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IMPLEMENTING PPPS IN TIMOR LESTE
– Institutional Challenges in the Near North

LAURE DARCY

CONTEXT

When Timor Leste became an independent country in 1999, much of its basic power, water, transport and telecommunications infrastructure had been destroyed in the preceding years of conflict. Almost everything needed to be rebuilt and the country faced a massive task in planning and executing a wholesale infrastructure investment program estimated at more than $10 billion. Eleven years later, while notable progress had been made in some sectors, Timor-Leste remained far behind its original investment targets. While the country possessed significant oil & gas resources to support infrastructure financing, its capacity for investment planning and implementation remained constrained, and as such its engagement with the private sector was narrowly focused on traditional construction and engineering contracts. Much of the potential for the private sector to expand the Government's capacity to deliver infrastructure and related services remained untapped.

Recognizing the need to broaden the scope of this private participation in infrastructure, the Government began the development of an enabling framework for public-private partnerships (PPPs) in 2010. This framework was to include a policy statement, a law, project cycle procedures, guidance material and standardized documents, all of which were to be designed to facilitate the preparation and implementation of PPP projects.

ISSUES

When it was first conceptualized, the PPP framework was met with some resistance from a range of observers. It was argued that PPPs were not suitable for Timor Leste because:

- There was no public sector capacity to plan, execute and implement PPP contracts,
- The existing commercial legal framework was incomplete, and
- Timor Leste did not have a sovereign credit rating, which would inhibit commercial financing.

While these issues are real, and remain impediments to a large-scale PPP program, they do not in themselves inhibit the implementation of an initial set of PPP contracts. Indeed, Timor Leste itself entered into a concession contract with a consortium led by Portugal Telecom in 2002 for the construction, rehabilitation and operation of the fixed line and mobile telecommunications networks. Other emerging and post-conflict economies, such as Papua New Guinea, Laos, Vanuatu and Lebanon, have also implemented PPP contracts in the absence of a robust legal and institutional framework for these arrangements. Where these frameworks do not exist, the risk premium for investors is commensurately higher, pushing up the costs of financing and requiring the public partner to assume much more of the risk than they would otherwise in a mature PPP environment. It also often results in a smaller pool of potential private partners, as many global companies will not enter into PPP arrangements in countries with no experience with these transactions and no formal process for developing them.

The Government of Timor-Leste, recognising its potential to develop a pipeline of PPP projects and understanding the benefits of a standardized, predictable process for preparing these projects, began developing a PPP framework in late 2010. This framework would begin to address the first impediment to a successful PPP program: the public sector's ability to plan, execute and implement PPP contracts. The two other major impediments, the incomplete commercial legal framework and the absence of a sovereign risk rating, would need to be addressed with separate initiatives.

DEVELOPING THE PPP FRAMEWORK

With technical assistance from the Asian Development Bank (ADB), an incremental approach was designed to facilitate dialog, understanding and buy-in from government counterparts, many of who were unfamiliar with PPP concepts. The first step in this process, the PPP Policy, was finalised and endorsed by the Ministry of Finance in early 2011. The policy outlined the basic principles to be espoused in a future PPP law, as well as the process and institutional roles for preparing and implementing PPP transactions.

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While in most countries PPP Policy development can be a complex process, in Timor Leste it was complicated by a highly dynamic institutional and regulatory environment, specifically,

- The creation of the National Development Agency, the Infrastructure Fund and the Major Projects Secretariat in 2010-11, redistributing some of the functions of the line ministries for infrastructure planning and implementation;
- The splitting of procurement functions between the new Procurement Commission and a subcontracted private procurement agent;
- The continued procurement of some infrastructure projects on a direct selection basis by members of government, often as a result of unsolicited proposals prepared by private companies; and
- The absence of a regulatory framework for the power, water, telecommunications and transport sectors.

The PPP Policy therefore needed to focus on a core set of principles, powers and processes that could be implemented within this dynamic environment. Drawing from international experience with PPP programs, the Policy specifies the following:

- The roles, responsibilities and powers of the Ministry of Finance, PPP Unit, Contracting Authorities and PPP Steering Group to prepare, assess and sign PPP agreements
- A special procurement regime for PPPs, outside of Government's traditional procurement processes but fully consistent with the guiding principles of transparency, fairness and competition
- The range of content of PPP agreements, which can include extensive output specifications and parameters to guide pricing in the absence of a regulatory framework.

The PPP Decree Law, which was endorsed by the Council of Ministers in February 2012, mirrors the Policy and specifies that unsolicited proposals for PPPs can only be considered if they are not for projects already identified in the Government's infrastructure investment plan. Where these proposals are judged to have potential to offer value for money, they will be subjected to the same PPP project development cycle (including competitive tendering) as solicited projects.

With Timor Leste's PPP Decree Law now in force, work is underway to establish the institutional mechanisms required for its implementation. This will include additional regulations outlining the PPP project cycle, guidance material, model documents, as well as the establishment of the PPP Unit and PPP risk assessment functions. As PPPs are but one modality for delivering infrastructure services, the broader infrastructure investment planning process will need to be strengthened to ensure that future PPP projects fit within the Government's priorities.

Parallel to this, three initial PPP transactions are now under preparation, which will allow the PPP Unit to gain experience, lend credibility to the process and further refine its procedures. These projects were selected after a rigorous screening process, with support from the Asian Development Bank and International Finance Corporation (IFC). Twenty-two planned infrastructure investments were screened for their suitability to be procured as PPPs, from which three emerged as appropriate pathfinder projects; the upgrade and operation of the Dili Airport, the construction and operation of the new Tibar Bay port and the operations and maintenance of the new 137 MWe power station at Betano. ADB and IFC are continuing to provide support to the PPP Unit for the preparation of these PPP transactions.

STRENGTHENING THE COMMERCIAL LEGAL FRAMEWORK

One of the key benefits of the PPP law is that it provides a clear legal basis for PPP projects and establishes transparent rules and procedures for their procurement. This is an important first step in reducing the risks associated with PPPs in Timor Leste. In order to build momentum in the program and further reduce risks and transactions costs, however, key gaps in the commercial legal framework will need to be addressed. These include provisions for insolvency and reorganization, secured transactions, land registration, business taxation and dispute resolution. Some of these reforms are already underway (e.g. land registration), others will need to be accelerated. The enforceability of contracts against the government will also be of concern to potential PPP investors, as there is little experience with this in Timor Leste. The government's record of honoring its contractual commitments to date, however, should serve as a mitigating factor. Until these issues are addressed, most PPP agreements are likely to require the Government to assume more of the project risks than would be expected in a mature PPP market. This would be consistent with the experience of other countries in the early stages of their PPP programs. In South Korea, which has developed a very successful PPP program, the Government provided both guarantees and financing to many of its early PPP transactions, a practice that was discontinued as the PPP market grew and matured.

REDUCING SOVEREIGN CREDIT RISK

Timor Leste has not sought and therefore does not possess a sovereign credit risk rating from any of the three major rating agencies. Commercial lenders often look to these ratings for an informed assessment of the country's ability to service its existing and future debt obligations. The ratings include an assessment of political risks, including the likelihood that successive Governments will honor long-term payment obligations such as those inherent in PPPs. This is not the same as the question of the enforceability of contracts cited above, as political risk is focused on stability in Government and the propensity of politicians to honor contracts signed by previous administrations.

Timor Leste has very low levels of sovereign debt and substantial future revenue flows from its oil and gas resources, which are transparently managed through the Petroleum Fund. These factors, combined with the country's relative political stability, should serve to mitigate the sovereign credit risks assessed by future commercial lenders. While it is certain that lenders will demand a far higher risk premium for projects undertaken in Timor Leste than in Australia or Korea, for example, this risk premium will decrease as the country develops a track record of PPP transactions and strengthens its commercial legal framework, as cited above. In the interim, partial risk guarantees can be secured from multilateral institutions to help reduce the costs of finance, as is common practice in frontier markets.

NEXT STEPS

Timor-Leste has made rapid progress in developing a PPP framework over the past 18 months. While other Pacific countries have languished for years, unable to finalize their PPP legislation, what Timor Leste has achieved is commendable. While it remains a work in progress, achievements to date are a direct result of the political commitment to expand the role of the private sector in the economy and accelerate the pace of infrastructure development. The newly elected Government now has an opportunity to underscore this commitment by investing in the institutions that will deliver the PPP program, addressing the key gaps in the commercial legal framework and ensuring that the first PPP transactions currently under preparation are successfully implemented.

To support the institutions required to deliver the PPP program, it is recommended that outside expertise be used to supplement existing and newly recruited Timorese staff in the PPP Unit and Ministry of Finance; some of this external expertise will be supported by development partners, but this can only be an interim solution. The PPP Unit's business plan provides a good outline of its staffing

requirements that could serve as the basis of a formal budget request. In addition, the Government will need to define the most effective mechanism for monitoring the implementation of PPP contracts; this can be done by the sponsoring public contracting authority, the PPP Unit or a regulatory body. Finally, it is also recommended that the Government set aside funds for a project development facility to finance transaction advisors on a case-by-case basis. The most prevalent cause of failure of PPP programs is inadequate transaction preparation, so it will be critical to get this right to give the program credibility.

As the PPP program gets underway, remaining gaps in the commercial legal framework should be addressed. While the new civil code, which came into force in March 2012, has chapters on contracts and property, it is not yet clear if these will be entirely supportive of PPP arrangements. Other commercial laws which regulate insolvency and reorganisation, secured transactions and dispute resolution will need to be developed to ensure that they facilitate rather than inhibit future PPP transactions. With a sustained commitment from the new Government, Timor Leste is poised to develop the Pacific region's first successful PPP program.

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Ms. Laure Darcy has more than 18 years of experience implementing state-owned enterprise reforms and facilitating private investment in infrastructure. She has worked extensively in Asia, the Pacific, Middle East and Eastern Europe. SInce 2007 she has been managing the SOE reform and PPP work supported by PSDI in the Pacific, as a full-time consultant. In this capacity she has developed PPP legal and institutional frameworks, conducted PPP opportunity assessments and pre-feasibility studies, and promoted PPPs as an effective service delivery model in the Pacific.