

# Public-Private Partnership - an Alternative Investment Mechanism



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## Introduction

Public-private partnership (“PPP”) is a relationship between the public and private sectors. On one side, the interests of public and private sector are so different and even sometimes conflict each other, so no partnership between them could be imagined. However, in light of economy’ change, there are many points of convergence, where the partnership between public and private sector has the right to exist.

Public private partnerships (PPPs) is a governance mechanism of short and long-term agreements between the public and private sector for solving socially significant tasks on mutually beneficial terms. PPP is a partnership in the context of a public infrastructure, which is aimed to increase the contribution of the private sector in infrastructure investment, to relieve the burden of public finance and to increase efficiency in the provision of public facilities and public services. The well-regulated partnership allocates the roles between the government and the private sector, so that each of the sector may contribute its own resources and own expertise in order to effectively provide public facilities or services.

There are also two other terms used for such type of activities, private sector participation and privatization.

## What is the role of each sector in the PPP?

By definition, there is always a public and a private component to a PPP. The form that this component takes depends on the project.

The role of private sector is contribution of investment capital, their technical expertise and their time and people resources to govern the day-to-day operation of the project.

The public sector’s participation can take the form of financial support, in-kind contribution, e.g. in a form of provision of land or equipment, or contingent support, such as guarantees or insurance, the level of tariffs permitted, etc. that can support the country’s PPP program or encourage the financial markets to lend into projects.<sup>1</sup>

1. <https://ppp.worldbank.org/public-private-partnership/financing/government-support-subsidies> - Government support in Financing PPPs

A key motivation for governments considering public-private partnerships is the possibility of bringing in new sources of financing for funding public infrastructure. PPPs are a more common way of financing infrastructure projects worldwide, entailing fiscal obligations on the government. Fiscal obligations could arise from contractual obligations, either from making payments related to asset availability/ service delivery (direct liabilities), and/ or, in the event of fiscal risks (contingent liabilities – implicit or explicit) materializing under the PPP contracts.

Contingent liabilities could be created through various forms of guarantees or compensation clauses by the government to the concessionaire (private investor). Form of guarantees contains debt/ revenue/ exchange rates, etc. Such guarantees could be applied in varied situations including early contract termination, renegotiation of contracts, unforeseen problems or uninsurable force majeure events.

## PPP models

Typically, the PPP can be arranged in the following ways:

- Service contracts
- Management contracts
- Lease contracts
- Build-operate-transfer / Build-operate-own / Design-build-operate or other similar models
- Concessions
- Joint-ventures

Service and management contracts are most appropriate for the existing projects or for the facilities that are already built and are on the balance of the state of governed by the state. Whereas the model that are used for discrete new projects or planned infrastructures are BOT and similar models.

## PPP in Azerbaijan

Azerbaijani law has no comprehensive PPP law that would establish guiding principles of PPP. Instead, Azerbaijan has several legal acts and regulations that to certain extent regulate separate types of public-private partnership.

The BOT model was first introduced in 2016 through the Law

on the implementation of special Financing for Investment Projects in connection with Construction and Infrastructure Facilities, adopted on 15 March 2016 (“BOT Law”).

The BOT Law is a relatively new concept in Azerbaijan yet, certain projects are currently being implemented in Azerbaijan by using the BOT model. One of the current PPP project is related to the construction of dormitories for the students and the Asian Development Bank provides transaction technical assistance (TA) and project preparatory assistance.<sup>2</sup>

## Existing experience with public-private partnership projects in Azerbaijan

Besides the BOT model and before adopting the BOT Law, Azerbaijan has implemented several projects that by its nature are considered as PPP.

One of the example is a project related to construction and operation of waste-to-energy plant, which was executed by CNIM Group. The state-owned company Tamiz Shahar JSC, which is responsible for utilization of the solid municipal waste of Baku city, awarded CNIM the design, construction and operation for 20 years of an energy recovery facility.<sup>3</sup>

One of the forms of the public-private partnership is a management contract. As an example of this type of a PPP, is management of the Central Clinic (Mərkəzi Klinik Xəstəxana) within 10 years period by the Turkish company “AY-MED Medical Yatirim Danishmanlik Ticaret”.<sup>4</sup> Actually, PPP is often used worldwide in healthcare in three main directions: a) build or refurbish public healthcare infrastructure; b) to add or expand service delivery capacity or c) to provide a comprehensive package of infrastructure and service delivery. One more example of PPP in the form of a management contract is a contract on management of Shahdag Ski Resort signed between PGI Management and Azerbaijan’s Shahdag Winter-Summer Tourism Complex, which is part of the State Tourism Agency.<sup>5</sup>

## Legal basis

Additionally, to the BOT Law, a decree the President of the Azerbaijan, dated 7 December 2016 (“BOT Order”) establishes the particularities with respect to conditions of the investment, requirements to private investors, procedure of investor’s selection process, etc.

Pursuant to the BOT Law, the BOT model is a specific form of project financing, according to which investors recoup their investments expenses with regard to projects on infrastructure objects through procurement of goods/services to the customers or competent government bodies.

The competent authority that is responsible for implementation of the BOT model in Azerbaijan and acts on behalf of the public sector in the PPP arrangements is the Ministry of

Economy of the Republic of Azerbaijan.

The BOT model is applicable to construction, restoration, rebuild, repair, operation and transfer of bridges, tunnels, water warehouses, water cleansing plants – constructions, sewerage systems, and other publicly important infrastructure objects in the fields of education, health, culture, tourism, etc. in accordance with BOT agreement.

Pursuant to the BOT Law and BOT Order (together “BOT legislation”), the process of cooperation between public and private sector within the BOT model is structured in the following steps:

**Step 1:** The sectoral authority (e.g. in a project with dormitory construction – the Ministry of Education of the Republic of Azerbaijan) applies to the competent authority (the Ministry of Economy of the Republic of Azerbaijan), with a proposal, covering technical background and general definition of infrastructure and services needs and analysis of institutional options of the particular project (“Project”).

**Step 2:** The Ministry of Economy after initial review and approval of the Project, prepares the requirements for a potential investor and announce the bidding process, which is governed by the BOT Law. The provisions of the Law of State Procurement are not applicable.

**Step 3:** Within the bidding process the potential investor should provide a feasibility study and project estimation.

**Step 4:** After the completion of the bidding process and selection of the investor based on the submitted documents, the selected Investor should establish a legal entity, which cannot be involved in any other activities besides governing the project (“Project Company”). Afterwards, the Ministry of Economy concludes an agreement with the selected investor (“Investor”) on implementation of the Project (“BOT Agreement”).

**Step 5:** Maximum term of BOT agreements is 49 years. After the contract period is over, the facilities (which were build and operated by the Investor / Project Company) should be returned to the government.

## Institutional conditions and managing the fiscal risks

Based on the experience of some countries, the institutional capacity is a key element to organize, manage and implement a PPP process. At this time, the Government of Azerbaijan does not have a centralized PPP unit, which will be responsible for undertaking risk estimation, monitoring, managing and reporting related activities for a PPP projects. The Ministry of Economy and Small and Medium-Sized Business Development Agency (“SMBDA”) are the competent state entities that are responsible for development and implementation of PPP projects. The Ministry of Finance (MoF) plays a decisive role in managing fiscal risks arising from sovereign guarantees.

As one of the ways to restrict the fiscal risks, the BOT Law prescribes the annual volume of sovereign guarantee for projects undertaken under BOT model at 10% of the project cost. In addition, the Ministry of Finance and the Ministry

2. <https://ap3f.adb.org/our-activities/piloting-delivery-university-students-accommodation-and-services-baku-through-public>

3. <https://cnim.com/en/energy-recovery-azerbaijans-capital-comes-date>

4. Order of the President of the Republic of Azerbaijan No 704 dated 24 April 2001 <http://e-qanun.az/framework/2543>

5. <https://pgimgmt.com/project/duo-diligence-equipment-analysis-tender-process-and-providers-evaluation-for-shahdag-mountain-resort-azerbaidjan/>

of Economy estimates annual guarantee obligations for projects undertaken through the BOT model, based on which government commitment is incorporated in budget for the respective year.

Before selection of the investor for implementation of an infrastructure project, the Ministry of Economy coordinates with the Ministry of Finance to conduct a techno-economic assessment (such as pre-feasibility study, financial viability assessment and market assessment). Once the decision on implementing a project through BOT model is met, the Ministry of Economy coordinates with Ministry of Finance to prepare a draft BOT Agreement for the investment project, and they prepare implementation milestones against which success of the project are determined.

In addition to the above measures, certain safeguard mechanisms are also in place to meet unforeseen eventualities. The government has established a “safeguard fund” within the state budget and the Ministry of Economy is authorized to use the safeguard fund to manage fiscal risks, e.g. in case the competent authority has provided the investor with the tariff or revenue guarantee, such guarantee to purchase goods or services or to pay the service charges on behalf of the population.

In spite of the above mentioned equally important is the need to have a robust, comprehensively built oversight framework for managing PPP related fiscal risks. Based on the global experience of costly PPP failures, management of fiscal risks associated with PPP projects require a strong, effective financial oversight mechanism to be in place.

## Risk allocation

Pursuant to the BOT Legislation, the Investor – it can be either a legal entity or an individual – is participating in the bidding process and is a party, investing funds into the project and party of the BOT Contract. What is then the role of the Project Company? As it is evident from the BOT legislation, the main purpose of establishment of a Project Company is to enable the Ministry of Economy on behalf of the Government to control and supervise the Project.

Consequently, there are open questions, e.g. who is responsible for the Project’s implementation and how the risks and liabilities are allocated among the parties. If the project involves many significant risks, it is more efficient to manage it collectively, i.e. by government embracing and sharing the risks with the designer, the constructor and/or the operator/maintainer, rather than by allocating them to a particular party.

## Property issues

In some cases, the Project may require the transfer of certain facilities or land owned by the State to the private Investor for the repair purposes, rather than construction of the facilities from scratch. The BOT Legislation does not stipulate the ownership issues. Based on the Azerbaijani legislation, i.e. the Order of the President of the Republic of Azerbaijan on adoption of the State Program on Improving of Management

of State Property in the Republic of Azerbaijan, the State Property Issues Committee of the Republic of Azerbaijan is the body that acts on behalf of the State with respect to the property that is owned by the public bodies and state owned legal entities. Based on this, we may come to conclusion that the Ministry of Economy as a competent authority for the implementations of BOT projects is not eligible or authorized to transfer any state property (facilities) to a private investor based on the BOT Contract.

The same situation is with respect to the land. The private Investor, investing in an infrastructure project, may want to assure his rights on certain assets and land. For the duration of the BOT Agreement, the State should remain the owner of the land, while the private Investor remains the owner of the facilities, but has the rights and obligations of an usufructuary with regard to the land on which the facilities are built.

### **Proposed regulations**

The goal of the public sector is to provide a clear title with respect to the land and other state-owned property and scope of rights that the Investor obtains for the period of BOT Agreement. The legislation should provide a clear guidance as to who is considered as the owner of the facilities within the operation period - the Investor, State or the Project Company and if the State – which of the state authorities execute the ownership rights on behalf of the State for BOT purposes. It would be appropriate to authorize the competent authority – Ministry of Economy or established PPP unit – to act on behalf of the State with respect to the state-owned property for BOT Agreement purposes or to create simplified procedure for obtaining consent from the State Property Issues Committee.

## Tax issues

The BOT Law does not create a special tax regime that supersedes the Tax Code of the Republic of Azerbaijan, so the general rules of the statutory tax regime established by the Tax Code should be applicable to the PPP law.

### **Balance sheet treatment**

Besides the ownership issue, an open question relates to the right of allocating the facilities to its balance and calculate the depreciation charges with respect to the facilities. Following the logic of IFRS standard, assets should be reflected on the balance of that entity, which will receive the future economic benefits associated with the asset. It can be either the legal owner or the lessee within the financial lease arrangement. IFRS itself, as well as the Tax Code of the Republic of Azerbaijan provides the criteria of financial leasing and the facilities operated within BOT model will likely fall within the financial leasing, that will give the right to depreciate the assets. However, the existing “financial leasing” provisions under the Tax Code can be construed to deny taxation deductions to a tax payer.

What if the party of the BOT Agreement and the entity that invests in construction or renovation of any state-owned facility is the Investor, whereas the entity that actually uses the assets/facilities in their entrepreneurship activities is a Project Company. At the balance of which entity the mentioned

property in this situation should be reflected?

The correct answer should be at the balance of the Project Company. In order to allocate the asset (facilities) to the balance sheet of the Project Company the legal basis – legislation or contractual base – is required. Due to the lack of legislative basis, the Investor should transfer the facility to the Project Company for operation and management based on an agreement. Consequently, such transfer will be viewed as taxable alienation, subject to profit tax and VAT.

#### **Transfer of assets**

During the lifecycle of the BOT Project, the transfer of assets (not only the repaired facility) from the State to the Investor, from the Investor to the Project Company and vice versa will occur many times. Treatment of such transfer as a taxable event will create additional tax and compliance burden for all participants of the BOT Project within each of the following transactions during the entire lifecycle of the BOT Project:

1. Transfer of the facilities from the State to the Investor
2. Transfer of the facilities from the Investor to the Project Company
3. Return of the facilities back to the Investor
4. Return of the facilities back to the State

#### **Proposed regulations**

Transfer of any property between the participants of the BOT Project should not be treated as a taxable sale for profit tax as well for VAT purposes and can be viewed as a tax neutral transaction.

#### **Dividend distribution**

Set-up of the Project Company is a requirement of BOT legislation. The Investor contributing funds to the Project is aiming to return its investment. In case of set-up of a Project Company, all profits generated by the Project Company during operation can be distributed to the Investor only in form of dividends, subject to withholding tax at source.

#### **Proposed regulations**

The establishment of the Project Company is a compulsory requirement of the legislation and we believe that in such case the Investor should not bear additional tax burden with respect to return of investment. In order to attract interest of private investors to the infrastructure investment, it is advisable to exempt dividend distribution from a Project Company to the Investor from the withholding tax.

## **Conclusion**

Some of the issues discussed within this article can be addressed through contractual terms, whereas some of them would need to be stipulated by law. A PPP-specific law, governing not only BOT model of PPP, but creating a legal framework could not only address the discussed issues, but also demonstrate political commitment to the PPP program. Although care is needed to avoid conflict with any other existing relevant laws.

Given the potential which PPPs have for the delivery of essential public services we would like to make the following recommendations:

- Build national PPP Unit;
- Address legal and tax issues, especially with respect to the property;
- Work on the balance sheet treatment;
- Allocate risk between the parties;
- Provide certain tax incentives in order to attract the private sector to undertake a PPP
- Develop mechanism of contingent support from the government and financing of the BOT projects.

#### **Authors' biography**

**Ms. Gunel Sadiyeva** is a Corporate Tax Manager in PwC Azerbaijan. She boasts more than 9 years of experience in tax and legal advisory, including Big4 experience where she has assisted clients with complex tax and commercial matters. Gunel's main practice areas comprise advising on issues related to international and corporate taxation, merger and acquisitions, as well as structuring of potential investments in Azerbaijan. She has a wide legal advisory experience in corporate, employment, and commercial law with companies in financial, construction, manufacturing and PSA sectors. She participated in advising and development of the project documentation and project structuring for PPP project on the basis of BOT model, negotiation with the tax authorities the tax implications and advising on tax and legal structuring of the project.

Her qualifications include a Bachelor degree in Law and a Master degree in Civil and Economic Law from Baku State University in Azerbaijan. In 2011, she has obtained her LL.M in Private and Public Economic Law from the Friedrich-Schiller University in Jena, Germany. In 2016 she has achieved Advanced Diploma in International Taxation - certification indicating a high level of competence in international taxation. Gunel is also an adjunct lecturer in International Tax Law at Baku State University.

**Ms. Ilaha Amirbayova** is a Manager in Advisory business (Consulting & Deals) in PwC Azerbaijan. With over 8 years, she has developed a particular expertise in helping clients in public and private sector to define and implement changes of their Enterprise Content Management (ECM) system to improve their efficiency and enable them to manage their knowledge more effectively. She is also specialized in business process optimization and re-engineering, bringing the efficiency of corporate functions of the clients' business. As well as international knowledge, Ilaha has a strong knowledge in legislation of the Republic of Azerbaijan of Clerical work and Archive and ECM. She is leading the stream of cooperation with Public sector and International Financial Institutions in PwC Azerbaijan.

Prior to joining PwC Ilaha has worked over 4 years for major mobile operator in telecommunication sector in Azerbaijan, initiating and developing of methodology of document management system and build up storage and electronic archive system, taking a part on implementation of electronic document and record management system, participated in internal audit projects. Ilaha has also worked over 2 years for government and non-government organizations.