Payments and Revenue

Tariff Setting

For many infrastructure projects such as transport, a user tariff based agreement is appropriate. Initial tariffs and subsequent tariff escalation are initially determined within feasibility studies to ensure a proper or market acceptable rate of return based on an efficient operation. The competitive bidding process aims to minimize the initially government estimated tariffs and the subsequent escalation rate.

The concept of a proper return incorporates several important subordinate, and sometimes contradictory, principles;

- The need for full cost recovery (capital, operating and financing costs) to ensure, if possible, that the project is viable and users pay (rather than general taxpayers).
- Affordability and ability to pay the proposed tariffs by users complemented by a subsidy if such level of tariffs precludes project financially viability. This is based on the viability gap concept that some potential and targeted users would be unable to afford a full cost recovery based service. Therefore a gap exists between how much investment the toll rates will support and the actual cost of the project.
- The proposed tariffs and basis for tariff escalation during the concession period should be project, not sector, based and both written into the concession agreement.

Any proposed subsidy will be finally determined through competitive bidding to ensure the lowest liability for Government

Tariff Adjustment

Tariff adjustment mechanisms are vitally important to transportation project concession agreements. Although the initial tariff and tariff adjustment formulas are normally negotiated and agreed prior to contract signing, there may remain many tariff uncertainties that are likely (or almost certainly likely) to occur during the concession period.

Over the concession period, much is likely to change, from the costs of major inputs, to specific service requirements and to the wider legal environment in which the concessionaire operates. In practice, many of these changes cannot be predicted accurately or even at all. Accordingly, concession contracts must allow prices to be adjusted over time, without prior knowledge of what those adjustments should be or what will trigger them.

To the extent possible, the length of Concession Agreements should be designed to initially meet and reflect financial targets to provide the right incentives to the private sector. However, concession periods can also have other objectives such as to encourage future competition and in consideration of what will happen at time of transfer, if a

BOT type project. Tariff adjustments should provide for reviews of efficiency to ascertain whether services are continuing to be provided at the lowest cost possible.

Within the Concession Agreement, governments should also consider how practical and meaningful incentive links can be established between the tariffs and the concessionaire's performance, i.e. if a concessionaire fails to meet performance guidelines by 'x', tariffs might be reduced by 'y'. The partners to the Concession arrangement can draw up a set of performance principles applicable to tariff setting and any revisions thereof. Such principles would differ between modes of transport.

For developing PPP transport projects, it is expected that exchange rate risk is to be largely (Except where major devaluations occur) borne by private operator. Therefore, it is generally proposed that the tariff adjustments should be linked to inflation rate, but that this may vary by project and/or sub-sector.

The methods recommended therefore must take into account the need to promote annual efficiency (Normally, encouraging efficiency, protecting the consumer from excessive tariff increases but also assuring the private sector operators that they will be able to stay profitable by recouping justified cost increases).

Both types of tariff determination systems i.e. rate of return regulation (profitability) and tariff cap formula (inflationary but may also include some type of mitigation of the risk related to major exchange rate movements), or a hybrid version which incorporates the best features of each are the basis of recommended tariff setting for PPP projects.

Unitary, Annuity and Availability Payments

For certain types of projects, i.e. those;

- without a direct revenue stream, or
- with a weak revenue base or
- with a weaker than acceptable demand or
- with higher than acceptable risks,

the Governments own feasibility study may recommend a system of annual unitary payments to the concessionaire based solely on availability or outputs (i.e. the meeting of specific project targets) by the concessionaire.

An example of an annuity is that the concessionaire contracts to fund and build the project and bears the construction cost and time-overrun risk. The opening of the project triggers a payment per year based on the concessionaire meeting certain pre agreed targets such as number of lanes, pavement standard, toll gates, toll queue times etc. The annual payment can be either (i) dependent on standards/performance of the operator or (ii) related to both traffic demand and performance standards. In the example (ii) it can be termed a shadow toll.

In the UK, the UK version of PPPs, called PFIs, the unitary payment system is very common and especially in the health and education sectors as well as roads. In India, the use of annuities to fund toll roads is also very popular.