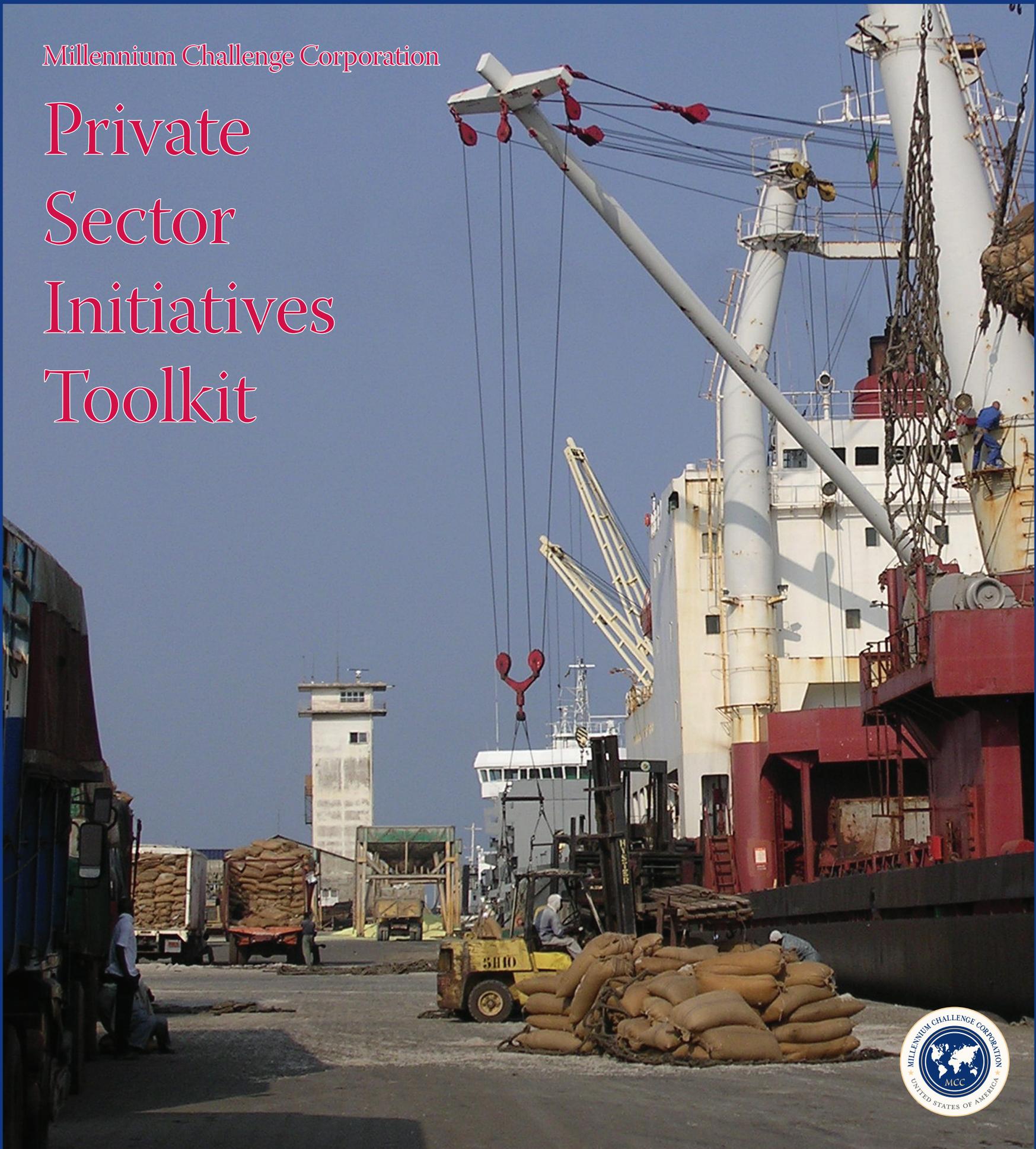


Millennium Challenge Corporation

# Private Sector Initiatives Toolkit



Reducing Poverty Through Growth

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# Acronyms

BDS	Business Development Services
BLCF	Business Linkages Challenge Fund
BOT	Build-Operate-Transfer
BOOT	Build-Own-Operate-Transfer
BOO	Build-Own-Operate
DBFO	Design-Build-Finance-Operate
DCA	Development Credit Authority
DfID	Department for International Development (United Kingdom)
EBRD	European Bank for Reconstruction and Development
EIF	Entry into Force
EOI	Expression of Interest
ERR	Economic Rate of Return
FIRR	Financial Internal Rate of Return
GDA	Global Development Alliance
GPOBA	Global Partnership on Output-Based Aid
HQ	Headquarters
IFC	International Finance Corporation
IFI	Intermediary Financial Institution
ICT	Information and Communication Technology
KBDS	Kenya Business Development Services
MCA	Millennium Challenge Account
MCC	Millennium Challenge Corporation
MFI	Microfinance Institution
MOU	Memorandum of Understanding
NBFI	Non-Bank Financial Institution
NGO	Non-Governmental Organization
OECD	Organization for Economic Cooperation and Development
OBA	Output-Based Aid
O&M	Operations and Maintenance
OPIC	Overseas Private Investment Corporation
PFI	Private Financing of Infrastructure

PPIAF	Public-Private Investment Advisory Facility
PPP	Public-Private Partnership
PSI	Private Sector Initiative
RFP	Request for Proposal
SME	Small and Medium Enterprise
SPV	Special Purpose Vehicle
USAID	United States Agency for International Development
VfM	Value for Money

# Foreword

As part of our mission to “Reduce Poverty Through Growth”, an MCC priority is to increase the impact of Compact funding by integrating the private sector into Compact development and implementation. The premise is that private sector participation will result in greater sustainability of Compact investments through increased employment, markets, innovation, efficiency and trade. Compact funding can play a catalytic role by facilitating private sector trade and investment in those countries that are accelerating reform and providing new opportunities for the poor to participate in that growth. MCC’s Private Sector Initiatives (MCC PSI) team actively seeks collaboration with the private sector that can contribute to economic growth and poverty reduction in Compact countries.

This toolkit presents four models of private sector collaboration: Private Finance of Infrastructure, Outsourced Management, Output-Based Aid, and Social Franchise. The toolkit includes a brief description of each model and suggested ways to incorporate the model into Compact design. Case studies, best practices and lessons learned are featured to demonstrate the benefits and challenges of these models. Financial tools that can enhance the models are also highlighted.

As private sector collaboration can be complex, MCC PSI encourages countries to consider and integrate private sector initiatives early in Compact design, and to consult advisors when additional expertise is required. MCC PSI offers itself as a resource to Compact-eligible countries that are considering and structuring private sector initiatives for their Compacts. There are also several organizations that MCC PSI can recommend for expertise and detailed advice on specific initiatives.

MCC PSI developed this toolkit with the assistance of the Emerging Markets Group, Ltd., (EMG), an international development consulting firm working with MCC since 2004. We would like to thank the members of this team which included from the MCC side, Jeri Jensen, Stephen Gaull, Tom Campbell, Andrew Farnum, Lia Arnold, and Matt Harsha-Strong, and from EMG, Fernando Balderrama, Mary Beggs, Andy Dijkerman, John Fay, Thomas Pellerin (Team Leader), and Ken Smarzik.

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# Introduction

## 1. Objective and Context

The mission of the Millennium Challenge Corporation (MCC) is to reduce poverty through sustainable economic growth. Fostering the growth of the private sector is an integral part of the MCC strategy and while the MCC has been active in promoting private sector development through dedicated programs, it also encourages Compact countries to propose programs that integrate the private sector to gain greater effectiveness and enhanced sustainability.

The objective of this toolkit is to expose Compact-eligible countries and their Millennium Challenge Account entities (MCA)<sup>1</sup> to ways to engage the private sector for leveraging and helping to ensure sustainability<sup>2</sup> of investments made by the Compact. The toolkit is designed to help host governments identify and structure projects at proposal development stage prior to Compact signing. The toolkit does not provide a cookie-cutter approach to developing partnerships; rather, it intends to stimulate creative thinking based on several available approaches to involving the private sector. With its tools and processes, the toolkit guides users through the critical thinking and steps necessary to put together a successful partnership. However, this toolkit is not exhaustive and host governments will likely need to tap into specialized expertise, whether in their own ministries or externally through donors, advisory firms, and others.

Four models of private sector engagement are illustrated by this toolkit: Private Financing of Infrastructure (PFI), Outsourced Management, Output-Based Aid (OBA), and Social Franchise. The toolkit is modular so each section can stand alone. Some general considerations of why to involve the private sector are introduced followed by a presentation of each model. Each module includes a description of the model, the roles of stakeholders, MCC parameters that must be addressed, key success factors, and a way forward supported by several case studies. Finally, each module contains a list of resources users can access to gain more insight into the use and applicability of the model for their particular situation.

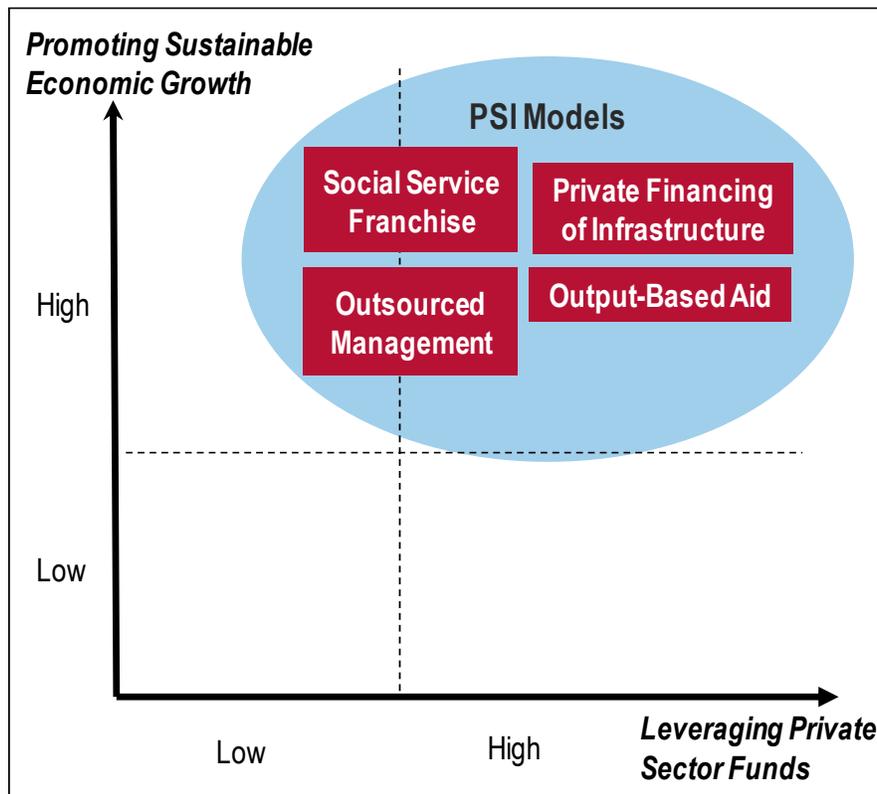
In each of the models there are many roles that must be filled for success. This document outlines how the MCC, MCA, partner governments and the private sector can assume appropriate duties and responsibilities. When determining who can do what, it is important to recognize that each situation is unique. For example, the funding of advisors might be assumed by either the partner government or the MCC before the Compact is signed, while work after Compact signing would be funded by the Compact. Partner countries will work with MCC to identify for each project the most adequate mix of resources and expertise.

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<sup>1</sup> Hereinafter, the Millennium Challenge Corporation is referred to as “MCC” while entities designated by governments of Compact-eligible countries to develop as well as implement Compacts are referred to as “MCA”.

<sup>2</sup> The terms leverage and sustainability are used often in this toolkit. Leverage refers to additionality of private sector funds, skills, and resources. Sustainability refers to the ability of an activity funded by a Compact to be financially viable using its own resources once Compact funding has ceased.

**Chart 1: Sustainability & Leverage**



Throughout this toolkit, the term Private Sector Initiative (PSI) refers to all types of collaboration with the private sector. This term is used because it is neutral from any specific approach that is presented and distinct from a more commonly-used term, Public Private Partnerships (PPP). Within the development field, PPP carries different meanings for different parties. For instance, the infrastructure industry uses this term to describe the numerous forms of private sector contracting available to governments, while the social sector might view PPP as a mechanism for tapping into corporate social responsibility. For this reason, the document avoids the use of PPP as a generic concept, though much of the literature uses the term.

**2. Why Involve the Private Sector?**

As developed markets mature and investment returns flatten, the private sector is drawn increasingly to emerging markets for high gains / high risk investment opportunities. This presents opportunities for MCC eligible countries to tap into additional funding for their activities and to ensure the sustainability of their MCC-funded activities. MCC-eligible countries have a demonstrated commitment to policy reforms that foster private sector-led growth. They are selected as high performers among their peers and can use this asset to attract more private sector investment and greatly accelerate their rate of economic growth.

**2.1. Who is the Private Sector?**

For the purpose of this toolkit, the private sector includes the indigenous, regional, and international firms and non-governmental organizations (NGOs) that do business in the country or that might do business. While multinational corporations bring opportunities for large-scale investment, indigenous and regional investors play an increasingly critical role in stimulating economic development. Successful examples of

collaboration between the public and private sectors in Indonesia, South Africa, Uganda, and Kenya all demonstrate the ability of the public sector to leverage financing from domestic markets. Within the range of activities supported by MCC funding and across the various PSI models this toolkit develops and describes, there are opportunities for all types of private sector stakeholders, giving host governments a broad range of additional players with which to work.

## **2.2. What Does the Private Sector Bring?**

Private sector involvement in Compacts can create sustainable employment, spur innovation, improve access to new markets, and/or stimulate trade. According to the UK Department for International Development (DFID), “nine out of ten jobs in the developing world are in the private sector.”

By engaging the private sector to bring its best skills and resources to the table—technical excellence, efficiency, sound management expertise, optimal capital allocation—the MCA can leverage the funding the MCC provides. This helps ensure that the impact of MCA projects is felt over the long-term and that the use of best practices is accelerated throughout the country.

Sustainable growth is a core element of MCC’s mandate and engaging the private sector enables Compact-eligible countries to multiply the size and impact of Compacts. It is important that any relationships with the private sector contribute to both economic growth *and* sustainability. Activities that engage the private sector’s bottom line business interests often deliver the most sustainable impact. This is best summarized by Kofi Annan:

*“There are many positive ways for business to make a difference in the lives of the poor—not through philanthropy, though that is also very important—but through initiatives that, over time, will help to build new markets.”<sup>3</sup>*

## **2.3. What Conditions for Involvement?**

In order to evaluate potential opportunities to engage the private sector in the delivery of core public goods, an understanding of the motivations of both the public and private sector is required. A relationship that provides long-term benefits and sustainability must provide value to all stakeholders. However, the private sector and the public sector use different lenses to evaluate potential opportunities: the public sector views projects in terms of economic viability, while the private sector is focused on financial viability.

Financial viability considers whether the investment will be financially sustainable over the long term; whether revenue will exceed expenses; and the degree of risk. The key metric for assessing financial viability, the Financial Internal Rate of Return (FIRR), measures the financial return on investment of an income generation project and is an indicator that investors use in making investment decisions.

When assessing opportunities, governments must look at the total economic viability of a project. Economic viability considers the macroeconomic effects of an activity over the long-term, a calculation that transcends financial viability as it must take into account the government’s responsibilities to create a sound operating environment, manage simultaneous demands for/on state resources and provide core services to its people. Access to good, reliable public services is critical for developing countries to lift themselves out of poverty and it is the role of public entities to ensure the provision of core public services

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<sup>3</sup> “Doing Business With the Poor, a Field Guide”, World Business Council on Sustainable Development, 2005

like safe water and sanitation, modern energy, transport, communications, basic education and health services. Since governments have many competing priorities and often limited resources, optimization of monies allocated to provide public services and goods is essential. Engaging the private sector can enhance government's effectiveness by transferring certain types of risk to the private sector and making use of its expertise and financial investments. MCC measures the economic viability of a project by measuring the Economic Rate of Return (ERR). The ERR is the result of a cost-benefits analysis whereby costs are the financial expenses of a proposed project, and benefits the increased income of a country's population or value added by its firms due specifically to the proposed project<sup>4</sup>. It is a key decision metric that MCC decision-makers use in accepting a given investment project into a Compact.

#### 2.4. What is Risk Allocation?

Successful partnerships involve an optimal allocation of risks, and all major investment projects include a multitude of risks that both the public and private sectors recognize and assume. The government, with input from the private sector, financiers and donors, can allocate the project risks to the party most able to manage and mitigate them. This is a critical success factor in the sustainability of public-private project efforts. This allocation of risks to the party most able to manage them is also the hallmark of an efficient financial structure. Inefficient structures raise the costs of a project and lower its returns.

- **Demand Risk.** Demand risk refers to the risk associated with consumers' ability and willingness to pay for services. When the responsibility for collecting user fees lies with the private operator, it faces the risk that political pressure could be exerted to continue service delivery, even when certain beneficiary groups are unable or unwilling to pay. This is a problem because individuals often find ways to use services and avoid payment (i.e. free-riders). The problem can be addressed by allocating demand risk to the public sector and performance risk to the private sector. Demand risk can be offset by credit enhancements such as credit guarantees or payment schemes as reflected in Output-Based Aid.
- **Payment Risk.** When a government assumes the responsibility to pay a private operator, payment risk is substituted for demand risk. In this case, the private operator may still be exposed to the risk of a government's creditworthiness and contractual commitment to pay. Credit guarantees may be a way to mitigate this risk.
- **Performance Risk.** This refers to risks of properly operating an asset, delivering quality service, and meeting performance standards. A core reason for engaging in PSI models is to shift the performance risk to the private sector which brings expertise in this area.
- **Political Risk.** The private sector is concerned that it could embark on a project with the public sector and the government could face changes which could alter its engagement. Potential investors all ask similar questions: What is the stability in the country? What are the chances that a contract can be voided by a new government, leading to expropriation or creeping expropriation?
- **Regulatory Risk.** Regulatory risks can encompass a wide range of issues, but the one which most often causes difficulty is the unwillingness or inability of a regulator to increase tariffs in line with increasing costs of service delivery. Private firms have learned from experience to be very wary of long-term commitments that expose them to the risk of inadequate tariff revision. This can be mitigated by allocating demand risk to the government and making the latter responsible for payment

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<sup>4</sup> For more information on MCC's Economic Rate of Return, please consult [www.mcc.gov/programs/err](http://www.mcc.gov/programs/err)

on the basis of service availability or performance targets as discussed below. This is an appropriate risk to allocate to the public sector because it has the means to choose between raising tariffs for users or absorbing the increased costs through public finance. In well-structured deals, there is a role for donors to work with governments and help them anticipate and absorb this kind of risk.

- ♦ **Foreign Exchange Risk and Financing.** Large investments financed through debt denominated in foreign currencies are subject to the risk of local currency depreciation and devaluation, which may seriously affect the financial viability of a project. To circumvent this problem, private firms now routinely look for domestic financing (loan, bonds) to avoid currency mismatches. In most developing countries, long-term debt financing is usually not available and requires support from donors or international financial institutions. To help secure domestic currency denominated bonds, a credit guarantee could be used.
- ♦ **Sector Specific Private Sector Approaches.** There are certain sectors in which private sector firms are more likely to invest than others. Primarily, private sector firms are interested in becoming full partners in sectors that provide predictable market returns such as telecom, gas lines, airports, etc. In other sectors such as utilities, water, and sewerage, there is more hesitancy about participating. Private sector approaches need to take this into account by maximizing leverage where possible and selecting less advanced models when necessary.

### 3. Presentation of the PSI Models

Below are brief introductions to the PSI models that the following sections of this toolkit elaborate in greater detail. It is important to point out that these models can be used across projects or sectors and that there are some linkages (and overlap) between them. They can be mixed and matched to ensure the success of large, complex projects.

Reviewing and building upon the structures through which donors have engaged the private sector, there are four distinct models that could leverage Compact investments and contribute substantially to the sustainability of those investments. Though these PSI models all contribute to both leverage and sustainability, they do so to varying degrees; providing host governments a range of ways to integrate the private sector.

- ♦ **Private Financing of Infrastructure (PFI).** This model can produce the highest degree of private sector involvement. Private companies undertake to finance an asset with a public entity—in whole or in part—and use a contractual arrangement to deliver the public good under the supervision of the Compact-eligible government or MCA entity, for a predefined period of time. Typical arrangements include concessions, a build-to-operate transfer (BOT), and combinations or derivatives thereof.
- ♦ **Outsourced Management.** Similar to PFI, Outsourced Management helps ensure that the financed asset continues to provide a public good. Through open and competitive procurement processes, the Compact-eligible country or MCA entity engages a private company to provide the public good according to well-defined terms of reference. This can lead to improved operational efficiency, and improved service levels.
- ♦ **Output-Based Aid (OBA).** As with the first two models, this model can enhance the effectiveness of an asset that is designed to deliver a public good by addressing both demand and performance risks. Pre-defined and explicit performance-based subsidies are used to deliver a public good through a private firm. OBA is designed to improve the delivery of basic public goods when the target group is unable to bear the full cost of the service. It transfers risk to the private sector that receives government

subsidy payments upon satisfactory delivery of agreed-upon outputs. The subsidy benefits the end-user and encourages the participation of capable private firms to deliver the service. Typical sectors include delivery of water, sanitation, and utility services.

- **Social Franchise.** Delivering a public good with broad social value is a challenge that most Compact-eligible governments face. This model can greatly enhance investments in the health and education sectors, by ensuring that the delivery of the service occurs. Franchising is used to deliver public services through private sector providers on a for-fee basis. The benefit to the MCC eligible country is that investments in bricks and mortar—schools, clinics, hospitals, etc.—are long-term and sustainable.

#### 4. Application of Models by Sector

As previously mentioned, it is important to point out that several models can be used in the same project or sector. In this paper, the four models are treated as stand-alone models. In practice, however, it is evident that they can be used together. To illustrate this, examples in health, infrastructure, and private sector development follow.

**Infrastructure:** The infrastructure sector includes transportation, water and sewage, and energy. PSI models can be used for infrastructure development, maintenance and repairs, network expansion, and management and administration. For infrastructure development, both the PFI and Outsourced Management models can be used. These involve shifting risks to the private sector and are used most often for the construction of toll roads, ports, airports, power plants, etc. They are also used for the management of existing infrastructure such as water and sewage systems, ports, airports, etc. Output-Based Aid is a model particularly useful for expanding an existing infrastructure network, for instance to target lower income populations in peri-urban areas.

**Chart 2: Application of PSI Models in Infrastructure**

<b>Infrastructure Development</b>	<ul style="list-style-type: none"> <li>▪ Private Financing of Infrastructure</li> <li>▪ Outsourced Management</li> </ul>
<b>Maintenance &amp; Repairs</b>	<ul style="list-style-type: none"> <li>▪ Outsourced Management</li> </ul>
<b>Network Expansion</b>	<ul style="list-style-type: none"> <li>▪ Output-Based Aid</li> </ul>
<b>Management &amp; Administration</b>	<ul style="list-style-type: none"> <li>▪ Outsourced Management</li> </ul>

**Health:** In the health sector, there are six relevant investment areas: health service delivery, health infrastructure development, technological innovation, training, and administration. Chart 3 presents the PSI models best adapted to each area. For training, social franchises could help develop a centralized curriculum that taps into economies of scale for providing standardized, high quality training. With health service delivery, the Social Franchise is a very effective tool for extending an organization into a network of service provision outlets capable of producing large social benefits on a considerable scale. OBA can be use to develop an organization capable of providing

**Chart 3: Application of PSI Models in the Health Sector**

<b>Health Service Delivery</b>	<ul style="list-style-type: none"> <li>▪ Social Franchise</li> <li>▪ Output-Based Aid</li> </ul>
<b>Health Infrastructure Development</b>	<ul style="list-style-type: none"> <li>▪ Private Financing of Infrastructure</li> <li>▪ Outsourced Management</li> </ul>
<b>Training</b>	<ul style="list-style-type: none"> <li>▪ Social Franchise</li> </ul>
<b>Administration</b>	<ul style="list-style-type: none"> <li>▪ Outsourced Management</li> </ul>

managerial and technical support to various stakeholders.

**Private Sector Development:** Broad spectrum development of the private sector can involve many areas where encouraging the active participation of the private sector is key to sustained economic growth. More and more, Compact-eligible countries are moving to improve the competitiveness of sectors within their economies, including enhancing export capacity, improving competitiveness, and developing sectors (ICT, agriculture, tourism). Several models can be used to help to develop the private sector. Most commonly some sort of funding mechanism to support innovation and commercial upgrading is included to help offset some of the initial investment costs to enhancing the competitiveness and performance of the private sector.

***Chart 4: Application of PSI Models for Private Sector Development***

<b><i>SME Development</i></b>	<ul style="list-style-type: none"> <li>▪ Outsourced Management</li> </ul>
<b><i>Export Promotion</i></b>	<ul style="list-style-type: none"> <li>▪ Guarantees</li> </ul>
<b><i>Training</i></b>	<ul style="list-style-type: none"> <li>▪ Social Franchise</li> </ul>
<b><i>Competitiveness</i></b>	<ul style="list-style-type: none"> <li>▪ On-lending</li> <li>▪ Private Financing of Infrastructure</li> <li>▪ Guarantees</li> </ul>
<b><i>Sector Development</i></b>	<ul style="list-style-type: none"> <li>▪ On-lending</li> <li>▪ Private Financing of Infrastructure</li> </ul>



# Model 1: Private Financing of Infrastructure

## 1. Background Description

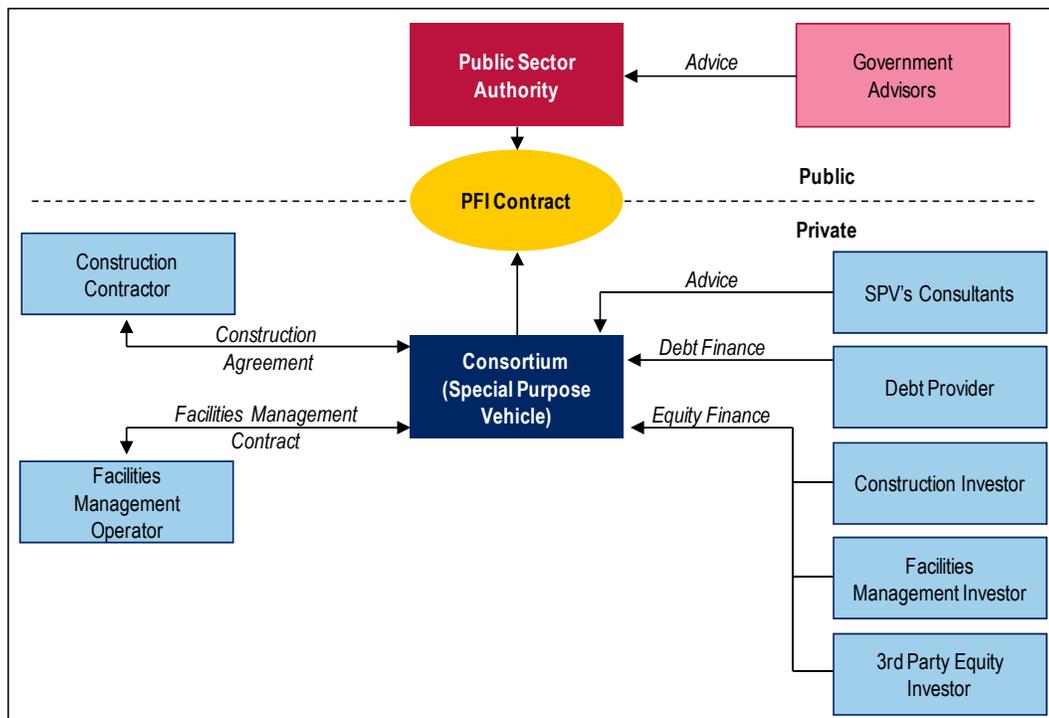
The Private Financing of Infrastructure (PFI) model consists of an agreement between a public sector entity and a private operator to provide a public service, whereby the private operator is in charge of the financing, operation, and maintenance of the asset, as well as design and construction for greenfield projects. The agreement usually takes the form of a concession to the private firm for a specified period of time.

### 1.1. Objective

The objective of a PFI contract is to bring about more efficient and cost-effective delivery of public services by shifting a maximum amount of risk to the private sector.

### 1.2. Structure

**Chart 5: Structure of Private Financing of Infrastructure Model**



The financing is made up of both debt and equity with a level of debt ranging from 50% to 90% of the total project capital expenditure. Equity investors are usually assembled into a consortium that includes

construction companies, the operating firm, and equity investors (local industrial groups, international infrastructure funds, etc.). The private sector operator is responsible for the construction and operation of a facility over a certain period of time after which the asset is transferred to the public sector. A special entity, also referred to as a Special Purpose Vehicle (SPV), is created and comprises the consortium of equity investors, which frequently includes the main operator, a construction company and other financial players.

### 1.3. Advantages

PFI models can deliver a higher quality of public service if the PFI transaction is appropriately structured. By allowing the private operator greater responsibility in managing the asset, the PFI model offers greater efficiency. Indeed, the private sector, focusing only on the bottom line, is better suited to make rational capital allocation decisions. PFI models allow the private sector to engage in the design stage and places the consortium in a better position to optimize the design for the construction, operation, and maintenance of the asset over its useful life. This model also provides more flexibility to offer innovative technologies to the public sector.

In addition, the public sector is able to take advantage of private sector financing. As a result, it is particularly adapted to public entities with limited financial capabilities, which are unable to finance the infrastructure on their own. Another key advantage of private sector financing is that the financial liabilities incurred through a project—such as debt—are transferred from the public sector to the private sector. In other words, these liabilities are taken off of the government’s balance sheet, thereby freeing up capacity for the government to invest in other areas.

Lastly, PFI contracts are performance-based. The private operator and the public sector entity agree on a set of performance targets to which the private operator is held accountable. Conversely, there are undertakings to which the government is held accountable as well. Depending on how the contract is structured, failure to meet the targets may lead to penalties, while exceeding targets may generate bonus payments or profit-sharing.

#### ***Payment Mechanisms***

- ◆ ***End-user / traffic payment.*** *The end-user pays the private operator on a pay-as-you-go basis (e.g. an urban household uses tap water provided by a water operator). The private operator bears the demand risk (e.g. legal usage of water) and the payment risk (billing and collecting payment for water service).*
- ◆ ***Performance-based payment.*** *The public agency pays only when the services are delivered (e.g. the asset is built). Recurrent payments are dependent upon the private operator meeting performance standards agreed in the contract. Performance must be linked to the delivery of the public service as specified in the contract. Key performance indicators should be specific, measurable, realistic, and time-bound. The operator can be encouraged to exceed performance standards through benefit-sharing / bonus schemes.*
- ◆ ***Availability payment.*** *This mechanism relates to the usability of the asset. The public sector pays the private operator based on asset availability, not on the demand the asset generates. If the asset is only partially available, or unavailable, deductions are made from the payment the operator receives. Availability standards for a road could include 24-hour access, minimal congestion, air quality, and visibility in tunnels, etc.*
- ◆ ***Minimum take agreement.*** *In case the off-taker (the client) is the public sector, it can set tariffs and guarantee minimum purchase levels in a contract with the operator. This practice is widely used in power projects where a Power Purchase Agreement (PPA) between the investor in an Independent Power Project (IPP) and the government entity sets the tariff levels and minimum quantity of electricity bought each year.*

### 1.4. Variants of Private Financing of Infrastructure

- **Build-Operate-Transfer (BOT).** Under a BOT, the private operator is responsible for the design, construction, and operation of the asset, which is transferred after a specified period of time to the public sector. The BOT arrangement usually involves a greenfield investment in an infrastructure asset that is financed by the private sector.
- **Build-Own-Operate-Transfer (BOOT).** Under a BOOT, the private operator is responsible for the design, construction, and operation of the asset. The concessionaire owns the asset until the end of the concession period when it is transferred to the government.
- **Build-Own-Operate (BOO).** Under a BOO, the private operator is responsible for the design, construction, and operation of the asset. However, the concession contract has no provisions for the transfer of the asset, which will be determined at the end of the concession period.
- **Design-Build-Finance-Operate (DBFO).** The DBFO model is similar to the BOT model except that it shifts the focus from conventional asset procurement and operation to procurement of a public service. It was first developed by the UK Highway Agency.
- **Brownfield investments.** The private operator takes over the operations and financial responsibilities of an existing asset. There may be infusion of cash, rehabilitation of asset, or purchase of equipment from the public sector prior to private sector involvement.

## 2. Roles

**Chart 6: Role of the Private Sector, MCA and/or Government in the PFI Model**

Private Sector	MCA and/or Government	
<ul style="list-style-type: none"> <li>▪ Design / construct asset</li> <li>▪ Finance capital expenditure (capex)</li> <li>▪ Operate asset and deliver public service</li> <li>▪ Meet key performance indicators</li> </ul>	<ul style="list-style-type: none"> <li>▪ Project design oversight</li> <li>▪ Project monitoring</li> <li>▪ Take necessary actions during project life</li> <li>▪ Release payments</li> </ul>	<ul style="list-style-type: none"> <li>▪ Provide grant towards capital expenditure</li> <li>▪ Finance advisors</li> <li>▪ Fund operating subsidy</li> <li>▪ Arrange / fund financial tools to mitigate risks</li> </ul>

### 2.1. Private Sector

The role of the private operator is laid out in the contract negotiated with the public sector entity. The contract indicates the operator's responsibilities: design and construction of the infrastructure asset in a first phase; operation and maintenance of the asset and delivery of the public service in a second phase; and financing across both phases.

The private sector provider is compensated by the revenues derived from operating the asset. In the case of concessions, the private sector is responsible for billing, collection, and customer relations.

The private operator, not the government, employs the staff operating the facilities. For existing assets (brownfield projects), the private operator likely will hire part of the staff from the former public entity.

For availability payment and performance-based payment contracts, the PFI contract includes key performance indicators such as public coverage, level of service, quality of service, services offered, etc. Failure to meet the key performance targets will result in a lower payment or penalties.

**2.2. Government**

The government’s role switches from operating the asset and delivering the service to regulating the private operator and ensuring that services are provided and public good is generated. The new role of the public sector entity entails:

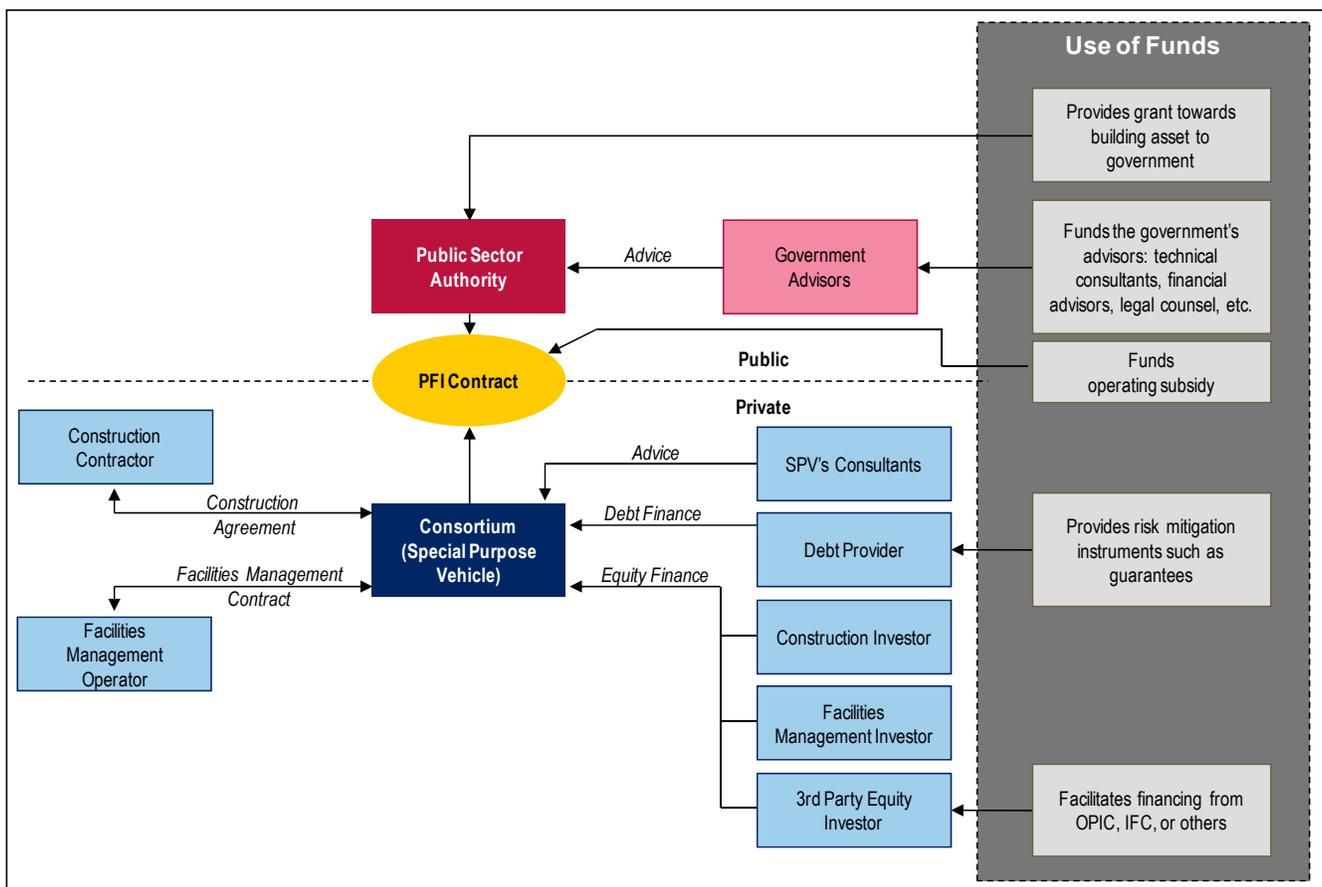
- Designing a sustainable project that allows the private sector to derive a profit while meeting the desired quality and scope of public service;
- Monitoring delivery of the service against key contract performance indicators; conduct regular audits (operational and financial) on operator’s performance; and ensure timely submittal of information by the private operator;
- Taking action as per the contract when the level of service does not meet the agreed level; and
- Releasing payments as per the contract based on performance.

To achieve this mission, the public sector entity, the regulator, must adopt a new internal organization and ensure that its staff has the necessary skill sets.

**2.3. MCA**

Compact funds can be used to help the government attract a PPP contract. The MCA could have five main roles as laid out in Chart 7:

**Chart 7: Possible Uses of Funds in Private Financing of Infrastructure Model**



- **Providing a grant to a public entity towards the construction of a public asset managed by a private sector partner.** Compact funding could partially finance the construction or the improvement of an infrastructure asset. However, Compact funds would provide for only a minority part of the overall capital expenditure; the bulk of it would be financed by the private sector. The monitoring of performance standards agreeable to MCA would be one of the public sector entity's responsibilities. Of particular importance is that revenues be used to operate, maintain, and upgrade the public asset, rather than being diverted to other public sector purposes. MCA also would be very involved in selecting the private sector consortium, thereby ensuring that procurement rules abide by MCA and MCC standards. The selection of private partners could be based on a bid for the lowest subsidy required.
- **Financing the costs of advisors to structure a PFI partnership and build regulator capacity.** The public sector authority will need support to structure the PFI model in the most appropriate manner. The MCA or MCC could provide support by funding engineering, financial, and legal advisors and it could provide technical assistance to the public sector entity in its new role as a regulator. Indeed, the public sector will shift from a traditional role of operating a public asset to regulating and managing a PFI contract, which requires different attributes and qualifications.
- **Providing an operating subsidy.** The public sector will seek to maximize the economic rate of return of a project, while the private sector will maximize its financial rate of return. If there is a gap between the two, the public sector may consider providing an incentive in the form of an operating subsidy to attract private sector investment in a PFI project. This financing mechanism would be a transitional operating subsidy during the first years of project life that would decrease over time as its financial performance improves. Large capital expenditure projects tend to require high user fees and a transitional subsidy allows users to afford the service through gradual rate increases. A transitional subsidy also could be used to help an operator improve the collection rate. The selection of private partners could be based on a bid for the lowest subsidy required. While the subsidy may exceed the Compact timeframe, MCA might be able to disburse the entire amount to the public sector authority, which would be held accountable for these funds during and beyond the Compact timeframe.
- **Mitigating the private sector's financial risks through risk mitigation instruments, such as guarantees.** MCA could provide direct support to the private sector by facilitating financial instruments that would reduce such risks, like guarantees provided by OPIC, MIGA, and other organizations. The Financial Tools section provides a discussion on available financial instruments.

### 3. MCC Parameters

*Avoiding Market Distortion:* Compact funding should be utilized in ways that do not create market distortions and disrupt existing economic balances. Grants and subsidies should be used only in ways that do not favor one market participant over another. Because of the unique nature of infrastructure projects that usually do not allow competition *in* the market, competition *for* the market is necessary. Competition for the market is ensured through a competitive bidding process open to all qualified firms.

*Accountability:* Compact funds are subject to a high level of accountability and transparency as part of MCC rules and regulations. Use of Compact funds must be appropriately documented.

*MCC Timeframe and Compact Length:* Often, PFI partnerships have long durations reaching 20 to 40 years, with at least a couple of years up front to design and procure the transaction. In contrast, Compacts can last no more than five years. However, this is not a fatal constraint as the optimal use of Compact funds is during inception of a PFI transaction (see MCA roles above). One way to deal with this is to structure the transaction so that other parties and instruments can operate after Year 5, such as partial credit

guarantees to extend the tenor of financing.

*Liens and Other Restrictions:* Current MCC policies prevent MCC funding being subject to liens and encumbrances without prior approval. The case of MCC partially or fully funding an asset that is to be tendered into a concession requires prior approval by MCC.

*Procurement:* Best practice for competitive bidding of PFI is the two-step process of an Expression of Interest (EOI) followed by Request for Proposal (RFP), which allows a pre-selection based on technical expertise and a level playing field among submitted proposals. The two-stage process reduces the amount of preparation work on bidders and it is likely to generate more bids. In addition, it is standard practice for an RFP to include a draft contract that lays out the structure of the transaction, including risk allocation; the method of payment; scope of work; etc. Including a draft contract for comment is a way to reduce the post-award negotiation timeframe.

#### **4. Key Success Factors**

The PFI model has been used in numerous transactions in low to middle-income countries. A body of best practices has emerged in learning from the successes and failures of these projects. Taking the following list of key success factors into account can help make a PFI model successful. Because of its degree of sophistication, the PFI model is difficult to implement and should be considered only for countries that have experienced some level of private sector participation in delivering public services.

##### **4.1. Optimal Risk Allocation**

The pillar of a successful PFI transaction is an optimal allocation of the risks between the public and private sectors. An optimal transaction is one that shifts risk to the party that is most able to manage it. For instance, the operation and maintenance of the asset is better done through the private sector rather than a public agency and in a PFI structure the private operator is in charge of this aspect.

The spirit of the PFI model is to shift operating risk from the public to the private sector to benefit from private sector efficiency and access to financing. Operating risks include: construction delays (greenfield), construction cost overruns (greenfield), defects, initial asset quality (brownfield), foreign exchange, demand, payment, political, and regulatory. When identifying all the risks of a PFI project, the public sector entity may decide to keep some within the realm of the public sector because they would not be acceptable to the private sector, or the risk shift would be too costly.

##### **4.2. Foreign Exchange Risk in Financing**

When structuring a PFI transaction, the government should minimize mismatches between the currency in which the funding is denominated (US\$, Euro) and the currency in which the cash-flow for servicing the debt is denominated (local currency).

In the late 1990s, a number of public-private infrastructure partnerships in emerging markets and developing countries were financed through the use of US\$-denominated funding. However, the cash-flow available for repayment of the debt came from end-user or government payments, which were in the local currency. These deals ran the risk of the depreciation of the local currency against the US\$, in which the debt was denominated. When financial crises hit emerging markets (Russia and Asia in 1997/98, and Latin America in 2001), a sharp depreciation of local currencies (e.g. -70% for the Indonesian Rupiah) hit the financial fundamentals of a number of projects in these countries.

The immediate reaction of operators was to renegotiate the contracts, including passing some of the debt service burden to end-users who saw huge hikes in tariffs. Eventually, these partnerships failed and had to be renegotiated.

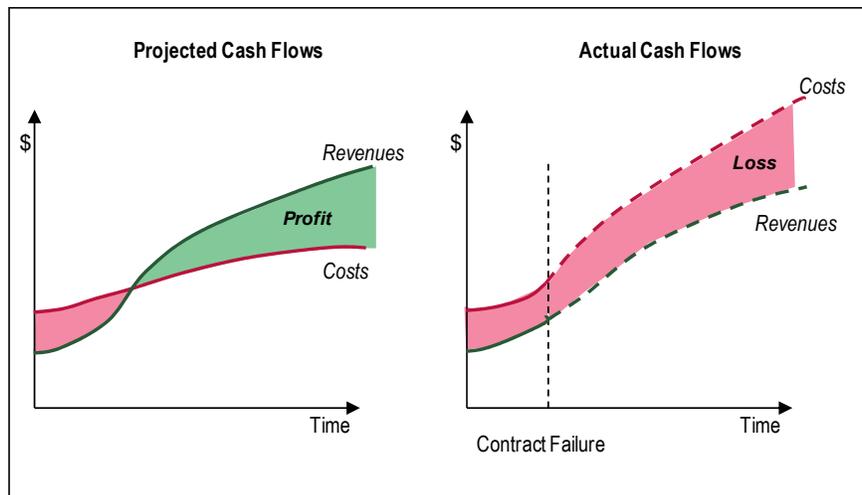
In conclusion, PFI projects must mitigate the foreign exchange risk to insulate the project’s repayment capacity from variations in foreign exchange rates. This can be done by indexing the tariff to movements in exchange rates. Alternatively, one option is for the private sector to buy foreign exchange hedging through future contracts. Another option is that the private sector buys political risk insurance that covers currency depreciation. Both options are expensive. Another option is to source debt funding through local banks; however, the feasibility of this mechanism depends on the depth and maturity of local financial markets.

**4.3. Cost-Recovery**

In some sectors such as water, the financial rate of return necessary for the private operator to make a profit requires a level of tariff that may be too high for the end-users. There have been many examples of concession contracts going bankrupt because the estimation of demand and affordability of the service at the design stage was overly optimistic. The reasons for that could be: too sudden a tariff increase for users to afford; lower than expected increase of demand for service; lower than expected increase in user fee collection rates; underestimation of the operating costs due to poor initial equipment; delays in network extension; etc.

As a result, the private operator ends up in the situation of “tyranny of cost recovery”<sup>5</sup>. The wrong incentives come into play to recover its costs: slashing operating expenses and reducing quality of public service while pressuring the regulator to increase tariffs. This situation ends up in the overall deterioration of the public service delivered and ultimately a failure of the contract. Chart 8 illustrates the problem in financial terms.

**Chart 8: Cost Recovery — Projected vs. Actual Cash Flows**



A key success factor of a well-designed PFI program is one which accurately projects demand and operating expenses and measures affordability. Should the cash-flow generated not cover the costs, the

<sup>5</sup> Interview with Denis Clarke, Chief Investment Officer, International Finance Corporation

public sector may want to think of options for covering some of the expenses. For instance, in the past the private operator could generally cover operating expenses, but would fail to cover capital expenditures necessary for the maintenance, upgrading, and expansion of the infrastructure. In this case, the public sector should think of directly funding the capital expenditures. Alternatively, the public sector could look at the Outsourced Management and Output-Based Aid models.

**4.4. Stakeholder Participation**

The best practice for PFI program design is to include stakeholders who are outside the public sector entity and the private sector operator in the design and implementation of a PFI program.

The first type of stakeholder to involve is the end-user of the public service. It could be an association of water users in the case of a water system; commuters and trucking companies for a road or highway; air passengers and airlines for an airport; shipping companies, freight forwarders, exporters and importers for a container terminal; etc. The design team should obtain their input in terms of the level of quality, scope, and price of services. During implementation, end-users should remain engaged with the private operator through a customer service function and with the regulator to influence the nature of the public service.

**Chart 9: Stakeholder Consultation**



The second type of stakeholder is the broader civil society including environmental groups and NGOs, business and trade associations, etc. These organizations have an impact on society at large and public acceptance of a private sector-managed public service is necessary for successful partnerships.

A third type of stakeholder is the people that may be affected by the creation of new infrastructure. For instance a railway will inevitably come close to living areas and may force re-settlement of homes and businesses. Engagement with these stakeholders will come at the design phase when government will have to find adequate mitigating measures. For instance, the government would have to offer a fair

compensation plan for expropriation of property and a re-settlement program<sup>6</sup>.

The fourth type of stakeholder is the actual staff operating the assets, whether working for an agency or a private operator. They are at the front end of public service delivery and know the ongoing constraints and what areas need improving. They also are a stakeholder group that will be impacted by the PFI.

The fifth stakeholder category includes the public sector entities that will participate in or be affected by the PFI contract, such as line ministries, and municipalities.

Last but not least, the government should engage the private operators and investors who would have an interest in the project whether they are domestic and foreign entities.

### ***Suez Approach to Private Sector Participation***

*Suez Environment is a leading water services company in the world, with a mix of successes and failures in non-OECD countries. Suez learned that stakeholder management is key and developed a model of partnership where civil society is associated via formal participation mechanisms:*

- ◆ *Obtain input on civil society's priorities*
- ◆ *Involve civil society in decisions with a societal impact*
- ◆ *Provide civil society access to information.*

#### **4.5. Legal and Regulatory Framework**

The host country must have a strong rule of law to give a private operator the confidence and trust to solve problems arising during the life of the contract through legal mechanisms. In particular:

- ◆ Consistent enforcement of laws and regulations through judicial courts and regulatory bodies, and
- ◆ Effective mechanisms of alternative dispute resolution to resolve contractual issues (ADR center usually hosted within a chamber of commerce).

The legal framework must be in place to welcome foreign investment and transfer of ownership from the public to the private sector. The investment code must be in line with international standards. Countries such as South Africa, the Philippines, Chile, and Hungary have adopted specific laws to foster PFI investment such as PPP laws or BOT laws. Although having such a legal framework in place facilitates the development of new PFI transactions, it is not a pre-requisite. Most countries started their first PFI projects without a dedicated legal framework.

The regulatory authority must be professional, and operationally and financially autonomous in its mission. The body must have competent staff with expertise in the sector that is being regulated and it also must have a large degree of autonomy and a legitimate mandate to carry out its mission. The regulatory body must be insulated from political interference. Finally, it must have the means to carry out its mission of setting tariffs and enforcing them.

#### **4.6. Offtake Agreements**

An offtake agreement is an agreement between the provider of a service and the main (and usually sole) client for this service. An offtake agreement normally includes the tariff for a specific period of time, as well as minimum level of purchase for the service. The minimum take is a “take or pay” clause in the agreement that stipulates that the offtaker will remunerate the operator in case the take is less than an agreed level. Offtake agreements allow reducing uncertainty for the demand of a service and therefore enhance the credit profile of a project. In the field of power generation, a Power Purchase Agreement (PPA) is a key document that financiers will look at to fund an Independent Power Project (IPP).

<sup>6</sup> See MCC resettlement policy.

## 5. Case Studies

PFI contracts have been used widely in developed and developing countries. Developing countries face additional risks though and the track record has been a mix of successes and failures. Below are case studies illustrating the use of PFI in various sectors.



Lesotho National Referral Hospital – Netcare	
Players	Sector
<ul style="list-style-type: none"> <li>▪ Netcare (UK)</li> <li>▪ GPOBA</li> <li>▪ IFC</li> <li>▪ Government of Lesotho (Ministry of Health, Ministry of Finance)</li> </ul>	Healthcare
	Location
	Lesotho
Analysis	
<p>Queen Elizabeth II Hospital faced a shortage of specialized staff (nurses and doctors), as well as hot water, heat, medical supplies, pharmaceuticals, and regularly functioning equipment. It needed a replacement but the country could not afford a new hospital through conventional procurement financed solely with public funds.</p> <p>In 2005/07, the Government of Lesotho with the help of IFC Advisory Services designed and prepared the procurement of a new hospital using the Private Financing of Infrastructure model. The PFI contract is to design, build, finance, equip, and operate a 390-bed national referral hospital at a greenfield site, replacing the old Queen Elizabeth II hospital and refurbishing and operating three feeder clinics. The feeder clinics provide primary and secondary health care services to the public while the new hospital also provides lower tertiary clinical services. Operating costs for the new hospital are roughly equivalent to those at the existing facility. This means that patients will have access to significantly better medical services at the same minimal charge they pay today.</p> <p>In this PFI scheme, the private sector finances the hospital and receives a unitary payment from the Government of Lesotho on a monthly basis. The contract is for 17 years + 2 years for the hospital construction. The unitary payment has a partial risk guarantee from the IFC. The Global Programme for Output-Based Aid (World Bank) will put in place a \$6.25 million Output-Based Aid grant program to expand the number and type of key services available. The private operator may also provide private clinical services at the site for its own revenue.</p> <p>The winning bidder is a consortium led by Netcare of the UK that includes Lesotho investors.</p> <p>Lesotho does not have specific PPP regulation. However, the government of Lesotho applied IFC guidelines for PPP procurement and benefited from the lessons learned in the South Africa PPP market.</p> <p>Source: IFC, Netcare, GPOBA</p>	
Key Learning Points	
<p>In this example, MCA could fund the advisory services provided by IFC and risk mitigation tools such as IFC’s partial-risk guarantee:</p> <ul style="list-style-type: none"> <li>▪ The Government of Lesotho chose a PFI model in part to provide the additionality of private sector financing of medical infrastructure.</li> <li>▪ Although Lesotho does not have a PPP law, it benefited from the PPP experience in South Africa and received advice from the IFC</li> <li>▪ Built-in options for revenue diversification by using hospital traffic to develop additional services</li> <li>▪ The GOL chose the PFI route to: 1) bring technical expertise to improve the quality of medical services delivered, 2) focus on accountability of results, and 3) benefit from predictable expenditures (agreed unitary payment).</li> </ul>	



Manila Water Concessions	
<b>Players</b>	<b>Sector</b>
<ul style="list-style-type: none"> <li>▪ Manila Water (Ayala Group, Bechtel, ...)</li> <li>▪ Maynilad (Benpres, Suez)</li> <li>▪ IFC</li> <li>▪ Government of the Philippines</li> </ul>	<b>Water</b>
	<b>Location</b>
	<b>Philippines</b>
<b>Analysis</b>	
<p>In 1997, the Government of the Philippines decided to concession the Manila Water and Sanitation Systems (MWSS). MWSS was heavily indebted and overstuffed, suffered years of under-investment, and had major operational inefficiencies. The IFC advised GOP for what was then the world's largest water concession. GOP decided to split the water system into two concessions: East and West of Manila. The procurement was based on which bidder could provide the lowest water tariff. Maynilad, a consortium led by Benpres of the Philippines and Suez of France won the West concession, while Manila Water, a consortium led by Ayala of the Philippines and Bechtel of the US, won the East concession.</p> <p><b>West Concession – Maynilad:</b> The West concession was the concession with the poorest people and the oldest water system and equipment. It also inherited 90% of MWSS US\$380 million debt, while only 10% went to the East concession. Despite early improvements in tariffs and expansion of coverage, the concession by 2001 was making huge losses.</p> <p>Several reasons appear to have led to this situation. On one hand, the concessionaire drastically underestimated the operational costs and overestimated the revenues it could earn. These estimations largely rested on the information available during the bidding stage, of which some turned out to be inaccurate. On the other hand, with the 1998 Asian financial crisis and the devaluation of the Peso, user payments could not cover the service of the overbearing US\$-denominated debt. Given that the West concession inherited 90% of that debt, it suffered a lot more from currency devaluation than the East. With the financial difficulties, financiers stopped lending to the concessionaire, which stopped financing network improvements.</p> <p>The concessionaire and the government re-negotiated the contract in 2001, allowing foreign exchange losses to be passed on to the users and reducing performance targets. This sparked an increase in tariffs and protest among the population. In 2003, the Maynilad investors tried to pull out of the concession. After a tumultuous period, MWSS acquired 85% of Maynilad in 2006, effectively re-nationalizing the company. The performance has not much improved since.</p> <p><b>East Concession – Manila Water:</b> The Manila East Concession did face similar problems at the beginning, however managed to stay in place through contract renegotiations. In 2003 came the 5-year landmark for tariff rebasing. The regulator authorized a rate increase based on new operational costs, capital requirement and demand projections.</p> <p>As of today, the East concession delivered on its main targets: the 24-hour coverage increased from 26% in 1997 to 98% in 2007. Manila Water is profitable and it was listed in 2005 on the Philippines Stock Exchange.</p> <p><i>Source: World Bank, WaterAid, Harvard Business School</i></p>	
<b>Key Learning Points</b>	
<p>The lessons learned from the Manila water concessions are:</p> <ul style="list-style-type: none"> <li>▪ PFI design is important. Imposing 90% of US\$ denominated debt on one of the two concessions was an unfavorable term which became a huge financial burden.</li> <li>▪ Foreign exchange risk needs to be taken into account and possibly neutralized. The 50% devaluation of the Philippine Peso during the Asian financial crisis doubled the cost of debt servicing by the operator.</li> <li>▪ A strong and independent regulator is important and MCA can help build the capacity. The regulator in Manila was influenced at times to public and political pressures, and at other times to private operators.</li> <li>▪ Failing PFI deals can be saved, but the right elements need to be in place in the concession agreement and the regulatory framework.</li> </ul>	



N4 Toll Road between Mozambique and South Africa	
<b>Players</b>	<b>Sector</b>
<ul style="list-style-type: none"> <li>▪ Government of Mozambique</li> <li>▪ Government of South Africa</li> <li>▪ Trans African Concessions (TRAC), including Stock and Stocks, Bouygues, Basil Read, South Africa Infrastructure Fund; Rand Merchant Bank; and five other investors.</li> </ul>	<b>Toll Road</b>
	<b>Location</b>
	<b>Mozambique &amp; South Africa</b>
<b>Analysis</b>	
<p>In 1996 the governments of South Africa and Mozambique signed a framework agreement for the development of the Maputo corridor, starting with a toll road. In May 1997, a 30-year concession was awarded to a private consortium, Trans African Concessions (TRAC), to build and operate the N4 toll road from Witbank, South Africa to Maputo, Mozambique. After 2028, control and management reverts to the governments. The contract was worth R3 billion.</p> <p>The N4 was financed with 20% equity and 80% debt. The governments of South Africa and Mozambique jointly guarantee the debt of TRAC and, under certain conditions, guarantee the equity as well.</p> <p>The N4 faced demand risk. Traffic volumes, which were dependent on increased regional trade and economic growth in Mozambique, were below projections. However, from 2003 to 2004, the traffic grew in volume by 4.5%, in line with the expectations of TRAC's management. There was considerable user-payment risk in Mozambique as poor communities were unable and unwilling to pay high toll fees. TRAC cross-subsidized the Mozambican portion of the road with higher revenues from the South African side. It also provided discounts to local users and public transport on both sides of the border.</p> <p>Among other results, the toll road has reduced the overloading of trucks on the road. Less overloading will reduce deterioration of the road and increase its durability. To win hearts and minds, TRAC has actively promoted the role of small, medium and microenterprises through the issue of 150 tender packages valued at R83 million. Nevertheless, the N4 toll road has encountered strong antagonism from both residents of towns bordering the roads and voices in the civil society against mega-infrastructure projects.</p> <p>Source: South African Institute of International Studies &amp; TRAC N4 <a href="http://www.tracn4.co.za">www.tracn4.co.za</a></p>	
<b>Key Learning Points</b>	
<p>The governments of Mozambique and South Africa jointly guaranteed the concession's debt, which catalyzed investment from private and multilateral development banks. MCA could play a similar role in countries. In addition, the concession agreement included innovative solutions to make the concession financially viable.</p> <ul style="list-style-type: none"> <li>▪ The cross-subsidization from South African to Mozambique users allowed a reduction in the payment risk. Toll roads are successful only when users have the ability to pay.</li> <li>▪ The commercial risk was spread to a wide range of financial partners.</li> <li>▪ The highway spurred economic development in many ways: burgeoning of businesses near the highway, increased tourism from South Africa, and attracted investments in Mozambique including an aluminum smelter and gas plants.</li> </ul> <p>Despite the concession's relative success in terms of contractual performance, the project faced much criticism from opponents to the private-sector financing and operating public goods.</p>	



Toamasina Container Terminal Concession in Madagascar	
<b>Players</b>	<b>Sector</b>
<ul style="list-style-type: none"> <li>Government of Madagascar (GOM)</li> <li>International Finance Corporation (IFC) / DevCo</li> <li>World Bank</li> <li>International Container Terminal Services, Inc. (ICTSI)</li> </ul>	Port
	<b>Location</b>
	Madagascar
<b>Analysis</b>	
<p>In 2005, the government of Madagascar selected ICTSI of the Philippines as the private operator for the container terminal of Toamasina. The port is the largest in Madagascar, accounting for 90% of all container traffic in Madagascar. The transaction came as a result of efforts towards privatization of the transportation sector. GOM received technical assistance from the IFC as well as DevCo, a donor-supported technical assistance facility managed by IFC. DevCo provided \$650,000 in specialized legal, technical, social, and accounting consulting services.</p> <p>GOM created a port authority, the <i>Société de Gestion du Port Autonome de Toamasina</i>, whose role is to regulate and manage the concession contract and look after the container terminal which remains a public asset. It is expected that the concession will generate over \$300 million in royalties, concession fees, and investments over the 20-year concession period.</p> <p>This concession focuses on the operation, management, financing, rehabilitation, and development of the container terminal on a PPP (public-private partnership) basis. Under this contract, the government of Madagascar retains ownership of the port through the Port Authority. The contract is driven largely by operational and performance management indicators and embeds large penalty fees in case of non-respect. The operator is granted the exclusive right over all container operations up to the level of 400,000 TEUs. Traffic in 2003 was 90,000 TEUs. The concession comprised an up-front fee to cover development costs and an initial budget for the Port Authority. In addition, the contract stipulates fixed and variable yearly fees. Under the contract, the operator is mandated to rehabilitate and improve the container terminal over the first two years. The contract also stipulates that the operator must keep the 350 staff for at least 5 years.</p> <p>The procurement was competitive and transparent, under the auspices of the World Bank. Pre-qualified bidders included world-class operators such as AP Moller, Hutchison, ICTSI, and the consortium of Malta Freeport – CMA CGM-Bolloré. The financial criterion was the highest royalty fee per 20-foot container handled. <i>Source: IFC</i></p>	
<div style="border: 1px solid black; padding: 10px;"> <p><b>Contract includes:</b></p> <ul style="list-style-type: none"> <li>• Performance indicators</li> <li>• Staff retention requirement</li> <li>• Rehabilitation program</li> </ul> </div>	
<b>Key Learning Points</b>	
<p>In this case study, MCC or MCA could play DevCo's role. DevCo funded the hiring of specialized technical assistance necessary to structure the transaction from engineering to legal and financial advisory. MCA also could fund part of the up-front fee to enhance the attractiveness of the concession if necessary.</p> <ul style="list-style-type: none"> <li>The role of the port of Toamasina is shifting from operator to regulator of a public-owned asset under private management. The government ran a competition for the right to serve as the container terminal management provider. The competitive tender attracted world-class port-operators from Hong-Kong, the Philippines, Denmark, and France.</li> </ul>	

- The public agency mandated the operator to keep existing staff for at least five years. This move resulted from the PPP deals in other countries that collapsed under the pressure of labor unions. Mitigating the risk of strike and personnel disenchantment is key to successful and sustainable PPPs.
- Support from DevCo and the IFC was crucial in several ways. The involvement of international donors raised the credibility of the project and helped undermine some of the traditional risks including political risk.

## 6. Way Forward

This section aims to assist MCC-eligible countries design successful PFI programs. Based on the key success factors identified earlier, this tool can help country teams think through all the key elements to have in place.

### 6.1. Partnership Design Tool

The Partnership Design Tool supports eligible countries in designing PFI programs. The tool lists the critical areas countries must consider to have a successful program.

**Chart 10: Partnership Design Tool – Private Financing of Infrastructure**

	Area	Issue	Best Practices & Guidance	Country Status	Outcome & Action Steps
Legal and Regulatory Framework	Legal Framework	Is the adequate legal framework in place?	A PFI requires the government to enter into a transfer of risk and responsibilities over a public asset. For that purpose, a PPP or BOT law is preferable.	NON-EXISTENT	<b>STOP:</b> A PFI is not possible without the adequate legal framework
				WEAK	<b>REMEDIAL ACTIONS:</b> Conduct assessment of discrepancies and amend laws / ordinances where necessary
				SATISFACTORY	<b>GO</b>
	Regulatory Capacity	Does the public sector entity have the level of administrative capacity to regulate a PFI contract?	The PFI requires the government agency to switch from operating the asset and delivering the public service to regulating a private operator.	NONE	<b>STOP:</b> It is preferable for the government to choose a simpler model like Outsourced Management with its lighter regulatory oversight requirements
				WEAK	<b>REMEDIAL ACTION:</b> The agency must receive technical assistance to transition from operator to regulator
				SATISFACTORY	<b>GO</b>
Capacity and	Expertise in-Country	Is there expertise in forming PFI partnerships in the country already? Is there a PPP unit within the government?	Because they are complex, PFI transactions require substantial expertise. Government agencies that have done PFI transactions in the past are a good source of	NONE	<b>REMEDIAL ACTION:</b> The government should tap into outside PPP expertise: World Bank, IFC, MCC, private firms, consultants, etc. <b>STOP:</b> Alternatively, the government should think of a less complicated PSI model such as

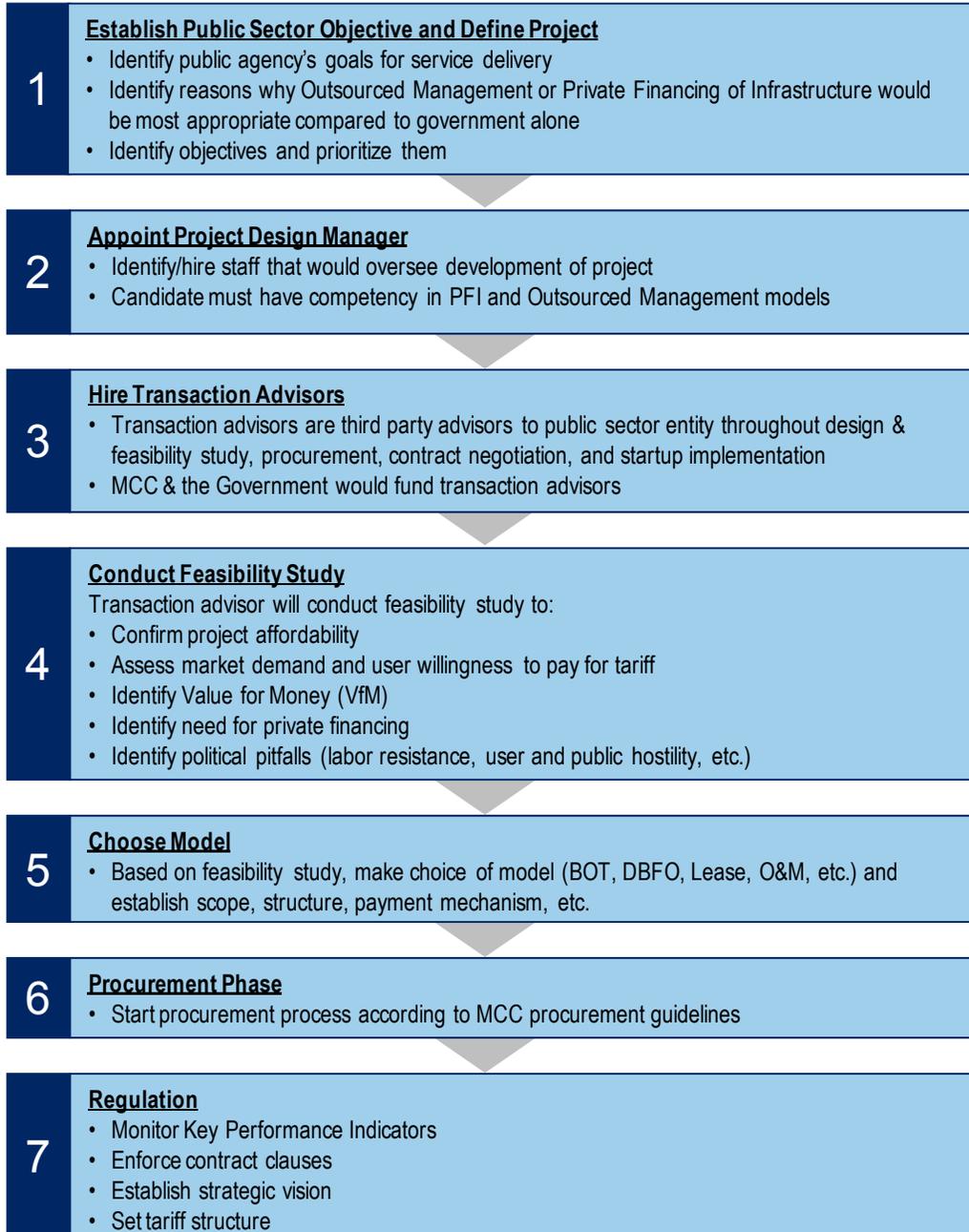
	Area	Issue	Best Practices & Guidance	Country Status	Outcome & Action Steps
Economic, Commercial and Financial Risks			expertise. If the country has had many PPPs, it may have a national PPP unit within the government.		Outsourced Management or OBA.
				<b>SOME</b>	<b>REMEDIAL ACTION:</b> The government should tap into PPP expertise from outside: World Bank, IFC, private firms, consultants, etc.
				<b>YES</b>	<b>GO</b>
		<b>Tariff and Cost Recovery</b>	Are tariffs expected to cover the cost of operations and capital expenditures?		<b>STOP:</b> The private sector will not be interested if it cannot make a profit. The Output-Based Aid model might be particularly adequate to smooth user fee increases due to high capital expenditures.
			The government must assess whether the tariff expected from the operations of the asset can reasonably cover the operations and capital expenditure necessary for the asset.	<b>NO</b>	
				<b>PARTLY</b>	<b>ALTERNATIVE OPTION:</b> The government should think of providing an initial grant to improve asset and minimize capex costs during project life. OBA should also be considered.
				<b>YES</b>	<b>GO</b>
		<b>Project Size</b>	Is the project big enough to attract the private sector?		<b>STOP:</b> If the project is too small for the targeted class of private operators, it will not attract any bidders.
			The government must ensure that the project size is large enough to attract private operators with the right expertise.	<b>SMALL</b>	
				<b>NOT BIG ENOUGH</b>	<b>ALTERNATIVE OPTION:</b> The government should go back to its project concept and explore ways to increase private sector involvement, e.g. bundling other assets and services into one project.
				<b>YES</b>	<b>GO</b>
		<b>Payment Risk</b>	Is the private sector willing to take the payment risk?		<b>STOP:</b> If the private operator is unlikely to accept the payment risk from either the users (high risk) or the government (lower risk), then using the private sector for the project should not be considered.
		To attract the private sector, the government will have to ensure that the payment risk (from users or the government) is manageable for a private operator.	<b>NO</b>		

	Area	Issue	Best Practices & Guidance	Country Status	Outcome & Action Steps
				<p style="text-align: center;"><b>NO, BUT INTERESTED IN PROJECT</b></p>	<p><b>ALTERNATIVE OPTIONS:</b> If the private sector cannot take the user payment risk, an operating subsidy can be introduced. Alternatively, the government should keep the payment risk on the public side. Other forms of payment can be introduced such as shadow tolls or availability payment.</p>
				<p style="text-align: center;"><b>YES</b></p>	<p><b>GO</b></p>

**6.2. Process and Timeline**

The Process and Timeline for establishing designing PFI and Outsourced Management contracts is the same and they are presented below:

**Chart 11: PFI Process**

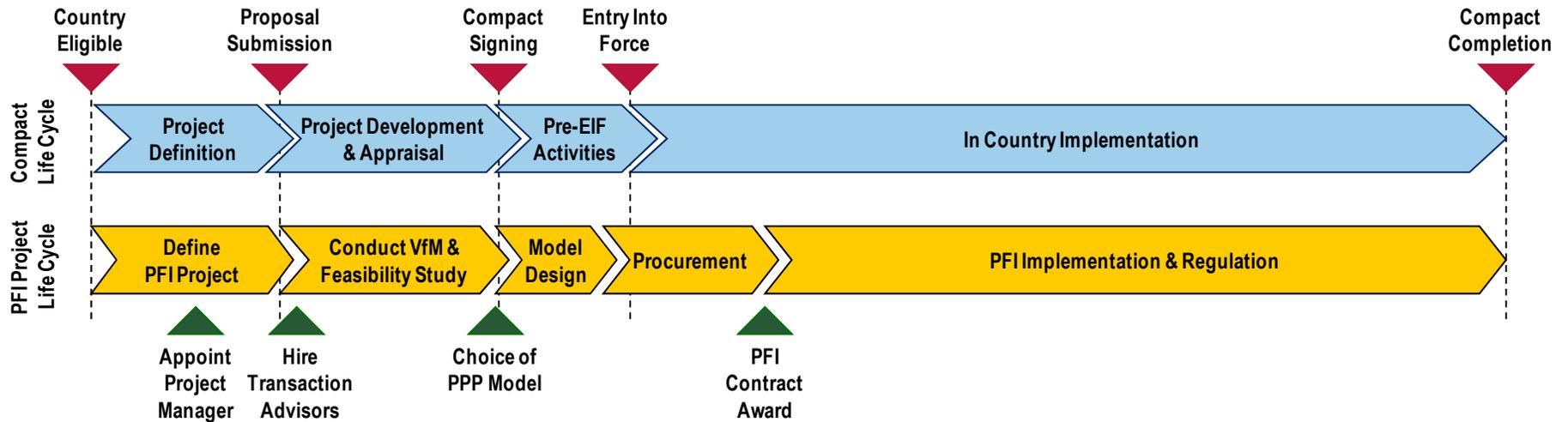


**STEP 1. Establish Public Sector Objective and Define Project.** The public sector entity needs to establish clear objectives for its public service mission. A rapid assessment should analyze the state of the public service in the sector considered, and identify necessary improvements. The public sector entity should establish the public service goals to be achieved by the project. The next step is for the public sector

entity to define the project scope and to determine how the project will meet the stated government objectives. The Partnership Design Tool will help achieve this first step.

- STEP 2. Appoint Project Design Manager.** Best practices suggest appointing a Project Design Manager within the MCA entity to conduct the overall process of design, procurement and implementation of the partnership. The Project Design Manager must have a good knowledge of the Private Financing of Infrastructure and Outsourced Management models, as well as expertise setting and implementing public sector strategies.
- STEP 3. Hire Transaction Advisors.** The PFI and Outsourced Management models are complex and require specialized technical expertise in structuring transactions. MCA and/or MCC could hire transaction advisors to provide support during the various phases of design, feasibility study, procurement, contract negotiation, and startup implementation. Transaction advisors should bring comprehensive expertise in legal, financial, economic, technical, and environmental issues. They are the right hand of the MCA and the government during the project structuring process.
- STEP 4. Conduct Feasibility Study.** The cornerstone of the design phase is the feasibility study. The objective of the feasibility study is to assess the potential of private sector participation and present a structure that balances public sector objectives with the project financials. The transaction advisors conduct the feasibility study. Initially, they will conduct a needs assessment to specify the services to be procured, both quantitatively and qualitatively. They also will carry out a Value for Money (VfM) analysis, which consists of assessing whether the government would get value for money by using the private sector instead of the public agency. An initial affordability assessment identifies the project costs if implemented by the public sector. The VfM considers the net present value over the project life of both options. Besides this figure, VfM also has a qualitative aspect which takes into account the speed at which services are delivered, the wider economic and social benefits of both options, etc. As part of the feasibility study, the advisors also will determine what risks should be transferred to the private sector to optimize service delivery and cost. The feasibility study also includes a demand assessment (market survey and user willingness to pay), a stakeholder assessment (including labor and users), an institutional and legal assessment, and an environmental assessment.
- STEP 5. Choose Model.** Based on the feasibility study, the MCA would decide on the type of model to adopt. In particular, they must decide on the risks to be transferred to the private sector and its remuneration structure. These two items are key factors in attracting the private sector.
- STEP 6. Procurement Phase.** Once the project is designed, MCA would start the procurement process through a procurement agent and with the support of transaction advisors. The procurement will be competitive, with a double-stage process of 1) an Expression of Interest (EOI) and 2) the Request For Proposal (RFP). The RFP should describe the key elements of the structure, including a scope of work, performance requirements, payment mechanisms, technical expertise required, risk allocation, requirements for local sourcing and staff retention, a copy of the proposed contract, and the evaluation criteria. In line with international best practices, Value for Money should be a key selection criterion. In addition, the bidders should be allowed to conduct their own due diligence on the project through access to the infrastructure and to a data room. This can take significant time as bidders conduct their own project preparation studies to ensure project viability. Furthermore, the concessionaire will need to negotiate key project agreements (EPC, O&M, supply agreements/offtakes, etc.); obtain permits, licenses, approvals; and structure the various partnership agreements.
- STEP 7. Regulation.** Once the contract is awarded, a regulatory body within the Public Sector Entity will be in charge of regulating the PFI or Outsourced Management contract. A Regulatory Board will meet every quarter to review the private operator's performance and make necessary decisions in terms of tariffs, investment, strategy, etc. The regulatory body is in charge of the day-to-day monitoring of the key performance indicators set in the contract and against which the private operator will be measured and eventually remunerated.

**Chart 12: PFI Indicative Timeline**



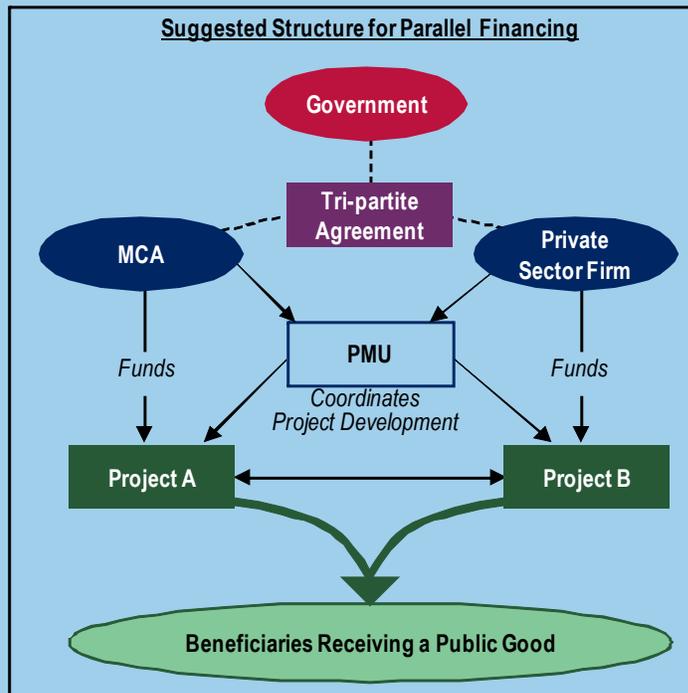
*The timeline for the Private Financing of Infrastructure project life cycle is indicative and dependent on the situation.*

### Parallel Financing of Infrastructure

Some infrastructure projects need complementary infrastructure to serve their public good purpose. For instance, when a power company builds a power plant, it also needs a distribution system for the electricity produced (“pipes and wires”).

MCA could be involved in financing an infrastructure “Project A,” in parallel to another “Project B,” financed by the private sector. A 5-step approach is recommended:

1. During the Proposal Development stage, MCA would engage in discussions with the private sector to identify relevant projects that could include parallel financing from MCA.
2. Once identified, the local government, MCA and the private sector firm shall sign a Memorandum of Understanding to establish that project A sponsored by MCA would be conditional to the private sector investing in project B. The MOU would also explain the relationship between the two projects, and stipulate the anticipated roles and responsibilities from each party.
3. The Compact shall include project A as one of the projects.
4. After the Compact is signed, MCA and the private sector firm would finalize an agreement on how infrastructure projects A and B would feed into each other.
5. Ideally, a Project Management Unit (PMU) would be set up to coordinate the development of projects A and B and their connection. The PMU would be governed by a board made of representatives of MCA, the local government, and the private sector firm.



### MCC Lesotho Compact

The Lesotho Compact is one example of such a parallel financing scheme. The Compact has a sizable water project which consists (among other activities) of building a bulk water conveyance system. The purpose of this system is the transmission of water from a water dam – the Metolong dam – to be constructed and funded by other donors (Kuwait, Saudi Arabia, and OPEC). Both infrastructure projects will be built concurrently.

MCA will set up and fund the Metolong Dam Program Management Unit (MPMU) that will oversee the development of both projects. MCA will hire an international firm to run the MPMU. MCA plans to have the MPMU up and running before the compact enters into force, so that the two projects are ready to start immediately and no time is wasted under the 5-year timeframe.

## 7. Resources

### *General Resources*

Public-Private Infrastructure Advisory Facility, World Bank, [www.ppiaf.org](http://www.ppiaf.org)

PPP Unit, National Treasury, Republic of South Africa [www.ppp.gov.za](http://www.ppp.gov.za)

PPP Centrum, Czech Republic, [www.pppcentrum.cz](http://www.pppcentrum.cz)

PPP in India, Ministry of Finance, Government of India, [www.pppinindia.com](http://www.pppinindia.com)

Partnerships UK, [www.partnershipsuk.org.uk](http://www.partnershipsuk.org.uk)

HM Treasury, United Kingdom

[www.hm-treasury.gov.uk/documents/public\\_private\\_partnerships/ppp\\_index.cfm](http://www.hm-treasury.gov.uk/documents/public_private_partnerships/ppp_index.cfm)

Partnerships Victoria, Australia, [www.partnerships.vic.gov.au](http://www.partnerships.vic.gov.au)

Canadian Council for Public-Private Partnerships [www.pppcouncil.ca](http://www.pppcouncil.ca)

US Department of Transportation, Federal Highway Administration

[www.fhwa.dot.gov/PPP](http://www.fhwa.dot.gov/PPP)

Public-Private Partnership, Republic of Ireland, [www.ppp.gov.ie](http://www.ppp.gov.ie)

PPP Unit, Government of Mauritius, [www.gov.mu/portal/sites/ncb/ppp/index.htm](http://www.gov.mu/portal/sites/ncb/ppp/index.htm)

PPP unit, Ministry of Finance, Singapore [www.mof.gov.sg/policies/ppp.html](http://www.mof.gov.sg/policies/ppp.html)

European PPP Center, Hungary, [www.epppc.hu](http://www.epppc.hu)

PPP Bulletin, [www.pppbulletin.com](http://www.pppbulletin.com)

### *Sector-Specific Toolkits*

#### PPIAF Toolkits

- Port Reform Toolkit <http://www.ppiaf.org/Port/toolkit.html>
- Toolkit on Public-Private Partnerships in Highways  
<http://rru.worldbank.org/Documents/Toolkits/Highways/start.HTM>
- Toolkit for Water Sanitation & Reform  
[http://wbln0018.worldbank.org/ppiaf/activity.nsf/files/WaterToolkit.pdf/\\$FILE/WaterToolkit.pdf](http://wbln0018.worldbank.org/ppiaf/activity.nsf/files/WaterToolkit.pdf/$FILE/WaterToolkit.pdf)
- Toolkit on Market-Based Approaches in Private Sector Provision of Bus Services  
<http://www.ppiaf.org/UrbanBusToolkit/>
- How to Hire Expert Advice on Private Sector Involvement in Infrastructure: A Toolkit for Policymakers <http://www.ppiaf.org/hiringadvisors/fulltoolkit.pdf>
- Labor Toolkit for Private Participation in Infrastructure <http://www.ppiaf.org/LaborToolkit/toolkit.html>
- Toolkit for Tourism PPPs –PPP Unit, Republic of South Africa  
[http://www.ppp.gov.za/Toolkits/Tourism\\_Final/Toolkit.htm](http://www.ppp.gov.za/Toolkits/Tourism_Final/Toolkit.htm)

***Public-Private Partnerships Manuals***

Industry Canada, *Public-Private Partnerships: A Canadian Guide*

[http://strategis.ic.gc.ca/pics/ce/p3guide\\_e.pdf](http://strategis.ic.gc.ca/pics/ce/p3guide_e.pdf)

Singapore Ministry of Finance, *Public Private Partnership Handbook*

[http://www.mof.gov.sg/policies/attachments/Revised\\_PPP\\_Handbook\\_Oct\\_04.pdf](http://www.mof.gov.sg/policies/attachments/Revised_PPP_Handbook_Oct_04.pdf)

***Value for Money and Public Sector Comparator***

Industry Canada, “Public Sector Comparator – A Canadian Best Practices Guide,” (May, 2002)

[http://strategis.ic.gc.ca/pics/ce/ic\\_psc.pdf#search='Public%20Sector%20Comparator%20%E2%80%93%20A%20Canadian%20Best%20Practices%20Guide](http://strategis.ic.gc.ca/pics/ce/ic_psc.pdf#search='Public%20Sector%20Comparator%20%E2%80%93%20A%20Canadian%20Best%20Practices%20Guide)

HM Treasury, United Kingdom, Value for Money Assessment Guidance

[http://www.hm-treasury.gov.uk/media/4/4/vfm\\_assessmentguidance061006opt.pdf](http://www.hm-treasury.gov.uk/media/4/4/vfm_assessmentguidance061006opt.pdf)

# Model 2: Outsourced Management

## 1. Background Description

Outsourced Management contracts allow governments to tap into private sector expertise to manage public assets and deliver public services. Public agencies hire private operators through open and competitive procurement to provide services according to defined terms of reference. The Outsourced Management model differs from the PFI model in that the private operator does not finance the asset, but simply operates, manages, and maintains the asset and may take on the commercial risk (demand and payment). The allocation of the demand and payment risks can be structured in many different ways, borne by the private sector if there is a lease, or the public sector with an operations and maintenance contract.

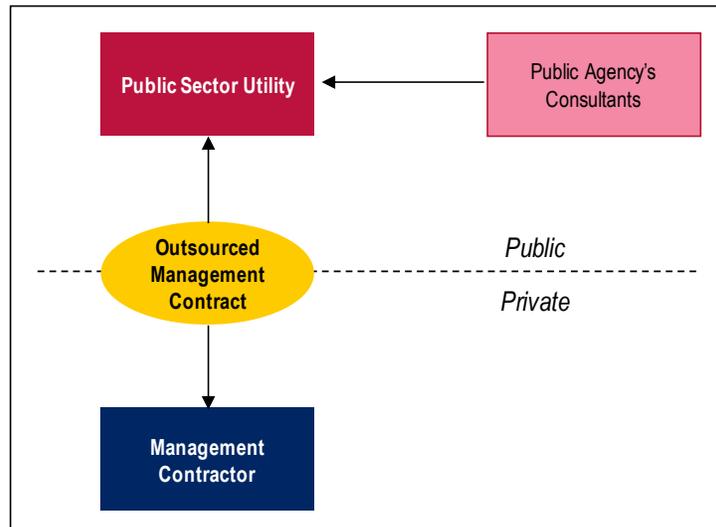
Outsourced Management contracts are particularly applicable to existing assets (brownfield) as opposed to the design and build of new assets (greenfield). They are widely used in developing countries as a first step towards private sector participation in the management of assets that have always been within the realm of the public sector.

### 1.1. Objective

The objective of Outsourced Management contracts is to take advantage of private sector efficiency in the delivery of public sector services, though with a more limited scope than for PFI contracts. Outsourced Management contracts keep the financing risk within the public sector, whereas the private sector assumes payment or demand risk. The private sector brings efficient management practices in the field of operations, revenue collection, customer service, asset management, and human resources.

### 1.2. Structure

**Chart 13: Basic Outsourced Management Structure**



As presented in Chart 13, the public sector utility establishes an Outsourced Management contract with a

private entity that provides the services. The public sector side is usually advised by technical consultants.

### 1.3. Advantages

Outsourced Management models are particularly useful for introducing private management of public assets. They may also be a logical first step towards greater involvement by the private sector such as in the PFI model.

With an Outsourced Management contract in place, the assets financed by the Compact would be maintained at a satisfactory level beyond the end of the Compact implementation period. This would build sustainability into the assets that the Compact finances.

Outsourced Management contracts are also an opportunity to build the capacity of local organizations (SMEs, NGOs, etc.) and thereby enhance the sustainability of the Compacts. Although local companies may not have expertise that is identical to multinational corporations, the expertise they do have is locally relevant and may suffice for delivering specific tasks under service contracts. As capacity grows, local businesses can take on greater responsibilities for delivering services and managing government-owned assets through Outsourced Management contracts.

Outsourced Management contracts can be used in any type of public services including health, education, energy, transportation, etc.

### 1.4. Variants of Outsourced Management

**Chart 14: Summary Table of Outsourced Management Contracts**

	Service Contract	Operations & Maintenance	Lease
<b>Scope of Private Sector Involvement</b>	Specific tasks & services	Overall management	Overall management
<b>Timeframe</b>	< 2 years	3 to 5 years	> 5 years
<b>Commercial Risk</b>	Public Sector	Public Sector	Private Sector (regulated by Public Sector)
<b>Responsibility for Capital Expenditure</b>	Public Sector	Public Sector	Public Sector

- **Service Contract:** Agencies enter into service contracts with private firms for the delivery of specific tasks related to the operations or the maintenance of a public asset — vehicle maintenance; upgrading and maintenance of roads; or non-core functions such as billing, security, etc. The management of the public asset remains with the public agency. Service contracts are typically for short-term periods of one to two years.
- **Operations and Management (O&M) Contract:** O&M contracts constitute an outsourcing of the management of a public asset to the private sector, which has the responsibility to operate, maintain and manage an asset while the long-term direction and financing of future investments remain with the public sector entity. O&M contracts are usually for a three to five year period. An example is the management of a water distribution company. Under this variant of Outsourced Management, the contractor receives payments directly from the public sector entity and thus bears no demand risk.
- **Leasing:** A public sector entity awards a long-term lease to a private operator to deliver services generated from a public asset. The lessee agrees to pay an up-front fee to obtain the right to collect the

revenues generated, and is responsible for the operations, management and maintenance of the public asset, but not for any capital expenditures. The lessee bears the commercial risk of running the infrastructure, i.e. setting the tariffs and collecting payments from end users, but the ownership of the asset remains with the public entity.

## 2. Roles

**Chart 15: Role of the Private Sector, Government and MCA in the Outsourced Management Model**

<b>Contract</b>	<b>Private Sector</b>	<b>MCA and/or Government</b>	
<b>Service Contract</b>	<ul style="list-style-type: none"> <li>▪ Deliver service as per contract</li> </ul>	<ul style="list-style-type: none"> <li>▪ Design scope of work (SOW) for services</li> <li>▪ Monitor performance</li> <li>▪ Release payment</li> </ul>	<ul style="list-style-type: none"> <li>▪ Provide grant towards capital expenditure of asset</li> <li>▪ Finance advisors</li> </ul>
<b>Operations and Maintenance Contract</b>	<ul style="list-style-type: none"> <li>▪ Deliver service as per contract</li> <li>▪ Meet key performance indicators in contract</li> <li>▪ Take over management of infrastructure asset</li> </ul>	<ul style="list-style-type: none"> <li>▪ Design contract including SOW, key performance indicators</li> <li>▪ Monitor performance</li> <li>▪ Take necessary actions during project life</li> </ul>	<ul style="list-style-type: none"> <li>▪ Set tariffs</li> <li>▪ Provide grant towards capital expenditure of asset</li> <li>▪ Finance advisors</li> <li>▪ Release payment(s)</li> </ul>
<b>Lease Contract</b>	<ul style="list-style-type: none"> <li>▪ Deliver service as per contract</li> <li>▪ Meet key performance indicators in contract</li> <li>▪ Manage, maintain, and operate infrastructure asset</li> <li>▪ Take on payment and demand risks from end users</li> </ul>	<ul style="list-style-type: none"> <li>▪ Design contract including SOW, key performance indicators</li> <li>▪ Project monitoring</li> <li>▪ Take necessary actions during project life</li> </ul>	<ul style="list-style-type: none"> <li>▪ Provide grant towards capital expenditure of asset</li> <li>▪ Finance advisors</li> <li>▪ Fund operating subsidy</li> <li>▪ Arrange / fund financial tools mitigating risks</li> </ul>

### 2.1. Private Sector

Generally, the role of the private sector is to operate the facilities based on a contract with the public sector entity. The private operator must finance its own working capital, but is not responsible for the financing of new capital expenditures.

In a service or O&M contract, the private operator provides specific services or takes over the management of the entire asset and makes the day-to-day management decisions. There are no financing or commercial risks involved, and the operator is remunerated directly by the public sector entity on a fee, availability, and/or performance basis. Service and O&M contracts differ in that in a service contract, the private operator is responsible only for a specific task or service (e.g. servicing transportation vehicles) and the asset / public service is still managed by a public authority. In an O&M contract, the operator takes over the overall management of facilities from the public sector. Service and O&M contracts are a good alternative to PFI or leases when both do not allow full cost recovery.

Under leases, the tariff is used to remunerate the operator. In this case, the private operator is particularly motivated to increase collection levels as tariffs constitute the sole source of payment. In contrast, collection levels for O&M contracts are only one indicator among many that determine payment.

**2.2. Government**

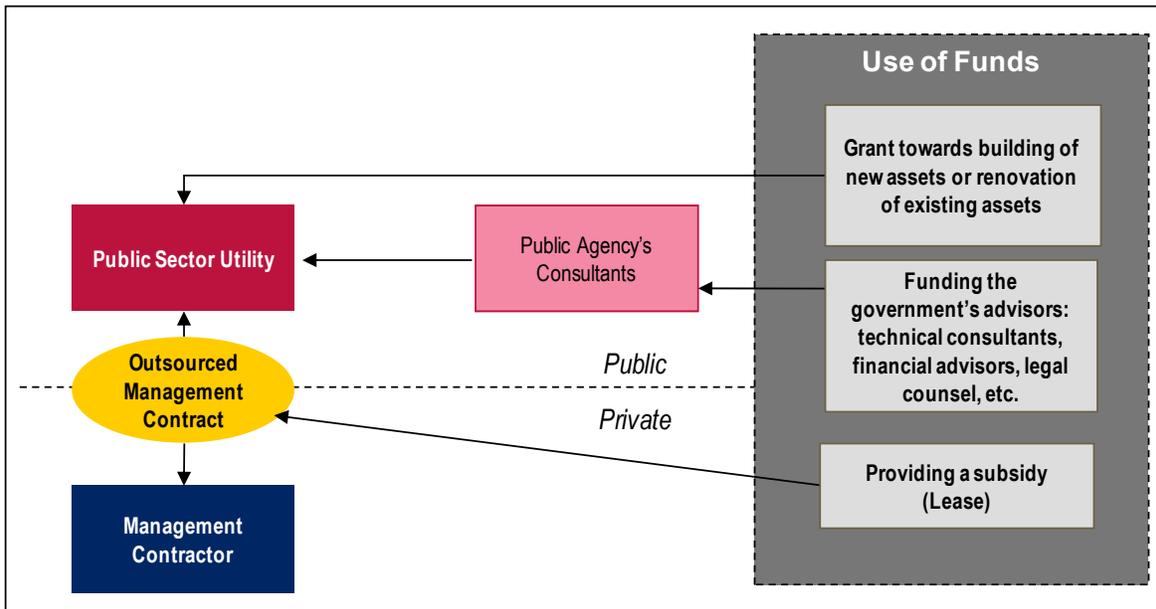
The government’s role switches from being the direct operator to being an indirect operator or regulator of the facilities. Several institutional changes are needed including bolstering the contract management capacity, and technical supervision of the private operator.

**Chart 16: Public Sector Responsibilities for Outsourced Management Contracts**

Service Contracts	Operations & Maintenance Contracts	Lease Contracts
<ul style="list-style-type: none"> <li>◆ Determining the scope of work for services to be delivered</li> <li>◆ Determining payment mechanisms</li> <li>◆ Monitoring performance of the private operator.</li> </ul>	<ul style="list-style-type: none"> <li>◆ Determining key performance indicators and setting targets that the private operator must achieve</li> <li>◆ Monitoring delivery of the service against the contract’s key performance indicators, conducting regular audits (operational and financial) on operator’s performance, and ensuring timely submittal of information from the private operator</li> <li>◆ Agreeing with the private operator on staff management and policies</li> <li>◆ Taking action measures as per contract when the level of service does not meet the agreed level</li> <li>◆ Releasing payments based on performance as stated in the contract</li> <li>◆ Establishing medium-term and long-term strategies for public service delivery</li> <li>◆ Providing capital expenditure and working capital financing</li> <li>◆ Determining fees for operations and maintenance service.</li> </ul>	<ul style="list-style-type: none"> <li>◆ Determining the key performance indicators and setting targets the private operator must achieve</li> <li>◆ Monitoring delivery of the service against the contract’s key performance indicators, conducting regular audits (operational and financial) on operator’s performance, and ensuring timely submittal of information from the private operator</li> <li>◆ Agreeing with the private operator on policies as stated in lease agreement</li> <li>◆ Taking action measures as per contract when the level of service does not meet the agreed level</li> <li>◆ Establishing medium-term and long-term strategies for public service delivery</li> <li>◆ Providing capital expenditure financing</li> <li>◆ Determining lease amounts</li> <li>◆ Regulating tariffs the private operator sets.</li> </ul>

**2.3. MCA**

The Compact funds could be used to help the government attract a contract. The MCA could have three main roles as laid out in Chart 17:

**Chart 17: Possible Uses of Funds in Outsourced Management Model**

- Providing a grant to a public entity for the construction and/or upgrading of a public asset managed / leased by a private sector partner.** Compact funding could go towards the construction or upgrading of an infrastructure asset. MCA could partially or entirely underwrite the financing of the asset and then transfer it to a public sector entity that would own it and hire a private sector operator for it under an Outsourced Management contract. MCA would participate in drafting the Outsourced Management contract and defining the role and responsibilities of the public sector entity. Among the public sector entity's responsibilities would be the monitoring of performance standards agreeable to MCA. MCA also will be highly involved in selecting the private sector operator according to Compact procurement standards.
- Financing the costs of advisors to structure an Outsourced Management contract and build the capacity of the regulator in case of a lease.** The public sector entity may need support in structuring a performance-based O&M or lease contract. MCC or MCA could provide support by funding engineering, financial, and legal advisors. In addition, Compact funds could provide technical assistance to the public sector entity in its new role as a regulator in case of a lease. Indeed, the public sector will shift from a traditional role of operating a public asset to regulating and managing a lease contract, which requires different attributes and qualifications.
- Providing a subsidy in the case of a lease.** Similarly to a PFI contract, the lessee bears the commercial risk. The three main variables in the calculation of a lease contract's financial rate of return are the up-front lease fee, the tariff for using the service, and the cost of operations. Compact funds could lower the up-front lease fee to make a lease contract more attractive to the private sector. In addition, the Output-Based Aid model could complement a lease contract as a way to expand service (see Output-Based Aid Module).

### 3. MCC Parameters

*Accountability:* Compact funds are subject to a high level of accountability and transparency as part of MCC rules and regulations. Use of Compact funds must be appropriately documented.

*MCC Timeframe and Compact Length:* Outsourced Management contracts vary from three to five years for service and O&M contracts, and five or more years for leases. MCA's possible roles require involvement at the front end of these timeframes (see MCA roles above).

*Procurement:* Best practice for competitive bidding of Lease contracts is the two-step process of an Expression of Interest (EOI) followed by a Request for Proposal (RFP). It allows a pre-selection based on technical expertise and a level-playing field among submitted proposals. The two-stage process reduces the amount of bidder preparation work and generates more bids. For leases, it is standard practice that the RFP include a draft contract laying out the transaction structure including risk allocation, method of payment, scope of work, etc. Including a draft contract for comment can reduce the time needed for post-award negotiations. For service contracts of small value, a one-step procurement process is enough.

#### **4. Key Success Factors**

This section presents key factors to consider for a successful Outsourced Management model. It looks at the past experience in Outsourced Management implementation and presents a list of key success factors based on best practices from around the globe and lessons learned from past failures.

##### **4.1. Public Sector Competency**

The public sector entity must be credible as a credit counterparty, an enforcer of a service or O&M contract, and as a regulator of a lease contract. It must have autonomy in management and the means to carry out its mission, both in terms of funding and competency. The public sector entity must be able to set tariffs while keeping a balance between the level of affordability for users and the private operator's need to recover costs. The public sector entity must monitor key performance indicators and enforce contracts accordingly.

##### **4.2. Cost Recovery**

As with PFI transactions, a lease contract must allow the private operator to make a profit. The lessee will take on the commercial risk. There are four financial variables the public sector should look at when designing a lease contract: lease fee, tariff, contract duration, and cost of operations. As early as the project design stage, the public sector needs to find the right balance among all four variables:

- First, the amount of the fee the private operator pays for the lease is set in the lease contract. The fee must be reasonable. Payment of the fee can be in one amount up-front, or as an annual lease fee that increases moderately from year to year;
- Second, the tariff level or formula the regulator (public authority) sets affects operator revenues; it must be both affordable for end-users and allow the private operator to recover costs.
- Third, the duration of the contract is the variable that can strike the balance between the first two. In cases where the private operator anticipates losses in the first years of operations before becoming cash-flow positive, the lease duration must be long enough to allow time for full cost-recovery.
- The last variable is the cost of operations to provide the service, which is an exogenous variable. The lease contract should include flexibility in case the operational costs far exceed projections, so the operator can recover its costs.

Service and O&M contracts are more straightforward since they do not bear demand risk and are paid directly by the public sector entity. However, the contracts are usually performance-based, and the targets

set in the contract must be reasonably achievable.

### 5. Case Studies

Outsourced Management contracts have been widely used in developing countries, particularly as a first step to introduce private sector management of public services. Water and sewage services is a sector where the Outsourced Management model is widely used because often the gap between cost recovery and affordability of services is too large to enable a PFI model. Nevertheless, Outsourced Management is a good intermediary contract before additional risk is shifted to the private sector under a PFI contract.



Dar-Es-Salaam Water Lease	
<b>Players</b>	<b>Sector</b>
<ul style="list-style-type: none"> <li>▪ Dar-Es-Salaam Water and Sewage Authority - DAWASA</li> <li>▪ World Bank</li> <li>▪ Biwater (Germany)</li> <li>▪ CWS (SPV majority-owned by Biwater and minority-owned by local investors)</li> </ul>	Water
	<b>Location</b>
	Tanzania
<b>Analysis</b>	
<p><b>Situation:</b> The Dar-Es-Salaam Water and Sewage Authority (DAWASA) is the utility that provides water and sewage services in the city of Dar-Es-Salaam, Tanzania. In 2002/2003, DAWASA was in a poor state with equipment breaking down, many illegal connections, few customer meters, and no bulk meters. Of the 100,000 billed customers, only 15,000 paid. The tariffs were low and there were frequent political pressures to supply free water. Informal private water suppliers arose, selling water for more than eight times the DAWASA price. In addition, DAWASA was overstaffed by people who lacked key skills and there was considerable corruption among customer service staff.</p> <p><b>Involving the private sector:</b> The Tanzanian government decided to involve the private sector in DAWASA as a way to improve operational efficiency and isolate operations from political influence. DAWASA designed a lease contract whereby the operator would pay the government a rental fee and have exclusive rights to provide piped water supply and sewerage services in the operator’s area for ten years. An Operator tariff is paid by users to the operator and covers operations, maintenance, working capital, small equipment, and a return. Users also pay the utility a Lessor Tariff. The tariffs employ an automatic value escalation mechanism that is fixed for five years and reassessed in the sixth year.</p> <p><b>Lease Contract:</b> The lease contract defines the split of responsibilities—maintenance and asset replacement, asset inventory, installing meters, etc.—between the private operator and DAWASA. The contract also includes performance requirements including number of new customer meters to be installed each year, improvements in collection, water and effluent quality, percentage of customers receiving 24-hour water supply, reductions in non-revenue water, etc. DAWASA requires 20% minimum in local participation. A contract feature stipulates that the operator monitor the system for the first year to confirm bid assumptions. Should those assumptions prove inaccurate, performance indicators and tariffs would be adjusted upwards or downwards. The lease contract also provides different dispute resolution mechanisms based on the nature of the dispute.</p> <p><b>Procurement:</b> The government prequalified three bidders through an EOI (Saur, Vivendi, and Biwater/Gauff). Through a competitive dialogue procedure, the government defined contract terms and definitions for bidding documents and bidders conducted their own due diligence. The award went to the lowest proposed operator tariff; Biwater/Gauff won the bid and signed the contract February 2003.</p> <p><b>Setup phase and start of operations:</b> In March-July 2003, DAWASA was restructured as an asset owner (not an operator) and Biwater/Gauff formed a special purpose vehicle with a local investor called CWS to operate the asset.</p> <p><b>Implementation and Problems:</b> Once the contract began, it quickly became apparent that CWS could not improve asset performance and collections. In December 2003, CWS began falling behind with the monthly rental fee and by June 2004 it stopped paying the fee completely. CWS requested that adjustments be made because bid assumptions were incorrect. In August 2004, an independent party conducted a review of PriceWaterhouseCoopers to determine whether there had</p>	

been a material change. CWS pushed to renegotiate the lease, which DAWASA eventually agreed to. However, both parties could not come to an agreement, DAWASA took possession of the assets in June 2005, and the lease contract was cancelled.

Source: *Emerging Markets Group*

**Key Learning Points**

This Lease contract failed because of a poor original design and flaws in procurement. The lessons learned include:

- During procurement stage, bids must be realistic, particularly the capacity to improve payment collections and contain operational costs
- Lease contracts need clear dispute resolution arrangements accessible by both parties. In this case, CWS ignored all dispute resolution arrangements and went straight to the regulator to seek a political solution. Regulator should not have been included as dispute resolution option. Expert panel for dispute resolution should be identified prior to signing the agreement.
- Lease contracts need to state clearly how changes in bid assumptions would be translated into changes in contract economics (tariffs, payments, risk allocation) once the contract is in place
- Lease contracts need to allow for partial claim of a performance bond. Claiming the full amount is more difficult to attain and does not serve the purpose for managing performance. Indeed, a contractor usually fails to perform on a specific task for a specific amount that is less than the full amount of the contract.
- There is a need to properly protect the Lessor Tariff collections from misappropriation by the Operator.



Amman Water and Sanitation Management Project	
<b>Players</b>	<b>Sector</b>
<ul style="list-style-type: none"> <li>▪ World Bank, European Investment Bank, Italian bilateral assistance, KFW, USAID</li> <li>▪ Government of Jordan</li> <li>▪ Suez &amp; Montgomery Watson Arabtech Jardaneh</li> </ul>	<b>Water &amp; Sanitation</b>
	<b>Location</b>
	<b>Jordan</b>
<b>Analysis</b>	
<p>Jordan is one of the most water-challenged countries in the world. In urban areas, coverage and continuity of water supplies is deficient. The situation is particularly acute in the capital city of Amman, where the population relies mainly on water pumped vertically 1,200 meters from near the Dead Sea—a practice that is energy intensive, costly, and insufficient.</p> <p>To address these issues, the Amman Water and Sanitation Management Project (AWSMP) was designed to assist the Government of Jordan use water more efficiently by reducing the excessive amount of unaccounted for water and improve system operations and maintenance. The World Bank played a central role in assembling the co-financers for AWSMP: the Italian bilateral assistance and USAID funded technical advisors, while the European Investment Bank and KFW funded the capital investment program (asset rehabilitation).</p> <p>To ensure that project objectives could be accomplished, AWSMP identified a private procurement agent that tendered a full and open procurement in 1999 and selected LEMA, a joint venture comprising <i>Suez Lyonnaise des Eaux</i> and <i>Montgomery Watson Arabtech Jardaneh</i>.</p> <p><b>Project Development Objectives:</b> LEMA was contracted to: i) improve efficiency, management, the operation and delivery of water and wastewater services for the Amman Service Area, and ii) lay the groundwork for sustainable involvement of the private sector in the country’s management of water and wastewater services.</p> <p><b>Main Beneficiaries:</b> Amman’s population in 1999, estimated at two million, constituted the main beneficiary of this project. However, a massive migration of Iraqis to Amman, estimated at 500,000 between 2003 and 2007, further increased the impact of the project. The expected benefits included more equitable access to scarce water resources.</p> <p><b>Implementation:</b> The project was implemented under a management contract with LEMA whose initial contract, from 1999</p>	

to 2003, was extended twice and remained valid through the end of 2006. The project design allowed ownership to be maintained by the Government of Jordan. Below is why AWSMP sought a private operator:

- Eight previous World Bank-funded water supply projects had failed under public sector management. Efficiency, effectiveness, and alacrity in implementation were identified as key factors for success.
- It was necessary to retain a sizeable number of Water Authority of Jordan (WAJ) staff, both to maintain continuity of experienced staff and to mitigate alternative employment issues in the WAJ. Because AWSMP retained project ownership, it was possible to get a commitment from the private operator to retain at least half of the WAJ staff.

**Results:** Project achievements were measured in two related ways: i) by comparing the actual values of key performance indicators to target values at appraisal; and ii) by assessing the efficacy of various project components in terms of their respective output (i.e. management contract, operating investment fund, capital investment program, and technical assistance). Based on these assessments, the Amman water and sanitation project was rated “moderately satisfactory.”

*Source: World Bank*

#### **Key Learning Points**

- Risk allocation between contract parties must be described in as much detail as possible to help the private sector price its risk and to determine the appropriate level of risk-sharing.
- The availability of accurate baseline data is crucial for assessing operator performance.
- Excluding the operator from managing the capital investment component may have a negative impact (e.g. delays) on achieving certain performance targets.
- Operators should have a say in determining innovative ways to manage and operate water supply systems.
- Tariff adjustment is better made when the public operator is still in charge of the service. If it is done after the private operator is hired, it may create opposition to the idea of private management of a public good. In this case, AWSMP adjusted the tariff in 1997, prior to inviting LEMA to assume operational responsibilities.
- When the utility has always been managed and owned by the public sector, an introduction to private sector participation is more successful with management contracts (than with PFI models) of long duration. A four to six year contract provides time to achieve meaningful improvements in utility management and assets, and in the role of the government.

## **6. Way Forward**

This section aims to assist MCC-eligible countries to design successful Outsourced Management programs. Based on the key success factors, the tool can help country teams think through the most important elements to have in place.

### 6.1. Partnership Design Tool

The Partnership Design Tool provides support to eligible countries in designing Outsourced Management programs. The tool lists the critical areas countries need to look at in order to have a successful program.

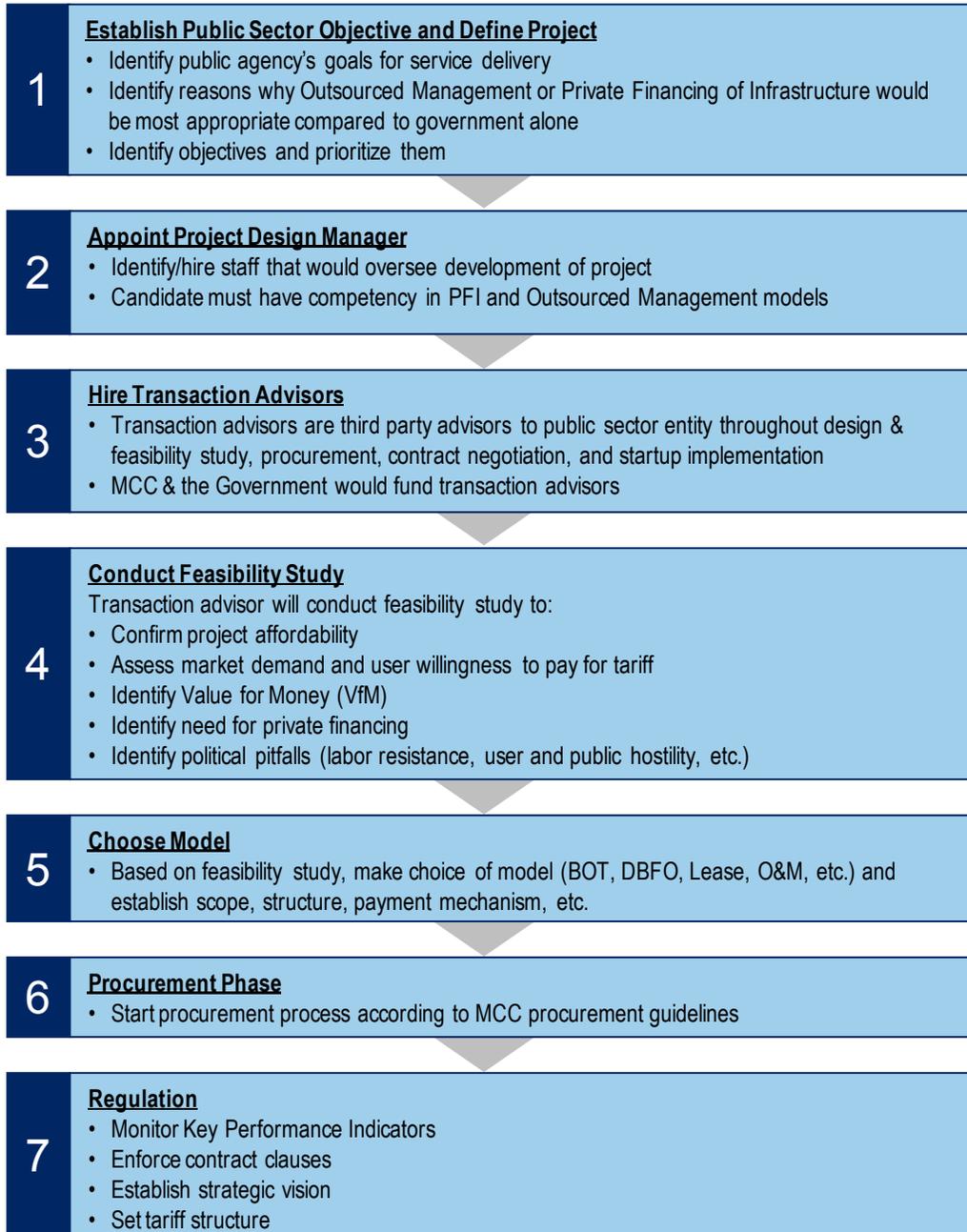
**Chart 18: Partnership Design Tool – Outsourced Management**

	Area	Issue	Best Practices & Guidance	Country Status	Outcome & Action Steps
Legal Framework	Legal Framework	Is the adequate legal framework in place?	An Outsourced Management contract requires a stable business environment, including adequate contract / commercial laws.	NON-EXISTENT	<b>STOP.</b> An Outsourced Management contract is not possible without the adequate legal framework
				WEAK	<b>REMEDIAL ACTIONS.</b> Assess discrepancies and amend laws / ordinances where necessary
				SATISFACTORY	<b>GO</b>
Government Capacity & Structure	Government Capacity and Structure	Does the public sector entity have the administrative capacity to manage Outsourced Management contracts?	Outsourced Management contracts require the government agency to monitor and regulate the private sector contract.	POOR	<b>REMEDIAL ACTION.</b> The public sector entity will need technical assistance prior to procuring the Outsourced Management contract, as well as during its execution
				WEAK	<b>REMEDIAL ACTION.</b> The public sector entity will need technical assistance to manage the Outsourced Management contract
				SATISFACTORY	<b>GO</b>
Economic, Commercial and Financial Risks	Tariff vs. Lease Fee Setting	For lease contracts, are tariffs expected to cover the cost of operations and the lease fee?	The government must assess whether the tariff expected from operation of the asset can reasonably cover the operations and the lease fee paid by the operator within the contract timeframe	NO	<b>STOP.</b> The private sector will not be interested if it cannot make a profit. The government should look at service or O&M contracts.
				PARTIALLY	<b>ALTERNATIVE OPTION.</b> The government must change the risk allocation and/or restructure the payment system with a mix of an increase in tariffs, decrease in the lease fee, and a change in the duration of the lease. Another option is Output-Based Aid
				YES	<b>GO</b>

**6.2. Process and Timeline**

The Process and Timeline for establishing designing PFI and Outsourced Management contracts is the same, and they are presented below.

**Chart 19: Outsourced Management Process**



**STEP 1. Establish Public Sector Objective and Define Project.** The public sector entity needs to establish clear objectives for its public service mission. A rapid assessment should analyze the state of the public service in the sector considered and identify necessary improvements. The public sector entity should establish the public service goals to be achieved by the project. The

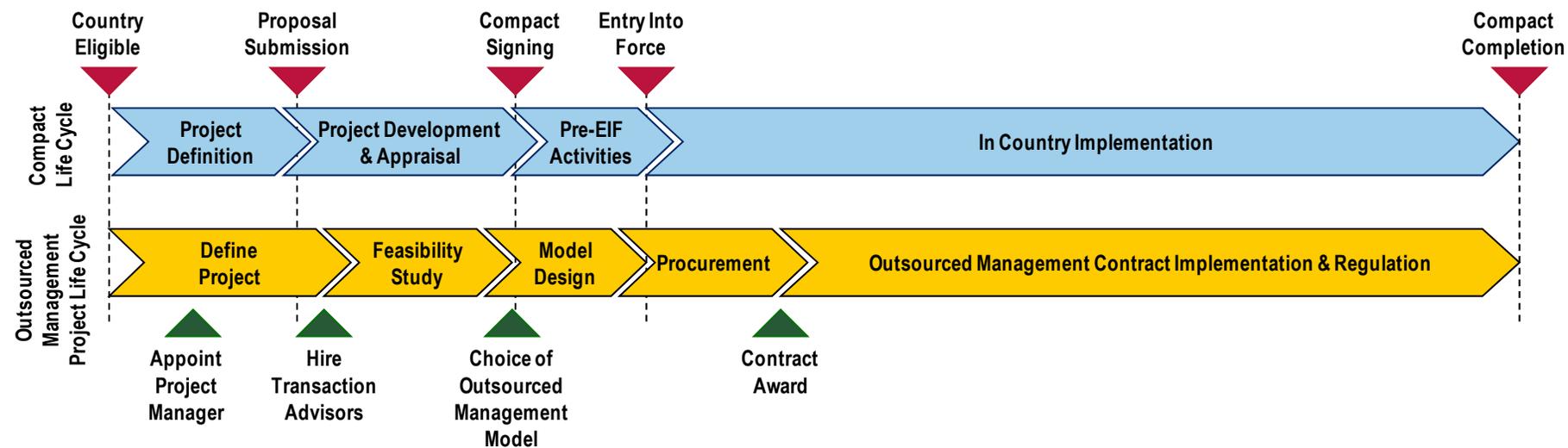
next step is for the public sector entity to define the project scope and determine how the project will meet the stated government objectives. The Partnership Design Tool can help achieve this first step.

- STEP 2. Appoint Project Design Manager.** Best practices suggest appointing a Project Design Manager within the MCA entity to conduct the overall partnership design, procurement, and implementation process. The Project Design Manager would be hired during Compact development while the public sector entity formulates its strategy and project design. The Project Design Manager must have a good knowledge of the Private Financing of Infrastructure and Outsourced Management models as well as expertise in developing and implementing public sector strategies.
- STEP 3. Hire Transaction Advisors.** Like PFI, Outsourced Management is complex and requires specialized technical expertise in structuring transactions. MCA, with support from the government and MCC, can hire transaction advisors to provide support during the various phases of design and feasibility study procurement, contract negotiation, and startup implementation. Transaction advisors should bring comprehensive expertise in legal, financial, economic, technical, and environmental issues. They are the right hand of the MCA and the government during the process of structuring the project.
- STEP 4. Conduct Feasibility Study.** The cornerstone of the design phase is the feasibility study that occurs prior to compact signing. The objective of the feasibility study is to assess the opportunity of private sector participation, and to present a structure that balances public sector objectives with the financials of the project. The feasibility study is conducted by the transaction advisors. They will first carry out a needs assessment that will specify the service to be procured, both quantitatively and qualitatively. They will also carry out a Value for Money (VfM) analysis, which consists of assessing whether the government would get value for money by using the private sector instead of the public agency. An initial affordability assessment identifies the project's costs if implemented by the public sector. The VfM considers the net present value over the project life of both options. Besides this figure, VfM also has a qualitative aspect which takes into account the speed at which services are delivered, the wider economic and social benefits of both options, etc. As part of the feasibility study, the advisors will also determine what risks should be transferred to the private sector to optimize delivery and the cost of the service. The feasibility study also includes a demand assessment (market survey and user willingness to pay), a stakeholder assessment (including labor and users), an institutional and legal assessment, and an environmental assessment.
- STEP 5. Choose Model.** Based on the feasibility study, the Project Officer and the MCA will decide on the type of model to adopt. In particular, they must decide on the risks to be transferred to the private sector and its remuneration structure. These two items will be key factors to attract the private sector.
- STEP 6. Procurement Phase.** Once the project is designed, MCA will start the procurement process through the procurement agent and with the support of the transaction advisors. The procurement will be competitive, with a double-stage process of first Expression of Interest (EOI) and then Request For Proposal (RFP). The RFP should describe the key elements of the structure, including a scope of work, performance requirements, payment mechanisms, technical expertise required, risk allocation, requirements for local sourcing and staff retention, a copy of the proposed contract, and the evaluation criteria. In line with international best

practices, Value for Money should be a key selection criterion. In addition, the bidders shall be allowed to conduct their own due diligence on the project through access to the public sector assets and to a data room.

**STEP 7. Regulation.** Once the contract is awarded, a regulatory body within the Public Sector Entity will be in charge of regulating the PFI or Outsourced Management contract. A Regulatory Board will meet every quarter to review the private operator's performance and make necessary decisions in terms of tariffs, investment, strategy, etc. The regulatory body is in charge of the day-to-day monitoring of the key performance indicators set in the contract, and against which the private operator will be measured and eventually remunerated.

**Chart 20: Outsourced Management Indicative Timeline**



*The timeline for the Private Financing of Infrastructure project life cycle is indicative and dependent on the situation.*

Z



## 7. Resources

### *General Resources*

Public-Private Infrastructure Advisory Facility, World Bank, [www.ppiaf.org](http://www.ppiaf.org)

### *Sector-Specific Toolkits*

#### PPIAF Toolkits

- ♦ Port Reform Toolkit <http://www.ppiaf.org/Port/toolkit.html>
- ♦ Toolkit on Public-Private Partnerships in Highways  
<http://rru.worldbank.org/Documents/Toolkits/Highways/start.HTM>
- ♦ Toolkit for Water Sanitation & Reform  
[http://wbln0018.worldbank.org/ppiaf/activity.nsf/files/WaterToolkit.pdf/\\$FILE/WaterToolkit.pdf](http://wbln0018.worldbank.org/ppiaf/activity.nsf/files/WaterToolkit.pdf/$FILE/WaterToolkit.pdf)
- ♦ Toolkit on Market-Based Approaches in Private Sector Provision of Bus Services  
<http://www.ppiaf.org/UrbanBusToolkit/>
- ♦ How to Hire Expert Advice on Private Sector Involvement in Infrastructure: A Toolkit for Policymakers <http://www.ppiaf.org/hiringadvisors/fulltoolkit.pdf>
- ♦ Labor Toolkit for Private Participation in Infrastructure <http://www.ppiaf.org/LaborToolkit/toolkit.html>
- ♦ Toolkit for Tourism PPPs –PPP Unit, Republic of South Africa  
[http://www.ppp.gov.za/Toolkits/Tourism\\_Final/Toolkit.htm](http://www.ppp.gov.za/Toolkits/Tourism_Final/Toolkit.htm)

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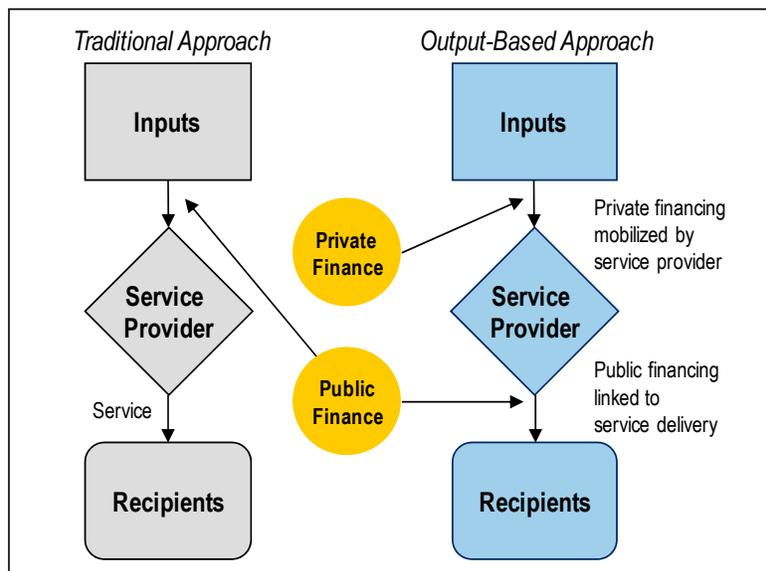


# Model 3: Output-Based Aid

## 1. Background Description

Output-Based Aid (OBA) is an alternative approach to traditional public service delivery, with particular application in the water and sanitation, energy, social, health, telecommunications, and transport sectors. The intent of OBA is to provide efficient delivery of public services by combining targeted user subsidies and performance-based contracting. Under an OBA approach, basic service provision is contracted out to a service provider through a pre-defined payment subsidy that is tied to the successful delivery of agreed-upon outputs. Public funding is provided upon delivery of outputs, as opposed to financing projects inputs up-front (see Chart 21). This shifts performance risk to the provider in return for assured payment at an acceptable rate of return, paid upon delivery of agreed terms. By linking subsidy payments to satisfactory delivery, public funds are used effectively to provide important services to underserved end-users. The model is applicable where policy concerns justify public funding to complement or replace user charges when intended poor or disenfranchised recipients are unable or unwilling to absorb the true cost of service.

**Chart 21: Traditional and Output-Based Approaches to Service Delivery**



Source: Global Partnership for Output-Based Aid, World Bank

The key attributes that distinguish OBA from other publicly-funded subsidies are that OBA is explicit and performance-based. OBA interventions ensure explicit recognition of why the subsidy is being provided; who is receiving the subsidy and who is providing it; and the activities and financial sums being subsidized. The model recognizes that some public services cannot be provided with high enough financial rates of return to interest the private sector. Therefore, to attract private operators and the benefits of their efficiency, the public sector utilizes subsidies that target users in order to align the risks associated with satisfactory delivery of public services with an appropriate return.

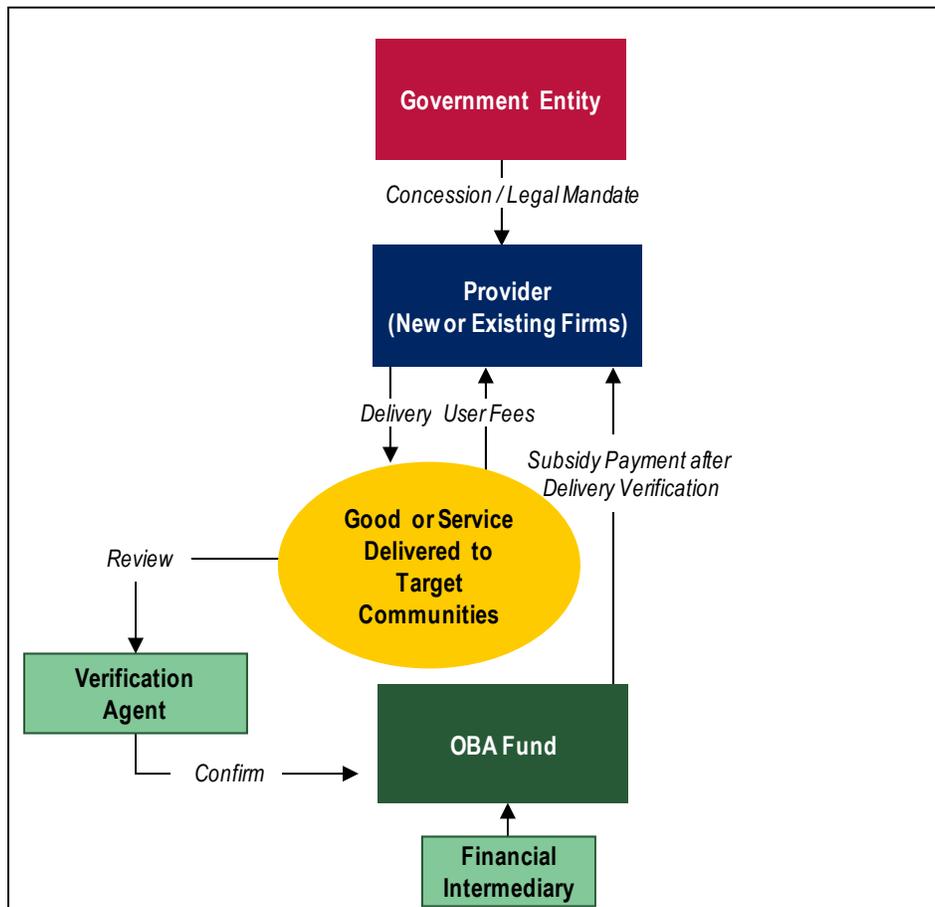
**1.1. Objective**

The objective of OBA is to provide incentives to providers for the supply of basic services to targeted poor communities unable to cover full user fees. The provider receives full market value for delivery of agreed-upon services in a transparent, accountable, and efficient manner.

**1.2. Structure**

The typical structure of an Output-Based Aid project is for a government entity to provide a concession or legal mandate to a provider. Under OBA, the service provider can be a government municipality / agency, a civil society organization, or a private sector provider—the discussion below focuses on OBA utilizing private sector providers. The provider finances the delivery of the agreed-upon outputs to targeted poor communities or individuals and, depending on the sector and the agreed-upon OBA structure, the end-user may provide a portion of the delivery cost. Upon delivery, an independent verification agent conducts a review to determine if the terms of agreement are met. If the terms have been met, a subsidy payment is released to the provider from an OBA fund that is managed by the government, a donor, or a financial intermediary funds manager (See Chart 22). The subsidy may be provided either one time or continuously over the duration of the project.

**Chart 22: Output-Based Aid Structure**



The OBA approach is performance-based because it links payment for services to the provider’s effective delivery of specified outputs. The provider often pre- or self-finances the delivery of services and receives

reimbursement after verification of their successful delivery (as contracted). Therefore, performance risk is inherently transferred from the public entity to the service provider without causing market distortions.

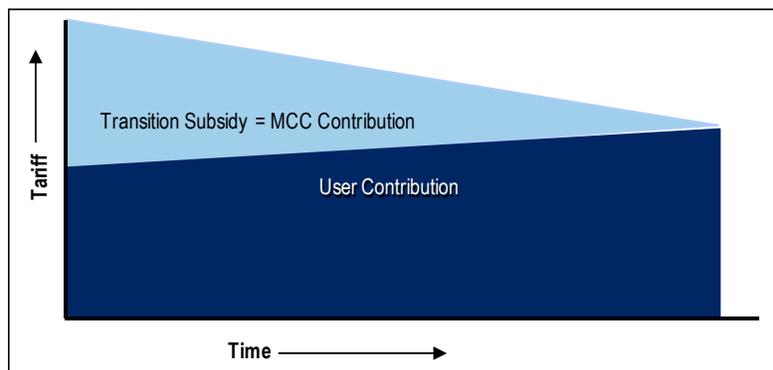
### 1.3. Advantages

In return for taking on the performance risk, Output-Based Aid gives the private sector provider the necessary financial incentive and level of comfort to motivate it to engage in the sustainable delivery of core government services to poor communities or individuals. A performance-based subsidy backed by creditworthy government or donor funding can reduce the risks associated with provider payment recovery. With payment risk reduced and tied to performance, providers can focus on properly providing their services. Most importantly, OBA can enhance a project's financial viability by increasing the likelihood that the private sector firm can achieve an acceptable financial rate of return, thus making an otherwise unattractive opportunity feasible to the provider from a cost / benefit perspective.

### 1.4. Variants of Output-Based Aid<sup>7</sup>

- **One-off subsidies.** The most common use of OBA usually involves capital subsidies aimed at increasing access to services. The subsidy is usually paid after targeted beneficiaries are connected to a network and connections are verified. To increase sustainability, a portion of the subsidy may be withheld until after verification of a specific service delivery period (e.g. one year).
- **Transitional consumption subsidies.** These are designed to help fill the gap between what the user is deemed able or willing to pay and the actual cost of providing the service. They are especially relevant when large capital expenditures to expand service capacity significantly increase the necessary level of user fees. The subsidy is phased out over the course of a given number of years as the user contribution increases (see Chart 23)

**Chart 23: Example of Transitional Subsidy Arrangement**



Source: *Global Partnership for Output Based Aid*, World Bank

- **Ongoing consumption subsidies.** These are required when there is a perpetual gap between affordability and the cost of providing the service. Clearly earmarked sources of future funding are required, which renders sustainability an ongoing issue.

<sup>7</sup> GPOBA Annual Report 2007

## 2. Roles

The roles of each party must be well-defined and understood for Output-Based Aid to be successful. Incentives must be aligned to reinforce effective and efficient follow-through by each stakeholder. The following are general roles for stakeholders:

### Access to Finance Challenges

*Obtaining necessary financing to deliver agreed upon goods or services is a major challenge for potential private sector providers, particularly local or regional providers. Subsidy disbursements must be flexible in terms of how “output”-based the project can be. For example, an Armenian OBA project connecting poor urban households to a gas network for heating disburses a 20% advance payment upon contract signing with service contractors. In another innovative approach, a water project in Kenya involves a partnership between a microfinance institution and community-based providers, with the OBA subsidy providing security to the lender that they will be repaid if agreed upon outputs are delivered.*

*Source: GPOBA Annual Report 2007*

**Chart 24: Role of the Private Sector, MCA and/or Government in the OBA Model**

Private Sector	MCA and/or Government	
<ul style="list-style-type: none"> <li>▪ Competence in understanding local markets and ability to provide necessary services in an effective and efficient manner</li> <li>▪ Provision of verification and fund management services if necessary</li> </ul>	<ul style="list-style-type: none"> <li>▪ Ensure appropriate business and regulatory environment exists</li> <li>▪ Coordinate conceptualization, design, and implementation</li> <li>▪ Continued commitment and financial support for duration of the project</li> </ul>	<ul style="list-style-type: none"> <li>▪ Assessment and design</li> <li>▪ Mitigate risk to encourage participation of private providers through access to finance, guarantees, or insurance</li> <li>▪ Provide subsidy payments via an OBA fund</li> </ul>

### 2.1. Private Sector

Within the private sector, a competent provider must exist to take on the responsibility and risk to deliver the service. The private sector must be able to determine the demand and ability to pay for the service within the target community in order to place a competitive bid that provides an appropriate rate of return. The need for in-depth local knowledge is in part the reason for increased reliance on competent small and local providers.

Additional key roles for the private sector are as providers of professional services. Successful OBA delivery needs unbiased, completely independent verification agents who are impervious to corruption and have the capacity and competency to determine and verify if contractual obligations have or have not been met. Projects may also require a financial intermediary to disburse funds properly upon verification, which requires an independent organization that can be trusted and depended upon to make prompt, timely disbursements.

### 2.2. Government

The government plays a key leadership role in any OBA project—it must drive conceptualization, design, and implementation of the OBA concession or legal mandate. If capacity or knowledge does not exist in the responsible governmental entity, it should engage an expert consultant to assist in the proper design of the OBA contract. After the project is designed, continued governmental support of target beneficiaries must occur to ensure that funding remains available and is disbursed for specified outputs. The government also must commit to safeguarding against corruption and enforcing agreed-upon contracts.

### 2.3. MCA

Compact funds can assist with designing a locally-appropriate OBA project, including feasibility assessments and overall OBA design. Depending on the level of experience in the country, consulting expertise may be necessary for project design, procurement of private sector actors (providers, verification

agents, a financial intermediary), establishment of verification services or fiduciary agent and general project management oversight. To the extent this occurs before Compact signing, costs could be assumed by the MCC or the Government.

Depending on the business environment in the country, Compacts also can help mitigate risk for the private sector providers and entice their participation. Tools for risk mitigation include guarantees.

**Minimizing Economic Distortions**

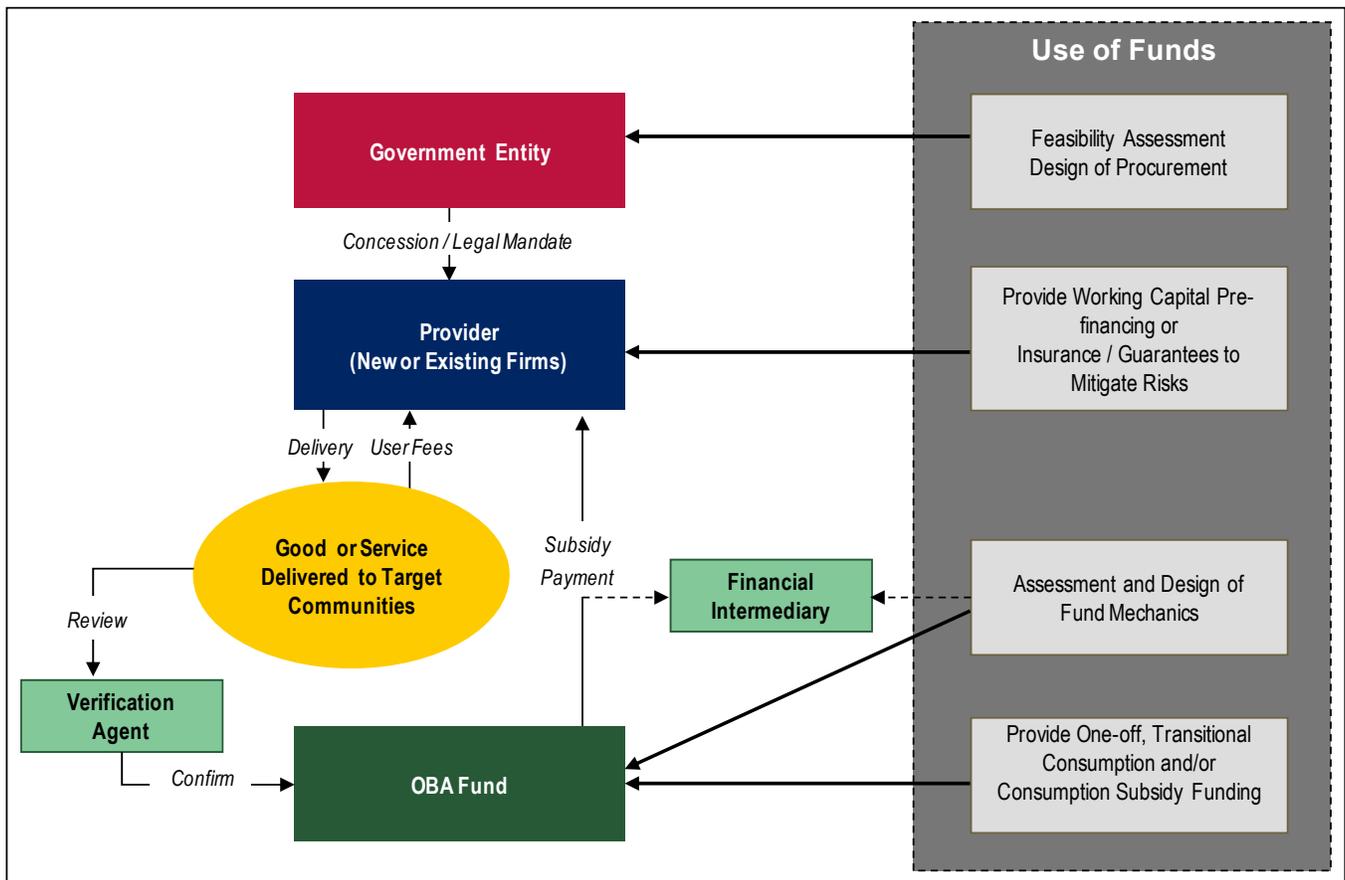
*Use of the lowest minimum subsidy bidding creates a competitive environment where economic distortions of the subsidies can be mitigated. A Mongolian OBA to extend telecommunications services to rural areas produced significant competition amongst pre-qualified bidders resulting in a winning subsidy amount much less than the maximum allowable and a savings that was reallocated to further expand service to another region.*

*Source: GPOBA February 2008 Note No. 18*

Most importantly, Compact funds can be used to establish the OBA fund that provides one-off, transitional, and/or consumption subsidy payments targeted at poor communities or households, making it financially viable for the private sector to provide the service. Depending on the situation, the Compact might be able to provide necessary financing for an OBA fund for any of the following subsidies: one-off subsidy, a transitional consumption subsidy, or a consumption subsidy if it addresses a necessary key priority such as vouchers to support health and well-being of poor communities.

OBA can also be used with other models. For instance, a private operator who manages a utility under a PFI or an Outsourced Management model can be incentivized to expand the network through OBA.

**Chart 25: Possible Uses of Funds in Output-Based Aid (OBA) Model**



### 3. MCC Parameters

*Avoiding Market Distortion:* OBA can be a useful tool for MCA countries to leverage funding while meeting specific development objectives. However, publicly-funded subsidies may be necessary to provide essential services to targeted poor communities. Critical to the success of an OBA initiative is the minimization of market distortions during the process. This is done by requiring end-users to provide an appropriate contribution toward the user fee. Competitive bidding also should be utilized and the procurement process should seek to maximize Compact funding by using lowest subsidy or the highest number of recipients served as bid evaluation criteria.

*Accountability:* OBA performance-based subsidies ensure effective and transparent use of Compact money by explicitly recognizing and identifying subsidy flows — X target group receives Y service. Because payment is dependent upon it, results monitoring is internalized in the process.

*MCC Timeframe and Compact Length:* OBA can be effective within the prescribed five-year Compact timeframe. One-off subsidies, often used in creating connections in water, sanitation, and energy, are well suited to a limited timeframe. Alternatively, transitional consumption subsidies, which can effectively reduce tariff shock when moving towards cost recovery, are often designed for five or fewer years in order to create a lasting and sustainable development outcome.

### 4. Key Success Factors

Output-Based Aid does not need to be overly complicated to be successful. However, it must be designed for the local environment through a collaborative, trusting relationship between public and private stakeholders. This section focuses on the key factors that make an OBA model successful. These key success factors are derived from global best practices and lessons learned.

#### 4.1. Conducive Regulatory and Economic Environment

Regulatory capacity and economic support must exist within the country for OBA to be possible. Success of OBA depends on the existence of a favorable operating environment in the host country. The OBA model is relatively new so experience and knowledge may be limited, which can cause uncertainty and increase initial start-up costs and implementation time. As a result, a competitive private sector must exist within the country or the country must be able to attract international companies to the local business environment. For OBA to work, the private sector, and particularly local providers, must have access to capital, insurance, or guarantees.

#### 4.2. Appropriate Design

Appropriately designing OBA is the most critical factor for success of the model. When designing OBA schemes, the goal is to ensure that public funds are channeled in a way that provides incentives for improving the delivery of services to intended recipients. This requires significant attention to scheme-specific tailoring—the design must adequately address each of the

#### **Exposure to Foreign Exchange and Price Fluctuations**

*When designing an OBA program, it is important to understand implications of exchange rate and material price increases as local providers may not be equipped to hedge these variables, but must bear the risk as OBA pays upon output. For example, an OBA project in Dakar, Senegal working to increase access to on-site sanitation faced challenges from a marked increase in the cost of cement and other key materials. In addition the subsidy was set in US dollars, which have depreciated significantly against the local FCFA. To mitigate these risks, the project design includes mechanisms for subsidy renegotiation or incorporates hedging strategies that ensure uncontrollable macro circumstances do not put service delivery at risk.*

*Source: Senegal – Increasing Access to On-site Sanitation Presentation, Sylvie Debomy, February 27, 2008, World Bank*

following local market factors in the OBA structure:

- ♦ Eligibility to receive OBA services — who are the intended recipients and what is the subsidy ceiling per household / community
- ♦ Optimization and realism of the percentage of user fee payments by recipient vs. subsidy
- ♦ Careful consideration of the subsidy payment schedule and delivery, possibly to include payment up front and guarantee of payment upon delivery
- ♦ Potential for exchange rate (if subsidy provided in a foreign currency) or material price increase risks
- ♦ Contractual adaptation and dispute settlement mechanisms.

#### ***4.3. Sustainability of Subsidy***

The subsidy must be sustainable. It either has to be a one-off or transitional or the subsidy funding source has to be highly reliable if it is not possible to achieve cost recovery or sustainability within the five-year Compact period. The duration of a subsidy must be carefully considered to ensure that provision of the public service is sustainable over the long term.

### **5. Case Studies**

OBA is a relatively new approach whose ability to increase aid effectiveness through private sector involvement has resulted in increased use in developing countries around the world. As OBA projects continue to scale up, valuable lessons learned and expertise will be developed, helping to further OBA's effectiveness. The following case studies provide important lessons learned from OBA projects in Bolivia, Uganda, and Senegal that can be applied when evaluating OBA opportunities within Compacts.



Decentralized Infrastructure for Rural Transformation (IDTR) – Bolivia	
Players	Sector
<ul style="list-style-type: none"> <li>▪ Bolivian Vice Ministry for Electricity</li> <li>▪ Alternative Energies and Telecommunication (Management Agency)</li> <li>▪ World Bank (Financier)</li> <li>▪ iiDevelopment (Transaction Advisor)</li> <li>▪ Private Sector Providers</li> </ul>	<b>Rural Power Generation</b>
	Location
	<b>Bolivia</b>
Description	
<p>A majority of Bolivia’s non-electrified households are in highly dispersed, rural settings too remote from the national grid to permit an economically justifiable grid extension. In order to provide electricity to these regions, which are home to some of the country’s poorest citizens, innovative, off-grid technologies and supply schemes, such as photovoltaic power-generating Solar Home Systems (SHS) that match electricity demand in a flexible, cost-effective manner are required. To address this problem of extremely low rates of rural electrification, the Bolivian government and the World Bank embarked on a ten-year, US\$60 million Decentralization Infrastructure for Rural Transformation (IDTR) program.</p> <p>Phase 1 of this three-phase program provides one-off subsidy payments to enable to installation of at least 15,000 Solar Home Systems, reaching more than 50,000 rural people in 14 target areas. In 2005, 14 contracts varying in size from 350 – 2,200 future SHS users were successfully bid out in a competitive tender. To minimize subsidies and market distortion, each area was awarded to a qualified bidder through a greatest impact bidding process in which the winning bid promised to service the largest number of users. Price caps were set to prevent monopoly pricing, while target areas were required to have a minimum number of users to prevent excessive per unit subsidies. Explicit, clear, and ambitious performance indicators were also put into place. For the 14 contracts, the IDTR international tender was successful in selecting two providers from 220 contacts made during a road show, eleven pre-qualified firms, and four bids. Empresa Isofoton S.A. was awarded ten contracts and Consorcio Energetica – Aned – Hansa Ltd was awarded four contracts.</p> <p>Service contracts and subsidies of the Decentralization Infrastructure for Rural Transformation (IDTR) program end after four years, at which time users and suppliers move to open competition. Payment is contingent upon successful delivery of agreed-upon terms. The IDTR subsidy disbursement schedule is as follows: 15% for marketing of the program, acceptance of prototypes, and training of technicians; 68% for installations on a quarterly basis; 12% for annual verification visits over four years; and 5% at the end of the contract, upon compliance with all obligations.</p> <p>The tender process and engagement of private firms has significantly increased efficiency and scale of the project as the winning bids exceeded the Government’s user-per-area target by 25% on average and unit subsidies were lower than comparable previous projects in Bolivia. This has resulted in an efficiency gain of about US\$2.5 million, compared to the US\$500,000 in expenses for the tender preparation and process.</p>	
Key Learning Points	
<ul style="list-style-type: none"> <li>▪ Open competition and a reliable tender process, including a comprehensive road show, were critical to gaining the confidence of the private sector and ensuring transparent use of donor funds</li> <li>▪ Encouraging international consortia to bid with local firms can build local capacity and provide access to finance</li> <li>▪ Provides benefits to targeted poor communities and households; designed to maximize benefit to poorest residents through design features such as SHS sizes and regional focus</li> <li>▪ The acceptance of OBA during a time of deteriorating public perception of private sector delivery of core services in Bolivia indicates that OBA can be balanced to provide benefit to the government, end users, and the private sector</li> <li>▪ The IDTR program has clear budgetary lines and a transparent flow of funds, clearly indicating how monies are being allocated, and directly and measurably demonstrating impacts and economic rate of return on money spent.</li> </ul> <p><i>Source: OBA Approaches, March 2007, Note Number 12, Output-Based Aid in Bolivia</i></p>	

<b>Output-Based Aid Voucher System for Healthcare Provision– Uganda</b>	
<b>Players</b>	<b>Sector</b>
<ul style="list-style-type: none"> <li>▪ Marie Stopes International Uganda (Management Agency)</li> <li>▪ Venture Strategies for Health and Development (Voucher Advisors)</li> <li>▪ Mbarara University of Science and Technology (M&amp;E Consultants)</li> <li>▪ KfW Development Bank (Financier)</li> <li>▪ Microcare (Voucher Database operation)</li> <li>▪ Uganda’s Ministry of Health</li> <li>▪ Healthcare Provider Facilities</li> </ul>	<b>Health</b>
	<b>Location</b>
	<b>Uganda</b>
<b>Description</b>	
<p>Marie Stopes International Uganda (MSIU) designed a pilot Output-Based Aid (OBA) Reimbursable Voucher Scheme to subsidize the diagnosis and treatment of sexually transmitted infections (STIs). The Ministry of Health (MoH) and KfW agreed to the design of the Voucher Scheme to be implemented at approved Health Care Provider Facilities in the greater Mbarara District. KfW is funding the OBA voucher scheme.</p> <p>The voucher is provided to poor, at-risk patients either for free or at heavily subsidized rates. Providers are reimbursed after independent verification of delivery of contracted services. In addition to expanding access to health services by the poor, the objective is to incentivize proper diagnosis and treatment of STI by approved healthcare providers. Qualified providers were identified through an initial baseline survey, given rigorous lab training, and then reviewed once more. This resulted in the pre-qualification of 20 providers, 18 of which signed contracts to be part of the Voucher Scheme in mid 2006. In the first 18 months of the program, 18,000 patients have been treated through the scheme, which distributes the vouchers through drug shops, pharmacies, and targeted behavior change campaigns in areas known to be frequented by the poor at risk of STIs.</p>	
<b>Key Learning Points</b>	
<ul style="list-style-type: none"> <li>▪ OBA health programs like the Ugandan STI scheme are designed with multiple goals in mind: to give patients the economic power to demand high quality healthcare delivery, target high risk or low income patients for critical services, augment general population utilization rates, and contain per-unit costs</li> <li>▪ Health-related OBA requires qualification and periodic certification of a large number of providers to ensure adequate service delivery for targeted communities and individuals</li> <li>▪ Substantial capacity must exist to systematically verify that treatment has been adequately provided in a cost-efficient and effective manner and to monitor results on an ongoing basis</li> <li>▪ Health-related OBA often require consumption subsidies funded by donor financing which can be financially unsustainable</li> <li>▪ Targeted marketing campaigns must be put in place and sustained in order to reach desired recipients</li> <li>▪ Health OBA programs must safeguard against providing vouchers to patients who could have otherwise afforded the full cost of the service.</li> </ul> <p>Source: <a href="http://oba-uganda.net/">http://oba-uganda.net/</a></p>	



Increasing Access to On-Site Sanitation– Senegal	
<b>Players</b>	<b>Sector</b>
<ul style="list-style-type: none"> <li>▪ Office National de l'Assainissement du Sénégal or ONAS (Senegalese Public Agency)</li> <li>▪ Agence d'Exécution des Travaux d'Intérêt Public contre le sous-emploi or AGETIP (Contract Management Agency)</li> <li>▪ Multiple Private Contractors and Community-Based Organizations (CBOs)</li> <li>▪ International Development Association (IDA), World Bank (Financier)</li> </ul>	<b>Sanitation</b>
	<b>Location</b>
	<b>Dakar, Senegal</b>
<b>Analysis</b>	
<p>An OBA approach has been leveraged to address the low level of access to sanitation in the peri-urban communities of Dakar. The objective is to reach 15,000 households in poor neighborhoods, using a demand-driven approach whereby the recipient must provide a 25% user contribution. Five neighborhoods have been targeted with a US \$5.7 Million IDA grant which offers five environmentally-friendly options of on-site household sewerage facilities (conventional sewerage is not technically and financially viable). The funding is for the installation of the facilities only; it does not include funding for a consumption or transitional subsidy.</p> <p>Disbursements to private contractors are paid thus: 40% on purchase of materials, 50% upon on-site verification of installed facilities, and 10% retention disbursed after one year of use to ensure quality functioning of facilities. The disbursements to Community-Based Organizations (CBOs) are as follows: 20% advance disbursement and 80% upon verification of agreed upon performance indicators through household visits, registered facility demand, and hygiene education training sessions. Disbursements were designed differently for private contractors and CBOs in order to help address local constraints of both organizational types, encourage competitive bidding, and enable successful delivery.</p>	
<b>Key Learning Points</b>	
<ul style="list-style-type: none"> <li>▪ Project success depends on building trust relationships with the private contractors and Community-Based Organizations who will implement; this requires a clear process and guidelines adhered to by all parties</li> <li>▪ Convincing the public utility of the feasibility of OBA and building confidence between beneficiaries and public actors that the scheme will be effectively implemented is a challenge that must not be underestimated</li> <li>▪ To ensure a demand-driven approach, the OBA design must define the right user contribution and payment schedules</li> <li>▪ Disbursement arrangements must be flexible to accommodate the local business environment and assist qualified providers if access to finance is prohibitively high or unavailable to local providers</li> <li>▪ Local and community-based providers may be the only ones interested in or appropriate for delivering services in the targeted region</li> <li>▪ OBA requires the expertise of experienced consultants as it often is new to stakeholders and requires time and funding to climb a learning curve and generate comfort for those involved</li> <li>▪ Exchange rate risks must be monitored; the decreasing value of the dollar compared to the local currency, the decreasing purchasing power of targeted recipients, and substantial increase in the price of building materials are causing financial difficulties and may require renegotiation of payments to providers.</li> </ul> <p><i>Source: Sylvie Debomy, OBA Learning Event, World Bank Presentation, February 27, 2008</i></p>	

## 6. Way Forward

This section aims to assist MCC-eligible countries design successful OBA programs. Based on the key success factors identified earlier, this tool can help country teams think through the key elements needed for an OBA program.

### 6.1. Partnership Design Tool

In order to explore if conditions are favorable to an OBA, the following partnership design tool focuses on the baseline conditions necessary for an OBA to be incorporated within a Compact. By exploring the areas and issues delineated below, potential challenges to implementing an OBA project will be identified and vetted early in the process. From this high-level analysis, Compact designers should be able to determine if the local context is conducive to OBA, as well as identify if remedial steps can be taken to ensure proper baseline conditions are in place to increase the probability of efficient use of Compact funds. The following is not an exhaustive list of factors to consider, as each OBA needs individual tailoring, but provides a template for understanding if basic attributes exist for OBA.

#### Lesson Learned in Guinea

*An OBA in Guinea was designed to transition users to cost-covering water tariffs. However, this failed because while the subsidy scheme worked smoothly, contractual and regulatory mechanisms for achieving cost savings were not present, which ultimately hindered delivery performance and rendered the service too costly for users.*

*Source: World Bank Output-Based Aid Book*

**Chart 26: OBA Partnership Design Tool**

	Area	Issue	Best Practices & Guidance	Country Status	Outcome & Action Steps
Legal and Regulatory Requirements	Legal Recourse	Is the adequate legal framework in place?	OBA requires an environment in which the private sector has confidence that contractual terms will be respected by beneficiaries and government. There must be legal recourse to enforce user payment and supportive regulatory protection against pilfering / corruption / payment risk throughout operations.	NO	<b>STOP:</b> Without adequate legal frameworks to enforce recourse, OBA cannot proceed
				WEAK	<b>REMEDIAL ACTIONS:</b> Identify risks / concerns of potential private sector stakeholders and amend where necessary
				YES	<b>GO</b>
Capacity and Structure	Government Capacity	Does the government entity have the administrative capacity to manage an OBA contract and subsidy disbursement?	Government must have the ability to prioritize objectives and regions; effectively design an OBA (or hire appropriate expertise); transparently procure a competitive bid to the private sector; administer contracts; provide for verification of	LOW	<b>STOP:</b> Without the active role of government to effectively engage in design and administration, OBA cannot proceed
				WEAK	<b>REMEDIAL ACTIONS:</b> Without adequate government capacity, government must make a commitment to and engage expertise to build the requisite capacity

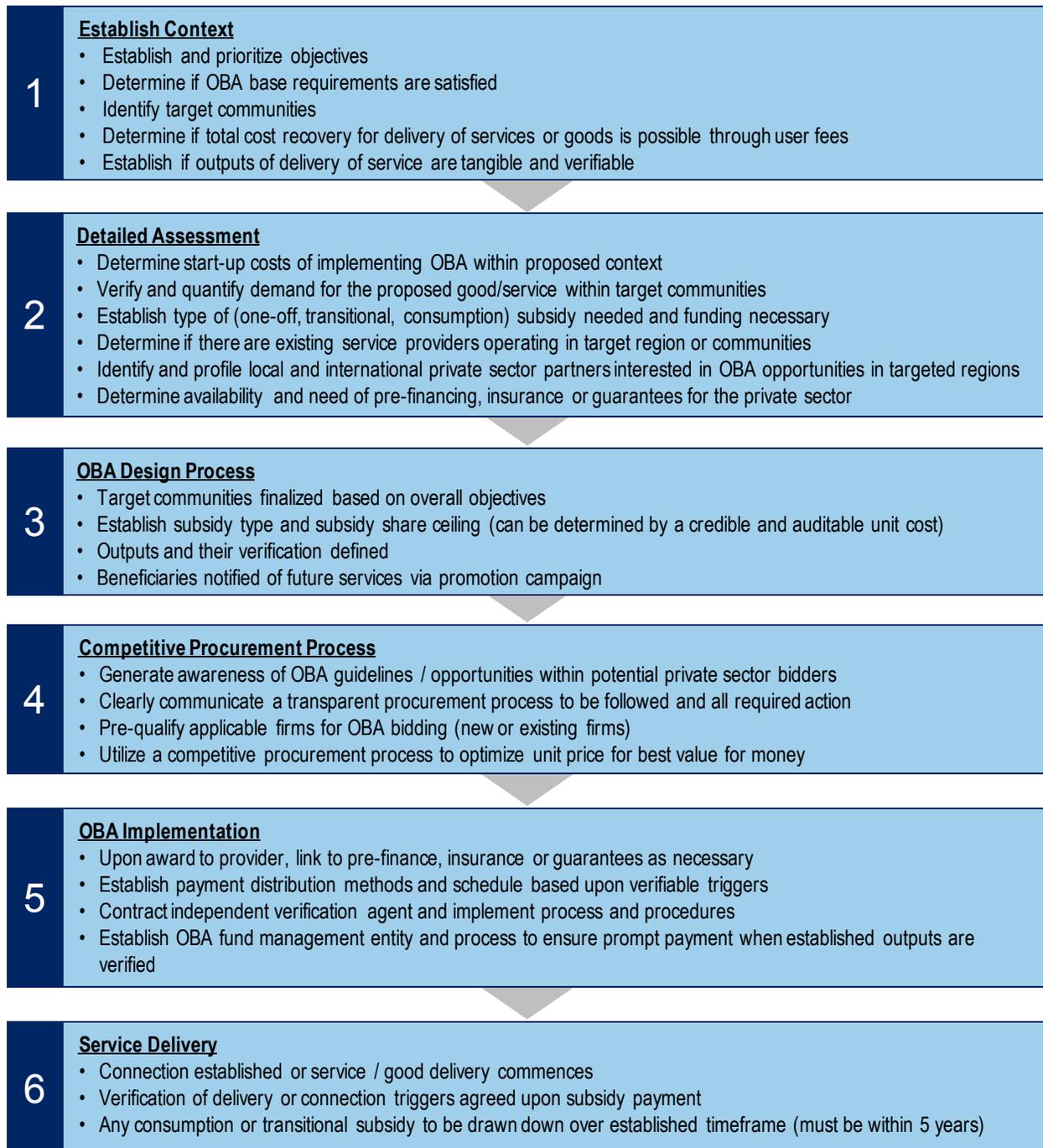
	Area	Issue	Best Practices & Guidance	Country Status	Outcome & Action Steps
Commercial Risk	Private Sector Capacity	Is there interest, competence and understanding of OBA within the local or international private sector?	contractual terms; and manage subsidy disbursements in a flexible and transparent manner.	SATISFACTORY	GO
				NONE	<b>STOP:</b> Without interested, competent providers and private sector partners, OBA cannot proceed
				SOME	<b>REMEDIAL ACTIONS:</b> Provide OBA training to increase awareness and interest within competent private sector
	Asset Ownership	Who owns the asset created by an OBA?	There needs to be clear definition and structure in place to determine who owns assets created with OBA subsidies, especially with one-off connection subsidies.	YES	GO
				UNCLEAR	<b>STOP:</b> Without ability to transparently determine ownership of benefits generated with subsidies, OBA cannot proceed
				SOME AMBIGUITY	<b>REMEDIAL ACTIONS:</b> Conduct assessment of discrepancies and weaknesses and amend laws / ordinances where necessary
	Tariff and Cost Recovery Risk	What percentage of connection / consumption fees do service users cover?	Ability and willingness to pay user fees must be accurately understood and optimized within OBA design – e.g., subsidy ceilings per household / community must be clear. Additionally, any use of transitional or consumption subsidies must be clearly defined and aligned with MCC timeframe and objectives.	LOW COST RECOVERY	<b>STOP:</b> Accurate understanding of cost recovery is critical to OBA success
				MEDIUM COST RECOVERY	<b>REMEDIAL ACTIONS:</b> Conduct in-depth assessment to understand the ability / willingness of each community to pay for services
				HIGH COST RECOVERY	GO
	Demand Risk	Does demand and scale of proposed OBA align with provider interest?	The OBA initiative must be of the appropriate scale to generate bids from potential providers. Demand projections for the proposed outputs must be accurate and realistic. OBA success depends on a strong understanding of the local context; therefore interest tends to be highest among local providers.	NO	<b>STOP:</b> If scale of project does not align with private sector interest, OBA cannot proceed
				PARTIALLY	<b>REMEDIAL ACTIONS:</b> Scale and scope can be altered with OBA design to align with private sector requirements
				YES	GO

	Area	Issue	Best Practices & Guidance	Country Status	Outcome & Action Steps
	<b>Performance Risk</b>	Is the private sector willing to take the delivery risk?	OBA provides payment upon delivery of output; shifting financing and delivery risks to the private sector. Provider interest to participate depends on ability to access affordable finance until service / goods can be verified and disbursements paid	<b>NO</b>	<b>STOP:</b> Without a vibrant private sector – local or international – willing to take on delivery risk, OBA cannot proceed
<b>SOME</b>				<b>REMEDIAL ACTIONS:</b> Establish financial tools to mitigate performance risk, such as guarantees	
<b>YES</b>				<b>GO</b>	

## 6.2. Process and Timeline

The way forward is an outline for evaluating OBA from conception to delivery. Following are the basic steps to consider when evaluating the applicability of OBA to meet Compact objectives.

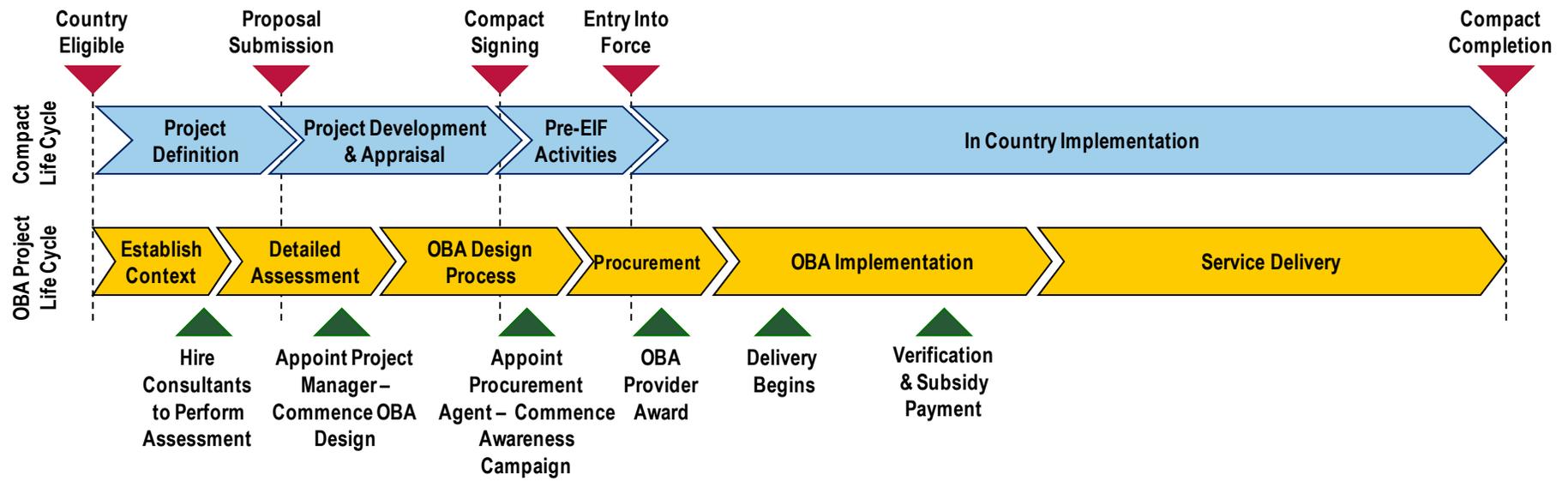
**Chart 27: OBA Process**



- STEP 1. Establish Context.** Ensuring Output-Based Aid is in line with the MCA country objectives and priorities is the first step in evaluating the applicability of OBA. If extending services to specific groups or communities that have been disenfranchised from public services is a priority, a review should be performed. This assessment should identify and prioritize target communities for the services, determine the cost sensitivity of potential service recipients, and investigate if the local regulatory and commercial environment is conducive to OBA. It will also be extremely important to establish if potential outputs can be accurately measured and verified. If the results of the high-level applicability assessment are positive, an in-depth assessment should be undertaken.
- STEP 2. Detailed Applicability/Feasibility Assessment.** Success of OBA depends on understanding local conditions and incorporating this knowledge into program design. It is recommended to hire experienced advisors to determine if OBA is applicable to local conditions. The assessment should map out all relevant factors applicable to OBA. First, the assessment needs to fully determine the demand for the service in a particular location and the ability and willingness of recipients to pay for it. In addition to any payment or demand risk, it is also important to assess how payment is to be received from users. Next, determining the amount and type of subsidy required is necessary, whether a one-off, transitional or perpetual consumption subsidy. Determining the timeframe, type and amount of subsidy will allow the assessment to determine the amount of funding required for the OBA to proceed. If determined possible from a financial and sustainability standpoint, the assessment will then need to move to mapping all potential private sector and civil society partners to identify any incumbent providers and to determine if local providers are capable and interested. A clearly-defined project scale and scope will help identify which providers are appropriate and interested. As OBA is predicated on performance-based payments, it also is necessary to understand if private sector partners will need additional assistance in terms of financing, insurance, or guarantee of payment. If the assessment finds that OBA is applicable and feasible, one can continue with the OBA design process.
- STEP 3. OBA Design Process.** Once it is decided to proceed based on the analysis, an experienced project manager should be hired to oversee subsequent implementation and delivery. Once appropriate personnel are put in place, the OBA design should describe in some detail which communities the subsidies will benefit, what type of subsidy will be provided, the subsidy ceiling per household or community, the verifiable outputs to be measured, and the process flow of service delivery and payment. This step is critical to the overall success of an OBA intervention and should be developed appropriately in consultation with OBA experts to ensure an appropriate design that meets all local needs and conditions. Intended beneficiaries should be engaged at this point for their input as they will be required to cover a portion of the delivery cost and to create early awareness of the future service.
- STEP 4. Competitive Procurement Process.** Once the OBA design is decided and agreed on, a transparent, competitive procurement process must be used to select the private sector partner(s), in accordance with MCC procurement guidelines. The procurement process should aggressively communicate the opportunity to all potential bidders, pre-qualify interested bidders, and clearly outline services required and compensation ceilings for such services. Establishing trust with the private sector is extremely important throughout each step of the process; therefore a transparent procurement process with third-party independent evaluators is recommended for selecting private sector partners—provider, verification agent, and financial intermediary.
- STEP 5. OBA Implementation.** Implementation must be coordinated closely between the government entity and the private sector partner with all guidelines and processes clearly defined and understood. The private sector firm needs to put in place all the necessary infrastructure, both to deliver the service and collect payment from users. Any available linkages to pre-finance, insurance, or guarantees should be provided immediately upon award to facilitate timely implementation. The public entity also needs to establish an independent verification entity and create an OBA fund that is able to process and manage the disbursements upon triggers based on satisfactory delivery of the public good.

**STEP 6. Service Delivery.** Once service delivery begins, the system of verification and disbursement must ensure prompt payment for satisfactory delivery of the public good. Additionally, if a transitional subsidy is utilized, the scale-down of payments must ensue along agreed-upon timeframes to ensure sustainability of the public good being provided.

**Chart 28: Output Based Aid Indicative Timeline**



*The timeline for the Private Financing of Infrastructure project life cycle is indicative and dependent on the situation.*

## 7. Resources

Global Partnership on Output-Based Aid (GPOBA), World Bank <http://www.gpoba.org>

Private Sector Development Blog – Output-Based Aid Category:  
[http://psdblog.worldbank.org/psdblog/outputbased\\_aid/](http://psdblog.worldbank.org/psdblog/outputbased_aid/)

### *Publications*

Contracting for public services: Output-based aid and its applications, Penelope J. Brook and Suzanne M. Smith, World Bank, 20001, <http://rru.worldbank.org/Features/OBABook.aspx>

The Market for AID, Michael Klein and Tim Hartford, International Finance Corporation, 2005

### *Toolkits and Databases of PPP*

World Bank Business Environment Toolkits: <http://rru.worldbank.org/Toolkits/>

Database of private participation in infrastructure: <http://ppi.worldbank.org/>

Public-Private Infrastructure Advisory Facility: <http://www.ppiaf.org/>

### *Sectors*

Energy Sector Management Assistance Program: <http://www.esmap.org/>

A guide to competitive vouchers in health: <http://www.icas.net/new-icasweb/docs/A%20Guide%20to%20Competitive%20Vouchers%20in%20Health.pdf>

Water and Sanitation Program: <http://www.wsp.org/>

# Model 4: Social Franchise

## 1. Background Description

Franchising is a mechanism which has long been used in the private sector to enable rapid expansion in the distribution of products and services. The model takes advantage of proven private sector formulas to achieve rapid and cost-effective provision through the achievement of economies of time<sup>8</sup> and scale<sup>9</sup>. Franchising has been successfully implemented in industries as diverse as health, education, professional services and hospitality, among many others.

*Think McDonalds. A Social Franchise is similar to its commercial counterparts: both rely on proven private sector formulas to provide goods and/or services of standardized quality. Efficiency, quality, and expediency in product/service delivery are all important goals to both social and commercial franchising. What's the difference then? Social Franchises are set up to address social problems, thus operating within the context of a double-bottom line: social impact and financial sustainability.*

Until recently the franchising model was used exclusively by the private sector. American fast-food chains, for example, use the franchise model to expand geographically. Franchisees help to spread a business concept rapidly, with minimal capital from the franchisor, yet still full control of the product/service and the brand.

In the 1990s, the development sphere started to recognize franchising as a new paradigm for the delivery of social services. Social Franchising entails the application of the franchisor-franchisee relationship to public services like health and education. *Social franchisors* tend to be non-profit entities set up to develop and oversee the implementation of specific business formulas. *Social franchisees* are typically small, for-profit service provision outlets.

Generally, *social franchisors* receive payments from *social franchisees* for providing branding rights and services, such as marketing, quality monitoring, training and capacity building. In turn, *social franchisees* collect payments from end-users and beneficiaries. Quality assurance and cost-recovery are explicit and essential goals in all social franchising relationships.

*A franchising contract or agreement specifies the terms of the relationship between the social franchisor, the social franchisees, and the general public which they are serving.*

### 1.1. Objective

The objective of the Social Franchise model is to rapidly and effectively deliver goods and services of standardized quality. This model is particularly applicable when governments are unable to effectively deliver public goods and services such as capacity building (i.e. SME development, Business Development Services, agricultural training), health (i.e. maternal care or infectious disease prevention and treatment) and education (i.e. primary, secondary, or vocational). The

*“A major hindrance to a wider solution for a number of challenges is that many players do not reach broad coverage. Thus, the wheel is constantly –and often poorly– reinvented... Replicating successful projects is the way forward [and] Social Franchising is one way of achieving this.”*

*Source: International Social Franchise Summit Report – Berlin, Germany, December 6, 2007.*

<sup>8</sup> Economies of Time: Cost savings achieved by standardizing business operations.

<sup>9</sup> Economies of Scale: Cost advantages that organizations obtain due to expansion. Within Social Franchises, economies of scale are achieved by spreading fixed costs associated with setting up the *social franchisor* (i.e. development of the franchise formula, operational expenses, managerial costs, etc) over a greater number of *social franchisees* and ultimately end-users participating in the network.

model can be pursued when: a) there is sustained or growing consumer demand for a product or service, b) there are trainable franchisees with skills and access to seed capital, and c) the structure of the market can sustain new entrants.

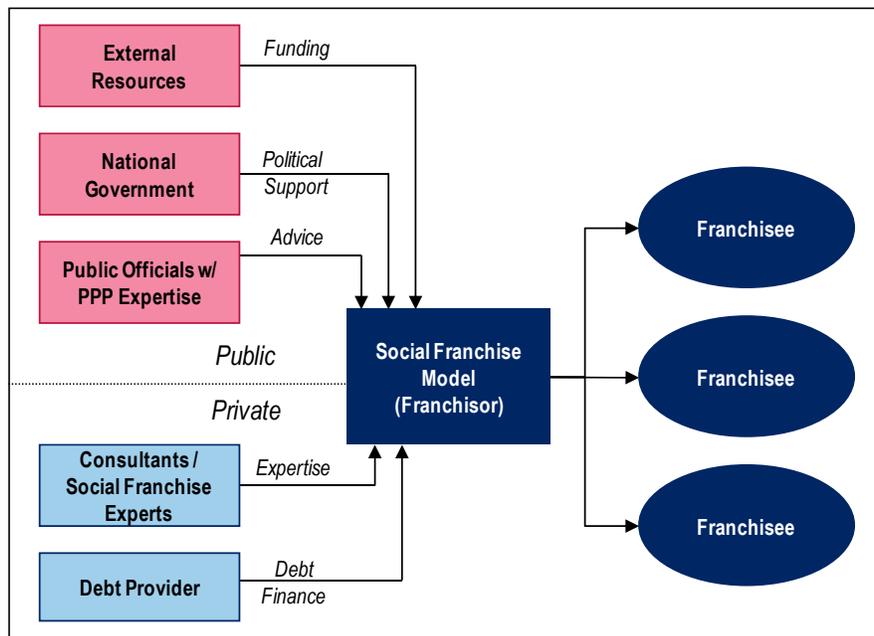
One of the main risks associated with social franchising model is overestimating the end-user’s ability to pay, which can lead to financial difficulties for the social franchisee. Although financial self-reliance is ideal, it is important to assess the critical nature of the services being provided under the franchising scheme, as it is possible for continued service provision to warrant sustained support from the public sector. This is the case when the services provided have a substantial social impact (see the Aflatoun case study below).

**1.2. Structure**

Although social franchises come in many shapes and forms, the most basic structure assumes the participation of a *social franchisor* and one or more *social franchisee(s)*. *Social franchisors* tend to be non-profit entities set up by external agents (donors, national governments, other NGOs) at the local or national level to tackle social problems such as rural poverty, illiteracy, maternal mortality, and others. *Social franchisors* can address these challenges by developing and testing business formulas that guide *social franchisees* in the process of providing social services to end-users. Typically, *social franchisees* are small service provision outlets motivated by profit that provide services such as technical training, education, and maternal health.

The diagram below portrays this basic structure with two variants. First, two private sector entities—social franchising consultants and debt providers—are included to illustrate the relevance of the private sector not only among *social franchisees*, but also among *social franchisors*. To the extent that the Social Franchise is “bankable”— i.e., that end-users are able to pay for services received—debt instruments may assist in financing the establishment of a Social Franchise above and beyond donor and public sector funds. As expected, social franchising experts may assist in designing and establishing the Social Franchise.

**Chart 29: Social Franchise Structure**



### 1.3. Advantages

The rigor in the design of the Social Franchise and its flexibility in service delivery imply a number of advantages over other forms of service provision:

- **Sustainability** – In general, Social Franchises incorporate a fee-for-service component to be paid by final service users to franchisees; and by franchisees to franchisors. To the extent that a social franchising network is able to capture a consistent or growing revenue stream from end-users, a Social Franchise may achieve self-sustainability within a relatively short time-span.
- **Rapid Expansion in Service Provision** – With a centralized structure, Social Franchises can advance service delivery on many fronts simultaneously to achieve economies of time and scale. This plays particularly well in situations where the service delivery is imperative to the well-being and growth of the community (i.e. education, training, health).
- **Quality Assurance** – To the extent that Social Franchises adhere to pre-specified business formulas, their products and services tend to have similar characteristics. This is important in ensuring that services delivered across different geographical areas are of similar quality.
- **Flexibility** – Although Social Franchises offer service provision of standardized quality, the array of services does not have to be standard. Instead, service provision can be adapted to accommodate local service needs and the ability to pay.
- **Ease of Monitoring and Evaluation** – Due to its centralized nature—one franchisor, several franchisees—conducting monitoring and evaluation exercises is relatively straightforward within Social Franchises. Most franchisors require their franchisees to submit regular information regarding operations, revenue, service reach, etc. As a result, donors can have access to data that inform impact assessments and sustainability.
- **Support of the Private Sector** – Social Franchises have the potential to leverage social investments and build the private sector in developing nations. By accelerating entrepreneurial learning and facilitating the exchange of processes and technologies, Social Franchises can foster local enterprise and market development. Moreover, Social Franchises may use spare capacity in the private sector to deliver public services. In this way, the model may reduce unemployment amongst newly-trained professionals and technicians.

### Variants of Social Franchise

- **Fractional:** Under this arrangement, existing service delivery outlets add only a specified set of services to their practice. In this case, the franchise system applies only to those services that have been added. The co-branding (i.e. presenting two different logos in the same brochure) of franchised services and non-franchised services is common practice.
- **Stand-alone:** Under a stand-alone arrangement, *social franchisees* are the exclusive providers of the *social franchisor's* goods and services. In this case, the franchise system applies to all services provided. This variant often demands significant investments from *social franchisees* into new service outlets.
- **Plural:** Under a plural Social Franchise arrangement, the *social franchisor* owns and operates some of the franchised outlets. These outlets can serve as model training facilities, and profits can support the overall franchise operations.

## 2. Roles

**Chart 30: Role of the Private Sector, MCA and/or Government in the Social Franchise Model**

Private Sector	MCA and/or Government	
<ul style="list-style-type: none"> <li>▪ Acting as social franchisees</li> <li>▪ Acting as social franchisors</li> <li>▪ Acting as social franchising experts/consultants</li> <li>▪ Providing financing for the establishment of “bankable” Social Franchises</li> </ul>	<ul style="list-style-type: none"> <li>▪ Regulating service provision</li> <li>▪ Deregulating specific sectors of the economy to include private sector involvement</li> <li>▪ Establishing quality standards</li> <li>▪ Establishing pricing parameters</li> <li>▪ Collecting and disseminating sector information</li> <li>▪ Funding the creation and establishment of the franchise model</li> </ul>	<ul style="list-style-type: none"> <li>▪ Tendering out an RFP to select the most appropriate private sector franchisor (if relevant)</li> <li>▪ Funding sector research</li> <li>▪ Providing seed operational capital</li> <li>▪ Supporting physical infrastructure development</li> <li>▪ Funding knowledge infrastructure development</li> <li>▪ Affording expert consulting services</li> </ul>

### 2.1. Private Sector

Social Franchises involve the private sector in a number of ways. In most cases, the private sector is manifested through the involvement of *social franchisees*. Generally, *social franchisees* are small-scale service delivery outlets motivated by profits.

However, the private sector may also be represented through one or more *social franchisors*. As entities directly involved in the training and development of the franchising network, *social franchisors* help *social franchisees* advance their managerial and technical skills.

Finally, the private sector may be represented through expert consultants on Social Franchises and financiers interested in the “bankability” of the Social Franchise.

### 2.2. Government

The government’s role switches from providing public services to regulating service provision through the private sector. First, the government must ensure that key performance indicators are being collected and analyzed. Subsequently, the government must render information publicly available. This level of transparency enables the end-users to increase their relative bargaining power. In some cases, governments must also deregulate to achieve service provision through the private sector. Furthermore, governments must ensure that the legal framework welcomes the participation of the private sector in the delivery of public services. This can be accomplished through the creation of laws that protect private interests and defend the validity of contracts and licensing agreements.

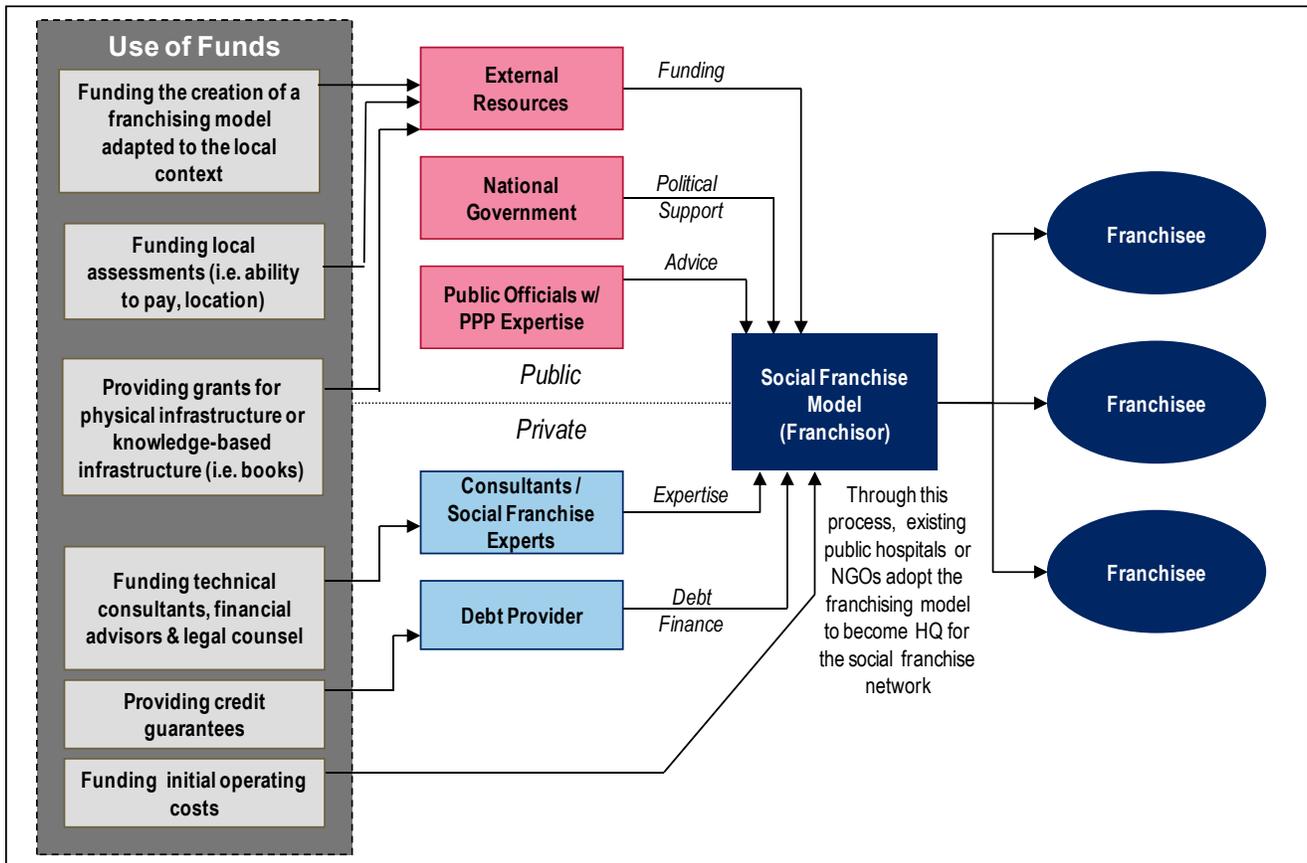
### 2.3. MCA

As laid out in Chart 31, the Compact can fund the creation of a Social Franchise model that is tailored to the specific country context. This may imply: a) tendering out an RFP to select the most appropriate private sector franchisor, b) providing funds for in-depth sector research, and/or c) providing seed operational capital. Additional roles for the MCA may include: d) funding infrastructure development projects embedded in the Social Franchise (i.e., construction of hospitals), e) funding knowledge

infrastructure (i.e., paying for educational materials contextualized according to location and language), and/or f) affording expert consulting services for developing and implementing Social Franchises.

To illustrate, the Compact could cover the costs of setting up and building the infrastructure needed to render franchised services (i.e. training centers, clinics, schools). In turn, these investments would result in substantially lower fees required from ultimate service beneficiaries, thus rendering the project viable for poorer end-users.

**Chart 31: Possible Uses of Funds in the Social Franchise Model**



### 3. MCC Parameters

*Avoiding Market Distortion:* Compact funding should be utilized in ways that do not create market distortions and disrupt existing economic balances. Grants and subsidies should be used only to the extent that they address market failures. Generally, Social Franchises operate in areas not previously serviced by the private sector. The limited ability of end-users to afford services has prevented the establishment of the private sector. In these instances, supporting Social Franchises is not distorting the market, but rather catalyzing its creation.

*Accountability:* Compact funds are subject to a high level of accountability and transparency as part of MCC rules and regulations. Due to the centralized nature of Social Franchises, monitoring and evaluation exercises can be relatively straightforward. *Social franchisors* typically require *social franchisees* to submit regular reports on operations, revenue, service reach, etc. Thus, through Social Franchises, MCC would have ready access to valuable information.

*MCC Timeframe and Compact Length:* Social Franchises are typically expected to achieve operational sustainability within the first five years of existence so the Compact timeframe fits well with their implementation.

#### 4. Key Success Factors

This section focuses on the key factors that make a Social Franchising model successful. These key success factors are derived from global best practices and lessons learned. In particular, it should be noted that Social Franchises are complex organizations that demand a high level of coordination and commitment from all stakeholders. In the absence of these two ingredients, Social Franchises will not flourish and will likely prove unsustainable.

In the process of implementing a Social Franchise, it is imperative to identify an appropriate Social Franchise strategy for each type of service delivery need. Social franchising tends to work best in the provision of essential public services (i.e. education, training and health). It is also important to determine outright the standards that the franchisee should be held to. These standards should correspond to local needs and local conditions. Once these tasks are accomplished, MCAs should devise a flexible implementation strategy that builds on lessons learned.

- **Franchising-friendly policy environment:** The policy environment must be considered. Having relaxed regulations that allow licensing and accreditation as well as franchising-friendly policies are important determinants for success of Social Franchises. Ensuring quality in the private sector works best when the public sector establishes clear leadership by articulating norms and standards of care to service beneficiaries. Recognition of the private sector's key role in bringing about efficiencies to the delivery of public goods must be established early on.
- **Segmentation of the target population:** Segmentation allows Social Franchises to provide services to targeted populations that would otherwise not be able to afford them. To do the contrary, that is to provide free services to people able to afford payment, is to introduce perverse incentives in the market.
- **Diversified funding sources:** Studies and consultations have revealed that Social Franchises could greatly benefit from diversifying their funding sources. This means not only diversifying external sources of funding (i.e. donors, financial institutions, parent organizations) but also internal revenues. For instance, collecting fees for curative services (which are highly demanded) may support the provision of preventive services (usually in less demand). Diversified funding sources allow franchises to achieve earlier financial sustainability.
- **Quality of providers:** Aside from carefully selecting each franchisee, it is important to find ways to *retain* good franchisees. Having high human resource management standards and paying attention to the benefits of membership within the franchise are two ways in which franchisees can be retained. On the other hand, ensuring that credible threats (i.e. disenfranchisement) exist if franchisees under-perform is also a factor worth considering.

#### ***PROSALUD'S Diverse Service Portfolio Results in Higher Cost Recovery***

*PROSALUD (a Social Franchise in Health operating in Bolivia) has tested various strategies for achieving financial sustainability, including cost-sharing arrangements with physicians, insurance products, and a sliding-fee scale for the provision of curative and preventive care. By cross-subsidizing the provision of preventive care through the revenues created through curative services, PROSALUD has been able to assist poor households in services. By 2007, PROSALUD was well on its way to achieving a 100% cost-recovery rate.*

- **Franchising motivation:** While Social Franchises can be a powerful way to involve the private sector in public service provision, the shortcomings inherent in this model ought to be considered. Low motivation to succeed among franchisees can be a serious challenge. Thus, franchisees ought to be carefully selected. They need to be both technically savvy and entrepreneurially oriented. Otherwise, their motivation could dwindle at the first signs of difficulty, which would undermine franchise operations and result in high franchisee turnover.
- **Monitoring progress:** To ensure quality standards in Social Franchisees, it is essential to measure progress continually. This is accomplished by conducting: a) regular monitoring visits to franchisee premises, b) close scrutiny of financial and sales reports, c) spot-checks and visits by inspectors, and d) social outcome assessments. Early on, it is also important to consider the feasibility of the Social Franchisee's long-term sustainability.

Other factors worth considering at the time of setting up a Social Franchise are:

- It is important to develop a strong *social franchisor* – managerial expertise, training capabilities, ongoing training & support, oversight, monitoring & evaluation.
- Organizational responsiveness and flexibility are key factors for sustainability. Changing market conditions demand the existence of flexibility mechanisms within the Social Franchise.
- Utilizing cost-effective means of monitoring and evaluation will ensure the sustainability of these systems. It is best to choose only a few, key indicators that will be monitored.

## 5. Case Studies

Although Social Franchises exist in both developed and developing countries, their applicability to developing countries has proven challenging for two important reasons. First, legal and regulatory environments may require modifications and, second, franchisees in the developing world generally do not have the seed capital needed to begin a franchising relationship. Nonetheless, the potential impact of Social Franchises in developing countries cannot be underestimated, as they carry an inherent double bottom line: the creation of profit and the provision of goods and services with broad social value (i.e. education, SME training, health services).



PROSALUD	
<b>Players</b>	<b>Sector</b>
<ul style="list-style-type: none"> <li>▪ Government of Bolivia (GOB)</li> <li>▪ USAID Bolivia</li> <li>▪ Management Sciences for Health</li> </ul>	Health
	<b>Location</b>
	Bolivia
<b>Analysis</b>	
<p>The PROSALUD model arose in Bolivia amid political and economic crises in the 1980s, which nearly collapsed the public health sector. Lack of access to high-quality basic health services was reflected in high infant and maternal mortality rates.</p> <p>With USAID support, PROSALUD was established as an independent NGO and two franchises opened in large municipalities. PROSALUD represents a network of decentralized clinics and a referral hospital, supported by a national office and six regional offices. The network is an example of a <i>Plural Social Franchise</i>, which means that PROSALUD, as the <i>social franchisor</i>, owns and operates its own franchisees. To establish PROSALUD, donors provided support in the following areas: organizational design, financing of physical infrastructure, capacity-building and initial operating expenses.</p> <p>PROSALUD offers a wide range of health services, from preventive to curative services. The franchise has grown to become one of the most technologically advanced health networks in Bolivia. During its early years, the network focused on urban and peri-urban areas, but it has recently branched out into more rural locations. The core of this sequential approach to service delivery was the achievement of financial self-reliance. Coupled with having users who could afford the costs of basic health service provision, this prudence recently resulted in operational sustainability.</p> <p>The distinctive features of PROSALUD include:</p> <ul style="list-style-type: none"> <li>▪ An integrated, comprehensive package of services offered 365 days a year</li> <li>▪ Cost recovery of new franchises within 9 to 12 months</li> <li>▪ Market research to scale up clinic locations and create client-focused services</li> <li>▪ Standards for service quality</li> <li>▪ Merit-based selection for employees and ongoing training</li> <li>▪ Community involvement (i.e. health fairs, cooperation with women’s groups).</li> </ul> <p>The support and guidance received from USAID/Bolivia representatives in the Office of Health and Human Resources (HHR) and the technical assistance received from Management Science for Health were crucial in the design and development of the Social Franchise model. Decentralization and the renewed democratization of municipal governments—factors present in the Bolivian context through the early stages of PROSALUD—fostered broader participation in health concerns from both public and private agents. Political support for the Social Franchise, expressed through public sector contracts, greatly assisted the infrastructural development of the network.</p> <p>Today, PROSALUD manages an extensive and innovative network of high quality, low-cost, client-focused services. PROSALUD serves over 700,000 low- and lower middle-income Bolivians (about 15-20% of the total population).</p>	
<b>Key Learning Points</b>	
<ul style="list-style-type: none"> <li>▪ <b>Market Segmentation</b> – The PROSALUD model has made important inroads in segmenting the market according to socio-economic standing, age and gender, as well as type of services demanded (curative vs. preventive). This has been crucial to achieving an optimal pricing scheme.</li> <li>▪ <b>Cross-Subsidization</b> – Segmentation also has allowed PROSALUD to create cross-subsidization schemes. In this way, highly demanded curative services subsidize poorly demanded, but crucially important, preventive services. Similarly, better-off urban area hospitals provide subsidies for relatively poor rural health service outlets.</li> <li>▪ <b>Human Resource Excellence</b> – To achieve consistent quality in service provision, it has been important for PROSALUD to develop excellent human resource management procedures. In this way, PROSALUD provides competitive compensation packages and ongoing trainings to administrative personnel and nurses and profit-sharing schemes to doctors and specialists, practices that have kept staff turnover to a minimum.</li> </ul>	

Aflatoun – Child Social & Financial Education	
<i>Players</i>	<i>Sector</i>
<ul style="list-style-type: none"> <li>▪ International Child Support (ICS)</li> <li>▪ Skoll Foundation</li> <li>▪ Plan International</li> <li>▪ Ashoka</li> <li>▪ The Schwab Foundation for Social Entrepreneurship</li> <li>▪ Foundation to Earth, Mankind through Inspiration and Initiative (FEMI)</li> </ul>	Education
	<i>Location</i>
	Uganda, Nigeria, Zimbabwe, Mali, South Africa, Vietnam, Philippines, Argentina, Egypt, Serbia.
<i>Analysis</i>	
<p>Based on a successful pilot that taught school children in India how to save money, the Aflatoun network was started in 2005 and has grown into 11 national chapters. Using multiple and existing local implementation partners that act as franchisees, the program equips children aged 6 to 14 with knowledge and skills that help them become economically self-reliant. The program is geared at imparting awareness on the banking system and the benefits of savings. In this way, Aflatoun allows children to break away from a generational cycle of financial illiteracy. Aflatoun's vision is to "build a global movement of Aflatoun children and 400 partners who commit over \$25 million in resources and advocate for policy change supporting Child Social and Financial Education (CSFE)."</p> <p>With local implementation partners in eleven countries, the Aflatoun network seeks to grow by adopting a social franchise framework. Currently, the program is made of an Executive Secretariat which seats within the premises of the Dutch Central Bank. The Secretariat, acting as franchisor, supports the efforts of local implementation partners by:</p> <ul style="list-style-type: none"> <li>▪ Providing technical assistance on the program</li> <li>▪ Facilitating the sharing of best practices</li> <li>▪ Improving the core program material</li> <li>▪ Providing support for scale-up activities</li> <li>▪ And, creating global awareness about the social and economic rights of children</li> </ul> <p>Local implementation partners vary from country to country. In some cases, they are for-profit entities. In others, they are local NGOs seeking to support the objectives of the program. In Peru, for instance, Aflatoun has teamed up with Vision Solidaria—an existing local NGO that invests in youth initiatives—to start the program's chapter. Together, these two organizations have trained 116 teachers from 25 schools within less than 2 months.</p> <p>Although local implementation partners currently receive financial support from Aflatoun's Executive Secretariat, it is expected that national education budgets will eventually provide financial support to the program. This can only be achieved, however, once the program's cost per child becomes low enough so that it can be absorbed by national curricula. By centralizing the costs associated with developing programs, running the organization, and conducting trainings, Aflatoun seeks to bring down its program's costs by 2010 –time at which accelerated scale-up is scheduled to begin.</p> <p>The Executive Secretariat of Aflatoun currently receives financial support from ICS, the Skoll Foundation, Plan International, Ashoka, the Schwab Foundation for Social Entrepreneurship, and FEMI. To date, the project has trained over 3,000 teachers and educated over 100,000 school children on financial literacy and awareness in 11 countries.</p>	
<i>Key Learning Points</i>	
<ul style="list-style-type: none"> <li>▪ <b>Scalability &amp; Feasibility go Hand-in-Hand</b> – While Aflatoun has rolled out its training programs in 11 countries, the organization recognizes that achieving cost savings is essential to further roll outs and further roll outs are essential to achieving cost savings. Without the support of donors and partner organizations, Aflatoun would never be able to grow to the point at which its product's cost is low enough to be afforded.</li> <li>▪ <b>Sustainability Plans can be Flexible</b> – Most social franchises seek to attain financial sustainability by recovering fees from end-beneficiaries. In the case of Aflatoun, however, it would be difficult to expect fees from children. Instead, the program expects to recover its costs directly from national governments. To the extent that services provided by the social franchise are essential (i.e. primary education), Social Franchises may merit public support.</li> </ul> <p>Source: <a href="http://www.aflatoun.org">www.aflatoun.org</a></p>	

Mwenzi Kali Program	
<i>Players</i>	<i>Sector</i>
<ul style="list-style-type: none"> <li>▪ <b>Government of Kenya (GOK)</b></li> <li>▪ <b>K-Map (local NGO)</b></li> <li>▪ <b>Department for International Development (DFID) / British Council</b></li> </ul>	<b>SME Development</b>
	<i>Location</i>
	<b>Kenya</b>
<i>Analysis</i>	
<p>The Mwezi Kali Program (est. 1994) was a Social Franchise created jointly by DFID and K-Map to offer business development services (BDS) to micro and small enterprises (MSE). Using multiple and existing local service provider organizations (SPOs) that act as franchisees, the project aimed to: i) help individuals start micro and small businesses through the Business Startup Project, and ii) assist those already in business expand their operations via the Business Growth Project. Although the costs of training were partly subsidized, end-beneficiaries contributed between 40% and 50% to training expenses.</p> <p>Involving face-to-face classroom training, followed by a series of on-site individual business counseling sessions, the program helped business owners address challenges through: planning, competitive landscape analysis, competitive advantage identification, debt management, and others. The project approach was known as the “PESOS formula,” and involved:</p> <p><b>P</b> – Preparing the learner psychologically for learning  <b>E</b> – Explaining to the learner the concepts and new techniques to be learned  <b>S</b> – Showing the learner by demonstrating how the technique works  <b>O</b> – Observing the learner practice the newly acquired skills and assisting where necessary  <b>S</b> – Supervising the learner when applying the technique and skills through visits and counseling sessions.</p> <p>The social franchise was structured as follows: the Mwezi Kali Program, acting as the franchisor, paid a bursary of \$100 to <i>for-profit</i> service provider organizations for each participant recruited and trained. The bursary afforded the costs associated with market development, institutional capacity building and marketing support, and it served as an incentive to develop additional programming. In turn, franchisees, or SPOs, offered business development services to micro and small enterprises for competitive fees.</p> <p>Evaluations drawn at the end of the first phase of implementation indicated that assisted businesses grew by an average of 33% per year and added three new employees each. For this reason, the program received additional funding from DFID in 1999. By 2003, there were ten pre-selected SPOs located in strategic towns across Kenya: Mombasa, Nairobi, Embu, Nakuru, Kisumu, Kakamega, and Eldoret. Over 1200 entrepreneurs have undergone training and counseling under the Mwezi Kali Program countrywide both for business startup and business growth initiatives.</p> <p>At the end of 2003, the Mwezi Kali Program (the franchisor) was phased out by DFID. However, the project had accomplished a key objective: <u>market development</u>. Mwezi Kali allowed a number of SPOs (former franchisees) to become financially viable competitors in the marketplace, thus ensuring programmatic sustainability. As Kiringai Kamau, owner of an SPO, explained to our team: “I am a product of Mwezi Kali. As a client who was trained to start my business, I became a business counselor/mentor for the program. Later on, when [the project was phased out], I became a service provider.” Kiringai Kamau is still in business today and has, since 2003, started two other companies: <a href="#">Octagon Data Systems Limited</a> and <a href="#">WillPower Enterprise Development Limited</a>, as well as <a href="#">VACID Africa</a> –an NGO providing Mwezi Kali-type services to communities.</p>	
<i>Key Learning Points</i>	
<ul style="list-style-type: none"> <li>▪ <b>BDS Marketing</b> – Being intangible, the process of marketing BDS requires an aggressive and entrepreneurial approach to reach the MSEs. MSE owner-managers are often skeptical about training since they do not see immediate, tangible outcomes. To counter this, it is important to conduct awareness campaigns and provide incentives for recruitment</li> <li>▪ <b>Program Delivery</b> – Flexibility in schedules and venues for training is critical. Under MK, this has usually taken place near the entrepreneur’s premises and outside the normal working hours, including weekends. Various innovative techniques should be used to motivate learners to acquire new business skills</li> <li>▪ <b>Training of BDS trainers</b> – It should be noted that it often is necessary to train more trainers than may be needed because of the high attrition rate. These efforts should be on-going.</li> <li>▪ <i>Source: Kiringai, Kamau</i></li> </ul>	

## 6. Way Forward

This section aims to help MCC-eligible countries design successful Social Franchise programs. Based on the key success factors identified earlier, this tool has been developed to help country teams think through all the key elements to have in place.

### 6.1. Partnership Design Tool

The Partnership Design Tool provides support to MCC-eligible countries to design Social Franchise programs. The tool lists the critical areas countries need to look at in order to have a successful program.

**Chart 32: Partnership Design Tool – Social Franchise**

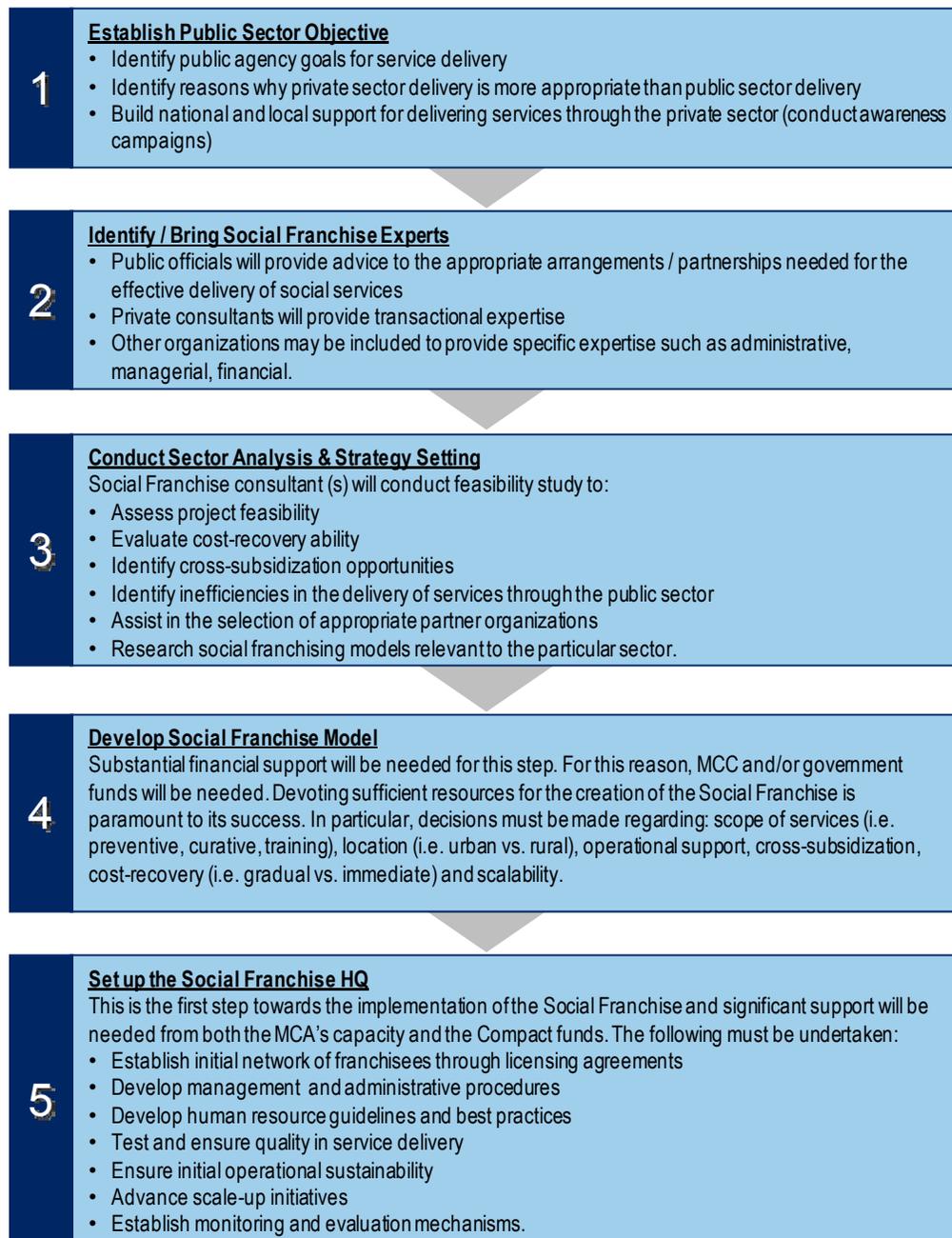
	Area	Issue	Best Practices & Guidance	Country Status	Outcome & Action Steps
Legal and Policy Framework	Legal Framework	Is an adequate legal framework in place?	A Social Franchise (SF) requires appropriate legal protection for private ownership. The legal framework should include provisions that aim to insulate the SF from government interference	NO	<b>STOP.</b> A SF is not possible without an appropriate legal framework
				WEAK	<b>REMEDIAL ACTIONS.</b> Amend laws / ordinances where necessary
				YES	<b>GO</b>
	Policy Environment	Is the policy environment conducive to private sector service provision?	Social Franchises require policies that accommodate licensing agreements	NOT CONDUCTIVE	<b>STOP.</b> In the absence of policies that protect private ownership, both franchisor and franchisee would be too vulnerable to political risk.
				WEAK	<b>REMEDIAL ACTIONS.</b> Conduct a review of the policy environment and suggest solutions to the government.
				CONDUCTIVE	<b>GO</b>
Government Capacity and Structure	Expertise in-Country	Is there in-country expertise in forming Social Franchises?	Due to the critical importance of creating robust models, SFs demand technical capacity up-front. When absent, this capacity can be attained through technical advisories and/or partnerships with experienced organizations	NON-EXISTENT	<b>REMEDIAL ACTION.</b> The government should tap into external consulting expertise. <b>STOP.</b> The government should think of a less complicated PSI model such as Outsourced Management.
				WEAK	<b>REMEDIAL ACTION.</b> The government should tap into external consulting expertise
				EXISTENT	<b>GO</b>
	Access to Information	Can the public sector provide relevant information regarding service	The success of a SF depends on its ability to assess the market accurately. The public sector may be instrumental in providing	NOT AVAILABLE	<b>STOP.</b> Without appropriate information, it would be extremely difficult to forecast the revenue stream, cost structure, break-even point, etc.
				PARTIALLY	<b>REMEDIAL ACTION.</b> Conduct surveys, assessments, and/or

	Area	Issue	Best Practices & Guidance	Country Status	Outcome & Action Steps	
		delivery? Is sector information available? Is it possible to assess supply and demand?	some of this information, particularly if it was previously involved in service delivery. The ability to conduct primary and secondary sector research is critical	AVAILABLE	other forms of research to assess the viability of introducing private sector delivery of services	
				AVAILABLE	GO	
	Political Will	Is there political will behind private sector participation?	Opting for private delivery of public goods must be a government choice after an in-depth analysis. The highest government levels must embrace private sector involvement as opposed to being forced into it, which will result in problems down the road	NONE	STOP. Lack of public sector support in the development of SFs will render difficult the creation of a good and sustainable franchising model	
				SOME	REMEDIAL ACTIONS. Conduct awareness campaigns that elucidate the benefits of service provision through the private sector to attain commitments from public officials	
				STRONG	GO	
	Government Control	Is the government willing to cede control over operations?	Social Franchises allow governments to benefit from private sector efficiency in the delivery of public services. This translates into a loss of positive publicity and/or economic resources associated with service delivery. The government must be willing to cede control	NO	STOP. If the government is not willing to relinquish control over service delivery, perverse incentives may appear in the development of SFs	
				PARTIALLY	REMEDIAL ACTIONS. Identify a 'champion' within the public realm who may advocate for the creation of a SF.	
				YES	GO	
	Economic, Commercial and Financial Risks	Cost-Recovery	Can the market afford fees that allow cost recovery? If so, how long before cost recovery can be attained? Will there be opportunities to diversify revenue (i.e. sale of service and products)?	The government must assess whether expected fees from service delivery can cover the costs associated with operating the SF. Social Franchises are usually expected to be self-reliant within a pre-determined period of time. It is important to create reasonable expectations, particularly in delivering basic public services to the poorest communities. Cross-subsidization may be an option.	NO COST RECOVERY	STOP. The private sector will not be interested and/or sustainable if it cannot recover costs.
					SOME COST RECOVERY	ALTERNATIVE OPTION. Conduct cost-benefit analyses to assess the possibility of contributing public sector funding for the continued provision of social services through the private sector.
HIGH COST RECOVERY					GO	

	<b>Economies of Scale</b>	Can economies of scale be realized within service delivery? If so, how long will it take for them to be evident?	It is important to consider that SF networks are expected to become financially viable as they grow. This may result from efficiencies achieved in training, capacity building, product distribution, procurement, and/or advertising	NONE	<b>STOP.</b> The sector may not be particularly suited to welcome a franchising arrangement. Worse, dis-economies of scale (such as higher per unit costs of management) may be present in situations of high complexity
				SOME	<b>ALTERNATIVE OPTION.</b> If economies of scale can be realized at later points, then public authorities may decide that it is desirable to provide extra funds at the beginning of the franchising arrangement
				LARGE	<b>GO</b>
	<b>Commercial Risk</b>	What are the risks that service delivery if the Social Franchise fails financially?	Social Franchises are generally created to provide basic public services. If financially unsound, service delivery may suffer disruptions. Thus, it is necessary to conduct sensitivity analyses (e.g. who will provide funding for continuing operations if cost-recovery expectations fall 50% short? and what if they fall 70% short?)	HIGH	<b>STOP.</b> If commercial risks in private sector service delivery are too high, then public service delivery may be more appropriate. This holds particularly true in urgent services such as the prevention and treatment of HIV/AIDS
				SOME	<b>ALTERNATIVE OPTIONS.</b> To provide emergency operating funds for the Social Franchise. This must be done up-front to prevent moral hazard (i.e. franchisees will not have an incentive to become financially viable if they think the govt. will bail them out in troubled times)
				LOW	<b>GO</b>
<b>Private Sector Capacity</b>	<b>Institutional Capacity</b>	Will the franchising network have sufficient institutional capacity to conduct rigorous business planning? Will it be able to respond to changing market conditions?	Any plan to achieve scalability must be based on a tested model that is built into the business plan. The business plan must demonstrate a thorough understanding of consumer and provider markets. To the extent that they can anticipate opportunities and constraints within consumer and provider markets, SFs will be strengthened	NONE	<b>STOP.</b> Weak SFs are no better than weak public institutions. As a result, investments in franchising systems would not be warranted
				WEAK	<b>REMEDIAL ACTIONS.</b> Hire external consultants to strengthen the institutional capacity of the franchisor
				STRONG	<b>GO</b>

## 6.2. Process and Timeline

**Chart 33: Social Franchise Process**

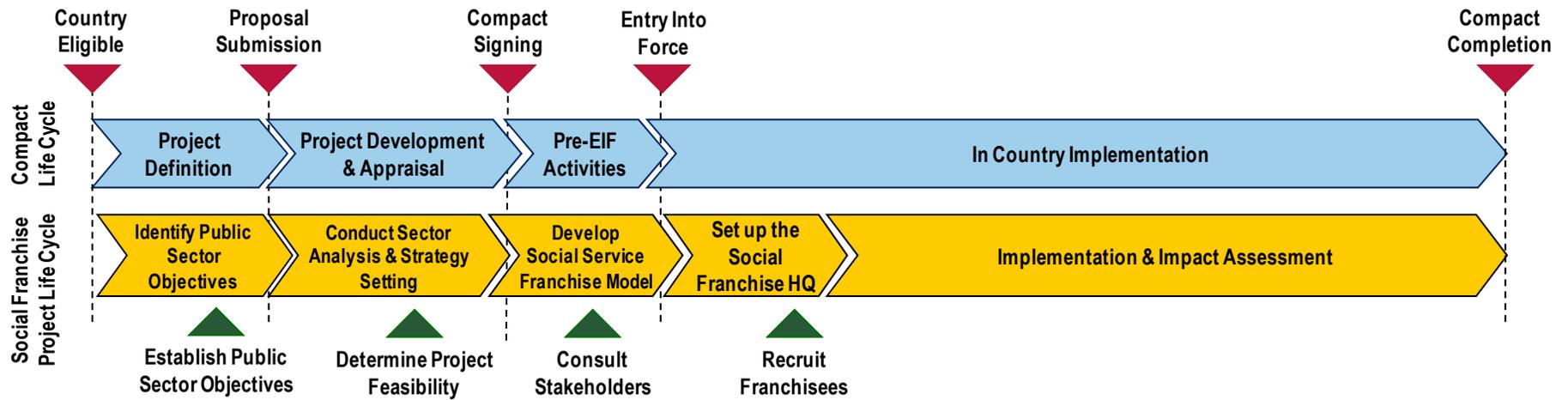


The way forward under this model demands a thorough understanding of its relevant service sector. Service sectors range from addressing rural poverty (i.e. agricultural business development services) to providing basic health care. Steps 1 through 3 must take place before Compact Signing. Depending on lead times, Step 4 may take place after Compact Signing but before Entry into Force (EIF). A blueprint for the Social Franchise is needed for EIF. Thus, it is expected that Step 5 will occur in tandem with the in-country implementation.

- STEP 1. Establish Public Sector Objective.** At this stage, it is important to clearly and succinctly identify public agency goals for service delivery. What needs to be accomplished? Where? What is the target population? This must be followed up by an analysis as to why the private sector is more appropriate than the public sector for service delivery within this activity. What types of efficiencies could the private sector bring? Are economies of scale achievable? Will the private sector be able to handle the relevant managerial challenges? Once proven that the private sector is needed, then momentum must be built around its involvement. To a degree, this will avoid confusion and misinformation.
- STEP 2. Identify / Bring Social Franchise Experts.** Public officials should be included in this process, as they may be able to provide advice regarding the appropriate arrangements / partnerships needed to devise an appropriate system for the effective delivery of social services. Concurrently, private consultants can bring in transactional expertise to formulate a list of questions to be answered in Step 3. Other organizations may be identified and included to provide specific expertise such as administrative, managerial and financial. This second step consists of realizing the political, technical and operational clout needed to carry out the sector analysis and start analyzing franchising agreement options.
- STEP 3. Conduct Sector Analysis and Strategy Setting.** In this step, the Social Franchise consultant will conduct a feasibility study to:
- Assess project feasibility
  - Evaluate cost-recovery ability
  - Identify cross-subsidization opportunities
  - Identify inefficiencies in the delivery of services through the public sector
  - Assist in the selection of appropriate partner organizations
  - Research social franchising models relevant to the particular sector.
- STEP 4. Develop Social Franchise Model.** Substantial financial support will be needed for this step. Devoting sufficient resources for the creation of the Social Franchise is paramount to its success. In particular, decisions must be made regarding: scope of services (i.e. preventive, curative, training), location (i.e. urban vs. rural), operational support, cross-subsidization, cost-recovery (i.e. gradual vs. immediate) and scalability. A detailed plan must be produced with input from those stakeholders identified in Step 2 as well as the general public. The more consultative this process is, the better its chances for success.
- STEP 5. Set up the Social Franchise Headquarters (HQ).** Once the design of the Social Franchise has been completed, the next step is to begin implementation of the franchising network. First, a *social franchisor* outlet must be set up and the recruitment of *social franchisees* must begin. Most Compact support should be expected to be provided at this stage, as implementation of Social Franchises is costly. An initial network will help the social franchisor establish the following:
- Management and administrative procedures
  - Human resource guidelines
  - Monitoring and evaluation mechanisms

It is crucial to ensure that mechanisms that guarantee the quality of the services provided are in place. This may include an array of incentives and disincentives that reward good performance and discourage under-performance. Cost-recovery projections must be refined and financial sustainability time estimates be made. Discussions on scaling-up the franchising network are important to the extent that sustainability is linked to greater scale. In most Social Franchises this is generally the case.

**Chart 34: Social Franchise Indicative Timeline**



*The timeline for the Private Financing of Infrastructure project life cycle is indicative and dependent on the situation.*

## 7. Resources

### *General Resources*

The Social Enterprise Alliance, a network of social entrepreneurs with resources on social enterprises):  
<http://www.se-alliance.org/>

Social Franchise, a U.S.-based social franchising consulting firm: <http://www.socialfranchise.com/>

Private Sector Partnerships for Better Health, a USAID initiative: <http://www.psp-one.com/>

Community Wealth, a social enterprise consulting firm with a good reputation:  
<http://www.communitywealth.com/about.htm>

The International Franchise Association: <http://www.franchise.org/>

# Financial Tools

## 1. Introduction to Financial Tools

The preceding sections describe various models that MCAs can use to encourage private sector participation in Compacts. This section presents financial tools they can use in conjunction with the models to facilitate the structuring of a project and/or to leverage additional funding. Per MCC’s legislation, Compacts can only consist of grant funds. However, MCA can use Compact grant funding for these types of financial tools. Through these tools, MCA itself is not going to take the role of a banker, investor, or insurer. This is best done by organizations which have it as their core business practice. MCA should be the facilitator by bringing in these financial partners. MCA could also provide financial support to secure these products if the private sector is not willing or able to secure them on its own.

The table below shows how the financial tools described in this section can be used in conjunction with the models described in the previous section. When used together, these tools reduce risks for the private sector and encourage their participation in more Compact-supported activities.

**Chart 35: Financial Tools Applied to Models**

Financial Tools	Models	Application
<b>Guarantees</b>		
Mitigates risk associated with a loan or bond issue. These instruments, issued by a third-party “guarantor”, guarantee that at least a portion of the loan/debt issue will be repaid. If the borrower defaults, the guarantor will pay the agreed-upon amount.	PFI	A credit guarantee enhances a PFI transaction by protecting the lender from a private sector entity defaulting on its loan.
	Outsourced Management	A credit guarantee enhances the credit of lease transactions for working capital loans.
	OBA	Guarantees help provide access to finance, which enables capable providers that lack access to finance to bid and helps mitigate performance risk in environments without established financial access for providers.
	Social Franchise	Guarantees can be useful for Social Franchises in two ways. First, they can guarantee loans that are associated with network infrastructure development, if not already in place, when an income stream is expected. Second, they can guarantee a working capital line of credit.
<b>On-Lending</b>		
A variation of debt finance in which a primary financial institution or donor lends money to an intermediary financial institution that then “on-lends” to other borrowers. The practice promotes lending when the formal financial sector sees the risks and costs of lending to certain groups as too high, or if there is not enough capital or liquidity in the market.	PFI	Does not apply
	Outsourced Management	Does not apply
	OBA	Can assist OBA by providing access to finance to providers so they can finance the delivery of agreed-upon outputs.
	Social Franchise	On-lending could target the capital expenditure and working capital needs of a portfolio of potential franchisors and franchisees.

Financial tools can be either unfunded or funded:

- **Unfunded:** An unfunded option is considered a contingent liability that will be paid out only if and when the financial instrument is called. Unfunded tools still require that MCA outlay cash to acquire the instrument from a third-party; an example is MCA paying the guarantee premiums up-front to a third-party guarantor. However, unfunded tools do not require as much of a cash outlay as funded tools. This is because, with unfunded tools, MCA only needs to compensate the third-party for the risk that the contingency will occur, and not for the cost of the contingency itself.
- **Funded:** A funded option implies a full outlay of cash by the MCA. Examples include reserving the entire amount of a guarantee in the MCA accounts (enough to cover the complete cost of the contingency) or funding monies that are to be on-lent.

Financial tools can be categorized as methods of risk mitigation for private sector investments and are particularly relevant in facilitating debt finance—loans and bonds. The most important risk faced by lenders is credit risk—that borrowers might default for whatever reason—while the key risks for investors are standard commercial risks associated with doing business—from the likelihood that a venture will not be profitable to political environment risks. Private sector investors are used to assessing risk and weigh the expected return on an investment relative to the perceived level of risk prior to making a business case to proceed. These financial tools respond directly to this risk and to a lender’s requirement for credit worthiness.

The tools discussed below present several options for MCAs, but it is critical to determine under exactly what circumstances the MCA is to be involved. Ideally, private sector investors should be able to obtain financing directly from lenders, but if this is not the case because the perceived risk is too high or liquidity is unavailable, then these tools can be used to facilitate MCA activities and encourage private sector investment. If some intervention is needed, the MCA should choose the least expensive and risky option.

## 2. Guarantees

### 2.1. Background Description

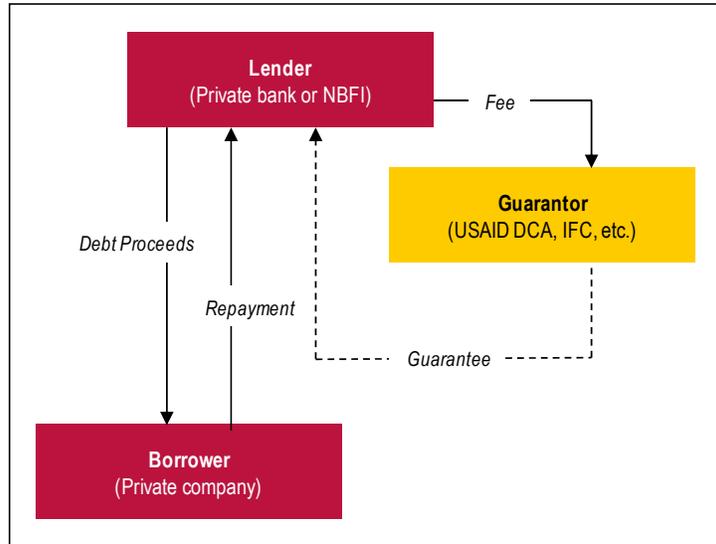
For this toolkit, guarantee refers to credit guarantees that cover debt investments and enhance the borrower’s credit rating. Guarantees are used widely in both developing and developed markets as a way to offset risk and can take many forms, as shown below. They are effective tools for creating linkages between borrowers and lenders. Governments worldwide use them while they address broad enabling environment issues such as lack of credit information, poor contract enforceability, etc. Even when the environment is strong, guarantees can be useful as credit enhancements to projects whose demand risk and other risks without the guarantee would be too high to attract private sector interest.

**Objective:** Guarantees are financial instruments that mitigate lending risk by ensuring that at least a portion of the debt is repaid regardless of the reasons for default. Private sector and government borrowers use guarantees to increase access to more reasonably-priced finance. By assuring that at least a portion of the debt is repaid, guarantees enhance borrower credit worthiness and mitigate the overall lending risk. Guarantees enable private sector investors to access finance and leverage MCA investments.

**Structure:** Guarantees are fairly simple in structure. A financial institution engages with a borrower and upon assessment determines the need for additional collateral to balance risks the borrower cannot offset. If the lender requires additional collateral, they and/or the borrower can request a third party institution to provide support in the form of a guarantee. The third party guarantor assesses the risk, attaches a fee to the

coverage and then charges either the lender or the borrower the fee. Most often the fee is absorbed by the lender and passed on to the borrower as part of the overall package of fees the borrower pays the lender.

**Chart 36: Structure of Guarantees**



**Variants:** Guarantees are flexible financial instruments that can be structured in many different ways. Following are some variants, including those offered by one third-party guarantor provider, the U.S. Agency for International Development’s Development Credit Authority (DCA).

Credit guarantees ensure that no matter what happens, the loan will be repaid at the percentage agreed upon by the guarantor. Guarantees cover a percentage of the total debt principal amount, from 50% to 100%, though a full 100% guarantee does not optimize risk sharing with the lender. By sharing risk, a partial credit guarantee ensures that all parties’ interests are aligned and that they all bear some degree of risk in the investment. The lender has an incentive to conduct proper due diligence and the borrower has an incentive to pay back the loan and honor the loan commitments.

To illustrate how diverse credit guarantees can be, the following table shows the variety of products that the DCA offers lenders in developing countries:

USAID Development Credit Authority (DCA) Guarantees	
<b>Loan Guarantee</b>	
<p>Covers a single loan from a financial institution to a specific borrower for a particular project or activity. This guarantee is used when borrower, lender, and use of the loan are known up front and when the loan would not be made without the guarantee.</p>	<pre> graph LR     L[Identified Lender] -- Loan --&gt; B[Identified Borrower]     B -- Repayment --&gt; L     DCA[DCA Guarantee] -.-&gt; L             </pre>
<b>Loan Portfolio Guarantee</b>	
<p>Similar to a loan guarantee except that the guarantee covers loans to a number of borrowers, rather than just one. This guarantee is meant to encourage lenders to extend credit to sectors or geographic areas that are underserved by financial intuitions. Each borrower must meet a pre-agreed definition of "eligible borrower", which is determined at the time the guarantee is designed.</p>	<pre> graph LR     L[Lender (Once Identified)] --&gt; B[Identified Borrower]     DCA[DCA] -.-&gt; L             </pre>
<b>Bond Guarantee</b>	
<p>Used to support the sale of bonds that generate capital for a borrower. The guarantee ensures that investors receive the stated repayments from their investment when they purchase a bond.</p>	<pre> graph LR     I[Institution Issuing Bonds] -- Purchase --&gt; Inv[Investors]     Inv -- Repayment --&gt; I     DCA[DCA Guarantee] -.-&gt; I             </pre>
<p>Source: USAID, Year in Review 2005, "Credit Guarantees: Promoting Private Investment in Development"</p>	

DCA has established application and training processes, cost-recovering premiums, and tested assessment criteria for offering guarantees to international and domestic investors and to municipalities to back government bonds (covered below). Other private guarantors and bilateral and multilateral donors offer their own packages, which usually can be tailored to the specific deals and partners MCA proposes. When choosing a guarantor, MCA needs to explore which one offers a relevant package for the type, term, size, and sector under consideration.

**Bond Guarantees:** One particularly useful type of guarantee that the MCA could use to access additional finance is a guarantee for a bond issuance for a sub-sovereign entity or municipality or a structured or project finance transaction. A bond is a debt instrument issued by an entity such as a municipality, or a special purpose vehicle usually in local currency. Purchasers may be individuals, companies, insurance companies, pension funds—typically those seeking long-term investments. Bonds can be structured in a variety of ways, including both time—when they mature and when they pay out—and how they pay out—interest only, principal and interest, discounted to be paid out entirely at maturity, etc. In general, bond issuances have a higher probability of payback than other investments, but if the issuer is an entity that has a less than investment grade credit rating, or no credit rating at all, it can be difficult to launch a successful bond issuance. A guarantee can lower the perceived risk of a bond by assuring investors that they will receive their money.

There are some private financial institutions that offer guarantees for bond issuances, though the availability of such an instrument depends on the situation. Bond guarantees may be of particular interest to MCAs as a way of increasing the overall amount of finance they are able to mobilize. Bonds can bring additional private sector finance to sub-sovereign entities and municipalities for project activities. Through the issuance of guarantee-backed bonds, MCA could vastly increase the overall financing available to support development initiatives.

**2.2. Roles**

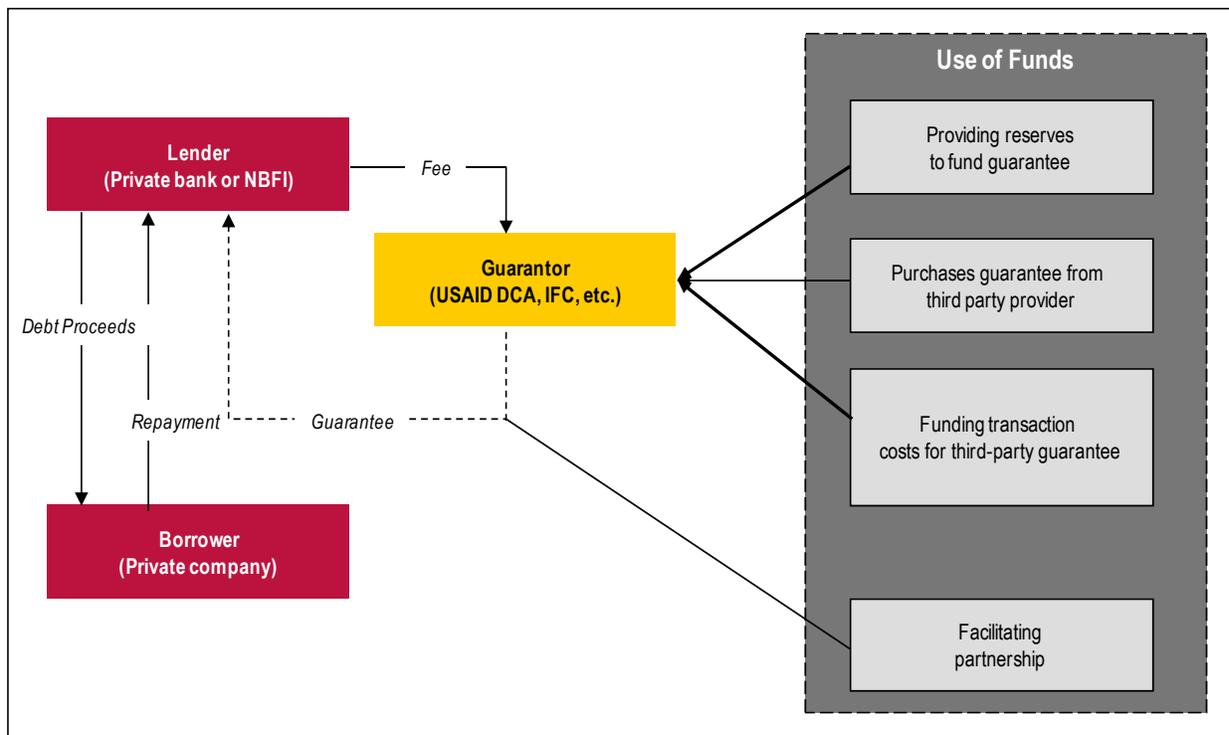
**Borrower:** The private sector investor or bond issuer is the primary borrower. It is their responsibility to repay the loan and ensure to the best of their ability that there is no default.

**Lender:** For loans, the lender most likely will be a bank. For bonds, lenders could include domestic or foreign institutions such as insurance companies or retirement funds. In either case, the lender will conduct due diligence on the borrower and decide the type and size of guarantee that will be required, if any.

**Guarantor:** The guarantor will conduct due diligence on the borrower and/or project to determine credit worthiness and form a contractual relationship with the lender for the period of the guarantee. The guarantor will hold the calculated risk associated with the guarantee on its balance sheet and, in the case of default, it will pay back to the lender the previously agreed upon amount.

**MCA:** MCAs would not be issuing guarantees themselves, but would collaborate with a third party guarantor for both unfunded and funded options:

**Chart 37: Possible Uses of Government and/or Compact Funds in Guarantees**



- **Unfunded Options:** Guarantees by their nature are unfunded because they are contingent liabilities for which Compact funds are used only when the guarantee is called. Under an unfunded scenario, MCA can facilitate the introduction to either a multi or bilateral organization or a company that offers

guarantees. Compact funds may be used to pay all or a portion of the guarantor’s transaction costs, could subsidize the guarantor’s fee during the tenure of the Compact, or buy the guarantee through a one-time payment, compensating a third party guarantor to hold this reserve on its balance sheet. The exact amount necessary for this one-time payment depends on the nature of the activity and the private sector partner. Many guarantor organizations have established analytic methods that MCA can explore.

- **Funded Option:** As needed, MCA can escalate its involvement through funded options. For example, MCA could put aside the entire guaranteed amount as a reserve that would sit in an MCA or third party account for the term of the guarantee as a contingent liability. However, with this Funded Option, the entire guaranteed amount would sit unused in an account for the duration of the Compact. Another disadvantage of funded guarantees is that no guaranteed loans could be made beyond the Compact term; unfunded guarantees, on the other hand, can be sustained beyond the Compact term because Compact funds would be disbursed up-front.

### 2.3. Key Success Factors

This section presents the key success factors that should be present for guarantees to function effectively.

*Additionality and Credit Worthiness:* A well-designed guarantee program enables a financial transaction that would not have otherwise taken place. It responds to a market need—an achievable opportunity, a capable manager (borrower), and an interested lender—but with some risk elements that do not allow the transaction to occur. In working with a credit worthy borrower, a guarantee creates additionality and critical links between lender and borrower. If successful, these linkages will not require additional third party support in future dealings.

If used successfully, guarantees, over time, can help create a more dynamic market for credit. By having lenders, guarantors and rating agencies (in the case of a bond issue) conduct due diligence, a deeper understanding of credit worthiness and risk is achieved and encourages lenders to move into sectors previously deemed too risky.

*Structure of the guarantee:* Guarantees should be structured so borrower and lender share the risk. For an opportunity to be successful and for the partners to manage towards that goal, there must a sharing of risk so that incentives are aligned with the common objective. Risk mitigation products must be structured in a way that encourages investors and lenders to carefully consider their investments and take steps to ensure the project does not default.

*Robustness and independence:* Credit guarantee programs should be as broad as possible and spread their own risk of loss across both geographic and economic spectrums, while avoiding cookie-cutter approaches. Guarantee programs require stable financial systems in order to pay out on a guarantee and, depending upon the arrangement, take any final actions, if needed, against the borrower. Finally, they should not be influenced by any outside party.

*Investment opportunities should be winners:* Guarantee programs should not be used to finance “pie in the sky” ideas. They should target only opportunities that have clear chances of success and are managed by

#### **Characteristics of Well-Designed Guarantees**

*Corrects Market Failure:* The guarantee corrects market imperfections that have resulted in a lack of finance available to credit worthy borrowers

*Brings Additionality:* The guarantee is designed to stimulate new private investment, rather than subsidize existing sources of capital (in other words, the transaction would not have taken place without the guarantee)

*Incentives are aligned:* The guarantee is structured in such a way that both the lender and the borrower have incentives to act responsibly

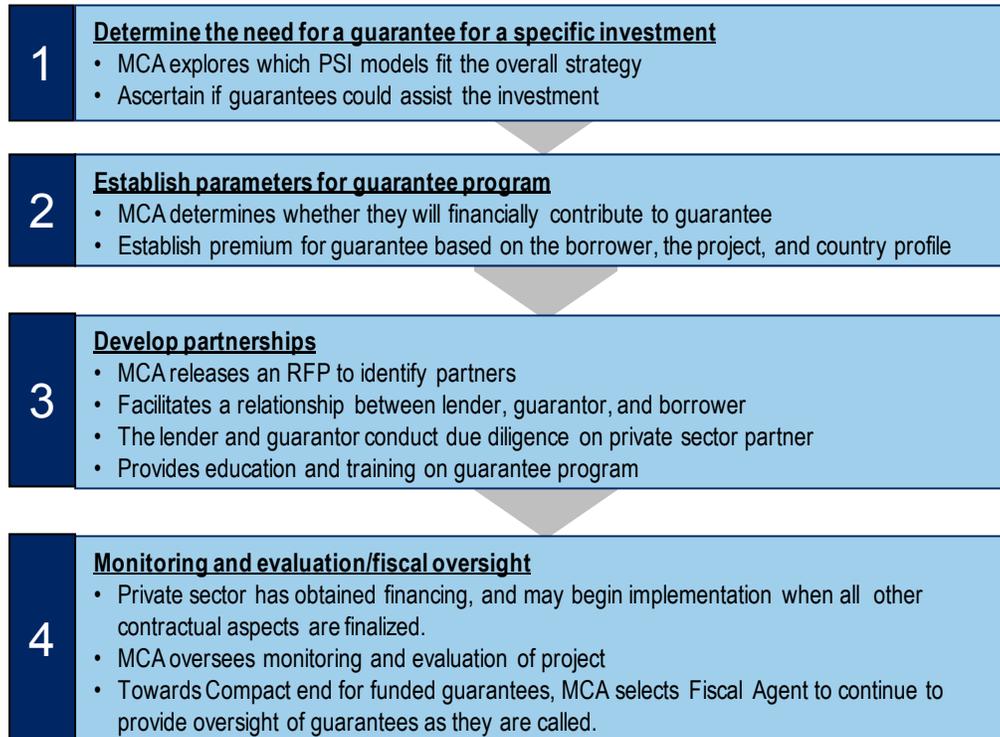
Source: Paul Freedman  
“Designing Loan Guarantees to  
Spur Growth in Developing Countries” USAID, 2004

capable sponsors. If, during due diligence, either the project is deemed to be too risky or management not up to the required competence, the guarantee should not be extended. In other words, the guarantee should respond to a borrower's inability to procure adequate funding to ensure success.

#### 2.4. Way Forward

Each guarantor organization will have its own set of steps for obtaining a guarantee. However, the following steps offer general guidelines for navigating the guarantee process:

**Chart 38: Guarantees – Process**



**STEP 1. Determine the need for a guarantee for a specific investment.** Once a specific PSI model is identified for a Compact, the need for guarantees should be assessed. Possibly in conjunction with a financial advisor, MCA would test the market to determine: 1) if a guarantee is required; 2) each player's role and responsibilities; 3) the financing of different project aspects; and 4) which entity would control project assets. Based on this market analysis and estimates of the necessary guarantee fees, the Compact should allocate an upper limit on funding of the guarantee as well as specify whether the guarantee will be funded or unfunded. Under this allocated limit, the exact amount of Compact funding needed for the guarantee would depend on the Step 3 calculation of the guarantee premium and negotiations among MCA, the financial institution, and the borrower.

**STEP 2. Establish parameters for guarantee program.** MCA needs to determine before Compact signing how much of a role they would like to take in the guarantee program. Considerations include whether MCA will financially contribute to guarantee, or whether they will go solely through an existing provider. If the latter prevails, a decision must be made as to the appropriate guarantee amount. This can include establishing a premium for the guarantee based on the

borrower, the project, and country profile

**STEP 3. Develop partnerships.** Guarantees involve three groups of stakeholders: financial institutions, guarantors, and borrowers. These roles are open to a range of organizations, indigenous and international, in the public and private sectors. MCA will need to develop an RFP to attract private sector partners. The RFP should specify that funds are available for a guarantee. Partners selected by the MCA after entry into force should present the best technical approach in the most cost-effective manner for the specific situation. Once it has identified all partners, MCA would facilitate and help maintain relationships among the lender, guarantor, and borrower. This helps the financial institution and guarantor determine the level of risk inherent in the loan/bond issue based on factors that could affect the borrower, project, and country. Once the guarantor's analysis determines the guarantee premium, MCA, the financial institution, and borrower must establish the exact amount of Compact funding needed to undertake the project.

**STEP 4. Monitoring and evaluation/fiscal oversight.** Once the guarantee contract is finalized, the borrower can use it to access funds from the partner lender and initiate implementation of the project. The private sector partner repays the loan with interest to the lender, and unless the Compact has funded the outright purchase of the guarantee, the lender pays fees to the guarantor for the life of the loan. MCA provides fiscal oversight of all project activities for the duration of the Compact, including monitoring and evaluating the guarantee process.

For funded guarantees only, MCA would have to, in year four of the Compact, formulate a plan for the disposal of any uncalled guarantee funds and release an RFP to select a liquidation agent for these funds. Because unfunded guarantees require only a one-time disbursement after entry into force of the Compact, there would be no uncalled guarantee funds to liquidate.

### 3. On-Lending

#### 3.1. Background Description

On-lending is a way to support private sector investment and economic growth. Making capital available through an on-lending facility can help overcome financial system weaknesses such as the lack of liquidity or liquidity of a certain maturity and the risk of lending to certain sectors. Capital usually is made available through a government ministry or directly to commercial financial institutions, which then lend it to targeted beneficiaries (on-lending).

#### 3.2. Objective

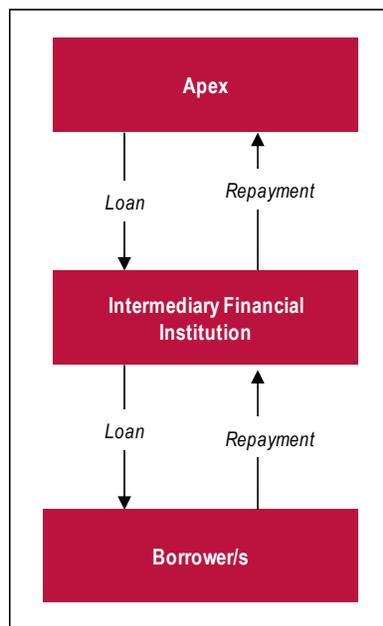
On-lending facilitates access to credit for specific groups of borrowers. The objective is to ensure that productive sectors of the economy have access to enough capital to support their growth and contribute to broader private sector-led economic growth. On-lending allows qualified borrowers to gain access to capital and exposes financial institutions to new market opportunities. It also helps to reduce the overall cost of borrowing through the addition of liquidity to the financial system. Another long-term goal of on-lending is to help the financial system identify sources of, or develop methodologies for building, liquidity—such as capital from deposits or indigenous capital markets—that do not require outside funds for lending.

### 3.3. Structure

As with the other financial tools, on-lending has a simple structure. A provider of funds either grants or lends money to a second tier government or private organization known as an Apex, which then makes funds available to commercial financial institutions for on-lending, with certain conditions, to targeted beneficiaries.

In this structure, MCA would be the funds provider. On-lending allows MCA to reach borrowers who have limited or marginalized access to the financial system. It can target these borrowers by establishing on-lending criteria—sector, location, size of loan, gender, etc.—depending on the objectives to be achieved. Decisions on whether or not to make these funds available to a single financial institution or several institutions need to be made when designing a program. Ideally, competition for the funds should come into play, but most important is that on-lending provide the financial system with additional liquidity.

**Chart 39: On-lending Structure**



### 3.4. Variants of On-lending

On-lending can be a stand-alone tool or mixed with other financial tools to maximize the chances of success of a Compact-funded initiative.

- **Simple:** Simple on-lending is when one donor or financial institution provides a loan to another that then on-lends to other borrowers. This has been a useful tool of many multi-lateral banks for some time. Typically, the primary lender charges a lower interest rate than the intermediary and the intermediary is able to lend the money at a profit and repay the primary financial institution.
- **On-lending with risk share:** In the simple on-lending example, the intermediary institution takes on the entire risk of default and must repay the loan to the primary lender whether or not it is repaid by end-borrowers. On-lending also can be designed to include a risk-share element that could provide either a guarantee through another institution or loan forgiveness from the original loan provider.

- **On-lending with technical assistance:** On-lending can target certain marginalized groups that MCAs consider high priority by establishing criteria the end-borrower must meet to qualify for funds. Targeting certain borrowers can tie in with other MCA technical assistance programs (e.g., those for farmers). MFIs can provide on-lending funds to those farmers and can include helping them to apply for loan funds and to manage the loan repayment. Technical assistance can also be extended to the financial intermediary to help it structure and price loans to end-borrowers with which it may have little experience.

### 3.5. Roles

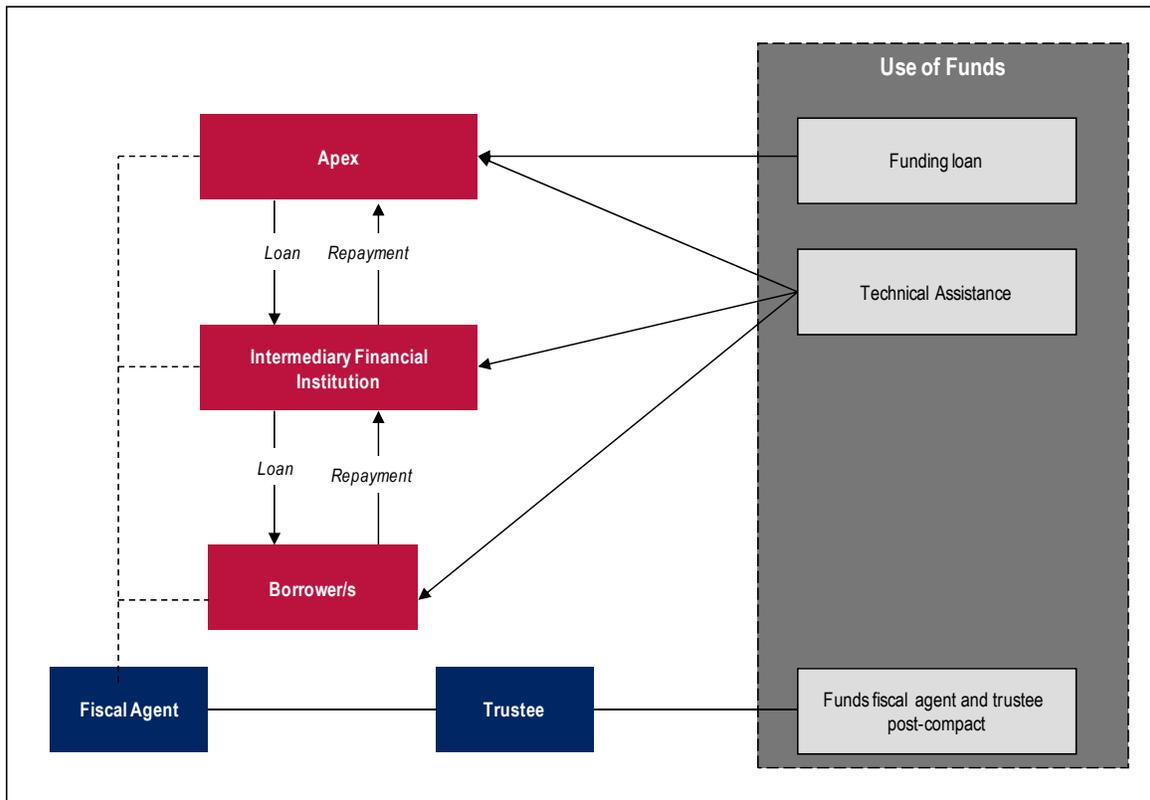
**Apex Organization:** The Apex Organization receives the funds from the MCA. It can be either in the public sector—a central bank, ministry of finance, minister of planning—or a private entity such as a bank. If the Apex is in the private sector, the MCA should select the firm through an open public tender. Quality and cost of the service would be determining factors. If the Apex is in the public sector, the funds on-lent to commercial financial institutions should include a nominal interest rate. The Apex is responsible for ensuring that participating commercial institutions follow the correct procedures to procure, disburse, and repay the funds from the loans they make.

**Financial Intermediaries:** These are the financial institutions—banks, non-bank financial institutions, insurance companies, microfinance institutions—that lend the funds to target groups. They are responsible for conducting due diligence of the end-borrowers, collecting required collateral, monitoring the loans, and the financial intermediary. In the event of non-payment, they also are responsible for making efforts to collect or—if a guarantee program is associated with the on-lending program—make a claim or write the amounts off and report that information to the financial intermediary.

**Private Sector:** The end-borrowers - the beneficiaries who are part of the target sectors that MCA wants to assist - are responsible for preparing their loan applications, providing sufficient collateral (if required) and equity, applying for the loan, and repaying it. Their relationship is with the commercial financial institutions.

**Fiscal Agent:** As Compacts last only five years and most on-lending programs will continue beyond the end of the Compact, a fiscal agent will be required to continue monitoring repayment of and eventually liquidate the reflows. MCA will need to formulate a plan for disposition of reflows and issue an RFP for the fiscal agent in year four of the Compact. In addition, MCA must hire a trustee to ensure that funds are where they should be and fiscal agent collects fees per the MCA contract.

**MCA:** During the Compact design stage, MCA and MCC would determine the Compact's target sectors and objectives and consider whether an on-lending program would be required. The decision about on-lending would depend on the liquidity and capacity of the indigenous private and financial sectors. If an on-lending facility is included in the Compact, MCA would provide the capital for on-lending to targeted beneficiaries through the Apex Organization. MCA would provide the Apex Organization with Compact funds in a lump sum at the beginning of the Compact term. As discussed, the Apex Organization will then on-lends to intermediary financial institutions (IFIs). The IFIs and the lending prices would need to be determined on a case-by-case basis. This is discussed in more detail in the Success Factors section. On-lending is a fully-funded activity and MCAs, through fiscal agents, must monitor the flows and the beneficiaries throughout the life of the Compact. In addition, MCA or a contractor should conduct due diligence on the intermediary institutions that are targeted to carry out the on-lending activities.

**Chart 40: Possible Uses of Funds in On-lending**

### 3.6. Key Success Factors

The following section discusses some of the key success factors which must be present for on-lending programs to be successful.

*Capacity to manage funds within the financial intermediaries:* For on-lending programs to be successful there must be constant monitoring and reporting of fund outflows and inflows. This centralized tracking activity must be able to provide status reports on an as-needed basis and information should include individual borrowers, amounts, commercial financial institutions, etc.

*Commercial financial institutions:* Commercial financial institutions must be interested in lending to the target sector. A major reason for the failure of some on-lending programs is the lack of incentives for commercial financial institutions to participate. The pricing of funds from financial intermediaries to commercial institutions must be such that they can add a margin that makes it profitable for them to participate. Competition, communication and motivation to engage the target market are key to keeping these institutions actively engaged in lending to those markets. Importantly, if commercial institutions are not committed to working with MCA beneficiaries, they should not receive funds for on-lending.

*Pricing:* Pricing of loan funds—from the financial intermediary to the commercial financial institutions to the target beneficiaries—must have incentives built into each level, so the opportunity to lend to marginalized borrowers is profitable enough to ensure success.

*Maturity:* On-lending programs should target maturities that are not currently available in loan markets. Providing short-term capital when access to long-term capital is the constraint is not a formula for success.

Often in Compact-eligible countries, the market for medium to long-term funds is where financial institutions need access to liquidity, while the Central Bank works to deepen the financial markets of the country.

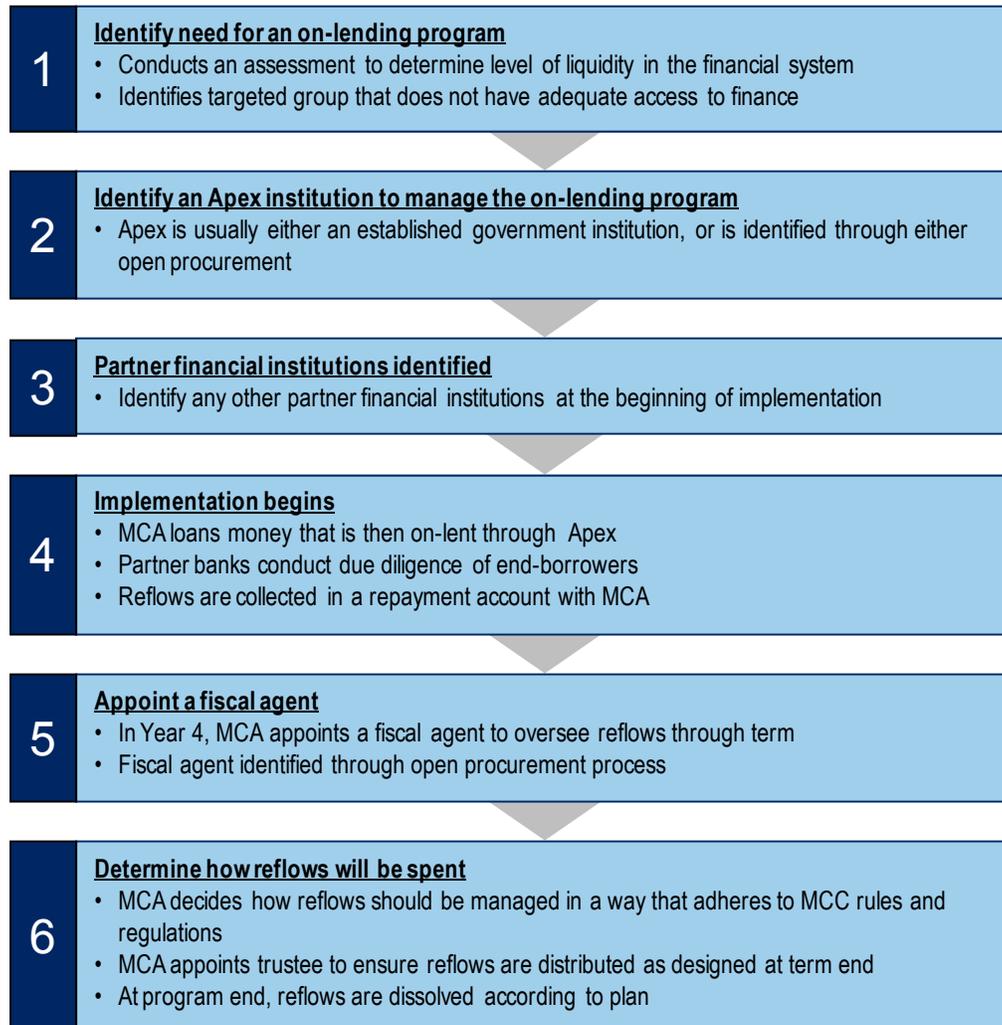
*Reflows managed carefully:* The issue of reflows is critical for MCAs to consider; it must be managed according to MCC rules and regulations that specify possible uses. Currently, Compacts employ a repayment account to collect reflows that is in the name of MCA but managed by a fiscal agent. If the intermediary financial institution needs additional money, it must apply to the repayment account (funds do not revolve) to access the funds anew. Over time, the amount of reflows coming in is much greater as more loans are made and MCA and the commercial financial institutions continue to issue loans to the end of the Compact. This is a key success factor that assures borrowers they can borrow funds at any time.

*True limited liquidity:* MCA must conduct research to ensure that there really is a lack of liquidity in the financial sector. There is a risk that financial institutions might request on-lending funds when they could lend directly, but do not want to risk their own capital and prefer to use on-lent funds. The additionality of on-lending situations must be carefully monitored, particularly in risk-share structures.

*Exchange Rate Risk:* On-lending institutions should not be exposed to any exchange rate mismatches, according to best practices. Those should be borne by the apex institution or passed on to sub-borrowers.

### ***3.7. Way Forward***

On-lending programs are an excellent way to target specific groups and share risk. Although the principles are generally the same, program designs can vary greatly. Following are some of the key steps MCAs should consider.

**Chart 41: On-lending Process**

**STEP 1.** **Identify the potential for an On-Lending Program.** MCA should conduct an assessment to identify both the level of liquidity in the financial system and determine whether a targeted group lacks adequate access to finance. This should fit the MCA goal for use of Compact funds and need for relevant assistance programs.

**STEP 2.** **Identify an Apex institution to manage the on-lending program.** Once MCA decides that an on-lending program would benefit project participants, it should identify a financial intermediary to manage the funds. MCA should select this partner either through an RFP or by working with a government-identified entity like the Central Bank. The apex institution should convert the US\$ from the Compact into local currency. The on-lending institution should not be exposed to exchange rate mismatches. MCA and the financial institution must enter into a contractual arrangement that is in accord with standard MCC procurement guidelines and involves expert transaction advisors.

**STEP 3.** **Partner financial institutions identified.** If there will be partner financial institutions to further on-lend Compact Funds, these should be identified in the first year of the program.

This has been done by MCA in the past through the formation of an Accreditation made up of representatives of the financial intermediary, MCA, government, NGOs, and private sectors. They determine which financial institutions would be credit worthy partners. The targeted number is probably around five or six different partners but will vary by program.

- STEP 4. Implementation begins.** MCA lends the funds that are, in turn, on-lent through the intermediary institutions. Partner banks conduct due diligence of end borrowers and determines their credit worthiness. When they approve a borrower, partner banks apply to a Credit Committee (a group similar the Accreditation Committee) presenting the borrower's by demonstrating that they meet required criteria (sector, income, marginalized group, etc.) and requesting that they receive funds. The On-Lending Institution provides the funds and collects loan payments, which it returns to the MCA to be deposited in a separate account. This account can be accessed by MCA upon approval of the Fiscal Agent. The On-lending Institution can apply to access these reflows. Loans are on-lent until the very end of the five-year Compact and reflows continue to come in for three to five more years. Loans can also be tied to other technical assistance programs.
- STEP 5. Appoint a fiscal agent.** As the Compact begins winding down in year four, MCA should appoint a fiscal agent to manage the intermediary institution for the rest of the loan period. This agent would in effect replace the MCA's oversight function. MCA will use an open procurement process to identify and recruit the fiscal agent.
- STEP 6. Determine how reflows will be spent.** In year four, MCA also should determine how the reflows should be spent. Depending on the success of the program, it could be a significant amount of money and it is essential that it be used in a way that adheres to MCC rules and regulations. Past projects have donated it to NGOs, other domestic charities, or the on-lending institutions. The MCA-appointed trustee should ensure that reflows are distributed as planned and the on-lending program ends as intended.

## 4. Case Studies



Madagascar Refinance and Guarantee Fund	
<b>Players</b>	<b>Sector</b>
<ul style="list-style-type: none"> <li>▪ Millennium Challenge Corporation (MCC)</li> <li>▪ MCA-Madagascar</li> <li>▪ Madagascar Savings Bank</li> </ul>	Finance
	<b>Location</b>
	Madagascar
<b>Analysis</b>	
<p>Agriculture and cattle-raising, largely of a subsistence type, are the backbone of Madagascar's economy. Collectively, they account for approximately thirty percent of the country's gross domestic product, employ approximately seventy-five percent of the labor force and generate over thirty percent of the country's exports (excluding the free zones). The principal agricultural products are rice, livestock, seafood, coffee, vanilla, sugar, cloves, cotton, sisal, peanuts and tobacco. In 2005, seventy-three point five percent of the rural population lived below the poverty line.</p> <p>The Compact between MCC and the Government of Madagascar calls for MCA-Madagascar to develop an agriculture program to provide technical assistance to farmers in rural Madagascar to assist them in improving their productivity. MCA-Madagascar created a US\$4 million refinancing and guarantee fund (the "Fund") to facilitate access to finance for the projects developed through this agriculture project.</p> <p>The Fund is designed to assist financial institutions that have proven their willingness to reach populations in rural areas and have satisfied the required eligibility criteria ("Participating Financial Institutions" or "PFIs"). The Fund offers these PFIs refinancing or guarantee services, depending on their needs. If the PFIs are liquidity constrained, they can choose to borrow funds for on-lending to rural farmers at market rates, without a guarantee. If the PFIs prefer to use their own funds, the Fund provides a partial credit guarantee scheme through which, in return for a guarantee fee, the Fund will cover up to 50% of the PFI's losses on specific, eligible loans.</p> <p>The Fund's guarantee scheme is fully funded, meaning that the entire amount guaranteed by the Fund is placed in a local bank account to cover potential future payouts. This limits the potential dollar amount of loans that can be guaranteed to US\$8 million (the Fund can cover up to 50% of the losses on these loans, i.e. US\$4 million).</p> <p>The management of the Fund has been entrusted to a third party, the Madagascar Savings Bank, a financial institution which has a strong presence in rural Madagascar and experience managing on-lending and guarantee programs.</p> <p><i>Source: MCC</i></p>	
<b>Key Learning Points</b>	
<ul style="list-style-type: none"> <li>▪ Coordinating agriculture and finance programs can help the agriculture beneficiaries gain access to finance for their projects while ensuring higher quality investment opportunities for the finance project</li> <li>▪ A fully funded guarantee program limits the scale of a finance project. The losses on the guarantee program will likely be much lower than US\$4 million, meaning a majority of the funds could be used to provide either additional credit or to support additional guarantees under a partially funded program</li> <li>▪ Finding a local, competent fund manager is key for small scale finance projects. A US\$4 million Fund could never support the administrative costs of a third part expatriate firm managing the Fund.</li> </ul>	

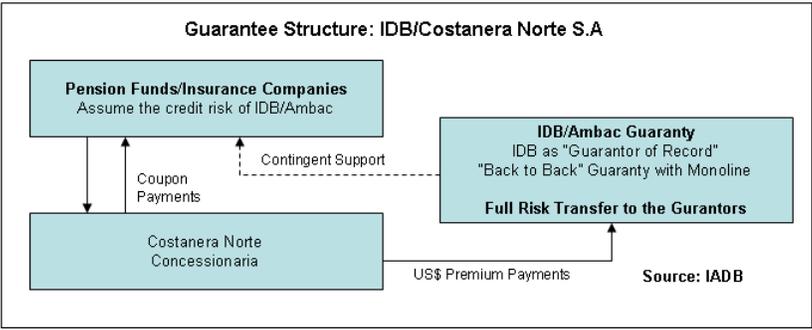


Uganda DCA Guarantee Program for SMEs															
<b>Players</b>		<b>Sector</b>													
<ul style="list-style-type: none"> <li>▪ USAID/EGAT/DC; USAID/Uganda</li> <li>▪ Ugandan Banks and Financial Institutions</li> </ul>		Rural and Agricultural SMEs													
		<b>Location</b>													
		Uganda													
<b>Analysis</b>															
<p>Lending to SMEs, particularly in rural area agricultural sectors, is generally considered to entail higher risk than loans to larger companies. One large loan to a company that has an established history with the bank and has significant collateral is easier and less expensive than several medium-size loans to SMEs. In Uganda, SMEs were having trouble getting loans—specifically loans that are larger than what MFIs typically handle, but lower than those banks make to large companies. This is the lending <i>gap</i> that DCA guarantees seek to fill.</p> <p>In 2002, USAID/Uganda and the DCA launched a guarantee program to help alleviate this gap in the market. They began to offer a series of DCA Loan Portfolio Guarantees (LPG) to selected financial institutions that lent to SMEs. An LPG guarantee covers borrowers who meet certain criteria and is used to target a specific set of borrowers.</p> <p>The first series of DCA loan guarantees in Uganda was referred to as DCA I. DCA I criteria for eligible borrowers were broad with guarantees applying to SMEs in multiple sectors with the majority of loans (80%) facilitating agriculture, trade, and the service industry. They facilitated medium-sized loans ranging from US\$1,500 to \$212,500. The average size was just under US\$90,000 and the absolute maximum was US\$1 million. In five years of operation, DCA I guarantees facilitated 272 loans worth a total of US\$26.5 million.</p>															
<table border="1"> <thead> <tr> <th colspan="4">Leverage from DCA I Loans to SMEs in Uganda</th> </tr> <tr> <th># of Loans</th> <th>Value of Loans</th> <th>Subsidy Cost Paid by Mission</th> <th>Budget Leverage</th> </tr> </thead> <tbody> <tr> <td>272</td> <td>US\$24.2 million</td> <td>\$869,530</td> <td>US\$27.84 to US\$1</td> </tr> </tbody> </table> <p>Source: USAID/Uganda</p>		Leverage from DCA I Loans to SMEs in Uganda				# of Loans	Value of Loans	Subsidy Cost Paid by Mission	Budget Leverage	272	US\$24.2 million	\$869,530	US\$27.84 to US\$1	<p>USAID/Uganda and the DCA offered guarantees to six financial institution partners—primarily domestic and international banks operating in Uganda. USAID/Uganda subsidized the cost of the loans by paying some of the premium. The overall leverage for USAID’s investment is</p>	
Leverage from DCA I Loans to SMEs in Uganda															
# of Loans	Value of Loans	Subsidy Cost Paid by Mission	Budget Leverage												
272	US\$24.2 million	\$869,530	US\$27.84 to US\$1												
<p>estimated to be 28 to 1. In addition to the leverage of additional finance, USAID/Uganda was able to increase overall economic growth through job creation and increased sales as a result of the available finance for SMEs.</p> <p>USAID/Uganda reports in their evaluation of the program that the guarantees met both additionality and sustainability criteria. Bankers surveyed for the final evaluation reported that they wouldn’t have issued the loan, or it would have been for a lesser amount, without the guarantee. Furthermore, 70% of borrowers received new loans without a guarantee. Thus, the DCA loans helped create a more efficient market system and brought new borrowers into the financial systems.</p> <p>Source: USAID/Uganda, <i>Evaluation of DCA Guarantee Programs and Impact: 2002-2007</i></p>															
<b>Key Learning Points</b>															
<ul style="list-style-type: none"> <li>▪ Partial credit guarantees should correct a market failure which limits access to finance for credit-worthy borrowers. By design, guarantees are temporary market adjustments that create long-term sustainable lending patterns. In the Uganda SME case, the use of guarantees successfully illustrated the true credit worthiness of lower-income borrowers.</li> <li>▪ Loan Portfolio Guarantees are particularly useful for serving certain identified groups. However, DCA also utilized this successfully by selecting partner banks whose core business customers were similar to the targeted groups. Therefore, while creating additionality, it did not require a large stretch for the financial institutions.</li> <li>▪ It is critical to structure the guarantee to align risks between all parties. It also is important that the lender has incentives to conduct proper due diligence to ensure credit worthiness and that the borrower is compelled to repay the loan.</li> <li>▪ USAID-provided technical assistance helps guarantors enable the loans and includes DCA guarantee management as well as general aspects of lending.</li> </ul>															



Millennium Challenge Ghana On-lending Fund	
<b>Players</b>	<b>Sector</b>
<ul style="list-style-type: none"> <li>▪ Millennium Challenge Corporation (MCC)</li> <li>▪ Millennium Development Authority (MiDA)</li> <li>▪ Central Bank of Ghana</li> </ul>	<b>Finance</b>
	<b>Location</b>
	<b>Ghana</b>
<b>Analysis</b>	
<p>Financial service providers are few and far between in the districts in rural Ghana (Northern Zone, Afram Basin Zone and the Southern Horticultural Belt Zone) targeted by the Compact projects. Only one commercial bank, the Agriculture Development Bank (“ADB”), is meaningfully engaged in making loans to agricultural clients in the Northern Zone and the Afram Basin Zone. Although there are thirty-seven (37) privately-owned rural banks and seven (7) financial NGOs that serve rural clients in the three zones, their resources and capacity are limited. Most of these financial institutions have limited knowledge of agricultural credit and even smaller appetites for the perceived risk; given the poor historical levels of repayment from the sector.</p> <p>To address the lack of credit available to agribusiness in these areas, MiDA, the MCA entity in Ghana, has developed a revolving credit fund (the “Fund”) to support agribusiness from production through the entire value chain - including processing, storage, transportation and marketing. MiDA has also developed several activities to complement the Fund, including building the capacity of financial institutions through training of their staff in agricultural credit, providing grants to expand loan production offices or branches and supporting the establishment of pilot programs including innovative financial products intended to speed the flow of credit along the agriculture value chain.</p> <p>It is anticipated that the Compact will provide US\$40.7 million over the five years of the Compact for the Fund and related activities. The fund will be available for on-lending on a revolving basis through eligible Participating Financial Institutions (“PFIs”). It will provide loans to commercial banks, rural banks, savings and loan companies and Financial NGOs, for short and medium-term on-lending to farmers and other agricultural sector players in the intervention zones.</p> <p>The basic structure of the Fund requires PFIs to operate as follows:</p> <ul style="list-style-type: none"> <li>• Borrow from the Fund at the ninety-one (91)-day Treasury bill rate (short term loans) and the Bank of Ghana prime rate (medium term loans);</li> <li>• Provide loans or on-lend to their clients at market rates; and,</li> <li>• Assume half of the credit risk of the loans.</li> </ul> <p>MiDA has engaged the Central Bank of Ghana to manage the day to day operations of the Fund. The Compact will provide funds for the loans to the PFIs to be used for subsequent on-lending to the end borrowers. If the end borrowers default, half of the losses will be covered by the Fund, with the other half covered by the PFIs themselves.</p> <p>At the end of the Compact, it is anticipated that the funds will be granted to the PFIs based on their performance (loan origination rates, borrower default rates, etc) during the life of the Compact.</p> <p><i>Source: MCC</i></p>	
<b>Key Learning Points</b>	
<p>An integrated agricultural development project that combines access to finance programs with other forms of assistance to farmers has been identified as essential to modernization and large scale commercialization of agriculture in Ghana. As it is early in the life of the Ghana Compact, it remains to be seen if farmers will be able to avail themselves of the opportunity to move to the next stage of commercial agriculture development.</p>	

Costanera Norte Urban Toll Road: Guarantees on Local Currency Bond Offering	
Players	Sector
<ul style="list-style-type: none"> <li>▪ Costanera Norte, S.A.</li> <li>▪ Inter-American Development Bank (IDB)</li> <li>▪ Ambac</li> </ul>	<b>Infrastructure - Toll Roads</b>
	<b>Location</b>
	<b>Chile</b>
Description	
<p>In Latin America, IDB responded to the decreasing availability of infrastructure finance by offering guarantees on bonds to fund construction projects. In the Costanera Norte urban toll road example, IDB guarantees were structured to enable the project to access local finance. Traditional sources of finance were limited by the project and political risk, including currency depreciation risk. International financial institutions were not interested in investing when revenues were tied to local currency. Additionally, new toll road projects in general are seen as a riskier investment because use of the road can not be fully guaranteed in advance.</p> <p>In 1999, the Chilean Government awarded to the concessionaire Costanera Norte a 30 year Build-Operate-Transfer (BOT) concession contract with the Ministry of Public Works (MoP) to operate an urban toll road in Santiago, Chile. The consortium was led by Impregilo S.p.A. (70%), Simest (10%), Empresa Constructora Tecsa S.A (10%). and Empresa Constructora Fe Grande S.A (10%). Construction began in 2001. Construction began in 2001.</p> <p>The toll road would cross the city going East-West, connecting two of the city's suburban areas with the business center and airport. The toll road employs a regionally innovative tolling model where users would be tolled through use of electronic devices that monitored passage through tags on vehicle license plates. The toll road was intended to reduce traffic congestion and pollution in Santiago.</p> <p>In 2003, IDB assisted in obtaining funding for the toll roads through a series of bond issues. IDB provided a full or 100% guarantee, ensuring the payment stream against anything that would threaten it. IDB guaranteed up to approximately 15% or US\$75 million, and then shifted 85% of risk to the monoline insurance company, Ambac, who acted as co-guarantor. Costanera Norte paid IDB/Ambac premiums for the guarantees. Enhanced by these guarantees, the bonds would then be purchased by pension funds and insurance companies.</p> <p>The Chilean Government also took on usage risk, demonstrating its commitment to the project. The concession was constructed in such a way that the government in Chile guaranteed a minimum revenue stream from the roads for twenty years. However, if the revenues exceeded a certain pre-established amount, the concessionaire would share 50/50 of the additional revenues with the GoC.</p> <p>The combined guarantees allowed the bonds to achieve a triple AAA rating, the highest rating available. Costanera Norte issued two series of bonds – one for 5% for 12 years, one for 5.5% over 21 years. The bonds created such a degree of consumer confidence and interest that they were 2.5 times over subscribed. The guaranteed bond issuance brought in an additional US\$256 million of private sector finance - just under half of the total project cost.</p> <p>The project was named Latin America Transport Deal of the Year for 2003 by Project Finance Magazine and Project Finance International.</p> <p>Sources: IADB, AMBAC, Road Traffic Technology, Project Finance Magazine</p>	



**Key Learning Points**

- In the example above, MCA could facilitate the guarantee by compensating a third party guarantor to hold the guarantee on their balance sheet, or by subsidizing the fee for the guarantee,
- One of the benefits of guaranteeing bonds is that it allows the whole project to be funded in local currency and bonds repaid in local currency, which guards against currency depreciation and exchange rate risk.
- Chile has strong capital markets and a high level of liquidity in the pensions and insurance organizations. IDB recognized this liquidity as an opportunity for long-term investment.
- In the case of Costanera Norte, greenfield (i.e., new as opposed to existing) toll roads in themselves cannot achieve a Triple AAA rating. The guaranteed bonds allowed them to receive a rating by using a credit enhancement to mitigate demand risk.
- Timing of the bond issuance may have been factor in their success in the case. The bond issuance actually took place about halfway through the construction of the project. According to Ambac, many of the more complicated features of the construction, such as several bridges, were already completed, which reduced the construction risk.

**7. Resources**

Overseas Private Investment Corporation (OPIC): <http://www.opic.gov/financing/index.asp>

European Bank for Reconstruction Development (EBRD): <http://www.ebrd.com/apply/large/index.htm>

Municipal Finance Task Force: [www.mftf.org/about/index.cfm](http://www.mftf.org/about/index.cfm)

FinMark Trust: [www.finmarktrust.org.za](http://www.finmarktrust.org.za)

**Guarantees**

USAID Development Credit Authority: [www.usaid.gov/our\\_work/economic\\_growth\\_and\\_trade/development\\_credit](http://www.usaid.gov/our_work/economic_growth_and_trade/development_credit)

World Bank, Multilateral Investment Guarantee Agency (MIGA): <http://www.miga.org>

The World Bank and PPIAF, “Review of Risk Mitigation Instruments for Infrastructure Financing and Recent Trends and Developments”, Matsukwa and Habeck, Trends and Policy Options No. 4, 2007



# Annex: Carbon Finance

Carbon finance, or the international trade in greenhouse gas (GHG) emission reductions, is an emergent and rapidly growing market. Governments and private corporations in industrialized countries are making significant investments in emission reductions activities outside their borders. In the U.S., participation in voluntary initiatives, such as the Chicago Climate Exchange (CCX), has attracted interest, including among firms that may be exposed to future GHG regulation. Carbon finance is a market-based mechanism whereby industrialized countries or carbon-intensive companies can earn emission credits through investment in sustainable development projects that reduce emissions. Linkages between emission reduction efforts and the poverty alleviation activities that are financed by each Compact present opportunities to partake in this market.

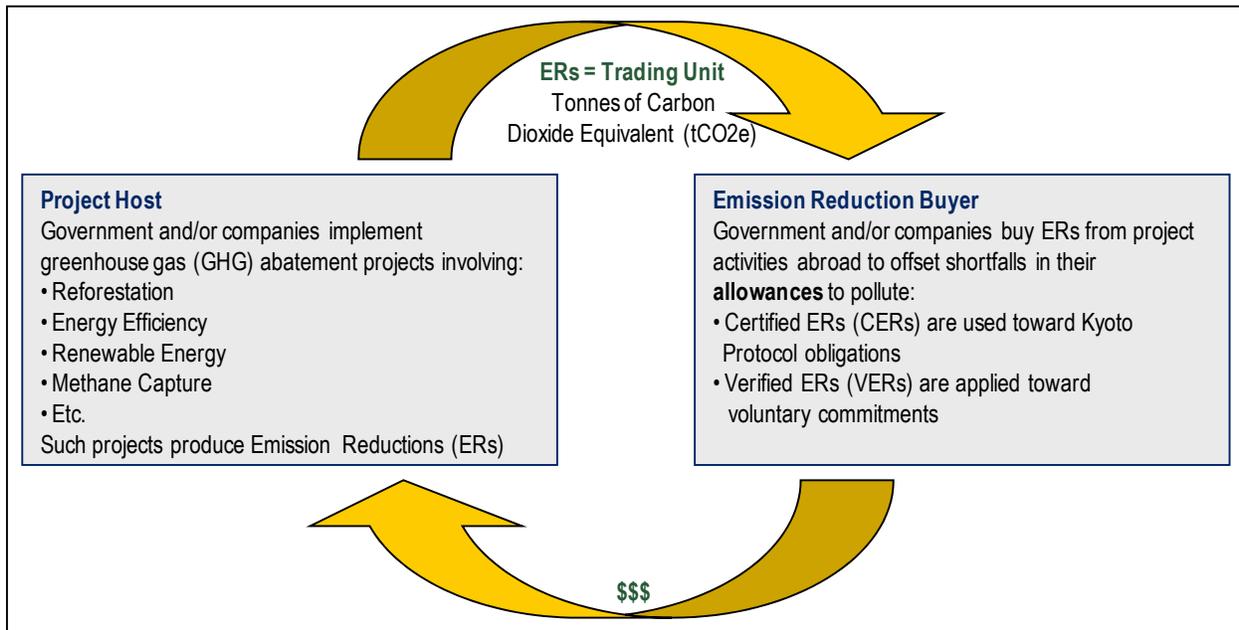
## Market Mechanism

Cap and trade systems assign a value to the global externality of GHG emissions, thus providing incentive to develop projects with lower carbon emissions. In many countries, international trade in mandatory greenhouse gas reductions is motivated by requirements of the Kyoto Protocol and by regional programs such as the European Union Emission Trading Scheme (EU ETS). Voluntary commitments and subsequent markets such as the Chicago Climate Exchange are also carbon finance participants, though voluntary markets represent a smaller market share of global carbon trading.

Carbon cap and trade regimes allow for the purchase of a fixed percentage of credits from project-based transactions to offset emissions in excess of allowances. Once project-based credits are issued and are finally delivered for carbon compliance, they may then be traded as carbon credits on marketplaces such as the European Climate Exchange (ECX), CCX, or other carbon exchanges. These project-based credits are compliance assets that need to be “created” through a process that has certain risks inherent with it, such as risk of regulation, project development, and performance.

MCC funds should not be directed to support activities associated with a Compact-eligible country’s efforts to comply with obligations under Kyoto Protocol, as the USG has not ratified the accord. However, MCC funds may be directed to support activities associated with carbon finance opportunities in the rapidly developing voluntary and “pre-compliance” markets (both in the U.S. and abroad).

**Chart 42: Carbon Trading Concept**



### Compact Applicability

While the process of generating carbon credits from a project can provide additional revenues, as well as environmental benefits, gaining approval can be lengthy, in-depth, and uncertain. Compact-eligible countries considering the possibility of developing carbon credits within their projects must fully understand the constraints and opportunities before allocating limited time, energy or money.

Voluntary markets are relatively new and not governed by binding commitments or standards, resulting in lower prices, easier access, and a high level of risk. There are not any limitations that would affect MCC funded projects in the voluntary market. U.S. firms do participate in voluntary markets, such as CCX and other forms of “pre-compliance” activity. Voluntary markets do not have as stringent verification standards or as drawn out approval processes as the mandatory markets for carbon credit creation. However, the voluntary market is fragmented without a single global standard; therefore, long-term sustainability of the voluntary carbon markets is uncertain.

Project types and methodologies in the voluntary markets are continually being approved, refined and proposed as the carbon markets continue to develop. Some sectors with carbon emission reduction potential for the voluntary markets include the following:

- Renewable Energy – Grid and Off-Grid
- Forestry – Afforestation / Reforestation
- Infrastructure – transport, water, sanitation, energy
- Fuel Switching
- Energy Efficiency
- Industrial Processes
- Methane destruction – biogas, landfill

- ♦ Mining.

In addition to assisting specific emission reduction projects, Compacts can provide funding for assessments, project management and technical assistance to assist in the development of projects that generate carbon credits for the voluntary markets. By creating institutionalized capacity within the local market to access carbon financing, Compact funds can leverage additional investments into the country.