POLICY BRIEF

THE ROLE OF PUBLIC PRIVATE PARTNERSHIPS (PPPS) AS A SUSTAINABLE ALTERNATIVE TO PUBLIC INFRASTRUCTURE INVESTMENTS IN SRI LANKA

Background

Sri Lanka is facing an economic crisis due to mismanagement of its public finances, prominently characterised by unsustainable levels of national debt. A part of this debt stems from borrowing to fund large-scale infrastructure projects between 2006 and 2019, which amounted to USD 12.1 billion or 14% of the country's GDP. These projects are often criticised as being inefficient—"white elephant projects"—due to their high costs, low returns, and minimal benefits to the local population, alongside causing environmental and social harm.

Sri Lanka had lost access to capital markets in 2020 following credit rating downgrades. This worsened following the default on its debt in 2022, making it difficult to secure financing through traditional means such as project bonds, thematic bonds, blended financing, or carbon credits.

After a country defaults on its debt, as Sri Lanka did in 2022, restoring its credit rating is a complex and gradual process. Initially, sovereign credit ratings can be expected to remain very low, typically deep in speculative or "junk" status, due to ongoing risks related to Sri Lanka's economic stability, governance issues, and future debt sustainability, despite restructuring efforts.

Once debt restructuring is successfully concluded, rating agencies may upgrade the country's credit rating to indicate reduced immediate liquidity risks and a more sustainable debt structure. However, these ratings will likely still be relatively low due to ongoing risks and uncertainties.

For instance, ratings could move from default status (such as 'D' or 'SD' - Selective Default) to higher but still speculative grades (such as 'B' or 'CCC'). This indicates that while the country can raise debt, it will be at a high cost. Sri Lanka's current rating as of 2nd Quarter in 2024 is still at a highly speculative grade ('Ca'[1] or 'RD'[2] - Restricted Default).

Thus Sri Lanka has limited options in borrowing internationally to finance public infrastructure but with the budget in deficit and local debt levels also elevated, local financing options are also limited.

Nevertheless, Sri Lanka's need for infrastructure development remains pressing, necessitating the exploration of alternative financing options.

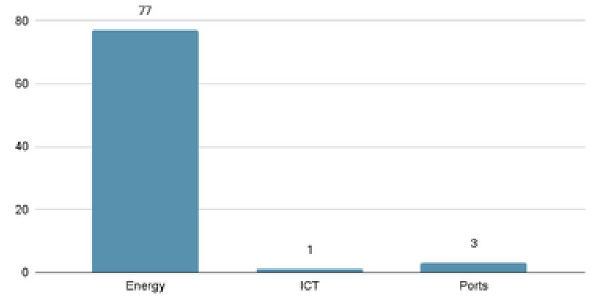
In the 2024 Budget Speech, Sri Lanka's Minister of Finance indicated that Public Private Partnerships (PPPs) will be sought out for the implementation and completion of many infrastructure projects going forward.[3] PPPs involve collaboration between the government and the private sector to invest in and develop public infrastructure. Both parties share responsibilities, risks, resources, and expertise, aiming to deliver services efficiently and generate significant returns. This approach helps reduce the burden on public finances, allows for innovative solutions, and enhances the efficiency of public facilities and services[4,5].

According to the Asian Development Bank's Public Private Partnerships Monitor, between 1990 and 2017 Sri Lanka entered into 81 PPP projects (which have reached financial closure) with a total investment of over $2,671 million. However, these projects were limited to the following sectors: Energy, Ports and ICT (See Figure 1 and Figure 2).

Successful PPPs require thorough analysis of short-term and long-term risks and clear development objectives. A supportive regulatory and institutional framework is essential, providing adequate governance and monitoring mechanisms.[6] In Sri Lanka, however, the potential role of PPPs for sustainable infrastructure investments is often underestimated. Despite being a pioneer in successful PPPs in South Asia during the 1990s (See Box 1), Sri Lanka now faces constraints due to regulatory and institutional weaknesses.

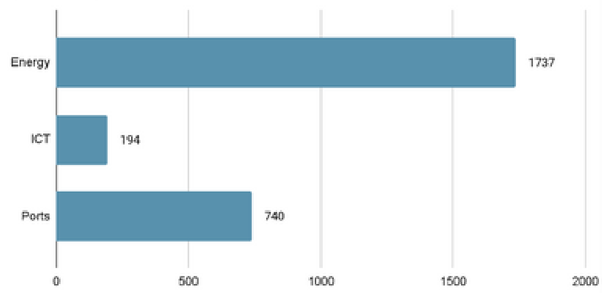
The International Monetary Fund's 2023 Governance Diagnostic Assessment Report highlights that Sri Lanka's PPP process operates independently of the public investment process and is subject to significant discretion by implementing agencies. This policy brief will examine these regulatory and institutional weaknesses and offer recommendations to address them and attract more private investment.

Figure 1: No. of PPP Projects in Sri Lanka by Sector, 1990 - 2017



Source: Public Private Participation Monitor Second Edition – Asian Development Bank (2019)[7]

Figure 2: Investment in PPP Projects by Sector 1990 - 2017 (USD Mn)



Source: Public Private Participation Monitor Second Edition – Asian Development Bank (2019)[8]

Regulatory Weaknesses

Sri Lanka's public infrastructure investment environment is beset by regulatory deficiencies, which not only introduce inefficiencies but also open doors to potential corruption. This section will specifically examine the regulatory obstacles that hinder private sector involvement in infrastructure projects.

- **Weak Compliance with Existing Framework for Project Prioritization:**

Currently, the Department of National Planning receives proposals from line ministries and public entities for infrastructure projects to include in a rolling four-year public investment program (PIP), aligning infrastructure investments with government policy priorities. Projects listed in the PIP are to be included in the national budget, with specified funding sources (e.g., public investments, donor funds, loans, or private investments). Although the current PIP for 2020-2024 has been prepared, most approved and implemented infrastructure projects, including PPPs, do not comply with the PIP.[9]

However, the new Public Finance Management Bill, which includes a section on Public Investment Management, aims to address this issue. If passed, it will legally require compliance with the PIP when infrastructure projects are proposed through public investments or PPPs.

- **Lack of A Clear Legal Framework for PPPs:**

There is no specific law expressly providing for executing PPPs in Sri Lanka. Currently, the Guidelines on Government Tender Procedure Part II for Private Sector Infrastructure Projects (BOO/BOT/BOOT Projects) Revised Edition of January 1998 (hereon referred to as 1998 guidelines for PPPs) serves to guide the procurement and execution of PPPs.

Although the 1998 guidelines for PPPs provide a foundation for PPP projects in Sri Lanka, they are not legally binding and lack details on many important issues. For example, the guidelines do not address land rights, restrictions on foreign investor participation, environmental and social issues, dispute resolution and enforcement mechanisms, or termination and compensation.

Guidance for most of these aspects can be found in various other acts and regulations, including the State Lands Ordinance No. 8 of 1947 (as amended), the Land (Restrictions on Alienation) Act No. 38 of 2014 (as amended), the National Environmental Act No. 47 of 1980 (as amended), the National Involuntary Resettlement Policy of 2001, the National Policy on Payment of Compensation of 2008, the Foreign Exchange Act No. 12 of 2017, and the Companies Act No. 7 of 2007.[10]

It is also silent on state-owned enterprise (SOE) participation in PPP projects, despite SOEs frequently engaging in joint venture arrangements with the private sector, and many such projects reaching financial close.[11]

The guidelines permit unsolicited proposals but require a public call for bids before any decision. However, the cabinet can bypass this rule in "exceptional circumstances," which allows for considerable discretion. In fact, a majority of PPPs in Sri Lanka have come about through unsolicited proposals.[12]

Additionally, the guidelines have been amended multiple times, and no unified, updated version is currently available for public agencies, which can affect the ways in which projects are implemented as PPPs. For example, stakeholders have revealed that there is a general lack of understanding about what constitutes a PPP, which has resulted in many entities pursuing projects as PPPs,

without conducting the necessary feasibility studies to assess its suitability as a PPP project. An official definition of what constitutes a PPP and what does not, was only introduced to public entities through a 2019 amendment to the 1998 guidelines.[13]

However, a new PPP law is reportedly in development, which is expected to address many of these issues.[14]

- **Lack of A Clear Central Authority Overseeing PPPs in Sri Lanka:**

Sri Lanka's PPP implementation framework has undergone multiple changes over the years, and there is no central authority to oversee the selection, approval, procurement, contracting, and quality checking of public infrastructure projects. This process is highly fragmented across multiple government agencies, including line ministries, the Cabinet and the National Agency for Public Private Partnerships (NAPPP).

Recognizing the need for a central authority to oversee PPPs, the World Bank supported the establishment of an official and independent PPP unit, the National Agency for Public Private Partnerships (NAPPP) in July 2017. The NAPPP was tasked with selecting and implementing PPP projects, defining the country's PPP pipeline, and providing guidance to line ministries and agencies as the single facilitation point for all stakeholders.

In 2019, after having identified significant gaps in the legal and implementation framework for PPPs, the NAPPP began significant reforms to the PPP regulations, aiming to introduce improved guidelines aligned with best practices and a comprehensive framework for unsolicited proposals, replacing the 1998 guidelines. However, the NAPPP was shut down in 2020 before these new guidelines could be finalized and released.

In 2022, the NAPPP was re-established by a cabinet decision. President Ranil Wickramasinghe allocated LKR 250 million for its re-establishment in his 2022 Interim Budget Speech, “for the purpose of identifying and facilitating investment to be undertaken in partnership with the public and private sector”. Despite this, stakeholders have reported that the NAPPP currently lacks the expertise and capacity to function as an oversight body for PPPs, instead acting as an advisory board for PPP projects.

This has led to a lot of confusion and discretion left at the line ministry level to decide on which projects to pursue as PPPs or not (including procurement, contract negotiation, risk management etc) while not having the technical capacity to make such decisions.

This has also been what led to project selection on political considerations, with no regard for investment criteria etc. Therefore, it's important to legally empower the PPP unit to act as the central authority for PPPs.

Investors are drawn to the legal certainty provided by dedicated laws and regulations. However, weaknesses in Sri Lanka's PPP legal structure and oversight institutions allow line ministries or departments and private parties to make discretionary decisions during tendering and contract signing. This can result in sub-optimal conditions in the PPP contract which the government will be inclined to agree on, due to the private sector's perception of increased risk arising from weaknesses in the legal framework.[15]

Institutional Weaknesses

It has been established that an absence of a proper regulatory framework has impacted the quality of oversight over public institutions entrusted with handling public infrastructure projects through PPPs. This section will highlight some of the key shortcomings amongst these institutions, which are currently impeding Sri Lanka's ability to secure PPP projects.

- **Lack of Technical Capacity Among Institutions that Facilitate or Execute PPPs**

Currently, there is ad-hoc decision making among public entities that are involved in public infrastructure project provision through PPPs, largely owing to a lack of capacity among these institutions regarding PPPs.

As mentioned previously, due to the lack of legislative provisions, the NAPPP functions only as an advisory board, limiting its influence on PPP decisions, such as on project selection and contract conditions. Additionally, the NAPPP lacks the technical expertise needed to facilitate PPPs effectively. Staff are recruited from existing public service roles, given only ad-hoc training, and expected to handle NAPPP duties alongside their original positions. Institutional capacity needs to be improved not only within the NAPPP but also among line ministry agencies responsible for PPP implementation.

These agencies should include professionals skilled in infrastructure needs, economics or finance, contract management, and financial risk assessment.

As an example, stakeholders have revealed a significant lack of understanding among public entities about what PPPs truly entail. Often, PPPs are mistakenly viewed as "free gifts" from the private sector, when in fact, they can involve substantial financial risks for the government. In a PPP, private entities provide infrastructure (design, build or rehabilitate, finance, maintain, operate, etc.)[16] in exchange for payment. This payment can come from user fees (e.g., tolls) or government payments covering all or part of these fees over the contract duration (i.e., contingent liability[17]). In Sri Lanka, public entities often lack the technical knowledge to foresee the full extent of contingent liabilities or the upfront costs (e.g., providing access roads or water supply to the development site). Consequently, PPPs are approved without considering these liabilities, leading to unanticipated and unbudgeted expenses.

Box 1: Case Study
The Success of Sri Lanka's South Asia Gateway Terminal (SAGT) PPP Project

South Asia Gateway Terminals (SAGT) is a Sri Lankan container terminal operating company jointly owned by John Keells Holdings (JKH) Evergreen Marine Corporation, APM Terminals and Sri Lanka Ports Authority (SLPA). Located at Colombo port's Queen Elizabeth Quay (QEQ), SAGT was the country's first public-private partnership project under the Board of Investment (BOI). Operations began in 1999 under a 30-year BOT concession. SAGT is globally and regionally recognized for its high performance, productivity, and efficiency. The QEQ was an existing port needing expanded container handling capacity and modernization to capitalize on Sri Lanka's strategic position along international shipping routes.

Negotiators successfully closed the deal despite the country facing a civil war. The Bureau of Infrastructure Investment (under the BOI) led negotiations with private entities to develop QEQ into a modern, efficient facility. Although 16 potential investors received RFPs, only a group led by JKH and the global shipping line P&O submitted a bid. Their bid requested a 50-year lease on the terminal for an annual $2 million rental and offered a 7.5% shareholding to the government-owned SLPA. Despite being the sole bidder, the initial financial offer was dismissed in April 1996. By the time the deal was finalized in 1999, the lease term was reduced to 30 years, a royalty for every container handled was secured, and SLPA's stake in the venture was increased to 15%.

The success of SAGT is attributed to achievable goals in converting a purely government-owned project into a PPP, transparent policies, robust regulatory and institutional frameworks, skilled negotiators, and a formerly conducive business environment for attracting private investments in infrastructure projects in Sri Lanka. As the first project of its kind in South Asia, SAGT's success can serve as a model for PPPs in public infrastructure in the country.

There is a lack of understanding about the suitability of infrastructure projects for PPPs. Often, private sector financing via PPPs is sought only when a project cannot secure public funding. There is no requirement to conduct pre-feasibility studies to determine if a project should be financed through private or public funds.[18] As a result, public infrastructure projects are automatically pursued as PPPs without clarity on their suitability as a PPP. Line ministries typically rely on private sector bidders to assess if a project is technically, economically, and financially viable as a PPP, which can create fiscal risks for the government. This reliance gives private entities an unfair advantage in influencing contract terms and the project's nature.

These risks are heightened when private entities submit unsolicited proposals for infrastructure projects. While unsolicited proposals can be beneficial, there should be strict procedures in place to determine their viability. Therefore, it is crucial to conduct thorough analysis by professionals within the line ministries before proceeding with PPPs, especially for unsolicited proposals. This includes identifying fiscal and technical risks through sound feasibility studies, determining risk allocation between the government and private investors, and assessing the project's value for money.

Additionally, essential documents for transparent procurement (e.g., concessional arrangements, financial feasibility reports, environmental and social impact reports) should be prepared prior to approving projects. Doing these will assist the government to make accurate comparisons between proposals received (even unsolicited ones) and determine the best proposal. It will also help to ensure that infrastructure projects pre-identified by line ministries for PPPs are 'bankable' (i.e., that the project will attract private investors).

As such, it is vital to improve the capacity of professionals in the NAPPP and line ministries engaging in project identification, conception, development, and contract management for PPPs. Ensuring this will also facilitate integration between line ministries and higher-level entities like the NAPPP and the Ministry of Finance and will dispel the mistrust between them in a PPP transaction.

- **Lack of Transparency and Credibility Among Institutions Facilitating and Executing PPPs**

The lack of institutional capacity creates disruptions within the system leading to a lack of visibility and accountability in how PPPs are procured, implemented and managed. Decision making in the procurement and implementation of public infrastructure projects for PPPs are biased and largely politicised, jeopardising the allocation of scarce resources especially in the context of fiscal constraints.

As highlighted earlier, there is a lack of compliance with the Public Investment Program (PIP). and a majority of PPP infrastructure projects already implemented in the country have come through unsolicited proposals.
There is currently no way for the public to access up-to-date information on pre-feasibility and feasibility study results, environmental and social impact assessments, evidence of competitive bidding, the number of awarded PPP tenders, bid evaluation reports, final project contract values, project duration, and progress reports for PPP projects. Current regulations do not address these matters. While the Department of Project Management and Monitoring of the Ministry of Finance publishes a quarterly report on mega-scale infrastructure projects, including contractor names, contract values, and durations, this report does not cover PPP projects.

The government recently entered into a PPP with an Indian and Russian firm to manage Mattala International Airport in Hambantota. This airport has been widely regarded as an unsuccessful project due to its low number of flights, environmentally sensitive location, and persistent financial losses.[19] There is no publicly available information on whether a competitive and fair bidding process occurred for this PPP, highlighting a long-standing and continued lack of transparency among entities that execute PPPs.

This lack of transparency in PPP procurement and execution can undermine the credibility of the institutions involved and the country as a whole. When the public and stakeholders cannot access information on PPP projects and therefore are not afforded an opportunity to make critical comments on their procurement and execution, it signals to potential investors that procurement is not competitive and that the investment climate is unfair, especially in the context of the economic crisis which came about due to the mismanagement of funds.

While it is crucial to adhere to meticulous design and uphold transparency throughout all stages of PPP development, it is equally essential[5] to acknowledge that the political climate can significantly influence the feasibility and success of these partnerships.

PPPs thrive when the political environment is conducive to collaboration between public and private sectors, and when stakeholders are receptive to innovative approaches to addressing public needs.

However, political[10] moments are fleeting. They present narrow windows during which ambitious projects, like PPPs, can be realised. Attempting to perfect every aspect of a PPP agreement may result in missed opportunities as political momentum shifts or external circumstances evolve. Therefore, a delicate balance must be struck between crafting comprehensive agreements and capitalising on the right[6] political moment.

Achieving this balance necessitates pragmatism and adaptability. While it is essential to ensure that PPPs are structured to maximise returns and attract private investment, it is equally vital to remain agile and responsive to shifting political dynamics. This may entail streamlining processes, prioritising key elements of agreements, and being prepared to seize opportunities as they arise.

In essence, successful PPP implementation requires more than just meticulous planning; it demands a keen awareness of the political landscape and the ability to act decisively when the moment is ripe. By striking a realistic balance between developing a robust agreement and seizing the political moment, stakeholders can maximise the potential of PPPs to deliver value to both the public and private sectors, advancing shared goals of economic growth and societal development.

Policy Recommendations

A future national infrastructure plan/agenda can include the following reforms to improve public private partnerships in public infrastructure provision in Sri Lanka:

1.Legal and Regulatory Reforms

- Accelerate development and approval of the upcoming PPP law or Act, to provide legal certainty to both public entities and potential investors with regards to PPPs.
- Ensure the new PPP law or Act will address weaknesses in transparency and accountability in the current guidelines in relation to the procurement and implementation of PPPs

1. Require competitive bidding and procurement practices, including the requirement that a minimum duration between issuing Request for Proposals (RFPs) and receiving bids. Exceptions can be provided for (i.e., unsolicited proposals) but under[5] specific conditions which should be[6] detailed.
2. Require financial, legal, environmental and economic pre-feasibility and feasibility studies to be conducted by the NAPPP and the line ministry in charge prior to undertaking a PPP project.
3. Require clear statements of anticipated contingent liability and upfront or indirect costs to the government (i.e., guarantees if any) by PPP professionals in the line ministry, and for such costs to be approved by the Ministry of Finance prior to executing infrastructure projects.
4. Require the inclusion of these contingent liabilities, upfront or indirect costs associated with infrastructure projects in the Annual Budget for the duration of the PPP contract.
5. Provide legal mandate/authority for a dedicated PPP unit (the National Agency for Public Private Partnerships) to operationalize PPPs for infrastructure projects and influence the country's investment decisions in line with international best practices.
6. Outline clear roles and responsibilities of line ministries in relation to the execution of PPP projects (e.g., how to manage the PPP contractual process).
7. Ensure that non-compliance with best practices in relation to the procurement and implementation of PPPs will have legal consequences (e.g., non-competitive procurement practices outside of exceptional grounds)

- Publish the country's Public Investment Program online, to facilitate efficient allocation of private investments for priority projects.
  - The PIP should contain an updated, clearly defined and feasible public infrastructure project pipeline for the medium term, disaggregated by sector and preferred investment type (public investments, pure private investments or PPPs) for potential investors to refer to and match with projects that they have expertise in providing.
  - Ensure compliance (through legal mandate) with the country's Public Investment Program to ensure public entities do not deviate from the list of priority projects, to reduce over-reliance on unsolicited proposals with low returns and benefits and reduce the politicisation of infrastructure project plans.

2.Capacity Building

- Empower the NAPPP through legal provisions to recruit adequate skilled personnel to improve its capacity to oversee PPP infrastructure projects. The NAPPP should comprise professionals who are trained in project financing, can liaise with different government entities, should come from an engineering, finance, banking and legal background, are able to negotiate a good 'deal' within the contracting process with private investors.

- Ensure there are budgetary provisions for the NAPPP to attract and retain such skilled and eligible personnel by hiring them at market rates.
- Ensure there are budgetary provisions or access to multilateral development grants for both the NAPPP and line ministries to operationalize PPPs (conduct the necessary feasibility/pre-feasibility studies, environmental or social impact assessments, calculations of anticipated contingent liabilities to the government etc).
- Empower implementing agencies (line ministries) to have their own PPP units or cells which would liaise with the NAPPP, with professionals trained in economics or finance, have good contract management knowledge, including in overseeing how the private entities are meeting obligations and taking action if obligations fall short or are not met and possess an understanding of associated financial risks with proposed project and PPPs etc.

3.Improving the Investment Environment for PPPs

- Implement measures that will help[5] reduce the cost of investments[6] in order to attract private investments to public infrastructure projects (e.g., implementing tariff exemptions on selected construction materials, providing guarantees against investments being appropriated/expropriated by the government etc.)
- Facilitate PPPs in infrastructure projects in two stages. Firstly, focus on transferring existing government owned assets to PPPs for private entities (local or foreign) to operate and manage (E.g., brownfield projects like Mattala International Airport). Once Sri Lanka's debt restructuring negotiations conclude, and investor confidence improves, PPPs can be sought out for new infrastructure projects (i.e., greenfield projects).

Endnotes

(1).https://www.moodys.com/credit-ratings/Sri-Lanka-Government-of-credit-rating-600023158?cy=asia
(2).price | Demand, Supply & Market Equilibrium Definition | Britannica Money
(3). Budget Speech 2024, Ministry of Finance
<https://www.treasury.gov.lk/api/file/ed037ac8-9727-4292-ae9b-edac08c7a314>
(4).https://ppp.worldbank.org/public-private-partnership/how-ppps-are-financed
(5).https://ratetiger.com/what-is-a-good-hotel-occupancy-rate/
(6).https://www.researchgate.net/publication/248500860_The_length_of_stay_in_tourism
(7).In Sri Lanka, the classification of hotels into distinct categories is presented in a gazette published in 2016. According to this gazette, certain mandatory requirements have to be met in order for a hotel to be classified as a 1,2,3,4 or 5 star hotel (Appendix 2). In addition to these criteria, there are several non-mandatory requirements outlined, each with marks attached to each standard that is met. The cumulative total of these marks helps determine the classification. In accordance with this gazette, a star class hotel is subject to reclassification every three years.
(8).https://www.adb.org/publications/public-private-partnership-monitor-2nd-edition
(9).https://www.imf.org/en/Publications/CR/Issues/2023/09/29/Sri-Lanka-Technical-Assistance-Report-Governance-Diagnostic-Assessment-539804
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(15).https://pdf.usaid.gov/pdf_docs/PA00MB58.pdf
(16).https://ppp.worldbank.org/public-private-partnership/ppp-contract-types-and-terminology
(17).Contingent liabilities are often financed through 'viability gap financing'. This type of financing is often based on public funds or through some variety of debt and is obtained to ensure that the infrastructure user fee rate determined by the private entity is cancelled out or made more affordable to the public using the infrastructure service. I.e., viability gap financing ensures that the project becomes viable.
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(19).https://ceylontoday.lk/2024/04/27/mattala-airport-to-be-managed-by-indian-russian-firms/