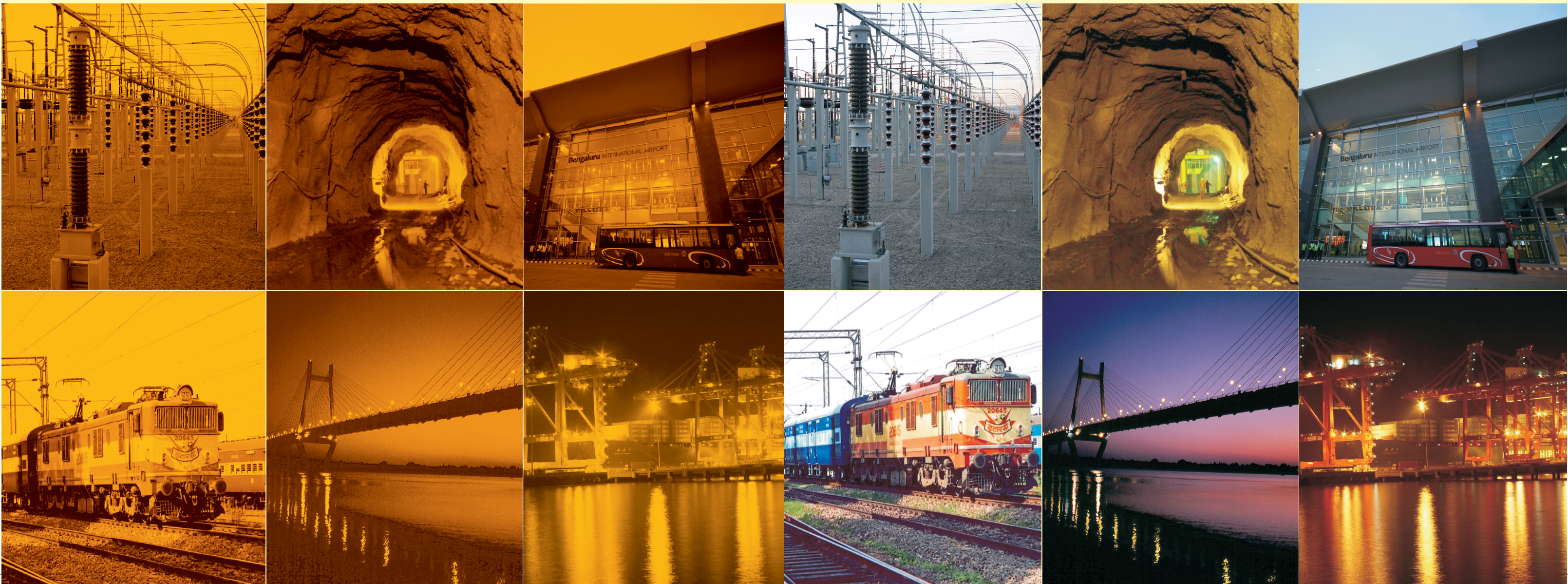




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Guidelines Joint Ventures in Infrastructure Sectors





Guidelines on Establishing Joint Ventures in Infrastructure Sectors

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Preface

Public Private Partnerships (PPPs) are normally governed by an agreement between a private entity and a public entity. Agreements for provision of roads, ports, airports, railways and power transmission systems are thus entered into between the respective public and private entities. These agreements typically contain provisions that determine the user charges, performance standards and other matters affecting the users and the public exchequer. They may also involve transfer of valuable public assets, delegation of the power to collect user charges and payment guarantees constituting a contingent liability for the exchequer.

Though a single concession/procurement agreement is the norm for PPP projects, public entities sometimes prefer the joint venture (JV) route which requires them to subscribe to the equity of the selected private entity. This implies a two-level relationship i.e. a shareholders' agreement for a JV between a public entity (holding a minority stake) and a private company (holding the controlling stake) on the one hand and a concession/ procurement agreement between the public entity and the JV on the other hand. These two parallel agreements often pose issues that are more complex than those arising in case of a JV that sells its output in a competitive market and does not enter into other parallel agreements with the public entity.

In the absence of guidelines, some JVs for PPP projects in infrastructure sectors have been formed without a clear appreciation of the potential problems that can lead to unintended outcomes and loss to the public exchequer and users. There could also be a perceived conflict of interest in awarding an infrastructure project to a JV inasmuch 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 has profit as its primary objective. The public sector entity would thus be the 'regulator' of the concession agreement as well as the 'regulated' under the same agreement.

Notwithstanding the above, in cases where it is decided to form

a JV, it would be necessary to address issues relating to conflict of interest, accountability of the public sector entity, valuation of assets, contingent liabilities, exit and termination clauses etc. The public sector entity should be fully aware of the risks and responsibilities it is undertaking as a partner in a JV which is a private entity that would normally have to be treated at par with other private entities, especially in the matter of procurement. Moreover, the process of selection of the private entity would have to be competitive, fair and transparent, as it would confer upon the selected entity several financial and other advantages.

Where the public sector's contribution to a JV is in terms of assets or assured revenues, the valuation of such assets or revenues should be carried out diligently and reflected appropriately. 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. Since the formation of a JV involves public funds, it should also be established that the objective cannot be met through alternate means that would save on public expenditure and eliminate the potential liabilities arising out of a JV.

A note on the aforesaid issues was considered in the 17th meeting of the Committee on Infrastructure (COI) held under the chairmanship of Prime Minister on December 5, 2007 when it was resolved that the matter be deliberated upon in a Committee of Secretaries (CoS) with a view to formulating appropriate guidelines. The guidelines contained in this volume are an outcome of the deliberations in the CoS and have since been approved by the Finance Minister and Deputy Chairman, Planning Commission.

These guidelines will apply to all Ministries and Departments of the Central Government, all statutory entities under the control of Central Government and all Central Public Sector Undertakings (CPSUs). They may also be adopted by the State Governments by way of best practices.



(Gajendra Haldea)

Adviser to Deputy Chairman
Planning Commission

July 20, 2009

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.*



(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 5th 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 inasmuch 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.