

Model Concession Agreement for Highways: An Overview

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The highways sector in India is witnessing significant interest from both domestic as well as foreign investors following the policy initiatives taken by the Government of India to promote Public Private Partnership (PPP) on Design, Build, Finance, Operate and Transfer (DBFOT) basis. A comprehensive policy and regulatory framework necessary for addressing the complexities of PPP, and for balancing the interests of users and investors has been adopted in the form of a Model Concession Agreement (MCA) and standard bidding documents.

The MCA addresses the issues which are typically important for investors as well as for limited recourse financing of highway projects, such as mitigation and unbundling of risks; allocation of risks and rewards; symmetry of obligations between the principal parties; precision and predictability of costs and obligations; reduction of transaction costs; force majeure; and termination. It also addresses other important concerns such as user protection, independent monitoring, dispute resolution and financial support from the Government.

A comprehensive framework is a pre-requisite for PPP

The MCA also elaborates on the basis for commercialising highways in a planned and phased manner through optimal utilisation of resources on the one hand and adoption of international best practices on the other hand. The objective is to secure value for public money and provide efficient and cost-effective services to the users.

Rationale for phased development

The four critical elements that determine the financial viability of a highway project are traffic volumes, user fee, concession period and capital costs. As the existing highways have dedicated traffic and the Government has prescribed the user fee for uniform application across India, revenue streams for a Project Highway can be assessed with a fair degree of accuracy. The concession period, on the other hand, can be extended only marginally for improving project viability as the growth of traffic would not permit very long concession periods. In any case, the present value of projected revenues, after say 20 years, is comparatively low from the Concessionaire's perspective.

As three of the four above-stated parameters are predetermined, capital cost is the variable that determines the financial viability of a project. Bidders would, therefore, seek an appropriate capital grant/subsidy from the Government in order to reduce the capital cost for arriving at an acceptable rate of return.

In the given scenario, higher the capital cost, greater would be the compulsion of

project sponsors to seek larger grants from the Government. This, in turn, would restrict the ability of the Government to leverage a larger pool of extra-budgetary resources, including private investment, and would hence result in a limited programme of highway development.

In view of the foregoing, it is important to rely on cost-effective designs and to combine them with a phased investment programme to enable a more efficient and sustainable programme of highway development.

As a general principle, capacity augmentation of highways should be based on the standards recommended by the Indian Roads Congress for different bands of traffic volume. The emphasis should be on phased development rather than on providing high cost roads for catering to the projected growth in the long term.

Phased development will be affordable and cost-effective

Where traffic intensity is comparatively low, limited widening of highways could be undertaken with further widening planned after 7-12 years depending on projected traffic growth. Upgradation of designs and standards, construction of bypasses in urban and semi-urban areas and other improvements may also be planned in phases depending on traffic intensity. These issues have been subjected to in-depth examination and reflected in a Manual of Standards and Specifications that forms part of the standard documents associated with the MCA.

Technical parameters

Unlike the normal practice of focussing on construction specifications, the technical parameters specified in the MCA are based mainly on output specifications, as these have a direct bearing on the level of service for users. Only the core requirements of design, construction, operation and maintenance of the Project Highway are to be specified, and enough room would be left for the Concessionaire to innovate and add value.

Technical parameters will focus on the level of service for the users

In sum, the framework focuses on the ‘what’ rather than the ‘how’ in relation to the delivery of services by the Concessionaire. This would provide the requisite flexibility to the Concessionaire in evolving and adopting cost-effective designs without compromising on the quality of service for users. Cost efficiencies would occur because the shift to output based specifications would provide the private sector with a greater opportunity to innovate and optimise designs in a way normally denied to it under conventional input based procurement specifications.

Concession period

The guiding principle for determining project-specific concession period is the

Concession period to be linked to projected traffic

carrying capacity of the respective highway at the end of the concession period. As such, the concession period is determined on a project-specific basis depending on the volume of present and projected traffic. Toll paying users should not be subjected to congested highways and the Concession should, therefore, cease when full capacity of the road is reached, unless further augmentation is built into the MCA.

The time required for construction (about two years) has been included in the concession period so as to incentivise early completion, implying greater toll revenues.

Selection of Concessionaire

Selection of the Concessionaire is based on open competitive bidding. All project parameters such as the concession period, toll rates, price indexation and technical parameters are to be clearly stated upfront, and short-listed bidders will be required to specify only the amount of grant sought by them. The bidder who seeks the lowest grant should win the contract. In exceptional cases, instead of seeking a grant, a bidder may offer to share the project revenues with the Government.

Competitive bidding on single parameter will be the norm

Grant

Based on competitive bidding, the Government may provide a capital grant of up to a maximum of 20 per cent of the project cost. This would help in bridging the viability gap of the PPP projects. Where such assistance is inadequate for making a project commercially viable, an additional grant not exceeding 20 per cent of the project costs may be provided for O&M support during the period following the commissioning of the Project Highway.

Grants to bridge viability gap

Concession fee

Concession fee is a fixed sum of Re. 1 per annum for the concession period. Where bidders do not seek any grant and are instead willing to make a financial offer to the Government, they will be free to quote a premium on concession fee in the form of a share in revenues from user fee. In addition, the revenue share quoted for the initial year could be increased for each subsequent year by an additional 1 per cent. The rationale for the above fee structure is that in the initial years, debt service obligations would entail substantial outflows. Over the years, however, the Concessionaire will have an increasing surplus in its hands on account of the declining debt service on the one hand and rising revenues on the other. Recognising this cash flow pattern, the concession fee to be paid by the Concessionaire will be on an ascending revenue share.

Concession fee should be levied only if revenue streams can sustain it

Risk allocation

As an underlying principle, risks have been allocated to the parties that are best suited to manage them. Project risks have, therefore, been assigned to the private sector to the extent it is capable of managing them. The transfer of such risks and responsibilities to the private sector would increase the scope of innovation leading to efficiencies in costs and services.

Risk allocation and mitigation is critical to private investment

The commercial and technical risks relating to construction, operation and maintenance are being allocated to the Concessionaire, as it is best suited to manage them. Other commercial risks, such as the rate of growth of traffic, are also being allocated to the Concessionaire. The traffic risk, however, is significantly mitigated as the Project Highway is a natural monopoly where existing traffic volumes can be measured with reasonable accuracy. On the other hand, all direct and indirect political risks are being assigned to the Authority.

It is generally recognised that economic growth will have a direct influence on the growth of traffic and that the Concessionaire cannot in any manner manage or control this element. By way of risk mitigation, the MCA provides for extension of the concession period in the event of a lower than expected growth in traffic. Conversely, the concession period shall be reduced if the traffic growth exceeds the expected level.

The MCA provides for a target tariff growth and stipulates an increase of upto 20 per cent in the concession period if the growth rate is lower than projected. For example, a shortfall of 5 per cent in the target traffic after 10 years would lead to extension of the concession period by 7.5 per cent thereof. On the other hand, an increase of 5 per cent in the target traffic would reduce the concession period by 3.75 per cent thereof.

Financial close

The MCA stipulates a time limit of 180 days (extendable up to another 120 days on payment of a penalty) for achieving financial close, failing which the bid security shall be forfeited. By prevalent standards, this is a tight schedule, which is achievable only if all the parameters are well defined and the requisite preparatory work has been undertaken.

Project implementation must commence as per agreed timeframe

The MCA represents a comprehensive framework necessary for enabling financial close within the stipulated period. Adherence to such time schedules will usher in a significant reduction in costs besides ensuring timely provision of the much needed infrastructure. This approach would also address the typical problem of infrastructure projects not achieving financial close for long periods.

User fee

A balanced and precise mechanism for determination of user fee has been specified for the entire concession period since this would be of fundamental importance in estimating the revenue streams of the project and, therefore, its viability. The user fee shall be based on the rates to be notified by the Government.

The MCA also provides for indexation of the user fee to the extent of 40 per cent thereof linked to WPI. Since repayment of debt would be virtually neutral to inflation, the said indexation of 40 per cent is considered adequate. A higher level of indexation is not favoured, as that would require the users to pay more for a declining (more congested) level of service when they should be receiving the benefit of a depreciated fee. A higher indexation would also add to uncertainties in the financial projections of the project.

Local traffic

Owing to the absence of an alternative road, highways should be open to use by local residents without any payment of tolls until free service lanes are provided. This would ensure local support for the project and avoid legal challenges or local opposition arising out of easement rights.

Frequent users should be entitled to discounted rates, in accordance with the tolling policy.

Construction

Handing over possession of at least 80 per cent of the required land and obtaining of environmental clearances are among the conditions precedent to be satisfied by the Government before financial close.

Safety and quality of service must be ensured

The MCA defines the scope of the project with precision and predictability in order to enable the Concessionaire to determine its costs and obligations. Additional works may be undertaken within a specified limit, only if the entire cost thereof is borne by the Government.

Before commencing the collection of user fee, the Concessionaire will be required to subject the Project Highway to specified tests for ensuring compliance with the specifications relating to safety and quality of service for the users.

Operation and maintenance

Operation and maintenance of the Project Highway is to be governed by strict

Maintenance standards will be enforced strictly

standards with a view to ensuring a high level of service for the users, and any violations thereof would attract stiff penalties. In sum, operational performance would be the most important test of service delivery.

The MCA provides for an elaborate and dynamic mechanism to evaluate and upgrade safety requirements on a continuing basis. The MCA also provides for traffic regulation, police assistance, emergency medical services and rescue operations.

Right of substitution

In the highways sector, project assets may not constitute adequate security for lenders. It is project revenue streams that constitute the mainstay of their security. Lenders would, therefore, require assignment and substitution rights so that the concession can be transferred to another company in the event of failure of the Concessionaire to operate the project successfully. The MCA accordingly provides for such substitution rights.

Lenders will have the right of substitution

Force majeure

The MCA contains the requisite provisions for dealing with force majeure events. In particular, it affords protection to the Concessionaire against political actions that may have a material adverse effect on the project.

Concessionaire will be protected against political actions

Termination

In the event of termination, the MCA provides for a compulsory buy-out by the Government, as neither the Concessionaire nor the lenders can use the highway in any other manner for recovering their investments.

Termination payments have been quantified precisely. Political force majeure and defaults by the Government shall qualify for adequate compensatory payments to the Concessionaire and thus guard against any discriminatory or arbitrary action by the Government. Further, the project debt would be fully protected by the Government in the event of termination, except for two situations, namely, (a) when termination occurs as a result of default by the Concessionaire, 90 per cent of the debt will be protected, and (b) in the event of non-political force majeure such as Act of God (normally covered by insurance), 90 per cent of the debt not covered by insurance will be protected. However, if the Concessionaire fails to commission the project owing to its own default, no termination payment would be due.

Pre-determined termination payments should provide predictability

Monitoring and supervision

Day-to-day interaction between the Government and the Concessionaire has been kept to the bare minimum by following a ‘hands-off’ approach, and the Government shall be entitled to intervene only in the event of a material default. Checks and balances have, however, been provided for ensuring full accountability of the Concessionaire.

Independent supervision is essential

Monitoring and supervision of construction, operation and maintenance is to be undertaken through an Independent Engineer (a qualified firm) that will be selected by the Government through a transparent process. Its independence would provide added comfort to all stakeholders, besides improving the efficiency of project operations.

The MCA provides for a transparent procedure to ensure selection of well-reputed statutory auditors, as they would play a critical role in ensuring financial discipline. As a safeguard, the MCA also provides for appointment of additional or concurrent auditors.

To provide enhanced security to the lenders and greater stability to the project operations, all financial inflows and outflows of the project are to be routed through an escrow account.

Support and guarantees by the Government

By way of comfort to the lenders, loan assistance from the Government has been stipulated for supporting debt service obligations in the event of a revenue shortfall resulting from political force majeure or default by the Government.

Support and guarantees by the Authority are essential

Guarantees have also been provided to protect the Concessionaire from construction of competing roads, which can upset the revenue streams of the project. Additional tollways would be allowed, but only after a specified period and upon compensation to the Concessionaire by way of an extended concession period.

Miscellaneous

A regular traffic census and annual survey has been stipulated for keeping track of traffic growth. Sample checks by the Authority have also been provided for. As a safeguard against siphoning of revenue share by the Concessionaire, a floor level of present and projected traffic has also been stipulated.

An effective dispute resolution mechanism is critical

The MCA also addresses issues relating to dispute resolution, suspension of rights, change in law, insurance, defects liability, indemnity, redressal of public

grievances and disclosure of project documents.

Conclusion

The aforesaid contractual framework addresses the issues that are likely to arise in financing of highway projects on DBFOT basis. The regulatory and policy framework contained in the MCA is a pre-requisite for attracting private investment with improved efficiencies and reduced costs, necessary for accelerating growth.

Private participation should improve efficiencies and reduce costs