

# Procurement Issues in Structuring Output-Based Aid (OBA) Operations Financed by the World Bank

## Guidance Note for Procurement Staff <sup>1</sup>

April 11, 2008

This Note provides guidance to Procurement Specialists (PS) and Procurement Accredited Specialists (PAS) on how to ensure compliance with the Procurement Guidelines (the “Guidelines”) in operations that involve an OBA approach.<sup>2</sup>

The Note contains two annexes. [Annex 1](#) provides a flow chart showing the different scenarios and actions required by PS/PAS. [Annex 2](#) provides an illustrative sample checklist for conducting procurement capacity assessments (PCA) of incumbent service providers.

### 1. Output-Based Aid (OBA) Approaches

1.1 OBA is the use of explicit, output or performance-based subsidies to complement or replace user fees. It involves the contracting out of basic service provision (e.g., infrastructure, health, or education) to a third party—such as private companies, non-governmental organizations (NGOs), community-based organizations (CBOs), and government-owned enterprises<sup>3</sup>, hereinafter referred to as “service provider”—with subsidy payment tied to the delivery of previously specified outputs or services meeting certain pre-specified performance standards. This implies that the service provider assumes the risk of pre-financing the achievement of the agreed outputs.

1.2 OBA should not be confused with performance- or output-based procurement, addressed in paragraphs 3.14 and 3.15 of the Guidelines. OBA may be considered a specific application of the performance- or output-based procurement concept, but its application is limited to the payment of the subsidy element.

1.3 Examples of possible OBA applications include payment of subsidies tied to:

- Number of new working connections made (e.g., when the goal is to expand access to network services), typically to poor households;
- Verified household consumption (e.g. equivalent to the difference between a life-line tariff payable by poor households and the full tariff);
- Achievement of positive externalities (e.g., the achievement of specific environmental targets such as cubic meters of waste water treated); and
- Voucher schemes, typically for targeted disadvantaged groups in health and education projects (e.g., to be redeemed by beneficiaries with a service provider of their choice

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<sup>1</sup> This Guidance Note was developed jointly by staff from the GPOBA unit of the Finance, Economics and Urban Development Department (FEU) and the Procurement Policy and Services Department (OPCPR), and incorporates the lessons learned from procurement assessments conducted under OBA pilot operations across regions, as well as peer reviewer comments.

<sup>2</sup> For additional information, see *Structuring Output-Based Aid (OBA) Approaches in World Bank Group Operations, Guidance Note for Staff*, November 17, 2005.

<sup>3</sup> As defined in Paragraph 1.8 (c) of the Guidelines.

among those selected competitively by the government, for provision of primary health care services).

1.3 OBA is a mechanism that always involves a pre-agreed payment for the delivery of a specified output. Under an OBA approach, a service provider operates on a commercial basis within the framework of a contract/legal agreement for service provision, and the disbursements (payments) are tied directly to the terms of the specific individual contract with the service provider.

1.4 Output-Based Disbursement (OBD)<sup>4</sup> mechanisms utilize a similar but distinct approach. OBD specifically applies to government or public entities which do not meet the definition in Paragraph 1.8 (c) of the Guidelines (i.e. they do not operate on a commercial basis). In this case, Bank loans to the government are disbursed upon the achievement of clearly specified outputs.

## **2. Risk transfer under OBA Approaches**

2.1 The output-based nature of the legal documents (e.g., loan and/or grant agreements, and service contracts) is important for the success of projects involving an OBA approach. Hence, while carrying out a risk analysis, the PS/PAS should keep in mind the following OBA principles are applicable:

2.1.1 *Subsidies are explicit and pre-agreed in order to ensure transparency.* Subsidy levels are generally determined either through a competitive process or a non-competitive process to choose the service provider. Whenever there is a competitive process to choose a service provider, the subsidy level is considered in the award criteria, which are generally: (i) the least subsidy required per pre-determined output; (ii) the greatest coverage per fixed offered subsidy; or (iii) the least connection cost per fixed offered subsidy. In the case of an incumbent service provider, where the subsidy level is not determined as part of the procurement process for the selection of the service provider (see section 5 of this Guidance Note), subsidy levels are determined through the establishment of standard costs or agreement on a unit cost schedule, both verified by independent consultants during project preparation.

2.1.2 *Payment on output delivery:* The performance and operational risks are borne by the service provider, mostly through the pre-financing of the inputs necessary to deliver the outputs against which OBA disbursements are made. The outputs are independently verified prior to payments in accordance with the payment schedule in the contract or agreement for service provision entered between the contracting authority and the service provider.

2.1.3 *The service provider receives only the pre-agreed payment for the specified outputs – regardless of the actual cost.* The service provider has strong incentives to be efficient in procuring the goods, works and services required for the inputs necessary to produce the outputs, as well as in maintaining satisfactory provision of the services.

## **3. Types of OBA Approaches**

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<sup>4</sup> For more information on OBD, see *Implementing Output Based Disbursement Mechanisms for Investment Operations, Operational / Technical Guidance Note to Staff*, OPCS, April 2, 2007.

3.1 From the perspective of Bank participation in the financing of an OBA operation, there are two main types of OBA operations governed by Paragraph 3.13 of the Guidelines:<sup>5</sup>

- Projects where there is no existing service provider; or
- Projects where there is already an existing service provider (incumbent concessionaire or equivalent arrangement).

#### **4. Procurement requirements where there is no existing service provider**

4.1 In projects where there is no existing service provider, Paragraph 3.13(a) of the Guidelines requires that the service provider be awarded the service concession or similar arrangement (with or without OBA components) through International Competitive Bidding (ICB) procedures acceptable to the Bank. During bid preparation, the PS/PAS' role is to review the bidding procedures, documents, evaluations, award recommendations, and contracts to ensure that the procurement process is carried out in accordance with Paragraph 1.11 of the Guidelines<sup>6</sup>.

4.2 It must be clarified that to be acceptable to the Bank, the ICB procedures need not be identical to the Bank's ICB procedures described in Section II of the Guidelines, but should meet the overall Bank's procurement principles of economy, efficiency, transparency and fair competition<sup>7</sup>, as well as the principles of Section II provisions. Furthermore, similarly as under other Bank-financed operations, if the legal conditions of the project justify the use of National Competitive Bidding (NCB), such procedures may also be acceptable, provided that they meet the requirements of Paragraph 3.3 of the Guidelines, including the principles of economy, efficiency, transparency and broad consistency with the provisions included in Section I of the Guidelines, or may be modified as necessary to become acceptable by the Bank<sup>8</sup>.

4.3 For PS/PAS review purposes, as long as the contracted subsidy involved in any of the three award criteria (as described in paragraph 2 of this Note) is the result of a competitive selection under procedures acceptable to the Bank, the subsidy is deemed to reflect a unit price for the desired outputs that is reasonable, economic, and efficient. In these cases, the PS/PAS is not required to conduct any further assessment or other review of contracts after

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<sup>5</sup> For ease of reference, see the flow chart in Annex 1 to this Note, which is cross-referenced to the relevant sections of this Guidance Note.

<sup>6</sup> Paragraph 1.11 of the Guidelines states: "The Bank reviews the Borrower's procurement procedures, documents, bid evaluations, award recommendations, and contracts to ensure that the procurement process is carried out in accordance with the agreed procedures. These review procedures are described in Appendix 1. The Procurement Plan approved by the Bank shall specify the extent to which these review procedures shall apply in respect of the different categories of goods and works to be financed, in whole or in part, from the Bank loan."

<sup>7</sup> In accordance with Paragraph 3.13 (a) of the Guidelines, the procurement procedures used to select the service provider (or concessionaire) may include several stages in order to arrive at the optimal combination of evaluation criteria. A well-managed selection process normally should at least include the following steps prior to contract signing: (a) wide advertisement and promotion; (b) prequalification of bidders; (c) clear and non-discriminatory bidding documents; (d) clear procedures for bid submission and public bid opening; (e) transparent bid evaluation criteria well defined in the bidding documents; and (f) selection of one firm for award of contract based on the evaluation criteria.

<sup>8</sup> For acceptability requisites, refer to those described in footnote 15 of this Guidance Note.

the service provider is awarded the contract with an OBA element, except for the service provider's procurement plan for the first year of the project, which will require PS/PAS review to ensure that the Guidelines' eligibility requirements are met. The awarded service provider selected in this manner may use its own procedures or the Bank's if it so chooses, to procure the goods, works, and services required to produce the outputs<sup>9</sup> (referred to as "downstream procurement"). In accordance with Paragraph 3.13(a) of the Guidelines, the PS/PAS shall review the Project Appraisal Document (PAD or equivalent), and the project legal documents to ensure that they adequately specify the type of expenditures incurred by the service provider to produce the outputs against which Bank funds will be disbursed. As customary under Bank operations, the PS/PAS assists in the review of the PAD and the project legal documents, as appropriate, including, in particular, review arrangements.

4.4 Since downstream procurement carried out by the service provider for selecting his suppliers or contractors is not subject to post review based on the fact that the service provider will only get paid upon verification of actual delivery of the promised outputs, the contract entered into with the service provider must clearly establish that those outputs must be verified by an independent agent acceptable to the Bank, prior to the payment of the subsidy in accordance with the contract's payment schedule.

4.5 In addition, per the October 2006 Guidelines on Preventing and Combating Fraud and Corruption in Projects Financed by IBRD Loans and IDA Credits and Grant, the Bank has the right to inspect and audit the service provider's accounts and records and documents related to the submission of proposals and contract performance to ensure that the service providers operates in accordance with the highest professional and ethical standards. To that effect, the Bank requires that a specific provision establishing the Bank's right to audit and its available remedies in case of evidence of fraudulent and corruptive practices, be added to the bidding documents for the selection of and to the contract entered with, the service provider for the provision of the services, as well as in all those contracts procured by the service provider with suppliers and contractors. The PS/PAS should make sure that the contract entered with the service provider includes both the requirement for Bank-acceptable independent verification of outputs and the Bank's right to audit, and the requirement for the service provider to include the Bank's right to audit in all downstream procurement.

## **5. Procurement requirements where there is already an existing service provider (incumbent concessionaire or equivalent arrangement)**

5.1 If at the time the Bank considers to participate in the financing of an OBA component, the concessionaire/service provider is already in place, the PS/PAS should determine whether the incumbent service provider was selected through ICB procedures acceptable to the Bank. This determination leads to two possible outcomes:

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<sup>9</sup> In compliance with Paragraph 1.8(a) of the Guidelines, the inputs, whether goods, works and consultants services, towards which the Bank will provide a subsidy must come from eligible sources (manufactured in countries or by firms that have not been excluded or found ineligible by the Bank).

5.1.1 *The incumbent service provider was selected through ICB procedures acceptable to the Bank.*<sup>10</sup> As indicated in Paragraph 3.13(a) of the Guidelines, “If the incumbent service provider was selected through ICB procedures acceptable to the Bank, it is free to use its own procedures to procure the goods, works, and services required to produce the outputs”. The PS/PAS is not required to review the procurement arrangements of the service provider or review contracts procured by the service provider, except for the service provider’s procurement plan for the first year of the project, which will require PS/PAS review to ensure that the Guidelines’ eligibility requirements are met. At this stage, the PS/PAS would only provide clearance for the use of the procurement system of the incumbent service provider in the framework of the Project Appraisal Document and in the legal documents prepared by the Bank. Since downstream procurement carried out by the service provider for selecting his suppliers or contractors is not subject to post review based on the fact that the service provider will only get paid upon verification of actual delivery of the promised outputs, the contract entered into with the service provider must be modified to clearly establish that those outputs must be verified by an independent agent acceptable to the Bank, prior to the payment of the subsidy in accordance with the contract’s payment schedule. In addition, per the October 2006 Guidelines on Preventing and Combating Fraud and Corruption in Projects Financed by IBRD Loans and IDA Credits and Grant, the Bank has the right to inspect and audit the service provider’s accounts and records and documents related to contract performance to ensure that the service provider operates in accordance with the highest professional and ethical standards. To that effect, the Bank requires that a specific provision establishing the Bank’s right to audit and its available remedies in case of evidence of fraudulent and corruptive practices, be added to the contract entered with the service provider for the provision of the services, as well as in all those contracts procured by the service with suppliers and contractors. The PS/PAS should make sure that the contract entered with the service provider includes both the requirement for Bank-acceptable independent verification of outputs and the Bank’s right to audit, and the requirement for the service provider to include the Bank’s right to audit in all downstream procurement.

5.1.2 *The incumbent service provider was not selected through ICB procedures acceptable to the Bank.*<sup>11</sup>

5.1.2.1 In this case, Paragraph 3.13(b) of the Guidelines applies. If strictly applied, Paragraph 3.13(b) requires that all contracts for goods, works and services be procured under Bank ICB procedures (those described in Section II of the Guidelines). In practical terms, this represents a major obstacle for clients to develop OBA approaches, as the contracts to be procured can be rather small in value and not always suitable to such a comprehensive procurement method. Recognizing this, OPCS issued on November 7, 2005 an *Operational Memorandum on the Application of Paragraph 3.13 of the Procurement Guidelines to Cases Involving Incumbent Concessionaires*.<sup>12</sup> This Operational Memorandum (Paragraph 3.13 OM) clarifies the standards and conditions under which an incumbent service provider can use its own procurement procedures. For this to be possible, the following conditions need to be present:

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<sup>10</sup> See Section 4.2 in this Guidance Note.

<sup>11</sup> *Idem*.

<sup>12</sup> See, OP/BP 11.00. *Operational Memorandum on the Application of Paragraph 3.13 of the Procurement Guidelines to Cases Involving Incumbent Concessionaires*. OPCS, November 7, 2005.

- The case should involve the expansion of an existing system where an incumbent service provider (or concessionaire) already exists;
- The incumbent service provider (or concessionaire) should be a privately-owned company or a government-owned company operating on a commercial basis;<sup>13</sup> and

5.1.2.2 The PS/PAS can clear the use of the incumbent service provider's procurement procedures to procure the goods, works, and services required to produce the outputs,<sup>14</sup> if (i) the two above conditions are met; and (ii) an up-front assessment by the Bank of the procurement capacity of the service provider (or concessionaire) and of the procurement practices used in conducting regular business to procure goods, works and services from third parties (in particular for the provision of inputs required to produced the desired outputs) results in a determination that the service provider (or concessionaire) possesses adequate capacity and acceptable procedures<sup>15</sup>.

5.1.2.3 The referenced OM also establishes the Bank's right, during supervision, to conduct post-reviews as frequent and to the extent and depth it may consider necessary to satisfy itself that the procurement capacity of the concessionaire (or service provider) has not diminished below the level accepted by the Bank, and that the procurement actions carried by the concessionaire (or service provider) have followed the procurement procedures that were acceptable to the Bank.

5.1.2.4 Procurement plans should be designed in such a way that Bank prior review interventions are minimized, having due regard to the assessed overall procurement risk, but adequate post-review and monitoring should be exercised by the Bank. The PS/PAS should be encouraged to prior review the draft OBA legal documents as negotiated and agreed on between the borrower/recipient and the incumbent service provider. The contracts pre-financed by the service provider should be subject to Bank post-review.

5.1.2.5 In addition, per the October 2006 Guidelines on Preventing and Combating Fraud and Corruption in Projects Financed by IBRD Loans and IDA Credits and Grant, the Bank has the right to inspect and audit the service provider's accounts and records and documents related to contract performance to ensure that the service provider operates in accordance with the highest professional and ethical standards. To that effect, the Bank requires that a specific provision establishing the Bank's right to audit and its available remedies in case of evidence of fraudulent and corruptive practices, be added to the contract entered with the service provider for the provision of the services, as well as in all those contracts procured by the service with suppliers and contractors. The PS/PAS should make sure that the contract entered with the service provider includes the Bank's right to audit, and the requirement for the service provider to include the Bank's right to audit in all downstream procurement that he conducts for selecting suppliers or contractors.

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<sup>13</sup> As defined in Paragraph 1.8(c) of the Guidelines.

<sup>14</sup> Id. See footnote 11.

<sup>15</sup> To be acceptable, the service provider's procedures must result in (i) fair competition to bidders (which may be limited to national bidders where appropriate); (ii) economy (lowest cost); (iii) efficiency (satisfactory quality); (iv) transparency; and (v) no preference granted to contractors of the same group of shareholders of the service provider.

5.1.2.6 The subsidy amount per output is initially proposed by the incumbent service provider. However, in order to ensure that the unit price represents a reasonable, economic, and efficient cost of service, an independent assessment must be carried out to determine the optimal subsidy level per output as well as compliance with acceptable technical standards and service specifications. This usually involves hiring an independent consultant. If the borrower/grant recipient hires the consultant, it shall do so using the Bank's Standard Request for Proposals document and under Terms of Reference acceptable to the Bank, and with PS/PAS prior review. This independent assessment, which needs to be reviewed by the TTL as part of project preparation, does not require detailed involvement by the PS/PAS. The TTL can, however, decide to hire the independent consultant under the e-consult procedures of the Bank's Administrative Manual (AMS 15.00).

5.1.2.7 It is important to bear in mind that the Paragraph 3.13 of the above referenced OM specifically excludes the case of service providers (or concessionaires) not selected under ICB procedures acceptable to the Bank, who are nevertheless undertaking a "greenfield" project (e.g., an existing concessionaire obtains another concession in a different area not associated with the existing concession) for which Bank-financed OBA subsidies may be requested. The reason for the exclusion is that a "greenfield" project normally involves high value procurement of goods, works and services.

## **6. Checklist for procurement capacity assessment of incumbent service providers**

6.1 Annex 2 to this Note provides a checklist to conduct capacity assessments in OBA projects as described in Section 5.1.2 above. This checklist is based on the content of Appendix 1 of the Operational Memorandum of July 15, 2002, on agency's capacity assessment to implement procurement in Bank-financed operations and incorporates the lessons learned from procurement assessments conducted under OBA pilot operations across regions, as well as peer reviewer comments.<sup>16</sup>

6.2 The checklist is meant for assessing incumbent service providers of significant size (e.g., infrastructure utility companies under concession contracts). However, in assessing small service providers, some sections of the checklist may not be applicable and may need to be further adapted for the specific OBA project. As indicated in the November 17, 2005 Guidance Note to Staff: "Simpler procurement procedures may also be applicable to projects that involve the participation of communities, NGOs or local labor or know-how. The Bank provides an expedited review of the applicable regulations and bidding documents normally used in the country, and the modifications are reflected in the legal agreements."

6.3 The nature of the project should determine the specific areas requiring more in-depth analysis at capacity assessment. PA/PAS should seek further advice and guidance from the Regional Procurement Manager (RPM) on the extent and scope of these assessments. The PS/PAS is also encouraged to forward questions to the contact staff indicated at the bottom of the checklist.

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<sup>16</sup> See Appendix 1 to the Office Memorandum, *Revised Instruction for Carrying out Agency's Capacity Assessment to Implement Procurement; Setting of Prior-Review Thresholds and Procurement Supervision Plan*. OPCPR, July 15, 2002.