Plenary 14: Description of the concession agreement

Thursday, 12:00 to 13:00

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Session agenda

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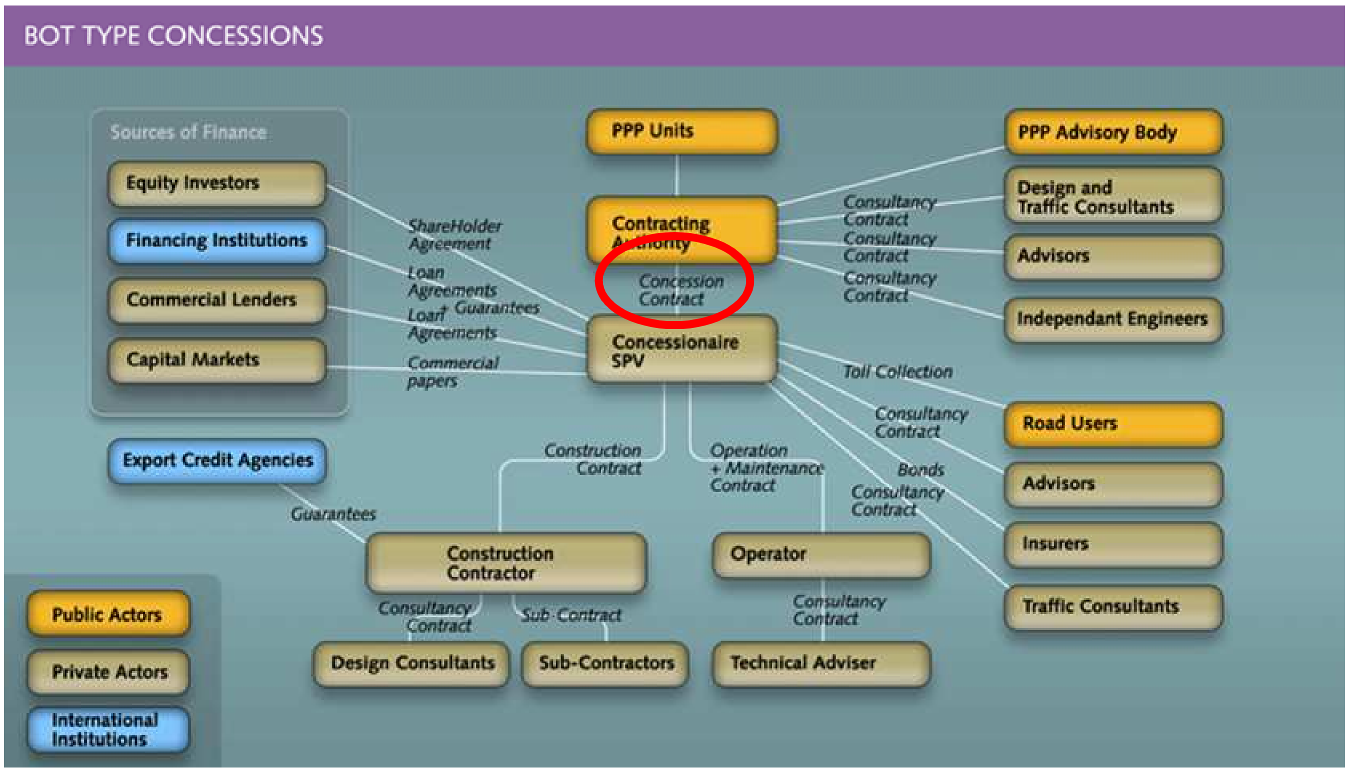
1. PPP contracts
2. Incomplete contracts
3. Model concession agreements
4. Key concession agreement issues
5. Renegotiation
6. Summary and further reading

PPPs and contracts

- PPPs are based on a series of contracts centred on the SPV.
- All relationships are governed by contract to some extent.
- While the structure of contracts will be different for each project, the example below shows an example structure for a toll road BOT. Each link represents one or more contract.



The key contracts here are:

- **Concession contract**
- Shareholder agreement
- Loan agreements
- Guarantees
- Commercial papers
- Construction contracts and sub-contracts
- Consultancy contracts
- Operation and Maintenance Contracts
- Insurance bonds
- Commercial agreements

The concession contract

- The concession agreement is the most important contract in a PPP structure. These agreements are unique to PPPs and is the main instrument for risk allocation.
- It is the agreement between the government (grantor/contracting authority) and the project company. Its role is to define the requirements of the project and to grant licences for construction/operation/maintenance.
- The concession agreement must clearly set out the scope of work for the concessionaire including their obligations and permissions, and the duration for which this is granted.

Typical provisions include:

- Project Completion and Timing
- Scope of Work
- Design
- Land use rights
- Environmental safeguards
- Material Adverse Governmental Action
- Pricing Formula
- Government Support
- Secondary Developments
- Currency Conversion, Availability, & Transferability
- Cross-Subsidization
- Non-Compete clauses
- Local requirements
- Compensation for Breach
- Liability and indemnification
- Dispute Resolution
- Force Majeure
- Assignability/Sub-contracting
- Confidentiality
- Records and information sharing

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Incomplete contracts

- There are some circumstances where complete (or near complete) contracts can be written, particularly with the case of certain IPPs / BOTs.
- However the long duration of contracts makes it difficult to cover all eventualities.
- Contracts are limited by the extent of detail that can be stipulated as well as the observability of certain objectives (for example the effort made to maintain safety) → proxies must be used to approximate many desired outcomes.
- When drafting contracts, parties must make sure that proxy measures do not create opportunities for gaming.
- One solution to the almost inevitability of incomplete contracting is to take a “partnership approach” where parties act together to ensure the sustainability of projects, rather than reaching for the contract as soon as any discrepancy arises.
- PPPs must not be treated as traditional procurement exercises.

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Model concession agreements (MCAs)

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- MCAs are structured legal documents employed by some governments, including India, South Africa and the UK to facilitate concession PPPs.
- Standardisation can help streamline the procurement process and enhance the stability of the regulatory and policy framework.
- Each contract initiated under standard conditions involves limited tailoring and minimal scope for negotiation – thereby also supporting governments with weak capacity and experience in PPPs.
- MCAs have been viewed as particularly successful when used for a number of similar projects in a country (for example, toll roads in India), but have also been criticised for bringing in rigidity and not being suitably adapted to changing circumstances in different types of projects.
- MCAs are useful where there are a number of planned projects that can benefit from the standardised document – in the case of only one or few projects, the transactions costs may be too high.

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Common issues for concession agreements

- Concession agreements must address a number of important issues including:
  - concession period;
  - construction;
  - tariff / pricing;
  - role of the government;
  - change orders;
  - termination;
  - force majeure;
  - stabilisation;
  - dispute resolution; and
  - choice of legal jurisdiction.

Concession period

- The concession period can be defined in terms of:
  - the duration of rights to operate the facility; or
  - achieving a specified return on investment.
- At the end of the period, the SPV may retain liability for design and construction warranties.
- When defined in terms of time (not returns) the duration is selected is a function of:
  - the cost of construction – allowing sufficient time to earn an appropriate return;
  - cost of selecting a private partner – costly processes may make frequent retendering inefficient; and
  - competition – can competition 'for the market' put downward pressure on prices that regulation cannot.

Construction

- Construction is likely the most important obligation of the SPV.
- Requirements must be tightly defined:
  - Date – contracts usually specify the time within which construction must be completed. This may be supplemented by bonuses for early completion and penalties for delays. What "completion" objectively entails must be defined.
  - Govt input – There is often a requirement to submit designs and other info to the govt.
  - Standards – Minimum standards will be specified, as with how these are monitored, and the consequences are if they are not met. Minimum standards, the government's monitoring rights and the consequences of failing to comply with standards must be defined at the following stages:

Construction
Technical specifications for design and construction

Completion of the facility
Operation and maintenance standards

Termination
The condition at transfer to the govt., including any warranties

Tariff setting / pricing

- Tariff structure is essential as revenue streams are essential to the project finance approach.
- Pricing structures can also be a tool to allocate risks.
- Various dimensions must be specified in the contract:
  - Regulation – is the tariff regulated? If so, how? And by whom? – market determined, legislation, regulator, contract?
  - Tariff structure – based on quantity consumed, access fee etc.?
  - Access and discrimination – is price differentiation allowed, is there a responsibility to ensure access to poor or frequent users?
  - Administration – cost of assessing and collecting tariffs.
  - Government subsidy.
- Reduced discretion rules can be a partial solution to uncertainty.

Role of the government

- A number of risks and responsibilities remain with governments. The government can give the SPV incentives for investment, construction and operation. Some of these include:
  - Tax incentives – exemption from certain taxes e.g. corporation tax or import duties.
  - Contribution of land and assets – land and easements are usually provided at least until the end of construction.
  - Network and logistical support – the government may need to construct, or arrange for the construction of other facilities.
  - Supply of labour and materials – may ensure a given quantity and price.
  - Remittance of income – foreign currency restrictions may be waived.
  - Guarantees and stand-by financing – a common form of guarantee is an off-take agreement in which the government is a purchaser. This is often a minimum revenue to the SPV subject to having capacity to deliver that level.
  - Non-competition – assurance that competing facilities will not be constructed under certain circumstances.

Other important concession agreement issues

- Change orders – the right for govt to modify the contract usually with respect to construction but with compensation for the SPV for its costs.
- Termination – provisions specifying when the government can terminate e.g. for insolvency or material breach of contract, notice period required, compensation for sunk investment, surviving obligations etc.
- Force majeure – definitions of risk or compensation events.
- Stabilisation – provisions to deal with exceptional events such as changes in law, licences etc.
- Dispute resolution – designation of a court or arbitration body to resolve conflicts in an enforceable manner.
- Selection of legal jurisdiction.

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Renegotiation

- Renegotiations of concessions and other PPP contracts are common place across infrastructure sectors. For example, excluding telecoms, more than 41% of concessions in the LAC region have been renegotiated.
- Renegotiations are also costly and involve considerable time and effort. Hence renegotiations should be carried out only if it enhances welfare by addressing a failure in the nature of the PPP contract.
- More generally, renegotiations can be avoided to the extent that the PPP contract is well designed and properly implemented.
- Ensuring appropriate rules for addressing uncertainty also helps limit renegotiation.

Avoiding renegotiation

Good contract design

- Contracts should be designed to avoid ambiguities as much as possible.
- Contracts should include clauses committing government to no renegotiation except in the case of well-defined triggers.
- There should be some system of compensation to operators for unilateral changes to contract by the government.

Good implementation

- Avoid hurried, quickly organised PPP programmes.
- Use competitive bidding process to award contracts.
- Put in place an appropriate regulatory framework and agency prior to awarding contracts.
- Make appropriate choice of type of regulation, understand allocation of risk of each type and implication for renegotiation.
- Proper regulatory accounting in place to avoid ambiguity

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Summary

- Concession agreements are just one of many contracts necessary for a PPP.
- BUT they are the most important element and tool to establish risk allocation.
- Important elements include:
    - concession duration;
    - construction timetable and quality;
    - setting tariffs / pricing; and
    - the role of government.

Further sources

Online

1. Indian MCAs
   http://infrastructure.gov.in/mca.htm
2. South African PPP Provisions
   http://www.ppp.gov.za/StandPPPProv.htm
3. UK PFI contracts
   http://www.hm-treasury.gov.uk/ppp_standardised_contracts.htm
4. UNESCAP (2007) "A Legal Perspective of Public Private Partnerships"
   http://www.unescap.org/ttdw/ppp/trainingmaterials/PPPs_LegalWorksheet.pdf
   http://www.unescap.org/ttdw/ppp/trainingmaterials/PPPs_Legal_Perspective.pdf
5. PPIAF "Toolkit for Public-Private Partnerships in Roads & Highways"
   http://www.ppiaf.org/ppiaf/sites/ppiaf.org/files/documents/toolkits/highwaystoolkit/4/4-32.html

Books

1. Shugart and Alexander (2008) "Tariff Adjustment Rules: Guidelines for Regulators"
2. Vinter (2005) "Project Finance, A Legal Guide" 3 rd . Ed Sweet and Maxwell
3. Delmon (2005) "Project Finance, BOT Projects and Risk" Aspen