Executive Summary

This case study reviews the evolution of public-private partnership (PPP) policy in the Republic of Korea in chronological order and identifies the lessons learned. It describes the background of the country’s innovative infrastructure financing scheme in the early 1990s and the policy measures that were used to promote private investment in the wake of the Asian financial crisis in the late 1990s. It also discusses how the Korean government has coped with rising concerns triggered by the fiscal liabilities that PPPs have left the government with.

Facing an infrastructure gap, the Korean government passed the PPP Act (the Act on Promotion of Private Capital into Social Overhead Capital Investment) in 1994 to expand its fiscal space by inducing private investment in infrastructure development. However, the new act was not very effective at this task, mainly because of the lack of detailed rules and regulations surrounding the new investments, the limited capacity of government officials, and the weakness of Korean financial institutions. It was the amendment of the PPP Act in 1999, in the wake of the Asian financial crisis, that provided the driving force to the PPP market, enabling a sizable number of PPP projects to begin. Adding to the existing tax incentives and land acquisition privileges for the special-purpose vehicles (SPVs) formed to implement PPP projects, the government provided substantial support, including a new risk-sharing scheme, the Minimum Revenue Guarantee (MRG) clause, to mitigate project risk for SPVs. The government also encouraged unsolicited PPP proposals, thereby allowing private companies to develop projects in advance of government planning.

The new risk-sharing scheme of the MRG clause was effective at quickly expanding the PPP program. However, the MRG policy went on to pose long-term challenges to the government’s fiscal sustainability. The government had
to accept fiscal liability for low demand for PPP projects and pay substantial amounts of money through the MRG clause. Also, both users of the new infrastructure and politicians criticized the high tolls charged.

As concern rose about the fiscal sustainability of PPPs, the government revised the PPP Act again in 2005, and a series of new policies were introduced to strengthen fiscal discipline in PPP implementations. A rigorous Value for Money (VfM) test, introduced as a due-diligence measure, now had to be met before a project was designated as a PPP.

Korea’s experience with PPPs demonstrates the importance of balancing market promotion and fiscal discipline in PPP policy. A PPP system is sustainable when projects are (a) financially viable and bankable and (b) efficient enough to deliver VfM in fiscal management.

Introduction

In the early 1990s, Korea’s infrastructure gap, particularly the country’s shortfall of land transportation infrastructure, was considered a critical bottleneck to economic growth.

With the country’s economic growth during the 1980s, Korean society experienced unprecedentedly rapid motorization. From 1980 to 1990, the per capita annual income in Korea had increased from US$1,686 to US$6,505. As a consequence, the number of registered passenger cars had increased more than eightfold, from 249,000 to 2,075,000, as cars became more affordable. However, during that same period, there had been only a marginal expansion of the transportation network. The country’s road length had increased only about 20 percent, from 46,900 km to 56,700 km, and the rail length had remained almost constant, at around 3,200 km.

This expansion was far from enough to meet the increased demand for travel, resulting in serious traffic congestion and high logistical costs. Nationwide transportation congestion costs and logistical costs were calculated at 3.1 percent and 14.8 percent of the country’s GDP, respectively, in 1993. Both costs continued to increase through the 1990s; by 1999, the former reached ₩18.4 trillion, or 4.1 percent of GDP, and the latter increased from ₩18.9 trillion in 1993 to ₩41.2 trillion in 1999. These congestion costs effectively illustrated the aggravated condition of traffic, and they were used to elicit support from the general public and politicians to find additional funds to expand the nation’s transportation network. The Ministry of Construction and Transport and the Ministry of Maritime Affairs and Fisheries estimated that the two ministries had to obtain an additional ₩31 trillion to implement their infrastructure development plan for 1993–2003 (Noh 2014).

The Korean government had to find alternative sources of financing in order to expand the country’s infrastructure. In August 1993, an interministerial taskforce, the Social Overhead Capital (SOC) Planning Commission, was organized within the Blue House, the presidential office of Korea, to formulate policies for infrastructure financing. Two acts were passed to fill the infrastructure gap. The first, the Transportation Tax Act of 1993 (subsequently renamed the Act on Transportation, Energy, and Environment Tax of 2007) established a tax on fuel consumption earmarked for infrastructure development that accounts for about 40 percent of the consumer price of fuel. The second was the PPP Act, or the Act on Promotion of Private Capital into Social Overhead Capital Investment of 1994.

The PPP concept recognizes the existence of options for the timely provision of infrastructure besides public finance and public delivery. Given tight budget constraints, the government cannot finance all the projects that society needs. The difference between the desirable level of investment and the resources available to invest in infrastructure can be defined as the infrastructure gap, which is illustrated in figure B.1.1. Box 1 explains how PPPs can expand the government’s fiscal space to fill the infrastructure gap.

Figure B.1.1 and table B.1.1 illustrate how PPPs can expand the fiscal space of governments for infrastructure investment. Suppose a government has a budget constraint of US$330 billion. The government should set investment priorities among a group of projects, A through I, that the government is considering implementing. The light gray bars illustrate each project’s benefit-cost ratio (B/C), representing the project’s desirability, and the dark gray bars illustrate each project’s revenue-expenditure (R/E) ratio, representing the project’s financial viability. Figure B.1.1 shows that the implementation of projects A through F is desirable because their B/C ratios are higher than 1.0 (and thus each project’s cost is outweighed by its social benefit). Meanwhile, given the budget constraint of US$330 billion, the government can finance only projects A, B, and C. The missing funds required for D, E, and
F, US$220 billion, are defined as the *infrastructure gap*. Because the R/E ratio of project B is 1.1, meaning it would be financially viable without government subsidy, the government could find a private company to implement the project on a commercial basis. By implementing project B through a PPP, the government can divert the money it would have spent on project B, US$150 billion, to projects D and E. This fiscal space expanded by the PPP is illustrated by the thick arrow in figure B.1.1.

However, the PPP Act was not followed by sizable private investment in infrastructure development. All the act did was declare that the government was ready to welcome private companies to the PPP party; it gave no instruction as to how the party would be conducted. Rules and regulations as to how to implement each step of a PPP project, and detailed guidance on how the financial risks and returns of these projects would be shared, were not in place.

It was not until the revision of the PPP Act in 1999 that Korea’s PPP program expanded substantially. Various government supports, such as risk sharing, were introduced to promote private investment in infrastructure, and technical guidelines were formulated to define the roles and responsibilities of public and private entities for each phase of PPP implementation, which made the implementation process more transparent and easier to plan for. Unsolicited proposals were also encouraged, to expedite project implementation, and bonus points were awarded in the bidding process to project initiators.

However, the growing number of PPP projects soon sparked concerns about the fiscal sustainability of these projects. In particular, the increase in government payments to SPVs in accordance with the MRG clause of the PPP contract had become a substantial burden on the government’s infrastructure funds. Once this fiscal burden was recognized, around 2005, the policy began to swing from promoting new PPPs to strengthening existing ones.

**Key Delivery Challenges**

The first PPP Act focused on promoting private investment in infrastructure development. It introduced several schemes of government support for PPPs. First, the companies implementing PPP projects and individual private investors in them were eligible for tax benefits. SPVs, which are companies created by private investors for the implementation of specific PPP projects, were exempted from acquisition and registration taxes on real estate, and no value added tax was levied on construction services for PPP projects. For individual investors, the interest income from long-term (at least 15-year)
infrastructure bonds issued by SPVs was separated from the investors’ combined financial income taxes, and a lower tax rate of 15 percent was levied on that income. The dividends from infrastructure funds were also taxed separately from an investor’s combined financial income. Separate taxation decreased the effective tax rate on these gains, because Korea’s combined financial income tax has a progressive profile.

Second, a PPP’s implementing agency was allowed to provide expropriated land or other public property to the project’s SPV free of charge or below the market price. According to the PPP Act, SPVs themselves were allowed to expropriate or use private land if necessary to execute a PPP project. The idea was to expedite the implementation of PPP projects by authorizing their private concessionaires to acquire land.

Third, the Infrastructure Credit Guarantee Fund was created to facilitate PPP project financing. SPVs could purchase various types of guarantee services provided by the fund for facility loans, working capital loans, bridge loans, and such.

The PPP review committee, under what was then known as the Ministry of Finance and Economy, approved 45 projects from 1994 to 1998, for which the accumulated project cost was \(¥37.8\) billion. Most of those projects had long been listed in the sectoral plans of the relevant authorities or line ministries responsible for infrastructure provision, waiting for funding to start construction. However, only five of these projects reached financial closure or the ground-breaking stage by the end of 1998, far short of government expectations (Taskforce on Comprehensive Countermeasure for Infrastructure 1998).

Three key delivery challenges hampered the expansion of Korea’s PPP program, as summarized in box 2.

**Lack of Detailed Rules and Regulations for PPP Project Implementation**

Even though the PPP Act had been passed to induce private investment, detailed phase-by-phase guidelines to implement such projects had not yet been developed. There were no standard guidelines for structures and procedures such as the PPP bidding process, the scope of government support, the allocation of risk, the projects’ internal rates of return, and other factors important for investment. Each implementing agency developed its own PPP structures and procedures. As a result, private investors—especially foreign investors—had difficulty understanding how they could get involved in Korean PPP projects.

According to the Korea Development Bank’s survey of 40 foreign financial institutions operating in Korea, before they would be willing to invest in PPP projects, these institutions required the Korean government to develop guidance on PPP implementation procedure and public administration practice based on global standards. The institutions also pointed out that to obtain confidence from the market, the government must develop certain and transparent rules and regulations on government supports and securing investment cost recovery (Taskforce on Comprehensive Countermeasure for Infrastructure 1998).

The rules and regulations for PPP implementation in Korea were not as streamlined as global standard practice. For example, factors critical to the financial viability of projects, such as risk allocation and the scope of government support, could be changed by government officials even after a contract was signed, which made the returns of private investments uncertain. Furthermore, there were many unnecessary regulations to protect project officers from being audited or inspected in the future, which could delay the implementation of a project. The private investors thought that “even though the name of the PPP Act aimed to ‘promote’ private investment in infrastructure, the implementation process for PPPs was filled with practice ‘regulating’ it.”

Given the uncertainty surrounding return on investment and the timeline of project implementation, which are the most critical factors in deciding whether to invest in a project, private investors had difficulty understanding how they could get involved in Korean PPP projects.

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1 Information obtained in an interview with managers of private companies that were involved in early PPP projects.
project, private companies (and, in particular, foreign financial institutions) were not attracted to the new PPP market in Korea.

Also, PPP projects were selected on an ad hoc basis without clear and consistent criteria. Some projects were even selected without economic and financial analyses, and feasibility studies were regarded as a formality. Some government officials used the list of PPP pipeline projects to postpone government investment in those projects or to relieve political pressure during the budget allocation process.

In addition, there were no guidelines for the allocation of risk between public and private parties, and the expected level of return from PPPs was not high enough to offset the projects’ risks, which is a critical problem from the investor’s perspective. The return on investment was set at around 10 percent of construction costs regardless of a project’s specific risk profile, and risk premiums during the operation period were not taken into consideration. Furthermore, risk allocation was not based on the basic efficiency principle of PPPs, “allocating some of the risks to a private party which can better manage them, reduce the project’s overall cost to government, and minimize risk to the taxpayer” (World Bank 2017). On the contrary, construction risks were borne by the public party, as the construction costs were settled after the completion of construction, not at the signing of the contract. For another example, getting the necessary permits for construction from various public organizations was the task of the private party, and that party also bore all the demand risk.

Lack of Skilled Labor within the Implementing Agencies

A second delivery challenge was a lack of skilled labor in the public sector, especially within the implementing agencies. The PPP legislation was led by the then-EPB, but PPP projects were to be implemented by line ministries. Even after the first PPP Act was passed, few government officials in line ministries understood the structure of PPPs.

Managing PPPs requires an additional skill set to those required for conventional procurement. To initiate a PPP project, the project officer has to identify a project suitable for a PPP and develop the structure of the PPP, which includes identifying and allocating risks and responsibilities between parties and appraising project feasibility, commercial viability, and fiscal responsibility. Because a PPP is a long-term contract between public and private parties, the project officer must also know about legal transactions for contract management. A third necessary skill is financial analysis, which is needed to structure PPP projects and formulate implementation plans. These skills were not readily available among government officials, who were familiar only with conventional government procurement processes.

Furthermore, the Taskforce on Comprehensive Countermeasure for Infrastructure found that government officials in line ministries were afraid of being subject to future audits and inspections if their PPP projects failed (Taskforce on Comprehensive Countermeasure for Infrastructure 1998). The limited capacity of the government officials, coupled with a lack of standardized rules and regulations, hindered PPP implementation, and, with few exceptions, those officials preferred conventional government procurement to PPP procurement.

Lack of a Strong Private Financial Institution Capable of Developing Long-Term PPP Financing

A third delivery challenge was the lack of a strong private financial institution with the capacity to develop long-term financial products that could finance PPPs. The key financial structure for a PPP is long-term project financing, which can be arranged when an infrastructure project is capable of functioning profitably as an independent economic unit. Thus, the existence of private financial institutions that can appraise the financial viability of a project from a long-term perspective and on a nonrecourse or limited-recourse basis is a critical condition for the promotion of a PPP market. However, Korea’s financial institutions, which had been operated under close supervision and strict regulation by the supervising government entities, had neither the capacity nor the incentive to develop long-term investment products, including long-term financing for PPPs. Without a domestic guarantee product for foreign investors, and in light of the unclear rules and regulations on project implementation, few foreign investors were interested in Korean infrastructure projects (Taskforce on Comprehensive Countermeasure for Infrastructure 1998).
In this situation, in which the development of PPP projects was already stagnant, the financial instability caused by the Asian financial crisis of 1997 further undermined Korea’s PPP market. Before the 1997 crisis, several road PPP projects were being developed under the strong leadership of the Ministry of Construction and Transportation. Because the country’s private financial institutions had no experience with long-term financing (over 10 years), the SPVs for these PPP projects were led by construction contractors with the encouragement of the Ministry of Construction and Transportation. Construction contractors had joined these SPVs expecting to derive most of their profits from construction works rather than long-term dividends from capital investment. They had to borrow additional money from financial institutions to meet equity investment requirements, which do not apply in the case of conventional government construction works. Because of these requirements, when the financial crisis hit and interest rates skyrocketed, the implementation of PPP projects entirely lost momentum.

To mitigate economic instability and restructure the Korean economy, the Korean government undertook extensive reforms of the public sector, corporate sector, labor market, and financial institutions. As a part of the implementation plan for corporate sector restructuring, big companies, including the big construction contractors that were the main sponsors of PPP project companies, were requested to improve their debt-equity ratios to the levels of their counterparts in developed countries within two years (Lee 2011, 125). To meet these financial requirements, construction contractors who led the SPVs of PPPs wanted to withdraw from the ongoing projects because of the sponsors’ liquidity problems.

**Tracing the Implementation Process**

**Promoting the PPP Market**

In the wake of the Asian financial crisis of 1997, the development of PPPs in Korea took a new course. PPPs were once again viewed by the Korean government as a vehicle with potential to fill the country’s financial gap. This time, however, the purpose of PPPs was not merely to expand the country’s transportation network but also to circumvent the government’s tight fiscal constraints and finance infrastructure, thereby reinvigorating the economy in the absence of the capacity for direct government spending. Under the standby loan agreement, the Korean government committed to a tight fiscal policy to provide for the uncertain costs of restructuring the financial sector. The performance target for the consolidated central government budget was set at a fiscal surplus of 0.25 percent of GDP as a part of agreements with the International Monetary Fund (IMF; Lee 2011).

Under the fiscal circumstances, the Korean government tried to induce sizable private investment in major projects, which required offering sufficiently strong incentives to private investors. Given its confidence in the fundamentals of the nation’s economy, the Korean government wanted to invest in an economic stimulus package involving major infrastructure projects. However, the government could not increase direct expenditures enough to implement such a package because of the fiscal austerity measures it was operating under. PPPs were seen as a tool that would enable the government to circumvent the IMF’s requirements. It was against this background that the PPP Act and Act Decrees were revised to proactively induce private investment, which they did by streamlining PPP rules and regulations and introducing incentive schemes such as new risk-sharing arrangements for private investors.

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Among the PPP promotion measures, three specific measures were effective in expanding the PPP program.

**Risk Allocation Scheme**

Under the new PPP Act, substantial project risks were to be retained by the public party, especially the demand risk.

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2 This assessment by the author was confirmed in a discussion with a government official who was involved in setting PPP policy.

3 This assessment by the author was confirmed in a discussion with a government official who was involved in setting PPP policy.
of the project, which made PPP projects more attractive to financial institutions. Several risk mitigation measures were adopted in and following the 1998 amendment of the PPP Act.

First, the amended PPP Act included a clause called the Minimum Revenue Guarantee that effectively removed the demand risk for SPVs (the risk arising from the gap between forecast and actual demand for the facility) by guaranteeing to match 80–90 percent of forecast revenue regardless of actual demand for the project. For example, if 90 percent of forecast revenue for a road project was guaranteed and the actual revenue for the project was 70 percent of the forecast revenue, the government would make up the 20 percent deficit with cash from the government budget. The maximum coverage of guarantees for solicited projects was set at 90 percent, and for unsolicited projects, 80 percent. This risk-sharing scheme was applied to existing contracts as well as to new contracts to keep sponsors of SPVs from abandoning ongoing projects in the wake of the financial crisis.

Second, an early-termination payment clause was included, and a buyout option was given to SPVs. Under the early-termination clause, the government would pay a fee, according to a predetermined formula, if the PPP contract was terminated for force majeure or other unforeseeable reasons. An SPV would be eligible for the government payment even if the PPP contract was terminated because of its own fault. In addition, SPVs could request that the government buy back operation rights to the asset in the case of force majeure or for other reasons listed in the PPP Act Decrees. These arrangements for early termination and buybacks made PPP projects attractive to debt financiers because the government payments would be high enough to cover debt services for senior debt in any event.

Third, the amended PPP Act mitigated foreign exchange volatility risks to foreign investors, because the instability of the exchange rate of U.S. dollars to Korean won had been a bottleneck to inducing foreign investment after the Asian financial crisis. If the foreign exchange rate fluctuated by more than 20 percent, an SPV could request an adjustment of user fees or a direct government subsidy of operating costs and could renegotiate the PPP contract.

Finally, coverage of the SOC Credit Guarantee Fund was increased, and management of the fund was streamlined, to make the fund more accessible to private entities. The total amount of guarantee products was increased from 15 times the total amount of funding raised to 20 times that amount. The maximum guarantee amount for a PPP project was also increased, from W30 billion (about US$30 million) to W100 billion (about US$100 million), and a guarantee product was introduced for infrastructure bonds. Also, the managing organizations of the various funds were merged into a single organization, the Korea Credit Guarantee Fund. The amended PPP act also provided a legal basis for a new Infrastructure Fund to finance PPP projects as an equity investor or lender.

Encouraging Unsolicited Proposals

Another important measure to promote PPPs was encouraging the development of project proposals unsolicited by the government. The PPP Act had already allowed unsolicited proposals in 1997. However, there were no detailed guidelines on how to proceed with unsolicited proposals. To fix this problem, the PPP Act Decrees set a step-by-step timetable specifying how the government would proceed with such proposals. The competent authority, or the public entity responsible for a PPP project, was to decide whether to accept or reject the proposal within 15 days after reviewing whether the proposal met the legal requirements for a PPP project and whether it was aligned with the policy direction of the sector’s infrastructure investment. After acceptance, the project’s economic and financial feasibility would be reviewed by the newly established PPP center, the Private Investment Management Center of Korea (PICKO), within 60 days. Finally, if the project was deemed to be suitable for a PPP, a request for proposal would be issued.

For unsolicited proposals, the competent authority required substantial details about the contents of the project and its implementation plan. This requirement led to the initial proponents of unsolicited projects spending billions in project development costs at their own risk. To reward these efforts, and to encourage the private sector to develop more PPP proposals, the original proponent of a project was awarded bonus points at the bidding stage (up to 10 percent of its score). This incentive was quite effective at attracting private parties, particularly construction contractors that were interested in winning bids mainly for the profit they would earn from construction works. It also allowed project officers to save the time and expense of developing a project plan. However, the bonus point system hampered the
government’s ability to competitively select the most efficient and innovative bidder.

Establishing a PPP Unit

To build the capacity within the public sector needed to manage PPP projects, the amended PPP Act of 1999 established a PPP center within the PICKO. This center was created under the Korea Research Institute for Human Settlement (KRIHS), a government think tank focused on infrastructure planning and territorial and regional development. The central role of PICKO was to facilitate the process of carrying out PPP projects by providing technical assistance to implementing agencies.

When the PPP center was established, two options for its institutional position were considered. One was to make the center a single interministerial organization that would serve all government organizations as well as private investors. The other was to create multiple PPP centers under individual ministries that hoped to develop a sizable number of PPP projects, such as the Ministry of Construction and Transport and the Ministry of Maritime Affairs and Fisheries. Given the limited capacity for PPP management in the public sector as a whole and the lack of an enabling environment for PPPs, the first option was chosen, and the PICKO was created as an interministerial organization.

The functions of the PICKO were as follows:

- Support the streamlining of institutional arrangements for PPPs, such as the PPP Act, the PPP Act Enforcement Decrees, and the Annual PPP Plan.
- Support the formulation of mid- and long-term PPP plans and policies.
- Develop the pipeline of PPP projects and conduct feasibility studies.
- Support the formulation of requests for proposals.
- Support tender evaluation at the bidding phase.
- Support negotiation and contract signing.
- Consult with domestic and foreign investors on PPP investment.
- Manage public relations around PPPs and conduct promotion events to attract foreign investors.

The PICKO held capacity-building programs for government officials on a regular basis. It also conducted research on PPPs and hosted a conference with international organizations, including the World Bank, to understand the global trends concerning PPPs.

Another mandate of the PICKO was to induce private investment, including foreign direct investment, in PPP projects. The PICKO identified pipeline PPP projects of infrastructure-related ministries and disseminated information about them to private companies that were interested in developing infrastructure projects through PPPs. The concept of “one-stop service” was emphasized, and a strict timeline by phase of project implementation was set to prevent unnecessary delays in PPP implementation.

In summary, a series of policy measures (new risk-allocation schemes, the encouragement of unsolicited proposals, and the creation of the PICKO) effectively promoted Korea’s PPP market, expanding the country’s PPP program in a relatively short time. In 2000, 24 unsolicited proposals were submitted, and 16 and 20 proposals were received in 2001 and 2002, respectively. The record high—35 unsolicited proposals—occurred in 2003.

Strengthening Fiscal Discipline

Although proactive government policies expanded Korea’s PPP market, in time these policies posed challenges to the country’s fiscal sustainability. The demand risk borne by the public sector, mainly through the MRG clause present in many projects, was expected to burden government fiscal management at the operational stage because the projects’ actual revenue would fall short of the revenue guaranteed to private parties.

Many PPP projects were criticized on the grounds that the participating SPVs enjoyed too high of a return without bearing substantial project risk. The Citizens’ Coalition for Economic Justice was one of the strongest and most sustained voices against the PPP policy, arguing that PPP projects were wasting taxpayers’ money (Citizens’ Coalition for Economic Justice 2003). It also argued that the practice of collusion while bidding for PPP concessions prevented effective competition, hence securing high profits for private investors, and it called for a comprehensive audit and inspection of PPP projects by the National Assembly. SPVs also paid much higher interest rates to lenders of subordinate loans, which, in many cases, were also equity investors.

The combined results of these phenomena were high charges for users of PPP projects. Citizens who used PPP roads with high tolls, such as the Incheon International Airport Highway and the Seoul-Chuncheon Expressway, made the tolls into a political issue in the 2008 election of National Assembly members (Kangwon Daily News 2007). Rising concern and criticism were voiced by the
public and in the political arena that these highly tolled private operations must have not met the VfM criterion and thus should not have been initiated as PPPs in the first place (Citizens’ Coalition for Economic Justice 2003). Opponents of PPPs argued that government spending would have been lower and fiscal productivity higher if the projects had been fully financed by the government.

In 2005, the Korean government revised the PPP Act again to strengthen its fiscal discipline concerning PPPs. First, it changed the risk-sharing scheme for PPPs, particularly the MRG policy, to decrease the government’s fiscal liabilities. The MRG clause originally applied for the full duration of a project’s contract period and guaranteed up to 90 percent of projected revenue for solicited proposals and 80 percent for unsolicited proposals. Since 2003, the government had required, in order for private partners to be paid through the MRG clause, that a project’s actual revenue be larger than 50 percent of forecast revenue. This additional requirement was meant to prevent SPVs from overestimating future demand on purpose and from making serious mistakes in their estimates. In January 2006, the MRG policy on unsolicited proposals was abandoned. For solicited proposals, the maximum guarantee period of MRG clauses was reduced to 10 years, and the maximum level of guarantee was set at 75 percent for the first 5 years of operation and 65 percent for the following 5 years. The retained risk covered by the government through the MRG clause gradually decreased until, in 2009, the MRG policy was canceled for all types of PPP projects.

Second, a rigorous VfM test was introduced to assess whether PPP procurement could deliver better value for taxpayers than conventional procurement. Through the VfM test, a PPP project would be authorized only if it was economically viable (in other words, if its benefit-cost ratio was greater than 1) and delivered value for money from the taxpayer’s perspective. All unsolicited proposals are now reviewed by the new PPP unit of the PIMAC (Public and Private Infrastructure Management Center) at the Korea Development Institute (KDI), which is mandated by the PPP Act to carry out the VfM test.

Third, the PIMAC was created by merging the former PICKO of the KRIHS with the Public Investment Management Center (PIMA) of the KDI. Although the KRIHS had close interactions with the Ministry of Land, Infrastructure, and Transport (the country’s biggest infrastructure developer), the KDI had long been working with the Ministry of Strategy and Finance, which controlled the country’s budget. The PIMAC has legal mandates to facilitate the implementation of PPPs by performing due diligence on PPP projects and providing governments with technical assistance at various steps of the project implementation process, including project selection, bidding, negotiation, and refinancing.

The key role of the PICKO had been to facilitate the implementation of PPPs by providing government officials with technical assistance. Under its regime, the function of “one-stop service” was emphasized. In contrast, the PIMAC put a higher priority on improving efficiency and sustainability in fiscal management than on facilitating PPP processes. It applied to its due-diligence monitoring of PPP projects the same analytical framework and culture of rigorous project appraisal developed by its predecessor, the PIMA, for use on public infrastructure projects.4

The PIMAC developed a unified public investment management framework that encompassed both conventional government projects and PPP projects. The exact same cost-benefit and financial criteria were set to assess the feasibility of both types of projects. The huge amount of information required to conduct the VfM tests was drawn from the data obtained during the PFS process. In summary, the watchword under the PIMAC has shifted from “one-stop service” to “value for money,” maximizing the value of taxpayers’ money through due diligence.

Fourth, competition between private participants was encouraged in order to bring about the full benefit of PPPs. The efficiency gains that are expected from PPPs do not automatically come into reality. Creative ideas and innovations in management arise from competition among private entities. To promote competition at bidding, the government tried to diversify its profile of investors, in particular, to induce strategic investors to join SPVs, which had been dominated by construction contractors. To invite third-party bidders to compete with a project’s original proponents, the government also decided to reimburse a maximum of two-thirds of the bidding costs of qualified losers in the bidding process.

Lessons Learned

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4 Established in 2000, the PIMA had developed analytical methods and consistent databases to conduct prefeasibility studies (PFS) on infrastructure projects.
The experience of Korea’s PPP program holds a few important lessons regarding the implementation of PPP programs.

First, a streamlined institutional framework is a critical factor in the promotion of PPP programs. Development of detailed guidance that explains each step of the PPP implementation procedure, as well as PPP legislation, is necessary to induce private investment. Such guidelines benefit both private and public parties. They will reduce project risk (and, accordingly, the return on investment required by private participants) by making the futures of projects more foreseeable. Guidelines will also help government officials who hesitate to develop PPP projects out of concern that they might be blamed if the projects fail. Officials can base their decisions on the guidelines, and they can resort to those guidelines if they are requested to take responsibility for a failed project in the future.

Second, it is important to balance market promotion and fiscal soundness. The Korean government’s efforts to promote PPPs—especially the MRG clause—and to expedite the PPP initiation process were effective at expanding the country’s PPP program in the wake of the Asian financial crisis. However, the program’s rapid growth posed a new fiscal management burden. In particular, the government’s payments as a result of the MRG clause and the high charges imposed on users of PPP projects caused much criticism of PPPs. To address those negative side effects, the Korean government has emphasized fiscal discipline in the management of PPPs since 2005.

In 2015, the government introduced new risk-sharing schemes called BTO-rs (build-transfer-operate risk sharing) and BTO-a (build-transfer-operate adjusted) under which the government shares the risk of PPP projects in order to prevent SPVs from going bankrupt for lack of revenue. This new risk sharing scheme is meant to induce investment from private investors who otherwise would not invest in PPP projects with high risk and low returns.

Third, a specialized PPP unit proved to be an effective institution, able to play multiple roles to promote and streamline the PPP implementation process. Korea’s PPP unit filled the roles of policy adviser, designer and implementer of PPPs, and manager of long-term PPP contracts. It also improved the institutional capacities of public and private parties by providing capacity-building programs on a regular basis.
References


Further Reading

