



# Public Private Partnerships (PPP)

in

# Infrastructure Projects

# Public Auditing Guidelines

Comptroller and Auditor General of India

2009

**PUBLIC PRIVATE PARTNERSHIPS (PPP)**

**IN**

**INFRASTRUCTURE PROJECTS**

**PUBLIC AUDITING GUIDELINES**



सत्यमेव जयते

**COMPTROLLER & AUDITOR GENERAL OF INDIA**

**2009**



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## *Foreword*

Creation of durable and high quality infrastructure is a prerequisite for rapid economic development and requires sustained investment supported well by technological innovation, skilled workforce and excellent project management. For governments alone to bring together all these elements is not always possible. This realization has brought together the public and the private sector in a mutually beneficial relationship in the form of Public Private Partnerships (PPPs) to execute not only infrastructure projects but also engender innovative strategies for social development.

PPPs, while bringing in private capital and experience, also involve transfer of valuable public assets as well as foregoing future revenues in the form of concessions. To ensure that such arrangements always enjoy high credibility in the public eye, due diligence, transparency, objectivity and probity of the entire decision making process are all paramount if these arrangements are to succeed and continue for future projects. The role of public auditors, therefore, becomes critical in assessing whether such arrangements are truly in public interest and are also fair and balanced in sharing of risks as well as rewards. Audit of such entities poses a huge challenge and requires a change in the audit methodology as also the approach of public auditors. The audit while promoting accountability should not discourage private sector involvement, investment and innovative management techniques.

To meet this objective, it has been felt necessary to bring out a Guideline for audit of Public Private Partnership Projects that at once reflects the best practices world over and yet is rooted in our experience of auditing government operations over the years. As PPP mode of financing in creation of public infrastructure is gaining momentum in India, timeliness of these Guidelines cannot be disputed. This concern was felt by the Prime Minister himself while addressing the Accountants General Conference in 2008 when he stated that “Public Private Partnership Projects are becoming increasingly common in key infrastructure sectors of transport, power, urban infrastructure, tourism and railways. Audit needs new skills to evaluate these complex arrangements”.

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The Guidelines have been primarily framed for use by the officers and staff of the Indian Audit & Accounts Department. It is expected that these Guidelines will provide a logical framework in auditing the projects under PPP arrangements and help auditors in determining whether Government and other public authorities have got the best possible deal.

I hope that the officers and staff of the department would find the Guidelines very useful and practical. The Guidelines will indeed need to be continuously updated and revised based on the experience gained in future.

20 October, 2009  
New Delhi



(Vinod Rai)  
Comptroller and Auditor General of India

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## *Preface*

Public Private Partnerships (PPP) implies the coming together of two dominant but divergent sectors of the economy, each with different prescriptions and objectives, for the overall development of the community. Public Private Partnerships have emerged as one of the latest and successful instruments of public finance, and are increasingly adopted by both developed and developing countries for building and rebuilding their infrastructure framework. The Eleventh Five Year Plan accords high priority to PPP projects both in the Central and States' Plan initiatives in the endeavor to overcome the yawning infrastructure deficits that face the country.

The basic intent of PPP is to encourage the private sector to dedicate its capacity to raise capital and the ability to complete projects on time and to budget for the welfare of the community, without having to compromise the profit motive. At the same time, the public sector would retain its responsibility to provide goods and services to the public at large at affordable rates. This arrangement, indeed, calls for a judicious approach to decision making and underscores the need for a framework that enables the private sector partner to make reasonable returns on investments without diluting the standards and quality of services provided. The key to the success of PPP projects is a balanced and fair sharing of risks and benefits between the partners, and transparency and accountability in all transactions relating to the award and management of the contract.

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. In pursuance, INTOSAI had issued its PPP Auditing Guidelines in 2001, followed by certain comprehensive recommendations based on the findings of a dedicated workshop on PPP Audit in 2007. These are indeed valuable and are followed by members of INTOSAI. However, the need to develop a set of guidelines customized to the requirements of public sector auditors in India particularly those authorized to carry out audits under the mandate of and powers vested in the Comptroller & Auditor General of India has been keenly felt in the recent years. These Guidelines are the outcome of the efforts made in that direction.

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These Guidelines are comprehensive and cover various aspects of PPP contracts and management, as they are conceptualized and developed in India. The Guidelines have been fashioned to test the transparency, accountability, and value for money aspects of the PPP project activities as also compliance with the norms and procedures established by the Government of India and the Planning Commission. As regards the regulatory issues in a PPP Project, the audit guidelines on Performance Audit of Regulatory Bodies shall apply. It is expected that staff and senior officers of the IA&AD who are responsible for carrying out public sector audits in India in accordance with the mandate and powers of the Comptroller & Auditor General of India<sup>1</sup> would find the clarifications and explanations relating to the various stages and aspects of PPPs and the audit criteria included in these Guidelines very useful and practical.

Like all such documents, these Guidelines also have to be seen as a ‘living document’, and would need periodical updating and modifications. Meanwhile, public auditors who are employed on this challenging and emerging area of audit may use the guidance provided in the Guidelines as a reference manual to fine-tune their work.

Care has been taken to avoid mistakes and errors in the Guidelines. However, if any such instance has unfortunately crept in, they may be brought to notice for rectification in the next edition. Suggestions for the improvement may also be sent to the Director General (Audit), Office of the CAG of India.

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<sup>1</sup> *In various chapters of this Guideline the expression public sector auditor will refer exclusively to the officers & staff carrying out audit work under the mandate and powers vested in the Comptroller & Auditor General of India*

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## SECTION I

# *Public Private Partnership (PPP): An Overview*

## Public Private Partnerships (PPP) in Infrastructure Projects

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## 1.1 Introduction

**1.1.1** Public Private Partnerships offer a unique and innovative method of involving the private sector in the nation building activity and in accelerating the delivery of public goods and services of high quality through joint enterprises, without spreading the limited available resources too thin. The Eleventh Five Year Plan has estimated that in order to sustain the envisaged high annual growth rate, the investments in the infrastructure sector will have to be of massive proportions<sup>2</sup>. It would be impossible for the public sector to meet such huge commitments in view of its limited capability for additional capital mobilization. The anticipated shortfall of at least 30 percent of the estimated total plan requirements<sup>3</sup>, which itself will be of a huge magnitude will have to be met by seeking active private sector involvement in the development of the infrastructure sector. Public Private Partnership (PPP) will be an attractive option in meeting this challenge.

**1.1.2** Private sector participation in infrastructure development is not, however, a simple matter. It requires a framework that can enable the private sector to secure a reasonable return at manageable risk, assure the user of adequate service quality at an affordable cost, and facilitate the Government in procuring value for public money. These conditions are more difficult to fulfill than is commonly realized. Because of multiple stakeholders pursuing conflicting interests, risk mitigation arrangements are usually complex. Inadequate preparatory work in relation to the framework for PPP projects, identification of projects, selection of private participants, preparation of strategic plan and project reports, drafting of contracts and other associated activities will only lead to excessive transaction costs, years of delay in project implementation, inadequate quality, and large contingent liabilities to the Government<sup>4</sup>. A project beset with such problems even after completion can get enmeshed in a high cost low demand syndrome.

**1.1.3** A number of questions arise in the context of the audit of PPP projects. The Comptroller and Auditor General of India (CAG) has already taken up the audit of a few PPP projects implemented by the National Highway Authority of India (NHAI) as also a few projects undertaken by State Governments. These audits were mainly based on the

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2 Estimated in the 11<sup>th</sup> Plan document at US \$494 billion at 2006-07 prices and a projected GDP growth rate of 9 %

3 Investments in Infrastructure during the Eleventh Plan; The Secretariat for the Committee on Infrastructure; Planning Commission (October, 2007).

4 Montek Singh Ahluwalia, Deputy Chairman, Planning Commission, Foreword to PPP in National Highways, Model Concession Agreement, November, 2005.

guidelines issued by the International Organization of Supreme Audit Institutions (INTOSAI), among others. Since then, the need to develop a set of guidelines specifically adapted to Indian conditions has been keenly felt. Framed in the above context these guidelines are aimed at providing the required guidance in the audit of PPP projects especially in the infrastructure sector, to the public sector auditor.

## 1.2 What are Public Private Partnerships?

**1.2.1** Several definitions and explanations are readily available to clarify Public Private Partnerships (PPPs). United Nations<sup>5</sup> defines public private partnerships as “*innovative methods used by the public sector to contract with the private sector who bring their capital and their ability to deliver projects on time and to budget, while the public sector retains the responsibility to provide these services to the public in a way that benefits the public and delivers economic development and improvement in the quality of life*”. According to the UN, Public Private Partnerships which aim at financing, designing, implementing and operating public sector facilities and services will have three main characteristics, namely,

- a) Long term (sometimes up to 30 years) service provisions;
- b) The transfer of risks to the private sector; and,
- c) Different forms of long-term contracts drawn up between legal entities and public authorities.

**1.2.2** In a paper titled “*Managing Public Private Partnership*”<sup>6</sup>, the World Bank describes PPPs as “*long-term arrangements in which the governments purchases services under a contract either directly or by subsidizing supplies to consumers. In other PPPs, the government bears substantial risks - for example, by guaranteeing revenue or returns, - on projects that sell directly to consumers*”. According to the Secretariat for the Committee on Infrastructure, Government of India, a “*Public Private Partnership (PPP) Project means a project based on a contract or concession agreement between a Government or statutory entity on the one side and a private sector company on the other side, for delivering an infrastructure service on payment of user charges*”.

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5 Guidelines on Promoting Good Governance in Public Private Partnerships (UN-2006) : United Nations Economic Commission for Europe.

6 Marc Dutz, Clive Harris, Inderjit Dhingra and Chris Shugart

**1.2.3** The South African Law<sup>7</sup> on the other hand defines PPP as a contract between a public sector institution / municipality and a private party, in which the private party assumes substantial financial and technical risks in the design, financing, building and operation of a project.

**1.2.4** In most cases PPPs combine the best of both worlds: the private sector with its resources, management skills and technology and the public sector with its regulatory actions and protection of the public interest.

**1.2.5** The concept of PPPs is of recent origin and started with the initiative of the Conservative Government in the United Kingdom under Prime Minister Margaret Thatcher, who actively promoted what is known as ‘Private Finance Initiative’ (PFI)<sup>8</sup>. The idea was to make private contractors meet the cost of constructions awarded to them in return for the public authorities agreeing to rent back the finished projects to provide public services. This enabled the government to build additional social facilities such as schools, hospitals, reformatories etc., without resorting to additional resources mobilization while the private sector retained gains and savings arising from designs and project management and also received from the government agency regular rents for the facilities. Though the arrangement seemed to benefit both sides, there were criticisms that the government was just “mortgaging the future” and there were apprehensions that the long term cost of paying the private sector to run these schemes was more than it would cost the public sector to build them on its own.

**1.2.6** Unlike in the case of PFIs, PPPs are projects jointly undertaken by governments, public sector bodies and entities with private sector partners to provide infrastructure services of the required / improved quality to the public and consumers at large and involves balanced sharing of the risks and benefits. In PPPs, the private sector invariably brings in the necessary finance to build the projects, undertakes designs and construction as also operation and maintenance, in return for the public sector either transferring its right to collect user charges, levies or tolls or pays compensation in accordance with an agreed pattern by way of viability gap funding, annuity or annual charges, based on certain pre-determined norms and principles.<sup>9</sup> There could be different types of PPPs as

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7 South African Finance Act, 1976

8 Some examples are Thames Crossing, Birmingham Relief Road, several hospitals under National Health Scheme (NHS) etc.

9 In certain situations where the viability of a project is high the private sector partner may be willing to share the upside of the revenue with the Government / any other public sector partner



discussed in paragraph 1.3 below; but they all will have the following ingredients, which may be kept in view:

- i) government departments or agencies and bodies and entities under them on the one part and selected private sector parties on the other will enter into valid and legal contracts;
- ii) partnership between the two will be to provide long term public services (and/or goods) of required quality;
- iii) the public sector will, while transferring the responsibility to design, construct and/or operate the project to the private sector, retain the overall responsibility to provide the public service;
- iv) the private sector will bring in the required finance either fully or substantially to complete the project and to operate it, with the public sector providing right to revenue likely guarantees to financiers or viability gap funding / annuity in appropriate cases;
- v) the public sector will assign the right to collect revenues arising from the project to the private sector for a defined period based on demand projections, or pay grants or annuity and/ or agree to share any surplus, subject to a balanced sharing of the risks and gains;
- vi) value for money will be the basic criterion for the public sector to enter into the arrangement.

**1.2.7** According to the ‘Guidelines for Formulation, Appraisal and Approval of PPP Projects’, issued by the Secretariat of the Committee on Infrastructure, Planning Commission, “predictability and risk mitigation are key to successful PPPs. Unlike private projects where prices are generally determined competitively and government resources are not involved, PPP infrastructure projects *typically involve transfer of public assets, delegation of government authority for recovery of user charges, private control of monopolistic services and sharing of risks and contingent liabilities by the government.* Protection of user interests and the need to secure value for public money, as such, demand a more rigorous treatment of these projects”<sup>10</sup>.

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<sup>10</sup> Gajendra Haldea, Secretariat for the Committee on Infrastructure.

### 1.3 What Are the Types of PPPs?

**1.3.1** Broadly, PPPs could be categorized into *Institutionalized PPPs* and *Contractual PPPs*. Institutional PPPs are usually a joint venture (JV) between public and private sector stakeholders to carry out PPP projects by sharing the risks and to provide public services on a long term basis. The Noida Toll Bridge Company (NTBC) and the Bangalore International Airport Limited (BIAL) are examples of this kind. On the other hand, contractual PPPs fall under the concession model, in which case a facility is given by the public sector unit concerned to a private sector partner which usually designs, constructs and operates the PPP project for a given period of time. In some cases, the operation of a facility may be contracted out to another private party. Under both the categories the users pay for the facility availed and such charges accrue to the JV or the private sector partner.

**1.3.2** The usually adopted PPP models are as indicated in the table below :-

<b><i>Build, Operate and Transfer (BOT)</i></b>	Under this category, the private partner is responsible to design, build, operate (during the contracted period) and transfer back the facility to the public sector. The private sector partner is expected to bring the finance for the project and take the responsibility to construct and maintain it. The public sector will either pay a rent for using the facility or allow it to collect revenue from the users. The national highway projects contracted out by NHAI under PPP mode is an example.
<b><i>Lease, Operate and Transfer (LOT)</i></b>	As the name indicates, under this type of PPPs, a facility which already exists and is under operation, is entrusted to the private sector partner for efficient operation, subject to the terms and conditions decided by mutual agreement. The contract will be for a given but sufficiently long period and the asset will be transferred back to the government at the end of the contract. Leasing a school building or a hospital to the private sector along with the staff and all facilities by entrusting the management and control, subject to pre-determined conditions could come under this category.

***Build, Own, Operate (BOO) or Build, Own, Operate and Transfer (BOOT)***

This is a variation of the BOT model, except that the ownership of the newly built facility will rest with the private party during the period of contract. This will result in the transfer of most of the risks related to planning, design, construction and operation of the project to the private partner. The public sector partner will however contract to ‘purchase’ the goods and services produced by the project on mutually agreed terms and conditions. In the latter case (BOOT), however, the facility / project built under PPP will be transferred back to the government department or agency at the end of the contract period, generally at the residual value and after the private partner recovers its investment and reasonable return agreed to as per the contract.

***Design, Build, Finance and Operate (DBFO) or Design, Build, Finance, Operate and Maintain (DBFOM)***

These are other variations of PPP and as the nomenclatures highlight, the private party assumes the entire responsibility for the design, construct, finance, and operate or operate and maintain the project for the period of concession. These are also referred to as “Concessions”<sup>11</sup>. The private participant to the project will recover its investment and return on investments (ROI) through the concessions granted or through annuity payments etc. It may be noted that most of the project risks related to the design, financing and construction would stand transferred to the private partner. The public sector may provide guarantees to financing agencies, help with the acquisition of land and assist to obtain statutory and environmental clearances and approvals and also assure a reasonable return as per established norms or industry practice etc., throughout the period of concession.

***Operations Concession***

This is a generic term, used to clarify the essential features of PPP arrangements. The PPP agreements which authorize the private partner to recover its investments and expected returns

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<sup>11</sup> The term concession is used rather loosely to describe generically the various types of PPP arrangements as most of these bestow on the private sector partner the right to collect and keep in full or part the project revenue over a specified period called ‘Concession Period’.

on investments through concessions granted for a certain period, computed on the basis of demand projections and growth, are called operations concession (OC). In these cases, the public sector (department or agency) which is responsible to provide the service to the public and collect revenue by way of user charges, toll, tariff etc., assigns its legal or statutory right to the private partner in return for the latter undertaking the responsibility to implement the project and maintain the required quality. The concession may be by collecting tolls and user charges or by the public sector making periodical payments of annuities or monthly / quarterly/ half-yearly charges on certain assumed basis, like shadow tolls etc.

***Joint Ventures***

In a PPP arrangement commonly followed in our country (such as for airport development), the private sector body is encouraged to form a joint venture company (JVC) along with the participating public sector agency with the latter holding only minority shares. The private sector body will be responsible for the design, construction and management of the operations targeted for the PPP and will also bring in most of the investment requirements. The public sector partner's contribution will be by way of fixed assets at a pre-determined value, whether it is land, buildings or facilities and /or it may contribute to the shareholding capital. It may also provide assurances and guarantees required by the private partner to raise funds and to ensure smooth construction and operation. The public service for which the joint venture is established will be provided by the entity on certain pre-set conditions and subject to the required quality parameters and specifications. Examples are international airports (Hyderabad and Bangalore), ports etc.

**1.3.3** The Government of India, Ministry of Finance, Department of Expenditure in July 2009<sup>12</sup> have issued Guidelines for establishment of Joint Venture Companies in infrastructure sector at Union Government level. Public auditors while auditing the PPP Joint Ventures of the State Governments should treat these guidelines as the best practice where the State Governments have not brought out such guidelines.

**1.3.4** All the PPP models described above may not be absolutely distinct from one another. In fact different PPP models may have overlapping features. What, however, distinguishes each type of PPP model from one another is the degree of risk and responsibility borne by the private sector partner as shown in the Chart A below:

**CHART- A**

**{Degree and Involvement of Private Sector in service Concession Agreements<sup>13</sup>}**

<b>Degree Of Private Sector Risks And Responsibility</b>	10. Privatization
	9. Build, Own, Operate.
	8. Build, Own, Operate, Transfer
	7. Design, Build, Finance, Operate
	6. Design, Build, Operate, Maintain
	5. Operations Concessions
	4. Design, Build
	3. Management Contracts
	2. Service Contracts
	1. Government Directly Providing the Public Service
<b>Degree of Private Sector Involvement</b>	

**1.3.5** To better appreciate the pre-requisites, the objectives, responsibilities and risk sharing arrangements under each variant of PPP, please see Charts B, C and D below.

<sup>12</sup> The Government of India, Ministry of Finance, Department of Expenditure vide OM No.24(24)/PF-II/2009 dated 21<sup>st</sup> July 2009 have laid down a clear set of Guidelines for establishment of Joint Venture Companies in infrastructure sector. Under these guidelines, issues of conflict of interest, accountability of public sector entity, extent of government shareholding, selection of JV partner, chairmanship of JV, evaluation of assets, appraisal and approval process, exit and termination of the JV have been covered. These guidelines have been reproduced at Annexure V of this volume.

<sup>13</sup> International Federation of Accountants (IFAC): Accounting and Financial Reporting for Service Concession Agreements; 2008

Chart 'B'

### Mapping PPP Options to Prerequisites

Option	Requirement			
	Political Commitment	Cost-covering Tariffs	Regulatory Framework	Good Information
<i>Service contract</i>	Low	Low	Low	Low
<i>Management contract</i>	Moderate	Moderate	Moderate	Low
<i>Lease</i>	Moderate	High	High	High
<i>BOT</i>	Moderate	High	High	High
<i>Concession</i>	High	High	High	High

Chart 'C'

### Mapping PPP Options to Objectives

Option	Objective				
	Technical Expertise	Managing Expertise	Operating Efficiency	Investment in Bulk	Investment in Distribution
<i>Service contract</i>	Yes	No	Some	No	No
<i>Management contract</i>	Yes	Yes	Some	No	No
<i>Lease</i>	Yes	Yes	Yes	No	No
<i>BOT</i>	Yes	Some	Some	Yes	No
<i>Concession</i>	Yes	Yes	Yes	Yes	Yes

Chart 'D'

### PPP Options - Summarised

Mode	Asset Ownership	O&M	Capital Investment	Commercial Risk	Duration (Years)
<i>Service contract</i>	Public	Public and Private	Public	Public	1-2
<i>Management contract</i>	Public	Private	Public	Public	3-5
<i>Lease</i>	Public	Private	Public	Shared	8-15
<i>Concession</i>	Public	Private	Private	Private	25-30
<i>BOT / BOO</i>	Private and Public	Private	Private	Private	20-30
<i>Divestiture</i>	Private and Public	Private	Private	Private	Indefinite

## 1.4 Public Private Partnerships (PPP) and Private Finance Initiative (PFI) / Procurement of Goods and Services

**1.4.1** Apart from being distinguished from Private Finance Initiative (PFI) (see para 1.2.5) PPPs, have also to be differentiated from procurement of goods and services from the private sector providers as well as privatization and market testing.

**1.4.2** Unlike the PPPs in which the users of a public facility e.g. a toll road, bridge or an airport pay the private sector party a charge to defray, in full or part, the cost of construction, operation or maintenance, PFIs, as these were set up in U.K, were structured to allow the local authorities to pay directly to the private sector party a rent for the facilities like schools, hospitals, public lighting etc. The central Government in U.K in turn funded the capital cost of the facilities by transferring to local authorities PFI credits thus enabling the latter to pay the rents due to Private sector party provided it maintained the standard of service. Though the private sector party carries the risk of not being able to provide the requisite standard of service, in practical terms this risk is not significant enough to bring PFI at par with a PPP arrangement where the financial risk of failure is predominantly with the private sector party. Also, in actual practice public authorities may, however, follow business models that have elements of both the models. The National Audit Office, UK, has brought out a number of audit reports on PFI, which would be of interest to the auditors.

**1.4.3** In the case of outright procurement of goods and services by the government from a private sector party the costs would be invariably and substantively be paid by the government upfront thus leaving with the private sector party only the risk relative to completion of the transaction and realization of profits. This would be true even where stage by stage or running payments are made to the private sector party. The risk of failure of the transaction or a project would also be borne by the government without any significant remedy.

## 1.5 Public Private Partnerships and Privatization

**1.5.1** The main difference between PPP and privatization is that in the former there is no permanent transfer of ownership of the assets to the private partner and moreover, the public sector agency remains accountable for providing services of the required quality. Thus, the responsibility and accountability to deliver the goods and services

efficiently remains with the public sector, which is not diluted because of the PPP arrangement. On the other hand, in privatization, not only the ownership is transferred to the private sector, but the accountability is also shifted totally to the purchaser, though the government may set standards and retain price / quality control by establishing appropriate regulatory mechanism, as per the relevant legislation.

## **1.6 Requisites for the Success of Public Private Partnerships Projects**

**1.6.1** Entering into a PPP contract does not reduce the responsibilities and the accountability of the public sector agencies and the public servants concerned. On the other hand, it places substantial responsibility on them to see that the arrangement succeeds in safeguarding public interest by managing the PPP economically, efficiently and effectively. It is therefore essential to plan and implement PPPs efficiently and meticulously, and without pitfalls. In this context, it would be useful to recount the features and requirements for the successful conclusion of a PPP.

**1.6.2** The international experience has been that PPPs are difficult to implement, especially in an environment of inadequate legislative and judicial institutions. PPPs call for competent institutions which can develop healthy contractual relationships, processes and procedures to develop them efficiently. According to UN-UNECE, the lack of well-performing institutions in many countries is reflected in several things such as the protracted length of negotiations between public and private partners, the slowness of reaching closure, the lack of flexibility in risk-sharing and the cancellation of many projects with all the resultant wastes.

**1.6.3** UNECE advocates that PPPs should take into account the following objectives:

- Fair and transparent selection process.
- Assurance of Value for Money.
- Improvement of essential public services, especially for the socially disadvantaged and adequate training for those to be involved in the partnerships.
- Fair incentives to all parties and fair returns to risk takers, combined with commercial success.



- Sensible negotiation of disputes that assures continuation of services and prevents collapse of projects and consequent public wastes.
- Enhanced security in the face of new threats and a general improvement in the safety of services provided under the PPP arrangement.

**1.6.4** According to the World Bank<sup>14</sup>, the success of a PPP project will depend on the following features:

- Governments need to be able to design projects with a package of risks and incentives that make them attractive to the private sector.
- Governments need to be able to assess the costs to the tax-payers, often harder than traditional projects because of the long-term and often uncertain nature of government commitments.
- Governments need contract management skills to oversee these arrangements over the life of the contracts.
- Governments need advocacy and overreach skills to build consensus on the role of PPPs and to develop a broad programme across different sectors and levels of governments.

**1.6.5** It is noteworthy that the Government of India<sup>15</sup> realizes that the key features for the success of PPPs in India include, among others, the following:

- i) *A stronger policy and regulatory framework*, both at the Centre and States.
- ii) Need to develop appropriate market instruments and capacity to raise long-term equity and debt.
- iii) A shelf of bankable PPP projects.
- iv) *Better and stronger capacity to manage PPP projects.*

**1.6.6** It is evident that before launching any PPP initiative the public authority will be expected to undertake thorough groundwork that will involve clear definition of deliverables, comparator costs, a sound understanding of the legal framework, factors

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<sup>14</sup>Public Private Partnerships Units- what are they, what do they do? Mark Ditz, Clive Harris, Inderbir Dhingra and Chris Shugart, World Bank Occasional Paper.

<sup>15</sup>Mr.P.Chidambaram, Former Finance Minister at the International Conference on PPP in India, 2007, Ministry of Finance.

influencing the choice of business model, preliminary demand, cost and revenue projections, scope of force majeure and other game changing situations. In this context, the role of independent consultants in guiding and hand holding public authorities seeking to engage in a PPP becomes critical.

**1.6.7** A PPP of large magnitude can have a variety of stakeholders all of them being interlocked in complex web of mutually dependent risk sharing arrangement. It could include the main sponsor PPP usually a consortium of parties constituting an incorporated or unincorporated Special Purpose Vehicle (SPV) as each of these parties may bring in their strengths viz., finance, technological know-how or project management skills and one of them may be a lead partner. Besides the government / public authority there will be other stakeholders like financiers, investment bankers, vendors, transaction advisors, insurers, legal experts and public interest groups.

## 1.7 Objectives of Public Private Partnership

**1.7.1** In order to carry out their audit objectively and without bias, public auditors must develop a deep understanding and appreciation of the basic objectives of Public Private Partnerships. In the words of the “The National PPP Policy Framework of Australia” (December, 2008), the PPP policy provides a framework that enables public and private sectors to work together to improve public services delivery through private sector provision of public infrastructure and related services.

According to the above Framework, the objectives of PPP are to:

- Encourage private sector involvement in public infrastructure and related services where value for money for the government could be clearly demonstrated.
- Encourage innovation in the provision of infrastructure and related service delivery.
- Encourage rigorous governance over the selection of projects and competition for the award of contracts.
- Clearly articulate accountability for outcomes.

**1.7.2** To put it more succinctly, PPP projects are aimed to provide ‘improved’ public services by sharing risks in a balanced manner. These are also intended to result in

enhanced ‘value for money’ for the public agencies concerned through cost effective designing and technology as well as better project management. These are achieved by following a fair and transparent selection process, fair and reasonable incentives to all stakeholders, assurance of value for money and implementation through long-term contracts. *Innovation is the key to the success of PPP projects.*

## 1.8 Role of Private Sector Partners in PPP Projects

**1.8.1** The role of the private sector partners in PPP projects is fiduciary and needs careful appreciation. It must be accepted that the private entrepreneurs come into the PPP arrangements primarily with profit motive, and with a view to pursuing their business prospects, which alone impels them to assume the risks associated with the PPP projects. However, these arrangements involve substantial public interest which both the parties to the arrangements are bound to safeguard, with the public sector partner retaining the accountability to ensure it. This does not mean that they are competing between them, but are to work together as partners and colleagues in the process of national development. In auditing the PPP projects, public auditors must appreciate the respective roles of each partner and focus in audit on the achievement of the end results, and compliance with the established rules and procedures at all stages of the project.

**1.8.2** The private sector partners have to bring in not only the required finances and suitable technology for the project, but also have to be innovative in approach. There should be no tendency to “over engineer” the projects and to pad the total capital expenditures. They must also have excellent project management and O&M capability, and must be able to demonstrate their commitment to the partnerships. They must not merely look forward to making profits at any cost, but must be committed to providing sustainable and quality service to the customers. The PPP agreements should essentially yield VFM to the government or the public sector partner concerned. The public auditor will always be expected to be mindful of the fact that the private sector partner should equally gain from the improvements and innovations brought about by it.

**1.8.3** The somewhat conflicting objectives of the public and private participants in a PPP arrangement should ideally get resolved within the framework of the PPP based on shared risks and rewards and should, therefore, not lead to disputes affecting the provision of services to the public at any time during the operation of the contracts. This is best achieved by establishing clear and transparent norms prior to the establishment of the PPP and by entering into unambiguous and specific contract relationships. There

should be built into the contracts an efficient *dispute resolution mechanism* for resolving disputes which may arise, speedily and without disruption to the service provided. To have a good idea of the norms and guidelines to be adhered to by promoters of PPP projects, the public auditors must familiarize themselves with the various documents and model agreements issued by the Ministry of Finance and the Planning Commission in this regard.

## 1.9 Public Private Partnership Audit in Different (Infrastructure) Sectors

**1.9.1** Public private partnerships are increasingly adopted for the development of all infrastructure sectors in India to fill the huge ‘infrastructure gap’ which exists currently. Maximum PPP contracts are however signed in the case of national highways, followed by state highways, namely the road sector. Airport development is another area where PPP has made an impact, along with the power sector and the port sector. There are a few PPP projects already operating in the Railways, and it is expected that during the current and future five year plans, more emphasis will be given to PPP for Railway’s development and Modernization programme, with a target of about 40 percent of the outlay. Each of these sectors and PPP arrangements pertaining to them will have their own unique and special features; but there are several common features running across all of them, which have been discussed in these Guidelines at appropriate places.

### *1.9.2 Reserve Bank of India Definition of Infrastructure*

Reserve Bank of India has defined infrastructure as: A company engaged in developing or operating and maintaining any infrastructure facility that is a project in any of the following sectors, or any infrastructure facility of similar nature:

- a. road, including toll road, a bridge, or a rail system;
- b. a highway project including other activities being an integral part of the highway project;
- c. a port, air port, inland waterway, or inland port;
- d. a water supply project, irrigation project, water treatment system, sanitation or sewerage system, or solid waste management system;
- e. telecom services whether basic or cellular including radio paging, broadband network, internet service;

- f. an industrial park, or special economic zone;
- g. generation and distribution of power;
- h. transmission or distribution of power by laying a network of new transmission and distribution lines;
- i. construction relating to projects involving agro-processing and supply of inputs into agriculture;
- j. construction for preservation and storage of processed agro-products, perishable goods such as fruits, vegetables and flowers including testing facilities for quality;
- k. construction of educational institutions and hospitals; and,
- l. any other infrastructure facility of similar nature.

**1.9.3** Under the Government of India scheme for Financial Support to PPPs in Infrastructure, however, the eligibility for the support is available for only the following sectors:

- a) Roads and bridges, railways, seaports, airports, inland waterways;
- b) Power;
- c) Urban transport, water supply, sewerages, solid waste management, and other physical infrastructure in urban areas;
- d) Infrastructure projects in special economic zones; and, International Convention Centres and other tourism infrastructure projects.

**1.9.4** In some States, the management and running of schools have been transferred to private management, by leasing the school buildings and other infrastructure facilities, subject to conditions. The private management may receive annuity payments for the management of the schools. Such public private partnerships are subject to public audit; and the guidelines included in this document could be usefully adopted to test their efficiency and effectiveness.

## SECTION II

# *Institutional Arrangement for Appraisal and Approval of Public Private Partnership Projects*

## Public Private Partnerships (PPP) in Infrastructure Projects

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## 2.1 Organizational Structure for the Appraisal and Approval of Public Private Partnership Projects

**2.1.1** The institutional arrangement for the appraisal and the approval of Public Private Partnership (PPP) Projects sponsored by various Ministries is centralized in the Ministry of Finance (MOF). Guidelines for formulation, appraisal and approval of PPP Projects were issued vide Ministry of Finance O.M.No.1/52005 dated 12<sup>th</sup> January, 2006. Please refer to the web site of the Ministry of Finance for details. The highest authority which lays down the PPP policy and procedures and considers and approves individual PPP projects is the Committee on Infrastructure constituted under the chairmanship of the Prime Minister. The Committee includes the Finance Minister, the Deputy Chairman of the Planning Commission, Ministers in charge of the respective infrastructure Ministries, and two members of the Planning Commission.

**2.1.2** The institutional arrangement has been designed to carry out comprehensive and meticulous due diligence to address the risks attached to PPP project proposals and purportedly addresses the need to secure ‘good value in terms of performance standards, user concerns, public revenue and contingent liabilities’<sup>16</sup>. The broad-based “Public Private Partnership Appraisal Committee” (PPPAC) established for the purpose comprise of the following members:

Secretary, Department of Economic Affairs – Chairperson.

Secretary, Planning Commission.

Secretary, Department of Expenditure.

Secretary, Department of Legal affairs.

Secretary, Department sponsoring the Proposal.

**2.1.3** The Committee will be serviced by a Special Cell set up for the purpose in the Department of Economic Affairs (DEA). Moreover, the Ministry of Finance (MOF) will be the nodal ministry to examine concession agreements from the financial angle and the guarantees to be extended, and to assess the risk allocation from the investment and banking perspectives. MOF is also responsible to ensure that PPP projects are scrutinized from the perspective of government expenditure. Further, in the Planning Commission, a PPP Appraisal Unit (PPPAU) has been established to evaluate PPP project proposals and to prepare appraisal notes for the PPPAC on all relevant issues including on the

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<sup>16</sup> Ministry of Finance, Department of Economic Affairs O.M. dated 29<sup>th</sup> November, 2005



concession terms. Ministry of Finance and the Planning Commission may engage experts in related areas to undertake the due diligence, as considered necessary.

## 2.2 Financial Powers of PPPAC

**2.2.1** Under the initial guidelines of the MOF, all Public Private Partnership (PPP) Projects where the *capital cost or the underlying value of assets* are more than Rs.100 crores were to be brought up before the PPPAC. However, by a subsequent decision, projects costing more than Rs.100 crores but less than Rs.250 crores will be appraised by a Committee comprising Secretary, DEA and the Secretary of the Department sponsoring the project, so much so, only projects in excess of this limit will be appraised by the PPPAC. For appraisal of individual projects under the National Highway Development Authority (NHDA) which are of Rs.250 crores or more but less than Rs.500 crores and fulfill certain established criteria, another committee with Secretary, DEA and the Secretary, Department of Road Transport and Highways (DRTH) has also been set up. It is to be noted that projects costing below the limit of Rs.100 crores will be considered and approved by the Expenditure Finance Committee / Standing Finance Committee (EFC/SFC) of the Ministry concerned. Detailed guidelines have been issued by the Department of Expenditure (DOE) in this regard.

**2.2.2.** After the clearance of the relevant committees, the sponsored projects would be submitted to the Committee on Infrastructure for final approval.

## 2.3 Procedure for Formulation and Appraisal of PPP Projects

**2.3.1** Under the guidelines of the Finance Ministry, the sponsoring Ministry may develop individual project proposals with the help of experts in relevant areas, or by availing the benefit of inter-ministerial consultative groups for the “in-principle” clearance of the PPPAC before inviting Expressions of Interest (EOI) from prospective investors. After getting the ‘in-principle’ clearance, the sponsoring Ministry may invite EOI, develop the required documents and carry out inter-ministerial consultations, pre-bid conferences etc. *It is to be noted that the concession agreements finalized for the purpose of inviting financial bids should be cleared by the PPPAC before technical and financial bids are invited.* However, ‘in-principle’ approval of the PPPAC will not be required where a project is based entirely on a duly approved Model Concession Agreement (MCA). Please see paragraph 2.6.1 below for details.

## 2.4 Appraisal by / Approval of PPPAC

**2.4.1** Request for Proposal (RFP) or invitation to submit financial bids should be accompanied by all agreements that are proposed to be entered into with the successful bidder. After formulating the draft RFP, the sponsoring ministry will seek the clearance of the PPPAC before inviting the financial bids. These will be reviewed by the PPP Cell, PPPAU and Ministries concerned and their observations will be conveyed to the sponsoring Ministry for responses. The PPPAC will take a view on the Appraisal Note and other comments and responses etc. duly circulated to the members and in appropriate cases, recommend the proposal for the approval of the Committee on Infrastructure under the Prime Minister. Details to be included in the Memorandum for PPPAC, Term Sheet for the proposed Concession Agreement etc. are available as part of the MOF Guidelines on Formulation, Appraisal and Approval of PPP Projects.

## 2.5 Financial Support to PPP Projects in Infrastructure

**2.5.1** Ministry of Finance has notified the guidelines for Financial Support to PPP projects in Infrastructure (Viability Gap Funding) vide its OM No. 1/5/2005-PPP dated 12<sup>th</sup> January, 2006. The scheme provides for financial support to roads and bridges, railways and sea ports, airports and waterways, power, urban transport, water supply and sewerage, solid waste management, tourism projects etc. In order to operate the scheme, the Government has set up an Empowered Committee, supported by an Empowered Institution. The Committee / Institution are authorized to approve financial assistance to PPP projects which satisfy the eligibility criteria specified in the scheme. The Committee is chaired by the Secretary of the Department of Economic Affairs and has the Secretaries of Planning Commission, Department of Expenditure and the sponsoring Ministry as members. The Committee is empowered to sanction Viability Gap Funding (VGF)<sup>17</sup> of up to Rs. 200 Crores for each project subject to the budgetary ceiling indicated by the Finance Ministry. Amounts in excess of the above ceiling will require the approval of the Finance Minister. The Empowered Institution is competent to sanction financial support up to Rs.100 Crores for eligible projects subject to budgetary ceilings and has the Additional Secretaries of DEA and Expenditure and the Joint Secretaries of DEA, Planning Commission, and the sponsoring Ministry as members. The scheme is applicable to PPP Projects proposed by the Central Ministries, State

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<sup>17</sup> The scheme defines VGF as a 'grant one-time or deferred, provided under this Scheme with the objective of making a project commercially viable.

Governments and statutory authorities which own the underlying assets of the projects. It is important to note that the benefits under the scheme will be available only if the concession is awarded to a private sector company in which 51% shares or more of the subscribed and paid equity are owned and controlled by a private company and has been selected on the basis of competitive bidding, with responsibility for financing, construction, maintenance and operation of the project during the entire period of the concession. The project should also provide a service against payment of a pre-determined tariff or user charge. In case parallel financial support is available from any other Ministry of the Central Government under another on-going scheme for assistance to PPPs, the Empowered Committee will consider the recommendations of that Ministry for any additional assistance under VGF in appropriate cases.

**2.5.2** The financial support available under the VGF will be in the form of a capital grant at the stage of project construction. The amount of VGF will be equivalent to the lowest bid for capital subsidy, subject to a maximum of 20% of the total project cost (TPC). In case the sponsoring Ministry or the State Government or the statutory authority proposes to provide any assistance over and above the VGF, it will be restricted to a further 20% of the TPC.

**2.5.3** Within the prescribed period of three months of the award of the assistance or any permitted extended period, the Lead Financial Institution (LFI) which will be the approved funding agency for the project will send its appraisal of the project to the Empowered Committee / Institution along with its recommendations for final approval. VGF will be disbursed only after the private sector participant has subscribed and expended the equity contribution for the project and will be releasable in proportion to debt disbursements remaining to be given thereafter. The LFI will be responsible for the regular monitoring and periodic evaluation of project compliance with agreed milestones and performance levels under a tripartite agreement to be signed for the purpose.

## **2.6 Model Concession Agreements (MCA)**

**2.6.1** No discussion on the Institutional Arrangements for PPP Projects would be complete without a mention of the Model Concession Agreements (MCA). The MCA is a document prepared by the Planning Commission, at the instance of the Committee on Infrastructure, to ensure that the complex problems relating to PPP projects and the conflicting interests of the partners of such arrangements are adequately addressed up front. The MCA also seeks to achieve an appropriate balance of risks and obligations

shared between the partners. Apart from spelling out the policy and the regulatory framework of the infrastructure sector concerned, the MCA also deals with aspects such as the mode of financing the projects, mitigating and unbundling of risks, allocation of risks and rewards, reduction of transaction costs, force majeure and termination etc. The MCA also aims at cost-effectiveness in designs, phasing of the investment requirements, fixing the concession periods, and establishing technical parameters based on output specifications etc. An important clause in the MCA provides for the forfeiture of the bid security if the concessionaire fails to achieve financial close within the stipulated (six months) period. The MCA is a carefully drafted legal document which helps the partners of the project to define and spell out mutual rights and obligations clearly and in specific contractual terms. As mentioned earlier, material or substantive deviations from the MCA will require specific approval of the authority which approved the MCA (Committee on Infrastructure) whereas those which are not material will require the clearance of the PPPAC and the Finance Minister.

**2.6.2** Planning Commission has brought out separate MCAs for PPP in National Highways, State Highways, Operation and Maintenance of Highways, and Ports. In addition, Planning Commission has also issued Manuals of Specifications and Standards for Four-laning of Highways to be used along with the MCA concerned. Public auditors are encouraged to familiarize themselves with all MCAs published by the Planning Commission and refer to the relevant ones to verify the compliance by the PPP partners, as part of the audit scrutiny during assignments.

## **2.7 Institutional arrangements in State Governments**

**2.7.1** Various State Governments have made specific institutional arrangements to encourage entrepreneurs to invest in PPP projects and to process and appraise PPP project proposals received by public agencies in the respective States. For instance, Andhra Pradesh and Gujarat have passed laws to promote and regulate PPP projects while some others have established their own rules and regulations and issued related notifications. In some States like Karnataka, special or dedicated cells have been constituted in the Secretariat to deal with PPP policy and project proposals whereas in some others like Tamil Nadu, State Infrastructure Corporations undertake most duties and responsibilities regarding the promotion of PPP in those States. Details of the State PPP organizations could be accessed from respective State Government websites.



## SECTION III

### *Scope and Objectives of PPP Audit*



### 3.1 Scope of Public Private Partnership Audit

**3.1.1** A contentious issue in the context of PPP arrangements and their audit relates to the scope of audit by Supreme Audit Institutions (SAI), in view of the following:

- The government or the public sector partner is usually only a minority partner /shareholder or will have only minority participation in the PPP arrangement, with the private sector partner controlling the majority stake.
- Most of the funds are brought in by the private sector partner.
- The construction, management and operational risks are transferred to the private sector partner.
- The work culture and the decision making processes of the private sector partner which may be alien to and contra-distinct from those of the public sector institutions.
- The emphasis of PPP projects is usually on the end results of the PPP arrangements and not on the means to achieve them.<sup>18</sup>

**3.1.2** Nevertheless, the following broad considerations would support the intervention of public audit in PPP projects:

- The authority of the government / public entity to provide the goods and services to the public at affordable cost stands transferred to the private sector partner.
- The right to levy tolls / user charges also gets shifted to the private sector partner.
- The cost of executing the project directly by the government or its agency may be relatively lower since they are able to raise funds (either from revenue or by borrowing) at a cheaper cost.
- The government / public agency concerned will continue to retain accountability for the provision of the service to the public at a reasonable cost.
- The contracts / concessions granted are usually for a long term and thereby alienates the statutory right involved for a very long period.

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<sup>18</sup> May also see paragraphs 1.8.2 & 1.8.3 in Chapter I



- The transfer of the public assets to the private body for the duration of the contract requires audit involvement.

**3.1.3** The most important factor that would weigh with the SAI to conduct the audit of PPP projects is to ensure the value for money aspects of such transactions. The main purpose of the audit, and based on which the scope could be defined, would thus be to provide a reasonable assurance to all stakeholders including the government, parliament / legislatures, and the public that the PPP arrangement subjected to the audit has yielded value for money and that public interests have been adequately protected.

**3.1.4** In order to reach valid audit conclusions on the PPP arrangements, therefore, the auditor should have a sufficiently wide and detailed jurisdiction covering all aspects of the transaction, beginning from the formulation of the proposal to the final end results. Since the SAI is the auditor for the government department and the public sector body which are party to the PPP arrangement, it follows that the documents and data relating to the arrangement will be available with them for audit scrutiny. However, the question arises about extending the audit scrutiny to the records of the PPP entity since these would be in the control of the private sector partner, who may raise the argument of commercial confidentiality to avoid the public auditing of their project activities. *(Please see discussion on this topic in Paragraph 3.4 below.)*

**3.1.5** Broadly speaking, the audit of PPPs by the SAI may cover the aspects of the project indicated hereunder :

- The data, records, **analysis and the decision process** of the government department / public sector agency to prefer the PPP route to execute the project instead of undertaking it directly.
- Documents and files leading to the **formulation, appraisal and approval** of the project.
- The **process of identifying the private sector partner, requests for proposals, bidding and tendering process** of the contract with due diligence to fairness, transparency and objectivity.
- **In-depth analysis of the project documents** including the shareholders' agreement, concession agreement, operation and maintenance agreement etc., total project cost, financing arrangements (including cash flow, ROI / ERR / DCF), justification for the viability gap funding, contract period etc.

- **Accounts documents**, bills, records and schedules relating to the construction, and oversight arrangements.
- **Value for money** considerations and safeguarding the **public interest**.
- **Operation and maintenance** of the assets, tariff / toll / user-charges collection and accounting and **revenue sharing arrangements**, escrow accounts.
- **Quality and standards of the service**, customer protection, **dispute resolution** and **asset transfer arrangements** etc.
- **End of the project operations** including valuation of residual assets, decommissioning, dispute resolution mechanism, etc.

**3.1.6** 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. The scope of audit will also extend to the following:

- 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.
- 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.

**3.1.7** It must be remembered in this context that even though the assets under the PPP will be under the control of the private sector partner, the concession agreements will normally provide for submission of reports and accounts through the Independent Engineer / Auditor (to be appointed from the panels maintained by the government), with contractual and professional responsibility to ensure the accuracy of reports. The fact that there will be one or more representatives of the government / public sector partner

on the Board of Directors / Management Committee or equivalent body of the PPP entity and that they will be privy to major decisions will also be helpful to public auditor. Hence, the public auditor must verify all such documents as are supposed to be in the possession of the public sector partner. That includes Board agenda and minutes and other related papers.

## 3.2 Objectives of the PPP Audit

**3.2.1** The basic objective of public audit 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. 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’<sup>19</sup>.

**3.2.2** The audit of PPP projects differ from the conventional audit of public entities in several ways. For instance, the very concept of PPP arrangements assumes and accepts, *ab initio*, the conflicting and fundamentally differing approaches of the two partners to the arrangement, namely the responsibility of the public sector partner to provide goods and services to the public at reasonable costs against the motive of the business partners to maximize profits (see paragraph 1.8.3). The former holds the authority and regulatory skill as against the management and technical skills of the latter. Even within the private sector partner different participating members may have divergent and conflicting objectives. For example, the sponsors /financiers may be interested in fixed cost construction contracts whereas the latter may prefer greater flexibility in this regard. While vendors may like to maximize revenue, the financiers / construction contractors may want to minimize such costs. The public auditor must remember this and appreciate that inspite of seemingly conflicting objectives the PPP is a fusion of the diverging talents and skills and that the common objective of the partnership must be to improve the value for money by combining the capabilities of both. Delivering the expected public facility within the desired cost, timeframe and

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<sup>19</sup> The Role of Auditing in Public Sector Governance : Institute of Internal Auditors

specifications is the surest guarantee that all the involved parties stand to gain. ‘The PPP policy provides a consistent framework that enables the public and the private sectors to work together to improve public services delivery through private sector provision of public infrastructure and selected services. Value for money is the driver for adopting the PPP approach rather than capital scarcity or balance sheet requirements’.<sup>20</sup> It must also be remembered that the audit should focus sufficiently well on the achievement of the contracted end products; it should not stand in the way of innovations injected into the partnerships which is one of the keys to the success of the enterprise.

**3.2.3** The main objective of the audit of PPP projects is to provide a reasonable assurance to all stakeholders about the wisdom, faithfulness, integrity, economy, efficiency and effectiveness of the PPP arrangement and to ensure that the infusion of the private sector agency into the project has resulted in improving the value for money for the government. The aim is to cover all aspects of the project contracting and execution, but without impacting the freedom and innovations built into the arrangement. Further, unlike in the case of audit of government departments and entities, the relevance of regularity and compliance audit will be limited since the focus of PPP audit will be on contract audit, validity of total project cost, economy and efficiency of operations of the entity as seen from the public participant’s point of view and most of all on achieving the objectives (results) of the partnership rather than on how the private sector partner secures goods and services for the project. These subtle points have to be borne in mind while planning and conducting the PPP audit.

### 3.3 What Are the Types of Documents to be Audited?

**3.3.1** A question uppermost in the mind of public auditors when they plan the audit of PPPs would be the type of documents to be subjected for the scrutiny. Since the majority stakeholder in terms of financing, construction, operation and maintenance of the project would be the private sector partner, (and since these and associated risks would stand transferred to it), the question will have significant relevance. This is also closely related to the issue of “audit evidence”, which refers to data, information and documents relied upon to arrive at audit findings and conclusions.<sup>21</sup>

**3.3.2** As described ante, PPP projects go through various stages before they take shape and provide the targeted results (see paragraph 3.1.5). The auditor should verify all such

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<sup>20</sup> National Public Private Partnership Policy Framework (Dec, 2008) Australia.

<sup>21</sup> Regulations on Audit and Accounts, Chapter 12 :CAG of India (2007)

stages and list out the data and documentation applicable to each stage, depending on the status of the project under audit.

**3.3.3** As discussed in paragraph 3.1.4 ante, most records relating to the project and due for audit would be available with the government department / public sector agency. These would include the original files and records on formulation, appraisal, bid evaluation and approval of the project, as also various contracts and agreements. Moreover, the reports and statements submitted by the Independent Engineer / Auditor and the private sector partner will also be available for scrutiny.

**3.3.4** Broadly speaking, public auditors should subject the following data and documents relating to the project for scrutiny.

- i) *Documents regarding the project formulation, appraisal and approval, available with the nodal ministry, promoting agency.*

**3.3.5** The most important checks to be exercised in a PPP project will include the scrutiny of the initial records in the government agency concerned so as to ensure that the decision to adapt the PPP route was fair and reasonable and was taken after considering all alternatives. The feasibility of the project including demand assessments and projections, the comparative benefit of executing the project departmentally or outright contracting (wherever relevant feasible), detailed specifications arising from the Detailed Project Report, total project cost and operating costs, financing alternatives, financial analysis of funding options, appraisal of the project proposal by empowered ministries, method of determining the concession and viability gap funding, if any, payment of annuity or revenue sharing arrangements etc. would be crucial for audit scrutiny.

- ii) *Data and documents relating to the contract documents and concession award originated by and available with the public sector partner.*

**3.3.6** These include all documents relating to the tendering procedures, award of tenders, tender conditions and processes, engagement of Independent Engineers and Auditors to oversee the construction and operation management, asset transfers, valuation of assets and all related information, which would provide adequate information regarding the execution of the project.

- iii) *Data and documents furnished to the public sector partner by the private contractor and available with the former for verification.*

**3.3.7** The third type of documents required to be scrutinized will be those generated by the private sector partner and submitted to the public sector partner, usually as mandated in the contracts. These will be the documents related to the financial closure, design and construction details, specifications and variations, if any, and requests for completion of pre-requisites (condition precedents) to undertake the work. Another important set of documents to be checked would be the returns relating to the volume of demand / traffic generation against projections, revenue realization, escrow account details, and periodical accounts statements etc. required to be furnished by the operating partner, after completion of the project.

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

**3.3.8** These documents will give a clear insight into the construction, operation and maintenance and the commercial aspects thereof of the project. Public auditors should verify them carefully to ascertain the compliance by the private sector partner with specified norms and specifications relating to the execution of the contracts.

**3.3.9** All documents referred to at sl.no. (i) & (ii) will be readily available with the concerned Government department / public authority. As mentioned in paragraph 3.1.7 documents referred to at sl.no. (iii) & (iv) can also be substantially accessed through the Government entity.

*(For a list of documents to be verified during the audit, please refer to Annex II of these Guidelines.)*

### **3.4 Accessing the Documents and Records of the Private Partner by Auditors**

**3.4.1** A question which requires to be addressed in this regard is whether the auditors are required to access the documents of the private partner for the purpose of their audit. It could be assumed that the private sector partners are likely to resist the move on the plea of commercial confidentiality.

**3.4.2** In the normal course, all documents and data required by the public auditors are

likely to be available with the government department and the public sector agency which promoted the PPP project. However, in case any additional information is essential for the purpose of verifying facts and for audit evidence, the public auditors may take recourse to Regulation 169 of the CAG's Regulations on Audit and Accounts 2007 which states as follows:

*“The form, type and extent of data, information and documents required for audit tests and evidence shall be determined by the audit officer. Audit shall have access to such data, information and documents subject to any law in force at the time. Data, information and documents would also include those obtained by the auditable entity from a third party and relied upon by it in performance of its functions. If such third party evidence as relied upon by the audited entity is found to be insufficient in audit, additional information may be requisitioned by Audit from the auditable entity with prior approval of the Accountant General (Audit). On receipt of such requisition, the same shall be obtained by the auditable entity from the third party and provided to Audit”.*

**3.4.3** The above procedure may be adequate to meet the requirements of public audit under most circumstances<sup>22</sup>. However, if the audit is being undertaken under Section 20 (1) or (2) of the DPC Act, and the body to be audited is either a joint venture with minority participation by the public sector agency (e. g. Delhi / Mumbai/Hyderabad / Bangalore International Airport Limited), the sanction issued by the President or the Governor, as may be, shall include a clause requiring the body to make available all data and documents requisitioned by the public auditors.

**3.4.5** In course of time, the statute relevant to public audit itself must include specific provisions regarding the mandate and the rights and obligations of the SAI for the audit of PPP arrangements, in unambiguous terms. In the meanwhile, the public auditors will have to rely almost entirely on the data, records and documents available with the

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<sup>22</sup> In the Operation, Maintenance and Development Agreement of the Delhi Air Port, the JVC is mandated to submit several reports to the Airport Authority of India (AAI) regularly, including (i) monthly activity report (ii) other operating statistics required by AAI etc., (iii) reports on various performance measurements as specified in the agreement, (iv) quarterly financial accounts etc. Moreover, the JVC shall make available, and if requested, provide copies of records for inspection of AAI. Further, AAI will be entitled to appoint one or more authorized representatives to check and take copies of such records. The JVC shall provide the AAI with such further information, explanations, and other assistance as may be reasonably requested by the AAI or any of its authorized representatives for the purpose of checking any of such records.

government departments and public sector agencies promoting the PPP projects and also on those which could be requisitioned through their good offices from the private sector partner.

### 3.5 When Should a PPP Project Be Subjected to Public Audit?

**3.5.1** In respect of large projects, the audit by SAI is always planned and undertaken at different stages of the project. When a large project with heavy investment commitments and a long time-frame is under execution, audit may be planned and executed even before the completion of the project. On the other hand, audit of projects and programmes of smaller magnitude, may be taken up after the completion of the project. The decision as to when the audit of an ongoing PPP project should be programmed will depend on several factors, mainly, the quantum, magnitude (especially the volume of the concession and the financial commitments of the public sector partner) and the time frame for the completion/ concession period of the project, as also all other risk assessments. In a PPP project, since there is a balanced sharing of risks between the public and private sector partners, it is necessary for the public auditors to identify these risks and determine the schedule of the audit having regard to the risks attached to the former. The decision in this regard will appropriately be taken by the head of the audit office, depending on the circumstances of each case, as also taking into account the availability of audit resources.

**3.5.2** A view could be taken that the audits by a public auditor are essentially meant for submission of the audit findings through the Audit Reports to be placed in the Parliament / State Legislatures, as may be and are, therefore, generally *post facto* in nature. On the contrary, it can be argued with equal conviction that once the Model Concession Agreement is signed between the parties, the audit findings will have only academic value since the contractual clauses could not be subject to amendments and alterations, and that in order to make the audit more fruitful, the public auditor should step in even before the agreement is signed. Though this reasoning tends to ascribe to public auditor the role generally assigned to Internal Auditors the exceptions may, if at all, be when the financial risk is substantial, and of such magnitude that the intervention of the SAI, even before the parties sign the contracts, would be only appropriate to safeguard public interest, and a special audit is taken up with the approval of the Headquarters office. In this context, the following guidelines issued by the INTOSAI Working Group on Audit of Privatization will be relevant:



*“The SAI should examine the public/ private finance and concessions deal as soon as it is practical. A good stage for the first examination of these projects may be soon after the contract has been awarded. Examining the deal soon after the contract signature has the merit that the terms of the deal are fixed; prior to this, the terms may be constantly changing as they are subject to re-negotiation.*

*In certain circumstances, however, and where this is constitutionally permissible, it may be necessary or desirable for the SAI to examine the deal before the contract is awarded, for example, if concerns are being expressed about the probity or likely value for money of the procurement process. Examining a deal prior to contract award has the advantage that any new weakness identified by the SAI can be corrected before the contract is signed and so, more serious difficulties avoided at a later stage. The SAI may therefore choose, if the project poses significant audit risks, to examine it at each of the most significant stages in procurement”.*

**3.5.3** For an appreciation of the risk perceptions, a reference may be had to Section IV of these Guidelines, under the caption **“Identifying and Sharing of Risks”**. In deciding to undertake the audit even prior to the contract execution, the possibility of conflict of interests arising at a future date should be carefully analyzed.

**3.5.4** Since the PPP projects go through several stages such as finalization of the contracts, financial closure, construction, maintenance and operation etc, it would be appropriate to conduct the first audit soon after the partnership comes into being. The subsequent audits could be programmed during construction, towards the completion of the project, and when the service operations are in progress.

**3.5.5** Depending on the circumstances, it may be useful to club a number of identical PPP projects and subject them to a combined audit rather than testing them individually. This will not only help to economize scarce audit resources, but will also provide comparators for audit purposes and will give a broader picture of the PPP exercises carried out under the same umbrella.

## SECTION IV

### *Mandate of Audit and Accessibililty to Records*

## Public Private Partnerships (PPP) in Infrastructure Projects

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## 4.1 Mandates for Public Audit of PPP Projects

**4.1.1** Public Private Partnerships may be formed by different government agencies and bodies usually to promote and develop infrastructure facilities by inviting private sector participation. Some examples are given below:

- a) Government departments directly or in conjunction with a PSU, investing resources in a PPP project and authorizing the private sector partner / JVC to build the project and to provide public services on cost recovery basis while holding only minority shares in the joint ventures formed for the purpose;
- b) Public sector undertakings (PSUs) contracting with private entrepreneurs for development of infrastructure facilities by providing concessions / annuity and / or viability gap funding;
- c) Autonomous bodies substantially funded by the Government joining hands with private sector entities to develop infrastructure projects, with the former investing in (the assets of) the project.
- d) Any other combination of the above which has significant investments of a public agency and shifts the responsibility to provide public services to a private entity in the PPP mode.

**4.1.2** Under the Comptroller & Auditor General's (DPC) Act, 1971, and as incorporated in the Regulations of Audit and Accounts (2007), the audit mandate of the CAG of India will extend to all types of (promoting) public institutions, namely, government departments (as the sole auditor of the accounts of the Union and States), PSUs (in terms of the Companies Act), and to bodies and authorities etc. (as provided under the DPC Act). The DPC Act however does not directly contemplate the audit of PPP projects or joint ventures with only minority participation by the government agency since these are recent innovations under the development strategy<sup>23</sup>. Under the circumstances, the public

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<sup>23</sup> In the United Kingdom, such bodies are recognized as 'Non-Departmental Public Bodies' (NDPB) and are defined as "bodies which have a role in the process of national government, but which are not government departments or part of one, and which accordingly operate to a greater or lesser extent at arm's length from Ministers". Public money is deemed to include 'all monies that comes into the possession of, or distributed by, a public body, and money raised by a private body where it is doing so under statutory authority' (Report by Lord Sharman). The scope of the national audit has been enlarged in countries like the United Kingdom, New Zealand and Canada to ensure improved accountability of all such bodies.

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.

**4.1.3** The exception would appear to be when the President or the Governor of a State requests the CAG to undertake the audit of a PPP organization in terms of section 20 of the DPC Act. To recall, under Section 20(1) of the Act, 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. Similarly, under Section 20(3) of the DPC Act, the CAG may propose to the President or to the Governor that he may be authorized to undertake the audit of accounts of a body or authority, the audit of which has not been entrusted to him by law, if he is of the opinion that such audit is necessary because a substantial amount has been invested in or advanced to that body or authority by the Government, and the President or the Governor may empower the CAG to take up the same. The above two sections are however qualified by Section 20(3) *ibid* to provide that in both cases, the President or the Governor must be satisfied that it is expedient to do so in public interest, and *after giving reasonable opportunity to the body or authority to make representations with regard to the proposals for such audit.*

**4.1.4** Pending an amendment to the CAG's (DPC) Act to provide for the audit of accounts of PPP projects by the SAI, where appropriate, the best course of action would be to include a clause in the contracts / concession agreements between the public sector bodies and the private sector partners to form the PPP arrangement to provide for the audit oversight of the CAG. This will assist in easy accessibility to the records and data available with the private partner, and / or enable the CAG to issue guidelines for the audit of accounts of such bodies by the independent external auditors.

## **4.2 International Auditing Standards and Guidelines for the Audit of PPP Projects**

**4.2.1** The International Organization of Supreme Audit Institutions (INTOSAI) has brought out a set of guidelines for the audit of PPP projects, a summary of which is available at the web site of INTOSAI. These Guidelines caution that there may be need to develop an appropriate audit methodology since the existing practices may not equip

SAIs to audit PPPs, as required. While SAIs may develop a set of guidelines specific to their own requirements, public auditors would still benefit by going through the INTOSAI Guidelines before they undertake the audit of any PPP arrangement. While a complete reading of the guidelines is recommended, some of these which would be more relevant and useful to public auditors in India are reproduced below:

- The need to examine the status of internal controls in the public bodies that enter into PPPs so as to provide a reasonable confidence that public resources would be protected and institutional objectives would be met.
- Verification of the strategic plan setting out the objectives for the PPP and the possible alternatives to balance conflicting priorities.
- Whether advisers were appointed after adequate scrutiny and evaluation and objectively, and 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.
- The need to carry out audit tests to evaluate systems and procedures and management of performance indicators.
- 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.
- System to receive regular information and returns on partner's performance and obligations.

**4.2.2** Basically, the INTOSAI guidelines list out the key risks facing the Governments and the SAIs in developing / auditing PPP projects, and these include:

*State's Risks*

- 1) Lack of clarity about partnership objectives;
- 2) Inadequate definition of business model of the partnership;
- 3) Risks associated with negotiating an appropriate partnership;
- 4) Risks to the State's interests as a minority shareholder;
- 5) Risk associated with monitoring of the State's interests in the partnerships, and;
- 6) State's exposure in the event of difficulties<sup>24</sup>

*Supreme Audit Institutions' Risks*

SAI's risks would include:

- 1) Insufficient domain knowledge;
- 2) Lack of expertise required to examine the process and the results;
- 3) Failure to identifying worthwhile lessons, and;
- 4) Absence of following up the audit work.

**4.2.3** Apart from the absence of comparable projects for evaluation, as well as the absence of norms to judge reasonable returns on investments for the private sector, etc.<sup>25</sup> SAI's risk factors include inability on its part to demonstrate commitment to support well-managed risk-taking and providing constructive guidance. It, therefore, follows that **SAIs should not focus merely on technical issues relating to procurements etc. at the cost of social and economical benefits and effects arising from PPP arrangements.**

**4.2.4** Incidentally, the INTOSAI guidelines were originally framed in 2001 when the thrust was on PPP projects mostly financed by 'annuity payments' of the governments.

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<sup>24</sup> These difficulties may arise from unforeseen developments that bring into existence a game changing situations that may have either positive or negative impact on project viability and the stake of public authority

<sup>25</sup> The Model Concession Agreement for National Highways by the Planning Commission envisages a ROI of 20% on the investment for Indian PPP partners, which may be used as the basis for audit tests.

They also cover aspects of Private Finance Initiatives (PFI). The PPP projects based on annuity payments were common in India in the early years of PPP models. According to the Planning commission<sup>26</sup>, 8 highway projects were awarded by National Highway Authority of India (NHAI) during the period 2001-04, and 12 highway projects of this nature were awarded from 2000 to 2004. The subsequent practice has been to promote user-financed projects where the cost of the projects is ‘self-liquidating’, in the sense the concessionaire, armed with government’s assets and also powers to recover user charges, directly deals with the users, often under *near monopoly conditions of supply*. The public sector partner’s risks involved in these projects are more substantial and virtual than the annuity-based PPPs and would need to be evaluated based on different and more specific audit criteria.

### 4.3 PPP Audit and Performance Auditing Guidelines

**4.3.1** There are several things in common between PPP audit and performance audit. For instance, performance audit is concerned with the audit of economy, efficiency and effectiveness of the programme subjected to audit and embraces<sup>27</sup>:

- i) audit of the economy of administrative activities in accordance with sound administrative principles and practices and management policies;
- ii) audit of the efficiency of utilization of human, financial and other resources, including examination of information systems, performance measures and monitoring arrangements and procedures followed by audited entities for remedying identified deficiencies; and,
- iii) audit of the effectiveness of performance in relation to the achievement of the objectives of the audited entity and audit of the actual impact of activities compared with the intended impact.

**4.3.2** ‘Performance audit is an independent assessment or examination of the extent to which an entity, programme or organization operates efficiently and effectively, with due regard for economy’<sup>28</sup>. It is true that the major entity involved in the PPP is a private participant who is outside the audit control of the SAI. But at the same, the entire operations carried out by it will impact the public sector partner which has sanctioned

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<sup>26</sup> Letter dated 20, October, 2007 from Adviser, Planning Commission.

<sup>27</sup> INTOSAI Auditing Standard 1.0.40

<sup>28</sup> Performance Auditing Guidelines-SAI India, Paragraph 1.9



the grant to build the facility, manage the operations and collect user-fee, tariff or toll by transferring the assets and the responsibility to do so and share revenue (or receive viability gap funding or annual payments, as may be). It will also impact the user community who belong to the public at large. Moreover, the accountability of the public participant for the provision of service at affordable cost continues as before in the PPP arrangement. Hence, it is important for the public auditors to assess the efficiency, economy and effectiveness of the operations of the PPP from the public accountability angle, and to that extent, the principles of performance audit would materially apply to PPP audit as well. In a larger sense, performance audit of any aspect of a public authority's functioning may also involve an examination of the PPP arrangements that such an authority may have entered into.

**4.3.3.** It will be beneficial therefore to keep in mind the relevant guidelines established in the SAI-India's Performance Auditing Guidelines when planning the audit of PPP projects.

## **4.4 Identifying and Sharing of Risks**

**4.4.1** 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. The INTOSAI Auditing Guidance discussed above identifies the risks of the governments in PPP projects and those guidelines are framed on the basis of such risks. The major risks associated with PPP projects<sup>29</sup> could be described as the following:

### ***i) Feasibility / Organizational Risk***

This may relate to the selection of the right type of PPP arrangement suitable for the project. Unless the promoting department or PSU has considered different alternatives for implementing the project and selected the most appropriate set up, the project may not succeed in the long run. Public auditors have to verify the feasibility study carried out by the promoter including demand projections, cash flow, rate of return etc., and review the analysis carried out before reaching a conclusion on the type of partnership selected for the programme. The risk associated with this aspect will remain with the government agency.

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<sup>29</sup> For a discussion on the accounting treatment of the PPP risks, please refer to 'Accounting and Financial Reporting of Service Concession Agreements: Discussion Paper', International Federation of Accountants (IFAC).

***ii) Condition Precedent Risks***

The public sector partner will have to fulfill several conditions precedent to enable the private sector partner to start work on the project, including making available the required land and assets etc. and environmental and other statutory clearances. The private party accepts these risks, but delays in making available the required facilities will impact the construction and operation of the project, which in turn will affect the timeliness of providing the service to be provided and also the revenue. These will constitute as red flags for the auditors to verify.

***iii) Financing Risk***

A major risk for the project will indeed be the financing risk. This involves two issues, one regarding the ease with which the required finance could be raised for the project, and the other is about the abatement of interest charges and repayment of the principal. The requirement of finance will be dictated by the total capital cost and the return on investment that the investors would expect to earn. This risk is of course transferred to the private partner, which is responsible for raising the funds and for its repayment. However, the total capital cost and the financing pattern will determine the amount of concession to be granted, and the user charges and the period of the concession. It may also involve government guarantees and commitments in the event of contingencies. In other words, the risk related to financing, though borne by the private sector partner, will impact the promoter as well as the customers significantly. Another aspect that needs to be examined are the collateral agreements between various partners within a consortium of bidders as well as the agreements between such consortia and the financiers if they are independent of the consortia. This is necessary because in more complex PPP arrangements the risks are widely shared with risk taken by one element of the arrangement being counter-balanced by the risk taken by another element of the arrangement on a back to back basis. Hence there is need for a very careful evaluation of all associated implications of the financing risks by the public auditors.

***iv) Construction Risk***

Construction risk is assumed in the PPP arrangement by the private sector party which will have to bear the consequences of the delays and variations caused due its inefficiency. On the other hand, all efficiency gains achieved through design efficiency and innovations will be its reward for it to keep. Public auditors should remember that

the focus of audit will be on whether the PPP project has achieved its end results and not necessarily on how it was achieved. The risk allocations will enable them to focus on the major objectives of the audit.

*v) Operation and Maintenance Risk*

The public sector partner has to ensure the quality of maintenance and the standard of the service to the public. This will primarily depend on the specifications and conditions laid down in the Operation, Maintenance and Development (OMD) Agreements, which will be one of the most important documents for verification by the auditors. The reports to be submitted by the Independent Engineers will provide detailed information on the quality and standard being followed by the private partners. However, the private sector partner which will bear the consequences of under performance in terms of scale and specifications of operation and maintenance of a public facility created under the PPP arrangement may diversify such risk by sub-contracting operation and maintenance to another party. The agreements between the private sector partner and the operation and maintenance contractor would come within the scope of audit while assessing the risk to the public authority.

*vi) Demand Risk*

This is a major risk which is usually shared by both parties to the contract. Even though the Detailed Project Report may have provided the basis and the justifications for the demand projections, the private sector partner is expected to conduct his due diligence of the project parameters before bidding for the project. However, since these are contracts for long periods and demands for services would also depend on the state of the economy among other factors, it may happen that there are variations between the projections and actuals. The contracts will provide for readjustments of the concessions / period of concessions to take care of such eventualities. Alternatively, there will be variations to the revenue sharing formulae depending on such variations. The public auditors should carefully review the assessments of the demand risks and the allocation of such risks, together with all conditionalities attached in the contract to ensure that they are balanced and reasonable from public interest point of view. It must be especially noted that if financial support through Viability Gap Funding (VGF) is provided, the question of increasing the tariff / user charges or the concession period so as to reduce the viability gap does not arise, and is prohibited.

***vii) Revenue Risks***

Shortfall in demand and consequentially the revenue has the potential of destabilising the PPP arrangement because the private sector partner may be forced at some stage to opt out. This may not only result in disruption of services but also delay ancillary development thus impacting adversely on the generation of expected revenue. Shortfall in revenue generation will hurt both parties. While the public authority loses the prospect of providing better and early service to the public, the private sector partner will stand to lose potential income. Such variations can also entail higher amounts of annuity being paid to the private sector partner where the public authority is committed to do so under the PPP arrangement. Shortfall in demand and revenue can result from unrealistically higher level of user charges allowed and fixed under the PPP arrangement. It has, therefore, to be seen whether the formula for tariff fixation or user charges is worked out correctly and takes into account the best interest of the user community as well as the investors.

***viii) Risk from unforeseen developments***

Unforeseen developments such as natural disasters are covered under contractual clauses relating to force majeure. However, there could be other developments which may relate to political and business environment, technological changes or any other factor that proves to be a game changer invalidating all the assumptions on the basis of which the business model of a PPP arrangement rests. Such undefinable risks have to be envisaged under the PPP arrangements and suitable provisions built in to allow all the parties particularly the public authority to extricate itself from such situations with minimal damage and to facilitate a movement forward out of a potential stalemate. The agreement between various parties may provide 'step in' and/or 'buy out' mechanisms to facilitate exit of one party and its substitution by another party to facilitate continuity of the project.

***ix) Termination Risk***

This risk will arise if the private sector partner fails in the project because of its management failure, bankruptcy, dismal performance, indebtedness etc. This risk is borne by the promoting public sector partner. The auditor will have to consider various aspects relating to the selection of the partner, qualifying procedures, reporting and oversight system etc., before coming to conclusions. It is important to examine whether

the public agency has considered the possibility of such events and worked out a suitable strategy to face such risks. The Request for Proposal (RFP) issued by the promoter may be scrutinized to check whether all conceivable eventualities were taken into consideration to anticipate the termination risks and to cope with such situations, in case they arose.

***x) Residual Value Risk***

This risk arises at the end of the PPP contract when the asset is to be transferred back to the government or its agency concerned, who will be holding the risk. The contract between the parties should include suitable provisions regarding the health of the assets, its valuation method and other aspects to avoid disputes and losses arising from poor maintenance of the assets and the assurance for their return in the desired conditions.

**4.4.2** In the process of audit planning all the above risks have to be listed keeping in view the nature, the magnitude and complexity of the PPP arrangement. In the course of their audit, public auditors will have to ascertain whether all the relevant risks were considered at the stage of project design and adequately reflected in the RFP document. It will also have to be ascertained as to what extent the risks have been adequately covered under various contractual arrangements between the parties and how these were dealt with in real situations during and after the execution of the project.

**4.4.3** Though under a PPP arrangement all the parties involved should be in a position to benefit, there could be seemingly a conflict of objectives between the various parties, viz. the principles, the concessionaires, operators, financiers, construction agencies, vendors, insurers and technology providers, etc. till risks envisaged by all the parties are in balance. However, the question uppermost in the mind of the public auditors would be to ascertain how each of the risks would impact the public sector participants as also on the consumers at large in the medium and long run, and whether the risk allocations have been judicious and fair for the sustained operation and management of the project.

## **4.5 Audit Planning and Selection of PPP Projects for Audit**

***i) Collection of Data and Information on PPP Projects***

**4.5.1** A problem commonly faced by field audit offices would be the difficulty in timely collection and compilation of information on PPP projects. Since many such projects are implemented by public sector partners by sourcing funds from outside the

government budgets and outside government accounts, the usual methods of receiving information through copies of sanctions issued by the governments may not apply. However, the Central Government and several State Governments have installed separate websites exclusively for PPP projects, which could be accessed as a reliable source of information on PPPs. Another source would be the agenda and minutes of Central and State Public undertakings which are parties to PPPs. A third source would be media reports and press information notes available from time to time.

**4.5.2** It would facilitate matters if a Central Unit responsible for the planning of audit assignments in each audit office is entrusted with the task of collecting information on PPPs and building up a library of all reports, data and information on PPPs.

**4.5.3** It will be necessary for the SAI to keep a close watch on PPP projects, both at the centre as well as in states. *Most audit offices may feel the need to establish dedicated units to collect and analyze data and information on all PPP projects within their jurisdiction.* The size and scope of such dedicated units will be a matter of local judgment in each case.

**4.5.4** The PPP Audit Units so established should have continuous and fruitful relation with the nodal agencies in the government concerned for better management. Further, the Unit may be made responsible to collect the basic project documents and to carry out preliminary analysis and to build up portfolios for audit of each selected PPP project, depending on the risk assessments and other factors.

***ii) Selection of PPP Projects for Audit***

**4.5.5** Selection of PPP projects for audit will depend on the risk factors associated with the projects. Although the private participant will be responsible for design, construction and financing and operation of the project, the public sector participant will not only have substantial investments in the project, but also significant shared risks and accountability. The factors which may be taken into consideration for the selection of a project for public audit are listed below.

- a) The extent and value of the shareholding / participation of the government / public sector partner in the PPP unit, value of assets transferred, total project cost (including interest during construction) and financing arrangements, viability gap funding, and annuity payments for operation, if applicable;

- b) Government guarantees and other state support elements provided in the contracts;
- c) The nature of the concession granted as per the contract, estimated value of concession / cost recovery, revenue sharing formulae and their soundness, method of fixation of the tariff or the toll as may be, the period of the concession and provision for renewals;
- d) The nature and criticality of the service to be provided by the PPP venture and its impact on the public at large;
- e) Standards and quality norms / criteria built into the contract;
- f) System for monitoring and evaluation of the performance of the service provider, including redressal of grievances, dispute resolution mechanism etc.

**4.5.6** The public auditors will take into account the need to provide a reasonable and fair assurance to the stakeholders about the transparency and accountability of the PPP arrangement as part of the audit, apart from commenting on the aspect of safeguarding of the public interest involved<sup>30</sup>. Apart from *financial materiality* and *significance* of the PPP arrangement, *visibility* and *the stage of the development* would be other criteria for adoption.

### ***iii) Preparation of the Audit Plan***

**4.5.7** There are two main issues which will constrain the audit planning of PPP projects by IA&AD. These are (1) the overall shortage of qualified and trained staff to take up additional areas of audit and (2) the need to train the selected staff for PPP audit, which is a new area, so as to equip them with the required skills and expertise for PPP audit.

**4.5.8** Generally, to make them viable and by their very nature, PPP projects are of very long durations. The first thing to be taken into consideration, therefore, in the planning of audit would be the coverage and periodicity of such audits. Moreover, the objectives and the demonstration effects of such audits on future PPP arrangements which impact the public interest also will have to be kept in view.

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<sup>30</sup> For further reference to factors which may influence the selection of subject for audit, please refer to Paragraph 2.18 of the Performance Auditing Guidelines-SAI India.

**4.5.9** It will be the task of the Planning Unit in the audit office to prepare a comprehensive audit plan for the PPP audit, once the project for the audit is identified. The audit plan will have the following elements for easy implementation.

- Details of the Partnership, description of the PPP project, and findings of the preliminary analysis of the project documents relating to the project.
- Objectives of the audit and the determination to be arrived at.
- Stage of the project and scope of the audit.
- Composition of the audit team and the duration of the audit.
- Issues to be discussed in the Entry Conference.
- Essential documents to be verified and details of the associated persons to be interviewed.
- Use of external experts, if proposed to be deployed.
- Related materials including correspondence from the government, media reports, collateral documents etc. if available.
- Suggested areas for close scrutiny by the auditors, such as the (i) analysis of risk sharing and balancing, demand projection studies, method of cost recovery and sharing of revenue arrangements;(ii) Details of government support approvals, guarantees and conditions precedent, details of payments, and commitments etc. ;(iii) Board agenda and minutes relating to the project, (iv) business model design, and; (v) Financing plan, sensitivity analysis of NPV under different scenarios, details of financial closure, analysis of appraising agencies and funding agencies, if available.
- Case studies carried out by academic and professional bodies, Non-Government organizations, Civil Society Groups, Environment Agencies etc.
- Details of escrow accounts, financial statements and returns and reports to be submitted by the PPP entity to the public participant.
- Systems of selection of the Independent Engineers and Independent Auditors and their mode of reporting and soundness of the system.
- Directions regarding the methods of audit, drafting audit findings and conclusions, audit evidencing and reporting.
- Exit Conference.
- Reporting and follow up.



**4.5.10** Since SAI's audits are generally 'post audits', and the contracts between parties to the PPP cannot be altered or amended based on the findings of the SAI, the benefits accruing from the contract audits are primarily for ensuring accountability and for future probity / lessons learnt. Moreover, the audit findings will help the public participant and authorities to manage their tasks and responsibilities in a more efficient manner. Besides, the projects being of long durations, the findings of the public audit will help to ensure that the parties to the PPP arrangement fulfill their obligations in time and without prejudice to the public interests. The end results of the project, the quality of the service provided to the public and the affordability of the user charges are all among the major objectives of the PPP, and hence, these have to be focus areas in planning the audit.

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

**4.5.11** The special circumstances relating to PPP arrangements would make it necessary to seek the cooperation of the private participant to cooperate with the public audit. As mentioned in paragraph 3.4, most documents required by the auditors would be available with the public sector partner of the PPP and easily accessible. Besides, the 'Independent Engineer' and 'Independent Auditor' will be responsible to report to the public sector participant on regular basis, and the public auditor could access those reports. In case any additional documents and data are required for the public audit, the auditors may request the public sector partner to provide them through their representatives. Generally, the contracts signed between the parties will include a clause that the documents required by the public sector partner and government agencies must be made available by the joint venture / private participant, which could be invoked to collect the additional information.

**4.5.12** However, it would be wise to cultivate the goodwill of the public sector partner as well as the private participant by interacting with their representatives and by assuring them of the audit objectives. The private sector partner may also be apprised of the role of the public auditors which is to provide a reasonable assurance to the government agencies concerned and to the public about the reasonableness of the risk transfers and about the quality and sustainability of the service provided by the partner, and that it is not about fault-finding. As affirmed in the INTOSAI guidelines on PPP audit, public auditors would do well to demonstrate that they support well-managed risk-taking by the public sector, and that their examination would not be focused on narrow considerations

of technicalities; but would focus on whether the project has met its economic and social objectives.

**4.5.13** The SAI has a constitutional responsibility to provide a reasonable assurance through its reports that the PPP project was awarded on transparent and equitable basis and bears value for money to the public. This will have precedence over the claims of commercial confidentiality of operations by the private sector partners of the project and will determine the scope and jurisdiction of audit.

**4.5.14** It will be also advisable to seek the cooperation of other government departments and agencies associated with the PPP project. For example, the Planning Commission has a PPP Division working under the Advisor to the Deputy Chairman, which is the nodal agency for PPP projects. The head of the audit organization may effectively coordinate with the PPP Division in the Planning Commission, prior to taking up the audit, and seek the cooperation of the Division to get all relevant documents including the analysis carried out by the Public Private Partnership Appraisal Committee (PPPAC) of project proposals. Similarly, cooperation of the Finance Ministry / Department may be helpful to access all required documents and data.

**v) *Engaging External Experts***

**4.5.15** According to INTOSAI, one of the major risks faced by SAIs in the audit of PPP projects would be the lack of ‘commercial expertise’ to evaluate whether State has protected its own interests adequately or whether it has taken unreasonable risks. In order to overcome this, SAIs may have to access specialized skills, if required. For instance, the Performance Auditing Guidelines issued by the IA&AD has clarified the stand to be taken regarding engaging experts to assist the public audit, where required<sup>31</sup>. According to these Guidelines (Paragraph 3.40), “the services of a consultant or expert of repute in the relevant field may be useful in developing the criteria, particularly on subjects that are either new or complex. *It will also contribute to acceptability and reliability of the criteria by the entity in particular and by the legislature, media, and public, in general*”.

**4.5.16** The areas where expert assistance is required must be carefully analyzed and the

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31 In the audit of ‘Public Private Partnership in Implementation of Road Projects by the National Highway Authority of India’ (No. PA 16 of 2008), the SAI engaged the Central Road Research Institute (CRRI) as an expert consultant to verify the quality of construction.

selection of such experts should be guided by impeccable choice. Experts are costly to engage and therefore, the audit planning unit must carefully analyze the cost benefit aspects before proposing the engagement of experts. The fact that the OMD contracts between the parties to the PPP arrangements will themselves provide for verification of the quality and parameters of the construction and operation by Independent Engineers and / or outside consultants must also be kept in view, and the need to engage another expert must arise only if there are doubts about the services provided by the Independent Engineers or if the project parameters justify such additional engagement. The final decision must be taken by the head of the audit office in consultation with the headquarters office.

**4.5.17** As pointed out by INTOSAI, the non-availability of appropriate expertise within the SAI to review the financial risks over a long timeframe through variable analyses may support the engagement of such experts for the purpose of audit. The lead financing institution's modeling and financial analyses will of course be available for verification by the public auditors. Engagement of outside experts may be required only in complex projects so as to confirm that the State has protected its commercial and technical interests adequately.

**4.5.18** In engaging external experts, public auditors have to take care to inform the audited entity sufficiently in advance of the decision, with details of their terms of reference. This will help the audited entity to prepare itself to receive the experts and observe the tests and investigations carried out by them. Advance intimation will also help to avoid any later controversies regarding the suitability or the capabilities of the experts, nature of the tests carried out etc., as also to get the cooperation of the audited entity for the smooth conduct of the investigations.

## SECTION V

# *Auditing Process and Criteria for PPP Audit*



## 5.1 Process flow of Public Private Partnership Arrangements

**5.1.1.** It is essential for public auditors to have a clear idea of the various stages through which a PPP project progresses before it starts providing public goods and services so that they could approach the subject of the audit without second guessing. They should also familiarize themselves with the process adopted to select the private sector partner, award the contract, mechanism adopted to fructify and manage the project and the nuances of each component of the PPP arrangement in position. The Chart E opposite will give a broad idea of the process flow of a typical PPP project.

## 5.2 Audit Methodology

**5.2.1** Audit of PPP projects requires a combination of skills and expertise; the audit methodology has also to be innovative. Since there are different types and categories of PPPs (as mentioned in Paragraph 1.3, Section I), the approach to audit should be dovetailed to target such divergent PPP arrangements. For instance, a Joint Venture Company (JVC) constituted for the purpose of an airport development will have a totally different composition and contracts arrangements than another partnership set up for a highway development, with a consortium of contracting companies carrying out the activity as an enterprise of their own. Similarly, BOT projects will differ from BOOT categories and so on. The focus of social sector PPPs (running schools, hospitals) will vary in their content and form to a significant measure from the PPPs set up for, say, road or port development. Nevertheless, most basic features will be common for all PPP arrangements, which will help public auditors to converge their approach to audit.

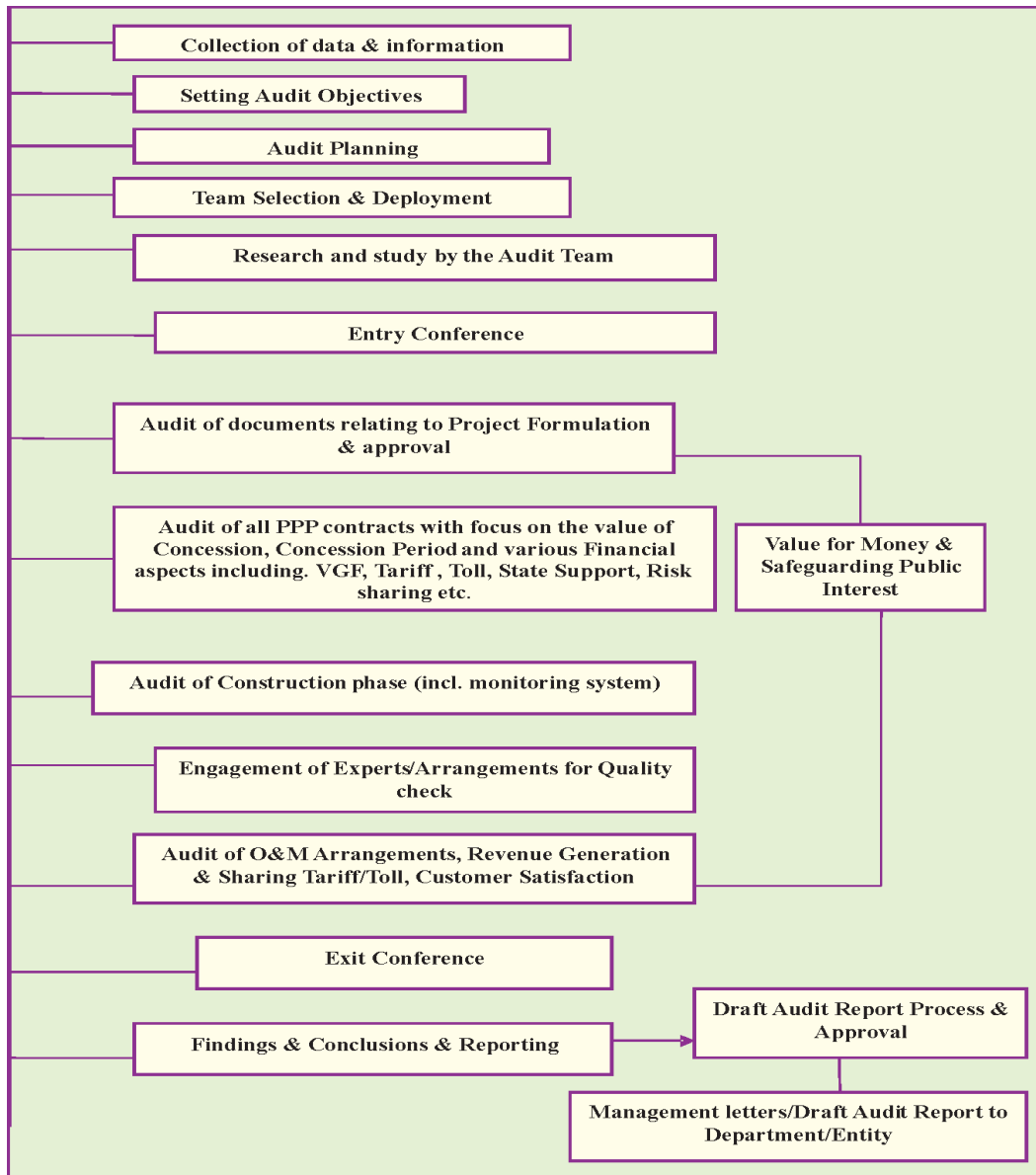
**5.2.2** The methodology for PPP audit will therefore have to be devised to suit the requirements of the individual projects under scrutiny. Basically, however, the following common approach to audit will form the basis of all PPP audits.

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

## Audit of PPP Projects

(CHART-E)

(A chart indicating the process of the audit of PPP projects is given below for information.)



- e) Financial audit to verify the justification for the viability gap funding / annuity payments.
- f) Limited audit of the construction and engineering to verify quality, innovations, economy and efficiency.
- g) Quality test, where necessary, to ensure the adherence to specifications and compliance with standards.
- h) Engaging experts to test aspects of quality and standards, if required.
- i) Survey to test the accuracy of demands and revenue collections against projections.
- j) Customer satisfaction level analysis through sampling techniques.
- k) To check the actual revenue generation and sharing.
- l) To ensure safeguarding the value of public money.

### **5.3 Audit of Public Private Partnership Projects: A Sequential Approach**

**5.3.1** A logical approach to PPP audit would be to cover the various aspects of the partnership arrangement sequentially as they occur in actual practice. In this regard, the first stage will be to analyze the project formulation and approval process. In the following paragraphs, detailed criteria / checklists for the audit of each important stage of PPP projects have been provided. It will be seen that some of the criteria given for different audit checks are common and overlapping; but these are repeated at the relevant places lest they should escape attention.

#### ***Audit of Project Formulation and Approval***

**5.3.2** The established procedures for the approval of PPP projects at the Central Government level envisage that the sponsoring ministry must identify the projects to be routed through PPP and undertake preparation of feasibility studies, project agreements etc. with the assistance of legal, financial and technical experts, as required. In order to obtain ‘in-principle’ approval<sup>32</sup> of the PPP Appraisal Committee (PPPAC), the proposals have to be accompanied by pre-feasibility / feasibility reports.

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<sup>32</sup> Where the PPP projects are based on an approved Model Concession Agreement (MCA), such ‘in-principle’ agreement is not required; but the need for a closer review of the feasibility during the audit is obvious.



**5.3.3** Generally, the following documents would be generated for the project formulation and approval.

- Strategic Plan.
- Feasibility Report.
- Detailed Project Report.
- Shareholders' Agreement.
- State Support Agreement.
- Operation, Maintenance and Development (OMD) Agreement.
- Concession Agreement.
- Technical Operation Agreement (where required.)
- Lease Agreement.
- Substitution Agreements.
- Independent Engineer's / Auditor's Agreement.
- Escrow Account Agreement.
- Other subsidiary Agreements.

Ideally, various forms of standard agreements as referred to above would be available for guidance of a public authority and would be used as the starting point in the process of arriving at documents like RFQ and RFP effecting conscious deviations and amplifications as required in each specific case. It may be mentioned here that the Planning Commission of India has brought out Model Concession Agreements for projects in different sectors of economy (see Annexure IV).

**5.3.4** In the audit of the project formulation, the following issues will be of relevance.

- a) Does the strategic plan identify the need and justification for the project, and prioritize the projects in accordance with a long term plan?
- b) Is the project justified on the basis of the demand projection? Did the feasibility study consider alternatives and was the choice of PPP taken after due diligence?
- c) Do the project characteristics logically lead to a PPP arrangement? Alternatively, was the PPP model adopted merely to overcome government budgetary restraints? Can the project stand on its own, and would be

- sustainable, based on the parameters?
- d) Has the feasibility study estimated the demand projections realistically and based on sample surveys/ statistical analysis?
  - e) Are the upgradation of design and standards, construction of facilities (like by-passes on the highways in urban and semi-urban areas) and other improvements planned to be taken up in phases, to match with effective and increasing requirements?
  - f) Are output specifications clearly and unambiguously spelt out? Alternatively, is there scope for doubts and misinterpretations regarding them?
  - g) Do the cost projections include all aspects of construction (such as service roads, toll plazas, by-passes/ passenger terminals and facilities, mandatory requirements, additional runways / deepening of channels, categories of berthing, lifts and equipments) and all other capital expenditures, including interest during construction (IDC) correctly?
  - h) Do the specifications in the feasibility/ project reports conform to approved specifications?
  - i) Are the cost estimates transparent?
  - j) Does the expected cash flow justify the total capital cost and feasible and timely abatement of the funding for the project?
  - k) What is the ROI (financial and economic) expected for the project? Has it been worked out correctly taking into account the most optimal formulation? Has care been taken to ensure that ROI envisaged in the RFP is not based on unjustified cost computations and is not inflated? Has the Discounted Cash Flow (DCF) technique been applied correctly to arrive at the Net Present Value (NPV)? Are the financial models designed carefully and realistically?
  - l) How was the pattern of state funding (VGF / Annuity) worked out? Are these reliable and as per the norms?
  - m) Were the established procedures for project approval correctly followed? Does the appraisal by various authorities bring out any features that would militate against the successful working of the project?

**5.3.5** The purpose of testing the feasibility of the project is to verify the integrity of the project formulation to ensure that the project was identified on the basis of sound

analysis of all project features and that it is not only viable and justified, but also lends itself into the format of a PPP project which would yield value for money. Though several features and assessments of the project authorities will be based on technical considerations and parameters, the important audit objective will be to check that these are transparent, based on accepted norms and specifications, and reliable.

## 5.4 Audit of Concessions and Concession Period

**5.4.1** One of the most important considerations during the audit of PPP projects is the review of the concession granted to the concessionaire in terms of the *quantum and the period* of the concession. Concession amounts to the delegation and transfer of the governmental authority for recovery of user charges / tariff to the private participant possibly under monopolistic conditions, with sharing of risks and contingent liabilities by the public sector participant. Hence, the critical issue before the auditors is to verify the reasonableness of the concessions granted, including the magnitude and the period of the concession.

**5.4.2** The aspect of commercial development referred to at (f) below is of considerable significance in the audit of PPP arrangements. Infrastructure projects invariably have tremendous potential in adding value to the land in the adjoining areas thus rendering them suitable for commercial development. This generates a great deal of potential revenue that is bound to be exploited by those holding title to the land. It is, therefore, important to ascertain the appropriateness of the area of land transferred by the public authority to the concessionaire for the purpose of the project and the extent to which it can use for commercial development or to what extent it can generate additional streams of revenue through commercial exploitation of land. It is also important to understand the extent to which the concessionaire can, legitimately and lawfully, generate income from similar commercial development by other land holders in the adjoining areas. Whether additional demand generated in the process for the services to be provided by the concessionaire has been factored in should be ascertained in audit.

**5.4.3** The public auditors may apply the following criteria, among others, during the course of their audit of the Concession Agreements.

- a) How was the concessionaire selected? Was **competitive bidding process** adopted, as required? Were all project parameters such as concession period, toll rates, price indexation, technical parameters etc. clearly stated upfront to

- make the process transparent and to ensure full and complete disclosures to the prospective bidders?
- b) Were the bidders clearly advised to indicate the **grant requirements** for the project so as to avoid future disputes? Were they also required to specify clearly the percentage of revenue they would be willing to share with the government agency?
  - c) Is the Concession Agreement fashioned faithfully on the pattern of the relevant **Model Concession Agreement** (MCA) issued by the Government? (In the case of States, where there are similar provisions / acts / rules / procedures, compare the agreements with them). If not, what are the major variations? Are they reasonable and justified?<sup>33</sup>
  - d) Are the provisions in the Agreement regarding the grant of the concession clear and specific, without giving room for **unintended gains** to and claims by the private partner? Are the language and the clauses of the Agreement worded clearly and unambiguously?
  - e) Is the concession closely linked to the total project cost? Was the **cash flow** from the completed project estimated properly and realistically? For instance, was it assessed year-wise for the concession period and analyzed on DCF technique etc. to arrive at the correct duration of the concession period?
  - f) Were all income realizations including that from **commercial development** (advertisements, service stations, recreation and amusement centres, commercial buildings etc.) taken into account in working out the cash flow? Did the bid document clearly spell out the scope, nature and extent of the commercial development and expected revenue generation?
  - g) Is the concession period too long? Too short? How was it fixed? What is the basis? Is the basis acceptable and transparent? For example, does the **concession period** correspond to the time of reaching the optimum traffic intensity? Was the present and projected traffic volume assessed carefully and realistically? How was this estimation carried out?

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<sup>33</sup> It would be advisable to pin-point and list out key clauses of the agreement and the critical facts that would have significant impact on the outcome of the agreement and the relative risks and responsibilities of various parties so that audit process remains focused without getting lost in the maze of information contained in copious documentation that constitutes an agreement.

- h) Was the **tariff formula** / toll / user charge computed on a transparent and reasonable basis? Is it cost-based? Is the formula fair to the user community? Does the estimated annual net income cover the debt-servicing, operation and maintenance costs, and reasonable profit, but not in excess of the established norms<sup>34</sup>?
- i) Is the tariff structure of an enduring and predictable mode? Or are they likely to be revised by an external agency / regulatory body (ERC / TAMP<sup>35</sup>) resulting in capping of tariff or, in certain periods, yielding possibly undue and **unanticipated benefits to the concessionaire** than what is contemplated as per the Agreement? How is it ensured that in the event of such revisions, the private participant / JVC does not retain income over and above the reasonable return envisaged in the Agreement?
- j) What is the extent of **return on investment** (ROI) envisaged / allowed in the tariff computations for the participants? Is it based on equity (as should be since debt servicing would be separately ensured) or capital employed? Alternatively, is the total capital cost the basis? *{Verify the implications of each and comment on any inflated rate of return provided in the Agreement, if applicable.}*
- k) Does the Concession Agreement provide for the payment of a **concession fee**? If this is in supplement of the revenue sharing arrangement, does it take into account the expected demand growth and cash flow of the concessionaire? Is the fee fixed for the duration of the concession period or is it varying depending on the actual revenue? Does it recognize the diminishing debt-servicing burden on the concessionaire and the likelihood of increasing revenue generation?
- l) Does the Concession Agreement provide for the **extension of the concession** period at its end for another equal or lesser term, at the option of the concessionaire? If so, is it designed to ensure value for public money and safeguard the public interest, or is it open-ended? Evaluate and comment on the wisdom of the policy for such extensions.

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34 For High Way projects, the norm is 20 percent of the capital employed and for power projects, 16 percent of the equity.

35 Electricity Regulatory Commission / Tariff Authority for Major Ports.

## 5.5 Audit of Risk Allocation

**5.5.1** As brought out earlier, 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<sup>36</sup>. A detailed list of risks has been provided in paragraph 4.4 of these Guidelines. The INTOSAI Guidelines also detail the various risks appurtenant to the PPP projects and the focus of audit relating to them.

**5.5.2** The public auditors may test the risk allocations of the project under scrutiny based on the following criteria, among others.

- a) Does the Concession Agreement identify the project risks and shift them to parties in a balanced manner? For instance, does it transfer the construction and operation & maintenance risks to the private participant with room for *innovation*?
- b) Who is entrusted with the financing risk? Who bears the total project cost risks? Is it the sponsoring consortia, the constructions agency, the financier/ bankers or the insurers or all of them to various degrees?
- c) What are the guarantees and assurances granted by the government / public sector partner? Are these well defined and quantifiable? Are the contingent liabilities arising from such assurances transparent and limited? Are the conditions, subject to which they could be invoked, realistic and specific? Are there clear and acceptable substitution clauses to face such eventualities?
- d) Who bears the political and economic risks like change of government policy or a sudden economic downturn? What are the conditions which rule them? Are these conditions justified?
- e) What are the revenue risks identified in the Agreement? How is the traffic and revenue volume assessed? Is the system proposed for surveying the volume of demand reliable and cost-effective? Is there a clause for re-adjusting the period of the concession in case the traffic volume and the

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<sup>36</sup> Risk allocation: PPP in O&M of Highways: MCA, Planning commission.

corresponding revenue fall short of the projections or exceed the projections?  
Are such re-adjustments in line with globally established norms and criteria?  
Are they too liberal or unrealistic?

- f) Are the clauses for extension / compression of the concession period worded in unambiguous and clear language to avoid disputes and counter claims? Are these likely to help in resolving disputes and differences?
- g) What is the extent of the risk of the private partner failing in his obligations? Does the contract include 'step in', 'buy out' clauses to face such an eventuality and to take remedial action without loss of time? Are the penalty clauses adequate to meet such events?

## 5.6 Audit of Financing Risks

**5.6.1** An important aspect to be verified during the audit is the transfer of financial risk. Public auditors must assess whether the entire risk was transferred to the private participant, and what was retained by the public sector partner. For instance, they should verify whether any guarantees were given by the government and if so, the conditions subject to which they could be invoked.

**5.6.2** Another important issue will be regarding *the financial closure* date given in the Agreement and the actual date of closure. Was the financial closure done within the sanctioned time? Has delay in financial closure resulted in any change of the assumptions underlying the project such as escalation of project cost, demand and revenue projections, etc.? Was any extension sought by the private participant? If so, was the penalty stipulated in the Agreement levied?

**5.6.3** A more crucial issue will relate to the nature of the financing arrangement. Were the terms of lending by the financing agencies reasonable? For instance, were the rates of interest levied at the RBI<sup>37</sup> / prime lending rates of leading banks? The auditors must verify the actual loan receipts and interest payments to ensure that the cost of financing the project is real and not disproportionate.

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<sup>37</sup> See definition of "Bank Rate": 'Bank Rate' means the rate of interest specified by the Reserve Bank of India from time to time in pursuance of section 49 of the RBI Act, 1934 or any replacement of such Bank Rate for the time being in effect. (MCA, Planning Commission.)

**5.6.4** It should also be checked that the schedule for the release of the sanctioned loans should match with the established milestones for the completion of the work from time to time. This will not only limit the payment of IDC; but will also ensure that the project gets completed to budget and in time. Verification of the Escrow Account information provided by the Independent Auditor should also be checked to see that the whole amount is received and invested for the project construction as per the TPC.

**5.6.5** Auditors must also check the performance bond furnished by the private sector partner and verify its adequacy, validity and the mode of releasing them. Was the bond released as per the terms of the Agreement? Does it provide the required level of assurances?

**5.6.6** Another issue to be checked is whether the analysis brings out any undue “loading” of the total project cost. This may occur when there is “over-engineering” of the project or if there is “padding” of the cost element, which is to be watched for. The working of the IDC should also be subjected to verification. (Please refer to the section on TPC below for details).

## **5.7 Audit of Viability Gap Funding (VGF)**

**5.7.1** Grants may be payable for the project either as viability gap funding (VGF) or as annuity during the construction and / or operation of the project. It is essential for the auditors to assess carefully the actual funding gap by analyzing the total capital cost, revenue generation based on projected demand, tariff / toll structure and capping (if imposed), rate of return and cash flow. The DPR will include the working of the total capital cost and the extent of shortage in financing the capital which may not be covered by the expected returns.

**5.7.2** The Central / State Governments provide viability gap funding up to 40 percent of the project cost in deserving cases. Under the “Financial Support to Public Private Partnerships in Infrastructure” (FSPPPI) scheme, infrastructure projects which are economically justified, but fall short of financial viability due to long gestation period, inability to raise the user charges to commercial levels etc. are granted financial support of up to 20% of the capital costs. Additionally, the sponsoring ministry or the State Government concerned could give grants of up to another 20% of the total capital cost. These are however subject to the condition that the private participant is selected on the basis of competitive bidding and would hold at least 51% of the shareholding of the PPP



unit. Further, the project agreements to be signed must adhere to the “best practices” that would secure “value for public money” and safeguard user interests.

**5.7.3** Among others, the following issues may be verified during the course of audit of VGF:

- a) Are all eligibility conditions including the status of the private participant, nature and type of the project etc. fully satisfied as per the FSPPPI Scheme?
- b) Was the total capital cost assessed properly? Are there any avoidable or non-essential elements built into the project cost? Are the constructions planned in a phased / modular manner to avoid the telescoping of expenditures?
- c) How was the tariff / user charge determined? Is the tariff / user charge reasonable? Has the sponsoring authority/ State Government certified the reasons why the charges could not be fixed at the commercial level? Are the reasons indicated realistic and acceptable?
- d) Have the financial / economic IRR been worked out correctly? Does the project merit VGF in real terms, based on the above factors?
- e) Was the private participant selected through the bidding process, as required under the FSPPPI Scheme? Was the procedure transparent and strictly as per established procedures?
- f) Were the project proposal and the financing plan reviewed by a leading financial institution? Does the analysis by the lead financier clearly establish the need for VGF?
- g) Are all constraints / conditions relating to tariff / user charges imposed by the VGF guidelines complied with in case the project has received such VGF?
- h) Are the Sponsoring Ministry / State Government / any other statutory authority providing a (matching) grant? If so, is there justification for the VGF in full or in parts?

- i) Has the private partner brought in / incurred the required equity support towards the project cost before the VGF was released? Is the mode of releasing the grant by the financial institution correlated / rephrased to meet the release of the debt installments? Is the system to monitor the project milestones for the purpose of release of the VGF devised as per the contract conditions?
- j) Has there any change in the scope of the project after the receipt of the VGF proposal and if so, what are its implications on the capital cost? Does the contract provide for taking into account such contingencies and to effect recoveries in appropriate cases?
- k) Do the accounts statements and returns (including by the Independent Engineer/ Auditor) clearly provide evidence of utilizing the VGF in the construction of the project?
- l) If the grant relates to the operation and maintenance, review the basis for arriving at the grant/ support, reasons and justifications, correctness of assumptions (regarding revenue, demand growth / shortfall in demand, tariff structure and other associated factors) for arriving at conclusions.
- m) Was the grant element arrived at on the basis of the lowest bid and as per the established procedures?

## 5.8 Audit of Tariff / Toll / User charges

**5.8.1** It may happen that the user charges for the facility created under the PPP arrangement may be subject to regulations by independent authorities or may be notified under the relevant statute by the state authorities concerned. For instance, the toll charges to be levied for a national highway may be notified by the Ministry of Road Transport & Highways or the port charges may be fixed by the Tariff Authority for Major Ports (TAMP). In the case of electricity, the State Electricity Regulatory Commission (SERC) is the empowered agency to fix the tariff. These features leave an element of uncertainty regarding the tariff or user charges to be levied in the future for the infrastructure facilities to be created under the PPP projects; whereas the Concession Agreements usually provide for the rate of return on investments on the basis of certain norms of tariff or formulae. Auditors have to carefully look for any possible ambiguities

and pitfalls in the fixation of tariffs and user charges which could be recovered by the private partners as per the terms of the contracts and for this purpose, they should undertake close scrutiny of the contract conditions.

**5.8.2** The rate of return (ROR) is a function of the equity support given by the partners for the project and should not be linked directly to the total project cost (TPC). This is because the TPC consists of both equity and debt usually expended in a reasonable debt-equity ratio. The Concession Agreement will indicate the debt-equity ratio agreed to for the project. Public auditors must verify the acceptability and reasonableness of the ratio by comparing it with the industry practice. Since the interest charges would be met directly from the revenue, and debt repayment will be a pass through in the tariff / user fee, allowing the return on the TPC will lead to double counting. Hence, the auditors have to carefully analyze the elements of the tariff / user charges and then decide on the justification for the rate of return receivable by the JVC / consortium, depending on what constitutes the tariff / user charges. The return on investment for the participants should not, in actual practice, exceed the norm established by the government in each case. In case there are no such norms or standards, the financial returns as per the industry norm may be ascertained and applied.

**5.8.3** Audit of regulatory issues in a PPP project will be conducted in accordance with 'Guidelines on Performance Audit of Regulatory Bodies'. However, the following audit points may be kept in view in the audit of tariff / user charges:

- a) What is the formula provided in the Concession Agreement to determine the tariff / fees / user charges? Is it reasonable and in line with the industry practice?
- b) Who is authorized under the Agreement to determine and levy the user charge / fees / tariff? Also, is there a cap on the user charge / tariff to be levied by the private partner?
- c) Are the user charge / tariff / toll (provided in the Agreement) subject to regulations by an independent authority? Will there be significant impact on the user charge / tariff provided in the Agreement in case the independent authority fixes the tariff common to (and applicable to) all providers of similar service? Does the agreement take into account such eventualities?

- d) In case the tariff/ fees are determined by a Regulatory Authority in common for similar infrastructure projects and the PPP stands to benefit beyond the stipulated ROI, is there a provision for the sharing of the windfall income between the parties to the PPP? How does the ROI factor affect the interest of the users?
- e) Is the user charge unreasonably linked to the total project cost? Is there a cap on the TPC?
- f) If at all the ROI is linked to elements of TPC, is there a clear and tight definition of TPC in the Agreement? Is there a cap on the TPC, in any case? Does the public sector partner have a right to review the reasonableness of the various elements of the TPC?
- g) Are there any provisions in the Concession Agreement/any features in the tariff structure that incentivize the concessionaire to report and reckon cost in revenue honestly and transparently?
- h) In case there is a change of scope during the construction, how are the tariff / toll / fees impacted? Is there a mechanism to safeguard the interests of the users?
- i) What is the system to revise the user charges periodically to index for inflation? Is the indexation linked to WPI (instead of CPI which is less relevant for user charges etc.) and if so, to what extent<sup>38</sup>? Is the formula for revision fixed in line with the procedure established by the Government? Is the indexation appropriate?
- j) Is the formula for levying the tariff / user charge cost based? If so, are there *cost norms* to control the costs? Further, is there a system to monitor the cost elements together with cost control procedures to ensure that the concessionaire does not inflate / gold plate the maintenance and operational costs?

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<sup>38</sup> WPI would reflect inflation in concessionaire costs more accurately than would CPI. Under MCA, Planning commission, the requirement is that only 40% of the user fee is indexed to WPI since debt is fixed in nominal terms and the real value of debt repayments decline with inflation; hence, there is no need to index the shares of revenues allocated to debt repayments.

- k) Are there incentives in place for the operator-partner to control the costs if they are a pass through in the tariff / user charge? Are there ceilings and caps on cost elements?
- l) Review the factors of the tariff / user charges which are likely to increase over time, and check whether there are adequate safety valves built into the formula to protect the consumer interest.
- m) In case there is a refinancing of the TPC with reduced interest burden, does the Agreement provide for automatic reduction of the TPC, with appropriate adjustments to user charges / tariff?

## 5.9 Audit of Total Project Cost

**5.9.1** Total Project Cost (TPC) is a critical input into several aspects of the contracting arrangements between the partners to a PPP. For instance, TPC determines the cost of construction, operation and management of the project, debt-equity mix, influences the user charge, viability of the project, financing pattern, financial rate of return (FRR) and economic rate of return (ERR). TPC could also be adversely impacted by concessionaire's risk perceptions in terms of attitude of the government authorities and degree of absolutism in the terms and conditions incorporated in the bid documents as to those aspects which can be precisely predicted and measured upfront. It is therefore very important for the public auditors to closely examine the TPC to see that it includes only essential items, its composition conforms to accepted accounting standards, and is not 'padded up'. Usually, the technical consultants for the project would have arrived at the TPC, which would be included in the DPR. The partners to the project are expected to have carried out their due diligence to ensure the accuracy and correctness of the TPC, but the private participants may have some inclination to over-engineer the project, partly due to their apprehensions of safety and security requirements of the project. Moreover, since the ROI from the project and the user charge / tariff / toll will depend on the quantum of the TPC, a higher cost of construction might benefit the private partner at the cost of the user community. It must be remembered that the transfer of the project risk to the private partner should not affect the cost of financing a project<sup>39</sup>. At the same time public auditors should eschew the temptation of expecting the public

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<sup>39</sup> Consultation Paper on PPP by the IMF

authority to transfer most of the risks to the private sector partner even as it may push up the project cost and thus prove counter-productive.

**5.9.2** Since one of the compelling reasons for adopting the PPP route is the superior technical and management skills of the private sector, this should be demonstrated by it through innovative approaches and tight control of the TPC (and operational costs). Public auditors are well-versed with the audit criteria to analyze capital expenditures and have sufficient expertise to review TPC. In order to help them in this task, however, some guidelines are given below.

- a) Does the Agreement provide for verification of TPC by the public sector partner on its own or through its representatives? Has it satisfied itself of the accuracy and correctness of the TPC on its own or through the Independent Engineer / Auditor?
- b) What is the definition of the TPC in the Agreement? What are the components of the TPC included in the financial package? Are they clearly defined? Are they directly related to the construction of the project, appropriate, and reasonable?
- c) Has the lead financing agency verified and recommended the adoption of the TPC and agreed to finance the same?
- d) Was the construction planned to be undertaken in stages and modules? Does the TPC represent the cost of only essential items and modules?
- e) Are there any items which could be postponed to a later stage of development in order to restrict the TPC?
- f) Is the cost of each item worked out in detail and as per approved / standard unit cost?
- g) Are there any non-essential / ornamental expenditure included in the TPC?
- h) Are any items of O&M / revenue expenditure wrongly included as capital expenditure?

- i) Is the financing cost worked out as per actual / RBI rates? Is there a provision to amend the TPC in case there is a refinancing plan during the concession period?
- j) Is the IDC correctly computed? Is there any loading for penalties and other charges?
- k) Are the insurance costs (during construction) added correctly as per approved/ standard practices?
- l) Are commissioning charges reckoned realistically?
- m) Is there any savings to be effected through innovative practices? In case of actual savings in TPC, what is the mechanism to reflect it on tariff / user charges?
- n) Are there any rewards / incentives provided in the contract to motivate the concessionaire to minimize the TPC? Are there caps and limits on various types of expenditures and cost items that could be added to the TPC?
- o) How is any cost accruing due to “*change of scope*” to be included in the TPC? Are these defined and restricted in scope?

## **5.10 Audit of Bidding and Evaluation**

**5.10.1** A major task to be carried out during the audit of PPP projects is the critical evaluation of the process followed by the government agency to select the private participant. Public auditors must verify the procedures followed in this regard from the beginning itself to provide assurance to stake holders about the integrity and transparency of the selection process. The basic postulate of PPP is that it should secure value for public money by ensuring transparency in the procedures followed and by ensuring adequate competition.

**5.10.2** Selection of the private participants by the government agency promoting the PPP Project may involve the following stages:

- *Request for Qualification (RFQ)*

**5.10.3** Where projects are likely to cost substantially and be complex both commercially and technologically, it is always necessary to have a layered bidding process whereby non-serious bidders are disqualified through an initial round of screening that focuses primarily on the capabilities, experience and track record of the bidder well before financial bids are called/opened. The RFP documents are invariably issued only to bidders who have requested for qualification and met all the parameters of RFQ.

- *Request for proposals (RFP)*

In order to generate adequate response, the promoter must make available details of the project with clarity, cost estimation, status of statutory and environmental clearances, tariff/toll/user charge formula, concession period, and opportunities for commercial development and the readiness to start the project. Details (though not the amount, which depends on the bids), of VGF, annuity payable etc., also may be made known. Restrictive clauses, if any, like the requirement of retention of existing staff, compensation payable to the staff, status of assets (land acquisition, encroachments, age of plant and machinery etc.,) also may have to be given.

- *Pre-bid Conference*

It is always to be expected that potential bidders who have purchased the RFP documents thus indicating their intention to participate in the bid process would have doubts, misconceptions about various facts as well as terms and conditions incorporated in the RFP document. It is similarly possible that those who have prepared the RFP document may not have a very clear and accurate understanding of the commercial and technological options at market could offer. It is, therefore, necessary that before the bidders submit their bids, there is a meeting of minds between the two sets of people which would, in most cases, result in fine tuning of the RFP document in order to bring them closure to reality on the ground and to thus ensure better response from the prospective bidders. However, holding of pre-bid conference does not absolve the bidders from their responsibility to carry out due diligence to make an assessment of various facts and terms and conditions and their impact on the possible bids they are likely to make.



- *Transparent evaluation of RFP*

The basis and method of evaluating RFPs to short list the bidders should be notified in advance. Auditors should verify whether the evaluation conformed to the criteria and was carried out impartially and strictly in terms of the accepted procedures.

- *Copies of Agreement*

The bidders must have access to copies of Agreements to be signed by them including Concession Agreements, State Support Agreements, and OMD Agreements etc.

**5.10.4** During the audit, the following issues may be checked among others to ensure the integrity of the process followed in the selection of the private participants to the project.

- a) Did the department/ PSU give adequate publicity to the proposal to generate widespread interest among all prospective bidders?
- b) While inviting RFP, were all required details and information about the PPP project made available to the likely participants?
- c) Was the procedure for evaluation and selection/award of the contract notified in advance?
- d) Were the prequalification prescribed for the bidders reasonable?
- e) Were the condition-precedents which would be fulfilled by the department/ government agency prior to the start date of the project notified? Were they appropriate?
- f) Were the short-listed bidders financially and technically qualified? Did they provide adequate proof for their capability and experience?
- g) Did the department/agency advise the bidders about the guarantees and assurances which it would offer to financing agencies, if required?
- h) Was the evaluation of the bids and proposals carried out based on well established criteria?
- i) Was a bid pre-bid conference held to clarify issues and to seek information on all aspects of the tender and bid documents before finalizing the tender?

Do the minutes of the conference provide any clue which needs to be investigated?

- j) Was the contract awarded to the bidder who offered the best terms in respect of lowest VGF/Annuity, highest revenue sharing etc.?
- k) Did the bidder comply with all terms and conditions of the bids such as performance bond, design and TPC etc.?
- l) If there was a 'Reserve Price', was this estimated properly and correctly?
- m) Were there any features relating to the process of bidding, evaluation and the award of the contract which might be questionable or not conforming to tendering principles and require special mention in the audit findings?

## 5.11 Audit of Construction of the Project

**5.11.1** Public auditors are conversant with the audit of construction of projects since PWD audit has been a mainstay of conventional auditing. In PPPs, since the construction risk is transferred to the private participant who is usually responsible for the design, construction, specification and quality thereof, the emphasis of the audit scrutiny may not be that of compliance, but that of the end product .

**5.11.2** The concession Agreements would provide for the appointment of "Independent Engineers" (IE) and "Independent Auditors" (IA) by the public sector partners to enable them to monitor the project activities, and to act on their behalf to accord sanctions and to coordinate the construction, technical and commercial activities. The IE is responsible to ensure the timely completion of the project by watching the milestones, quality of construction and adherence to the standards and specifications of the project by the implementing partner. For this purpose, IE will carry out quality tests and monitor the construction activities and report to the public sector partner periodically. The IE will also be empowered to give required clearances for the project activities and to accept the work on behalf of the public partner, after ensuring the quality through mandatory tests etc.

**5.11.3** The following criteria may be applied in the audit of construction of PPP projects.

- a) Did the public partner fulfill all conditions precedent which as per concession agreement were necessary for the private partner to start the construction on

- time?
- b) If there was any delay in the start up of construction, what were the attributed reasons? If there was delay on account of the private partner, was the penalty clause in the Agreement invoked?
  - c) Were the Independent Engineer /Auditor appointed on time? Were clear terms and directions issued to them for efficient monitoring of the construction activities? Is the monitoring system in practice satisfactory?
  - d) Were the preliminary/ pre-construction lists of the site conditions carried out in the presence of the Independent Engineer?
  - e) Were milestones for construction (stage-wise) laid down in the Agreement achieved? If there were delays, did the Independent Engineer bring them to notice in time?
  - f) Was penalty as per the Agreement levied on the private partner, if there were delays?
  - g) Did the Independent Engineer certify at every stage as to the quality of construction and adherence to specifications?
  - h) Was there any 'change of scope' in the construction effected at the instance of either partner? What are the implications of such 'change of scope' in terms of time and capex?
  - i) If the TPC has increased/decreased as a result of the 'change of scope', was necessary and consequential adjustments carried out in the TPC/VGF/ Financing arrangement?
  - j) Was the 'change of scope' due to faulty planning and avoidable? Has responsibility been fixed on the consultants (of DPR) or others concerned for the omission?
  - k) In case the private partner has made innovations in design, construction and management with substantial savings in project cost or project schedule, analyze the same and impact on TPC and revenue.
  - l) Was the project completed on schedule? If there was delay, analyze impact on cost, revenue and public interest.
  - m) Was any penalty levied for the delay as per the provisions in the Agreement?

- n) Did the Independent Engineer carry out the required quality tests before giving the ‘completion certificate’? Were the test results satisfactory?
- o) If outside experts have been engaged to test the quality and specifications of the project construction, analyze their findings and convey the same to the partners to the PPP arrangement for their responses and comments.

## 5.12 Audit of Monitoring of the Project Construction Activities

**5.12.1** The IA will verify all financing arrangements on behalf of the public sector partner, certify the expenditures where required, utilization of the VGF / annuity, and compliance of the private partner with the terms and conditions of the Agreements. He will also ensure that the items of expenditures reported are proper and reasonable, and admissible in terms of the contracts, and not ‘loaded’. Further, during the O&M stage, the IA will have to certify the legality and reasonableness of revenue expenditures, verify the revenue, and audit the escrow account and report to the public sector partner to the contract.

**5.12.2** During the audit of the PPP, the public auditors must check the process adopted for the appointment of the IE and IA, and ensure that the required procedures have been complied with. For instance, the Secretariat of the Committee on Infrastructure, Planning Commission maintains separate panels of qualified firms for engagement as IE and IA and the PPPs are required to source these experts from them. It must also be ensured that the selected representatives have the requisite expertise and qualifications. In other words, public auditors must test the integrity of the selection of the experts since they play a crucial role in ensuring the successful completion and operation of the projects. The terms and conditions of appointments of the IE and IA should also be verified to see that these are unambiguous, specific and appropriate. Besides, it should also be checked whether the fees payable to them are reasonable, since such payments would add to the TPC. More importantly, it must be seen whether proper guidelines and directions were issued to them for discharging their duties and that they have been made fully accountable for their tasks.

**5.12.3** A detailed review of the periodical reports submitted by the IE / IA, as per the prescribed schedules, would bring out the standard and the quality of their performance. Public auditors should bring out any deficiency noticed in their appointment and their performance (such as delay or omission to report, absence of adequate information on

conduct of quality tests, failure to report delays in achieving milestones, utilization of grants etc. ) by appropriate comments in the audit reports.

**5.12.4** Any other system deficiencies observed in the monitoring systems of the project construction and related activities should also be subjected to audit comments.

## **5.13 Audit of Commercial Development**

**5.13.1** Infrastructure projects developed through the Public Private Partnership route usually offer excellent opportunities for the commercial development of associated facilities (see paragraph 5.4.2). These may include advertising through hoardings on the highways or at the site of the project (ports, air ports etc.), land development (in the vacant lands allotted for the project or in their vicinity), gas and service stations, duty-free shops, wayside restaurants and recreation centres etc. The Concession Agreements usually allow the JVC or the private participant to exploit these commercial openings and raise revenue which must go to abate the TPC and to reduce the burden of toll / user charges on the consumers. In public audit, care must be taken to list out the commercial facilities granted to the consortium and to examine the cost incurred for such developments vis-à-vis their earning capacity and comment on any hidden benefits to the partners concerned. The scope for commercial development, however, is circumscribed by various factors like development controlled norms, environmental regulations and court directives on display of advertisements, municipal bye-laws. Public auditor should be aware of these constraints and ascertain that commercial development, proposed or actual, has been planned within these constraints to avoid any future adverse impact on likely revenues. Though the nature of the commercial development in each project may vary depending on the facility, location and other factors, the following criteria may be used in auditing such windfall benefits to the partners, with appropriate modifications as necessary.

- a) List out all commercial developments and facilities granted to the concessionaire as part of the Agreement and the expected / actual income derived.
- b) Check whether the cost of development claimed by the concessionaire is reasonable and appropriate.
- c) Verify the extent of income declared by the partner and its reasonableness.

In case the partner is allowed to lease the commercial property / asset for long terms, the implications on the concession period and the income generation must be tabulated. Does it affect the residual value of the asset to be transferred back to the government or the public sector agency?

- d) Verify that sufficient safeguards exist in the concession agreement to ensure that commercial properties are not rented or leased out by the concessionaire for any purpose that is unlawful or against public policy?
- e) Has the surplus income (after adjusting for cost incurred and maintenance, depreciation etc.) been fully accounted for and computed for the purpose of debt servicing, supplementing the user charges etc. as required?
- f) Has the Independent Auditor been directed to verify the actual expenditures and income as reflected in the original records and report? Is the IA performing his task as required under the contract with him?
- g) In case the JVC has collected any deposits for renting out the facilities, how are these accounted for?
- h) Is the sharing ratio for the commercial income with the public sector partner appropriately devised?

## 5.14 Audit of Operation, Maintenance & Development and the Collection of Revenue

**5.14.1** *In PPP projects*, the Operation, Maintenance and Development (OMD) risk is transferred to the private partner since it would be best suited to manage the task efficiently. The Model Concession Agreement (MCA) includes the terms and conditions for the OMD which are binding on the concessionaire.

**5.14.2** There could also be yet another type of PPP where the concessionaire is given an OMD contract to maintain and operate an already built or existing infrastructure facility (highways constructed by the NHAI / State Government, or an existing air port constructed by the Air Port Authority of India) and collect toll or user charge etc. to meet the cost. Private sector participation in the operation and maintenance of infrastructure 'would require a framework that enables the private operators to secure a reasonable

return at manageable levels of risk, assure the user of adequate service quality at an affordable cost, and facilitate the government in procuring value for public money<sup>40</sup>.

**5.14.3** According to the MCA, the guiding principle for determining the project-specific concession period for an O&M contract should be the periodic maintenance cycle of the project highway and should ideally terminate at a point where the life of the previous maintenance work has expired so that fresh investments are left to the next concessionaire. The stipulated optimum concession period is ten years to synchronize with augmentation of capacity requirements, as required. The concession period will take into account the TPC, cost of O&M, taxes and levies, ROI, and the user charges. The public sector partner will have prepared a cash flow statement based on these factors, which must be subjected to close verification during the public audit. The scrutiny will enable the auditor to assess the reasonableness and the justification for the user charges, and the concession period arrived at for contracting.

**5.14.4** The quarterly and annual statements of accounts and traffic / user charge information and other data to be provided by the private sector partner should be verified during the audit for accuracy and faithfulness. The verifications provided by the IE and IA may be used as supporting documents for audit evidence. Public auditors could also seek clarifications and assurances from these functionaries in case of doubts.

**5.14.5** The selection of the concessionaire has to be based on competitive bidding, with all project parameters clearly stated upfront. The usual criteria for such concessions may be followed in the public audit, including the following:

- a) Is the bidding process (if the PPP arrangement is for the O&M) transparent and as per established practice? Was the bidder who offered the maximum concession fee selected for the contract? Has the successful bidder provided the required performance security / guarantee in acceptable form?
- b) In case the contract is awarded on upfront payment basis, was the reserve price fixed correctly and by including reliable data on traffic demands, likely increases in demand, associated income, cash flow analysis, etc.? Were these verified by independent consultants? Was the NPV of the realizable revenue worked out correctly?

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<sup>40</sup> Deputy Chairman, Planning Commission; PPP in O&M of Highways: MCA (2006)

- c) Is the concession fee subject to annual increase in proportion with the increasing traffic?
- d) Was action taken to notify the toll / user charge promptly and without delay? If delays occurred with impact on revenue, analyze the reasons and make appropriate comments in the audit findings.
- e) Are toll plazas / toll booths constructed at requisite entry and exit points to avoid leakage of revenue?
- f) Have electronic and computerized vehicle counting machines (VCM) been installed at the toll plazas or at other places to monitor the traffic?
- g) Is the categorization of vehicles and toll rates fixed correctly and as per rules? Are weigh bridges / platforms in working condition and put to effective use?
- h) What is the formula for indexing the user charges in line with inflation? Is it appropriate<sup>41</sup>?
- i) Are there free service lines or auxiliary facilities attached? In the absence of free service roads, are local users given exemption from toll / user charges and are records of such cases maintained for verification?
- j) Has the concessionaire carried out annual or periodical traffic surveys and census to check the volume and increases in traffic and revenue? Do the IE / IA verify these surveys and ensure accuracy?
- k) Has the public sector partner carried out sample traffic / user survey on its own and reconciled with the returns submitted by the concessionaire?
- l) Has the concessionaire submitted the maintenance manual within the given period and are the preventive and regular maintenance carried out as per the manual and specifications?

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<sup>41</sup> MCA provides for indexation of the user fee to the extent of 40 per cent of WPI.



- m) Is the concessionaire remitting the concession fee to the public sector authority on regular basis? Is there a system to ensure the correct accounting and remittance of all revenues due as per the contract? Has the IA verified the Escrow Accounts and certified the accuracy?

## **5.15 Auditing Public Private Partnerships for Value for Money Evaluation**

**5.15.1** Public auditors should look at the PPP projects not only from the angle of safeguarding the interests of the public sector partners, but also from the user's viewpoint; besides, they must enquire whether the contract ensures profit sharing on equitable basis and whether there is a system to obtain regular information on the performance and in the discharge of the partner's obligations to the public participant, as also to the users at large. At the end of the day, what is of utmost concern is the customer satisfaction level; the public auditors' enquiries must be tuned to extract information on this crucial issue.

**5.15.2** The risk analysis should also include whether the public authority has planned to secure the best possible advice and analysis for the construction of viable solutions in the event of difficulties such as dismal performance of the partner, inability to finance the operations at some point etc., so as to avoid disruption of services to the public.

**5.15.3** Another important check to be exercised is to evaluate whether the PPP has met the intended social and economic objectives. The following questions, among others discussed elsewhere, would apply in a VFM examination of the public private partnerships.

- a) Has the PPP arrangement resulted in creating an efficient and economical facility/ asset for use by the public without forcing the government to commit heavy investments and avoidable borrowings?
- b) Has the PPP brought in technological excellence and innovation in construction and management which would reduce the cost, increase economy and efficiency and lead to better customer satisfaction?
- c) On the other hand, has it only led to a private sector monopoly in place of the public sector, without tangible benefits and visible advantages, to the detriment of the public?

- d) Has it placed a heavy future burden on the public sector by way of contingent liabilities and guarantees to be discharged at a future time? Has the agency/ government assessed and made provisions to meet the same?
- e) Would it have been feasible and affordable to create a project of similar quality and magnitude at a lesser cost by deploying state funds instead of depending on private sector funding and facilities? Was such an alternative feasible and affordable?
- f) Was the user community's interest fully taken care of by restricting/ adjusting the user charges / tariff / toll to affordable levels and at the same time, ensuring better and more efficient services?
- g) Are the concessions granted / annuity to be provided proportionate to the risks allocated to the private sector partner and reasonable?
- h) Is the concession period tailored to meet the reasonable TPC burden and the ROI, which could be considered as acceptable and as per the norms? Are the contractual provisions for the termination or extension of the concession period set in public interest?
- i) Is the revenue sharing arrangement between the partners justified from the public finance point of view?
- j) Was there adequate integrity and transparency in the selection of the private partner, did the process generate adequate competition, and could the partnership be reckoned as one finalized on level-playing field to all stakeholders concerned?
- k) Has the department / public sector agency put in place a system to safeguard its economic and financial interests by constant monitoring and reporting by independent and reliable representatives? Is the system sound and reliable?
- l) Is there a system to safeguard the consumers' interest regarding the quality and reliability of the service, and the affordability and reasonable nature of the toll / tariff / user charge? Is there a good system to monitor consumer satisfaction levels and to redress their grievances?

## 5.16 Audit of Valuation of Assets

**5.16.1** As part of their scrutiny, auditors must verify the valuation of the assets and infrastructure facilities which exist(ed) at the time of handing over the site / facilities to the successful bidder for the construction of the project and operation and maintenance.

**5.16.2** An important aspect to be verified in this regard will relate to the extent and value of the land made available for the project. Land usually forms a major part of the asset value, especially in urban areas where the land cost is not only very high, but will keep increasing over time. It is therefore important that for the public auditors to verify that the land acquired and handed over to the private partner is not more than what is really essential for the project. The value of the land handed over and brought into account is to be verified carefully since in many PPP arrangements, the value of the land and facilities transferred would become the government's share capital in the JVC to be formed. The tendency to acquire large stretches of land in the name of the project and to use it for unassociated or stand-alone commercial development by the private partner needs to be commented in audit.

**5.16.3** Valuation of the other assets transferred to the private partner or to the JVC is also very important and the auditors should verify the basis and reasonableness of such transfers. The valuation and the conditions for estimation of the residual value in the event of termination of the contract or at the conclusion of the concession period also require close attention.

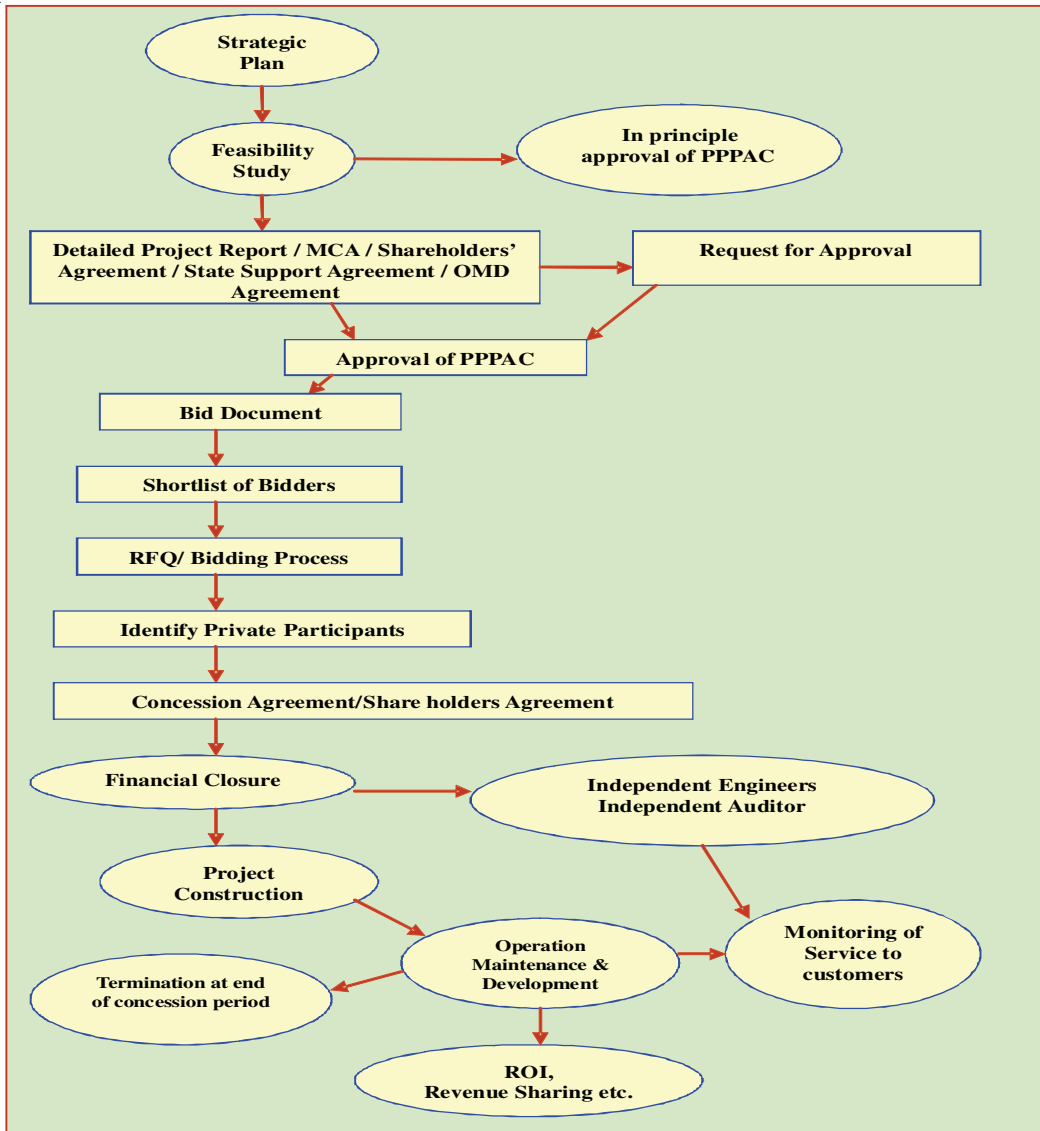
**5.16.4** Another question to be raised is whether the assets needed to be transferred on a permanent basis or whether they could not be transferred on temporary lease, with terms and conditions well defined. The value of the assets constructed by the private participant or the JVC must also be verified and the records examined; these valuations and the depreciations in respect of them would be of substantial concern in the event of termination of the contracts at future point of time.

**5.17** A flow diagram indicating the various stages through which the audit of a PPP arrangement will ordinarily pass is given opposite in Chart F.

CHART 'F'

## Flow Chart for Establishment of a Public Private Partnership Projects (PPPP)

(A flow chart indicating the stages through which a PPP project passes from the feasibility stage is given below)





## SECTION VI

# *Reporting Audit Findings and Recommendations*



## 6.1 Audit Findings and Reporting

**6.1.1** As is generally accepted, the contents of an audit report should be easy to understand, free from ambiguity and supported by sufficient, competent and relevant audit evidence, and be independent, objective fair, complete, accurate, constructive and concise. Public auditors of PPP projects must note that in respect of PPP projects, the important principle is to bring out in their reports, *what have been achieved* rather than *how it was achieved* by the private partner responsible to construct and manage the project. There is no doubt that good governance is a sine-qua-non in PPP projects as well, but since the objective of audit is not to audit the private partner as such, but to verify primarily the value for public money, the focus of the audit reports will be the review of end results rather than the *how* of achieving them.

**6.1.2** The major findings arising from the audit should be, as is the usual practice, presented at the Exit Conference. Care must be taken to support all audit findings with sufficient and relevant audit evidence. The findings must be carefully drafted to bring out full facts, evidence supporting the findings and conclusions and the arguments leading to the findings so that the public sector partner could provide its response without seeking further clarifications.

**6.1.3** Further, the SAI's<sup>42</sup> audit examinations should not focus on narrow considerations on what went wrong; but must disseminate the good practices noted during the audit scrutiny for the information of all concerned. Besides, multiple audits and evaluations should not give cause to discouraging the private partner. It is also important that the auditors do not focus only on technical issues at the risk of neglecting the social and economical effects of PPPs; they should also verify whether the project has met with those objectives in letter and spirit. Adequate opportunities must be provided to the partners of the PPP to respond to the audit findings, and their responses should find place in the reports in case those observations are retained in the reports.

**6.1.4** It will be a good approach to dovetail the audit findings in line with the established objectives of the audit. The fact that PPP aims at innovations through technological and managerial excellence should be kept in view. The audit observations should not be worded in a manner as would discourage innovations and risk takings.

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42 INTOSAI Audit Guidelines



Since the main feature of PPP is the sharing of risks in a balanced way, public auditors should not give the impression that they are against reasonable and calculated risk taking by the public sector partner. Though there may be no occasion to comment on the PPP policy as such, the impact of the policy on the project development and management and on the user community may be highlighted in appropriate cases, with supporting evidence. The guidance available in the CAG's Performance Audit Guidelines / Regulations on Audit and Accounts would be of use in drafting the PPP audit reports as well.

## **6.2 Audit Recommendations**

**6.2.1** Substantial care must be taken in framing the audit recommendations to be included in PPP audit reports. Recommendations, if included in the report, should be specific and precise and to the point. The effort should be to report on the lessons learnt rather than fault findings. The fact is that there is very little scope for amendments to the contract once they are signed and are in operation, even if the auditors point out omissions and deficiencies, unless they are patent violations to the terms of the agreements or erroneous interpretations or management failures. Nevertheless, the audit findings will bring out the deficiencies for future guidance as "lessons learnt", apart from helping to make the officials who processed the agreements accountable. They may also be helpful for the public sector partners to negotiate for better terms in implementation of the agreements depending on the nature of such findings. Hence, sufficient care must be taken in drafting the recommendations for inclusion in the audit reports; they should not be routine and must help the government department / public sector agency concerned to implement the project in the best public interest.

**6.2.2** It will be advisable to carry out a review of the audit findings and recommendations by comparing with the audit objectives established at the beginning as part of the audit plans, to ensure that these have been adequately met. Peer reviews of the draft reports would lend credibility to the reports.

# GLOSSARY OF TERMS



<b>Audit Guidelines</b>	Guidelines are those issued by the Comptroller and Auditor General for carrying out the mandate. These are generally on professional matters especially on emerging and important areas of audit or accounts. The guidelines are to be consistent with the Regulations on Audit and Accounts and are to be followed by the audit officers and accounts officers. (CAG's Regulations on Audit and Accounts 2007)
<b>Bank Rate</b>	The rate of interest specified by the Reserve Bank of India from time to time in pursuance with the RBI Act,1934 or any replacement of such Bank Rate for the time being in effect.
<b>Concession</b>	The right including the exclusive right, licence and authority granted to the private partner or a consortium or Joint Venture Corporation(JVC) formed by the parties to the Agreement, by the Government or a public sector partner under the relevant Agreement to construct, operate, and maintain the project for a mutually agreed period ( concession period) commencing from an appointed date and to receive grant, annuity at pre-determined levels and or to collect user charges, tariff or toll as may be for providing services from the project.
<b>Concessionaire</b>	The party to the PPP Agreement in whose favour, the concession is granted.
<b>Condition Precedent</b>	Conditions to be fulfilled by either party to the PPP Agreement prior to the appointed date so as to make the PPP agreement operative, and such as making available 80 percent of the required land by the Government/ public sector partner prior to that date.
<b>Contractual PPP</b>	Contractual arrangements between government departments or public sector undertakings under them and private sector entities whereby a facility is given by the public sector to the private sector or to a joint venture company which then operates the PPP for a certain period of time, known as 'concession period' and either recovers user charges and or receives annuity payments

from the government or the public sector, as may be. Often, this would also involve the designing, financing and constructing the project as well.

**Empowered  
Committee for PPP**

A Committee under the chairmanship of the Secretary, Economic Affairs, Ministry of Finance, and including Secretary, Planning Commission, Secretary, Expenditure and the Secretary of the line ministry dealing with the subject. The Empowered committee has powers to sanction viability gap funding up to Rs. 200 Crores for each PPP project subject to the budgetary ceilings indicated by the Finance Ministry. Amounts exceeding Rs. 200 Crores may be sanctioned by the Empowered Committee with the approval of the Finance Ministry.

**Escrow Account**

The bank account to be opened by the Concessionaire in which all inflows and outflows of cash on account of capital and revenue receipts and expenditures relating to the PPP project shall be credited or debited, as may be, in accordance with the provisions of the Concession Agreement and includes all sub-accounts of such Escrow Account.

**Eligible Sectors**

Eligible sectors for VGF are (i) Roads and bridges, sea ports, airports, inland waterways, power, urban transport, water supply, sewerage, solid waste management, and other physical infrastructure in urban areas, infrastructure projects in Special Economic Zones, and international convention centres and other tourism infrastructure projects.

**Financial Close**

Financial Close means fulfillment of all conditions precedent to the initial availability of funds for the PPP project under the Financing Agreements entered into by the Concessionaire with lenders.

**Good Industry  
Practice**

Good Industry Practice means the practice, methods, techniques, designs, standards, skills, diligence, efficiency, reliability and prudence which are generally and reasonably expected from a reasonably skilled and experienced operator engaged in the same

type of undertaking as envisaged under the Concession Agreement and which would be expected to result in the performance of its obligations by the Concessionaire in accordance with the Concession Agreement, applicable laws, and applicable permits in reliable, safe, economical and efficient manner.

- Infrastructure Deficit** The shortfall in infrastructure facilities in a given geographical confinement as compared to what it should be in saturated conditions, (which is proposed to be developed through PPP projects).
- Institutional PPP** Various forms of Joint Venture Companies between public and private stakeholders to undertake PPP projects.
- INTOSAI** International Organization of Supreme Audit Institutions- an international and independent body, which aims at promoting the exchange of ideas and experience between Supreme Audit Institutions in the sphere of public auditing.
- Net Present Value (NPV)** Net Present Value is the sum of all expected cash flows over the total economic life of the project, taken one year at a time, and discounted by a factor which represents the opportunity cost of capital.
- Private Finance Initiative (PFI)** A forerunner to PPPs initiated in the UK, under which the private sector designs, finances and builds social service facilities like schools and hospitals, which are then rented by the local authorities who pay for the services ( and not the users). The capital element of the funding enabling the local authorities to pay the private sector for such projects is released by the Central government as PFI credits. The loans are paid back by the service provider over the period of the PFI scheme; it is at risk if the service is not delivered to standards throughout.
- Public Private Partnership (PPP)** Innovative methods used by the public sector to contract with the private sector who bring their capital and their ability to deliver projects on time and to budget, while the public sector retains

the responsibility to provide those services to the public in a way that benefits the public and delivers economic development and improvement in the quality of life. The contracts entered for the purpose will have long terms, with a balanced sharing of financing, designing, construction and operation risks between the parties

**Public Private Partnership Project (PPPP)**

A project based on a contract or concession agreement, between a government or statutory entity on the one side and a private sector company on the other side, for delivering an infrastructure service on payment of user charges. (Financial Support to PPP in Infrastructure: The Secretariat for the Committee on Infrastructure, Planning commission.)

**Special Purpose Vehicle (SPV)**

An entity, usually a limited liability company, created to act as the form of a project consortium for a PPP project.

**Shareholder Agreement**

Shareholders agreement or institutional PPP cooperation model that is implemented between public and private partner by joint venture, regulates State administration structure law, Commercial law and Law on state and municipality capital shares and capital companies, as well as other related legal provisions.

**Public Sector Comparator (PSC)**

An estimate of what it would cost to undertake the project using traditional procurement methods. Public entities use the comparator as a benchmark to help to decide whether an alternative procurement method using private finance would offer better value for money.

**Total Project Cost (TPC)**

Total Project Cost means the lowest of the capital cost of the project (less equity support) as set forth in the Financial Package or the actual capital cost of the PPP project upon completion of the project including financing charges, interest during construction and provision for contingencies, minus grants given, if any.

**Value for Money (VFM)**

Represents economy, efficiency and effectiveness. In PPP projects, VFM means that the provision of the institutional

function or the use of the public sector property by a private party or JVC, in terms of the Concession Agreement, results in the benefit to the institutions defined in terms of cost, price, quality, quantity, risk sharing and a combination thereof.  
(Manual of PPP; South Africa)

**Viability Gap  
Funding (VGF)**

A grant, one time or deferred, provided and given by the Government of India under the Scheme for Financial Support to Public Private Partnerships in Infrastructure, with the objective of making such projects commercially viable.



## **ABBREVIATIONS USED IN THE GUIDELINES**

<b>Abbreviations</b>	<b>Expansion</b>
BIAL	Bangalore International Airport Limited
BOT	Build Operate and Transfer
BOO	Build Own and Operate
BOOT	Build Own Operate and Transfer
CAG	Comptroller and Auditor General of India
CPI	Consumer Price Index
DBFO	Design Build Finance and Operate
DBFOM	Design Build Finance Operate and Maintain
DCF	Discounted Cash Flow
DPR	Detailed Project Report
ERC	Electricity Regulatory Commission
ERR	Economic Rate of Return
FSPPI	Financial Support to Public Private Partnerships Infrastructure
FRR	Financial Rate of Return
IA	Independent Auditor
IE	Independent Engineer
IDC	Interest During Construction
INTOSAI	International Organization of Supreme Audit Institutions
IRR	Internal Rate of Return
JVC	Joint Venture Corporation
MCA	Model Concession Agreement
NAO	National Audit Office
NHAI	National Highways Authority of India
NIT	Notice Inviting Tender

Abbreviations used in the Guidelines

NPV	Net Present Value
NTBCL	Noida Toll Bridge Company Limited
MPTC	Major Port Tariff Committee
OC	Operation Concession
OMD	Operation, Maintenance and Development (Agreement)
PFI	Private Finance Initiative
PPP	Public Private Partnership
PPPP	Public Private Partnership Projects
PPPAC	Public Private Partnership Appraisal Committee
PPPAU	Public Private Partnership Appraisal Unit
PSU	Public Sector Undertaking
RBI	Reserve Bank of India
RFP	Request for Proposal
RFQ	Request for Qualification
ROI	Return on Investment
ROR	Rate of Return
SERC	State Electricity Regulatory Commission
SAI	Supreme Audit Institution
SPV	Special Project Vehicle
UNECE	United Nations Economic Commission for Europe
UK	United Kingdom of England and North Ireland
TAMP	Tariff Authority for Major Ports
TPC	Total Project Cost
WPI	Wholesale Price Index
VCM	Vehicle Counting Machine
VGf	Viability Gap Funding
VFM	Value for Money

*ANNEXURE – II*

**List of documents to be verified during the public audit of  
Public Private Partnership Projects**

<b>Sl.No.</b>	<b>A List of Documents to be Verified During the Audit of PPP Projects.</b>
i)	Strategic Plans of the entity.
ii)	Feasibility Reports and analysis of the same.
iii)	Detailed Project Report.
iv)	Business case for the project, including demand and revenue assessments and projections.
v)	Consideration of alternatives prior to deciding on the PPP mode.
vi)	Proposals submitted to SFC, ACPPP for ‘in-principle approval’.
vii)	Copies of the appraisals and comments recorded by the appraising agencies.
viii)	Sanctions and conditions, if any, attached.
ix)	Request for Qualification issued, and scrutiny of responses.
x)	Request for proposal issued and bidding process.
xi)	Financing pattern and total project cost estimation, if different from the DPR.
xii)	Viability gap assessment, sanction, payment records.
xiii)	Guarantees and assurances extended by the government / public sector partner as part of the contract.
xiv)	Funding offers and analysis of interest charges, repayment terms, financial analysis by the funding agency etc.
xv)	Evaluation and analysis of the bids.
xvi)	Model Concession Agreements and contracts including standards and specifications, OMD Contracts.
xvii)	Selection of Independent Engineers and Auditors.

**List of Documents to be Verified**

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xviii)	Inspection reports and quality reports submitted by the Independent Engineers.
xix)	Statements of project acceptance on completion, vouchers and bank statements relating to release of viability gap assistance, payments to independent engineers and accountants.
xx)	Documents relating to outside quality inspectors, if appointed.
xxi)	Details of Escrow Account to deposit revenue, meet expenditures and park overflow, and other receivable.
xxii)	Records relating to commercial developments, including contract arrangements, individual contracts etc.
xxiii)	Fortnightly / monthly statements receivable from the private sector partner relating to the operation of the assets.
xxiv)	Oversight mechanism to independently verify the actual traffic against the demand projections.

(Indicative only. Auditors must scrutinize each project episode on its own and prepare their own exhaustive list before the audit. Refer also to various documents listed under respective audit criteria in Section V)

### Check list for public auditors of Public Private Partnership Projects

Sl. No	Checklist to be Completed on Conclusion of the Audit	Verified	Not Verified
1	Does the audit portfolio contain all basic documents and information obtained from the auditee unit about the PPP Project?		
2	Was the project selected after prioritization on the basis its TPC, VGF, Concession period and relevance to the community among other things?		
3	Is the audit plan comprehensive? Does it include the scope of audit and the objective of audit?		
4	Has an entry conference been scheduled to be held and has the audit team collected the required materials to give a presentation on all basic issues? Is a preliminary list of documents and information to be requisitioned from the auditee unit ready to be handed over at the conference?		
5	In case it is proposed to engage external experts, have their tasks and terms of reference been finalized with the approval of the authorities concerned?		
6	Has the audit team verified the strategic plan, feasibility report, DPR and other documents and checked the process of project formulation, appraisal and approval, in detail?		
7	Are there any special features and conditions which would affect public interest in so far as Shareholders' Agreement, State Support Agreement, asset transfer, asset valuation, OMD contract etc which deserve mention in the audit report?		

8	Has the audit team analyzed closely the Concession Agreement to verify the value for public money with reference to the concession granted, concession period and other related benefits?		
9	Has the audit team assessed all risks associated with the project and checked the pattern of risk allocation? Are there any oblique risks or contingent liabilities which may affect public interest in the long run?		
10	Has the audit team verified the financial close methodology, financing pattern, financial risks and expected cash flow / DCF to check the extent of the elements of success for the partnership? Are there any factors which need to be brought to notice through the audit findings and recommendations?		
11	Has the team quantified the total VGF / Annuity / Grant received/ receivable by the private sector partner and checked the correctness and propriety of such payments?		
12	Has a detailed analysis of the tariff formula / basis of the expected toll / user charges been carried out? Has the future impacts of statutory / regulatory revisions been taken into account?		
13	Has the team checked the break down of the TPC and verified its faithfulness? Are there any padding and over-engineering cost in the TPC?		
14	Has the team verified the process adopted to invite RFP, evaluate the bids, select the participant etc. in light of the established procedures? Is there any deviation meriting comment?		
15	Was it possible to collect and verify complete information and reports on the construction of the project through the public sector partner and do they point to any slackness in quality, adherence to specifications, safety, standards etc.?		

16	Were the Agreements entered with the IE /IA verified? Is the system for the oversight of the project activities transparent and accountable? Are the terms and conditions and the directions and tasks of these agencies comprehensive? As seen from their reports etc., could their performance be considered to be efficient?		
17	Has the audit team applied the required checks relating to commercial development and associated concessions granted to the project developer and drawn conclusions?		
18	What are the features of the OMD contract which require special attention? Have they been verified fully to see the impact on the users in the long run?		
19	Has the team checked the method indicated for asset valuation at the time of termination of the contract, in appropriate cases? Is there any caution to be exercised by the management in this regard?		
20	On the whole, does the audit team consider that public interest has been fully safeguarded in awarding the PPP project to the private partner and that Value for Money has been materially achieved?		

*ANNEXURE IV***SUGGESTED REFERENCES**

<b>Sl. No</b>	<b>Publication / Title</b>	<b>Publishers</b>
<b>I.</b>	<b>Model Concession Agreements (MCA) for PPP projects</b>	
1	MCA for National Highways	Planning Commission
2	MCA for State Highways	Planning Commission
3	MCA for Operation & Maintenance of Highways	Planning Commission
4	MCA for National Highways (Six Laning)	Planning Commission
5	MCA for Urban Rail Transit Systems	Planning Commission
6	MCA for Non-metro Airports	Planning Commission
7	MCA for Greenfield Airports	Planning Commission
8	MCA for Ports	Planning Commission
9	MCA for Container Train Operations	Planning Commission
10	MCA for Re-development of Railway Stations	Planning Commission
11	Procurement-cum-Maintenance Agreement for Locomotives	Planning Commission
<b>II.</b>	<b>Model Bidding Documents for PPP projects</b>	
12	Model Request for Qualification Document (RFQ) for PPP projects	Planning Commission
13	Model Request for Proposal (RFP) for PPP projects	Planning Commission
14	Model Request for Proposal (RFP) for Selection of Technical Consultants	Planning Commission
15	Model Request for Proposal (RFP) for Selection of Legal Advisors	Planning Commission
16	Model Request for Proposal (RFP) for Selection of Transmission Consultants	Planning Commission



<b>III.</b>	<b>Guidelines for Appraisal, Approval and Assistance for PPP projects</b>	
17	Guidelines for Financial Support to PPPs in Infrastructure (VGF Scheme)	Planning Commission
18	Guidelines on Formulation, Appraisal and Approval of PPP Projects (PPPAC)	Planning Commission
19	Scheme for Financing through the India Infrastructure Finance Company (IIFCL)	Planning Commission
20	Guidelines for establishing Joint Ventures in Infrastructure Sectors	Planning Commission
<b>IV.</b>	<b>Policy Documents and Reports</b>	
	<i>Financing of Infrastructure</i>	
21	Projections in the Eleventh Five Year Plan: Investment in Infrastructure	Planning Commission
22	Private Participation in Infrastructure	Planning Commission
23	Report of the Core Group on Financing Plan for National Highways	Planning Commission
24	Report of the Task Force on Financing Plan for Airports	Planning Commission
25	Report of the Task Force on Financing Plan for Ports	Planning Commission
	<i>Regulation</i>	
26	Guidelines for Monitoring of PPP Projects	Planning Commission
27	Approach to Regulation of Infrastructure	Planning Commission
28	Draft Regulatory Reform Bill	Planning Commission
	<i>Power Sector</i>	
29	Report of the Task Force for operationalising Open Access in the Power Sector	Planning Commission
	<i>National Highways</i>	
30	Report of the Inter-Ministerial Committee on Restructuring of NHAI	Planning Commission

31	Report of the Committee of Secretaries on review of Toll Policy for National Highways	Planning Commission
32	Report of the Committee on Road Safety and Traffic Management	Planning Commission
	<b><i>Railways</i></b>	
33	Report of the Task Force on the Delhi-Mumbai and Delhi-Howrah Freight Corridors	Planning Commission
	<b><i>Ports</i></b>	
34	Report of the Task Force on Tariff Setting for PPP Projects in Major Ports	Planning Commission
35	Report of the Committee of Secretaries on Road Rail Connectivity of Major Ports	Planning Commission
36	Report of the IMG on Customs Procedures of Container Freight Station and Ports	Planning Commission
37	Report of the IMG on Reducing Dwell Time of Cargo at Ports	Planning Commission
	<b><i>Airports</i></b>	
38	Report of the IMG on Simplification of Customs Procedures in Air Cargo and Airports	Planning Commission
39	Report of the IMG on Norms & Standards for Capacity of Airport Terminals	Planning Commission
	<b><i>Best Practices</i></b>	
40	Selection of Consultants: Best Practices	Planning Commission
41	Frequently Asked Questions (FAQs) on Model RFQ Document	Planning Commission
<b>V.</b>	<b>Manuals of Standards and Specifications</b>	
42	Manual of Specifications & Standards for Two-laning of Highways	Planning Commission
43	Manual of Specifications & Standards for Four-laning of Highways	Planning Commission

**Public Private Partnerships (PPP) in Infrastructure Projects**

<b>VI.</b>	<b>Others</b>	
44	Guidelines for Formulation, Appraisal and Approval of Public Private Partnership Projects	Ministry of Finance
45	Guidelines for Invitation of Financial Bids for Public Private Partnership Projects	Ministry of Finance
46	Guidelines for Pre-qualification of Bidders for Public Private Partnership Projects	Ministry of Finance
47	Consultation Paper on Project Risk assessment for Public Private Partnership Projects Sponsored by Government/ Government Agencies / Public Sector Units Prior to Bid	Finance Ministry
48	Regulations on Audit and Accounts, 2007	CAG of India
49	Performance Auditing Guidelines	CAG of India
50	Report No. 16 of CAG of India for the Year ended March, 2007	CAG of India
51	Audit of Public Private Partnership Projects; Nandini Y. Kapdi	Indian Journal of Public Audit & Accountability, IPAI (Vol-1, No. 2, April-June, 2007.
52	Audit of Toll Collection Contracts, Sangita Choure	Journal of Management & Training, CAG of India (June-2008)
53	Guidebook on Promoting Good Governance in Public Private Partnerships	UN-2007; UNECE
54	Public Private Partnership	Fiscal Affairs Department, IMF (2004);In consultation with World Bank and Inter-American Development Bank
55	Managing Public Private Partnerships	World Bank, November, 2006

56	National Treasury Public Private Partnership Manual (Framed Under Public Finance Management Act, 1999), South Africa	Government of South Africa
57	Public Private Partnership Act, 2004	Government of Mauritius
58	National Public Private Partnership Policy Framework (December, 2008)	Government of Australia
59(a)	Guidelines for the Audit of Public Private Partnership Projects	International Organization of Supreme Audit Organizations (2001)
59 (b)	Guidelines on Best Practices for the Audit of Risk in Public Private Partnership	International Organization of Supreme Audit Organizations (2004)
60	INTOSAI Working Group on the Audit of Privatization: Guidelines on Best Practice for the Audit of Public / Private Finance and Concessions (Revised).	International Organization of Supreme Audit Organizations (2007)
61	Public Private Dialogue; The PPD Handbook (Operational Guidelines for the Charter of Good Practices in Using public Private Dialogue for Private Sector Development	Department for International Development, (DFID); UK
62	Standardization of Public Finance Initiative (PFI) Contracts	HM Treasury; UK (March, 2007)
63	Accounting and Financial Reporting for Service Concession Arrangement	International Federation of Accountants (IFAC) (March, 2008)
64	Case study on Concession for Delhi NOIDA Bridge	Sheoli Pargal, Planning Commission, August,2007
65	Case study on Concession for Nhava Sheva International Container Terminal	Bhart Salhotra, Planning Commission, November, 2007

*ANNEXURE V*

No.24 (24)/PF-II/2009  
Ministry of Finance  
Department of Expenditure  
(PF-II Division)  
New Delhi, dated the 21st July 2009

**OFFICE MEMORANDUM**

**Subject: Guidelines for Establishing Joint Venture Companies in Infrastructure Sectors**

1. The laying down of a clear set of guidelines for establishing joint venture companies in infrastructure sectors has been under consideration for some time. Based on wide discussions, guidelines for establishing joint ventures in infrastructure sectors have been framed and are enclosed. These guidelines shall apply to all Central Ministries/ Departments and Autonomous Bodies/Public Sector Undertakings under the control of the Central Government.
2. This issues with the approval of Finance Minister.
3. These instructions would come into force with immediate effect.

Sd/-  
**(Meena Agarwal)**  
Joint Secretary (PF-II)

To All Secretaries to Government of India

# Guidelines for establishing joint venture companies in infrastructure sectors

## 1. Introduction

1.1 In the meeting of the Committee on Infrastructure (COI) held under the chairmanship of Prime Minister on 5<sup>th</sup> December, 2007, it was resolved that Planning Commission would prepare a note regarding joint ventures in infrastructure sectors and send it to the Cabinet Secretary for further deliberations in a Committee of Secretaries (COS).

1.2 In pursuance of the above decision, a meeting of the COS was held on 8th September, 2008 when it was agreed that it would be desirable to formulate a set of guidelines to deal with proposals of Joint Ventures in infrastructure projects that typically involve Public Private Partnerships (the “**PPPs**”).

1.3 Accordingly, draft guidelines were prepared by the Planning Commission and circulated to the participants of the COS. The views of the members of the COS have been considered and incorporated in the guidelines that follow.

## 2. Scope

2.1 These guidelines would be applicable in cases where the Central Government or an entity owned or controlled by it (the “**public sector entity**”) and a private sector entity (the “**private sector entity**”) set up a Joint Venture Company (the “**JV**”) to formulate, develop or implement any infrastructure project or services associated with it.

2.2 The objective of these Guidelines is to lay down criteria which need to be examined carefully while considering formation of JVs in infrastructure sectors. Any deviation from these guidelines would need to be adequately explained and justified by the concerned Ministries/Departments.

### 3. Nature and scope of JVs in infrastructure projects

3.1 JVs are usually established because the JV partners have complementary objectives which they would be unable to achieve independently at lower cost or risk. These JVs have their own legal capacity, separate from the founders or equity holders. In most cases, 50 per cent or more of the equity of such JVs is owned by private sector entities and, therefore, these JVs are usually private sector companies.

3.2 Projects in infrastructure sectors often provide services of a monopolistic nature based on a power purchase agreement, concession agreement or project agreement (the “**concession agreement**”) between a public sector entity and a private sector entity. These services can be provided either directly to the users, as in the case of airports, ports and highways, or to a public sector entity such as in the case of purchase of power or transmission services by a public entity. In case a JV is formed for providing these services, it implies a two-level relationship i.e. a JV between a public sector entity and a private sector company on the one hand and a concession agreement between the public sector entity and the JV (controlled by the private sector entity) on the other hand. As a result, such transactions involve two separate agreements which pose issues that are more complex than the ones arising out of a JV formed as per extant guidelines of the Department of Public Enterprises that normally apply to production activity where the output is sold in the open market (eg. Maruti Udyog).

### 4. Conflict of Interest

4.1 There would normally be an element of conflict of interest in awarding an infrastructure project to a JV in as much as the public sector entity which is the grantor of the concession is also a partner in the recipient JV which is a private sector company. The grantor would normally be enforcing the terms of the concession, including imposition of penalties, with a view to securing the best possible outcome for the users and the public exchequer. On the other hand, it would be a shareholder in the JV which is controlled by a private sector entity that would normally have profit maximisation as its primary objective. At times, this could lead to conflicts of interest especially as the public sector entity would be the ‘regulator’ of the concession agreement as well as the ‘regulated’ under the same agreement.

4.2 Conflict of interest has the potential of leading to unintended outcomes at

different stages of a transaction. Be it in the form of a JV or in any other form, good governance requires identification and elimination of conflicts of interest in the formulation, award and implementation of infrastructure projects and services. This would also extend to the consultants and advisers of the public sector entity who should not be allowed to become advisers or beneficiaries of the private sector entity for the same project.

## **5. Accountability of public sector entity**

5.1 A JV would be seen in the public eye as a partnership between the public sector entity and private sector entity. Any lapses or failures of JV would expose the public sector entity to legitimate criticism even though the JV is managed and controlled by the private sector entity. Moreover, even the Government Directors on the Board of the JV would be liable and accountable for certain actions and decisions of the JV. These aspects should receive due consideration while evaluating a proposal to form a JV.

## **6. Multiplicity of agreements and obligations**

6.1 In infrastructure projects based on concession agreements between a public sector entity and a private sector entity, the entire range of rights, obligations, duties and support should be adequately covered in the concession agreement itself. In such a situation, no further value would normally accrue to the public sector entity through the formation of a JV and entering into a shareholders' agreement. Since, the rights and obligations of the equity partners in a JV would normally be determined by a shareholders' agreement which is essentially a commercial agreement, the sovereign rights being exercised by the public entity through the concession agreement could be compromised if the private entity takes recourse to enforcing its rights the shareholders' agreement.

6.2 The coexistence of a Concession Agreement and Shareholders' Agreement may allow the private sector entity to do 'forum shopping' by raising disputes either under the shareholders' agreement or under the concession agreement, depending on what is beneficial to it.

6.3 In view of the above, reliance on Shareholders' Agreement should normally be avoided. However, where a JV is to be formed and entering into a Shareholders' Agreement is considered essential, the Agreement should be simple and brief. It should



only contain provisions that are typically required for protecting the legal rights of a shareholder and not for addressing any issue that is or can be covered under the Concession Agreement.

## **7. Shareholding in a JV**

7.1 The share of the public sector entity in a JV could be in any proportion, say 74:26, 50:50 or 40:60, etc. If the public sector entity owns more than 50 per cent share, the JV would be regarded as a public sector entity. However, if the share of public sector entity is 50 per cent or less, then the JV is a private sector company and would, therefore, not be accountable to the Government, Public Accounts Committee, Public Undertakings Committee, C&AG, etc. Nor would the Government rules relating to procurement and expenditure apply to such a JV. Such a JV must, therefore, be treated at par with other private companies and any procurement of goods or services from such a JV must follow the normal tendering processes as per GFR.

7.2 The share of public sector entity is often kept at 50 per cent or less so as to enable the JV to function as a private sector entity with greater commercial freedom. However, this implies that though the public exchequer would contribute to the equity of such an enterprise, it would hardly exercise control over its functioning. It should be borne in mind that private sector entities would find such a JV to be more attractive as it would provide them with government funds and support without any accountability as noted above. It could also give them an undue advantage in government procurement as a JV would often be perceived to be a government or semi-government company. Such possibilities of undue advantage or vitiating of the government procurement process should be identified and eliminated in case a JV is proposed to be formed.

## **8. Equity versus Grant**

8.1 It is sometimes argued that where a project is financially unviable, the public sector entity should contribute to the equity of the proposed JV so as to make it viable. This view does not conform to established financial principles, as the financial viability of a project does not improve only because the equity is contributed by one party instead of another. The returns on project equity would normally remain the same whether or not the public sector entity contributes to its equity. On the other hand, if the objective is to improve project viability, the public sector entity should consider providing a grant

to the project. The Viability Gap Funding (VGF) scheme of the Central Government reinforces the rationale for providing grant support to projects that are not viable.

8.2 Before considering a proposal to form a JV for infrastructure projects and services, the public sector entity should carefully evaluate whether its objectives would not be served better if a grant is provided instead of equity in the JV.

## **9. Selection of JV partner**

9.1 In case it is decided to form a JV, the process of selection of the private sector entity must be fair and transparent, especially since the selection of a private sector entity to form a JV with a public sector entity confers financial and other advantages to the private sector entity. The selection of the private sector entity must be done on an open competitive basis so as to afford an equal opportunity to competing applicants and for securing the best outcome for the public sector entity. Selection through negotiations or on a nomination basis should normally be avoided.

## **10. Procurement of goods or services from a JV**

10.1 If a JV is a private sector company, any procurement of goods or services by a public entity from such JV should conform to the GFR and must follow a transparent competitive route. However, procurement through nomination, to the extent permitted by GFR, may be undertaken from the JV.

## **11. Other assistance to JVs**

11.1 A public sector entity should not encourage or advise other public sector entities or external agencies to contribute to the resources of such JVs or to procure any goods or services from the JVs. In other words, the public sector entity should treat the JV like any other private entity and ensure that it functions on a level playing field without getting any undue advantage on account of its partnership with the public sector entity.

## **12. Chairpersons of JVs**

12.1 In the case of JVs, senior government officials are often invited to function as Chairpersons of their Board of Directors. This can lead to situations wherein:

- (i) government officials function as chairpersons of the Boards of private companies, thus creating a perception that the JV is a government company;
- (ii) the private sector entity may derive unintended benefits arising from the perception that it is an entity promoted and supported by the government; and
- (iii) such an entity would be allowed to get business from the Ministry whose Secretary or Additional Secretary is its chairperson, thus leading to a potential conflict of interest.

12.2 It is, normally, not advisable for government officials to become chairpersons or hold other offices in a JV where the shareholding of private sector entities is 50 per cent or more.

12.3 In a JV under the Companies Act and where the Government is holding more than 50 per cent shareholding, the Central officers can only go on permanent absorption basis unless exempted by the competent authority. In other cases where Government's share is 50 per cent or less, Government officers cannot go to such organisations on deputation basis.

12.4 If a JV is set up as an autonomous /statutory organisation, then DOPT's guidelines on deputation for All India Services Officers issued on 28.11.2007 and similar guidelines for members of the organised Group 'A' and 'B' services, issued on 29.2.2008 would apply.

### **13. Equal share-holding by JV partners**

13.1 It is not advisable to form a JV with a stake of 50:50 between a public sector entity and a private sector entity since such a JV would be regarded as a private sector entity and would function as such even though the public entity would be an equal shareholder. There may be little merit in a public sector entity contributing 50 per cent of the equity and allowing the private sector entity to manage the JV as a private company. Moreover, equal shareholding also has the potential of a deadlock where public interest may be compromised.

13.2 In some cases, JVs are formed with equal participation by the Central and State

Governments, thereby creating JVs ostensibly in the public sector, but without applying the rules and regulations associated with public sector undertakings. Such PSUs are neither regarded as CPSUs nor as State PSUs. As a result, they are neither accountable to the Parliament nor to the State assembly. Moreover, neither the rules of Central Government nor the rules of the respective state governments apply to such companies. No such companies should, therefore, be formed by any public sector entity. It has been reported that in one such case, the C&AG is not clear whether its audit reports should be placed before the Parliament of the concerned state legislative assembly. It is necessary to examine these issues and find a suitable resolution. A separate exercise would be undertaken for making appropriate recommendations.

## 14. Valuation of assets

14.1 Where the public sector's contribution to a JV is in terms of assets, the valuation of assets should be carried out diligently and reflected appropriately. The public sector needs to ensure that its equity share properly reflects the value of the assets which it contributes. These may not be only tangible assets. In the case of assured or preferential procurement of any goods or services or other such revenue streams, it would be important for the public sector entity to identify the direct and indirect benefits to the private sector entity and factor the same in the structure and scope of the proposed agreement. The valuation of such tangible and intangible assets should be approved by the competent authority such as EFC, PIB, extended Railway Board, etc., as may be applicable.

14.2 In order to make a fair assessment of the potential value of the proposed JV, its projected revenue streams and business model should be assessed prior to the selection of the private sector entity. Further, the resource requirements, including funds, assets and staff, need to be considered at the outset. The manner of realizing returns and the dividend policy should also be determined upfront. The total resource commitment and estimation of revenue requirement should have the approval of the competent authority.

## 15. Contingent liabilities

15.1 The public sector entity should be fully aware of the risks and responsibilities it is undertaking by entering into the JV. It needs to consider carefully the implications of providing guarantees or warranties, or indemnifying the new company against any risks. Actions which may give rise to any potential liabilities should be avoided.

15.2 A careful assessment of potential operating losses should be made and the liability, if any, of the public sector entity to fund or support such losses must be clearly spelt out.

## 16. Exit and termination

16.1 The public sector entity will have to assess the possible recourse it would have for recovery of its investment in case the JV is unsuccessful. The exit provisions should also be formulated at the initial stage.

## 17. Appraisal and approval process

17.1 Since the formation of a JV involves public funds, assets, contingent liabilities and obligations, the objective for which the formation of JV is being considered needs to be examined carefully for establishing that the objective cannot be met by any other means. The public sector entity intending to form a JV with a private sector entity should carefully explore the possibility of meeting the desired objective through alternate means instead of creating a JV.

17.2 In particular, the proposal for formation of a JV should clearly identify and evaluate the following:

- (i) whether the issues arising out of the nature and scope of the proposed JV, potential conflicts of interest, accountability of the public sector entity, multiplicity of agreements and obligations, and the extent of shareholding have been considered and addressed (see paragraphs 3,4,5,6 and 7);
- (ii) whether the objectives of the public sector entity would be served better if grant is provided instead of equity in the JV (see paragraph 8);
- (iii) the objective for formation of the JV and the other potential options which may serve the purpose (see paragraph 17);
- (iv) the process of selection of the private sector entity is open and competitive (see paragraph 9);

- (v) government officials would not normally be proposed as chairpersons of a JV in which the private sector has an equity of 50 per cent or more (see paragraph 12);
- (vi) the extent of shareholding necessary by the Central Government in a JV with the State Government or a private entity (see paragraph 13);
- (vii) valuation of tangible and intangible assets being contributed by the public sector has been carried out diligently and has the approval of the competent authority (see paragraph 14.1);
- (viii) the total resource commitment and estimation of revenue requirement have been assessed and have the approval of the competent authority such as EFC, PIB, extended Railway Board, etc., as may be applicable. (see paragraph 14.2);
- (ix) the implications of any actions which may give rise to potential liabilities, such as providing guarantees or warranties, or indemnifying the new company against any risks (see paragraph 15);
- (x) an assessment of potential operating losses and the possible liability of the public sector entity to fund or support such losses (see paragraph 15.2);
- (xi) formulation of exit provisions and assessment of the possible recourse it would have for recovery of its investment in case the JV is unsuccessful (see paragraph 16.1);
- (xii) assessment of the liability and accountability of the public sector entity and the Government directors on the Board of the JV due to any lapses or failures of JV (see paragraph 5.1);
- (xiii) whether the consultants and advisers of the public sector entity can potentially be engaged as advisers or beneficiaries of the private sector entity of JV for the same project (see paragraph 4.2); and
- (xiv) whether the possibilities of any undue advantage or vitiating of the government procurement process have been evaluated and eliminated (see paragraph 7.2).

17.3 Proposals for formation of a JV in infrastructure sectors should be appraised and evaluated having regard to the issues raised above. Where an exception is to be made, approval of the competent authority should be obtained in accordance with extant procedures.

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