Audit of Public Private Partnerships in Central PSUs

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Public Private Partnerships (PPP)

What is a PPP?

A Public-Private Partnership is a contractual agreement between public and private sector partners that allows

- more private sector participation and/or ownership than traditional methods of procurement.
- PPP agreements define an expansive set of relationships from relatively simple contracts to very complicated and technical contracts

Abbreviations in PPP

- **BOLT** Build Operate Lease Transfer
- **BooT** Build Operate Own Transfer
- **Bot** Build Operate Transfer
- **CCEA** Cabinet Committee on Economic Affairs
- **CPSEs** Central Public Sector Enterprises
- **DEA** Department of Economic Affairs
- **EFC** Expenditure Finance Committee
- **GoI** Government of India

Abbreviations in PPP

- **IRR** Internal Rate of Return
- **MCA** Model Concession Agreement
- **NHAI** National Highways Authority of India
- **NHDP** National Highways Development Project
- **PAMD** Project Appraisal and Monitoring Division
- **PIB** Public Investment Board
- **PPP** Public Private Partnership
- **PPPAU** PPP Appraisal Unit
- **RFP** Request for Proposals
- **RFQ** Request for Qualification
- **SFC** Standing Finance Committee

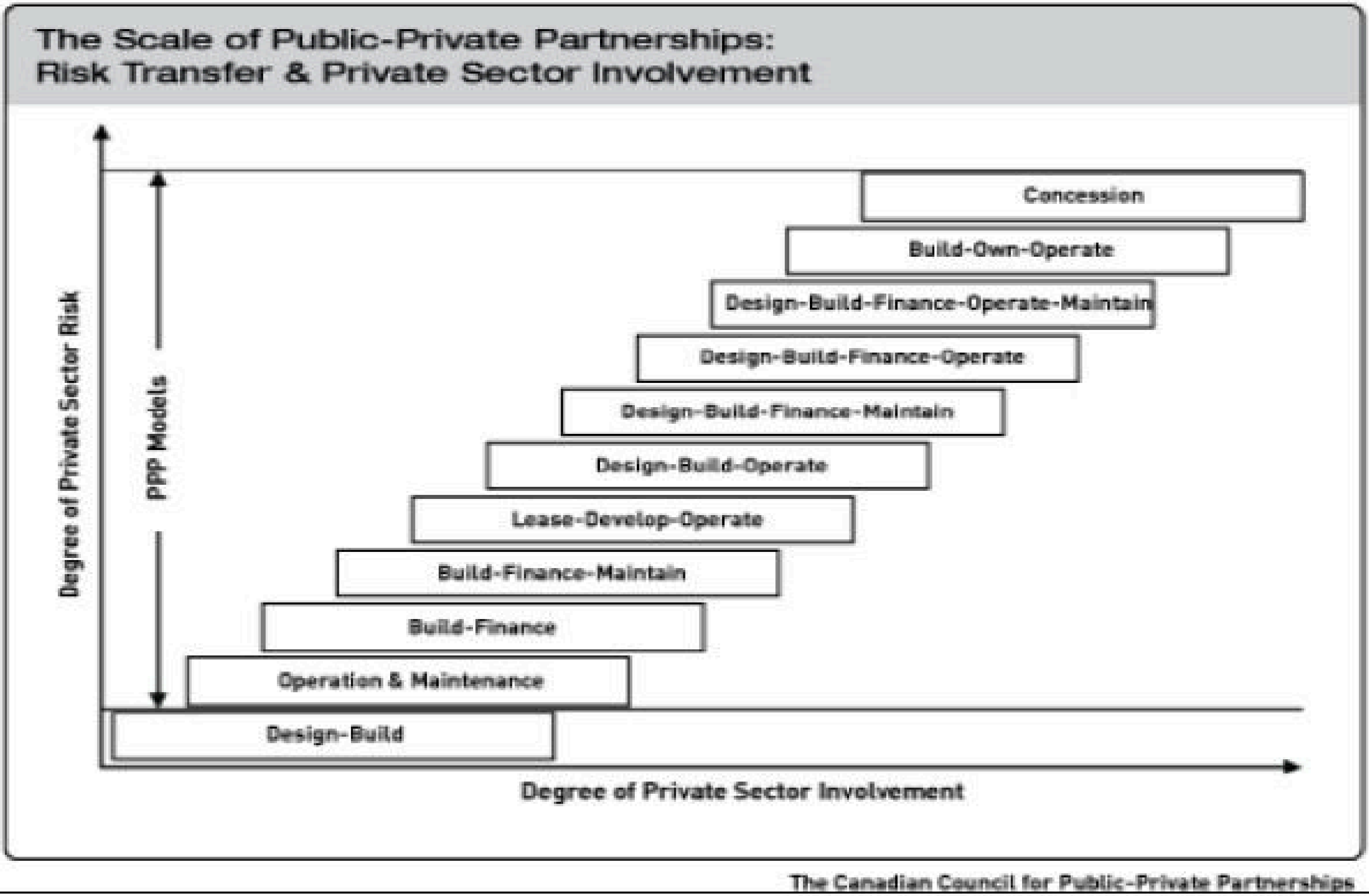

Public - Private
Partnerships

Type of Public Private Partnerships

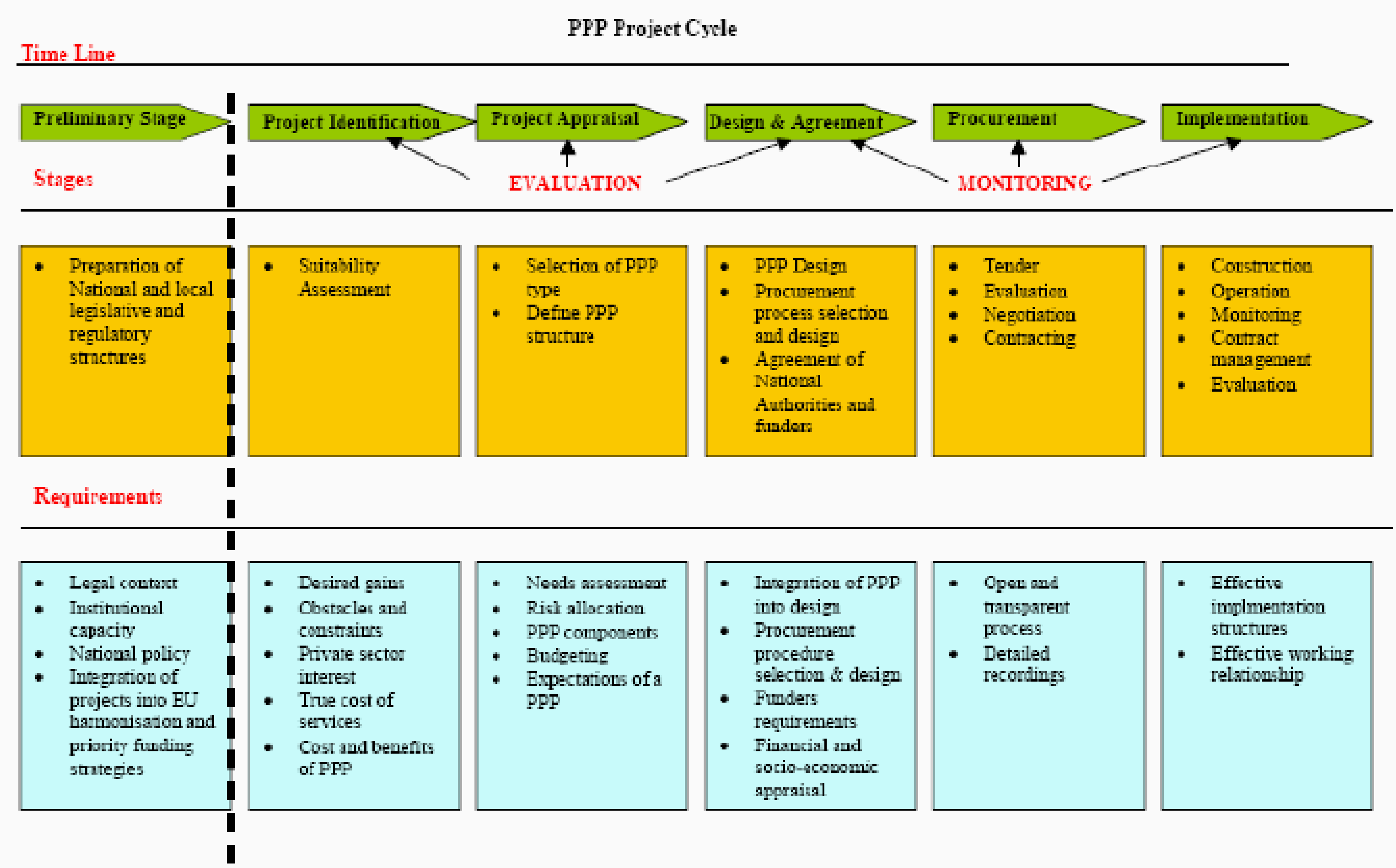
- Joint Ventures
- Franchises
- Concessions
- Privately Financed Investment Projects
- Privatization
- Retaining Minority Shares in Privatized Companies
- Market Testing
- Use of Private Sector Methods in Public Bodies

Types of PPP Projects

Figure 1. The Scale of Public-Private Partnerships



PPP Project Life



Audit Risks in PPP Projects

- Clarity about partnership objectives
- Negotiating an appropriate partnership
- Protecting the state's interests as a minority shareholder
- Monitoring the state's interests in the partnership
- The state's exposure in the event of difficulties

In India, Noida Toll Bridge was the first successful example of a Public Private Partnership in the transportation sector.

The Guidelines for Formulation, Appraisal and Approval of Public Private Partnership Projects (Projects of all sectors costing Rs. 250 crore or more or under NHDP costing Rs. 500 crore or more) **were notified by Ministry of Finance, Department of Economic Affairs, vide OM No. 1/5/2005 - PPP, dated January 12, 2006.**

Guidelines for Formulation, Appraisal and Approval of Public Private Partnership Projects

- (i) Costing greater than Rs. 100 crore but less than Rs. 250 crore for all sectors
- (ii) Costing Rs. 250 crore or more but less than Rs. 500 crore under NHDP

These guidelines have been notified by Ministry of Finance, Department of Economic Affairs vide OM No 10/3/2006-Infra dated July 24, 2007

GOI – PPP Notified Guidelines

- Government of India has notified guidelines for formulation, appraisal and approval of central sector PPP projects
- These guidelines will apply to all PPP projects sponsored by Central Government Ministries or Central Public Sector Undertakings (CPSUs), statutory authorities or other entities under their administrative control.
- The procedure specified herein will apply to all PPP projects with capital costs exceeding Rs. 100 crore or where the underlying assets are valued at a sum greater than Rs. 100 crore.

GOI – PPP Notified Guidelines

- Highlights of the guidelines are as follows
  - Setting up of The Public Private Partnership Appraisal Committee (PPPAC)
  - With the objective to fast track the appraisal and approval of PPP projects of all sectors
  - The sponsoring Ministry will identify the projects to be taken up through PPPs and undertake preparation of feasibility studies, project agreements etc.

GOI – PPP Notified Guidelines

- There could be projects, which involve more than one Ministry/Department. While considering such projects, PPPAC may seek participation of such Ministries/Departments
- Formulation of Project Documents
- Appraisal/Approval of PPPAC
- Invitation of Bids
- Time Frame
- Exemptions from the above procedure - Ministry of Defence, Department of Atomic Energy and Department of Space will not be covered under the purview of these guidelines.

NATIONAL HIGHWAYS

Incentives for Private Sector Participation

- Incentives offered under National Highways
  - Road Sector has been declared as an Industry.
  - 100% tax exemption in any consecutive 10 years out of 20 years.
  - Foreign Direct Investment (FDI) up to 100%.
  - Provision of Capital Subsidy up to 40% of the project cost to make projects viable.

Incentives for Private Sector Participation

- Provision of encumbrance free site for work, i.e. Government bears expenses for land and pre-construction activities.
- Easier external commercial borrowing norms
- Exemption of Capital gains tax for the bonds issued by NHAI.
- Duty free import of high capacity and modern construction equipments.
- NHAI Equity upto 30%.

Benefits to the Government

Potential Advantages to the Government in PPP

- National Highways
  - Encourage private investment in the infrastructure sector.
  - Reducing public direct spending.
  - Public budget could be used in other priority areas and projects, such as education and social programmes.
  - Risks are allocated to the party, which is best suited to handle it.
  - Introduce innovation and increased efficiency from the private sector.

Potential Advantages to the Government in PPP

- Involvement of experienced and creditworthy sponsors and commercial lenders, guaranteeing project viability.
- Tapping of advanced technologies and expertise with possible capacity building of contractors and consultancy firms.
- Development of local capital market.
- Right sizing of public institutions.
- Better road services to users and early delivery

State Support Agreement

- Provide applicable permits to the Concessionaire
- Assist access to infrastructure facilities and utilities
- Erect no barriers to interrupt free flow of traffic
- Assist in regulation of traffic
- Police assistance in the form of Highways Petrol Parties
- Not to undertake any act which violates
- State to pay claims on any breach
- No competing facility within 8 years

A badly prepared document can result in a huge amount of losses. e.g. Turkey power sector PPPs resulted in an estimated loss to the country of US$7 billion per year as a result of badly structured contracts.

Highlights of New MCA

- Partial guarantee of traffic risk to the Concessionaire.
- Concessionaire's interest protected in competing roads.
- Performance standards of the highways clearly spelt out.
- Provision for change in scope, if any, required during construction and operation period included.
- Utilities to be relocated by the Concessionaire but it will be excused from failure in case of delay by owning agencies.

Highlights of New MCA

- Focus on road User's safety
- Users fee charges, revision thereof and concession to local traffic clearly spelt out.
- NHAI has to provide land free from all encumbrances. NHAI to bear cost of all pre-construction activities.
- Risks are allocated to the party, which is best suited to handleit.

Highlights of New MCA

- Lowest subsidy/grant quoted by the bidders towards viability gap funding or earliest premium quoted by the bidder is the basis for award.
- Force Majeureconditions and relief to the party under such conditions clearly spelt out.

Highlights of New MCA

- Strong dispute resolution mechanisms.
- BOT bids are invited for 6 lane with 20 years concession period. However, exist option exists for Concessionaire and the NHAI after 8 years if not interested for 6 laning. In such case, concession shall be terminated after four laning with 12 years concession period.

Institutional Strengthening

- Committee of Infrastructure (COI) headed by PM.
- COS to resolve inter-ministerial issues and problems.
- Restructuring of NHAI to be a multidisciplinary body.
  - Planning, standardization and quality assurance (PSC) cell
  - Project appraisal Group/cell headed by Financial Analyst, and supported by Transport Economist, Transport Planner.
  - Human Resource (HR) cell
- Monitoring cell
- Sensitization to PPP

Role of State Govt. in National Highways BOT Project

- State Support Agreement **Pre-requisite for success of PPP** -
- Land Acquisition
- Utility Shifting –Speedy action
- Forest Clearance
- NOC from State Pollution Control Board
- Development of 2-lane Highways and levy of user fee

PPP
in
Health Care

PPP in Health Care

- The five areas where private sector contribution can prove very beneficial are:
  - 1 Infrastructure Development - Development and strengthening of healthcare infrastructure that is evenly distributed geographically and at all levels of care
  - 2 Management and Operations - Management and operation of healthcare facilities for technical efficiency, operational economy and quality

PPP in Health Care

- 3 Capacity Building and Training - Capacity building for formal, informal and continuing education of professional, para-professional and ancillary staff engaged in the delivery of healthcare
- 4 Financing Mechanism - Creation of voluntary as well as mandated third-party financing mechanisms

PPP in Health Care

- 5 IT Infrastructure - Establishment of national and regional IT backbones and health data repositories for ready access to clinical information
- 6 Materials Management - Development of a maintenance and supply chain for ready availability of serviceable equipment and appliances, and medical supplies and sundries at the point of care

PPP in Indian Railways

PPP in Indian Railways

- BOT is the most preferred model for PPP in IR
- Current Strategy of PPP in Indian Railways
  - Operation of container trains and Construction of Private sidings, ICDs and rail side warehouses
  - Construction of Dedicated Freight Corridor (Delhi-Mumbai and Delhi-Howrah) with a large component of PPP
  - High Speed Corridors
  - World Class Railway Stations, Passenger amenities and Commercial
  - utilization of land

PPP in Indian Railways

- World Class Railway Stations, Passenger amenities and Commercial
- utilization of land
- Pipavav Railway Corporation Limited
- K-RIDE A Joint Venture named K-RIDE (Rail Infrastructure Development (Karnataka) Limited
- The Wagon Investment Scheme (WIS)

PPP in Indian Railways

- Setting up of SPV for manufacturing of locomotives/coaches/wagons
- Parcel Services
- Catering Services, Budget Hotels and Food Plazas

Public Private Partnerships (PPPs) are an innovative way of delivering modern, high quality public services and promoting the country's competitiveness.

Assessment of PPP Model

- Four key principles on which any PPP model must be assessed

1 ***Effectiveness*** or the ability to meet program objectives

2 ***Efficiency*** or the financial efficiency in transfer of ownership and associated risks

3 ***Equity*** or the ability to accrue the benefits of the program to the poor people

4 ***Financial Sustainability*** or financial viability of the model

Features of Service Concession Arrangements

- The grantor is a public sector entity, including a governmental body, or a private sector entity to which the responsibility for the service has been devolved.
- The operator is responsible for at least some of the management of the infrastructure and related services and does not merely act as an agent on behalf of the grantor.

Features of Service Concession Arrangements

- The contract sets the initial prices to be levied by the operator and regulates price revisions over the period of the service arrangement.
- The operator is obliged to hand over the infrastructure to the grantor in a specified condition at the end of the period of the arrangement, for little or no incremental consideration irrespective of which party initially financed it.

Features of Service Concession Arrangements

- There are many different types of concession arrangements that are often specific to each jurisdiction or even in each municipality.
- Therefore, each arrangement should be analysed to determine the appropriate accounting based on the individual facts and circumstances.

Accounting Practice for Service Concession Arrangements

IFRIC 12 applies to a broad range of concession arrangements.

- Road and water treatment concession arrangements are two common examples, but other types of arrangements may meet the scope criteria such as contracts for the:
- provision of transport services;
- construction and operation of waste treatment plants;

Accounting Practice for Service Concession Arrangements

- provision of public airport services;
- construction and maintenance of hospitals;
- generation of renewable energy;
- production of electricity; and
- construction and operation of public transport systems, schools, prisons, etc

Accounting Practice for Service Concession Arrangements

- Revenues and costs of the operator relating to the construction or upgrade services phase of the contract are accounted for in accordance with IAS 11 Construction Contracts [IFRIC 12:14] and the revenue and costs relating to the operating phase are accounted for in accordance with IAS 18 Revenue.
- Where the operator performs more than one service under a single contract or arrangement, the consideration received or receivable is allocated by reference to the relative fair value of services delivered, when the amounts are separately identifiable.[IFRIC 12:13]

Accounting Practice for Service Concession Arrangements

- Where the grantor does not control or regulate what services the operator must provide with the infrastructure, to whom it must provide them, and at what price then such an arrangement is outside the scope of IFRIC 12
- The grantor does not control through ownership, beneficial entitlement or otherwise, any signifi cant residual interest in the infrastructure at the end of the service arrangement – not covered under IFRIC 12

Accounting Practice for Service Concession Arrangements

- Where the operator does not have a contractual right to receive cash or other financial asset from or at the direction of the grantor as described in paragraph 16 of IFRIC – not covered under IFRIC 12
- Where the operator does not have a contractual right to charge users of the public services as described in paragraph 17 – not covered under IFRIC 12

INTOSAI

- The International Organization of Supreme Audit Institutions (INTOSAI) has been engaged, over a long time, in developing comprehensive guidelines for the audit of PPP Projects.
- INTOSAI had issued its PPP Auditing Guidelines in 2001

Guideline

for

Audit of Public Private Partnership Projects

issued by

Comptroller and Auditor General of India

In

2009

Scope of Public Private Partnership Audit

- The scope of the public audit will include
  - a verification of the PPP arrangement
  - to ensure that the public sector agency
  - has effectively put in place a sound system
  - to oversee the efficiency and competence of the project implementation
  - including construction, quality management, compliance with contractual conditions, and integrity of the provision of the targeted public service strictly in terms of the established norms and contract conditions.

Scope of Public Private Partnership Audit

- It will also include
  - Actual volume of demand (viz., traffic) and revenue generation (including from commercial developments) against the projected flow and the arrangements to monitor the trend periodically.
  - System to verify the accuracy and reliability of reporting the results.

Scope of Public Private Partnership Audit

- Economy in the cost of operations and avoiding "padding" of costs, revenue sharing arrangements.
- Need to re-adjust the contract period in case the Rate of Return (ROR) is higher than what was projected.
- Quality and consistency of service at affordable cost to the users at large etc.
- Any other related issues which may be project specific.

Objectives of PPP Audit

- The objective is to
  - provide unbiased, objective assessment of whether public resources are responsibly and effectively managed
  - to achieve the intended results.
  - Auditors, through their evaluation, (should) help the government organizations achieve accountability and integrity, improve operations, and instill confidence among citizens and stakeholders.

Objectives of PPP Audit

- Public auditors' role supports the governance responsibilities of oversight, insight, and foresight.
- Oversight addresses whether government entities are doing what they are supposed to do and serves to detect and deter public corruption.
- Insight assists decision makers by providing an independent assessment of government programmes, policies, operations and results.
- Foresight identifies trends and emerging challenges'

Types of Documents to be Audited

- *Documents regarding the project formulation, appraisal and approval, available with the nodal ministry, promoting agency.*
- *Data and documents relating to the contract documents and concession award originated by and available with the public sector partner*
- *Data and documents furnished to the public sector partner by the private contractor and available with the former for verification.*

Types of Documents to be Audited

- *Reports submitted by the Independent Engineers and Independent Auditors*

Public Auditor

- The public auditor shall have to confine his audit to the data, records and documents in the possession of the government department, PSU or autonomous body which is the public sector partner of the PPP arrangement, and rely on it for additional information, as is required to fulfill his tasks.

Public Auditor

- Audit required under Section 20 of the Comptroller & Auditor General's (DPC) Act, 1971 is an exception

  "the President or the Governor may entrust the audit of accounts of any body or authority, the audit of which has *not* been entrusted to the CAG by or under any law, after consultation with the former, and on such terms and conditions that may be mutually agreed upon."

International Auditing Standards and Guidelines for the Audit of PPP Projects

- Highlights of the INTOSAI Guidelines are as follows
  - The need to examine the status of internal controls in the public bodies that enter into PPPs
  - The need to carry out audit tests to evaluate systems and procedures and management of performance indicators
  - Verification of the strategic plan setting out the objectives for the PPP

International Auditing Standards and Guidelines for the Audit of PPP Projects

- Whether advisers were appointed after adequate scrutiny, whether their compensation is linked to performance
- Examination of guarantees and assurances, generation of adequate competition, contractual clauses, sharing of surplus revenues etc
- Use of a portfolio of performance measures to evaluate the partnership, both financial and qualitative, including customer satisfaction levels, cash flow pattern, and other norms.

International Auditing Standards and Guidelines for the Audit of PPP Projects

- Whether a range of vehicles have been considered and a structure which best suits the public interests has been selected after reviewing the actual cash flow and sustainability through adequate Return on Investment (ROI).
- Whether third party reviews were undertaken before finalizing the partnerships
- Whether cost benefit analysis was carried out carefully, and contractual payments, if any, linked to milestones

International Auditing Standards and Guidelines for the Audit of PPP Projects

- System to receive regular information and returns on partner's performance and obligations.

PPP Audit and Performance Audit

- There are several things in common between PPP audit and performance audit
- It is important to keep in mind the relevant guidelines established in the SAI-India's Performance Auditing Guidelines when planning the audit of PPP projects.

A PPP partnership

involves several risks,

and

a balanced sharing of these risks

between the public and private sector partners

is essential for its

enduring success.

Major Risks associated with PPP Projects

- ***Feasibility / Organizational Risk***
- ***Condition Precedent Risks***
- ***Financing Risk***
- ***Construction Risk***
- ***Operation and Maintenance Risk***
- ***Demand Risk***
- ***Revenue Risks***
- ***Risk from unforeseen developments***
- ***Termination Risk***
- ***Residual Value Risk***

Stages in PPP Audit

i) Collection of Data and Information on PPP Projects

ii) Selection of PPP Projects for Audit

iii) Preparation of the Audit Plan

iv) Seeking the Cooperation of the Private Participant / Public agencies party to the PPP arrangements

v) Engaging External Experts

Audit Methodology

- Detailed scrutiny of project documents starting from the conceptual stage to the formulation and approval stage.
- Verifying the legal and contractual obligations arising from the several contracts and agreements entered into between the parties.
- Review of financial modeling to test the feasibility and justifications for the grant of concessions, testing revenue generation using quantitative techniques.
- Assessment of the transparency and integrity of the bidding process.

Audit Methodology

- Financial audit to verify the justification for the viability gap funding / annuity payments.
- Limited audit of the construction and engineering to verify quality, innovations, economy and efficiency.
- Quality test, where necessary, to ensure the adherence to specifications and compliance with standards.

Audit Methodology

- Engaging experts to test aspects of quality and standards, if required.
- Survey to test the accuracy of demands and revenue collections against projections.
- Customer satisfaction level analysis through sampling techniques.
- To check the actual revenue generation and sharing.
- To ensure safeguarding the value of public money.

Audit of Concessions and Concession Period

- Review of the concession granted to the concessionaire in terms of the *quantum and the period* of the concession.
- The critical issue before the auditors is to verify the reasonableness of the concessions granted, including the magnitude and the period of the concession.

Audit of Risk Allocation

- A major characteristic of the PPP arrangement is the balanced and fair allocation of risks between the partners.
- The underlying principle of risk allocation is that they are allocated to the parties that are best suited to manage them
- Few audit questions are as follows
  - Does the Concession Agreement identify the project risks

Audit of Risk Allocation

- Who is entrusted with the financing risk?
- What are the guarantees and assurances granted by the government / public sector partner?
- Who bears the political and economic risks like change of government policy or a sudden economic downturn?
- What are the revenue risks identified in the Agreement?
- What is the extent of the risk of the private partner failing in his obligations?

PPP Audit

- A PPP audit involves the following
  - **Audit of Public Private Partnership Projects:A Sequential Approach**
  - **Audit of Concessions and Concession Period**
  - **Audit of Risk Allocation**
  - **Audit of Financing Risks**
  - **Audit of Viability Gap Funding (VGF)**
  - **Audit of Tariff / Toll / User charges**

PPP Audit

- Audit of Total Project Cost
- Audit of Bidding and Evaluation
- Audit of Construction of the Project
- Audit of Monitoring of the Project Construction Activities
- Audit of Commercial Development
- Audit of Operation, Maintenance & Development and the Collection of Revenue
- Auditing Public Private Partnerships for Value for Money Evaluation
- Audit of Valuation of Assets

PPP Audit Report

- The contents of an audit report should be easy to understand, free from ambiguity and supported by sufficient, competent and relevantaudit evidence, and be independent, objective fair, complete, accurate, constructive and concise.
- The major findings arising from the audit should be, as is the usual practice, presented at the Exit Conference.

About the Author

- *CA. Rajkumar S Adukia is an eminent business consultant, academician, writer, and speaker. He is the senior partner of Adukia & Associates.*

- *In addition to being a Chartered Accountant, Company Secretary, Cost Accountant, MBA, Dip IFR (UK), Mr. Adukia also holds a Degree in Law and Diploma in Labor Laws and IPR.*

- *Mr. Adukia, a rank holder from Bombay University completed the Chartered Accountancy examination with 1st Rank in Inter CA & 6th Rank in Final CA, and 3rd Rank in Final Cost Accountancy Course in 1983.*

- *He started his practice as a Chartered Accountant on 1st July 1983, in the three decades following which he left no stone unturned, be it academic expertise or professional development.*

About the Author

- *He has been coordinating with various Professional Institutions, Associations, Universities, University Grants Commission and other Educational Institutions.*

- *Authored more than 50 books on a vast range of topics including Internal Audit, Bank Audit, SEZ, CARO, PMLA, Anti-dumping, Income Tax Search, Survey and Seizure, IFRS, LLP, Labour Laws, Real estate, ERM, Inbound and Outbound Investments, Green Audit etc.*

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Thank You