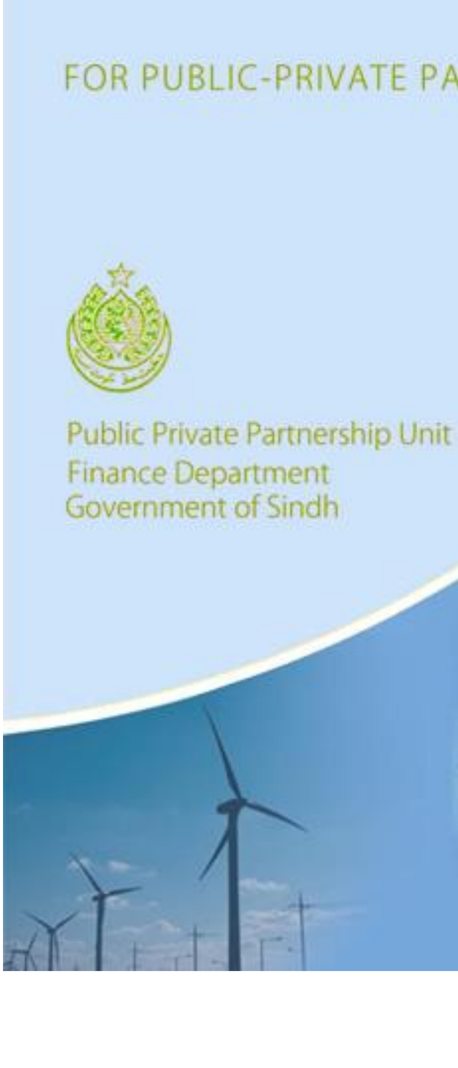
Guidelines for Viability Gap Fund 2017

FOR PUBLIC-PRIVATE PARTNERSHIP



Public Private Partnership Unit
Finance Department
Government of Sindh

FINANCE DEPARTMENT

GOVERNMENT OF SINDH

Guidelines for Viability Gap Fund ('VGF') for Public Private Partnership Projects in Sindh Province

The amended VGF Guidelines for Public Private Partnership (PPP) Projects have been approved by the PPP Policy Board in its 22nd meeting (7th November 2017) held under the chairmanship of Honorable Chief Minister Sindh.

TABLE OF CONTENTS

LIST OF ACRONYMS

ADB	Asian Development Bank
ADP	Annual Development Plan of Sindh Province
ESMS	Environmental and Social Management System
Government	Provincial Government of Sindh
NPV	Net Present Value
PDF	Project Development Facility
PFS	Project Feasibility Study
PMU	Project Management Unit inside SFD
PPP	Public Private Partnership
PPP Act	Sindh Province PPP Act, 2010, as amended
PSF	Public-Private-Partnership Support Facility
SFMH	Sindh Financial Management House
SFD	Sindh Province Finance Department
SPPA	Sindh Public Procurement Act, 2009, as amended
VGF	Viability Gap Fund
VFM	Value for Money (analysis)

1. INTRODUCTION

1.1 The Government of Sindh strengthened the Public-Private-Partnership (PPP) option as an infrastructure project development mode through promulgation and adoption of the Sindh Province PPP Act 2010, as amended from time to time ('PPP Act'), and established institutions under the PPP Act, comprising the departmental PPP nodes that initiate projects based on the development priorities, including those identified in the ADP, and facilitated by the PPP unit for final approvals by the PPP policy board.

1.2 The Government uses PPP procurement principally, but not exclusively, where it is possible for the private sector to charge the users of the infrastructure or its beneficiaries in order to recover its costs, repay its debts and make a return on its investment. The Government recognizes, however, that there will be potential PPP projects where it is the Government's policy not to charge the users of assets, for example public schools, public hospitals, rural roads/highways etc. There will also be economically justifiable projects where the payment by users or beneficiaries will be insufficient to make the project financially viable, for example where the operators of such projects are constrained, either by Government or by the market, from charging unacceptably high tariffs.

1.3 The Government also recognizes that there would be many infrastructure projects where user charges are not sufficient to meet the developer required return or there are projects which shall be developed on Annuity Based, Shadow toll/ income, or Performance based payments. For this reason, the Act enabled the establishment of the Viability Gap Fund (VGF) to make such requisite payments on a periodic basis over the life of the project and/or on an upfront capital subsidy basis using a Net Present Value (NPV) calculation. Existing VGF Guidelines were approved and promulgated in 2012.

1.4 To ensure that the obligations and commitments are met to provide required financial support over PPP concession period, the PSF now represents a formal independent VGF institution that has been incorporated as a ring-fenced section 42 Company under the Companies Act of 2017. The PSF will be used to enhance corporate governance and transparency of the new VGF. The PSF structure is intended to better ensure (i) rigorous use of Value from Money (VFM) analysis of VGF proposals, (ii) approval only of VGF structures that appropriately address the risk allocation intended under the PPP Act and (iii) taking necessary steps to explore viable alternatives for risk mitigation prior to any consideration of cash collateralization practices. Cash collateralization, should, in any event be minimized.

1.5 VGF regime shall have two systems working in parallel up to January 2022.The new VGF shall be controlled and managed by PSF. The existing VGF management will remain under Sindh Fund Management House (SFMH), Finance Department until January 1, 2022 and thereafter shall merge with new VGF controlled by PSF. The risk management function for new and existing PPP projects will however be centralized with PSF after its incorporation. However, any contractual obligations of old projects beyond 2022 shall also be paid through existing VGF beyond 2022. Projects for which investor solicitation has been initiated under the existing VGF mechanism, the funding for the same shall be done through the existing VGF.

1.6 This document is intended to supersede the 2012 VGF guidelines.

2. VIABILITY GAP FUNDING

2.1 The VGF will provide the funds for those projects approved by the PPP Policy Board that are economically and/or socially viable but financially unviable. The funds shall be disbursed to the private partner/ PPP project company which has been contracted to carry out the project under any PPP variants mentioned in the PPP Act in accordance with the applicable laws.

2.2 Approved VGF support will cover all forms of required commitments described in these guidelines (both capital and operating support) as required over project life. VGF will therefore either:

i. compensate for the initial outlay required from the Government in the PPP Project; and/ or

ii. compensate for the difference between the contractual payment necessary for the PPP Private Investors to recover costs (including debt servicing) and/or to meet agreed estimated return on investment.

2.3 The PSF shall also be responsible for managing all project risks over the concession life for its own new VGF exposure under these guidelines and for all existing VGF commitments. In this role, it shall be obliged to maintain all VGF commitment records including records for past VGF transactions.

2.4 The PPP laws, rules, regulations and policy provides several alternative financial evaluation criteria. Primarily, lowest present value of VGF subsidy for the period covered by the PPP concession shall be the preferred financial evaluation criterion.

3. ELIGIBILITY CRITERIA

3.1 For new VGF support, the PPP Policy Board shall approve PPP projects based on, *inter alia*, the VGF Guidelines (as approved by PPP Policy Board and amended from time to time).

3.2 The PPP nodes shall, in their recommendations for either new VGF or existing VGF, satisfy the following policy requirements:

I. Listed and Approved Sectors: The PPP project shall be from one of the sectors listed in Schedule I of the Sindh Public-Private Partnerships Act, 2010 (the Act) as amended from time. To prioritize the PPP projects, the nodes may (when necessary) incorporate independent and credible surveys. Projects that are evaluated as the most viable should be prioritized by the PPP nodes.

II. Under regime of the PPP Act: Government support through VGF in a PPP Project is subject to the PPP Act.

III. As per guidelines on procurement: The procurement of the project must have been in accordance with the Sindh Public Procurement Act, 2009 (SPPA)and the Sindh Public Procurement Rules, 2010, as amended.

IV. Government Agency Approval: The project must have been vetted by the administrative head of the Government Agency and this should be submitted to PSF (or PPP Unit in the case of Existing VGF) and subsequently PPP Policy Board.

V. Means of reducing viability gap exhausted: The concerned procurement agency/Node should provide reasons and conclusions for its required recommended structure and quantum of estimated funding requirement of VGF taking into account, the required findings in the Project Feasibility Study (PFS) listed in the PDF Guidelines. The PPP node will further certify its recommendations to PSF as follows:

(i) That it has analysed and confirms that the tariff/user charge cannot be increased to eliminate or reduce the viability gap of the PPP project with reasons including user ability to pay surveys, Government caps on user charge or the lack of capacity/ability to collect user charge by the Government agencies.

(ii) That it has analysed and confirmed that the PPP project concession term cannot be increased for reducing the viability gap so as (i) the project equipment life is not exceeded, (ii) concession parameters would require review due to expected changes in demand and quality and type of services to be rendered and/or (iii) any lengthening of such project concession term may not materially reduce VGF support levels;

(iii) That the capital cost estimates have been independently checked and verified by appointed transaction advisor in the case of an unsolicited bid where the proponent would have commissioned the initially submitted PFS.

(iv) That the project cannot generate market returns for investors and/or minimum base case debt service cover ratios for project finance lenders by virtue of Government caps on tariff/user charges that affect project financial viability, and project requires estimated VGF at levels recommended.

(v) That the Administrative Department is unable to provide relief on its own.

VI. **Capital Grants:** To address project viability gaps in the most transparent way, the most preferential use of VGF is upfront capital grants. Within the PFS, sizing of capital grants must be preceded first by establishing a base case cash model, then by undertaking a market benchmarking study to estimate a fair return to project investors. The capital grant amount together with the assumed timing of its injection vis-a-vis equity and debt shall be used to remove any negative gap between the estimated return of the base case cashflow model and the estimated project investor return.

VII. **Capital Grant pari-passu with Equity Common Share:** To ensure that PPP Project Investors are already at risk when VGF Capital Grants are made, VGF Capital Grants will be injected no earlier than on a pari-passu basis with common equity injection into a PPP Project. To facilitate ease of sponsor acceptance of this provision, the full VGF capital grant amount may be deposited into a net escrow account no later than the date of financial close of all debt and equity commitments for the subject PPP Project.

VIII. **Return Mechanisms Attached to Capital Grants:** The PFS shall identify significant upside case(s) for upside case cashflow projections and estimated additional market returns to investors. When appropriate, revenue sharing rights may be proposed to allow PSF as new VGF provider (or in the case of existing VGF, the Government) to share in general upside revenues / income or specifically defined income. PSF must receive payments in lieu of such rights in the priority and amount defined in the project Security Agreement flow of funds managed by a Security Agent Bank. The VGF provider must be a signatory to the Security Agreement.

IX. <u>Subordinated Debt:</u> The PFS base case cashflow model with or without use of Capital Grant may generate annual senior debt service coverage ratios regarded as too low by senior lenders surveyed under the PFS. The reduction of senior debt via subordinated debt replacement would be one means of increasing debt service coverage ratios to market norms. Therefore, VGF may be used to provide subordinated debt. However, it must ensure that:

(i) Loan documents provide for deep subordination meaning that senior debt would be retired before any subordinated debt principal can be paid and that subordinated debt payments would not be made to the extent that allocated revenues were insufficient.

(ii) As with return mechanism above, principal and interest payments can only be made from revenues derived under the priority and amount defined in the project Security Agreement flow of funds managed by a Security Agent Bank. The VGF provider must be a signatory to such project Security Agreement.

(iii) Subordinated debt would not be provided with event of default rights in the event of non-payment.

X. <u>Other forms of equity and debt:</u> Common equity, equity with voting rights or forms of equity shall be an allowable use of VGF. Similarly, provision of senior debt shall be an allowable use of VGF.

XI. <u>Charged Tariffs for Services:</u> The project should ideally provide a service against payment of a pre-determined tariff or user charge. The PPP node will ensure that the PFS presents an estimate of tariff or user charge for the proposed projects that covers all costs including any costs of funds borrowed and provides a market based return to the investors to attract credible and experienced private parties and make the project bankable. The estimated VGF requirement based on the proposed tariff/user charge should also be indicated in the PFS and the reasons given along with any tangible information/survey or Government policy / directive that would support this estimate. Estimates must take account of previous collection history and may incorporate conservative assumptions in cases where there is little or no collection history of a user fee or a materially increased user fee. This does not preclude projects in the following Performance based section with no charged tariff / user fee.

XII. **<u>Performance Based Payments:</u>** As a condition of VGF, the PPP concession contract should provide required detailed service levels and linked payments to such levels of service delivered or standards achieved by the Private Sector Partner. An acceptable independent system of measuring that performance must be put in place by the Government Agency. Costs of this service can be passed on in the tariff/user charge. The advantages of independent monitoring to ensure quality benchmarked delivery of outputs and outweigh any cost impact on VGF support level. The Government Agency may also use the option of establishing an independent regulatory boards/structures to ensure that actual outputs are appropriately measured against benchmarked requirements and accordingly paid. This minimizes arbitrary and unilateral actions by either party that may otherwise negatively affect the PPP concession contract integrity and payment regime.

XIII. **<u>VGF Limitation:</u>** VGF may not be used to reduce financial obligations of existing shareholders or project lenders in a debt restructuring. However, VGF increases may be used post financial closure to address Government approved PPP project expansion or improvement costs or in the case where the Government has taken back effective control of the PPP project company following a Concession Agreement default.

XIV. **<u>Relevant Procedures and Requirements are met:</u>** The Government Agency nodes should propose their selected type of VGF support and calculation of the VGF amounts (including estimated contingent liability (if any)) and these should be supported through the Project feasibility study which must have been reviewed by PSF (in the case of new VGF) [or by PPP Unit (in case of existing VGF)] and the PPP Unit and approved by the PPP Board. The nodes in their request must certify to the PPP Board that the review for VGF requirements has been completed as detailed in Section 3.1.5 above and they have conducted analysis and taken all necessary steps to reduce the need for VGF support.

4. MANAGEMENT AND CONTROL OF NEW VGF AND EXISTING VGF

4.1 The Government shall until January 1, 2022, ensure the following process for the use of the existing VGF and the new VGF facility under the control and management of PSF:

i) The existing VGF may only be used to support PPP projects approved by the Government through the PPP policy board under the PPP Act 2010 prior to January 1, 2022. This would include all existing approved and functioning PPP projects and new projects approved for VGF support prior to January 1, 2022.

ii) The Government shall continue to provide funding to the existing VGF to fulfil all commitments and obligations of the PPP project portfolio approved by the Government prior to January 1, 2022.

4.2 However, each new PPP project considered for VGF support shall first be submitted to PSF for VGF support. In the event PSF subsequently declines new VGF support for specific reasons, Government Agency shall refer the project together with the PFS to the PPP policy Board (through PPP Unit) with the request seeking funds from the existing VGF and providing full details and reasons.

4.3 PSF shall manage and control the new VGF using the PSF Financial Management Guidelines. SFD should continue to manage and control the existing VGF until January 1, 2022 at which time PSF shall become the sole custodian, manager and controller of all VGF activities and funds.

4.4 SFD will re-estimate, on an annual basis, the likely annual demands for the next fiscal year (in each quarter) that will have to be met from the new VGF. PSF shall review financial models, invoices and payment requisitions etc. for each PPP Agreement that is signed in order to ensure for their own satisfaction that payments from the new VGF have been properly calculated and authorized and that, if deductions have been made from any payment to a project company, the correct amount has been paid from the new VGF. For review of the said calculations, PSF shall rely on the data provided by the Government Agency, Private Sector Investor(s), PPP Unit or other party has requested support from the existing VGF. If the purpose of the new VGF is to meet capital cost subsidies or minimum levels of revenue (in the case of user-pay projects), PSF or its nominee shall have the power to obtain any information on costs or receipts that are held by the Government Agency or by the Private Sector Investor(s).

4.5 PSF in coordination with PPP Unit will estimate on an annual basis the contingent liabilities (including guarantees, warranties, etc.) relating to both new VGF and existing VGF. PSF will publish on an annual basis for the PPP Policy Board, the total amount of contractually-committed payments from the new VGF and an estimate of all non-contractually-committed new VGF liabilities for projects that have been approved but not reached financial close. The amount for each future Government fiscal year shall be identified separately.

4.6 PSF will study means of estimating probability weighted risk exposure attached to VGF contingent liabilities as addressed in more detail in the PSF risk management manual. Such estimates would govern the amount of targeted reserve funding for VGF contingent liabilities.

4.7 PSF will report to every meeting of the PPP Board the inflows into the new VGF, the outflows from the new VGF, the remaining and envisaged liabilities of the new VGF, status of funding of contingent reserves, and the balance of the new VGF and shall ensure to release the requisite funds required to meet these obligations.

5. REQUEST AND APPROVAL PROCEDURES

5.1 Each new PPP project considered for VGF support shall first be submitted to PSF for VGF support. The proposal shall include the evidence necessary, as described in Section 3 above, to demonstrate compliance with the eligibility criteria and categories the request for support as capital subsidy (including equity and debt commitments) or Operating support (including minimum revenue guarantees). Any proposal must propose a NPV methodology incorporating a discount factor which best approximates the PPP project's expected weighted cost of capital, using whenever possible equity and debt funding rates from comparable completed PPP project transactions. It is also important that a rigorous Value for Money (VFM) analysis is incorporated into the PFS as part of its evaluation taking into account both costs of the PPP project and the public-sector comparator and measurement of quantifiable and qualitative value added of the PPP project.

5.2 The Government Agency shall also provide evidence that it has assessed other options within the partial or full control of the Government that can reduce capital and/or operating costs i.e., availability of land, support infrastructure such as buildings, access roads, water supply, electricity availability, gas pipelines, environmental/ resettlement/relocation costs, etc., payment/waiver/discounts on taxes/duties, payments for any disputes, settlement costs or to meet upfront equipment/development costs so as to minimize VGF support levels.

5.3 PSF shall evaluate the project proposals and suggest any changes which may reduce the NPV of new VGF. The proposal shall include detail regarding what form and for what purpose such support is necessary.

5.4 VGF proposals that are derived from unsolicited bids are proposed by Government agencies follow the same process as above for pre-approval per the procedures detailed as in accordance with the applicable laws.

5.5 Within thirty (30) business days, from the date that PSF receives from the PPP Unit the complete proposal for pre-approval of new VGF support in accordance with issued instructions, PSF will submit its recommendations on VGF support to the PPP Unit which will submit them to the PPP Policy Board. The PPP Policy Board shall decide on pre-approving all, part or none of the new VGF requested by the Agency. In all cases, the PPP Policy Board shall have given its pre-approval decision on new VGF support for a specific project based on the estimate in the PFS before the Government Agency launches a PPP competitive bidding procurement procedure.

5.6 PSF may extend this period if the information or evidence included in the proposal for pre-approval is incomplete, insufficient or unable to be verified and PSF has issued a letter to the Government Agency requesting specific additional information. The decision of the Board shall be based on its assessment of whether:

(i) The PPP project is eligible in accordance with these eligibility criteria;

(ii) The assumptions made about net economic benefits, true cost, cost recovery amounts, affordable tariffs and/or the unitary payment are fair and reasonable; and

(iii) PSF has sufficient uncommitted funds to honor the VGF timing and amount of the disbursements set out in the proposal.

5.7 The PPP policy Board's decision will be communicated to the Agency and will include its calculation of the present value of the VGF support pre-approved for the PPP project.

5.8 In the event PSF subsequently declines new VGF support for specific reasons, Government Agency shall refer the project VGF request through the PPP Unit to the PPP policy Board with the request seeking funds from the existing VGF and providing full details and reasons referenced in Section 4.2 above. The provisions of Sections 5.5, 5.6 and 5.7 shall apply with PPP Unit substituting for PSF an existing VGF substituting for new VGF.

5.9 Prior to release of tender documents, any changes to the existing or new VGF amount from the approved levels shall require the full approval process above.

5.10 Following bid submissions under an open competitive bidding process, if one or more potentially successful bids require higher VGF amount than in assumed in the tender documents due to a deviation from the proposed base structure or for any other reason, the PPP Unit will need to request another approval from PSF (in the case of new VGF) or PPP Unit (in case of existing VGF). PSF or PPP Unit approval shall be required for any increase in VGF above the level assumed in the tender documents.

5.11 PSF (for new VGF) and PPP Unit (for existing VGF) shall review and provide input during negotiations with preferred bidder related to the structuring and usage of VGF, before final approval by the PPP Policy Board on the concession documents (including any VGF agreement).

5.12 The Government Agency shall negotiate, sign and administer detailed agreements with PPP Project Company to provide VGF to PPP Projects. Such agreements shall detail commercial terms and shall carefully define (i) events that would constitute draw stop events for VGF and (ii) detailed VGF Funder rights to share in insurance proceeds vis-à-vis PPP Project Company lenders and shareholders with such rights to be reflected in the project Security Agreement.

5.13 PSF shall apply ADB guidelines specified in the ADB loans to the Government of Pakistan for new VGF funding. This includes (but is not limited to) adherence to an ADB approved Environmental and Social Management System (ESMS), compliance with ADB's anti-corruption policy and ADB's prior written consent for each PPP project proposed to be supported by new VGF (unless and until ADB waives this requirement).