

BTL Experiences Worldwide

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1. Introduction

In 2005, the Korean government revised the Act on Private Participation in Infrastructure to introduce the Build-Transfer-Lease (BTL) type project. Different from the Build-Transfer-Operate (BTL) scheme which has been very popular in Korean Public-Private Partnerships (PPPs) market, in the BTL system, the private company constructs facilities such as schools, hospitals, public housing, and other social infrastructure facilities that do not generate profits at its own cost. The government pays the lease fee and bears major risks including demand risk.

BTL, however, does not refer to just a lease type Public-Private Partnerships (PPPs) project in Korea. The characteristics (service purchase, long-term contract, life-cycle management, etc.) and target facilities of Korea's BTL scheme are very close to those of long term service purchase contracts, mainly Private Finance Initiative (PFI) projects, in quite a few advanced countries. Thus, reviewing their experiences of PFI can provide meaningful implications for planning and implementing the BTL projects in Korea.

The paper consists of four chapters. The next chapter provides a brief outline and characteristics of the BTL projects in Korea. Chapter three discusses four major issues such as accounting rule, payment mechanism, employment, and transaction cost and reviews the international experiences regarding these issues across countries. Chapter four presents the policy suggestions for the BTL projects in Korea.

2. BTL project outline and characteristics

Under the BTL system, the private partner is reimbursed for constructing the facilities and transferring the ownership to the government by acquiring management and operation rights. The private company exercises its management and operation rights and leases the facilities to the government for a given period. Through agreed lease fee, the investment made by private company is returned. In general, government payment for purchasing service consists of facility lease fee and operating cost. The more detailed information of lease fee and operating cost is as follows:

Facility lease fee: The lease fee is calculated by taking the investment principal and interest that is facility investment cost (total private investment cost) reflecting the rate of return. Appropriate level of lease period (10~30 years) is set by individual project basis taking into account the economic life cycle of a facility and other factors such as government subsidies.

Operating cost: The operating cost is composed of facility maintenance and repair cost and other necessary cost for providing operating service. The yearly operating cost is set up in advance as a fixed amount in the contract. The actual operating cost payment, however, can be adjusted based on the performance of operating service.

Table 2-1, figure 2-1, and figure 2-2 presents the characteristics and structure of the BTL type and the BTO type projects. While the BTO scheme is mainly applied in economic infrastructure that can generate profits by user fee, the BTL project investment return is based on government payment. Also, the factor of whether the government bears demand risk is one of main difference between the BTO and the BTL schemes.

Table 2-1 BTO/BTL Scheme Comparison

Implementation Scheme	Build-Transfer-Operate	Build-Transfer-Lease
Facility traits	Getting a return is possible by collecting user fee from the end-user (financially free-standing project)	Getting a return is difficult by charging the end-user for use of the facility (Services sold to the public sector)
Return on Investment	User fee paid by the end-user (User Pays Principle)	Lease fee paid by the government (Paid from government budget)
Project risk	Private sector bears the demand risk	Demand risk of the private sector is eliminated

Figure 2-1 BTO

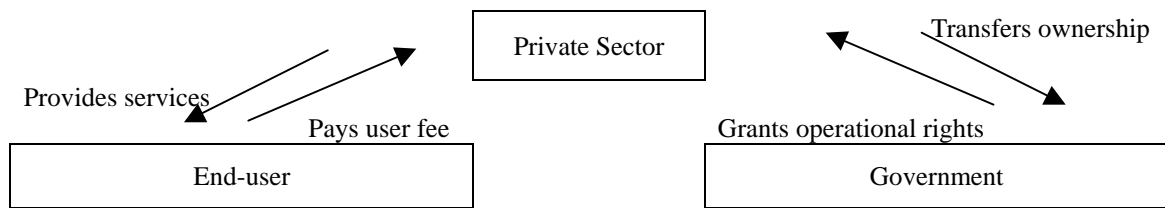
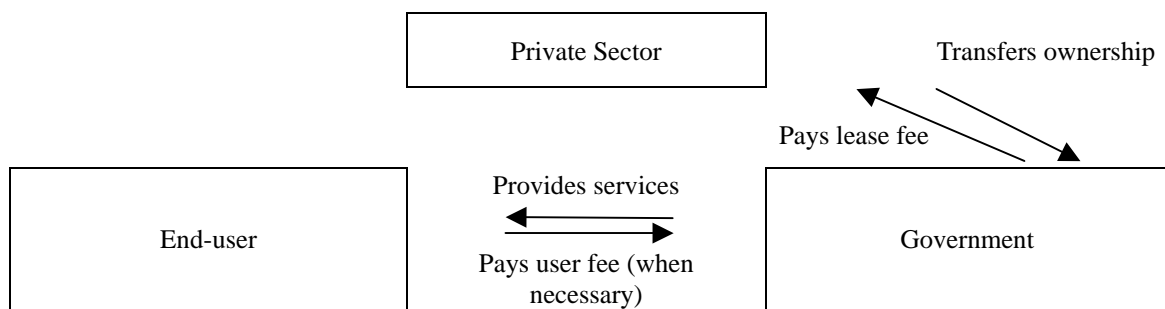


Figure 2-2 BTL



3. Major Issues for BTL type Contract

3.1 Accounting report for BTL transaction

Accounting and reporting for long term purchase contracts (BTL) is a critical issue in Korea. Some critics argue that the government should get approval of BTL contract in advance from the National Assembly because the payment of BTL contracts is the fixed government obligation to reimburse the investment cost of the private company. In other words, the government payment can be seen as a debt. In addition, there is a concern that the government could easily manipulate the BTL system to increase public spending without appropriate reporting. By the Constitutional Law, however, when the government issues debt, it has to repay the interest and principal to debt holders. The government should report the present value of the whole cash payment as a liability in its balance sheet.

However, the Ministry of Planning and Budget (MPB) recently announced that if a project is financed under the BTL scheme, the capital expenditure would not be normally reported as public expenditure because the private company arranges the finance and the government payment is contingent on the performance of operating service. In other words, the government obligation for purchasing contracts (BTL) is not regarded as debt. Therefore, the government does not have to get the approval of payment from the National Assembly.¹ The government, however, should submit the total investment amount of BTL projects to be implemented in the upcoming year to the National Assembly. Moreover, any changes in the total maximum amount of facility types, has to be reported.²

¹⁾ A Korean Accounting Standard capable of addressing characteristics of BTL transaction does not exist. Thus, the private company may use the lease standard to report its BTL contract. Most accounting experts expect that the BTL contracts are reported as financial lease and the lessee (the government) has the ownership of the asset. Since the lease fee by the lessee (the government) is more than 90 percent of asset value in BTL scheme.

Both the UK and Australia have a long experience in implementing the Private Finance Initiative (PFI). Their experience on how to account and manage the PFI transaction can give important implications for the policy towards long-term purchase contracts such as BTL projects.

The accounting standards of the UK treat lease and contracts for services differently. If the PFI contract can be separated with lease and contract for service, the lease should be treated according to general lease accounting rule and the contract for service is not necessarily defined as asset or liability. In case that the lease and contracts for service are not separable, who bears more property-related risks becomes the primary factor in deciding the owner of asset. Based on this principle, 57 percent of PFI lease are defined as financial lease, which means that the PFI transactions are defined as government assets.³

Currently, there is no internationally accepted accounting rule for PFI transactions. Some examples of accounting rule for PFI projects are as follows:

Australia has standard sets of tests to determine whether service purchase contracts are sorted into operating and financial lease.⁴ The contract is defined as a financial lease due to the fact that the lease term is more than 75% of the economic life of the asset, and the present value of the minimum lease payment exceeds 90% of the fair value of the leased property. The last test is whether the contract includes the clause that gives the government an option to purchase the property at a cost lower than fair value. Classification as a financial lease will require the current value of lease payment during the lease term to be recorded in the balance sheet as liability, thereby impacting on budget flexibility. Therefore, the government recommends classifying the contract as operating lease to minimize the impact on the budget.⁵

²⁾ Article 7-2 in Act on Private Participation in Infrastructure (2005)

³⁾ HM treasury (2003)

⁴⁾ Partnership Victoria Practitioner's Guide (2001)

⁵⁾ Private Finance Guidance: Defence Industry Advisory Council (2001)

Eurostat, the Statistical Office of the European Communities, suggests that assets involved in public-private partnerships should be defined as non-government assets if the private company takes the construction risk and at least one of either the availability risk or the demand risk. In this case, long-term purchase contracts are reported off balance sheet for government. Construction risk includes events such as late delivery, non-respect of specified standards, additional cost, technical deficiency, and external negative effects. Availability risk covers the cases when private company fails to satisfy the agreed volume and service quality. Demand risk is defined as the change in service demand caused by the business cycle, market trends, competition or technological obsolescence.⁶

3.2 Payment mechanism

In a private investment transaction of a lease type where return on investment cannot be compensated by charging the users, the government makes the payment for construction and operation on a long-term basis and can even penalize the private partner for not achieving the agreed level of service performance. When penalized, the private company would not receive a portion of the payment from the government.

In a privately financed project where the service is purchased by the public, the lease payment is comprised of the construction cost and operating cost, and can be made as a unitary payment or a separate payment.

There is a debate on how and how much penalty should be imposed. Since the penalty is charged on the basis of the service performance, the debate is also about whether to reduce the payment for operation only or reduce the payment that covers both construction cost and operation cost.

However, from the private partner's point of view, the unitary payment system makes

⁶ Based on Eurostat (2004)

the lease fee for construction cost at risk and thus has a negative impact on its financial status. Additionally, unitary payment system makes it difficult for the private company to raise the capital from the financial market because the entire project cost becomes subject to the service performance, which increases the financial uncertainty of the project.

Currently, the Korean government adopts non-unitary payment system, i.e., the payment is made by distinguishing the operating cost from the lease fee to compensate for the construction cost. Penalty is only applied to the operating cost portion of the payment. Non-unitary payment policy may imply that the Korean government bears more risks than other countries that have unitary payment system. Moreover, it reflects the government's standpoint in trying to attract investment from financial investors when project financing is in an early stage like Korean PPPs market.

The following is an example of payment and penalty policy of the UK and Japan.

A. The United Kingdom

1) Unitary Charge

In the UK PFI, generally, a unitary payment is made monthly without distinguishing the operating and maintenance (service) charge from the construction cost. The following is the calculation of a unitary charge.⁷

$$\text{NBMP} = \text{GBMP} - [\text{TUD} + \text{SPD}] + (-) \text{AD}$$

where,

NBMP: net basic lease fee

GBMP: gross basic lease fee

⁷⁾ Extracted from "A Guide for School"

TUD: penalty for unavailability

SPD: penalty for insufficient performance

AD: adjusted amount

2) Penalty

When the facilities cannot be made available for use on time or when the service quality does not meet the required level as agreed in the contract, the monthly lease fee is deducted by a certain amount as calculated based on relevant values. In principle, there is no maximum or minimum in calculating the penalty.

a) Penalty for unavailability

The penalty fee is determined by the terms of the contract and an additional charge incurs when unavailability continues.

$$TUD = ND \times DP \times R + CAFI$$

where,

TUD: total penalty deduction

ND: net deduction

DP: deduction period

R: repetition

CAFI: additional penalty charge on core facility

b) Penalty on performance

A deduction is made on the lease fee when performance outcome does not meet the level

agreed in the contract.

$$SPD = SFD \times DP \times R$$

where,

SPD: deduction based on unsatisfactory performance

SFD: penalty on individual performance

DP: deduction period

R: repetition

B. Japan PFI (the Seventh City School Building)

1) Non-Unitary Payment Method

In Japan, the lease payment is separately calculated as construction cost (facility cost) and operation and maintenance cost. The payment period and method are also separated. The followings are the details on how project cost of the Seventh City School Building PFI Project is calculated.

a) Facility inspection cost

In principle, the payments are made in quarterly installments for 15 years (60 payments) and the payment amount is recalculated by considering the interest rate on the installment balance every five years.

b) Maintenance cost

Payments are made in quarterly installments for 15 years and are adjusted according to inflation rate.

3) Penalty

In principle, the penalty is applied only to the maintenance and management cost and is based on the private partner's performance. (1 point per day) When it becomes impossible to use the facility, an additional accumulation of points can be applied when calculating penalty deduction. (2 points per day)

The following is a table for determining penalty deduction

Accumulated points	Consequence	Deduction size
0~2	No deduction	0
3~5	5% deduction	5%
6~10	Stopped payment	5%
11~15	Stopped payment	5%
16~20	Stopped payment	5%
21~29	Stopped payment	5%

When the accumulated points are 6 and above, all payments for maintenance and management cost are stopped. When stopped payment is continued, the available payment amount is reduced by every 5 percent for each step.

3.3 Employment issues

There are two main issues in employment. First is the concern about the status of current government employees in PFI projects and the employment conditions of those workers who will be employed by the private sector to operate the facility. The second concern is about background and/or security check issues on the workers who will be employed by private partners. A thorough and stringent security check is essential when employing workers at hospitals and schools and the responsibility may fall on the government even if the private partners hire them.

In the first concern, there may be a change in the status of the civil workers—mainly teachers—with regard to the newly constructed or remodeled facilities. In other words, when schools or public hospitals are constructed through PFI and managed by a private operating company, the workers who had been civil workers are changed to private sector workers.

Currently, the status of civil workers of the BTL project in Korea does not change. But the drawback is that when there are private workers who perform similar duties within the same school district and same services are provided at a lower wage, social pressure on the government to transfer their duties to the private sector can be actualized.

The employment risk also lies in workers hired by the private partners because the private company may take advantage of their employees through unfavorable working conditions in order to maximize their profit.

When the UK was faced with serious labor issues in the process of privatization, the government approached the problem by guaranteeing the civil worker status and provided a clear guideline on the labor conditions thus minimizing the workers' concerns. Such were some of the important factors that led to a successful PFI project implementation. The opposite case is found in Canada where conflict between the government and the labor union is still not resolved because the government could not effectively remove the uncertainty of employment conditions in the

privately financed projects.

The second topic of concern is the security issue. Social infrastructure facilities such as schools and hospitals are unique in that the safety and protection of their users (for example, students and patients) are directly affected. Thus, when these facilities do not run a security check on their workers because there would be no laws or regulations to enforce private concessionaires to do so, the users run the risk of being exposed of possible crimes. If the government lacks the authority to provide a security clearance on the employees of the facilities who would be working closely with young children and patients, then security issues would be a serious concern.

Korea is in the early stages of implementing BTL projects and there are only a few infrastructure projects (school, hospital, housing, etc.) that have begun their implementation. However, it is expected that there may be security issues and conflict between the employer taking part in the operation of the facility and the user after a few years when actual operation takes place.

It is worth to note that in the UK and Australia, the terms of conducting a security check and the terms for discharge are included in the contracts.

In the next section, the cases of the UK, Australia, and Canada are presented to explain how employment issues are handled.

A. The United Kingdom Private Finance Initiative

1) Protection of PFI Workers

During the 1980s and 1990s, the UK attempted to privatize many of its government facilities. The government, however, was challenged from lack of cooperation from the public labor union that requested guarantee of their civil worker status. Based on this experience, from the early stages of PFI project implementation, the government announced that the benefits and reduced costs achieved through PFI are not from wage cuts or unfavorable working conditions but from

continued management of project cost and through private sector creativity and efficiency. Accordingly, the government put forth various guidelines and policies to ensure that the current civil workers can still receive the pension benefits even after their status is changed to the private partner's employee. The Fair Deal for Staff Pensions was put forth by the Cabinet Office Statement of Practice in 1999. Such guarantee of pension meant that the concerned workers were given an option to deal with the pension benefits acquired thus far. In addition to pension benefits, the prior employment conditions did not change even if their employment status changed through PFI and the newly employed workers did not receive a different treatment from the earlier workers.⁸

On a separate level, workers who are employed in the five areas of hospital PFI facility that is affiliated under the Department of Health maintained their status as government employees of the Department of Health with an exception for administrative staff who may pose risk for the government so that efficient risk allocation can take place, which is the original intent of PFI.⁹

2) Conducting Security Check on PFI Workers

The government holds the authority to manage and run a background check on the employees working at the concerned facilities and has the right to discharge an employee. The following are some of the contents of a standard PPP contract¹⁰ regarding employees.

Supervision over employees

A staff who satisfies the conditions of the laws and regulations regarding the concerned facility is appointed. (this contract term can be applied to the employee of the subcontractor)

Alcohol and illegal drugs are prohibited.

⁸⁾ The Cabinet Office Guidance, the Cabinet Office Statement of Practice

⁹⁾ This paragraph refers to the "Retention of Employment" program that allowed 80% of the employers to retain their status as civil workers.

Smoking is only allowed in designated areas.

Confidentiality

Any information acquired from employment are to remain confidential

Reading and copying of documents is prohibited.

Security clearance of employees

A security check (including criminal record) is mandatory at the time of employment

Authority's rights to discharge

The authority reserves the right to remove an employee who violates the terms of regulation

B. Australia

1) Protection of PFI Workers

The government guarantees the former employees of the public sector the same benefits even after their status is changed from PFI implementation.¹¹

2) Conducting Security Check on PFI Workers

There is no guideline regarding security check. Even the regions of Victoria and New South Wales that actively incorporate PFI program do not have a guideline regarding security check.

¹⁰⁾ Scottish School Standard PPP Contract (version 3)

¹¹⁾ New South Wales Industrial Commission “no net detriment”

C. Canada

1) Protection of PFI Workers

When the civil workers of a public sector become an employee of the private partner through privately financed project implementation, there is no policy on the federal level that would guarantee the same working conditions. Agreements are made on the level of the state or the project between the authority and the private company. Due to this reason, the public sector labor union strongly opposes the private investment trend because it is perceived to weaken the status of the civil workers as in the case of privatization and private sector outsourcing. Such objections were the main reason for several discontinued school and hospital projects in Ontario and Nova Scotia.

2) Conducting Security Check on PFI Workers

There is no general guideline on conducting security check on employees of the concerned facility. Based on the fact that the hospital and school employees are hired without going through security clearance causes severe criticism from the general public because the safety of the students and patients are at stake. This is the major rationale in the argument against privately financed projects.

3.4 Reducing high transaction cost

Private companies often complain of the high transaction cost for long term service purchase contract.¹² They argue that the tendering cost for PFI type project is greater than that of conventionally tendered project because of two main reasons. First, PFI type tendering process requires more detailed design and contract terms, which incurs extra cost for private partners who prepare the bid. Second, bidding process of PFI project is relatively long and complex and the time taken between a bidding invitation and a final closing can be easily extended. For example, even after the preferred bidder is selected, a long negotiation period is inevitable to determine the details of the concession agreement thus creating enormous expense in the transaction cost.

Figure 3-1 presents bidding process in Japan. Table 3-1 and table 3-2 show the PFI procurement time span in Japan and the UK. On average, it takes 8.8 months from inviting tender to signing contract and upper bound of necessary time for bidding is 44.2 months and the lower bound is only 2.83 months in Japan. The bidding time in the UK is relatively longer than that of Japan. For example, the longest bidding time is 40 months (Health) and the shortest bidding time is 18 months (road).

¹²⁾ The report, *Seize the Initiative (1996)*, from Adam Smith Institute finds that the total tendering cost of PFI project is just under 3% of total project cost while the tendering cost of traditional project is about 1%.

Figure 3-1. PFI Process (Japan)

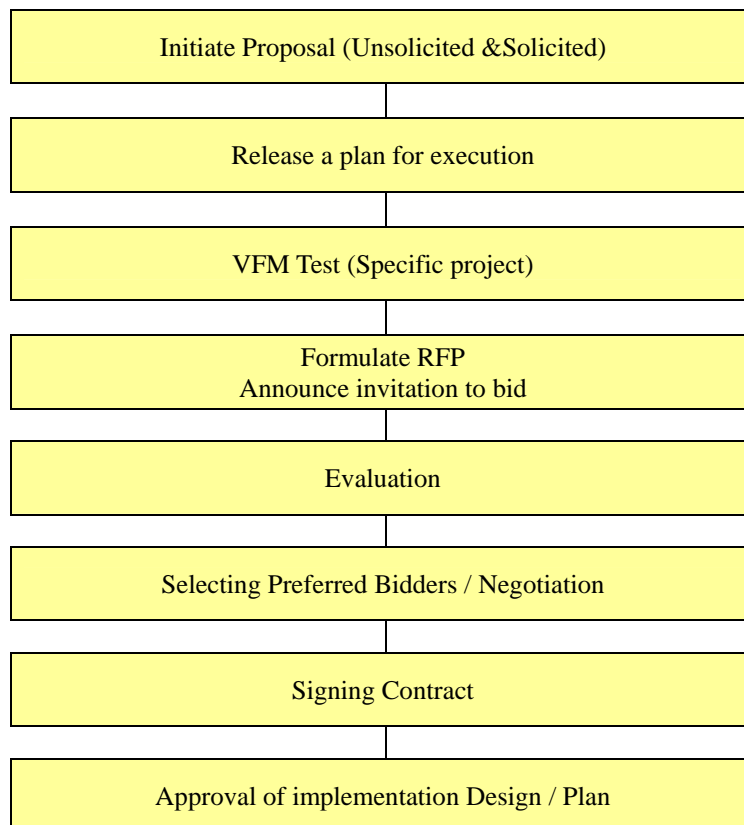


Table 3-2. Procurement times in PFI (Japan)

	Tender Invitation To Financial close	Upper / Lower Bound
Total 126 projects (‘99~’2005)	8.8 months	44.2 month / 2.83 minth

Japan PFI Association

Table 3-3. Procurement times in early PFI (UK)

	Procurement Dates (OJEC issued)	OJEC to Financial Close (months)	Upper / Lower bounds (months)
Health	December 1994- December 1998	40	22-60
Schools	March 1997- December 1999	23	15-25
Defense	November 1994- September 1999	23	18-32
Custodial / Prisons	March 1997- November 1999	21.4	14-25
Road	March 1986- November 1995	18	15-20
Tram / Light rail	March 1986- November 1995	22.3	13-30

HM Treasury (2003)

In order to reduce the transaction cost and uncertainty regarding PFI projects, the following policies has been adopted and implemented in advanced countries such as the UK, Australia, and Japan.

First, these countries have published detailed standard contract guideline for PFI projects. The purpose of the guideline is to allow a future project contract to maintain a consistent approach by incorporating standard conditions into all contracts. Also, manuals for local government managers were prepared focusing on reducing the time taken to finalize the PFI transaction.

Second, most governments have disclosed project related risks and preferred risk allocation in advance to give better chance to private partners. Moreover, they tried to simplify output specification requirement and made it hard to change the disclosed requirements.

Third, they shortened the bid evaluation process and clarified the evaluation standard to minimize the conflict possibilities and curtail the evaluation period.

4. Suggestions for successful BTL Scheme Projects

4.1 Accounting Rule

Generally the risk that the government bears varies with long term service purchase contracts such as BTL projects. Therefore, simply defining all long term service purchase contracts as financial lease (government asset) or operating lease (private company asset) can defer optimal risk allocation between the government and private company, which makes it difficult to get Value for Money (VFM). However, there is no internationally accepted principle on how to account for long-term service purchase contracts. Thus, as an interim process to develop a clear accounting standard for BTL transaction, it leads to disclose the government obligations that affect the budget flexibility in the future.¹³ Eurostat or Australian accounting standards can be used because their rules are relatively simple and easy to apply.

In addition, publishing forecasts of the committed expenditure under BTL contracts can be considered for better understanding the effect of BTL on future budget. In the UK, the treasury regularly reports estimated payment under PFI contracts to monitor the effect of signed PFI deals on the budget.

Moreover, there is a need to deliberate on establishing a BTL payment allowance rule or ceiling as a fraction of total budget. Then, the Korean government may effectively manage the expected payment for signed BTL contracts under the Medium-Term Expenditure Framework (MTEF).

4.2 Payment System

There are several reasons for supporting the unitary payment method. First, the

¹³⁾ IMF (2004) recommends that the stream of future contract payment under existing PPPs should be reported.

government is at an advantage in inducing quality management and operation by the concessionaire since the total payment received by the private partner is related to the operating performance. Second, the unitary payment makes it difficult to use traditional lease accounting rule. Thus, it leads to developing a more proper accounting rule for long term service purchase contract.

Most advanced countries that have PPP programs such as the UK, Australia, and Canada but excluding Japan, take on the unitary payment method. When the private investment projects are working in full force and with the matured capital market, the Korean government should consider changing to a unitary payment mechanism.

4.3 Employment Issue

So far there is no clear guideline regarding this issue. However, the government needs to take a firm stand and minimize any ambiguities that may exist in the issues of status and working conditions of workers who will be employed at various social infrastructure facilities such as schools that are constructed in the BTL scheme.

To minimize security concerns, a clause regarding a monitoring system should be established in the contract to make it an obligation for the employer to run a security check and in certain cases to exercise the right to discharge an employee.

4.4 High transaction cost

Publishing risk allocation guidance and standard contracts for a specific BTL project type such as school, hospital, and rental apartment can be considered to reduce high bidding cost. Even if the Korean government prepares standard contract for BTL project, the specific and detailed guidance is more useful because each type of project has different characteristics, which limit the scope for simple standard contract.

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