility in “working order” throughout the terms of a PPP Contract. The arguments for including Soft FM are:

- Bidders will take account of Soft FM requirements when bidding for and designing the Facility.
- It removes the interface risk - e.g. the Project Company will not have the excuse that a failure of Availability was actually caused by Soft FM providers not involved in the PPP Contract.
- It gives the Public Authority a one-stop point of contact for all service issues on the Facility.

Balanced against this:

- The level of payment deductions which can be made for poor service is limited, since the level of fees paid for soft services is such that the Soft FM Subcontractor cannot realistically be expected to take on responsibility for disproportionate financial consequences for failure to perform. For example, penalties may be a maximum of one year’s fees under the FM Subcontractor.
- It is precisely these Soft FM services which are at the front end of the Facility’s interface with the users and general public, and where failures has a disproportionate effect on support for PPP projects in general.
- These services also tend to employ the most staff, and therefore raise the most difficult issues relating to transfers of staff from the public sector.
- The Public Authority’s soft service requirements may change substantially over the life of a PPP Contract, and therefore a very long-term Soft FM Subcontract is too rigid for this purpose.
- Soft FM service providers are reluctant to sign very long-term Subcontract because of the difficulty of predicting their own costs.
- if there are provisions for benchmarking or market testing, these really divorce the Soft FM Subcontract from the rest of PPP Contract and further weaken the case for its inclusion.

Exclusion of Soft FM services from the PPP Contract does not mean they cannot be provided by the private sector, as they can still be provided under an entirely separate contract on an out-sourced basis. If Soft FM is not included, specifying service quality is likely to be less complex, since it will relate primarily to maintenance. So where a relatively straightforward building project is involved, the case for including Soft FM services within the scope of a PPP Contract is not strong, and a Public Authority will probably benefit from the greater flexibility of dealing separately with these services. However, if the Facility is complex, then there may be benefits in transferring all of the FM interface risk to the private sector. To take the ‘unbundling’ argument to its local conclusion, a Public Authority could set up its own Project Company, and then procure each of the Subcontracting elements and the financing separately.

3. Payment Structure

The basis for building up the basic Service Fee schedule, and the levels of payments, in summary, the revenue stream —whatever the type of PPP Contract —must be sufficient to cover:

- opex ;
- debt service, plus the lenders required Cover Ratios; and
- equity return.

This is a function of a PPP Contract term and payment profile. Inflation must also be taken under account, as relevant, when structuring Service-Fee revenues and projecting costs.

The service –Fee provisions also have to take into account:

- revenue during construction.
- the effect of a delay in completion
- capex contributions by the Public Authority
- capex payments to the Public Authority and
- revenue payments to the Public Authority .

3.1 Contract Term

Arithmetically speaking, the longer a PPP Contract lasts, the lower the level of Service Fees and so if the Public Authority wants to keep the Service Fees as low as possible, the PPP Contract should be signed for as long a term as possible. For example, if a project costing 1,000 is financed at an overall cost of 8% p.a. over 15 years, the annual payments to provide this return will be 117, but over 30 years the annual payments will be 89. However, it should be borne in mind that the longer the term of the PPP Contract, the longer the period of the private-sector financing at a comparatively high cost, and therefore any annual ‘saving’ derived from lengthening the PPP Contract period is an illusion. In the example just given, total (undiscounted) payments over 15 years are 1.752, while over 30 years they are 2.665 - i.e. the cost of paying for the project over another 15 years is over 50% higher. The natural limit for a PPP Contract period is the life of the Facility which is the object of the Contract, but a road, for example, really has no natural life, as it is continually being renewed with maintenance, and a building such as a school has no obvious or predictable end to its life. So the effective life of the Facility is often of limited relevance. Conversely, if the facility has a very short life, a PPP is not likely to be appropriate anyway. Therefore the main factors which need to be taken into account in considering the appropriate term for a PPP Contract are:

- **Affordability:** if the PPP Contract term is too short the Service Fees may be too high to be affordable either by end-users in the case of a Concession, or by the Public Authority in the case of a PFI-Model project²;
- **whole-life benefits:** if the PPP Contract term is too short, the benefits from whole-life design and costing from the initial bids will not be achieved;
- **lenders’ term:** the length of the repayment term lenders are willing to offer, may set a maximum length on the PPP Contract term, since it is not financially efficient to have a long Tail period after the debt is repaid;
- **the absolute financial benefit from extending term:** e.g. in the example above, extending the term from 15 to 30 years cuts the annual payments from the public budget from 117 to 89, albeit increasing the total amount of the payments; if the term were increased to 35 years the annual payment would be 85 - i.e. the marginal benefit of each increase in the term, in terms of lower annual payments, gets smaller and smaller;
- **long-term flexibility :** this is probably the most important limiting factor in setting the term - it makes little sense to make a small annual saving in payments while locking the Public Authority into a PPP Contract² which cannot be easily changed if its requirements may have changed substantially;
- **the maintenance cycle for the Facility:** e.g. does the Public Authority want to have the Facility returned shortly after a major maintenance, or, say, half-way through the major-maintenance cycle?

Especially in the case of Concession³, there may be a case for fixing the Service Fees and then letting bidders propose the term of the PPP Contract as part of their bid.

3.2 Payment Profile

The payment profile is also important. There is obviously a temptation for the Public Authority to ‘back-end’ the payment stream, so making the project cost less today and leaving someone else to worry about making higher payments in 20 years’ time. Such behavior pushes a PPP project towards being an expensive way of borrowing money. In principle, Service Fees should be level over the life of the Contract. The same public service is being provided by the Project Company over the life of the project, so the payments should be the same. This is a matter of ‘inter-generational equity’ - we should not expect our children to make disproportionate payments for benefits which we enjoy today. Conversely, investors will usually prefer to ‘front-end’ the payments, to increase their equity IRR⁶, which will mean that their long-term interest in the project performance will be reduced. A structure where Service Fees reduce sharply after the debt has been paid off is also unsuitable for these reasons. These general level-payment principal is, however, subject to the effects of inflation.

3.3 Revenue Payment During Construction

The public Authority shouldn’t make payments for something which is not completed, and hence normally payments should not begin until the facility has met the required standard of completion. (In the case of the Concession, clearly users will not pay until there is something to pay for.) However, if some form of interim service is being provided by the Project Company during the construction period - perhaps because construction is in phases - than a proportional payment can reasonably be made for this¹. Interim revenues can also be provided when the Project Company takes over an already -operating Facility, typically a Concession such as a road where tolls are already being paid, and uses these revenues as part-funding for construction. Any such arrangement adds to the construction-phase risks for the Project company, and raises similar VfM issues for the Public Authority to other types of capex contribution, as discussed below.

3.4 Delay In Completion

Subject to this point on interim revenues, the main incentive for the Project Company to ensure that the Facility is completed on time is that Service Fees aren’t paid until service is complete. Moreover late completion will eat into the operation phase, and thus further reduce the return for the investors. However the Public Authority may itself suffer a loss resulting from the late completion, because it has to make other arrangements for continued provision of the service. If such additional costs can be reasonably anticipated and quantified in advance it is appropriate for there to be delay liquidated damages payments (LDs) under the PPP Contract to cover them. LDs aren’t intended as a penalty, but a pre-agreed fair estimate of the losses the Public Authority will suffer from the delay; they may be secured by a bank bond (payment guarantee). The maximum amounts payable will normally be capped —i.e. there cannot be unlimited delays.

Any LDs will probably be passed on by the Project Company to its Construction Subcontractor, who will take the risk of taking them into account in setting the construction price. Thus LDs have a direct effect on the whole -life VfM of PPP Contract since this extra cost will have to be covered by extra Service Fees. It may be worth while getting the bidders to bid for the PPP Contract with and without Delay LDs to assess the best VfM position.

There may come a point (sometimes referred to as the ‘Sunset Date’)⁶ where completion of the Facility has been delayed so long that the Public Authority may wish to have the right to terminate the PPP Contract. If the Public Authority is charging Delay LDs, this point would normally come when these LDs run out (or if they are not paid).

In other cases, the longer the delay goes on, the more the financial pressure on the project Company, its investors and lenders, to sort the matter out. Assuming that the Public Authority would prefer to have the facility delivered late than not at all, there is no need for a ‘hair-trigger’ approach⁶ to termination for delay, and quite a lot of extra time can be allowed.

3.5 Capex Contributions To The Public Authority

A financial contribution from the Public Authority towards capex may be caused as a way of lowering long term Service Fees to make a PF1-Model project affordable³ or a concession financially viable; the contribution may be derived from revenue during construction, as discussed above, or the proceeds of sale of surplus land as a result of building the new Facility. However, capex contributions raise some risk transfer issues⁴.

3.6 Capital Payments To The Public Authority

In concession projects, the project may already have been partly-built with public-sector funding, so that for example a section of a road may already be collecting tolls from users; this already-built road section may be included in the Concession to make the project more viable by providing a stream of existing revenue while the new toll-road section is being built, as discussed above. The value of the toll revenues from the existing road section can obviously be taken into account by the private-sector investors, so reducing the tolls which have to be paid on the new road section. However, the Public Authority may consider that the effect of doing this is that the general taxpayer has paid the cost of constructing the initial road section, and now there are no toll revenues to offset these costs (and perhaps service public-sector debt which was taken on to cover them). Therefore the Public Authority may require bidders to include an initial lump-sum payment in their bids to cover this 'sunk cost'. The economic efficiency of this is open to question, as the end result is that the private-sector investors will have to take on more debt, at a higher cost than any public-sector debt which it is replacing, and feed this extra cost through to the road users' tolls. Payment for a Franchise to operate an existing Facility is similar in effect, but the motive is even more likely to be the benefit to the public budget despite any economic inefficiency. A toll road will have a higher value for a Public Authority than it does for a private-sector purchaser if the Public Authority values the stream of revenues by discounting them at the PSDR (Public sector discount rate) whereas the purchaser discounts at a higher cost of capital (which of course raises again the issue of whether the PSDR should be different to the private-sector cost of capital. On the other hand if the proceeds of a Franchise sale enable the Public Authority to pay off debt originally raised to pay for the Facility, this may improve its credit rating and thus reduce its overall cost of borrowing.

3.7 Revenue Payments To The Public Authority

A concession Agreement may also provide for payment of 'Concession fees' to the Public Authority. If these are based on a sliding scale depending on the usage of the Facility, this is a reasonable way for the Public Authority to share in the success of the project, although this does put the Public Authority in the position of a de facto investor without the normal rights which an investor has to control the business.

Payment of fixed Concession Fee, on the other hand is open to similar objections as those against payments of an initial capital sum to the Public Authority, discussed above: effectively this is an expensive way of raising revenue for the public sector as it will mean that the Concession term will have to be longer to fund these extra payments.

4. Usage-Based Payments

In general, private-sector investors are willing to take demand risk on a Facility:

- where it has an open-market usage, e.g. an office building which is provided to the Public Authority under a PPP, but if the Public Authority chooses to live the building it can be leased to a private-sector user; or
- where there is likely to be a consistent demand, e.g. for transportation.

The private sector will generally not take demand risk usage is dependent on the Public Authority's actions. For example in the early development of the PFI in Britain the idea of investors taking demand risk for PPP prisons was tested, but there was no appetite for this⁵.

Having placed the Facility in the category where demand or usage risk might be transferred to the private sector, how is the decision whether to do this finally reached? For example, a road could

either be provided under a Concession and thus subject to real tolls, or funded by the Public Authority with Shadow Tolls, or paid for on an Availability basis by the Public Authority. How is the choice made between these alternatives?

- Firstly, the Public Authority will normally examine if the road can be provided through a Concession, possibly with some public-sector financial support.
- Secondly, if the Public Authority wishes to transfer the usage risk, but real tolls are not practical (e.g. because of insufficient traffic, complex links with other roads, or because tolls would distort traffic flows too much), a Shadow –Toll structure can be considered.
- Alternatively, if the transfer of usage risk is not considered practical or does not provide VfM for Public Authority, an Availability- or – service – based payment structure can be adopted.

These alternatives are discussed in detail below.

4.1 Requirements For A Concession

Taking a road as an example, whether a Concession is likely to be viable is a function of:

- traffic projections; as a rough rule of thumb, traffic lower than 10.000-20.000 vehicles per day is likely to make it difficult to generate enough toll revenue to fund a stand- alone Concession;
- the level of tolls which could be generated on these assumptions;
- if traffic levels are too low, whether the project would become viable with some level of financial support by the Public Authority;
- even assuming that tolls could be generated, the Public Authority has to consider whether it is suitable for this road to be tolled, taking into account factors such as:
 - how tolling fits within the overall national roads policy;
 - whether there is a free, if slower, alternative road; closure of free roads to force drivers onto the toll road is fairly certain to cause political problems;
 - whether there is a ‘willingness to pay’ on the part of users – e.g. there are usually strong objections if a road which has not previously been tolled is then made subject to tolls unless there are clear new benefits for drivers; and the actual level of the tolls must take into account not only the financial requirements of the project, but also the ‘reasonableness’ of the toll level as perceived by users;
 - whether traffic not wishing to pay the toll would be diverted onto other less suitable roads, causing obstruction, or increasing environmental problems (e.g. from additional pollution);
 - the behavior of heavy goods vehicles (HGVs), tolls from which are usually a major component of revenues, as there is typically a substantial differential between tolls for cars and tolls for large vehicles; HGVs are much more likely to divert to free roads, so if HGV drivers decide to use alternative routes a toll road is unlikely to be viable;
 - how easy is it to operate a toll system, and how well would this fit with connecting roads; (note that there are two ways of tolling a road – a ‘closed’ system measures where drivers get on and off the road, and charges are paid for distance, and an ‘open’ system where there is one fixed payment for using any part of the road);
 - conversely, whether tolling the road would discourage local short-distance use of a road which is intended for long-distance traffic (the biggest problem with any new road which runs past a major conurbation).

If, having been through any exercise, it is clear that a real toll system isn’t workable (even with support from the Public Authority as discussed below), the Public Authority will then consider PFI-Model alternatives, namely either Shadow Tolls¹ or an Availability-based payment. Similar principles can of course be applied to other Concession-model Contracts.

4.2 Toll Levels

The level of tolls for a Concession road can be set in three possible ways:

- Bidders bid on the basis of fixed initial toll payments, which can then only be increased at, say, the rate of inflation during the Concession period.

- Bidders are given freedom to set tolls at whatever level the traffic will bear.
- The Public Authority sets the tolls, as part of a national road-tolling strategy.

The approach to this is likely to be linked to the extent to which the Public Authority provides any financial support for the Concession.

4.3 Financial Support From The Public Authority

If the projected usage and Service Fees for a Concession produce insufficient cash flow to make the project financially viable, the Public Authority may use various means to support the project. If the Public Authority is trying to keep the Concession out of the public budget, rules for the amount of support which can be given before it ceases to be off-balance sheet need to be borne in mind (e.g. no more than 50% support under Eurostat rules⁵). This public-sector support can be justified by the wider externalities produced by the Concession, although it could also be argued that the very fact that these externalities cannot be priced into tolls suggests that tolling should be used with caution.

Support can take a variety of different forms:

- capex contributions;
- revenue guaranties;
- subsidies; or
- debt guarantees.

Alternatively the Public Authority may decide that the Concession Model is not the ideal one, and support is best provided through the PFI Model via Shadow Toll or Availability payments.

Capex contribution. The Public Authority may provide a capex contribution, i.e. funding part of the capex, through:

- grants or subsidies (non-refundable);
- the proceeds of sale of surplus land no longer required for the facility;
- a loan - any loan will have to be subordinated to the other lenders, and interest payments and principal repayments may be postponed until net cash flow after the Senior Lenders' debt service has reached a certain level, or surplus cash flow may be divided between payments on the public-sector funding and Distributions to investors;
- equity investment – like the loan, payments of public-sector investors have secured an agreed level of return.

Capex contributions raise risk-transfer issues. It is obviously inappropriate for the public-sector money to go in first and thus bear the whole initial construction risk on the project – so it should go in last. Indeed the ideal position is that the Project Company should fund construction fully, and then only if completion takes place should any public-sector funding be injected, as otherwise the Public Authority is effectively taking back some of the construction-phase risk. The Project Company should be able to arrange interim funding which would be repaid from the public-sector contribution after completion. An alternative approach is to require the investors in the Project Company to guarantee repayment of any such capex contribution if construction is not completed (or to provide bank guarantees for this). But even after completion of construction there remain risk-transfer issues with capex contributions. There is a case for suggesting that capex contributions are simply inappropriate as they do not reflect the long-term nature of risk-sharing in a PPP-if the Project Company defaults a few years into the PPP Contract the Public Authority will probably not receive proper value for any capex contribution, since the Senior Lenders will have first claim on any value which the project has at that point. On the other hand, if support is provided for revenues, as discussed below, rather than capex, this means that the Project Company has to raise more private-sector funding, with a consequent effect on the Service Fees.

Revenue subsidies. If it is necessary to reduce Service Fees to make the Concession viable, a fixed subsidy towards operating costs can be offered. Clearly this remains a fairly crude approach, which makes it possible for the Project Company to earn wind-falls from unexpected traffic growth. A preferable method of subsidy is therefore payments on a sliding scale, reducing as usage increases.

Revenue guarantee. If the issue is not one of reducing the Service Fees, but uncertainty of whether there may be enough revenue although the Base Case gives a reasonable expectation that enough revenue can be generated, then a ‘Fare Box guarantee’³ (as it is known where passengers are involved, but the same principle applies to other usage guarantees, e.g. for a road Concession) may be used, i.e. the break-even level of passengers which covers opex and debt service is agreed, and insofar as the level of passengers is below this, the Public Authority pays the equivalent of enough fares to bring the total up again. If the number of passengers is over the guarantee level, the benefit of this is usually split on a sliding –scale basis between the Project Company and the Public Authority. This can be limited to a ramp-up guarantee whereby minimum usage levels during the first few years of operation are guaranteed, the theory here being that all parties expect the projected usage levels to be reached, and the only doubts is how long it will take to achieve these levels.

In all such cases, the proportion of support needs to be carefully considered: it is obviously unreasonable for the Public Authority to guarantee 100% of the Base Case revenues or passengers usage, as this not only negates any real risk transfer but also removes the incentive on the part of the Project Company to increase the numbers of passengers. Therefore a revenue guarantee should either be for a fixed percentage of projected revenues (e.g. 70 % as under the Chilean 1991 Concession Law)⁷, or a sliding scale of support(as used in South – Korea), which takes the ram-up point discussed above into account: thus 80% usage may be guaranteed for the first 5 years, 70% for the next 5, 60% for the next 5 and nothing thereafter, the effect being to cover opex and some, but not all, of the debt service, leaving equity fully at risk.

However, there is a fairly sorry history in various countries, e.g. Mexico in the early 1990s¹ and more recently in South Korea, of Concession being undertaken on the strength of revenue guarantees rather than a proper evaluation of the usage risk, with consequent heavy costs falling on the Public Authority as the guarantees are called in.

Debt guarantee. If the Public Authority and the investors consider that the project is viable as a Concession , but the lenders are not confident on the usage level, another cost-effective way of providing support to enable the project to proceed will be for the Public Authority to guarantee some of the debt. As with revenue guarantees, so long as a case can be made that such a guarantee is unlikely to be called upon, this may not have any effect on the public budget.

Concession extensions. Rather than providing direct financial support, the Public Authority may agree that if usage falls below a mutually-agreed level, the Concession term can be extended pro rata: the additional revenue at the tail-end may thus help to make up any deficit. This is very similar to bids on the basis of lowest NPV of revenues.

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