Contract Renegotiation of Transport PPP Projects

An overview of the Latin American Experience

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October 28, 2014

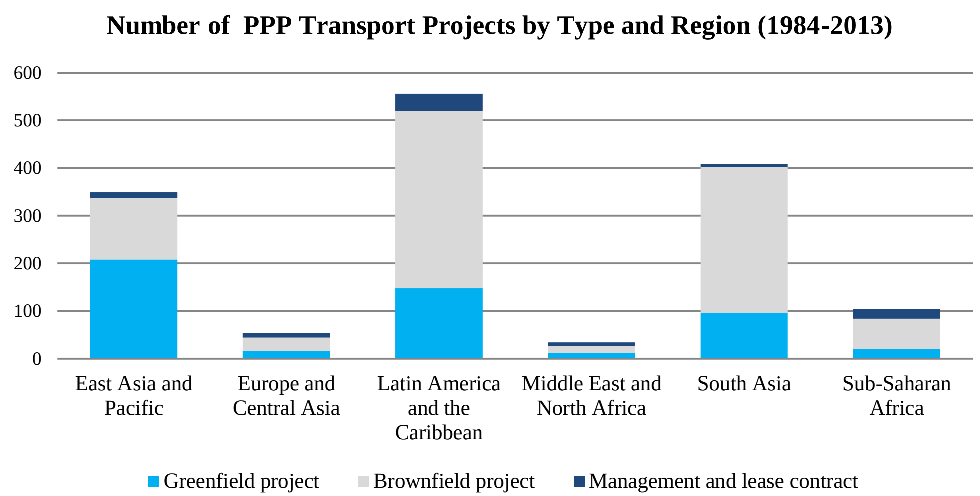
Work in progress

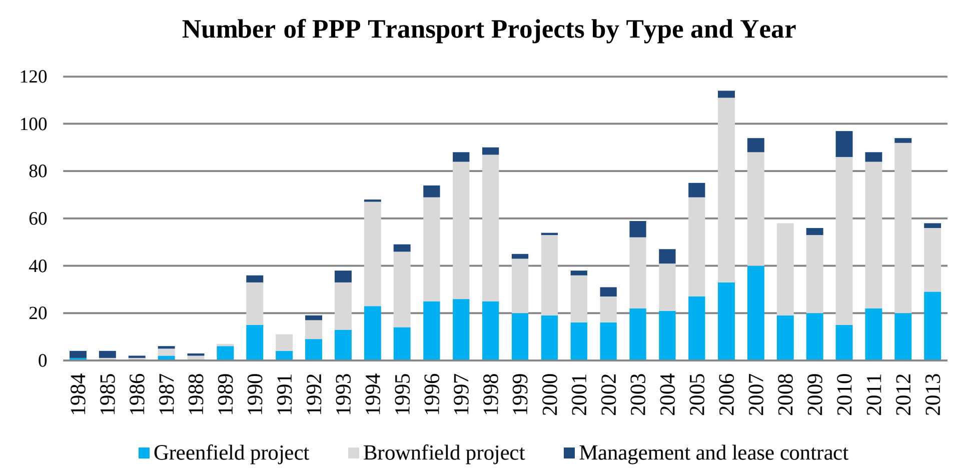
PPPs in developing countries: an overview

- More than 6000 PPP contracts have been signed in <u>developing countries</u> in the last 25 years*
  - Transport concentrates 25% of the total PPP contracts

- Three lead regions: Latin America, South Asia and East Asia and Pacific:
  - They concentrate almost 90% of the PPP transport projects in the last 30 years
  - Brazil, India, and China - large economies with high economic growth rates
  - In 2012, 78% of transport investments were concentrated in Brazil and India

**Source: World Bank / PPIAF database www.ppiaf.org*





Investments, promise, and contract renegotiations in LCR*

- Beyond much needed investments, another legacy is a large number of PPP contract renegotiations:
  - 55% of the PPP contracts in transport (1980-2000) were renegotiated with and fairly quickly after the signature of contract (3.1 years).
  - Colombia (roads) between 1993-2010 showed seven times the number of renegotiation in Chile or Peru
  - Chile: contract renegotiations for additional investments suggesting poor project preparation studies critical to assess the real dimension/scope of the infrastructure projects and budget bypassing issues

**LCR: Latin America and Caribbean Region*

High frequency of contract renegotiation

- It also occurs in countries with large experience with private sector participation (also India, Portugal, South Africa…)

Region / country	Sector	% of renegotiated contracts	source
Latin America and Caribbean	Total	68%	Guasch 2004 (2012)
	Electricity	41%	
	Transport	78%	
	Water	92%	
US	Highways	40%	Engel Fischer & Galetovic 2011
France	Highways	50%	Atthias and Saussier 2007
	Parking	73%	Beuve et al 2013
UK	All sectors	55%	NAO 2001

Source: Estache, Antonio and Stéphane Saussier, "Public-Private Partnerships and Efficiency: A Short Assessment", CESifo DICE Report 12 (3), 2014, 08-13

What do we mean by contract renegotiation?

Renegotiation is when:	Examples
i) a change in the risk matrix assignment and / or in the conditions of the contract, or ii) A change in compensation	• Reduce the level of services (airports, from IATA A to B). • Defer or advance investments for several years. • Extension of the contract term. • Reduction guarantees (financial bonds) • Increase the guarantee of the government (to pay lenders). • Delays in the reduction of tariffs (tolls), or levels • Reduce the thresholds of the economic equilibrium of the contract, etc.
iii) a change in project scope (if this was not regulated in the contract).	• Government requests new investments. • Reduction of fees for the government. • Ovoid bankruptcy of the operator. • Changes on the contract scope, etc.
Renegotiation is not when:	• Tariffs are adjusted with a formula set it in the contract or indexed by inflation. • Triggers are activated and eventual investments become mandatory. • Payments to operator if they are regulated in the contract, etc.

Why Renegotiation is an important issue? Implications

- **Eliminate the competitive** effect of the auction including transparency: questioning the credibility of the model/program
- **Voids value for money analysis**
- **Asymmetric information** and lack of negotiation skills of public sector to renegotiate the contract
- **Distortion** in public tender, in that the most likely winner is not the most efficient operator but the most expert/qualified in renegotiations
- **Decreases** the benefits/advantages of PPP and the welfare of users, and usually it has a fiscal impact by increasing liabilities to the government
- While some can be efficient, many of them are opportunistic

Costs associated with disputes, conflicts and renegotiations are:

- **Time and financial resources**: to address and resolve the conflict.
- **Social and Political**: Since conflicts tend to be highly visible and have great coverage of the media, leading to disenchantment of citizens, the PPP model tends to lose credibility and public support, and the government can be weakened.
- **Financial/Fiscal**: Often the results of the negotiation have a fiscal cost to the government.
- **Economic and Social**: Users tend to be adversely affected by the results of conflicts, particularly renegotiations (in terms of reduced access, higher or lower prices and delays in service quality)

Overall Incidence of Renegotiated and Cancelled Contracts in LCR

The increase in the complexity of PPP projects might suggest more renegotiation incidence; but on the other hand, the countries with PPP experience have improved their renegotiation regulations in their PPP legislation, which intends to reduce incentives and manage renegotiations with better structure and oversight.

Sectors	Percentage of Renegotiated PPP	Average Time to Renegotiation
All Sectors	68%	1.0 years
Electricity	41 %	1.7 years
Transport	**78%**	**0.9 years**
Water	87%	0.8 years
Social Sectors	39%	1.2 years
Other Sectors	35%	1 year

Infrastructure LCR: Total Number of PPP Projects	Cancelled	Percentage of Projects
1713	85	4.96 %
By sector	By sector	By sector
Transport	39	7.01%
Energy	19	2.46%
Water and Sanitation	22	8.56%
Telecom	5	3.91%

The number of cancelled contracts in Latin America is low, but increasing

**LCR: Latin America and Caribbean Region*

Renegotiation in Chile, Colombia and Peru

		Chile	Colombia	Peru
Total		**60**	**403**	**44**
How	Bilateral Agreement	83%	98%	100%
	Arbitration	17%	2%	0%
	Government-led	84%	40%	64%
	Firm-led	12%	20%	23%
	Jointly-led	4%	40%	13%
When	During construction	53%	51%	62%
	After construction	47%	49%	38%
What for	Complementary works	69%	39%	17%
	Change conditions	22%	55%	83%
	Both	9%	1%	0%
	Add new stretches	0%	5%	0%
Paid when	Present fiscal transfer	66%	42%	14%
	Deferred fiscal funds	55%	6%	0%
	Other costs realized later	36%	28%	39%
	No cost	14%	24%	47%
Types of cost	Fiscal transfer	66%	48%	20%
	Increase concession term	12%	12%	14%
	Higher toll tariffs	24%	1%	0%
	Other type of payment	16%	0%	0%
	Without direct cost	15%	45%	77%

Source: Bitran et al 2012

Drivers of Renegotiations Requests

- The renegotiations requests can have multiple causes, external and/or internal. For example, in the first case, in regulated markets, where no prices can be adjusted, significant changes in economic circumstances frequently lead to renegotiation requests, either by the operator or the Government (even if the risk allocation is established in the contract)
- Occasionally, economic conditions change unexpectedly because of the macroeconomic conditions beyond of the control of the parties (e.g. financial crises worldwide, the fluctuations of currencies, election where the new administration can change the regulation and affect the operator rights, etc.)
- Most commonly, demands for the renegotiation relate to bidding errors, aggressive offers, and poorly written contracts
- One of the main causes of the renegotiation is opportunistic behavior by operators and governments (governments may decide to modify the contract in benefit of users acting unilaterally to capture "excess profits" in electoral votes, or changing priorities after elections to anticipate investments). As well as the opportunity of governments to bypass the due process to secure additional financing and authorization (by parliament) expand investments
- The inability of Governments to credibly commit to a policy of no renegotiations and abuse of the exception for renegotiation
- Operators believe the circumstances confer them considerable influence on the host Government to grant them additional benefits through the renegotiation and weak contract monitoring

Measures that have been taken to tackle this issue

- A number of countries have taken decisions to address the issue with mixed success

Mexico	New Law and Regulations and Process
Peru	Review to the Law and Regulations
Chile	New Law and Regulations and Conflict Resolution Framework
Colombia	New Law and Regulations and Institutionality and Process
Portugal	Platform for renegotiations
India	Normative package to guide the process

Measures that have been taken to tackle this issue (II)

- More specifically, measures that have been taken are for example:
  - Use and implementation of "delivery unit" to high level.
  - Use and implementation of requirements unit (licenses, permits, rights-of-way, evaluations specific-environmental archaeological).
  - Greater role of the PPP Unit and regulatory agency (Peru, Colombia).
  - Disuse of clause of financial equilibrium (Chile and Peru).
  - Platforms of renegotiations and process led by the Ministries of Finance (Mexico,Chile and Peru).
  - Platform for efficient land expropriation and securing of rights of way (Mexico)
  - Use of regulatory accounting (Peru and Chile).
  - Transparency of the renegotiation process. Disclosure of information since the request, analysis, negotiations and final amendment- web information. Greater use of LPVR as the award criteria to mitigate demand risk (Chile, Colombia).
  - Control of aggressive bids by larger performance bonds (Uruguay).
  - A Freeze period for renegotiations (Colombia and Peru)
  - A statement in the law or regulations that the risk matrix cannot be altered (Mexico).
  - Use and composition of panels of experts (aggressive betting, renegotiation, arbitration, regulation).

Platform for Addressing Renegotiations

- The principles behind the platform are as follows,
  - Preserve the value for money of the PPP project/contract.
  - Inviolability of the Contractual/Bid Offer. When confronted with requests for renegotiation, the sacred character of the original contract/bid must be respected. And the operator should be held responsible for its offer.
  - The financial equation of the winning offer should always be the reference point, and if the contract would be modified in the case of the renegotiation or adjustment, the outcome should be an impact of zero net present value of the benefits and risks, and without changing the allocation matrix. Compensations to the other party have to be considered to insure any extraordinary benefit.
  - Renegotiation must not be used to correct errors in the basis for tender or excessively risky or aggressive bids.

Some ideas I

- The contract should stipulate the renegotiations approach, criteria and process.
- Increase the political costs of accepting renegotiations demands, by implementing a Transparency Framework-Use of Web, publish the requests, decisions and arguments, and using the media to inform on request and decisions and rational.
- Establish a reputation of not being well disposed to renegotiate by cancelling PPP/concessions processes particularly with aggressive bids.
- Establish a freeze period for renegotiations; say no renegotiations will be considered for three to five year after contract award. Only few exceptions can be accepted.
- Establish clear jurisdiction over the decision to renegotiate, at high level, such as Interministerial Committee lead by Minister of Finance.
- Establish in the contract the right to evaluate and reject aggressive and reckless bids, defining the criteria and standards, including submission of financial model for those bids or additional guarantees (financial bonds).
- Use panel of experts to evaluate: i) aggressive bids, ii) renegotiations request, ii) and conflict resolution.
- Matrix of risks with detailed risks identification and allocation-establishing that modifications of the contract must not alter the risk allocation.
- Establish that if the contract is modified, the net present value of the modifications must be zero, and preserve value for money
- Impose appropriate (biting) level of performance bonds: for example, at least 15% of the investment

Some Ideas II

- Clarification and wording of key contractual clauses and biding documents.
- Platform for efficient land expropriation and for the securing of rights of way (Mexico and Chile are good practices).
- Contingent financing over time, not all at the beginning (viability gap funding)
- Establish guidelines for levels of compensation.
- Simmetry on effects of unilateral actions by government
- Request a mandatory bidding process for additional infrastructure and the interest rate for PPP financing (Chile is the best practice)
- Establish transparent framework of conflict resolution (panel of experts and arbitration).
- Impose appropriate (biting) level of performance bonds: for example, at least 15% of the investment.
- Use appropriately the selection of competitive factors (such as the award criteria) to increase the costs – make more expensive the exit. When possible use as award criteria (for some sectors) the least present value of revenue, as it is quite robust to mitigate renegotiation requests (automatically extending the duration of the contract if economic conditions become adverse, Chile and Colombia are best practices).