

BEST PRACTICE GUIDE TO PROCUREMENT CHALLENGES OF PUBLIC-PRIVATE PARTNERSHIPS IN INFRASTRUCTURE DEVELOPMENT IN MALAWI

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ABSTRACT

Procurement of Public-Private Partnerships (PPPs) is underpinned by the project's potential to deliver Value for Money (VfM) through risk transfer to the private sector and the existence of enabling environments. In Malawi, PPP is a relatively new concept confined to the rail services, Information Technology and Airline sectors. Its use is quite limited in infrastructure development and there is no clear understanding or perception of the required PPP enabling environments and framework arrangements to assess risk transfer and VfM which are vital in steering successful PPPs and motivate private sector investment. The aim of this paper was two-fold, thus to review PPP procurement challenges from a Malawian perspective and propose a PPP methodology framework for best practice in infrastructure development from the findings. Semi-structured telephone interviews and Inductive thematic analysis were used.

Findings indicated that despite the potential for infrastructure PPPs in Malawi, the procurement process has several challenges some of which are common to the global PPP market. These include the protracted PPP procurement process of 12 to 24 months; handling of unsolicited bids; structure of the Special Purpose Vehicle; lack of robust assessment tools to ascertain VfM and risk transfer; limited capacity of local firms in handling PPP deals; high cost of private sector finance; funding restrictions and political risk. The PPP methodology framework for best practice in Infrastructure development was proposed and documented.

Keywords: Enabling environments, Methodology Framework, Procurement process, Risk transfer, Value for Money.

1. INTRODUCTION

Most governments world-wide have turned to Public-Private Partnerships (PPPs) to develop infrastructure and reduce dependence on public funds for development projects (Wamuziri and Jiang, 2008; Badu et al., 2012; Diz, 2014). Public-Private

Partnerships are long term agreements between the public and private sector for developing public assets using private finance and expertise in a favourable environment provided by the public sector (Kumaraswamy and Zhang, 2001; Wamuziri and Jiang, 2008; Malawi-Gazette, 2011).

Several European countries (Netherlands, Italy, Portugal, France, Germany and United Kingdom) have adopted the use of PPPs to develop infrastructure and enhance service delivery (Bult-Spiering and Dewulf, 2006). Leading among these is the United Kingdom through its Private Finance Initiative (PFI) which is a form of PPPs and has helped it achieve development even in the face of severe expenditure deficits (Akintoye et al., 2003).

Similarly, Sub-Saharan African governments have also turned to PPPs as evidenced by its adoption and use in South Africa in energy deals and toll roads, Nigeria in toll roads, airports, silos and water reservoirs and Kenya in the transport and energy sector (Thomson, 2005; Burger, 2009; Ugboaja, 2010; MENA, 2012; Iloh and Bahir, 2013).

In Malawi, PPP is a relatively new concept confined to the rail services, Information Technology and Airline sectors. Its use is quite limited in infrastructure development and there is no clear understanding or perception of the required PPP enabling environments and framework arrangements to assess risk transfer and Value for Money which is vital in steering successful PPPs and motivate private sector investment. Although such is the case, Malawi's annual infrastructure funding requirements are pegged at \$0.6 billion for the period 2006 – 2015 and face an infrastructure funding deficit of \$300 million annually. Its annual capability in meeting this deficit is \$175 million from the two largest funding sources thus the public sector and donors (Foster and Shkaratan, 2011). This has impacted on infrastructure development as well as affecting the country's competitiveness both regionally and globally hence being ranked 117 out of 142 countries on the Global Competitiveness Index (Ojukwu et al., 2013). The aim of this paper was two-fold, thus to review PPP procurement challenges from a Malawian perspective and propose a PPP methodology framework for best practice in infrastructure development from the findings.

2. PUBLIC-PRIVATE PARTNERSHIPS

Public-Private Partnerships is an umbrella term for projects jointly commissioned by the private and public sector thus encompassing a variety of names. In Australia, they are referred to as Privately Financed Projects (PFPs), while the UK term them as Private Finance Initiatives (PFIs), most parts of Africa including Malawi maintain the term PPPs (Jefferies, 2006; Akintoye and Beck, 2009; World-Bank, 2009; PPP-Policy, 2011). But what do PPPs entail? Understanding the process and structure of PPPs helped in appreciating the challenges that go with its procurement. Although much focus was on an ideal PPP system which is the PFI of the UK, its maturity and leading role in the global PPP market renders it perfect to be inferred on most PPP models (Ojukwu et al., 2013).

2.1 Procurement Process in PFI

Private Finance Initiative procurement process commences with the Outline Business Case (OBC) which highlights the rationale for the project using a 6% discount rate to ascertain viability (Shaoul, 2005; World-Bank, 2009). The OBC includes three options thus “do nothing”, “do the minimum” and the “preferred option”. The preferred PFI proposal is compared to a hypothetical model known as the Public Sector Comparator (PSC). If the PFI has a lower cost than the PSC then a Full Business Case (FBC) is developed (Hannah (2008).

Shaoul (2005) criticises and questions the dependability of a hypothetical PSC model as in practicality, the PSC can never be opted for the actual PFI project since it is no more than a conjectural model that cannot materialise. Similarly, Gaffney et al., (1999) contends that feasibility of PFI’s Business Case (BC) is masqueraded by HM Treasury’s imposed 6% discount rate which is taken as a policy decision aimed at pushing government’s agenda towards private finance. Underpinning their argument, they conducted an analysis that exposed the fragility of the BC if a minimal reduction is applied to the discount rate (Table 1).

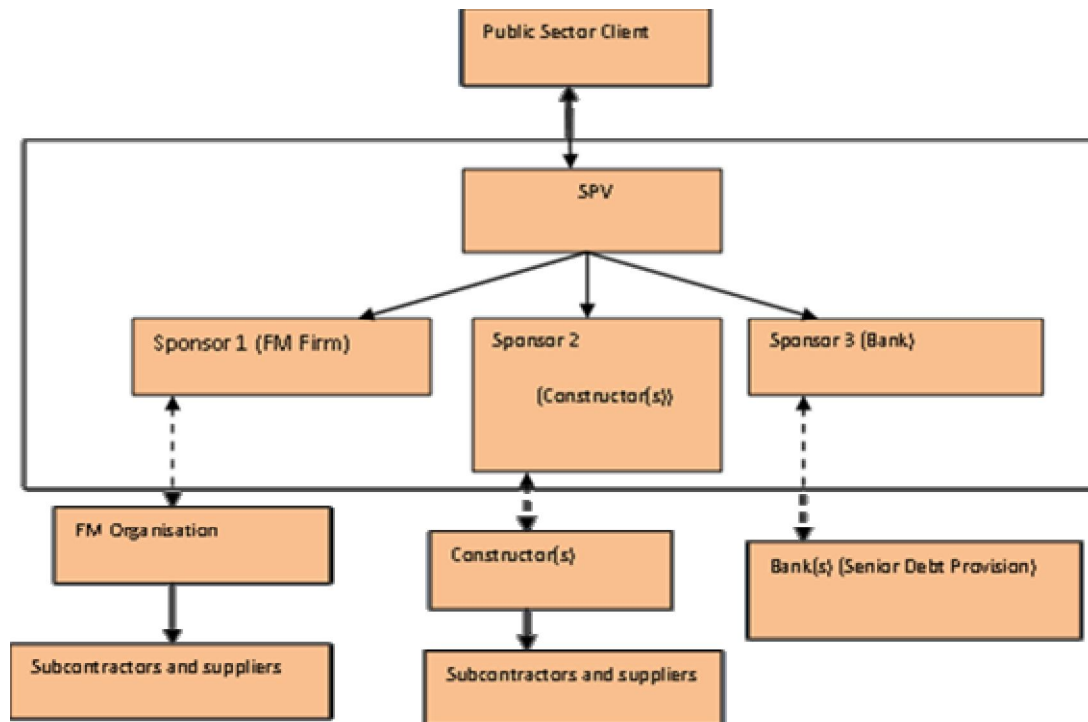
Table 1. : Effect of varying the discount rate on results of economical appraisal in Carlisle hospitals’ PFI scheme

Discount Rate (%)	Public sector option (PSC) (£000s)	Private sector option PFI (£000s)	Economic advantage of PFI over PSC (£000s)
6	174 337	172 633	1 704
5.5	185 803	186 692	-889
5	198 884	202 043	-3 159
4.5	213 900	219 480	-5 580
4	231 247	239 388	-8 141
3	275 027	288 622	-13 595
0	549 882	577 048	-27 166

(Source: Gaffney et al., 1999)

2.1.1 PFI Model and the Special Purpose Vehicle (SPV)

The structure of a PFI model (Figure 1) comprises three main players: the public sector, the Special Purpose Vehicle (SPV) and the sponsors (Chinyio and Gameson, 2009). The SPV provides the design, construction, financing and operation of the project. The sponsors objectives are risk reduction and wealth creation hence the need of passing on risk to the various subcontractors under them to ascertain bankability of the project (World-Bank, 2009 and Dixon et al., 2005).



(Source: Chinyio and Gameson, 2009)

Critics (Cuthbert and Cuthbert, 2008a; Shaoul, 2005) have deplored the high dividend returns on equity capital provided by the SPV and further questions the rationale behind the SPV's objectives due to reaping of supernormal profits in PFI deals. Their findings indicate significant excess profits not only from equity capital but from all types of private finance injected into the projects.

2.1.2 Transaction Costs and Value for Money

Transaction costs for PFI deals are high to both the private and public sector due to the protracted bidding process which takes 26-35 months (Dixon et al., 2005; Hellowell and Pollock, 2009; Haran et al., 2013). It was observed that the resultant costs from such a lengthy process translate into exorbitant legal, financial and technical costs thus affecting VFM.

Although HM Treasury advocates for low transaction costs and a competitive procurement process, evidence from literature indicate that high bidding costs, barriers to market entry and lack of competition are prevalent in PFI deals hence promoting monopoly and defeating the VFM concept (Dixon et al., 2005; Hellowell and Pollock, 2009; Demirag et al., 2011; Fombad, 2013).

The focal point of PFI projects is the asserted achievement of VFM, however, several scholars (Gaffney et al., 1999; Ball et al., 2000; Shaoul, 2005; Hannah, 2008; Fombad, 2013) have criticised the high costs associated with equity financing, the protracted bidding process, lack of competition and the discounted cash-flow analysis whose significance on public sector's non-profit making objectives is

questionable. Ironically, regardless of the raised criticisms, Treasury Taskforce Private Finance (2000) maintains that private finance's increased costs are minimal to endanger the concept of VFM. Ball et al. (2000) contests the Treasury Taskforce's view and claim that even with small margins, the probability of affecting VFM is significant considering the 20-30 year period of PFI projects.

Exploring other methods of assessing viability should be considered as an option since the highlighted arguments seem to question if VFM should be the underpinning basis of PFI projects due to the manipulation of its assessment tools (Shaoul, 2005; Hellowell and Pollock, 2009).

2.1.3 Private Finance and its Cost efficiency

The concept of using private finance on public sector projects has generated skepticism regarding its feasibility and ability to achieve VFM due to high interest rates accompanying private sector borrowing. A combination of debt and equity is common in PFI deals with varying ratios of 70-90% debt and 10-30% equity (Ball et al., 2000; Scottish-Parliament, 2008; Hellowell and Pollock, 2009; Ye, 2009; Bovis, 2010). It is argued that the same amount of finance can be borrowed by governments at a lower cost since the risk of borrowing governments is relatively low (Hellowell and Pollock, 2009). Further to that, Gaffney et al. (1999) questions the effectiveness of private finance due to high annual rates of return ranging from 15-25% in NHS projects.

2.1.4 Risk transfer

PFI has been justified by the British government under the guise of being able to achieve VFM through risk transfer to the private sector (Pollock and Price, 2008). Nevertheless, Gaffney et al. (1999) has flawed the risk transfer methodology used and argues that adjusting the PSC's net present cost with risk masquerades the PFI as an economically viable option. They further assert that risk is double counted through use of the 6% discount rate and adjusting the PSC with a lump sum. They carried out a study of NHS Trusts to demonstrate and substantiate their claims (Table 2).

Table 2. Risk added to PSC: net present costs over 60 years

Trust	PFI net present cost (£m)	Before risk adjustment (£m)	Risk added (£m)	After risk adjustment (£m)
Calderdale	1221	1191	73	1264
Carlisle	173	152	22	174
Dartford	928	881	55	937
Durham	177	153	24	177
Wellhouse	1206	1210	20	1230

(Source: Gaffney et al., 1999)

It is observed that the PSC's cost after risk adjustment becomes high as compared to PFI. This suggests that PFI's comparison against a hypothetical model is not reliable as a basis for economic viability.

Addressing the raised criticisms, Shaoul (2005) states that the British government decreed that both risk cost and risk transfer should be ascertained and included in PFI's financial appraisal. Despite the issued decree, the concept of transferring risk to a party better placed to manage it and not with a lowest and affordable risk premium is a cause for concern. Further questions are raised on: discounting the interest rate in assessing risk cost which can result in double counting, failure to consider extra risk that can arise from failure of the Special Purpose Vehicle and failure to embrace main risks like technical obsolescence, changes in regulatory framework, government policy and demand. It was further revealed that the 6% discount rate deals with 'Systematic risks' related to inflation and recession while excluding demand risk (Shaoul, 2005; Pollock and Price, 2008; Hellowell and Pollock, 2009).

2.2 PPP Procurement in Malawi

There is paucity of literature on PPPs in Malawi hence the review of the available documentation thus the policy and Act. Malawi has signed three PPP deals in rail services, fibre optic for communication infrastructure and Malawi Airways (Mchulu, 2014; Msusa, 2014). Its PPP policy framework and Act was approved by cabinet in 2011. Although the policy advocates for PPP procurement of public projects, traditional procurement methods still dominate the infrastructure sector.

2.2.1 Value for Money and Risk Transfer

The underpinning basis for all PPP deals is Value for Money, affordability and risk transfer. Malawi's PPP setting lacks methodologies for assessing VFM and risk transfer thus posing limitations (Malawi-Gazette, 2011; PPP-Policy, 2011). The policy state that viability shall be assessed through use of 'quantitative factors' and comparison against a PSC, despite lack of a description of the said quantitative factors. Lack of key benchmarks for assessment is challenging in ascertaining viability of proposed PPP projects.

2.2.2 Cabinet Approval of Proposals

Submission of proposals to cabinet for approval is a limitation (Malawi-Gazette, 2011). The major drawback with this approach is the political nature of a cabinet composition and the challenges facing developing countries regarding distribution of development projects. Questions are posed on how far impartiality can be exercised in approving projects falling within the jurisdiction of an opposition party. Although such fears can be quashed as irrelevant in developed countries, they can have a big impact in developing countries where sitting governments would want to stamp their authority in every single aspect.

2.2.3 Structure of the Special Purpose Vehicle

Malawi-Gazette (2011) stipulates inclusion of a cabinet minister within the SPV. Such provisos are challenging due to differing objectives between the public and private sector. It was noted that the policy is silent as to the actual composition of the SPV (PPP-Policy, 2011). Evasiveness in composition of such a key component can hinder the success of PPPs.

2.2.4 Unsolicited Bids

The PPP-Policy (2011) discourages entertaining unsolicited bids, while the PPP Act state that such proposals should be referred to the Public Private Partnership Commission for assessment (Malawi-Gazette, 2011). The existing ambiguity in handling of unsolicited bids is challenging thus sending mixed signals to private investors and it can be regarded as a limitation to the smooth delivery of PPPs. Although unsolicited proposals can be beneficial in other aspects, they promote lack of transparency, corrupt practices, poor VFM and monopolistic competition (World-Bank, 2009). It is apparent that such bids should not be entertained.

3. RESEARCH METHODOLOGY

The study was based on an exploratory design due to the contemporary nature of the issues under investigation hence the choice of a qualitative phenomenological research. This type of study endeavors to understand commonality of people's insights and intuitions on a specific concept (Leedy and Ormrod, 2010; Creswell, 2013). The overarching objective was to review PPP procurement challenges from a Malawian perspective and propose a PPP methodology framework for best practice in infrastructure development from the findings.

Due to the phenomenological nature of the study, purposive sampling was used with the aim of generating a sample that represents a viewpoint and not a population, thus selection criteria was based on the participants' ability to provide insights on the studied phenomena (Smith et al., 2009). The participants constituted 5 high-level executives educated to post graduate level with relevant experience in PPPs either as public-private investment executives or members that can constitute a Special Purpose Vehicle. The selected sample satisfied Creswell (2013) recommendation of selecting a sample size in the range of 5 to 25 with suitable experience on the issues being explored.

Non-probability sampling was used though it is termed subjective and limits generalisation of the findings (Henry, 1990; Flick, 2014). However, probability samples could not be used either due to the need to gain insights on PPP challenges in Malawi. Flick (2014) contests the basis of the generalisation argument as it focuses on numerical factors not reflecting the underpinning philosophies behind qualitative research.

Data was drawn from literature and audio-recorded, in-depth semi-structured telephone interviews. The themes that emerged from the literature were used to

inform the interview process and inductive thematic analysis was used (Tranfield et al., 2005; Scullin, 2008; Creswell, 2013).

4. FINDINGS AND DISCUSSION

4.1 PPP Procurement Challenges

4.1.1 Procurement Process

Procurement of PPPs in Malawi falls short of assessment tools to ascertain VFM, viability and affordability. Similar to stipulations in the PPP Policy and Act, the empirical results were silent on the exact tools to be used “...now what is key is that value for money should be attained, this is how the procurement process should be done, you know a business case for having that PPP”. The significance of the Business Case in a PPP deal cannot be overemphasized, however, Malawi’s case is in contrast with literature findings where a 6% discount rate is used to underpin viability through comparison of a hypothetical PSC model against the actual PPP project (Grimsey and Lewis, 2005; Shaoul, 2005).

4.1.2 Structure of the Special Purpose Vehicle

The Special Purpose Vehicle (SPV) in Malawi’s PPP model includes a Cabinet minister within its membership. The SPV is a project company responsible for designing, financing, operating and maintaining a proposed PPP project (Chinyio and Gameson, 2009). Thus the duties of the SPV are distinct from those of the public sector as the latter oversees and monitors the activities of the former. The results deplored the SPV’s composition as lamented by a participant, “...the involvement of cabinet is to approve, [...], that’s when we go and advertise, so I think that will be conflict of interest”. Inclusion of cabinet in the SPV can lead to conflicts, scare away potential investors or promote corruption.

4.1.3 Lack of Local Capacity

Participants indicated that local organisations and financial institutions are constrained to venture into PPPs due to huge capital requirements synonymous with such deals; “Major PP projects are very expensive, when you look at the magnitude of investment it’s massive, talking of \$50m to \$200m, local banks cannot finance such type of investment projects.”

“...It would be difficult for such firms to raise equity finance without actually borrowing due to the huge capital outlays that are involved. Further these firms have weak balance sheets, asset base and net worth which would not support such borrowings.” Capacity is one of the underpinning basis upon which firms decide whether they can afford to participate in PPP projects. Literature attributed capacity

challenges among small firms to the lengthy procurement process because of high transaction costs (Dixon et al., 2005; Hellowell and Pollock, 2009), while the results underpins capacity on capital outlays and the inability of local organisations to meet borrowing requirements.

4.1.4 Unsolicited Bids

Differing views emerged from the results on how unsolicited bids should be handled. Some felt that they should be referred to the Public-Private Partnership Commission (PPPC) although it might promote corruption while others stated it could lead to lengthy court battles, “... *unsolicited bids should be passed on to PPP Commission, who is going to investigate whether it is viable as a PPP project. [...] if somebody has come up with an unsolicited bid and then not get the contract, it may create problems or it could even lead to corruption.*”

“...*if you just single source, you are going to run into problems because these are major projects. [...] then it becomes a major litigation issue, then [...] such issues they will take years and years.*”

The assertions in the results are reflective of the contradiction that exists between the PPP-Policy (2011) and the Act. The policy warns against entertaining such bids while the Act provides laid down procedures on how they should be handled. It advocates that PPPC should evaluate and proceed with advertisements if they are found viable. Nonetheless, World-Bank (2009) is of the view that entertaining unsolicited bids can promote corruption and monopolistic competition as well as challenge a transparent procurement process.

4.1.5 High Cost of Private Sector Finance

It was lamented that the prevailing high interest rates in Malawi make PPPs expensive, “[...] *PPPs are not cheap. If you are going to use private sector money, that money is not cheap because the private sector, bring in equity, [...] and even if it's debt, bank interests are not cheap [...] they are usually more expensive.*”

Scholars further bemoaned high interest rates synonymous with private capital as well as the reaping of excess profits by private investors in PPP deals. It was found that annual rates of return are high and range between 7-25% (Gaffney et al., 1999; Ball et al., 2000; Shaoul, 2005; Hannah, 2008; Hellowell and Pollock, 2009).

For Malawi's case there was silence on high rates of return in the findings mainly due to the upcoming nature of its PPP market and non-existence of information on such experiences.

4.1.6 Political Risk

In Malawi, political cycles are five years between elections. A participant questions if such a cycle cannot pose threats to the procurement and implementation of PPP

deals due to uncertainties that may arise in the event of a change in political regime, “[...], then you look at political risk in Malawi, do we have the tendency that government awards [...] PPP contracts to investors and when government changes, will they reverse those investment projects and chase away the investors?” There is paucity of literature on political risk in PPP deals mainly due to the maturity of the World’s leading PPP models as well as the maturity of politics in the economies they exist. The context of the literature on political risk, however, focused on implementation of politically motivated projects by self-seeking politicians and top government officials in the Nigerian PPP market (Essia and Yusuf, 2013). Although issues of political risk may not be manifested in mature Western PPP markets, they can have a huge impact on the success of developing markets like Malawi.

4.1.7 Risk Management and Transfer

There is no quantitative risk assessment procedure to ascertain the amount of risk cost transferred to the private PPP partner from the findings, “[...]during negotiations, that’s when we share the risks, [...]e when we are doing the feasibility study that’s when we discuss how much risk can we transfer to the private party, so you determine before-hand that this risk can go to the private party, at what cost, maybe at this cost. [...] when you identify the risks, that’s when you are able to see that this risk can be mitigated by this. [...] it’s a social science, it’s not mathematics, qualitative risk assessment that’s how you come up with the risk and whether that risk can be borne by government or can be borne by the private party, so, i don’t think its mathematical something.”

Contrary to the findings, literature indicates that PPP’s financial proposal should include ascertained amounts of risk cost and risk transfer signifying a quantitative risk assessment process (Shaoul, 2005; Pollock and Price, 2008). The results echo the Malawian PPP policy which falls short of a robust risk transfer methodology to underpin the basis of all PPP deals (PPP-Policy, 2011). Problems may arise however, as the asserted qualitative risk assessment may have limitations in ascertaining quantitative amounts.

4.1.8 Funding Restrictions

Funding restrictions outlined in the results were not found in literature due to the paucity of literature on role of financiers in PPP deals (Demirag et al., 2011). Notwithstanding the paucity of literature claims, contextual differences in existence of some global and Malawi’s PPPs can also contribute to the lack of documentation on funding restrictions. Participants highlighted existing restrictions, “... then the directive on foreign currency lending would also apply – this prohibits banks from lending Foreign Currency Denominated Accounts beyond 69% of average monthly FCDA balances.”

"[...] the Financial Services Act in Malawi would not allow banks to take up equity

in non-financial services.”

Whilst the restrictions were concurred by both the Central and retail banks, it is worth evaluating negativities such restrictions can pose to the Malawian PPP market.

4.2 The PPP methodology framework for best practice in Infrastructure Development in Malawi

The findings emphasised the need for enabling environments if PPPs are to thrive. The global leading PPP model (PFI) has achieved significant strides due to mature policies and support from government. Such support is seen through mandatory PFI procurement of all central and local government projects (Bult-Spiering and Dewulf, 2006; Akintoye and Beck, 2009).

Whilst mandatory decrees may prove challenging to Malawi’s upcoming market in the short term, long term plans should consider such provisions as well as firming up on monitoring of PPP deals to achieve fruitful results. The proposed recommended PPP methodology framework for best practice in infrastructure development was illustrated in Figure 2 detailing the expectations of the participants as well as identified gaps that require reinforcement to mitigate identified challenges for successful commissioning, implementation and operation of PPPs in Malawi.

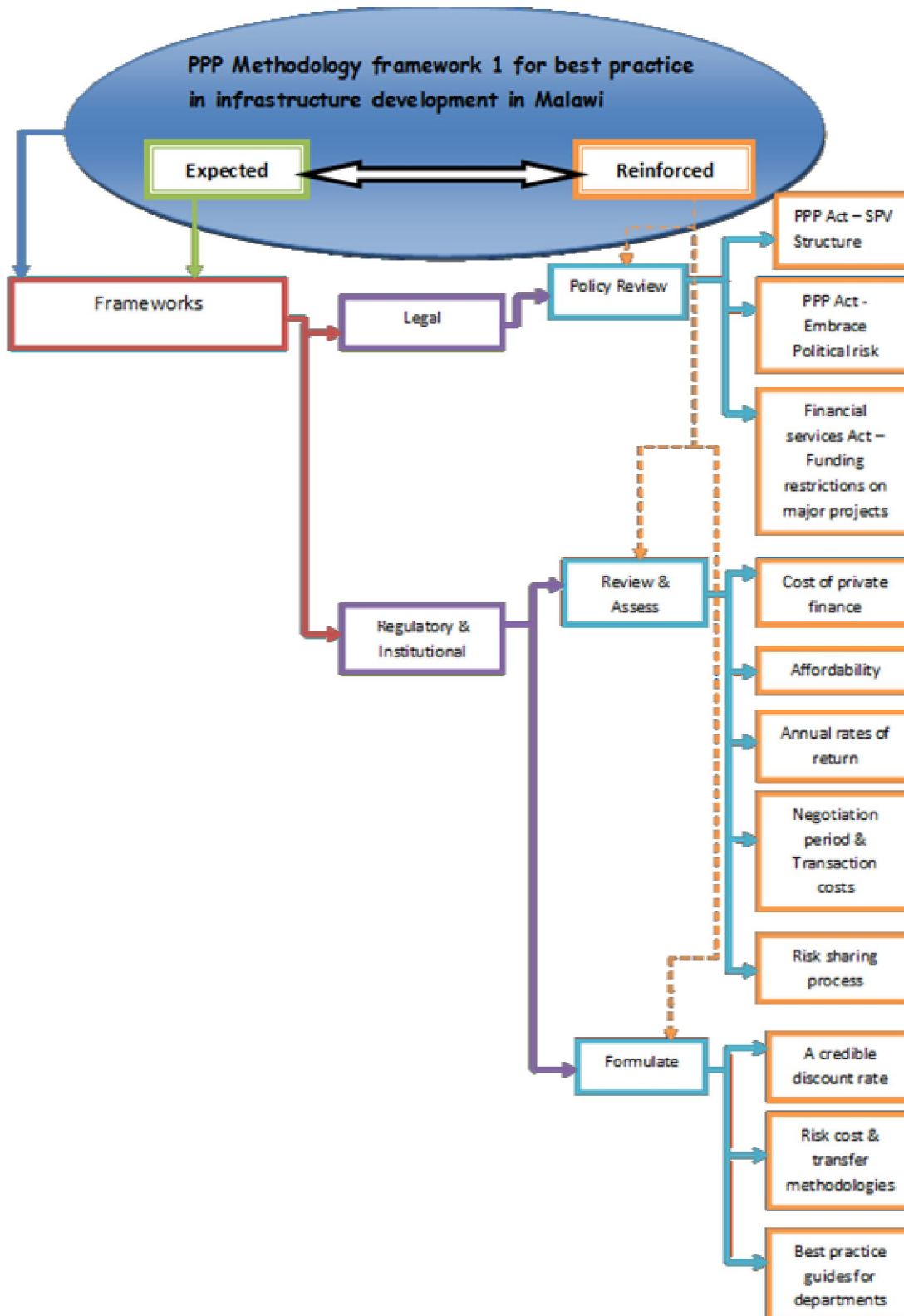


Figure 1: PPP methodology framework 1 for best practice in Malawi accentuating legal, regulatory and institutional frameworks

5. CONCLUSION AND RECOMMENDATION

Infrastructure development in Malawi faces a number of challenges such as a protracted procurement process, handling of unsolicited bids, structure of the Special Purpose Vehicle, lack of robust assessment tools to ascertain VfM and risk transfer, limited capacity of local firms to venture in PPP deals, high cost of private sector finance, funding restrictions and political risk. Considering the existing potential for PPPs in Malawi due to its annual infrastructure funding deficit (Foster and Shkaratan, 2011), the need to review the existing PPP frameworks cannot be overemphasized.

As such robust assessment tools should be formulated to underpin the foundational basis of PPP deals, stipulations in the policy and Act regarding handling of unsolicited bids should be reviewed to avoid promotion of corrupt practices as well as court cases that can emanate from entertaining the same, the structure of the Special Purpose Vehicle might also be a conduit for corrupt practices as well as a deterrent to potential investors hence the need to review its composition to promote best practice, political risk and funding restrictions should be dealt with at policy level to underpin government's commitment in fostering PPPs and government should negotiate competitive interest rates with private financiers to promote affordability.

The future of PPPs in Malawi depends on a need to adopt a holistic approach in addressing the highlighted challenges through evaluation of the recommended best practice PPP methodology framework for infrastructure development. It is vital to assess the benefits it can afford the overall procurement process from inception to implementation and operation. The proposed best practice guides should be as inclusive as possible encompassing all key elements for the successful delivery of Public-Private Partnerships. It is crucial to the successful procurement, implementation and operation of PPP deals.

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