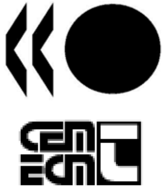

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Working Group on Transport Infrastructure Investment: Funding Future Infrastructure Needs

Working Document 13

CONSULTANT'S REPORT ON:

THE IMPACT OF LEGAL/REGULATORY FRAMEWORKS ON TRANSACTION COSTS FOR PRIVATE SECTOR INVOLVEMENT IN (TRANSPORT) INFRASTRUCTURE FUNDING

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The Impact of Legal/Regulatory Frameworks on Transaction Costs for Private Sector Involvement in (Transport) Infrastructure Funding

Report to the Joint OECD/ECMT Transport Research Centre

Nils Bruzelius
12 May 2005

1. Introduction

1.1 Background and task

The Organisation for Economic Co-operation and Development (OECD)/European Conference of Ministers of Transport (ECMT) Joint Transport Research Centre (JTRC) is conducting a study on funding future infrastructure needs for the development and maintenance of inland transport infrastructure, including roads, rail and inland waterways and inter-modal facilities. An important element of the JTRC project is the potential role that legal and regulatory frameworks can play in facilitating private sector involvement and in reducing the transactions costs involved, especially during the contractual stages. A key question for consideration in this context is thus: Can private sector involvement be facilitated and the transactions costs associated with private sector involvement be reduced by way of legislative/regulatory frameworks that clearly define specific conditions and provisions that will apply to all such projects?

To this end a study has been undertaken to identify the regulatory framework changes government have made and could make in future to facilitate private sector involvement and/or to reduce transactions costs. The terms of reference (TOR) for the study have been as follows:

1. Provide a brief overview of the key issues involved in facilitating private sector involvement and reducing the transaction costs of such involvement. As part of this, identify the important subjects, from a public interest perspective, that need to be specified in legislation, regulations and/or contracts, to facilitate such private sector involvement, assure appropriate regulatory controls and promote efficient development and operation of the infrastructure.

2. Models: For a selection of countries, identify legislative and/or regulatory arrangements that have sought to harmonise the conditions applied to private sector involvement in important recent transport infrastructure projects. This will include an assessment of the extent to which regulatory controls are established in legislation and/or regulations as opposed to contracts.

3. Where governments have sought to harmonise, by way of regulation and/or legislation, the basic elements of regulatory provisions for infrastructure projects involving private funding, provide advice on their coverage/application, a listing of the subjects and examples of the provisions.

4. Where possible, provide feedback on the extent to which the revised frameworks have been successful in facilitating private sector involvement or reducing transactions costs. At the same time, provide information regarding any unforeseen outcomes of the revised frameworks.

5. Compare the approaches in the transport sector with the distribution of legislative and regulatory provisions in other key sectors that have high levels of private sector involvement (e.g. telecommunications, energy, water). Draw out any important differences and specific characteristics of the land transport sector that arise from this comparison.

6. Draw overall conclusions regarding the potential role that common provisions in legislation or regulation can play in facilitating private sector involvement and reducing transactions costs for governments and the private sector. As part of this, seek to clarify whether certain such provisions are more appropriate to specific funding arrangements (i.e., BOTs, concessions, management contracts, etc.).

1.2 Assumptions and framework

Types of projects

A generic approach to private funding of infrastructure projects is not being made use of. Rather, the issues identified in the TOR are looked at in the framework of two types of infrastructure 'projects' in the transport sector assumed to be implemented by the private partner. Both types involve an agreement:

- for investment as well as
- operations and maintenance over a long period of time, and
- for the finance required for the investment to be mobilised by the private partner.

Type 1 is a design, build, finance and operate (DBFO) type of project, i.e. remuneration of the private partner is (primarily) by way of payments from the public partner. The remuneration is paid following the completion of the investment and thus during the operation period. Type 2 is a concession, implying that remuneration is (mainly) by way of payment by third parties (the users) to the private partner during the period of operation. The term PPP will be used to refer to both types of projects[1].

It is presumed that the public partner, in terms of existing law is responsible for the provision of the services to be made available by the project, and that the services are produced under monopoly conditions. The legislation that is reviewed regulates the framework under which these services can be delegated to a private partner.

Actors and agreements

In the realisation of the project, the following types of actors can be identified:

- The contracting authority (formally the public partner)

- Sponsor or sponsors (those – normally private actors – who propose and/or bid for a project)

- Project company. Often a sponsor or sponsors form a separate legal entity, which formally serves as the private partner. The sponsors may invite other parties to invest equity in the project company.

[1] In terms of the terminology used in the European Commission (2004) Green Paper on PPPs, the first type is a 'PFI-set up' and the second type is a 'concession'. Both types are referred to as 'purely contractual PPPs' in this document.

- Special purpose vehicle (SPV), is a particular type of project company which is characterised by that the financiers are awarded certain types of rights as discussed further below.

- The funders (the banks, etc.) which provide the debt required by the project company for realising the investment.

- The design consultant, contractor and operating company are engaged by the project company to prepare and realise the investment and then to operate it until the end of the period of the agreement between the private and public partners. In particular contractors are frequently also a sponsor, and commonly design consultants are as well, but not necessarily so.

A number of agreements will typically be required, and the legislation to be reviewed provides the framework for reaching and entering into those agreements. The following two ones are the core ones involving both the public and private partners:

- Project (or concession) agreement; the agreement between the contracting authority and the project company.

- Direct agreement; an agreement between the contracting authority and the funders (as explained further below). There may also be direct agreements between the funders, on the on hand, and the design consultant, contractor and operator, on the other.

These agreements make it possible for a number of other agreements between various private parties, including

- Loan agreement between the project company and the funders.

- Design, construction and operations agreements, between the project company, on the one hand, and consultants and contractors, on the other.

- Shareholders agreement, between the shareholders of the project company.

Procurement method and phases

The realisation of a project can be accomplished by three main approaches (there are various variants):

- Competitive tendering; the contracting authority identifies the project, a tender procedure is used to identify the private partner based on principles allowing for competition. This is also referred to solicited bidding.

- Direct agreement; normally a contracting authority identifies the project, but the private partner is identified without a tender procedure.

- Un-solicited bids. It is possible for a sponsor or a group of sponsors to propose the project to the public partner. If accepted, then the agreement can be reached either directly or by way of a tender process; examples will be provided below.

In the realisation of a project a number of phases can be identified as follows:

- Planning; normally done by the contracting authority to identify and appraise the project

- Preparatory; normally done by the contacting authority, in order to obtain (some of the) required permits and to prepare bid documents, and perhaps to obtain approval/support for engaging a private partner from other parts of the government

- Pre-qualification. This is an element of a certain type of procurement method ('selective' or 'negotiated'). The purpose is to identify a long-list of 'qualified' or 'eligible' sponsors and from this select a short-list (often about 3 to 6), of sponsors that will be invited to bid. When there is no pre-qualification phase, the procurement method is referred to as 'open'.

- Tender period.

- Evaluation. This phase may result directly in the selection of the best bidder (is the case in the 'selective' procedure). But the phase can also have several sub-phases, as will be required if the 'negotiated' procedure is used. An example: In the UK when procuring DBFO-projects in the transport sector, the first part of the evaluation phase consists of negotiations with all short-listed bidders leading to further specification of the tender followed by a request for more specific bids (best and final offers; BAFO). Based on the BAFO, the best (referred to as the provisional preferred bidder; PPB) and second best bidders are identified and negotiations are then initiated with the sponsor(s) of the best bid, whilst the second best bidder is told to be on hand, and other bidders are informed that they have been ranked lower. If the final negotiations with PPB are not concluded, then the contracting authority could initiate negotiations with the second-best bidder.

- Closure; signature of project agreement

- Financial closure; signature of loan agreement(s). For effectiveness of the project agreement, financial closure may have to be reached first.

- Construction; the end of this phase (resulting in commissioning or 'service commencement') may have to involve the acceptance, subject to certain criteria being fulfilled in terms of the project agreement, by the contracting authority.

- Operations (or 'service'); the provision of the services and maintenance of the facilities, until the end of the validity of the project agreement. This period can last for some 30 years.

1.3 Focus

Whilst the report will address all the issues identified in the terms of reference above, there will be an emphasis on aspects as seen from the point of view of the private partner, including

the cost of transaction, i.e. aspects which address concerns of the private sector and reduce the costs of entering into a contract.

A transaction cost is a cost incurred in making an economic exchange. A number of kinds of transaction cost have come to be known by particular names:

- *Search and information costs* are costs such as those incurred in determining that the required good or service is available on the market, who has the lowest price, etc.

- *Bargaining costs* are the costs required to come to an acceptable agreement with the other party to the transaction, drawing up an appropriate contract, etc..

- *Policing and enforcement costs* are the costs of making sure the other party sticks to the terms of the contract, and taking appropriate action (often through the legal system) if this turns out not to be the case.

It is only the *two* first types of transaction costs that are considered here. In the context of the two types of projects, the following cost components are assumed to make up search and information plus bargaining costs:

- prepare and submit documents for pre-qualification
- prepare short-list
- prepare tender documents
- prepare and submit bids
- evaluate bids
- negotiate agreement until signature and financial closure

These costs materialise with the public partner as well as different candidate private partners. They are often considered to be high in the context of the types of projects considered. The first DBFO contracts in the UK took 18 months from advertisement until financial close; later they have taken 13 months, on average. The financial costs associated with tendering for the winning private partner are reported as being 11 times higher than for traditional build contracts and 3 times higher than for a design-build contract[2].

[2] National Audit Office (1998) and (1999).

2. Countries and models

2.1 Legislation reviewed

Dedicated legislation may not be required in order for PPP projects to materialise. In the UK, for example, DBFO projects operate within the general framework of British company law, common law on contracts and regulations of procurement. There is no difference in nature between a DBFO contract and a contract between two private operators. Some adaptation of the law has been necessary to remove tax anomalies and refine public expenditure controls. In addition, in order to enable type 2 projects in the road sector, it has been necessary to enact separate legislation to enable both concession agreements to be entered into and tolls to be introduced[3].

In other countries, the legal tradition based on codification may suggest that a specific law is desirable. In addition, a separate law may be seen as an expression of a special will to promote PPPs by creating a dedicated environment and also decreasing legal uncertainties. The message may be aimed both inwards to government authorities, including at the local level, and to the private sector, including abroad. In a broad context, a dedicated law may therefore be seen as eliminating perceived barriers as relates the role of government and the legal environment for contractual relationships of a long-lasting nature between the private and public sectors.

The legislation of six countries, as listed below, has been reviewed, based on their translation into English. Arrangements for private funding of transport infrastructure projects in the UK are also reviewed. Additionally, the model legislation of the UN Commission on International Trade Law (UNCITRAL) has been reviewed.

Poland

- *Act on Motorways* (October 27, 1994), as amended by law of 8 September 2000. Regulations issued under this Act have not been available. The act enables type 2 projects, including concessions for already existing motorways.

- *Act on Public Private Partnerships* (draft as of July 2004), including motivation (“Rationale”). The draft act will apparently be revised before being passed. It will enable both type 1 and 2 projects, and for all kinds of government activities. Drafts of the regulations to be issued under the act have not been available.

Republic of Korea

- *Act on Private Investment in Infrastructure* (Act No. 5624, Dec. 31, 1998, as amended up to August 8, 2003). This act supports concessions in 34 different areas.

[3] For example the New Roads and Street Works Act in 1991 defined concession agreements for roads and set up a toll authorisation procedure. There are additional laws of relevance in this area in the UK, e.g. the Severn Bridges Act, 1992.

- *Decree on Enforcement of Act on Private Investment in Infrastructure* (Originally effective as from Aprl 1, 1999; last amendment in force as from March 12, 2003). Regulations issued under the act.

Ireland

- *Ireland: State Authorities (Public Private Partnership Arrangements) Act, 2002*. This act allows for both concessions and DBFO-type of projects in many areas. There are no regulations, but another act, the Roads Act of 1993, is the legal instrument enabling the tolling of roads and setting out the procedures to be followed when introducing a road toll[4].

Italy[5]

- *Merloni Law*, 1994, amended 1998 and again by Law 166 in 2002. Its scope is 'public works'. Regulations issued under this act have not been available. The Act originally only allowed for concessions, but the amendment in 2002 enabled both types of projects

Chile

- *The supreme decree-law of the Ministry of Public Works No. 900 (1996),* which sets out the reformulated text of the legally enforceable decree-law of the Ministry of Public Works No. 164 (1991), the Concessions Law. This law enables only concessions for 'public works'.

- *The supreme decree-law of the Ministry of Public Works No. 956 (1999),* Regulations under the Concessions Law

Spain

- *Ley 13/2003 Reguladora del Contrato de Concesión de Obras Públicas.* This act applies to 'public works' and has an emphasis on concessions, although type 1 projects are also allowed for[6].

- Pliega de Cláusas Generales para la Conservación, Explotación y, en su caso, Construcción de Concessión. (the General Bidding Terms for Highway Infrastructure

[4] The Irish government has issued 15 Public Private Partnership Guidance Notes which explain key issues relating to preparation, tendering, the contract and contract administration.

[5] Law 443/2001 ('*Legge Obiettivo*') and *Law decree 190/2002*; regulations under Law 433/2001 are not being considered. Legge Obiettivo, whilst concerned with private financing of public works, focuses on measures for how to speed up the process for the private funding in the specific context of Italy.

[6] Law 13/2003 effectively amends the Public Administrations Contracts Act in its remodelled text approved by Legislative Royal Decree 2/2000, of 16th of June. This latter law has not been reviewed, although it may contain provisions of relevance.

Concessions (GBTHIC)). These are draft regulations for concessions in the transport sector which have not yet been approved by the government.

UN Model Legislation

- *Model Legislative Provisions on Privately Financed Infrastructure Projects* of the United Nations Commission on International Trade Law. Emphasis is on type 2 projects, but type 1 projects are also accommodated for.

2.2 Overview of provisions

The core provisions in these laws may be divided into various categories as presented below. Note that this division is somewhat arbitrary. The meaning of some of these provisions is discussed further in the following chapters of the report[7].

a. **Enabling** from the point of view of the **public partner** (contracting authority and other parts of the government). Provisions related to:

   i. Identification and/or definition of type of project and/or service that may be delegated

   ii. Clarification of powers of the contracting authority and other parts of the government to enter into a project agreement

   iii. Clarification of powers of government to make commitments for public expenditures over the entire project period (important for type 1 projects)[8]

   iv. Clarification of responsibilities in government for planning and preparing the project.

b. **Enabling** from the point of view of **the private partner,** some of which are primarily of interest to the **sponsors,** some to the **financiers.** Provisions related to:

   i. Clarification of nature of procurement rules to provide transparency of selection procedures and possibility to appeal a decision

   ii. Enabling the establishment of a separate project company by the sponsors

[7] We will not consider provisions related to how to handle liabilities incurred in terms of project agreements for PPPs, from the point of government accounting. On this matter, see IMF (2004).

[8] In Brazil a *Draft Law Instituting General Rules on Public-Private Partnerships within the Realm of the Public Administration* contains a provisions whereby (i) seniority is granted to PPP contract payments over other categories of expenditure, except for debt service and constitutionally mandated spending; (ii) earmarking of revenues to meet PPP contract payments is allowed; and (iii) trust funds to guarantee PPP contract payments are created.

iii. Arrangements for financing, including securitization of revenue stream

iv. Undertakings by contracting authority to lenders (e.g. by way of a direct agreement), including step-in rights and rights to lien over assets (revenue stream)

v. Framework for transparent rules for tariff setting and tariff adjustment (in case of type 2 projects)

vi. Clarification of rules for handling the effects of legal changes on the financial performance of the project company

vii. Removal of rules with regard to sub-contacting by project company

viii. Rules on compensation in the event the project agreement is cancelled by public partner (e.g. on grounds of 'public interests')

ix. Enabling non-national sponsors to bid.

c. **Enabling from the point of view of both partners**. Provisions related to:

i. Clarification of matters to be covered in the agreement between the partners, including mechanism for making subsequent changes to the agreement

ii. Mechanism for dispute resolution, including arbitration regime

iii. Clarification of licensing (permit) regimes

iv. Arrangements for transfer of (controlling) interests in a project company.

d. **Protecting the public interest** provisions (some of these are of **general public interest**, others primarily of interest to the **users** of the services). Provisions that provide for:

i. Regime for testing for 'value for money', i.e. that society benefits from having a private partner performing the services and providing finance

ii. Requirement of a competitive procedures for selecting the private partner

iii. Mechanisms to strengthen competition (e.g. reimbursement of bid preparation costs)

iv. Arrangements for allowing for and promoting unsolicited bids (to stimulate innovations)

v. Arrangements related to tariff (in case of type 2 projects) and quality regulation (in both types of projects)

vi. Rules on maximum duration of project agreement

vii. Regime for allowing for supplementary works by private partner under certain conditions

viii. Regime on disclosure of evaluation of bids and project agreement (transparency of process and agreement).

e. **Providing incentives** to the private partner. Provisions related to:

i. Guarantees by the government with respect to debt incurred in both types of projects or to revenues in type 2 projects

ii. Partial public loan financing in type 2 projects

iii. Partial public grant financing in type 2 projects

iv. Inputs in kind

v. Rights of lenders in case of default (type 2 projects)

vi. Enabling supplementary business opportunities related to the (site of the) project.

f. **Facilitating partnering.** Provisions related to:

i. No pre-qualification stage

ii. Procedure for tendering and clarification of minimum standards for specification of project in tender documentation (including up front clarification of risk sharing) to enable pricing (without negotiation)

iii. Use of performance specifications in order to remove need for approval of detailed design

iv. Feasibility study to evaluate viability and potential need for subsidies; for type 2 projects.

Only some of these types of provisions will normally be found in any one of the laws (legal drafts). Some of the provisions may be found in other laws (e.g. laws on procurement). In addition, the government may also regulate by way of regulations and guidelines/policies.

Categories a to c above may be seen as *essentially necessary in order for a partnership to materialise*, seen from the point of view of the partners. Category d contains provisions which could be *necessary for the partnership to be acceptable to the public*. Category e refers to conditions enabling *a project* to materialise, i.e. to ensure adequate financial conditions for the private partner.

Only the last category has a direct bearing on the costs related to the transaction *per se*, as defined here. It is to be noted that provisions of this nature are often not to be found in laws, but rather in guidelines or policy documents.

2.3 Provisions in the laws (models) examined

The table below summarises *to what extent the aforementioned types of provisions or a framework is provided for addressing the issue identified by the provisions*, are to be found in the laws examined. The following should be noted at this stage (further comments will be made in the following chapters):

- There is considerable variation between the laws. This is the partly due to the scope of the laws. For example the Korean and Chilean laws concern concessions for public works only. One Polish law only concerns type 2 projects, whilst the other Polish bill and the Irish law cover many types of public functions, including type 1 and 2 projects. The Spanish, Italian and UN model law concern (mainly) public works and allow for both type 1 and type 2 projects (although there is an emphasis on concessions). As mentioned, some of the types of provisions mentioned above only pertain to type 1 projects, others only to type 2 projects.

- It is possible that additional provisions may be contained in regulations issued under the laws. The regulations under the ROK and Chilean law have been examined. The regulations under the Italian law, Polish law on motorways, and the Polish PPP bill have not been available, and the ones to be issued under the Spanish law, in respect of transport infrastructure, have not been published yet; a draft in Spanish is available. There are no (relevant) regulations to be considered for the other laws. In addition, other laws in the countries concerned may also have relevance for the types of provisions concerned, e.g. the other parts of the Spanish Public Administrations Contracts Law, which have not been reviewed[9].

- The most comprehensive acts, from the point of view of the types of provisions identified here, are the Spanish, Chilean and the UN Model Act. The missing provisions in the UN Model Law are of the kind mainly related to type 1 projects (e.g. item d.i), as well as items belonging to type f. provisions. Items related to type b., i.e. provisions of particular importance to the financing of projects, are well covered as they are also under the Italian act.

- There are few provisions of the f. type. However, the Spanish and Chilean law and regulations have been drafted with a view to ensure a speedy procurement process.

[9] See footnote 6.

- Ireland has a legal system similar to that of the UK. The main need for the law in that country is therefore to enable the public sector to engage with the private sector under PPP-type arrangements.

- The Polish law and bill have few provisions related to type b. i.e. provisions which empower the public partner to agree to conditions which are viewed important by the private partner. (Note however, that the regulations have not been examined.)

Table: Overview of provisions in the examined laws

	Country	*Poland*	*Poland*	*ROK*	*Ireland*	*Italy*	*Chile*	*Spain*	*UN*
Type of Provision	**Law** / **Item**	**Motor-way Act**	**PPP Bill**	**Act on PPI**	**State Authorities Act**	**Merloni Act**	**Concessions Law and Regulations**	**Law on Concessions**	**Model Act**
a.	i.	OK	OK	OK	OK	OK	OK	OK	OK
	ii.	OK	OK	OK	OK	OK	OK	OK	OK
	iii.		OK		OK		OK	OK	
	iv.	OK	OK	OK		OK	OK	OK	OK
b.	i.	OK	OK	OK		OK	OK	OK	OK
	ii.	OK		OK	OK	OK	OK	OK	OK
	iii.			OK		OK	OK	OK	OK
	iv.			OK	OK	OK	OK	OK	OK
	v.	OK		OK		OK	OK	OK	OK
	vi.			OK		OK		OK	OK
	vii.					OK	OK	NO	
	viii.	OK	OK	OK		OK	OK	OK	OK
	ix.	NO					OK		
c.	i.	OK	OK				OK	OK	OK
	ii.	OK	OK			OK	OK		OK
	iii.	OK		OK			OK	OK	OK
	iv.					OK	OK		OK
d.	i.		OK						
	ii.	OK	OK	OK		OK	OK	OK	OK
	iii.		OK						
	iv.			OK		OK	OK	OK	OK
	v.			OK	OK			OK	OK
	vi.					OK	OK	OK	OK
	vii.						OK	OK	
	viii.						OK		
e.	i.	OK		OK			OK	OK	
	ii.	OK		OK				OK	
	iii.	OK		OK		OK	OK	OK	OK
	iv.	OK	OK	OK	OK	OK	OK	OK	
	v.						OK	OK	OK
	vi.			OK			OK	OK	
f.	i.							OK	
	ii.					OK	OK	OK	
	iii.								
	iv.						OK	OK	

3. Requirements related to project financing and some other provisions of importance to the private partner

3.1 Introduction

In this chapter some of the provisions belonging to category b. will be examined, but also some other provisions of importance to the private partner. Many of the provisions of type b. are related to the needs arising from project financing. The next chapter will review provisions belonging to category f, which are related to the transaction process per se. Items b.i and b.v are straightforward.

Projects of type 1 and 2 are highly risky. In case of type 2 projects it is a question both of project specific and market risks. As concerns type 1, it is primarily a question of the project risk (as will be discussed further below). One of the reasons for engaging the private sector in transport infrastructure is precisely to have the private sector manage these risks. However this gives rise to the following issues:

- Lenders want to lend against security, normally with a security in assets on the balance sheet of the borrower. Since those who wish to bid for the project, say contractors, differ in the ability of their balance sheets to satisfy financiers, the competitive process to identify a suitable private partner will be decided not so much by the efficiency of the sponsors (and their proposals) to provide the service, but by their balance sheets. To promote effective bidding, there is therefore a need to neutralise this factor of potential bidders.

- This notwithstanding, asking contractors to finance themselves directly will make them very vulnerable because of the risks of the project plus the security required by the financiers. The risk of default will increase, which is not in the interest of the project, and hence of the public partner.

- Lending against security in assets on the balance sheet of a company is additionally not appropriate on account of the long duration of the project, which may require financing for 20 to 30 years duration.

The approach used to overcome this problem is the 'project finance technique', the main building stones of which are the following:

- Sponsors, e.g. contractors, form a project company, referred to as a Special Purpose Vehicle (SPV), solely for the purpose of implementing the project, and to serve as the official private partner. One purpose of this company is to ensure that proposals of the different bidders are not evaluated based on the balance sheets of the sponsors, but only on their own merits. The SPV enters into design, construction and maintenance contracts for the implementation of the project and the future operations.

- The SPV raises finance on the basis (mainly) of a security in the expected cash flow of the SPV.

- The contracting authority gives explicit recognition of this right by giving the financiers so-called 'step in rights' through a separate direct agreement with the financiers[10]. In the event of inadequate performance or default by the SPV, the lenders are able, under specific conditions, to replace the failing SPV with a new SPV. In this way lenders can ensure continued payments and continuity of operations, which is also in the interest of the public partner[11].

The project financing approach hence serves to:

- Strengthen competition
- Provide for continuity in the event of inadequate performance by the project company.

It does not, on the other hand, in itself reduce risks[12]. But the arrangement provides for an effective environment for managing risks, so that actions can be taken to reduce risks and therefore the costs associated therewith. This is achieved by way of separation of the market risks from the project specific risks. The latter are borne by the contractors as they will normally enter into a fixed price contract, with a bonus for timely completion and penalty in the event of a delay, with the SPV. The market risk is left with the SPV, and in the first instance its shareholders. The financiers serve as the monitors of that the work is done properly, as they will focus their efforts on preventing default by the contractors and the SPV.

3.2 Italy (b.ii-b.iv)

In an environment in which project financing is not a well established technique, it may hence be useful to include provisions such as b.ii, b.iii and b.iv, as was achieved in Italy by way of the amendment of the Merloni Act in 2002. Thus Article 37 quinquies (Special Purpose Vehicle) states the following:

> "*Call for bids for the granting of concessions to build and/or operate infrastructure or new services of public utility must provide for awardee's right to set up, upon having been awarded, a special purpose vehicle in the form of a joint stock or a limited liability company, which in either case may have a consortium aspect….The company so formed shall become the concessionaire and shall succeed the awardee in the relevant legal relationship with no need for approval or authorisation. The above succession shall not constitute assignment of contract. The call for bids may also require the awardee to set up a special purpose vehicle.*"

Article 37 – sexies (Special Purpose Vehicle: Issue of Debentures) provides as follows:

[10] The project agreement may identify conditions under which it is the contracting authority that may take over; these are separate types of 'step-in-rights'.
[11] In the Green Paper on PPPs by the European Commission (2004), the view is expressed that certain step-in type arrangements may present a problem in terms of transparency and equality of treatment. Whilst this could be so, the arrangement is, in principle, intrinsic to project financing, and this financing technique would likely not function or not provide for economy without some form of step-in rights.
[12] Risk and the economic costs associated therewith are not affected by the financing arrangements per se. See e.g. Jenkinson (2003).

"*Special purpose vehicles incorporated in order to build and operate a single infrastructure or new service of public utility, may, subject to prior authorisation by supervisory bodies, issue debentures…provided that those instruments are secured pro-rata by way of mortgage…*"

and this is followed up in Article 37 – nonies (Lien) with the following provision:

"*Debts payable to entities that finance public works, works of public interest, or the provision of public services shall be secured by a general lien over the concessionaire's movable property…*"

And in Article 37-octies on Succession the following is stated:

"*In all cases of termination of a concession for reasons attributable to the concessionaire, the project's financiers shall be entitled to avoid termination by designating, within 90 days upon receipt of a written notice from the grantor of its intention to terminate the relationship, a company to succeed the concessionaire, which company shall be accepted if the following conditions are satisfied:*

a) *The company designated by the financiers possesses technical and financial characteristics substantially equivalent to those possessed by the concessionaire as at the time of granting the concession;*

b) *The concessionaire's breach which should have caused the termination, has ceased within 90 days from the expiry of the above notice or within such longer term as shall have been agreed upon between the concessionaire and the financiers*."

Such provisions may also be necessary in view of that the existing public procurement legislation in a country may not allow for the tender documents to state that the agreement is to be entered into with a company, which is separate from the bidder.

3.3 Korea (b.ii-b.iv)

The Korean legislation also recognises that there may be a need to establish a separate company for implementing a project (Article 14):

"(1) A person who intends to conduct a private investment project by establishing a corporation shall include a corporate establishment plan when submitting the project proposal…"

(2)When the competent authority intends to designate a person who submitted the project proposals as prescribed in paragraph (1) as a concessionaire, the designation shall be made under the condition that the corporation shall be established.

(3) The person who has been granted the conditional designation pursuant to paragraph (2) shall establish the corporation which will conduct the private investment project before applying for approval of the detailed engineering and design plan for implementation as prescribed in…

(4) The corporation established pursuant to paragraph (3) shall not engage in businesses other than those acknowledged by the competent authority at the time of designation of the concessionaire.…"

3.4 Chile (b.ii-b.iv)

Project financing is enabled by means of mainly 3 articles in the Chilean concession law. Article 9 states the following:

> *"The concession grantee is obliged to: a) Incorporate, within the time limit and in compliance with the requirements determined by the Regulations or the Administrative terms of reference, a joint stock company, under the operation of Chilean law or an agency of a foreign corporation, with which the contract is understood to be entered…"*

Article 43 covers the security of the funders:

> *"A special collateral guarantee for a public work concession is established and which shall not affect the right to use and enjoy the rights and assets pledged. It shall be negotiated by the concession grantee with the financing sources of the work or its operation or through the issuance of debt certificates of the concession company. It may affect:*
>
> *a) on the right to the concession of the public work originates from the contract to the grantee of the contract;*
> *b) on all payments committed by the State to the concession company at any title, in accordance to the concession contract, and*
> *c) on the revenues of the company."*

And Article 21 provides for step-in-rights:

> "*…the concession company shall be governed by the provisions of private law and (is), in general, entitled to carry out any lawful transaction, without any need for a prior approval from the Ministry of Public Works…"*
> ….
> *"As from the date of the signature of the contract, the concession grantee shall be able to transfer the concession or the rights in the concession company."*
> …
> *"The Ministry shall give its authorization providing that the transfer is in favor of an collateral creditor, when these are the result of a foreclosure of obligations guaranteed by the collateral guarantee which is established in Article 43 of this law, in favor of any financial institution… "*

3.5 Other enabling type of provisions for private partner (b.vi-b.viii)

In this section, provisions such as b.vi, vii and viii will be considered. A provision like b.vi could be important to enable a partnership in view of that changes to laws can have a significant impact on performance and are difficult for the private partner to foresee. In

addition to the Korean law[13], an explicit provision of this kind can be found in the Chilean, Spanish and UN Model legislation. In the latter it reads (Model Provision 39):

> "*The concession contract shall set forth the extent to which the concessionaire is entitled to compensation in the event that the cost of the concessionaire's performance of the concession contract has substantially increased or that the value of the concession revenues for such performance has substantially diminished, as compared with the costs and value of the performance originally foreseen, as a result of changes in legislation or regulations as specifically applicable to the infrastructure facility or the services it provides*."

The reader is also referred to the document issued by the UK Treasury, *Standardisation of PFI Contracts (Version 3)*, 2003, chapter 13, which contains an extensive discussion of the issues related to legal changes, and how to account for them in an agreement.

Procurement rules in some countries may impose conditions on sub-contracting for large works, e.g. that a part of the works shall be sub-contracted. This will normally not be viewed as being in the interest of a private partner, and it is difficult to see that such a provision would contribute to the economic efficiency of a proposed project and therefore be in the public interest. The amendment of the Italian Merloni law thus repealed the sixth paragraph of Art 37 quarter which contemplated the awardees duty to sub-contract to third parties of at least 30% in value of a works contract[14]. The abolition of such requirement reflects the changes brought to Art.2 of the law whereby concessionaires of public works are no longer required to sub-contract a fixed minimum percentage of their works, although such a duty can be imposed by the contracting authority on a case by case basis, or it can be offered as an element of the bid.

By contrast, the Spanish law states as follows (Article 237.1):

> *"In the public works concession contract, the administration may require the concessionaire to subcontract a percentage of the works contracts subject to concession through third parties, representing at least 30% of the total value of those works…"*

It is understood that public procurement rules have to be adhered to in selecting the third party contractors.

A factor which has prevented a larger recourse to private investment in public works in Italy has been the instability of legal relationships between the government and private parties, on the ground of the government being able to withdraw from or change the terms of the transaction on grounds of "public interest". In case of a concession's revocation by decision of the public partner, the amended Merloni Act therefore provides that the public party will be liable to pay, by way of damages, the following amounts (Article 37):

- "*value of the works made, in addition to accessory costs, minus depreciation, or, if the works have not been commissioned yet, the actual costs incurred by the concessionaire";*

[13] There is reference to this issue in the Italian Merloni Act.
[14] For a background, see the Green Paper on PPPs, European Commission (2004).

- *"penalties and other costs incurred or to be incurred as a consequence of termination";*
- *"indemnification, in lieu of damages for loss of profit, in the amount of 10% of the value of the outstanding works or services, as assessed on the basis of the economic-financial plan*".

Similarly, the Korean law states as follows (in Article 47):

> *"(1) In the following cases, the competent authority may implement the disposition prescribed in.... against a party who has obtained designation, approval or confirmation under the conditions as prescribed by this Act:*
> 1. *Where it is necessary for public interest such as the efficient operation of the infrastructure, or a change of circumstances with regard to infrastructure facilities;*
> 2. *Where it is required for the efficient implementation of the construction of infrastructure; and*
> 3. *Where force majeure such as war or natural disaster takes place.*
>
> *(2) If there is any concessionaire who suffers loss due to the disposition as referred to in paragraph (1), the competent authority shall make due compensation for such loss. In this case, the competent authority shall consult with the concessionaire on the compensation for loss, and if the two fail or are unable to reach an agreement with one another, they may request a ruling of the concerned land expropriation committee under the conditions as prescribed by the Presidential Decrees."*

Unlike for the Merloni law, the principles to be followed to establish the compensation are not set out in the Korean legislation; the regulations are also silent on this issue.

3.6 Transfer of (controlling) interests in a project company (c.iv)

Several of the laws examined contain provisions relating to the transfer of shares, including a controlling interest, in the project company. There are two aspects to this matter, as seen by the private partner and as seen by the public partner. The sponsors of transport infrastructure projects are, as indicated, frequently contractors and consultants, who have a primary interest in the design and construction phase of a project, and thus may be less interested in the management of the facility during the service phase. These companies can therefore be expected to wish to eventually pull out, in order to be able to focus their attention to new projects.

The public partner, on the other hand, wants to ensure continuity in order to minimise risks and therefore that ownership is strong and remains technically capable. A balance may have to be struck, as exemplified by Article 21 in the Chilean law already referred to above. It stipulates that shares may be sold as long as the new owners, who may even acquire a majority interest, fulfil the basic – technical and other – qualifications as set out in the original request for proposals. However, under certain circumstances the creditors enjoy specific rights; see Section 3.3.

In the amended Merloni Act, Article 37 1-ter provides that sponsors may only sell their shares after the project has been completed and commissioned:

"…The concession agreement shall set out the manner, if any, in which shares in the project company can be transferred, provided that the shareholders who have concurred in fulfilling the requirements for qualification shall be required to participate in the company and to guarantee, within the above limits, the correct performance of the concessionaire's obligations until issuance of the work's commissioning certificate. Acquisition and disposal of shareholdings in the project company by banks and other institutional investors who did not concur in fulfilling the requirements for qualification, may however take place at any time."

The general rule recommended in the *UK Standardisation of PFI Contracts* (Version 3, April 2004), is that it should not be necessary for the project agreement to contain any restriction on the transferability of equity other than the need to inform the contracting authority (p 119).

Finally, model Provision 37 of the UN Model Act provides as follows:

"*Except as otherwise provided in the concession contract, a controlling interest in the concessionaire may not be transferred to third parties without the consent of the contracting authority. The concession contract shall set forth the conditions under which consent of the contracting authority shall be given*."

3.7 Incentives by way of supplementary activities (item e.vi)

The importance of incentives, in particular with respect to type 2 projects, will be discussed in Section 6.3. Mention should here only be made of that several of the reviewed laws provide for the project company to exploit business ancillary to the project as a means to enhance the financial equation. Article 223.1 of the Spanish law states

"*…the public works may include other zones or land for execution of complementary, commercial or industrial activities that may be necessary or convenient due to the utility the users of the works are provided with and which are liable to be subject to differentiated economic use, such as restaurant facilities, service stations, leisure zones, parking lots, commercial premises and others suitable for operation*."

And this is then followed up by Article 246.5:

"*The concessionaire shall also take remuneration form the revenue obtained from operation of the commercial zone linked to the concession…"*

The Korean law provides by way of Article 21 (Implementation of Supplementary Project);

"(1) If deemed necessary to secure the investment cost, or to administer a normal operation of the infrastructure concerned, the competent authority may have the concessionaire implement any of the following supplementary projects jointly with the private investment project concerned under the conditions outlined in the instruction for proposal…"

The Act then goes on to identify 10 different types of such supplementary schemes that could be piggy-backed to a concession for a road. These schemes are effectively made possible and commercially relevant by the accessibility created by such a road.

4. Provisions aimed at reducing transaction costs

4.1 Introduction

Provisions of type f. which explicitly aim at reducing transaction costs and speed up the selection of the private partner do not feature prominently in the reviewed legislation. But the structure of the legislation has clear implications for the transaction, its duration and the costs for bidding, selecting a partner and negotiating the contract. The legal approach used in the countries of Southern Europe and Latin America entails very detailed specifications of the selection process and the contents of the project agreement, as exemplified here by the laws of Spain, Italy and Chile[15]. The fact that so much is already set out in the laws and regulations in effect limits the scope for how to design the contract. By contrast the approach of the UK and Ireland gives much more scope for design by the partners during selection and negotiation, although the door is slowly being closed by the guidance material that has been made available in these countries on how to structure a contract. In this chapter, some additional observations will be made on some of the provisions which contributes or could contribute to reducing transaction costs.

4.2 Pre-qualification (item f.1)

The normal approach to procurement of public works contracts, including of type 1 and type 2 types of projects is to include a pre-qualification stage. The purpose is twofold, viz to identify only 'qualified' or 'eligible' bidders, and to be able to reduce the number of bidders to a short list comprising normally 3 to 6 sponsors. This procedure is also available in Spain in terms of Law 13/2003. However, it is also possible to use an 'open' bidding process, allowing for bids to be prepared without pre-qualification, a process which apparently is being used normally in order to reduce the time of the procurement process. Presumably, this approach is possible as the works to be concessioned are of such size that the number of bidders under any circumstances is limited.

4.3 Negotiated deal or not (item f.2)

An important aspect related to the transaction is the procedure used for selecting the private partner (given that they are qualified). There are basically two types of procedures that can be used, viz. negotiated and non-negotiated. The difference between negotiated and the non-negotiated approach is essentially that in the latter, it should be possible to put a price on the project based on the information made available through the request for proposals, whilst the former require further negotiations to arrive at the price.

There are essentially three conditions that lead to the need for negotiations:

[15] Much of the legislation in the field is not easily accessible to the layman. It is often very lengthy and written in difficult language. Translations into English complicate matters, because of different legal traditions and language usage. Whilst legislation shall serve to reduce transaction costs in general, it also contributes to new hurdles. PPP legislation in itself gives rise to a need for legal expertise, and even more so if an investor wants to enter a market in a different country.

- output specifications (see below) have not been finalised
- certain risks have not been allocated to either party ex ante
- aspects of the payment mechanism are not yet fixed.

Procurement procedures in EU member states are dictated by EU legislation for a DBFO-type of project, and a negotiated procedure is only possible subject to the condition that:

> "*Exceptionally, when the nature of the work, or works to be carried out under the contract is such, or the risks attached thereto are such, as not to permit overall pricing*"[16]

Works concessions are not subject to regulation by EU directives in this regard. In the UK, DBFO-contracts are usually viewed as falling under the above proviso, so that the negotiated procedure is the one being used. As already mentioned, the negotiated procedure probably explains in part why DBFO-contracts in the UK so far have been time-consuming and costly.

An alternative is to try to prepare a project so that pricing can be achieved in one step. It is clear that this may require additional preparatory work, but overall this may in the longer term reduce transaction costs. In Spain, the procurement process is thus speeded up by that the negotiated procedure is not being made use of, although it is available in terms of the legislation. The information submitted in the bids is expected to be adequate in order to determine not only qualified bidders, as no separate pre-qualification stage is made use of, but also the ranking of the bids.

Efficiency is apparently also achieved in Spain by not making a differentiation between the technical and financial proposals, as is otherwise a common approach in public works tendering. The reason that the Spaniards may approach the procurement in this way is that the request for proposal sets out the project and the draft contract in great details, as provided for in the existing legislation. The framework for the allocation of risks is given ex ante, as is much of the tariff regime. In Spain, it is not necessary to prepare a detailed design of the project before the bidding process is initiated, but a preliminary design is available. The Spanish approach to procurement is thus structured in a way that it should be possible to 'price' the bid based on the request for proposals, thereby eliminating the need for negotiations (item f.ii)[17].

The Chilean approach to negotiating deals is apparently also quite effective, albeit somewhat different from the Spanish one. The Chilean legal framework requires a detailed design (Article 18 of the Regulations) to be prepared before the bidding process commences. A two-stage procedure is used to identify the concessionaire, including a pre-qualification stage. The bid entails separate technical and financial proposals, and the latter are only considered for bidders that actually demonstrate that they are able to meet the minimum technical requirements by way of their technical proposals. As in Spain, the tender is so well specified in the request for proposals, including the allocation of risks, that there is no scope for any

[16] Treasury Taskforce (1998), p. 9.

[17] The Spanish track record as concerns speed of contracting is exceptional, as also witnessed by the number of deals concluded. In general the total period until closure is about 8 months. Some additional features of the Spanish process which contributes to reducing transaction costs are (i) that during tender evaluation, the bidders are able to review each other's offers ensuring full transparency and early elimination of potential conflicts; and (ii) that financial closure does not have to be reached at the time of the conclusion of the project agreement. Instead, the successful tenderer has to pay a 4% (of the total investment) bid bond to ensure commitment to the agreement.

negotiations. The average time to prepare the design and for awarding a contract has been about 16 months for road projects in Chile. A large part of this time has probably been required for the design alone[18].

4.4 Final design (f.iii)

The requirements with respect to, in particular, final designs will also have a bearing on the transaction process, but also on the actual performance of the project per se. Different countries offer different models. In Chile, the requirement is, as mentioned, that the final design should be prepared before the tender is launched[19].

In Korea the concessionaire prepares the detailed design and will then have to obtain approval from the competent authority before implementing the project (Article 15(1)). The competent authority shall also make a public announcement of its decision, which may entail requirements of making modifications to the proposed design. Similarly, the current legislation in Spain (Article 220.3) and Italy (Article 20.2) allows the public partner to require that the concessionaire finalises the final design and obtains official approval of it.

The approach of the UK and Ireland is different in the sense that it is based on performance specifications, referred to as output specifications. In terms of this approach, the performance of the project (from the point of the users of the services to be produced by the project) are set out in the request for proposals, and subsequently, agreed to and incorporated into the project agreement. There is no obligation on part of the project company to actually obtain approval of the final design, but it is likely that the project agreement will enable the contracting authority to review and comment on it[20]. The proposals submitted by bidders must of course include a description of the approach to be used to achieve the outputs, which will be evaluated as part of the evaluation process.

The use of output specifications can serve to reduce transaction costs, provided that the public partner is able to set them out in the request for proposals in a unambiguous way, which in addition allows them to be measured and monitored. The reason is that the finalisation of a final design is often a time consuming affair, which under the conventional approach has to be completed prior to any works being initiated. If performance specifications are used in lieu it is to some extent possible to run construction and design in parallel processes. An additional advantage is that performance specifications allow for innovations in the construction and maintenance of infrastructure.

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[18] The procurement procedure is discussed in the Green Paper on PPPs, European Commission (2004). A possible interpretation of the Commission's deliberations is that it wants to suggest that a new procedure (incorporated into a new directive on procurement), referred to as the competitive dialogue could be the appropriate procedure for PPP type projects. This procedure does not appear relevant, however, in the case of transport infrastructure projects. A competitive dialogue process will be time consuming and complicated. A more straightforward approach for transport infrastructure would be to go for an open or a selective procedure, requiring the contracting authority to fully work through the proposed project prior to tendering.

[19] It is understood that this is with a view to promoting small firm participation in the concession and thus increasing competition; see IMF (2004).

[20] See Standardisation of PFI Contracts, version 3, April 2004, Section 3.2.

4.5 Feasibility studies (item f.iv)

The presentation above makes it clear that the transaction costs of the procurement process is very much related to how well the public partner prepares for the project, and therefore how well this partner actually understands the conditions of the project. One reason why the PFI process in the UK and Ireland (and also in some other countries) appears to have been successful is that strong requirements were imposed from the beginning to test for value for money[21]. The purpose of such studies is to test the feasibility of having the private partner provide a project and the services to be derived from it. By carrying out a value for money exercise, the public partner also develops a fundamental understanding of the costs of the proposed project, its risks and other relevant properties; see also Section 5.1.

Similarly, it may be assumed that the clear requirements set out in the Spanish legislation for the execution of a feasibility study before initiating the procurement process contributes to a speedy such process. Article 227.1 states as follows:

> "*Prior to the decision to construct and operation public works under a concession regime, the relevant body of the Administration granting the concession shall order a feasibility study of the same.*"

The advantage of this approach is not only that some of the hurdles for obtaining the required permits may be overcome earlier; in addition the public partner develops an understanding of the costs of the projects as well as the financial conditions of a possible concession. A well-prepared feasibility study therefore makes it possible to draft good requests for proposals, and also to subsequently evaluate the proposals submitted by the bidders effectively.

[21] See for example HM Treasury (2004).

5. Some public interest provisions

This chapter covers examples of some public interest provisions.

5.1 Testing for value for money (d.i))

Concessions are presumably to be justified on the basis of their financial performance. Projects based on the DBFO-approach essentially only result in a delay in public expenditure, from a public financing perspective. For these latter projects it may therefore be important, from a public interest (or taxpayer) perspective, to demonstrate that they are beneficial to tax payers. In the UK PFI-approach a mechanism has been developed referred to as the Public Sector Comparator (PSC), to test the effectiveness of the DBFO-approach by comparing it with a conventional delivery approach. Guidelines for how to develop and apply a PSC have been developed[22], as has also been done in other countries following the British approach, including Ireland, states in Canada, states in Australia and South Africa.

Of the reviewed legislation, only one makes explicit reference to the need for a value for money test. The draft Polish PPP Act thus states (Article 14)

> "*1. Prior to the decision to implement a certain undertaking in the form of a public private partnership, …, the public entity shall prepare an analysis of such undertaking to determine its efficiency and the threats involved in its implementation in such form, and in particular….*
>
> ….
> *2) the economic and financial aspects of the contemplated undertaking, including the comparison of the costs of implementing the undertaking in the form of a public private partnership with the costs of its implementation in another form;"*
>
> …."

5.2 Paying the costs for tendering (d.iv)

A provision that may be seen to facilitate both involvement of potential private partners and to strengthen competition, relate to undertakings to compensate for the costs of tenders under certain circumstances. In the draft PPP law in Poland the following is stated (Art. 30):

> "*In case of particularly complex public procurement contracts or undertakings that require application of innovative solutions, the public entity may undertake to cover, for all bidders on equal terms, a part of the tender preparation costs as defined in the specification for the private partner selection.*"

[22] Value for Money Assessment Guidance, including annexes, HM Treasury, August 2004

5.3 Supplementary works (d.vii)

After a decision has been taken to implement a specific road project, additional needs may be identified by the contracting authority, for example the need for increasing the capacity of the road by adding lanes or for building additional access roads. Although these additional works are not part of the original contract, there could be good reasons to adjust the contract to allow the same project company to undertake them or to contract separately and directly with the project company for having them implemented. Such arrangements could simplify implementation and provide for economies of scale, but also creates a monopoly situation. A rule has to be established, being in the public interest, as to what kinds of and the scale of supplementary works to be allowed.

The Chilean law provides as follows (Article 19):

> *"The Ministry of Public Works, as from the moment that the contract is signed, may modify, for reasons of public interest, the characteristics of the works and services agreed on thereto and, as a consequence, must compensate the concession grantee with the indemnifications required should there be any damage, by agreeing with the concession grantee as to the indemnifications which may be expressed during the period of the concession, in the tariffs, in the contributions or subsidies or in other factors of the economic regime of the concession agreed on, and resorting to one or several of those factors simultaneously. The conflicts which may originate between the concession grantee and the Ministry regarding the said indemnification, shall be settled pursuant to what is stipulated in Article 36"*
>
> "*The terms of reference*[23] *shall establish the maximum amount of the investment which the concession grantee may be bound to effect…, as well as the maximum time limit within which the Ministry may order modification of the works under concession. If the terms of reference make no indication in this respect, the maximum amount of these investments shall not exceed 15% of the total amount of the initial investment made by the concession grantee, according to the value defined after the final delivery of the work, and it may not be requested either once half of the total term of the concession has elapsed, except in those cases of an express written agreement with the concession company*."

The UK *Standardisation of PFI Contracts* contains much more extensive provisions reflecting different circumstances (se Chapter 12 Change in Service). A distinction is made between small works and larger works, as well as changes proposed by the contracting authority and by the project company. Small works are to be executed in terms of rates agreed to and reflected in the contract. For larger works, the company is required to submit a quotation, and also of how the costing has been made, as well as information to ensure transparency e.g. by comparing against benchmarks. For substantial works, it is possible to write into the contract that the project company should call for a tender in order to implement the proposed works[24].

[23] That is the request for proposals.
[24] On this matter, see also the Green Paper on PPPs, European Commission (2004).

5.4 Transparency (d.viii)

Critique has been directed in the UK against the fact that very little information is normally disclosed about project agreements for PPP projects, including their direct implications for the public finances[25]. The UK *Standardisation of PFI Contracts* contains guidelines which are formulated as follows (para 25.5.2):

> *"The recommended approach is that as much information in the Contract as possible should be placed in the public domain and only information which is specifically identified as commercially sensitive by the Contractor or identified and justified by the Authority as sensitive for public interest (including national security) reasons should be excluded. The parties should aim to achieve a pragmatic balance between the public sector's interest in transparency and the need for commercial confidentiality."*

The regime supported by the Chilean law is as follows (Article 8):

> "*The award of the contract…shall be adjudged through a supreme decree of the Ministry of Public Works, which, in addition, is to bear the signature of the Minister of Finance."*

This is followed up by the regulations (Article 29) which provide for very detailed requirements about the information which has to be disclosed by way of the decree. It is understood that the requirements imply that essentially everything material about the contract and the procurement process leading to the award of the concession has to be made public. Similarly, if changes are made to the contract subsequently, these changes also have to be made public by way of a decree.

[25] See e.g. Blaiklock (2003) and 2004)

6. Impact

6.1 Introduction

A legal framework is, of course, a must in order to enable the government to delegate functions, for which it is responsible, to the private sector, including making the investments required to produce the services associated with the functions. The design of this framework will vary from country to country on account of legal tradition and the already existing laws. Sometimes a very elaborate new law is required, as for example has been the case in Italy and Spain. Sometimes lighter action has been required, as is the case in the UK and Ireland, where only some basic type of enabling legislation has been passed (in the UK only in order for concessions and tolling to be introduced in the road sector).

However, the framework setting out what may be done and how it should be done is not only identified in legislation (laws and regulations); it may also be set out in policy documents, guidance notes, and similar. In several countries an extensive advisory framework exists, which in effect often must be followed for approvals to be obtained by the government. And this advisory framework may provide many of the types of provisions, which in some other countries will be identified by way of laws and regulations. An example is the model provisions of a contract prepared by HM Treasury in the UK (*Standardisation of PFI Contracts*)[26]. As already mentioned, the Guidance Notes issued by the Irish Department of Environment and Local Government provide a similar framework, supporting the basic PPP legislation of that country.

6.2 What has happened?

To judge whether a country has been successful in launching a PPP programme by way of its legislation it is therefore necessary to review the supplementary supporting actions taken. When seen from this perspective, it may be claimed that the actions have lead to results. The following may be identified in particular (as concerns road transport infrastructure financed by the private sector) as evidence of the fact that the actions taken have resulted in the envisaged PPP projects and/or PPP projects at a rate not witnessed before:

1. Since the end of the 1980's, the concession framework in the UK has so far led to a number of tunnel and bridge projects, including the Dartford River Crossing, the Mersey Tunnel, the Severn Bridge, and the Skye Bridge. There is also one motorway concession, the M6 Toll road (about 43 km).

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[26] The Standardisation of PFI contracts has its root in a review of the PFI carried out in 1997 revealing concerns in the private sector about the cost of repeated negotiation on the same issue with different departments. The first edition was published in July 1999, the second in September 2002 and the third in April 2004. It is understood that the standardised version is to be used by all procuring authorities, although some departments use their own more specific versions; these have, however, to be consistent with the document issued by HM Treasury. In effect, the Standardisation of PFI Contracts document mirrors the details reflected in e.g. the Spanish, Italian and Chilean legislation reviewed in this report. At the same time the document, by being revised intermittently and after extensive consultations with the affected parties, ensures that best-practice is being disseminated, and therefore that it effectively can serve the purpose of reducing transaction costs.

2. Since 1993, the DBFO-framework in the UK has resulted in 14 projects for almost 800 km of road at a cost of about £ 1.4 billion.

3. In Chile, there have been 16 road concessions since 1992, which were in operation by 2002 involving 2,054 km of roads at a total investment of $ 3,180 million plus 8 airport concessions involving $ 289 million. A further 10 road projects plus one airport project were under implementation in 2002 involving $ 1.9 billion.

4. Since the new procedures were launched in Spain as from 1998 (which are now reflected in the new law adopted in 2003), 17 contracts have been awarded up to end of 2002, involving total investments by the private sector of € 4.15 billion. Ten projects have been completed and a further 7 are under implementation. These projects are the first and second phases of the national toll motorways programme, involving all in all 18 projects, for a total length of 1,292 km, and expected to cost in total about € 6,850 million. It is understood that part of the projects will be financed by the public sector.

5. In Ireland, the PPP program was launched in 2000 in the roads sector, involving a concession approach[27]. So far it involves 11 projects, including 3 pilot projects. One pilot project has been completed to date, whilst the remainder is in various stages of progress; one project has been abandoned. The programme involves investments in the amount of £ 1.3 billion.

6. In Korea, the new legislation implemented early 1999, had by 2003 resulted in 13 completed road projects (and numerous other types of projects), for 151 km and at an investment value of $ 3.4 billion. Another 22 projects, involving 314 km and costing $ 10.7 billion were at that time under implementation.

7. In Italy 824 initiatives have been taken during the period 2000-2003, involving projects worth € 11.3 billion, of which € 6.6 billion for unsolicited proposals and € 4.7 billion for solicited bids. Only a small part of these proposals involve roads. In terms of the Merloni law, one deal has been concluded (revamping two roads worth € 900 million), and a further was near conclusion in 2004 (the Milan-Brescia motorway for € 816 million).

As a whole therefore, legal and similar actions have led to results, in principle as envisaged. In several of the countries, including Italy, Korea, Spain and the UK this reflects in addition that there is a tradition for involving the private sector which predates the current laws (framework), so that the current approach has been devised based on experience from earlier attempts. In Korea, for example, the current law replaced an earlier law from 1994, which did not yield the expected result[28]. In Italy, earlier transport infrastructure development mainly involved state-owned companies, so that the recent changes have served to open up the market fully to the private sector. And the new Spanish law embodies the application of principles that that have taken shape for quite some time (several decades), and which actually have already been fully applied (without the current legal backing) during a number of concessions as from the year 2000.

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[27] Concessions were introduced before the PPP programme. The Eastlink and Westlink bridges on the M50 in Dublin have been operated on a concession basis since 1984 and 1990, respectively.

[28] The Promotion of Private Capital into Social Overhead Capital Investment Act (Act No. 4773), dated August 3, 1994.

Poland appears to be an exception and provides a different picture, in that the development of the motorway system has been slow also following the enactment of the Act on Toll Motorways, in 1994 and its amendment in 2000. In 2002, the motorway network consisted altogether of 406 km, of which more than half had been built before 1990. To date there are two concessions, for a part of the A4 motorway (Katowice to Krakow) dated 1997, and part of the A2 (from 1996). Two more concessions have been granted for two sections of the A2 motorway and one for the A1 motorway. The main reason for the slow progress in Poland is the fact that direct government revenue guarantees cannot be provided under the current law; investors apparently still view the market as too risky so that they are unprepared to invest without guarantees. It has also been suggested that the bureaucracy surrounding the approval process related to construction works has slowed down progress. The complications of financing roads by way of concessions were apparently not fully understood when the law was prepared in the early 1990s

Attempts have been made to repair this by way of an amendment of the law in 2000, whereby the National Motorway Fund was established. It provides for various mechanisms to support privately financed projects, including direct subsidies and interest-free loans. The functioning of this support system is of course dependent on the availability of money to the Fund, and this support system is hence less flexible than the one used in Korea, Chile and Spain, where straightforward government budget support is possible.

6.3 The importance of market risks for transport projects

The presentation in this report takes the transport sector as a starting point, and makes in the first instance reference to the roads sub-sector. However, with the exception of the Polish Law on Toll Motorways, the reviewed legislation is not specific to the transport sector. The Italian, Spanish and Chilean laws refer to public works, which may include water, drainage, sewerage and perhaps energy. The Irish PPP legislation, the Korean law and the draft Polish PPP act cover many more public activities.

Specifically, the only type of legal provision that may be required in order to introduce type 2 projects in the road sector – compared with other public works projects – is the power to impose tolls. Unlike most other works facilities, roads are normally open to the public, a feature of the road laws of most countries. For this reason, it was necessary to pass the New Roads and Street Act, 1991, in the UK and the Roads Act, 1995 in Ireland. The introduction of tolls on motorways in Poland was similarly enabled through the 1994 Act. In the other countries, Chile, Italy, Spain and Korea, tolls had already been introduced on certain types of roads before the enactment of the laws considered here.

The reviewed legal framework is therefore in general of relevance also to other sectors, in which a function may be considered to be delegated by the state, the performance of which will require an investment up front, to be followed by operations using that investment and for a finite, albeit lengthy, period of time. *The studied legislation hence does not make any reference to specific properties from an economic point of view, which may characterise the functions that may be delegated.*

In addition to the need to enable tolling, the only other aspect worth mentioning here possibly distinguishing transport projects from other projects is the fact that the market risks associated with transport infrastructure are likely to be more pronounced and the associated economic

costs, relatively seen higher. *Provisions which relate to the revenue side of a project are therefore likely to be more important for transport infrastructure projects than for other public works and similar projects, although they are not necessarily uniquely required by transport infrastructure.*

As mentioned, the main risks faced by a project are the project specific and market risks. The project specific risks relate to construction costs, and these risks, are normally possible to manage (resulting in reduced risk), but their costs may also be reduced by way of pooling. The SPV plays an important role in this regard. There is no apparent difference between transport infrastructure and other types of projects as concerns project specific risks.

The market risks are, however, much more difficult. Firstly they are substantial for transport infrastructure projects for the following reasons:

- Demand for transport is a function of economic growth, and strongly related at that, and future demand is therefore very difficult to predict and may also be quite volatile.

- Demand can normally not be influenced directly by the project company.

- There are often serious restrictions on the use of tolls as an instrument to directly affect demand. This is not just for social reasons, but also because the road manager/government may wish to maintain a policy of equal tolls per km on all parts of the tolled road network.

- There is no track record, as many transport infrastructure projects are green field projects. And even if some infrastructure was there before the project (assuming, for example, that the project actually involves an upgrading of an existing road), the introduction of a toll can have a significant impact on demand which may be difficult to predict.

- The demand may be severely affected by other parallel roads already existing or which may be built in the future.

That the market risk is high is also borne out by experience[29]. There are numerous examples of failed toll road projects, and the rate is likely to be higher than for other public works concessions. This also reflects that it is not possible to insure oneself against the impact of the market risk, as its cost cannot be eliminated by way of pooling. It is not surprising that considerations of the demand side have come to play a very significant role in the development of transport infrastructure with private finance.

Additional problems related to demand is generated by the bidding process itself. Ceteris paribus, the bidder with the most optimistic view of future demand will win a contest. Assuming that demand can be predicted in an unbiased way, each bidder will have different outlooks on the future. Therefore, selecting the bidder with the highest traffic estimate, will tend to increase the risk of financial problems ('the winner's curse'). On the other hand, it has sometimes also been speculated that bidders behave opportunistically, for example by actually assuming higher traffic in a bid than expected in the hope that the agreement later can be

[29] See e.g. Estache, Romero and Strong (2000) and Guasch (2004)

renegotiated and on more favourable terms (as has apparently happened in a number of instances)[30].

It is, however, not only ordinary road projects of type 2 which are affected by this. As part of the development of DBFO in the road sector in the UK, use has been made of 'shadow tolls', i.e. the private partner is remunerated by the public partner in terms of the number of vehicles making use of the road. The argument has been made that part of the market risk may be transferred in this way (implicitly suggesting that somehow this is to the benefit of society).

The argument for introducing shadow tolling is questionable from an economic point of view, as such a payment system is not likely to reduce overall economic costs, and in addition gives rise to additional problems for the public sector to predict public expenditure to be made under the project agreement. This is not the issue to be concerned with here, however. The matter to be concerned with is that the importance of market risks are reflected in certain legal provisions which feature prominently in the legislation. These include provisions of category e. providing incentives to the private partner, including providing revenue guarantees (of various forms) or allowing concessionaires to exploit related business opportunities, including land areas adjacent to a road.

As concerns shadow tolling it should be mentioned that the practice developed, reflecting the funders' concern with the market risks in the UK, has been to impose a number of restrictions on the possible variability of the total revenues due to the shadow tolls. For example the payment per unit is high for low levels of traffic, and then reduced for higher levels of traffic, and perhaps even eliminated for certain incremental amounts of traffic at high traffic levels, which is achieved by way of what is referred to as a banding structure. Also, the levels on the shadow tolls may be adjusted over time. Overall these various devises imply that revenues vary much less than traffic and that the associated risks as a consequence are reduced substantially[31]. It may be assumed that the complicated shadow tolling structure employed in the UK indeed has contributed to the apparently high transaction costs for DBFO projects.

Arrangements of a similar nature are also allowed for under some of the concession laws. These provisions enable the contracting authority to guarantee e.g. a minimum level of income, but generally at a price in that limits are also put on the maximum level of income that may be attained. For example in Spain the new law states (Article 246.3):

> *"…the economic-financial plan of the concession shall establish the relation of the rates to the demand for use of the works and…when the minimum and maximum levels set, respectively, in the tender are not reached or are passed."*

It is understood, that the regulations still to be issued, will then specify much more precisely how these guarantees will be implemented, as discussed further in Vassalo (2005).

The most discussed approach in this regard, is the Least Present Value of Revenue (LPVR) tendering mechanism made use of in Chile. The core selection principle is the lowest value required in terms of LPVR by tenderers. Since the toll level and discount rate is fixed by the contracting authority, the only variable that may be varied is the period of the concession. In terms of the LPVR-approach the concession will not terminate until the concessionaire has collected the tendered LPVR value. Effectively this bidding mechanism eliminates the market

[30] See the discussion in Engel et al. (2003), Guasch (2004) and Gómez-Lobo (2000).
[31] See Bruzelius (1998).

risk, in the same way as a fixed annual rate (an access fee) in lieu of a shadow toll accomplishes for a DBFO-type of project.

So far the LPVR-approach has only been applied on one project in Chile. However it should be mentioned that very similar principles have also been made use of for some of the concessions in the UK (Second Severn and Dartford Bridges).

It should also be mentioned that many of the other Chilean concessions provide for minimum revenue guarantees, at 70% of expected revenues during a year. The Korean government has an explicit policy on revenue guarantees. For solicited projects, it is possible to obtain a guarantee of up to 90% of estimated revenues. The price to be paid is that actual revenues in excess of 110% of the estimated revenues will be collected by the state[32]. For that reason, some companies abstain from including such a guarantee. The legal base is in Article 53 of the Act, which states:

> "*If it is necessary for the efficient implementation of construction projects of revertible facilities, the State or a local government may grant a subsidy or long-term loan, only where prescribed by the Presidential Decree.*

The regulations (Presidential Decree), Article 37 on financial support follows this up by saying[33]:

> *"(1) The State or local governments may grant any subsidy or long-term loan to the concessionaire within the scope of the budget after deliberation of the Committee, in the following cases under the provisions of Article 53 of the Act:*
>
> 1. *Where dissolution of the corporation is inevitable:*
> 2. *Where it is an inevitable measure to maintain the user fee at an appropriate level;*
> 3. *Where inducement of private capital is difficult due to a fall in the profitability of the project as a result of a considerable expenditure disbursed as compensation for the use of land;*
> 4. *Where the actual operational profit (referring to the amount obtained by multiplying the user fee by the demand for the concerned facility) falls considerably short of the estimated operational profit under the concession agreement, to such an extent that the operation of the facility is difficult;*
>
> ……"

The Polish Act on Toll Motorways, on the other hand, does not provide for any revenue guarantees. Both the Polish and Korean laws contain provisions and arrangements for credit guarantees, but at a price for the concessionaire.

[32] In case of unsolicited projects the limits are 80% and 120%, respectively.
[33] These regulations also allow for financial support to compensate for foreign exchange rate fluctuations.

7. Concluding words

The review suggests that there are certain legal provisions which are of particular importance in order to facilitate private sector interests in partnerships for providing transport infrastructure. Enabling provisions include:

- Provisions which make project financing possible. There are a number building stones as part of this
  - The possibility to establish a project company
  - Securitization of revenue flows to this project company
  - Direct agreement between contracting authority and funders to provide for step-in-rights under certain conditions
  - Power of project company to chose sub-contractors and on its own terms
  - Clear rules on revocation of project agreement and on compensation to owners of the project company

- Provisions which enable governments to provide financing. These include provisions
  - Which enable government to provide subsidies in case of type 2 projects
  - Which enable government to make long term commitments of public expenditure (in principle for the entire period of the validity of the project agreement).

A number of steps can be taken to by way of guidelines, or similar, which will greatly facilitate entering into agreements and reduce transaction costs. Such steps include the following:

- In case of type 1 projects, consider avoid having the project company bear the market risk by not using shadow tolls.

- In case of type 2 projects, consider reducing the market risk to be borne by the project company by using the LPVR-technique as has been done in the UK and Chile.

- Use performance specifications (in order to reduce the role of design as part of the approval regime), and also to enable innovation in design.

- Reduce the scope for negotiations, by preparing the project thoroughly upfront, including fully setting out risk allocation, payment mechanism and performance specifications in the request for proposals. In principle, this approach is preferable, because it would allow for establishing beforehand whether or not it will be possible to write a complete contract between the two parties. A complete contract will facilitate the subsequent implementation of the PPP.

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