DRAFT
Guidelines on Viability Gap Funds for PPP Project

MINISTRY OF FINANCE
GOVERNMENT OF PAKISTAN

October 2007
Revised January 2009

TABLE OF CONTENTS

ARTICLE V – DISBURSEMENT AND MONITORING

Ministry of Finance

Guidelines on Viability Gap Funds for PPP Project

Whereas:
The Government of Pakistan recognizes the importance of improving and expanding infrastructure services for sustaining economic and social development. To help finance growing infrastructure needs, the Government has developed a Public Private Partnership (PPP) program for Pakistan. This program aims to develop, amongst other things:

- An institutional structure to coordinate and promote PPP activities
- A facility to provide long-term, fixed-rate financing in local currency
- Policies and a mechanism for targeted subsidies for PPP projects.

Therefore:
In accordance with its policy objectives, the Government of Pakistan has decided to subsidize economically viable PPP projects that will not be financially viable if they are constrained to charge affordable user tariffs or unitary payments. The government will make such PPP projects financially viable by dedicating a portion its budget to fund the gap between the expected project revenues and costs. This dedicated budget shall be known as the Viability Gap Fund (VGF) which be targeted subsidy focused to benefit socio-economically disadvantaged groups of the population.

These Guidelines set the initial criteria for eligibility to receive funding from the Viability Gap Fund, the procedures for applying for, approving, disbursing and monitoring the Fund, and the arrangements for managing, controlling and governing the fund. The government may set-up a company or a committee to manage VGF. These guidelines use the terminology of Company for the sake of simplicity only.

ARTICLE I

General Provisions

Section 1. Objectives: These Guidelines set the criteria and procedures that should be followed to apply for, approve, disburse, and monitor Viability Gap Funds for PPP Projects.

Section 2. Definitions of Terms: Unless otherwise stated, the terms used in these Guidelines shall have the following meaning:

"Competitive Selection Process" or **"CSP"** means the process whereby a Private Party is granted the right to undertake a PPP Project, and which involves transparent and open competition among at least two unrelated bidders. The financial bid variable for selecting the Winning Bidder shall be the present value of the Viability Gap Funds required by the Private Party. The present value shall be calculated using an appropriate discount rate that reflects cost of capital of the government;

"Cost-recovery Revenue" means the revenue that is equal to or greater than, in present value terms (at approved discount rate of private party), the True Cost of the PPP Project;

"Economic Benefit" means the positive contribution to gross national product (or other measure of value) from an economic activity or project;

"Economic Cost" means the difference in costs between a without and with PPP project situation—that is, the extra use of resources necessary to achieve the corresponding Economic Benefits;

"Institution" means:

i. All levels of Government (i.e. Federal, Provincial, Local), or
ii. All Authorities of all levels of Government which are performing functions pursuant to any law in connection with the affairs of the Government, or
iii. All State Owned enterprises (Companies or otherwise) whose ownership or control is vested in a Government (all levels of Government) or in a person

iii) A person whose ownership or control is vested in a Government or whose ownership or control is vested in a person falling within number ii) above;
Explanation: For the purposes of number iii) above, the expression 'ownership' means the direct or indirect ownership of more than fifty-one percent of the voting rights in a person, and 'control' means the ability, directly or indirectly, to direct or cause the direction of the votes attaching to the majority of its issued shares or interests carrying voting rights, or to appoint or remove or cause the appointment or removal of those of its directors or equivalent office bearers holding the majority of the voting rights on its board of directors or equivalent body;

"Measurable Outputs" include completion of construction works (for example: building a road or rail or a section of it, building a reservoir, installing a pipe, or installing a water supply or electricity connection), achieving contract milestones
(For example: contract effective date, financial closure date, commercial operations date, and so on) or achieving a defined level of service (for example: supplying potable water continuously for 24 hours per day, 7 days per week; hours per day of availability of a power plant; and so on);

"Net Economic Benefit" means the present value of economic benefits minus the economic costs of the PPP project. The present value shall be calculated using an appropriate discount rate that reflects cost of capital of the government;

Private Party means a person that does not fall within the definition of the Institution

"Public Private Partnership" or **"PPP"** means a commercial transaction between an Institution and a Private Party by which the Private Party:

a) Performs an Institutional function on behalf of the Institution; and/or
b) Assumes the use of public property for its own commercial purposes;
c) Assumes substantial financial, technical and operational risks in connection with the performance of the Institutional function or use of the public property; and

d) Receives a benefit for performing the Institutional function or from utilizing the public property, either by way of:

i. Consideration to be paid by the Institution from its budget or revenue; or
ii. Charges or fees to be collected by the Private Party from users or customers of a service provided to them; or
iii. A combination of such consideration and such charges or fees;

"Socio-economic Characteristics" means quantitative factors that provide a direct or indirect measure of the social and economic status of a group of people;

"Socio-economically Disadvantaged" means a group of people that is below average in terms of several Socio-economic Characteristics, compared to the general population of Pakistan or to the relevant regional sub-population;

"Tariffs" means a Rupee amount charged to service users or consumers per unit of service provided (for example, Rs/m3, Rs/kWh, Rs/trip);

"Total Capital Cost" means the full and reasonable cost of making a PPP project operational, including project design, authorization and field development costs, material costs, construction costs, and equipment costs;

"True Cost" means the full efficient cost of a PPP Project, and which includes all fair and reasonable costs including Total Capital Cost and Operating Costs, and a reasonable return on investment, that must be recovered in order to enable the Private Party to operate the PPP Project in a financially viable manner;

"Unitary Payment" means the payment made by the Institution to the private party in respect of the services provided by the private party;

"Viability Gap Fund" is as defined in Article IV Section 1;

"Viability Gap Funds" means the funds that the VGF Company will transfer to an Institution, or to a Private Party on behalf of the Institution, to cover part or all of the difference between the expected True Cost of a PPP Project and the expected revenue from the Tariffs charged or Unitary Payment made for the services provided by such PPP Project and which includes Capital and Operating

Viability Gap Funds;

"Viability Gap Funds – Capital" means the Viability Gap Funds which are transferred during the development (including design, development, and construction prior to the commencement of operations) phase of the PPP Project;

"Viability Gap Funds - Operating" means the Viability Gap Funds which are transferred on a periodic basis (i.e. monthly, quarterly, half yearly, yearly etc) during the period wherein the private party provides services under the PPP Project after the commencement of operations;

"Viability Gap Fund Company" or "VGF Company" means a company incorporated and limited by guarantee in accordance with the Companies Ordinance 1984, which is governed by a Board appointed by the Federal Government, and whose budget shall come from transfers made by the Ministry of Finance following requests by the Board of the VGF Company;

"Winning Bidder" means the Private Party that was fully technically compliant with the bid documents, including having the technical qualifications and accepting the technical specifications of the PPP project and that proposed the lowest value for the financial bid variable in the Competitive Selection Process for a given PPP.

ARTICLE II

Eligibility Provisions

Section 1. Eligibility Criteria. To be eligible to receive Viability Gap Funds, a PPP Project shall meet the following seven criteria:

1) **Economically Viable**: The Net Economic Benefit of the PPP project shall be equal to or greater than zero; and

2) **Limited Viability Gap Funding:** The ratio of the present value of the Viability Gap Funds to the present value of True Cost (only Capital cost) of the PPP Project shall not be greater than zero point two (0.2) or twenty percent (20%). For operating cost, the VGF company/committee will determine limit of VGF Gap funding ratio; and

3) **Unaffordable:** Users of the services provided by the PPP project are unable to afford a Tariff, or the Institution is unable to pay a Unitary Payment, that is expected to generate Cost-recovery Revenue. It is therefore targeted subsidy and focused; and

4) **Targeted:** In a PPP Project where it is practical to segregate groups of users in accordance to Socio-Economic Characteristics, the Viability Gap Funds are only used to reduce the Tariffs charged to Socio-Economically Disadvantaged groups of users; and

5) **Competitively Procured**: The private party that will undertake the PPP Project is selected through a Competitive Selection Process; and

6) **Output-Based:** The disbursement of Viability Gap Funds is linked to the private party achieving Measurable Outputs, and

7) Project shall be implemented i.e. developed, financed, constructed, maintained and operated for the Project Term by a Private Sector Company to be selected by the Government or a statutory entity through a process of open competitive bidding. Project should provide a service against payment of a pre-determined tariff or user charge

8) Concerned Government/statutory entity should certify, with reasons that the tariff/user charges or project duration cannot be increased to eliminate or reduce the viability gap of the PPP;

9) **Selected Sectors**: The PPP project belongs to one of the following sectors:

   a) **Transport and logistics** including roads, rail, seaports, airports, fishing harbours as well as warehousing, wholesale markets and cold storage; or

   b) **Mass Urban Public Transport** including buses, and intra and inter-city rail, or

   c) **Municipal Services** including water supply and sanitation; solid waste management; low cost housing, and health / education facilities; or

   d) **Energy Projects;** or

   e) Any other infrastructure sectors that the Federal Government may define.

ARTICLE III

Request and Approval Procedures

Section 1. Request for Pre-approval: The projects may be presented by any institutions at federal, provincial or local government level which owns the underlying assets. Project proposals must be accompanied by a preliminary project appraisal (covering (a) techno-economic viability of the project, (b) financial appraisal and project financing arrangements, (c) Pre-feasibility and feasibility studies, and (c) extent and nature of viability gap funding proposed). The guidelines developed by IPDF for project preparation will be used by all government agencies intending to apply for VGF funding.

Prior to launching the Competitive Selection Process, the Institution will submit to the VGF Company a request for pre-approval of the Viability Gap Funds for a specific PPP project. The request shall include the evidence needed to demonstrate compliance with the eligibility criteria listed in section 1, Article II and categories such request as VGF Capital or VGF Operating. The VGF Company will develop the detailed instructions that applications should follow to demonstrate compliance with eligibility criteria. These instructions will be aimed at the all the Government Institutions and VGF Company.

Section 2. Pre-approval: Within fifteen (15) business days from the date on which the VGF Company receives a request for pre-approval prepared in accordance with the instructions issued, the VGF Company shall reach a decision on pre-approving all, part or none of the Viability Gap Funds requested by the Institution.

The VGF Company can extend this deadline once for a maximum of fifteen (15) business days if the information or evidence included in the request for pre-approval was insufficiently detailed or verified so as to enable the VGF Company to reach a decision within thirty (30) business days of receiving the request for pre-approval, and the VGF Company has issued a letter to the Institution requesting specific, additional information.

Requests from Institutions will be reviewed by VGF Company on a first-come first serve basis.

The decision of the VGF Company shall be based on its assessment of whether:

i. The PPP Project is eligible, in accordance to the criteria listed in Article II section 1, to receive Viability Gap Funds; and

ii. The assumptions made on Net Economic Benefits, True Cost, Cost-recovery Revenues, affordable Tariffs, Unitary Payment and Targeting are fair and reasonable, or whether adjustments in the Viability Gap Funds should be made to reflect the VGF Company's assessment of these assumptions; and

iii. Tariff/user charge or project duration cannot be increased to eliminate or reduce the viability gap of the PPP;

iv. The Viability Gap Fund has sufficient uncommitted funds to honor the Viability Gap Funds disbursements in the dates required by the PPP Project; and

The VGF Company's decision shall be communicated to the Institution and should include the present value of the Viability Gap Funds pre-approved for the PPP Project.

In case, it is imperative to revise the scope and manner of VGF in light of the pre-bid interaction with the potential bidders, the process of Pre-Approval of VGF will have to be re-initiated by the institution.

Section 3. Request for Final Approval: After completing the Competitive Selection Process, the Institution will submit to the VGF Company, a request for final approval of the Viability Gap Funds for the pre-approved PPP project.

The request shall include:

i. Evidence that the Competitive Selection Process was carried out, as well as a report summarizing its results; and
ii. An initialed draft of the PPP agreement between the Private Party and the Institution;
iii. The present value of the Viability Gap Funds requested by the winning bidder; and
iv. Detailed pre-feasibility and feasibility reports.

The VGF Company will prepare instructions that Institutions should follow when preparing their requests.

Should the present value of the Viability Gap Funds of the Winning Bidder be equal to or less than the Viability Gap Funds pre-approved by the VGF Company, the VGF Company's final approval shall be based exclusively on its satisfaction that the selection of the Winning Bidder followed a Competitive Selection Process, and that the draft PPP agreement is consistent with terms included in the request for pre approval.

Should the present value of the Viability Gap Funds of the Winning Bidder be greater than the Viability Gap Funds pre-approved by the VGF Company, the VGF Company's final approval shall be based on its satisfaction that the True Cost of the Winning Bidder is fair and reasonable and that it still meets the eligibility criteria "Limited Viability Gap Funding" as described in Article II, Section 1(2). If this increase is less than a certain proportion (to be determined by VGF), VGF Company/Committee can approve it. Otherwise, re-application is required from the Institution.

Section 4. Final Approval: Within fifteen (15) business days from the date on which the VGF Company received a request for approval prepared in accordance with the guidelines, the VGF Company shall determine whether the PPP Project is approved to receive Viability Gap Funds, or whether additional time and information is needed to establish if the True Cost of the Winning Bidder is fair and reasonable. If additional time and information is needed to establish if the True Cost of the Winning Bidder is fair and reasonable, the VGF Company must issue a written notice to the Institution notifying the Institution of the delay in approval and reasons thereof, and may take a maximum of fifteen (15) Business days from the date of issuing the written notice to reach a decision. If there is no decision after 15 days, the private party will be entitled to compensation for each day delay.

The VGF Company's decision shall be communicated to the institution in writing.

Section 5. Tripartite Agreement: Within sixty (60) business days from the date in which the VGF Company has issued its final approval, the Institution, Winning Bidder, and the VGF Company shall enter into a Viability Gap Funds Agreement which will be based on the model agreement prepared to that effect by the VGF Company.

ARTICLE IV

Management and Control of Viability Gap Fund

Section 1. To manage and control the Viability Gap Funds, the Ministry of Finance will create an arrangement with all of the following features:

- **Establishment:** The Viability Gap Fund shall be incorporated as a company limited by guarantee in accordance with the Companies Ordinance, 1984.
- **Funding:** The budget of the VGF Company shall come from transfers made by the Ministry of Finance following requests by the Board of the VGF Company.

- **Governance:** The VGF Company shall be governed by a Board whose members are appointed by the Federal Government.

The Board shall have the power to, amongst others:

i. Approve Viability Gap Funds for eligible PPP projects. The Board will approve all requests for VGF Funds for projects under PPP Modality. The present value of the Viability Gap Funds approved by the Board shall not exceed the uncommitted budget of the VGF Company when the approval was granted

ii. Approve the procedures to be followed for submission, appraisal and approval of Viability Gap Funds

iii. Approve model Viability Gap Funds Agreements

iv. Approve a business plan (including budget) prepared by the CEO

v. Request additional budget allocations from the Ministry of Finance.

Management: The VGF Company will be managed by a CEO appointed by the Board.

The power and functions of the CEO are to:

i. Prepare annual business plans and seek their approval by the Board

ii. Hire and fire the staff of the VGF Company

iii. Oversee the general management and administration of the VGF Company

iv. Analyze requests for Viability Gap Funds pre-approval and approval submitted by Institutions, make recommendations to the Board on whether it should approve these requests.

v. Enter into Viability Gap Funds Agreement for approved PPP Projects on behalf of VGF Company after approval by the Board

vi. Make Viability Gap Funds Payments to Institutions or Private Parties in accordance with Viability Gap Funds Agreements

vii. Monitor the effective use of Viability Gap Funds by Institutions or Private Parties, in accordance with Viability Gap Funds Agreements

viii. Represent the VGF Company in disputes or any other type of legal case

ix. Prepare quarterly operational and financial performance reports to the Board.

Accounts and Audits: The accounts of the VGF Company shall be operated jointly by the CEO and one officer of the VGF Company as directed by the Board.
The accounts shall be maintained in accordance with the provisions of the Companies Ordinance 1984 and shall be audited annually in accordance with the provisions of the said ordinance, and shall be subject to audit by the Auditor General.

ARTICLE V

Disbursement and Monitoring

Section 1. Disbursement: Viability gap funding can take various forms, including but not limited to capital grant, O&M support grants or interest subsidy or a combination. The funding is to be disbursed contingent on agreed outputs, preferably physical, and performance levels being achieved, as detailed in agreement. The funding can be provided in installments, preferably in the form of annuities, and with at least 15 per cent of the funding to be disbursed only after the project is fully functional. The VGF is disbursed only after the private sector company has subscribed and expended the equity contribution required for the project and is released in proportion to debt disbursements remaining to be disbursed thereafter.

Upon completion of agreed, measurable outputs defined in the Viability Gap Funds Agreement, the Private Party shall submit an invoice to the Institution, and the Institution shall verify that the outputs have been delivered. The

Institution shall submit the approved invoice to the VGF Company for payment. Funding will be provided directly by the VGF company to the private company according to the conditions of the agreement.

Section 2. Random Verification: The VGF Company will have the right to directly, or through the relevant government institution or through a third party, conduct at its own discretion audits to directly verify that outputs have been delivered.