

# Serving the Community

*By Using the Private Sector*

*An introductory guide to  
Public Private Partnerships (PPPs)*

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The Efficiency Unit welcomes comments from readers and users of this Introductory Guide. Comments may be addressed to:

Head, Efficiency Unit  
(Attn: Assistant Director (Efficiency Unit))  
14/F Hennessy Centre  
500 Hennessy Road  
Causeway Bay  
Hong Kong

E-mail: [helpdesk@eu.gov.hk](mailto:helpdesk@eu.gov.hk)  
Tel: 2165 7255  
Fax: 2881 8447



# Foreword

The Government is facing a conundrum; on the one hand, we are experiencing major budgetary pressures yet, on the other hand, we remain subject to demands for more and better public services. A key part of the solution is to enhance radically the use of the private sector in delivering government services.

Since promoting our Private Sector Involvement programme a couple of years ago, we have seen a significant increase in the value and quality of government outsourcing contracts.

We now wish to secure similar improvements from Public Private Partnerships (PPPs). This Introductory Guide presents the basic concepts and addresses the major issues relating to PPPs. It seeks to encourage both civil servants and the private sector to explore the use of PPPs for both traditional and innovative projects.

The major benefits of PPPs are that they -

- Deliver, cost-effectively, major long-term projects whilst spreading out the significant upfront investment that the government would normally have to make;
- Harness the flexibility, innovation, skills and resources of the private sector as well as encouraging them to enhance the range and calibre of the services made available to the community
- Improve value for money for Government (focusing on whole life costs) whilst creating long-term job and business opportunities for the private sector
- Share risks and rewards of public projects between the public and private sectors whilst encouraging long-term delivery of high quality services to the community.

Implementing PPPs takes time, effort and innovative thinking. But experience elsewhere shows that well-researched, planned and implemented projects provide real benefits: for the private sector, for government and, most of all, for the community we serve. I urge you to explore the opportunities that exist, and implement suitable projects with vigour.

**Donald Tsang**

Chief Secretary for Administration

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# Introduction

## ***Background***

Public Private Partnerships (PPPs) provide a number of alternative ways of involving the private sector in the delivery of public services. As the name suggests, they are 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. Examples of the government's contribution to the partnership might be the grant of land rights or the use of existing government assets, the construction of associated infrastructure, the sharing of certain risks and/or a commitment to purchase the services that meet a specified standard for the concession period. A PPP may take one of several forms, which are explained in the 'Serving the Community by Using the Private Sector' document, also issued by the Efficiency Unit in June 2001.

***This guide focuses on PPPs which involve the use of private financing*** to fund the construction of facilities and/or the purchase of assets, for the purpose of providing services. There are differences between these types of PPPs, depending on the means by which the private partner receives a return on his investment:

- At one end of the spectrum are financially free-standing projects where the services are provided for the use of the public which pays the private partner direct. Examples of this are toll-charging road bridges and tunnels.
- At the other end of the spectrum, the services are provided direct to the government sector which pays the private partner for those services. Overseas examples of this include the provision of prisons, government office accommodation and hospitals.
- In between the two ends of the spectrum are projects which provide services to the public, but 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.

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.

## ***Using this guide***

This document 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 their understanding of the government approach. Users of the Guide should recognise that it is not definitive and central departments, including FSTB, DoJ and EU, should be consulted in individual cases.

Throughout the guide the term department is used generically for all types of government organisations. Other terms and abbreviations used are explained on pages 58 to 61.

Amendments will be made in the light of experience. Please check the version posted on the Efficiency Unit website at <http://www.info.gov.hk/eu> for changes before making use of the guide.

*Exploit the best commercial skills, practices and disciplines to deliver high quality public services*

## Chapter 1 Advantages of PPPs

PPPs bring together the public and private sectors in a long-term relationship. The private sector becomes a long-term service provider rather than a simple upfront asset builder. As a result, government departments become more involved as regulators and procurers of services rather than direct providers of services to the public.

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. At times, PPPs may be attractive to the government because they can provide private funds in place of public sector capital to develop facilities and/or services.

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 mere public sector controls, irrespective of how hard the public sector tries to replicate those same incentives in its own approach.

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 but the government will have to continue to provide a subsidy.

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. The specific benefits will depend on the specific project. The benefits that may be achieved include:

- Allowing the government to concentrate on what it is good at, eg policy decision making, determining the outcomes it seeks, looking for best solutions, and overall regulatory review;
- Better exploitation of government assets, data (consistent with data protection law) and intellectual property;
- Unity of responsibility leading to improved delivery of public services;
- Reduced lifecycle costs of a project;
- Quantifying more accurately the costs of service delivery;
- Reduced risk of cost overruns;
- Increased revenues;
- Accelerated completion of capital works projects;
- Substantial improvement in the quality and durability of construction;
- More efficient and effective allocation of risks;
- Defining the scope and standards of service required, with timescales for development;
- New or expanded business opportunities for the private sector;

*Identify the benefits you would like to achieve and craft your PPP approach accordingly*

- Maintaining a small government and a lean civil service;
- Creating growth opportunities for the private sector;
- Spreading the government's capital works expenditure over the life of a project;
- Encouraging Hong Kong's development as a financial centre;
- Invoking private sector skills, experience, access to technology, and innovation;
- Defining constraints, eg staff, health-related, environmental, financial/tariff, legal and commercial issues; and
- Benchmarking projects that remain inside the public sector against PPP projects.

## Chapter 2 Common Elements of PPPs

- What are the common elements found in most PPPs?
- What is the government's fundamental role in PPPs?
- What is the fundamental role of the private sector in PPPs?

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

- 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, typically between 10 years and 30 years, depending on the nature of the facilities, assets or services 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 between the public and private sectors;
- There is an emphasis on output-based specifications; and
- A whole life approach to cost is taken.

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

- Set policy, identify opportunities, and define objectives;
- Decide amongst competing priorities for public resources;
- Ensure transparency and probity in the procurement process;
- Identify needs in terms of output 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;
- Identify and propose the allocation of risks;
- Provide a clear regulatory framework and perform regulatory functions; and
- Safeguard the interests of customers and the general public.

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

- Achieve defined levels of performance in service delivery;
- Provide expertise and innovation;
- Provide access to private financing, as appropriate; and
- Provide a sufficient return to investors and other stakeholders.

*If a project does not contain certain common elements, it is unlikely to be a PPP*

*Output specifications are essential to effective PPPs, although input elements are sometimes unavoidable*

*The private sector's role is to deliver high quality services efficiently*

## Chapter 3 Comparison of PPPs and Conventional Approaches

- ⇒ How in general does the PPP approach compare with conventional procurement?
- ⇒ How does the procurement of a facility compare?
- ⇒ How does the procurement of a service compare?
- ⇒ How does the funding of a facility/service differ?
- ⇒ How in each case will the whole life costs be assessed?
- ⇒ Are PPPs more or less adversarial in nature than conventional procurement?

### *How in general 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' of a number of smaller projects may be used to secure economies of scale;
- ⇒ Identifying a likely location or locations for the service or facilities;
- ⇒ Establishing whether there is general budgetary cover for any associated government expenditures. Many projects will not be entirely self-financing; and
- ⇒ Considering affordability and value for money issues.

Thereafter, the two approaches may diverge considerably, particularly with respect to the sequence of events. Procurement activities, 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 (ArchSD) to the client department and/or the private partner.

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

#### **Conventional approach**

- ⇒ 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.
- ⇒ 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.

#### **PPP approach**

- ⇒ The client department would form an Intelligent Client Team (ICT) incorporating its own and other departmental staff, as well as outside expertise, if required, to oversee the project.
- ⇒ The ICT 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, eg between 10 -30 years.

- Separate specialist contracts might be let to different private contractors for specialist equipment and facilities.
- 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.
- Upon completion of construction of the facility, the works department would inspect the works and, when appropriate, certify that the works have been completed.
- Following internal approval, the client department would seek approval of the Policy Committee before obtaining endorsement of the Finance Committee (FC) of the Legislative Council (LegCo).
- The successful consortium bidder would be the one that satisfies the minimum requirements specified with respect to quality of design, construction and operation and on terms which provide best value.
- In assessing the conforming proposals received, the ICT will benchmark them against a Public Sector Comparator (PSC) prepared by the ICT in advance of the Request for Proposal (RFP). The PSC is the risk-adjusted, estimated full lifecycle cost of the project if it was done by the conventional in-house approach.
- Where a firm decision has been made that a PPP approach is required for qualitative or policy reasons, or the project is financially free-standing, a PSC need not be constructed. However, the client department will still wish to be able to demonstrate that the project provides value for money.

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

#### **Conventional approach**

- 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 in the client department, Government Property Agency (GPA), Electrical and Mechanical Services Department (EMSD) and works departments, and a mix of different outsourcing contracts.

#### **PPP approach**

- A service will often be procured together with a facility as described above.
- Sometimes there will be a separate 'Operation and Maintenance (O&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.

***How does the funding of a facility/service differ?*****Conventional approach**

- ⇒ The funding of the capital and recurrent costs would normally come from a range of different sources within the government.
- ⇒ The capital costs of construction works would be met from the Capital Works Reserve Fund (CWRP).
- ⇒ The costs of the preparatory design and supervisory work for the construction contracts would normally be met by the project vote.
- ⇒ The operational costs would be met from the client department's Recurrent Account.
- ⇒ Occasional expenditure on replacement plant and equipment would come under the department's Capital Account.
- ⇒ Similarly, in works departments and GPA, expenditure under various departmental subheads would take place over the life of the facility.

**PPP approach**

- ⇒ The government would normally pay the winning bidder only after the facility was operational, and then payments would be only for services provided according to the contractual specifications.
- ⇒ Payments would incorporate elements of amortised capital costs paid out of the CWRP and monthly recurrent costs.
- ⇒ Payments would be subject to satisfactory performance in the provision of services on the part of the private partner.
- ⇒ Payments could include incentive elements where performance targets are set.
- ⇒ If the private partner 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 reduced, deferred, or halted in accordance with the terms of the contract.

***How in each case will the whole life costs be assessed?*****Conventional approach**

- ⇒ Usually only direct incremental costs are assessed.
- ⇒ The government does not always have an accurate assessment of the likely full costs of providing services over the lifecycle of a facility.
- ⇒ In any event, the estimated cost is only an estimate, and cannot be assured unless a binding contract for its provision has been let.
- ⇒ Subject to budgetary and management control, the costs of a new facility/service are open-ended.

**PPP approach**

- ⇒ Estimates of the whole life costs of the facility/service will be developed for both the PSC and by the private sector using the same period of time to ensure a common comparison basis.
- ⇒ The bidder's price will normally incorporate a formula to take account of inflation/deflation.
- ⇒ Costs are expressed on a Net Present Value (NPV) basis to enable comparison between options with different cashflow profiles.
- ⇒ The PPP partner is committed to the costs he submits in his bid, which are then included in the signed contract.

***Are PPPs more or less adversarial in nature than conventional procurement?***

PPP projects are premised on long-term relationships where a successful outcome is best achieved through partnership. It is essential that government 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 partner that shares similar attitudes/approaches to key issues;
- Adopt a partnership attitude supported by the right contractual framework;
- Have the right skills mix present at the right time; and
- Have the desire to make partnership work in practice.

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 private partner achieves its performance goals as specified in the contract.

## Chapter 4 Policy Support Issues

- Does the PPP approach have policy support?
- At what point does the client department decide to use the PPP approach?
- Do we need community endorsement of a PPP project proposal?
- Is it necessary to seek LegCo approval for a financially free-standing PPP project?
- Can the private sector bring projects to the government on an unsolicited basis?
- Can we negotiate detailed contracts with more than one bidder?
- Should the client department allow 'non-core' services to be provided in the facility?

### ***Does the PPP approach have policy support?***

There is broad policy support for the principles underlying PPPs:

The Chief Secretary for Administration wrote\* "...we have a responsibility to make the best use of both the public and private sectors... to encourage outsourcing and other modes of involving the private sector in delivering public services. We need to... fully utilise the skills and resources available in the private sector... Share risks with the private sector... seize on the opportunities that private sector involvement presents and pursue vigorously ways that creatively provide top quality services to the public."

*\*'Serving the Community by Using the Private Sector' June 2001*

The Financial Secretary said+ "...the market can allocate and utilise resources more effectively and has greater capacity to foster creativity, provide economic impetus and create employment opportunities... we will make use of market forces and strengthen our cooperation with the private sector to provide better and more effective services to the public..."

*+Budget Speech 6 March 2002*

The Financial Secretary said# "...the format for private sector participation may cover design, build and operate, or other options involving private financing."

*#Budget Speech 5 March 2003*

### ***At what point 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 including an initial assessment of the business case should be conducted. A decision to proceed with the PPP approach would usually follow from the feasibility study recommendations.

*There is solid policy support for PPPs*

*Good practice requires similar public consultation for PPP projects as for conventional projects*

### ***Do we need community endorsement of a PPP project proposal?***

In general the level of consultation for a PPP project should be the same as that for a conventional procurement. The principles of transparency and accountability mean that it is normal for the client department to at least explain the project to interested and affected parties. Where the use of a PPP will result in transfer of existing services to a private service provider, all the stakeholders need to be consulted.

### ***Is it necessary to seek LegCo approval for a financially free-standing project?***

It is possible that a financially free-standing project would require no formal legislative or financial approvals from the LegCo. However, it should be borne in mind that most PPP contracts are likely to be lengthy and of relatively high value. Client departments are advised to seek LegCo support (eg by consulting 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.

A project where the government intends to grant land for less than the paid-up market value would normally require consultation with the LegCo.

### ***Can the private sector bring projects to the government on an unsolicited basis?***

It may but, usually, a competitive bidding procedure would still be required to demonstrate value for money and to guarantee probity.

In certain limited circumstances, the government may grant a private party an exclusive mandate to fully develop a proposal, on a non-competitive basis, that it has brought to the government on an unsolicited basis. Such circumstances would be rare, eg 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 product did not exist.

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

The key objective of the procurement process is to select the right partner for the project. The bidding and negotiation process must be carefully managed. Negotiating with more than one bidder should generally be used to secure the most favourable terms. Overseas, some governments carry out very detailed negotiations, sometimes even to the point of fully negotiated contract documents with two or three preferred bidders. 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. 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.

*Negotiation with PPP bidders is an international norm*

Care should be taken to ensure that any decision regarding how many bidders to negotiate with meets, where appropriate, the World Trade Organization Government Procurement Agreement (WTOGPA) requirements. Legal advice should be sought in the light of the circumstances prevailing.

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, ie if the government only sets out minimum mandatory 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 traditional practice in relation to procurement through invitation to tender. For PPPs, the government does not issue an ‘invitation to tender’ but a ‘request for proposals’ (RFP). Accordingly, the words ‘tender’ and ‘tenderers’ should be avoided in the RFP documents. The government may wish to reserve the power to devise and amend the marking scheme from time to time. This will give the government more flexibility. An appropriate balance needs to be drawn between flexibility and certainty and the need to conduct the selection exercise fairly and transparently.

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. Normally, client departments would engage in full negotiations with only one - at most two bidders. But circumstances might require negotiations with a greater number. Client departments should provide themselves with as much flexibility as possible.

If it is decided to conduct detailed negotiations with more than one bidder, it is necessary to decide whether to negotiate with each bidder on the basis of a set of common terms or not. Doing so ensures greater simplicity for the public partner in terms of its comparison of bids. It also carries some risk of loss of innovation and achieving optimum pricing proposals. Allowing both conforming and alternative bids may be a solution.

It is very important that the government communicates the process to bidders at an early stage and does not deviate from it.

### ***Should the client department allow ‘non-core’ services to be provided in the facility?***

The ICT should consider whether it would be prepared to accept proposals for enhanced facilities/services or other commercial facilities on the site. The benefits of permitting the provision of facilities/services not required by the client department include:

- Better site utilisation;
- The provision of additional facilities/services for the community;
- Additional revenue for the private partner/government; and
- Cheaper public facilities/services.

***Sensible addition of ‘non-core’ services to a project can greatly enhance site utilisation, financial viability and the range of services offered to the public***

If the ICT is prepared to accept other facilities, it should ensure that any constraints to their acceptability should be made clear to all concerned in the process of developing the project during public consultations etc, and should be made clear in the RFP documentation. The 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;
- Objections to sensitive issues such as gambling-related or immoral activities;
- The ratio of core to non-core activities; and
- Other policy considerations.

If the private partner is allowed to keep income from the provision of additional facilities/ services, then sufficient control must be provided to ensure that the private partner will not be distracted from the delivery of core services which may be less profitable than the non-core services.

The client department may wish to provide sufficient flexibility for the private partner to introduce or change non-core 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 non-core services, and the fees charged to the public.

Client departments should note that insofar as land sale is concerned, there is a policy regarding an administrative ban for major modifications within 5 years of the 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 ie 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. Similar complaints might also be made by other developers who had not submitted any bids previously.

## Chapter 5 Procedures

- ⇒ What funding approvals are required for a PPP to operate?
- ⇒ Who will be accountable if things go wrong?
- ⇒ What should be the duration of a PPP contract?
- ⇒ What are the key procedural steps to take in selecting a PPP partner?
- ⇒ Will the bid preparation and contract management be onerous and time-consuming?
- ⇒ Who does the client department deal with in the private consortium?
- ⇒ Should the client department conduct environmental, traffic or other assessments prior to inviting proposals?
- ⇒ Do we need to conduct EoI and pre-qualification exercises?
- ⇒ Can the client department select more than one successful bidder?
- ⇒ What information should be given to potential bidders at the pre-qualification and/or bidding stages?
- ⇒ Are there disadvantages in providing too much information?
- ⇒ What is the Intelligent Client Team (ICT)?
- ⇒ Is there a role for the works departments on the ICT?
- ⇒ Why appoint outside advisors to the ICT?
- ⇒ What happens at the end of the contract?

### ***What funding approvals are required for a PPP to operate?***

After constructing a PSC, 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 will need to invite the Policy Committee, or the Executive Council (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 Financial Services and the Treasury Bureau (Treasury Branch), 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.

In respect of the LegCo, the client department would normally present the project first to the relevant LegCo Panel. Thereafter, the department will need to seek the Public Works Subcommittee (PWSC) and FC's approval for the CWRP funding required for the construction element, and FC's approval for the remaining long-term recurrent commitments. This may be done at the same FC meeting.

A set of procedures and a procurement flowchart are at Annexes A and B respectively.

***A clear and identifiable distinction between capital and recurrent costs is required***

*The government cannot avoid accountability*

*Contracts should be long enough to achieve best value for money*

*PPP contracts are long-term: getting the right partner for a lengthy relationship is essential*

### ***Who will be accountable if things go wrong?***

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 specifications; for conducting a fair and transparent contracting exercise; and monitoring the performance of the selected private partner. 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.

### ***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 many overseas PPP projects, contract periods are shorter than the design life of the asset. The rationale is 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 public, private and financial community in this scenario is that the asset (and its residual value) could then be used for redevelopment. The attraction from a financing point of view is that the shorter timeframe effectively leaves a useful 'tail' after maturity of the senior debt to secure the development.

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.

### ***What are the key procedural steps to take in selecting a PPP partner?***

The answer depends to an extent on the nature, size and value of the PPP project. The following are the usual steps, although for relatively simple projects some may be omitted:

- Request for EoI from the private sector;
- Pre-qualification of private sector companies that have submitted an EoI;
- RFP - an invitation to pre-qualified private sector companies to make an initial proposal;
- Conduct initial assessment of initial proposals and seek necessary factual clarifications;
- Proposals not meeting requirements excluded;
- Negotiate with conforming bidders to achieve improvements to bids whilst under competitive pressure. Client departments should note that it is not normal government practice to negotiate the land premium;
- Select a preferred bidder(s) to enter into detailed, fully negotiated contract documents (reserve the right to revert to an alternative(s) bidders if contract negotiations break down);

- ⇒ Request best and final offer; and
- ⇒ Recommend the preferred bidder to the relevant bid evaluation committee.

***Will the bid preparation and contract management be onerous and time-consuming?***

Structuring, bidding for, awarding and implementing a PPP contract will be a challenging process. Client departments will need a strong in-house team and appropriate external advisory support - this is known as the Intelligent Client Team (ICT). As listed above, 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. Once the facility is in operation, the client department will focus on monitoring performance against defined criteria.

***Who does the client department deal with in the private consortium?***

There should be a single point of responsibility within the private partner's consortium for the client department to deal with. This will be a clearer and simpler position than the conventional arrangements, where the client department has to liaise with a number of different departments and contractors. Similarly, the client department - or its ICT - should designate an officer as its point of contact with the PPP partner/bidder.

***Should the client department conduct environmental, traffic or other assessments prior to inviting proposals?***

Client departments will need to ensure that the relevant legislation, eg the Environmental Impact Assessment Ordinance, is complied with in respect of designated projects.

Client departments should conduct preliminary environmental, traffic and engineering feasibility assessments, and socio-economic studies, as appropriate, 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 time required for any studies that the successful bidder will have to conduct should be factored into the project timetable.

***PPPs require a serious and long-term commitment***

***The client department will need sufficient information to satisfy the LegCo to obtain funding approval***

***Consider whether EoI and pre-qualification exercises should be held separately. This might not always be required***

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

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, especially in the early days of PPP, and should not be compelled to incur excessive costs as a result of unnecessary bid requirements.

EoI exercises enable client departments to tap the experience and expertise of interested parties before finalising the scope of core and non-core services. They are not usually used to restrict future bidders.

The number of bidders can be reduced to a manageable number through a pre-qualification process. 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.

For some projects, the EoI and pre-qualification exercises may be conducted in one go, if it can save, time and effort all round. Care will need to be taken to ensure that sufficiently detailed information can be obtained to achieve the purpose of the exercise(s).

The ICT 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.

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

There may be circumstances where the client department is prepared to accept, or 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.

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 is considering replacing its in-house catering with PPP arrangements. The Authority divides itself administratively into five geographical 'clusters' of hospitals. For its PPP caterers, it may limit any one partner to serving no more than three clusters. Similarly, the Marine Department is exploring the feasibility of using the PPP approach for clearing floating refuse in Hong Kong waters. One issue to resolve is whether to use one PPP contractor for all of Hong Kong waters, or whether to divide the work geographically into two or more PPP contracts.

***One winner is the norm, but there are circumstances where more than one bidder can be selected***

***The client department should allow itself as much flexibility as possible in the RFP documents***

### ***What information should be given to potential bidders at the pre-qualification and/or bidding 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 tenderers to put together coherent, sound and innovative proposals, in the full knowledge of the requirements and risks involved, and reduce the likelihood of misunderstandings, withdrawals of bids etc.

The information to be given to potential bidders may include:

- A preliminary timeframe for delivery of the service/facility and whether early completion/delivery is desired or not;
- The land status (ie ownership) of the relevant site(s);
- The zoning on the statutory town plan(s);
- Information on whether a planning application under the Town Planning Ordinance or rezoning of the site(s) is required;
- The environmental, traffic or other assessments already done, or to be conducted by successful bidders;
- Carefully designed draft output-focused specifications;
- A draft Service Level Agreement (SLA);
- A draft contract (but see discussion below);
- The proposed performance indicators;
- The client department's proposed payment mechanism(s) (including rewards and deductions);
- An opportunity for bidders to comment/suggest amendments to the payment mechanism;
- The proposed step-in and termination provisions;
- Any avenues of redress/appeal on the part of the private partner;
- A matrix showing a proposed risk allocation;
- The preliminary/final estimate of the PSC;
- Advice on affordability constraints;
- The bid evaluation criteria;
- A requirement to demonstrate a commitment to ethical practices;
- Whether bidders may be allowed to provide non-core services;
- Whether a lump sum premium or other income/revenue is expected by the government;
- Where a land lease is involved, the Tender Notice and the Conditions of Sale;
- The insurance cover that the private partner will be required to obtain;
- Whether bidders are required/encouraged to employ serving civil servants; and
- 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.

*The more early, accurate and pertinent the provision of information the better*

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.

### ***Are there disadvantages in providing too much information?***

There may be drawbacks in providing a draft SLA and/or a detailed draft contract at the pre-qualification and/or the initial competitive bidding stages. If we inform bidders of the detailed contractual terms too early, the scope for negotiating will be limited, and the government may be disadvantaged. We may not get the best out of what is intended to be an innovative process.

A bidding exercise must be conducted in accordance with the principle of non-discrimination. If a bidder does not comply with an essential requirement set out in the documents 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 WTOGPA do not apply to a concession or franchise. However, it is still necessary for the government to act fairly even in the situation where the rules of the WTOGPA do not apply. 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 requirements specified should be limited to those that are truly essential.

### ***What is the Intelligent Client Team (ICT)?***

This is similar to the 'Project Steering Committee' used in the management of multi-disciplinary projects by works departments. The role of the ICT would be to oversee the progress of the project from start to finish. The ICT should contain the necessary authority, experience and expertise appropriate to its needs. In addition to the client department's own staff, it might include, for example, 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 ICT are employed from outside of the government, the client department will need to ensure against any conflict of interest arising. They should contractually prohibit advisors working on the same project for private sector bidders where this might risk the tailoring of advice or the use of inside information.

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

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

***In providing information, care must be taken to conform to WTOGPA requirements where applicable***

***PPP projects are overseen by the ICT on behalf of the client department***

***Use private sector to fill skill and experience gaps***

### ***Why appoint outside advisors to the ICT?***

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, eg writing output specifications; negotiating complex infrastructure contracts that underpin PPP transactions; and understanding the financial products that investment bankers promote to underwrite such transactions. 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. The appointment of external advisors should follow appropriate competitive procedures.

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

The assets will normally revert to the government at zero value or market rate. The contract should specify the required condition of the assets 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 private partner to demolish the facility before returning the site to the government.

Overseas, the assets are sometimes left with the private sector although this may not be appropriate in Hong Kong.

***Ensure that transitional arrangements are included in the contract***

## Chapter 6 Maximising Benefits and Managing Risks

- What are the benefits of output/outcome performance specifications?
- What problems may arise in the course of a PPP?
- What are 'force majeure', 'compensation events' and 'relief events'?
- The PPP approach addresses the management of risks. What are risks in this context?
- Which party should carry the risks associated with the project?
- Why transfer risk?
- Can all the risks be passed to the private partner?
- How can a monetary value be placed on risk?
- How can a client department be protected from project transition risk, particularly arising from late completion?
- How can a client department minimise the network and interface risks regarding technical equipment?
- Can insurance be used to manage risk?
- What is an 'Owner Controlled Insurance Programme (OCIP)'?
- What risks cannot be transferred?

### ***What are the benefits of 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 1000 people, the output specifications might require that seating for 1000 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, the means of escape and fire services requirements for the 1000 people would have to be permanent features.

Despite the desire to maximise flexibility, it is difficult to achieve 100% use of output 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 'output' 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 private sector on relief events (and possibly even force majeure and compensation events). 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. Once the cause of breach has been established to the government's satisfaction, government may wish to take action against either the SPV or the contractor, or both.

*Use output/  
outcome-based  
performance  
specifications  
whenever possible*

### ***What problems may arise in the course of a PPP?***

Hong Kong is fortunate in being able to learn from the decade or so of recent PPP experience elsewhere in order to minimise the likelihood of suffering some potential problems.

Nonetheless, any project that is not well prepared and implemented will have a higher chance of things going wrong. Experience demonstrates that for both conventional and PPP procurements poor drafting of the contract/performance requirements and/or poor contract monitoring can lead to problems downstream. For PPPs these may include:

- ⇒ Loss of control;
- ⇒ Increased costs;
- ⇒ Inadequate accountability;
- ⇒ Unreliable levels of service;
- ⇒ Lack of competition;
- ⇒ Bottom line considerations assuming disproportionate importance;
- ⇒ Business culture co-existing uncomfortably with culture of service;
- ⇒ Lack of flexibility, especially over the longer term;
- ⇒ Disruption of service, and costs incurred by the government when step-in rights exercised;
- ⇒ Inappropriate allocation of risks between the government and the private sector;
- ⇒ The government being 'locked-in' for the life of the project with need to compensate the private partner if it wants to exercise a 'break clause';
- ⇒ The private sector escaping liability through liquidation and use of limited liability companies;
- ⇒ Bias in the contracting process;
- ⇒ Large buy-out payments by the government to replace a poor performing operator;
- ⇒ Higher costs due to limited competition if suitably experienced/qualified PPP contractors are not available;
- ⇒ Greater difficulty and higher cost in removing an unsatisfactory contractor;
- ⇒ Higher financing costs; and
- ⇒ Greater secrecy and lack of transparency resulting in benefits not being shared with the government.

### ***What are 'force majeure', 'compensation events' and 'relief events'?***

The government can minimise the likelihood of repeating the above mistakes by reference to what are known as force majeure, compensation events and relief events. Events of force majeure should be very narrowly defined (as they usually are in these cases and not co-extensively with uninsurable risks). Compensation events apply to variations required by the government and discriminatory changes in the law. Relief events need to be extremely narrowly drafted and qualified by requiring the private sector to have taken all possible steps to have prevented or mitigated the accident (such as fire, loss or damage, failure by statutory undertakers, utilities companies etc). Similarly, general strikes only of the workforce (not site or project specific) should qualify as a relief event.

***Well prepared and drafted PPP contracts and performance specifications may avoid many potential problems***

*Risks exist in all projects. The key to success is managing them optimally*

*The party best able to manage each risk should carry that risk*

*Risks should be properly allocated*

*Private sector expertise is available to evaluate risks*

***The PPP approach addresses the management of risks. What are risks in this context?***

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. Exposure to risks arises in all projects, whatever the approach. PPPs provide opportunities for the better management of such risks by allocating 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.

***Which party should carry the risks associated with the project?***

The golden rule is that the party best able to manage each risk should carry that risk. In most projects this will mean that the client department retains some risks, the private partner 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 private partner would be expected to carry all other risks including general business risks.

***Why transfer risk?***

The main benefit is that the private partner is given a strong incentive to supply cost-effective and higher quality services on time. Reward should always be commensurate with risk. Private partners only start to receive their payments when the services start to be delivered, and continued payment depends on meeting agreed performance criteria.

***Can all the risks be passed to the private partner?***

Appropriate allocation of risk between the public and private sectors is a key requirement for the achievement of value for money in PPP projects. Experience elsewhere indicates that risk transfer should be optimal, not maximum. If the government seeks to impose excessive risk transfer to the private sector this will result in the private sector charging an excessively high premium; simply refusing to accept the risk altogether (ie they will not put in a bid); or failing to meet contract obligations.

***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, government 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); and
- ⇒ Assess the expected value of the risk.

External advisors can advise departments on financial evaluation of risk.

### ***How can a client department be protected from project transition risks, particularly arising from late completion?***

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. Any liquidated damages for late completion may be based upon the 'throw away' costs of the client department in preparing itself for transition, eg 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.

Another option is to transfer responsibility for the service elements well in advance of the move so that relationships can be developed and the service operation can be introduced and bedded down.

### ***How can a client department minimise the network and interface risks regarding technical equipment?***

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 PPP 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. An effective management communications strategy should be implemented in respect of day-to-day delivery of the two sets of services.

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

Generally, risk is best managed by a party able to influence relevant events. However, there may be occasions where neither the government nor the private partner is comfortable carrying a particular risk. In these circumstances, insuring against the risk can be considered. Insurance also helps cost a risk.

The private partner can generally be expected to insure in accordance with good industry practice. The client department will generally require that the private partner takes 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 private partner at an early stage in the procurement process and during negotiations as bidders will reflect the cost of insurance in their bids. Where the project asset is destroyed and/or provision of the contracted services ceases during the contract term, owing to an insurable event, the private party must reinstate the project facility and/or the provision of the contracted services (unless otherwise agreed by the government). Any insurance proceeds must be used for this purpose.

The contract should also address the issue of a risk becoming uninsurable. As a result of increasing risk of damage through terrorism after 11 September 2001, insurance companies are demanding considerably higher premiums or ceasing to provide such coverage totally.

### ***What is an 'Owner Controlled Insurance Programme (OCIP)'?***

This is where the private partner 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 which 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.

An OCIP was used successfully in the Airport Core Programme projects and recently in Kowloon-Canton Railway Corporation's and MTR Corporation Limited's major railway projects. Highways Department is using OCIPs for major projects including Route 9, Route 10 and the Deep Bay Link.

With the approval of the Secretary for Financial Services and the Treasury (SFST), 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.

***What risks cannot be transferred?***

Political risks cannot be transferred. This does not mean that you cannot transfer the delivery of services with a high political risk to the private sector. It does, however, mean that 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, eg evidence of risk assessment, control and mitigation;
- Risk management plans;
- Contingency plans;
- A shared government/private approach to testing, monitoring etc;
- Provision for periodic re-assessment of risks; and
- Opportunities for public participation in the monitoring/review processes.

***Political risks  
cannot be  
transferred***

## Chapter 7 Financial Issues

- ⇒ Where do the government funds come from in the case of a PPP project?
- ⇒ How will a PPP be paid for?
- ⇒ Should the client department impose a 'performance bond' on the private partner in the contract?
- ⇒ Should the government require additional security?
- ⇒ How accurate are claims that PPPs provide good value for money?
- ⇒ Since private sector borrowing costs are higher than public sector borrowing, how can PPPs be more cost-effective?
- ⇒ What is the benefit of using third-party private funding?
- ⇒ Will the PPP approach commit the government to long-term recurrent expenditure?
- ⇒ Can private partners retain revenue received from the public using the facility/service?
- ⇒ Are there any standard mechanisms for profit sharing?

### ***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 in effect met from the CWRF, and the recurrent costs are met from the client department's head of expenditure.

The client department, via its policy bureau, will need to secure funding via the RAE process. This will normally take place after the initial PSC (see page 31) has been constructed, and before any public consultation or Eol takes place. The capital funding requirement needs to be secured from the CWRF. The relevant bureau 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 unified payment) 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 services 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 commitment, and FC's approval for the remaining long-term recurrent commitments.

In the past, the Treasury Branch has normally advised departments to seek FC's funding approval before inviting bids, since the government would not wish to pre-empt LegCo's decisions. Recently, however, in the interests of time and in an effort to secure the best estimates before approaching the FC, departments have increasingly been allowed 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

***Clearly identify and separate capital and recurrent costs***

***Consider carefully when to seek PWSC and FC approval***

bill, remembering that different bidders could put in considerably different ideas for both core and non-core services, and that negotiations with the preferred bidder could result in more changes to the details of the project. Client departments and proposing bureaux will have to take a view on a case-by-case basis which approach would be most appropriate.

### ***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 payment mechanism will normally be proposed by the government, 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. Payment will normally consist of a single regular amount (eg monthly or annual) sum comprising one or more of the following components:

- Amortised capital costs. In the conventional approach, the government usually pays contractors for the capital works (eg construction) at pre-arranged stages during the course of construction. Under a PPP, the client department does not pay anything to the private partner until the works are certified as being completed and the services delivered; at this time regular payments will commence that include the amortised capital cost.
- Service delivery. The contract will specify that the private partner delivers a range of services, and these will be measured by an agreed set of criteria (eg opening hours, standards of cleanliness, lighting levels, customer service standards, employment of appropriately qualified staff).
- Headcount/shadow toll/throughput. The monthly payment could reflect the number of users of the facility, eg the number of swimmers using a swimming pool, or the vehicles using a bridge/tunnel;
- Revenues received. The private partner 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 private partner may, in some circumstances, be allowed/encouraged to perform other fee-generating services in the facility. This income might cross-subsidise the services that the government requires on the site. Alternatively, the client department might demand a revenue/profit sharing/turnover sharing arrangement, or might require a lump sum premium.

The client department will be entitled to defer, reduce or withhold specified amounts of the payment if the private partner fails to perform as required, eg the roof leaks, or specified services are not performed as required. These must reflect genuine estimates of loss/costs/damages incurred by the client department in rectifying the deficiency. This gives the private partner 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 deferral, reduction 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 private partner. These different levels of revenue risk will be reflected in the bid prices received or, indeed, ultimately whether any bids are submitted.

***Payments should be closely linked to performance***

***Examples of 'profit-rents' and 'turnover-rents' exist***

***Should the client department impose a ‘performance bond’ on the private partner in the contract?***

The private partner will normally use a Special Purpose Vehicle (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 as mentioned earlier.

***Should the government require additional security?***

In some PPP projects, the government will be contracting with a private partner which is a lowly capitalised SPV 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 private partner and its subcontractors will be able to meet their contractual obligations. The government may also wish to ensure that continuity of service is maintained even if the private partner becomes insolvent. It may be prudent in some circumstances to require that the private partner 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, eg costs incurred by the government in the exercise of ‘step-in’ rights. Sponsor guarantees may also be desirable in some instances.

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

There is a substantial and growing pool of data - mainly derived from reviews carried out by independent third parties, including government auditors - on which to base assessments of the value for money achieved by optimal risk allocation and other efficiency measures. One review in the United Kingdom (UK) found that on average savings of 17% were achieved over a range of sectors compared to the public sector alternatives. The Institute of Public Policy report published in 2002, however, indicated savings in the range of just 2 to 3%. Nonetheless, this and other studies concluded that value for money was being realised in a wider range of ways. For instance, the Institute of Public Policy report ‘*Building Better Partnerships*’ 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.

According to the UK National Audit Office 2001, most public bodies in the UK (81%) believe they are achieving satisfactory or better value for money. Over 70% of authorities and contractors view their relationship as being good or very good, with only 4% of contractors feeling their relationship with authorities is poor. For departments, the initial test will be a comparison between the bids actually received for the project in due course and the PSC. Beyond that, client departments need to ensure that the value for money anticipated at the time of contract letting is delivered in practice. To do so requires careful project management and close attention to managing the relationship with contractors during the life of the project.

***Overseas, independent third-party assessments report that PPPs are achieving value for money***

***Since private sector borrowing costs are higher than public sector borrowing, how can PPPs be more cost-effective?***

Since most governments borrow at cheaper rates than the private sector, it seems curious that projects involving the sale of services to the private sector are viable as PPP projects. However, when financing a project, it is the total risks of the project that determine the true cost of finance. The difference between the private and public sectors is that private sector capital markets explicitly price the risk of a project into the sources of finances. In the public sector, the risk of cost overruns, time delays or performance failures are not priced into the government borrowing rate. It is now becoming commonly accepted that the government must put a value on the transfer of risks to the private sector.

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 can represent good value for money to the taxpayer as the efficiencies and productivity that the private sector can achieve over the life of the project more than compensate for any higher cost of borrowing.

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

There is evidence from the UK that projects using third-party funding, ie not equity injected by the consortium members, have a higher degree of success. This is put down to the intense scrutiny of projects by the third-party financiers.

On the other hand, client departments should be aware that the infrastructure and assets of, and revenue from, the project will be subject to a charge in favour of the financier.

***Will the PPP approach commit the government to long-term recurrent expenditure?***

Most government assets and infrastructure projects effectively commit the government to a 'lifetime' of expenditure. Governments tend to focus on the cost of construction with only limited 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 make an informed decision before making contractual commitments.

Certain elements of operational services may not be procured for the full contract term, eg 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 30 years is currently problematical.

***Private sector efficiencies outweigh the higher costs of borrowing***

***Third-party scrutiny is valuable***

***Avoid hypothecation, unless suitable legislation exists or is planned***

***Can private partners retain revenue received from the public using the facility/service?***

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 and no 'netting off' payments unless specifically provided for in legislation. The question of hypothecation can be avoided if the payment to the private partner is calculated according to a formula based on the amount of revenue rather than the revenue itself. For example, part of the government's payment to the private sector may be a percentage, or a multiple, of the revenues collected. A multiple is most likely to apply where a fee for a service is subsidised by the government by 50% or more.

Monies received by private partners in their capacity as a principal, ie not an agent for the government, are not 'public monies' and are therefore not covered by the Public Finance Ordinance. Legal advice should be sought as to whether the particular circumstances of a PPP lead to the collection of public monies by the private partners.

The merits of individual cases would dictate whether it would be desirable to legislate for hypothecation.

***Are there any standard mechanisms for profit sharing?***

Revenue and profit sharing arrangements have been used in Hong Kong, eg Housing Authority retail premises. Precedents are available from the Commercial Unit of the Department of Justice (DoJ).

## Chapter 8 The Public Sector Comparator (PSC)

- ⇒ What is the PSC?
- ⇒ When do we construct the PSC?
- ⇒ How accurate are calculations of the PSC?
- ⇒ Is it advisable to disclose the preliminary/final PSC to bidders?
- ⇒ Must we always construct a PSC?
- ⇒ Can a project proceed if the lowest price conforming bid exceeds the PSC?
- ⇒ If no PPP proposal is judged to provide value for money the department might revert to the conventional approach. Won't this lead to several years' delay in the implementation of the project?
- ⇒ What if the successful bid is too expensive?
- ⇒ How can the client department be sure that it will get value for money from PPPs?
- ⇒ How do we guard against artificially low bids?

### ***What is the PSC?***

The PSC is the hypothetical, 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 provides a means of testing private party bids for value for money. It has four 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 or service is owned by the public sector);
- ⇒ Competitive neutrality adjustment (this removes any net advantages or disadvantages that accrue to a government business by virtue of its public ownership, eg tax advantages);
- ⇒ Transferable risk (the value of those risks which the government would bear under a public procurement but is likely to transfer to the private sector); and
- ⇒ Retained risk (the value of those risks that are likely to be retained by the government and are reflected in the PSC) is added to each private sector bid.

### ***When do we construct the PSC?***

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.

*A PSC helps to forecast whole life project costs, and test the value for money of private sector bids*

It is likely that the PSC will be reviewed and refined during the course of the procurement. The process should be as open and transparent as possible, so that potential partners can ascertain what factors/costs have been attributed to the PSC. It also enables omissions to be identified and raised with the client department. This will help engender the greatest possible confidence in the process.

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

Experience overseas indicates that the PSC cannot be calculated exactly. For projects envisaged to last for, say, 30 years it is not possible to derive an exact estimate of the PSC. Examples are now found of PSCs being quoted as a range.

***Is it advisable to disclose the preliminary/final PSC to bidders?***

The final PSC will be public knowledge by the time of the RFP as it will have normally been disclosed to LegCo's FC in the course of obtaining approval to proceed with the project. Providing it to bidders will discourage them from submitting bids that are higher than what is in effect the project's financial ceiling.

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

Where no public money is involved because the project is financially free-standing (ie the private partner recovers all costs through charges to the ultimate consumers), or where a firm decision has been made that the PPP approach is to be followed for policy or qualitative reasons, a PSC need not be constructed. Nonetheless, client departments will still wish to establish value for money, especially if public land has been provided at less than full market value.

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

As indicated above a PSC may be a range rather than an absolute number. If the lowest 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. 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 non-core services etc, then the client department would likely feel comfortable to proceed.

***If no PPP proposal is judged to provide value for money the department might revert to the conventional approach. Won't this lead to several years' delay in the implementation of the project?***

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, eg outcome specifications and designs submitted by PPP bidders may be used for the conventional approach. It is appropriate 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. It should be noted that the government must

*If no PSC is constructed, client departments will still wish to establish value for money*

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 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.

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

Any successful bid must be better value for money than the other competing bids and compare favourably to that of 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.

### ***How can the client department be sure that it will get value for money from PPPs?***

There is no guarantee that a client department will get good value for money from a PPP approach to every type of project. However, many projects 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 will be by:

- ⇒ Ensuring that the client department and bidders have a common, comprehensive and clear understanding of the requirements and constraints of the project;
- ⇒ Defining output requirements in a way which gives bidders the opportunity to innovate;
- ⇒ Allocating project risks optimally;
- ⇒ Running the bid process robustly, transparently, fairly and competitively;
- ⇒ Appropriate reporting, liaison and supervision of the contract throughout its life; and
- ⇒ Providing good contract documentation.

A comparison between the bids received and a fully developed PSC will enable the client department to confirm that the PPP offers better value for money before it enters into contractual commitments.

*Avoid post-contract signing changes - whether for PPPs or for conventional contracts*

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

A PPP approach should discourage the practice sometimes seen in conventional procurement whereby companies bid an artificially low price in order to win the contract - hoping to make money later through add-ons such as contract variations. This is because 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 private partner's responsibility - at its own cost. If such problems lead to the contracted performance service standards not being met, the private partner will face cuts, deferral, or withholding of payments. The contractor'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.

## Chapter 9 Selecting the Right Private Partner

- How do departments get the right private partner?
- Will PPPs restrict the opportunities for Small and Medium Enterprises (SMEs)?
- Will local service providers suffer from the introduction of PPPs?
- What types of project have been completed using the PPP approach?

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

As with all private sector involvement exercises, you need to:

- Conduct market testing to ensure that the private sector is willing and able to perform the tasks you have in mind;
- Give potential partners the opportunity to comment on details of the proposed scheme;
- Give sufficient publicity and time for potential bidders to prepare;
- Ensure you have output/outcome performance specifications that clearly identify the results you are seeking;
- Look for good alignment of the private partner with your own 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); and
- Select a private partner that you will be able to work well with throughout the life of the project.

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

### *Will PPPs restrict the opportunities for Small and Medium Enterprises (SMEs)?*

Many PPP projects will require skills and resources not available to one company. Much will depend on the details of each individual project. Thus bidders are likely to be consortia. Whilst the equity might be invested by some of the entities interested in securing the major contractual roles in the project, much of it is likely to come from third-party financiers. While SMEs are unlikely to feature as consortium members in larger projects, they will have opportunities to participate at the subcontractor level. This is little different from the picture under conventional procurement where major construction companies would be likely to take the leading contractual roles.

*Look for a  
reliable, long-  
term partner*

***Will local service providers suffer from the introduction of PPPs?***

Local players with local knowledge would be well placed to participate in bidding consortia, or act as subcontractors. Whilst there should not be any unfair competition between a local service provider and an overseas company, a minimum local content might be specified in the procurement documents. Care should be taken that this does not preclude service solutions that would increase the value for money to the government.

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

Because we are still at the early stage in Hong Kong there are few local examples of completed PPP projects, except for major infrastructure facilities such as the cross-harbour and other tunnels developed using the Build, Operate, Transfer approach.

Nonetheless, a considerable number of projects are at different stages of development, or have, for example, had feasibility studies conducted. These include:

- Hospital Authority catering;
- Route 3;
- West Kowloon Cultural District;
- Sports and recreation facilities; and
- Floating refuse collection.

Overseas, there are successful examples of a wide range of economic and social infrastructure facilities built and public services delivered using PPP approaches including:

- Airport management;
- Court buildings and facilities;
- Defence;
- Education (schools, police/military colleges, universities);
- Fleet management services (land, sea and air);
- Food, laundry and other support services for hospitals/prisons/elderly homes;
- Hospitals;
- Information technology services;
- Office and residential accommodation;
- Police stations;
- Prisons and prisoner escort;
- Railways/roads/bridges/tunnels;
- Scientific, and research and development facilities;
- Solid waste management facilities;
- Sports, leisure and recreation centres;
- Street lighting;
- Urban regeneration; and
- Water and waste water treatment plants.

## Chapter 10 Changes of Circumstances

- ⇒ Can we ensure long-term successful performance?
- ⇒ How, during the contract, can the client department seek changes to the size of facilities; the level or nature of services; or the technical standards?
- ⇒ Can the client department ensure that it benefits from technical upgrades?
- ⇒ What if the contracting department no longer retains responsibility for the service/contract?
- ⇒ Can the client department ensure that ownership of the consortium does not pass into the wrong hands?
- ⇒ What if the client department is corporatised/privatised?
- ⇒ If an equipment provider is part of the consortium will the client department be locked into using its equipment after the end of the contract or in replacement/upgrade exercises?
- ⇒ What if the private partner makes ‘windfall profits’?
- ⇒ What if there are unforeseen increases or decreases in the private partner’s operating costs, eg change of law?

### ***Can we 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 and not seek to impose unrealistic standards;
- ⇒ Putting in place procedures to accommodate 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; and
- ⇒ 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 private partner.

### ***How, during the contract, can the client department seek changes to the size of facilities; the level or nature of services; or the technical standards?***

Client departments should, as far as possible, structure their contracts, both in terms of capacity and technical standards on the basis of foreseeable, stable expectations. However, in the case of lengthy contracts it will not necessarily be possible to do this and 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; some form of benchmarking or market testing may be required for this purpose;
- ⇒ Break clauses after a period of time;
- ⇒ Renegotiation clauses;
- ⇒ Periodic review mechanisms; and
- ⇒ Referrals to mediation or arbitration.

*Acknowledge that circumstances will change over the life of a long-term contract, and make provision to handle the changes*

*Include approaches to address changes in the contract*

In particular, the contract should provide whether the department or the private partner assumes the risk of certain classes of change. For example, changes in economic conditions, costs of labour and materials, as well as taxation and changes in general law may be met by the private partner; whereas discriminatory specific legislation affecting the project may be met by the department.

Agreement between the department and the private partner may be required on :

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

### ***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 costs savings from technology changes or which might reasonably be expected from upgrades that could have been implemented. Whether such a provision is appropriate will depend on value for money considerations.

### ***What if the contracting department no longer retains responsibility for the service/contract?***

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

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 private partner, 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 private partner appropriately for the loss of the contract.

***Share technical upgrade benefits***

***The government - not the client department - is the formal party to the contract with the private partner***

***Can the client department ensure that ownership of the consortium does not pass into the wrong hands?***

PPP contracts typically contain provisions requiring the agreement of the client department to any changes in control of the consortium company - with such agreement not to be unreasonably withheld. The approach generally adopted is that the client department should be able to prevent ownership changes which 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, eg entities which had previously engaged in improper dealing or which have criminal associations or 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 project company to perform the contract after a change in its shareholding, other provisions in the contract, eg payment mechanism and termination trigger, should be capable of addressing this.

In permitting any change of shareholders, it will normally be necessary to appraise and review any performance bonds; ensure consent of bondholders and guarantors; and confirm the continuing strength of commitments from other shareholders and consortium members.

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

If the client department is not a legal entity, it will not be a legal party to the PPP contract - the contract should 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.

***If an equipment provider is part of the consortium will the client department be locked into using its equipment after 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 tolerated even under a conventional procurement.

***What if the private partner makes 'windfall profits'?***

Given the prolonged duration of most PPP projects, client departments will need to anticipate the likely occurrence of any refinancing. There has been public criticism in some other countries where private partners have made 'windfall profits', particularly as a result of project refinancing. Provision can be made in the contract for these gains to be shared with the government. The government's share of any refinancing gain could be taken as a cash lump sum at the time of the refinancing and/or as reduced service charges.

*The client department should reserve the right to veto changes in control*

*Arrangements can be made to share 'windfall profits'*

*Ensure that critical issues are addressed upfront*

***What if there are unforeseen increases or decreases in the private partner's operating costs, eg change of law?***

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 private partner, 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 private partner's perspective, the risk is that change of law will increase the cost of complying with its obligations. As most projects are contracted on a fixed price basis, the private partner is unable to pass on the additional cost to the government. The issue is thus the extent to which payments to the private partner should be adjusted to reflect its increased or decreased costs.

The government's starting point should be to require the private partner to bear the risk of all legislative changes unless they are discriminatory or specific to the project. All businesses and persons are subject to changes of law and it is commonplace for businesses to take legislative risk.

## Chapter 11 Managing Performance

- ⇒ What happens if the facility/service is not commissioned/commenced on schedule?
- ⇒ Should early commissioning be allowed/encouraged?
- ⇒ How can the client department monitor operational performance?
- ⇒ Which members of the private partner's consortium should the client department approach to make complaints, seek information, propose suggestions etc?
- ⇒ How can the client department protect itself from serious or persistent performance failures?
- ⇒ Are there established guidelines for dispute resolution?
- ⇒ What happens if a consortium collapses?
- ⇒ What happens if one of the consortium's main contractors collapses?
- ⇒ What happens if there is failure in performance entitling the government to terminate the contract and/or sue for damages?

### ***What happens if the facility/service is not commissioned/commenced on schedule?***

The private partner 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 which are predicated upon availability-based payments must carefully define in the project documentation what is meant by 'available' for this purpose.

Where a land lease is involved, a bring-into-operation covenant will normally be included thereby imposing a positive obligation onto 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.

### ***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.

### ***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. The contract should also allow for the production and monitoring of suitable performance indicators, which should be provided on a regular basis to the client department by the private partner. In addition, the contract provisions should permit the department to:

- ⇒ Have physical access to the facility at all reasonable times;
- ⇒ Have access to the accounts and other records;

***Availability-based payments discourage project delays***

***Utilise self-monitoring/reporting by the private partner to minimise the departmental resources required***

- Require user-satisfaction surveys to be conducted;
- Require the publication of regular reports on contractual performance; and
- Audit performance.

In some cases, various licences may be required for the private partner to operate. Consideration of licence applications, and their renewal/revocation may provide further opportunities to monitor operational performance.

***Which members of the private partner's consortium should the client department approach to make complaints, seek information, propose suggestions etc?***

The consortium should be required to nominate one single point of contact for all dealings with the client department. This individual should have sufficient seniority and authority to have access to, and influence over, consortium members. The department itself should also nominate a suitably senior single point of contact with the private partner.

***How can the client department protect itself from serious or persistent performance failures?***

The client department should maintain close and regular contact with the private partner 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 private partner's single point of contact cannot deal with them, the issue should be elevated to a more senior level. If problems persist, the matter may need to be brought to the attention of the private partner's lenders.

In the majority of cases, the government will wish to include a number of measures commonly found to ensure performance, or compensate for a lack of it, such as performance bonds, bank or parent company guarantees or warranties with subcontractors and 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 private partner 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.

There should also be provisions enabling the department to terminate the contract in the event of prolonged, persistent or very serious performance failures - though the consortium's lenders will first be given an opportunity to step in and rectify the problems. If appropriate, it may appoint (with the client department's consent) a substitute consortium, or member of the 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 private partner's procedures and practices;
- Require changes in the private partner's management personnel;

***The private partner should provide a single point of contact***

***Problems should be nipped in the bud to avoid them becoming serious***

- ⇒ Formally warn the private partner of unsatisfactory performance;
- ⇒ Issue a final, public warning; and
- ⇒ If the situation remains uncorrected, recommend termination of the contract.

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

The experience of other jurisdictions confirms that there will be disputes, as with other contracts. Dispute resolution in PPPs takes many forms and should reflect the specific requirements of the project and the nature of the parties' relationship. In practice, many PPPs provide for 'staged' or ramped dispute resolution procedures, eg starting with conciliation which provides flexibility to the parties and respects the need to maintain their commercial relationship in the face of their dispute. There will not only be the possibility of disputes that could end the project, but countless other smaller disputes that will require resolution. Appropriate models need to be considered and chosen for each type. This is particularly so in respect of technical and financial issues which need some form of resolution, eg expert determination, that is speedy and not too confrontational.

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

The consortium SPV will typically transfer all major consortium risks to its contractors - construction, operating, maintenance and so on. This means that the SPV is unlikely to collapse just because one of its contractors comes under commercial pressure. Its performance (operational as well as financial) will in any case be closely monitored by its lenders. 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. This drastic step will likely have adverse implications for the delivery of services, at least for a period of time.

To protect against the event that the consortium company itself does collapse the PPP project would need to be structured so that the assets would revert to the government.

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

The consortium SPV 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 which 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 lenders will insist on doing so too. Any subsequent change in a main contractor will require the client department's approval.

***Partnership does not mean avoiding disputes - it means addressing problems with a common aim of resolving them to mutual satisfaction***

***What happens if there is failure in performance entitling the government to terminate the contract and/or sue for damages?***

In the case of serious failure to perform, the contract may be terminated and the private partner moved off the site. This would be subject to any 'step-in' rights agreed between the client department and the consortium's lenders for the lender to rectify the problems and/or to replace all, or part of the consortium. Upon termination the asset is not usually forfeited - a termination payment, varying subject to the cause of termination, is usually paid.

The government would have to proceed with legal action, as appropriate, to recover from the defaulting private partner the costs incurred in rectifying defects, and in the maintenance and management of the facility.

## Chapter 12 Staffing Issues

- ⇒ Will a PPP project pose any industrial relations concerns to the civil service?
- ⇒ When should staff be informed/consulted?
- ⇒ How will staffing implications be tackled?
- ⇒ Should civil servants in the client department be allowed to work for a PPP partner?
- ⇒ How have staffing issues been dealt with in other jurisdictions?

### ***Will a PPP project pose any 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, eg whether it affects existing services or new services? Care should be taken to draw up a manpower strategy which 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 or for some of them to be transferred to the project company. In many cases, the private partner is likely to want to employ 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. 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 private partner can occur.

### ***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; and
- ⇒ 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.

### ***How will staffing implications be tackled?***

In evaluating the cost-benefit analysis of any PPP projects, the government will have to take into account all implications, including those on serving staff.

***Existing staff can offer much practical advice on how best to develop and structure a PPP project***

*Overseas experience indicates that private sector partners actively seek to employ civil servants, especially in areas where there had been a government monopoly in the provision of a particular service*

***Should civil servants in the client department be allowed to work for a PPP partner?***

Any civil servant is entitled to resign or retire and work for a private company, provided that he/she has 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 private partner in accordance with the prevailing civil service regulations. This can be done in a number of ways including:

- Secondments to the private sector provider (with an option to stay or to revert to the civil service);
- Introducing a voluntary departure scheme with adequate severance terms;
- Requiring the private partner to employ minimum numbers of serving departmental staff; and
- Giving bidders higher bid assessment scores for proposals involving the employment of serving departmental staff.

***How have staffing issues been dealt with in other jurisdictions?***

Elsewhere, including the UK and Ireland, this has been addressed using a combination of legislation (the Transfer of Undertakings (Protection of Employment) (TUPE) regulations) and with other contractual assurances. The TUPE regulations have helped to overcome staff concerns about PPPs.

## Chapter 13 Legal Issues

*Seek early legal advice from DoJ*

- What is the legal basis for PPP approaches?
- Are the government's constitutional or common law powers qualified by legislation?
- Can the government's enforcement powers be delegated to people other than public officers?
- What if there are enforcement powers that cannot be delegated to the private partner's staff?
- Is there any general statutory enabling legislation within Hong Kong similar to that found in the UK?
- Are there any other legal constraints on a PPP?

### ***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.

### ***Are the government's constitutional or common law powers qualified by legislation?***

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.

### ***Can the government's enforcement powers be delegated to people other than public officers?***

Where an ordinance confers a power or a duty on a particular public officer, that public officer must consider the exercise of the power or performance of the duty independently and judicially to the best of his/her ability. In other words the policy decision of a bureau whether or not to contract is not accepted in substitution for the consideration of the exercise of the power or duty by the holder of the particular office for the time being.

In addition to the need for the personal independent exercise of the power or duty, the nominated holder of the power or duty must have compelling reasons not to exercise; that is, to displace his statutory powers or duties which the legislature has expressly conferred on him and intended him to exercise according to the legislation. The non-exercise of any statutory power and a fortiori statutory duty in the manner and by the person intended by legislation 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. Despite the wide constitutional and common law powers of the government, where legislation has intended that functions, powers or duties be carried out by a public officer and charged and regulated in a statutory manner, it may not be lawful or permissible without amending legislation for those functions, powers or duties to be carried out outside the legislative framework. Everything turns on the interpretation of the particular legislation and its application to the particular facts of the case.

***What if there are enforcement powers that cannot be delegated to the private partner's staff?***

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 partners 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.

***Is there any statutory enabling legislation within Hong Kong similar to that found in 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 most cases. Client departments should always seek legal advice on whether particular legislation enhances or restricts their powers to contract.

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

Each project will involve many forms of activity on the part of a PPP partner. Before a request for proposals 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.

## Chapter 14 Land Issues

- How do we deal with land issues?
- Can departments issue licences of land?
- Can Short Term Tenancies (STTs) be used for PPPs?
- Will there be one contract that relates to both the land issues and the other PPP issues?
- Can a PPP project share a site with other Government/Institution/Community (GIC) facilities?
- Who owns the land/facilities?
- Can the private partner dispose of or otherwise benefit from the land granted for the purposes of a PPP?
- What zoning is appropriate for a PPP site?
- Should the private partner be charged a lump sum premium?
- Should the client department prescribe the land or premises to be used to deliver services?

### *How do we deal with land issues?*

The treatment of land as an asset should be dealt with on a case-by-case basis. 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 an enabling Ordinance. Client departments should consult the Lands Department and the DoJ at an early stage when considering a PPP. An indication of possible responses is given in the following questions and answers.

### *Can departments issue licences of land?*

Departments entering into PPP contracts may consider obtaining delegation from the Director of Lands under section 5 of the Land (Miscellaneous Provisions) Ordinance (Cap 28) to issue licences of land. This authority is delegated by virtue of section 18A of Cap 28 for public officers. 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 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 the Buildings Ordinance could be applied under the contract between the parties, enforcement would be more problematical; and
- A 30-50 year 'licence' is untenable because a licence would not pass title, which would cause problems for the private, partner in terms of obtaining loans and, possibly assignment. The private sector will almost certainly need exclusive possession and quiet enjoyment both physically and in terms of title. The nomenclature 'licence' does not determine the legal position. It is likely to be a lease whatever called.

*Consult Lands Department and DoJ at an early stage*

***Can Short Term Tenancies (STTs) be used for PPPs?***

The government sometimes grants STTs for the construction phase of a project so as to bring the Buildings Ordinance 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.

***Will there be one contract that relates to both the land issues and the other PPP issues?***

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 Housing Authority (HA) for example has also done this in procuring retail shopping services by two department stores on HA premises. The detailed terms of the service agreement relating to the management and operation of the facility were incorporated in the land lease. 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 can be kept reasonably lean and simple, focusing on the development and use of government land;
- ⇒ 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; and
- ⇒ 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.

***Can a PPP project share a site with other 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, and the type(s) of user under the PPP. Legal advice should be obtained on the issue of the best way to ensure that necessary government control and/or access is maintained. One possible approach would be by means of entrustment.

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

Depending on the intention, the government can form wholly-owned companies to hold the land and enter into partnership with private enterprise through SPVs for the delivery of service. Where a PPP partner has been granted a lease of land he 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 PPP partner 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.

### ***Can the private partner dispose of or otherwise benefit from the land granted for the purposes of a PPP?***

Client departments must ensure that the private partner 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 PPP partner will not benefit from a statutory compensation on resumption of the land.

In the case of PTGs 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 until after the lapse of a certain specified period and, in any event, until the required facilities have been brought into operation in accordance with the requirements as specified in the land sale conditions;
- Any alienation of the lot or any interest in the lot will not be allowed ‘except as whole’ ie no partitioning or subdivision of the lot will be allowed nor any assignment by way of undivided shares in the lot will be allowed; and
- 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 operator will be required to enter into a new SLA with the client department.

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

Most sites identified for government use are designated as GIC use. GIC use might continue to be appropriate for some PPP projects. However, in other cases the private partner might have proposed the provision of other ‘non-core’ services on the site that are not merely ‘ancillary’ to the principal use. In these cases, a change of zoning may be appropriate. 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 ‘non-core’ services are permitted as of right or may be permitted upon application under section 16 of the Town Planning Ordinance to the Town Planning Board.

***Changes to zoning are lengthy tasks and should not be left to the private partner unless unavoidable***

***Should the private partner be charged a lump sum premium?***

This will depend on the circumstances of each case. If the client department invites private partners 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 PPP partner is allowed or encouraged to provide revenue-generating services, 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 private partner 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.

***Should the client department prescribe the land or premises to be used to deliver services?***

The answer to this will vary from case to case. 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. Departments may wish to consider whether solutions involving the location of facilities/staff outside of Hong Kong would be acceptable. This will involve issues such as employment, competition, ethics, pricing, accounting and regulatory aspects. Further, departments will wish to consider legal safeguards on monitoring the supply of goods and services, international supply contracts, exemption clauses, arbitration and practical issues, eg enforcement.

## Chapter 15 Probity and Process Governance

*ICAC is willing and able to help*

- ⇒ How can the government ensure the transparency and fairness of the procurement process?
- ⇒ What procedures should be established for handling commercially sensitive bid information?
- ⇒ How can the private partner's probity be encouraged?

### ***How can the government ensure the transparency and fairness of the procurement process?***

The government should ensure that the procurement process is transparent and accountable and that all bidders are treated fairly. 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. A probity plan establishing the probity guidelines and procedures to be followed should be prepared prior to the commencement of the procurement process.

Given the comprehensive controls and regulations concerning civil service behaviour, Heads of Department may not wish to appoint a probity auditor.

The probity plan should deal with the following issues:

- ⇒ The role of the independent probity auditor (if appointed);
- ⇒ The 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 and queries;
- ⇒ Procedures for evaluation of bids; and
- ⇒ Procedures for identifying and addressing conflicts of interest.

### ***What procedures should be established for handling 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 which are in accordance with provisions under the Stores and Procurement Regulations (SPR), Security Regulations, Financial Circulars, Independent Commission Against Corruption (ICAC) guidelines etc.

*Probity auditors might not be required for the civil service*

***How can the private partner's probity be encouraged?***

The private partner should be required to appoint a probity auditor, who will be required to audit the consortium's own probity plan. For the successful bidder, the probity auditor should audit the consortium's probity for the life of the contract. Furthermore, the contracts appointing the private partner should include restrictions such as on:

- Accepting advantages (because section 3 of the Prevention of Bribery Ordinance does not apply to the private sector);
- Misuse of confidential, official and secret information; and
- Remuneration levels for unskilled workers below those commonly paid in the industry.

## Chapter 16 Managing Corruption Risks

*ICAC can advise*

- What are the major corruption risks?
- Is it acceptable to negotiate with bidders?
- Are there any 'negotiating procedures'?
- Should a contract won by corrupt means be terminated?
- Are any staff at particular risk?
- What about the private sector partner?
- Are there any other government regulations/guidelines concerning procurement/contract negotiations?
- Should the consortium winning a contract be included in the Schedule to the Prevention of Bribery Ordinance (Cap 201)?

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

Many of the corruption risks for which safeguards are required will lie with the private partner for the life of the project. Nonetheless, there are still areas of concern for the civil service. These are the selection of the bidder at the evaluation stage, valuation of contract variations and monitoring the performance of the contractor at the operation stage. To reduce these corruption risks, clear selection and assessment criteria and procedural guidelines will be needed. The Corruption Prevention Department of the ICAC can advise the government departments involved. Transparent and open processes minimise the opportunity for, and the risk of, fraud and corruption.

### ***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 the principle of non-discrimination and the provision of SPRs and WTO GPA, as in the conventional procurement process.

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

The ICT 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 should be fully minuted.

***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.

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

Members of the ICT 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 private partner.

***What about the private partner?***

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.

***Are there any other government regulations/guidelines concerning procurement/contract negotiations?***

SPR 385 'Tender Negotiations' and the SPR Appendix III(k) 'Guidelines for Tender and Contract Negotiations' are relevant.

***Should the consortium winning a contract be included in the Schedule to the Prevention of Bribery Ordinance (Cap 201)?***

A body providing public services should be added to 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 the provisions dealing with bribery and offering, soliciting and accepting advantages.

## Chapter 17 Assistance to Departments

- ⇒ Where can departments get help?
- ⇒ Are there sample documents?
- ⇒ Are there any case studies?

### *Where can departments get help?*

Departments should always seek advice from their policy bureaux if they encounter problems.

The Efficiency Unit is able to offer to departments general advice on PPPs and other private sector involvement opportunities, and can advise on external sources of advice. Wherever possible, consistency should be obtained by using the same channels. 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.

The 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. The Financial Services and the Treasury Bureau (Treasury Branch) should be consulted on the appropriate funding and procedures involved in seeking FC/PWSC endorsement.

### *Are there sample documents?*

There are a number of local PPP documents available at present. As more PPP projects proceed a body of useful documentation is being developed. The Efficiency Unit has some useful local and overseas documentation for reference.

A considerable amount of information is available on the internet, for example:

- ⇒ Australia : Guidance produced by 'Partnerships Victoria';
- ⇒ Holland : Guidance produced by the Kennis-Centrum (Dutch Government Taskforce);
- ⇒ Ireland : Guidance produced by the Department of the Environment and Local Government;
- ⇒ South Africa : Guidance produced by the National Trading Taskforce; and
- ⇒ UK : Guidance produced by the Office of Government Commerce; Department of Health; Department for Education and Skills, and 4Ps.

### *Are there any case studies?*

The Efficiency Unit has prepared a number of case summaries of overseas PPP projects, which are available on its website (<http://www.info.gov.hk/eu>).

The internet also 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.

## Abbreviations

ArchSD	Architectural Services Department
CTB	Central Tender Board
CWRF	Capital Works Reserve Fund
DoJ	Department of Justice
Eol	Expression of Interest
EMSD	Electrical and Mechanical Services Department
ExCo	Executive Council
FC	Finance Committee (of the Legislative Council)
GFA	Gross Floor Area
GPA	Government Property Agency
GIC	Government/Institution/Community
HA	Housing Authority
ICAC	Independent Commission Against Corruption
ICT	Intelligent Client Team
LegCo	Legislative Council
NPV	Net Present Value
O&M	Operation and Maintenance
OCIP	Owner Controlled Insurance Programme
PPP	Public Private Partnership
PSC	Public Sector Comparator
PTG	Private Treaty Grant
PWSC	Public Works Subcommittee (of the Legislative Council)
RAE	Resource Allocation Exercise
RFP	Request for Proposal
SFST	Secretary for Financial Services and the Treasury
SLA	Service Level Agreement
SME	Small and Medium Enterprise
SPR	Stores and Procurement Regulations
SPV	Special Purpose Vehicle
STT	Short Term Tenancy
UK	United Kingdom
WTOGPA	World Trade Organization Government Procurement Agreement



## Glossary of Terms

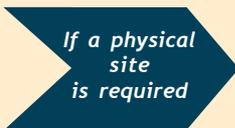
<b>Benchmarking</b>	A procedure for testing whether the standard and price of services is consistent with the market standard (if any), without any formal competitive bidding.
<b>Business case</b>	The establishment by the client department of the need for the project and its outline parameters and scope.
<b>'Core' and 'non-core'</b>	<p>'Core' facilities/services are those specifically required by the client department. 'Non-core' facilities/services are enhanced or additional features on the site, usually proposed by the private partner, bringing additional benefits, eg better site utilisation, revenue generation.</p> <p>Other jurisdictions have different 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 private sector.</p>
<b>Client department</b>	The department originating, and responsible for the intended project.
<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>	In response to an invitation, companies indicate their interest in, and ideas for, a project with a view to being invited to submit a proposal at a later stage.
<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>Intelligent Client Team (ICT)</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>Liquidated damages</b>	Stipulated amounts of money stated in the contract as compensation to the public partner under specified circumstances. Normally, the amounts are based on the estimated loss/cost to the public partner under these circumstances.

<b>Net Present Value (NPV)</b>	Discounted cashflow over a period of time by using the cost of capital 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, chaired by the Chief Secretary for Administration, to consider major issues requiring policy approval.
<b>Pre-qualification</b>	A process to short-list private companies which meet the requirements to be invited to submit a proposal for a project.
<b>Probity auditor</b>	A third party appointed by the ICT to observe and review the procurement process and ensure that the procedures are administered fairly and impartially.
<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 companies to make an initial proposal.



<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 private partner 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 private partner if certain requirements are met at the end of the contract.
<b>Site coverage</b>	The proportion of a site which is covered by a building.
<b>Special Purpose Vehicle (SPV)</b>	A project company established by the bidders which has as its sole purpose the delivery of a specific project, often referred to as the consortium.
<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 funders, 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.

## Establishing a PPP - Procedures

Action	Objectives/Controls/Approvals
<b>Step 1 Mobilisation and Development of a Business Case</b>	
<p><i>Step 1.1</i> Conduct needs analysis, market testing and PPP feasibility study</p>	<ul style="list-style-type: none"> <li>➤ Establish the need for the facility/services and define service objectives</li> <li>➤ Identify appropriate location(s) for the service or facilities</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>
<p><i>Step 1.2</i> Establish an ICT comprising civil servants as well as outside expertise if required</p>	<ul style="list-style-type: none"> <li>➤ Oversee project progress from start to completion</li> <li>➤ The ICT is normally chaired by the Director of the client department or a suitably senior colleague. Its composition may change at different stages of the project</li> </ul>
<p><i>Step 1.3</i> Establish whether a site is available</p>	<ul style="list-style-type: none"> <li>➤ Land would normally have been earmarked for use on appropriate plan by the Planning Department and zoned as GIC</li> <li>➤ The land use in GIC zone is governed by the Town Planning Ordinance</li> </ul>
 <p><i>If a physical site is required</i></p>	<p>(NB: Change in zoning from GIC to other uses is a lengthy process, involving submission to the Town Planning Board)</p>
<p><i>Step 1.4</i> Establish what services/facilities are required</p>	<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>

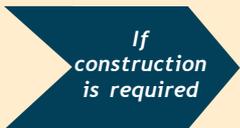


Action	Objectives/Controls/Approvals
<b>Step 1 Mobilisation and Development of a Business Case (cont'd)</b>	
<p><i>Step 1.5</i> Prepare a draft Statement of Requirements</p>	<ul style="list-style-type: none"> <li>➤ Draw up output specifications for the core facilities/services that the client department requires on the site, eg 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, eg fire and building safety standards, are complied with</li> </ul>
<p><i>Step 1.6</i> Consider whether to accept proposals for enhanced or other commercial 'non-core' facilities/services on the site</p>	<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>
<p><i>Step 1.7</i> Assess risks</p>	<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>
<p><i>Step 1.8</i> Prepare PSC with the assistance of other government departments, eg a works department, and seek policy endorsement</p>	<ul style="list-style-type: none"> <li>➤ Benchmark whole life costs of core activities</li> <li>➤ PSC is expressed in net present value to enable comparison between options with different cashflow profiles</li> <li>➤ PSC should be reviewed and refined during the course of procurement</li> </ul>
<div style="background-color: #004a7c; color: white; padding: 10px; text-align: center;"> <p><i>No need to conduct if qualitative or policy reasons predominate, or the project is financially free-standing</i></p> </div>	
<b>Step 2 Funding</b>	
<p>Submit a bid via the policy bureau for funds through the RAE process</p>	<ul style="list-style-type: none"> <li>➤ Secure capital funding under CWRP and ensure recurrent funding for the operation phase</li> </ul>

Action	Objectives/Controls/Approvals
<b>Step 3 Consultation and Land Requirements</b>	
<i>Step 3.1</i> Conduct consultations	<ul style="list-style-type: none"> <li>➤ Obtain support/approval in principle/initial commitments from the various stakeholders including:               <ul style="list-style-type: none"> <li>- Staff</li> <li>- Non-governmental local and territory-wide bodies</li> </ul> </li> <li>➤ Ensure staff informed/consulted before public airing of the project</li> <li>➤ Consult District Council and other statutory/non-statutory bodies</li> </ul>
<i>Step 3.2</i> 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 Housing, Planning and Lands or Director of Lands under delegated authority</li> <li>➤ Conduct environmental assessment</li> </ul>
<b>Step 4 Expression of Interest Exercise</b>	
Initiate an Eol 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>
<b>Step 5 Policy and Financial Approvals</b>	
<i>Step 5.1</i> 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 (May defer until after the issue of RFP)</li> </ul>
<i>Step 5.2</i> 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> </ul> </li> </ul>

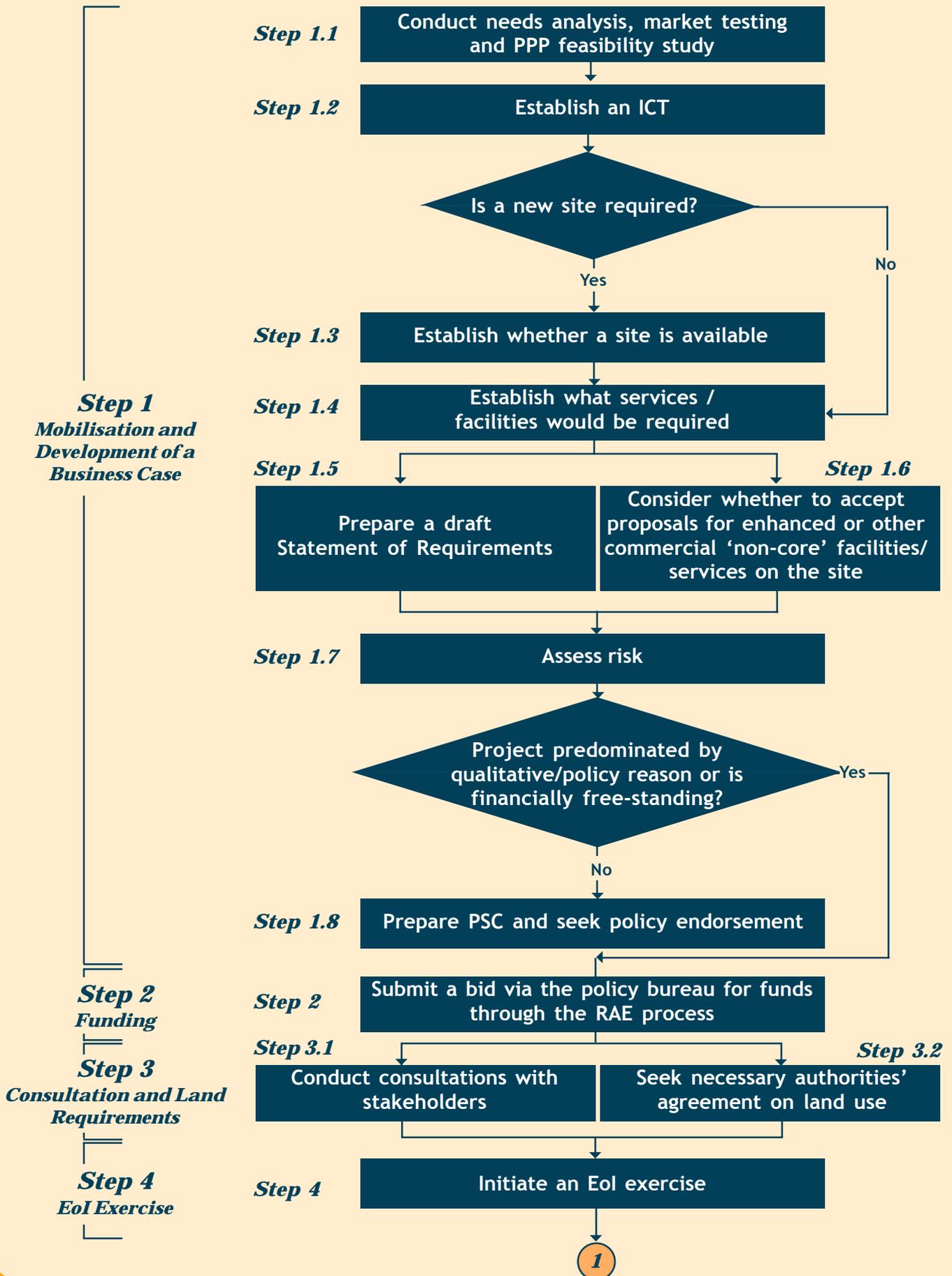


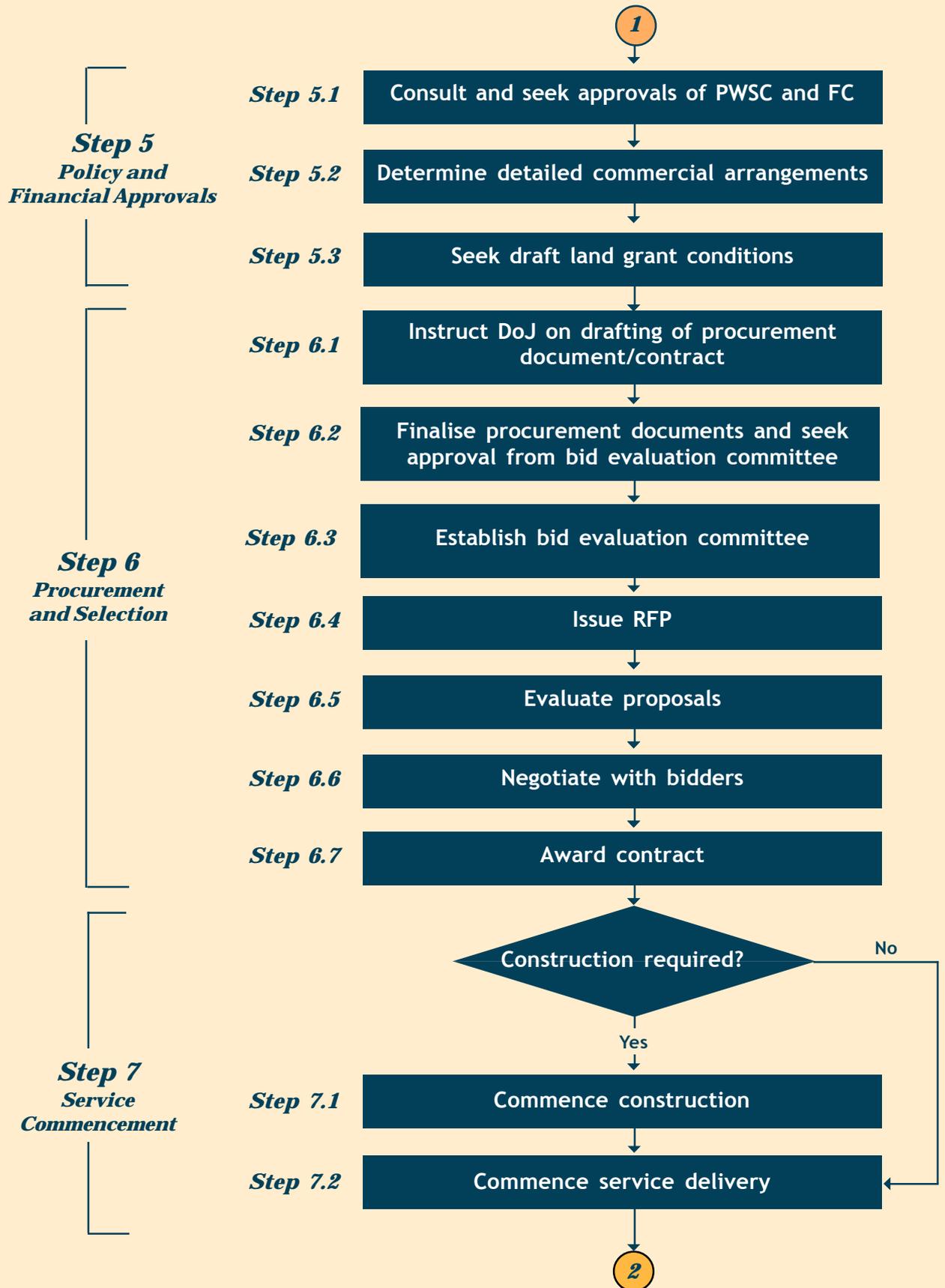
Action	Objectives/Controls/Approvals
<b>Step 5 Policy and Financial Approvals (cont'd)</b>	
<i>Step 5.3</i> Seek draft land grant conditions	<ul style="list-style-type: none"> <li>➔ Consult LACO on the drafting of land grant document</li> <li>➔ Formalise land grant conditions</li> </ul>
<b>Step 6 Procurement and Selection</b>	
<i>Step 6.1</i> Instruct DoJ on drafting of RFP document/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>
<i>Step 6.2</i> Finalise RFP documents and seek approval from the relevant bid evaluation committee to be approved by SFST	<ul style="list-style-type: none"> <li>➔ Draw up output-based performance specifications</li> <li>➔ Bid evaluation mechanism</li> <li>➔ Conduct fair and objective evaluation of the bids</li> </ul>
<i>Step 6.3</i> Establish bid evaluation committee including the necessary departmental/technical/financial experts	
<i>Step 6.4</i> 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> </ul>
<i>Step 6.5</i> Evaluate proposals	<ul style="list-style-type: none"> <li>➔ Conduct initial assessment of proposals to seek necessary factual clarifications. Exclude those not meeting basic requirements</li> <li>➔ Conduct 2-envelope (technical and financial proposals) or 3-envelope (core facilities, non-core 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> <li>➔ Consider how to maintain competitive pressure on bidders during negotiation</li> <li>➔ The process and procedures must fully comply with the provisions of relevant Financial Circulars and SPR</li> <li>➔ Select from best and final offer(s)</li> </ul>

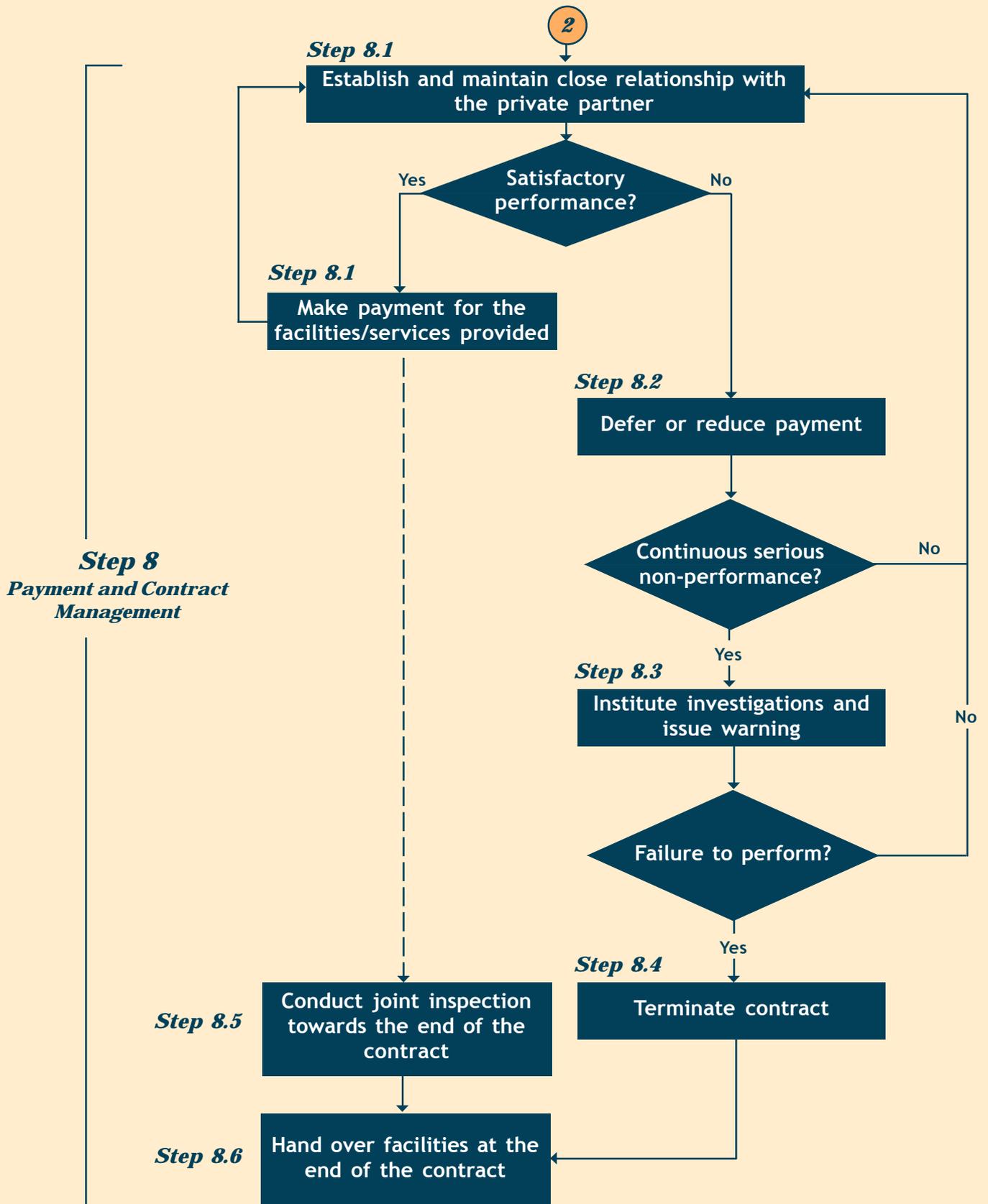
Action	Objectives/Controls/Approvals
<b>Step 6 Procurement and Selection (cont'd)</b>	
Step 6.6 Negotiate with bidder(s)	<ul style="list-style-type: none"> <li>➤ Prepare and seek approval of negotiating brief</li> <li>➤ Ensure the details of negotiations are fully recorded</li> <li>➤ Ensure that necessary checks and balances (eg set up clear selection and assessment criteria and procedural guidelines) are in place to reduce corruption risk. Consult ICAC where and when necessary</li> </ul>
Step 6.7 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, eg financiers</li> </ul>
<b>Step 7 Service Commencement</b>	
Step 7.1 Commence construction	<ul style="list-style-type: none"> <li>➤ ICT changes its role to monitoring and reporting the progress of the construction works of the project</li> <li>➤ ICT 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>
	
Step 7.2 Commissioning of facility and commence service delivery	<ul style="list-style-type: none"> <li>➤ ICT to facilitate commissioning</li> <li>➤ ICT to satisfy itself that the facility, where appropriate, is able to satisfy the delivery of contracted performance</li> </ul>
<b>Step 8 Payment and Contract Management</b>	
Step 8.1 Make payment for the facilities/services provided	<ul style="list-style-type: none"> <li>➤ Conduct regular liaison meeting to consider and resolve problems before they become serious</li> <li>➤ Maintain close and regular contact with the private partner</li> <li>➤ Monitor performance regularly against defined criteria and take action to address poor performance</li> </ul>

Action	Objectives/Controls/Approvals
<b>Step 8 Payment and Contract Management (cont'd)</b>	
<p><i>Step 8.2</i> Defer or reduce payment</p> <p><i>If performance is unsatisfactory</i></p>	<ul style="list-style-type: none"> <li>➤ Payment will be made for services provided according to the contract as measured against the performance specifications</li> <li>➤ If the private partner 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>
<p><i>Step 8.3</i> Institute investigations and issue warning</p> <p><i>Continuous serious non-performance</i></p>	<ul style="list-style-type: none"> <li>➤ Investigate the situation and require remedial measures to be taken by the private partner</li> <li>➤ If necessary, demand changes in private partner's procedures, practices and management personnel</li> <li>➤ Issue warning and make it public when needed</li> <li>➤ May recommend termination of contract</li> </ul>
<p><i>Step 8.4</i> Terminate contract</p> <p><i>Failure to Perform</i></p>	<ul style="list-style-type: none"> <li>➤ Seek legal advice in case of failure of the private partner to perform up to specified performance standard</li> <li>➤ Consider: <ul style="list-style-type: none"> <li>- 'Step-in' rights</li> <li>- Resumption of sites and taking over of facilities</li> <li>- Compensation negotiation</li> <li>- Needs and procedures to replace failed private partner</li> </ul> </li> </ul>
<p><i>Step 8.5</i> Conduct joint inspection towards the end of the contract</p>	<ul style="list-style-type: none"> <li>➤ Arrange for joint inspection of the assets with the private partner, eg two years before contract expiry, and require the private partner to make good any deficiencies</li> </ul>
<p><i>Step 8.6</i> Hand over facilities (at the end of the contract)</p>	<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 private partner</li> </ul>

## Establishing a PPP - Flowchart







This Introductory Guide has been prepared by the Efficiency Unit.

It has been posted on the Internet and may be accessed via <http://www.info.gov.hk/eu>. For copies of this Introductory Guide and advice on PPPs, please contact the Efficiency Unit Help Desk (Tel: 2165 7255).

Other documents in this series are:

- Serving the Community By Using the Private Sector (June 2001); and
- A General Guide to Outsourcing (November 2001).

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THE GOVERNMENT OF THE HONG KONG SPECIAL ADMINISTRATIVE REGION