

Contract renegotiation and adaptation

PPP contracts are more likely than others to be subject to adaptation or renegotiation for a number of reasons and which arise from the nature of the contract, quality of the parties and long duration of the project. This section, which provides the legal considerations of renegotiation, should be read in conjunction with Module 5 -> Amendments to Contracts and Dispute Resolution which presents methods and procedures.

Causes for renegotiation

A recent report conducted by the World Bank (2004) indicates that 41 percent of infrastructure concessions in Latin America were renegotiated, particularly in the transportation sector, and that such renegotiations occurred within 2 years of the contract award. The report stresses the fact that such a high incidence of contract renegotiation exceeds expected and reasonable levels and raises concern about the validity of the concession model. The report adds that this can undermine all the benefits of the competitive bidding process, which turns into a bilateral negotiation between the winning operator and the government. At that stage the operator has significant leverage because the government is often unable to reject renegotiation and is usually unwilling to claim failure, and let the operator abandon the concession, for fear of political backlash and additional transaction costs.

Analyzing the causes of this process, the report states that if bidders believe that renegotiation is feasible and likely, their strategic behavior and their bids will be affected and the process will not be likely to select the most efficient operator as intended. The appropriate answer from governments is not to concede to opportunistic requests for renegotiation and let operators abandon the concession as a price worth paying, since such an approach can in fact help governments by establishing a reputation of not being easy with renegotiation requests and thus discouraging future aggressive bids.

The report then quotes that, between 1990-2001, only 48 private infrastructure projects were cancelled out of a total of 2,485 projects granted worldwide, but of these 19 were in toll roads, which had the highest incidence of cancellation by sector.

The report considers this renegotiation issue as the biggest problem with concessions and highlights solutions to ensure that renegotiation should occur only when justified by contingencies or major unexpected events built into the initial contract.



Granting and Renegotiating Infrastructure Concessions - Doing it Right. J. Luis Guasch.
WBI Development Studies, 2004

Recommendations for improvement

The objective is to improve the design of concessions to secure long-term sector efficiency and foster compliance with the contract conditions by both the government and the operator. To establish such an environment, concession contracts should include: (i)

provisions required to design contracts that focus on securing long-term sector efficiency and discourage opportunistic bidding and renegotiations, and (ii) provisions required to implement regulations that impede opportunistic renegotiations and force contract compliance.

Contract provisions aimed at securing long-term sector efficiency

- a Concession contracts should be awarded competitively and designed to avoid ambiguity in the treatment of assets, the evaluation of investments, the outcome indicators, the procedures and guidelines to adjust tariffs, the criteria for early termination and the procedures for disputes resolution.
- b Concession contracts should contain clauses committing governments to a policy of no renegotiation except in the case of well defined triggers. They should stipulate the process for and level of adjustment: the first tariff review should not be entertained for at least five years unless contract contingencies are triggered.
- c Concession contracts should provide for significant compensation to operators in the event of unilateral changes to the contract by the government, including penalties.
- d Consideration should be given to making operator pay a significant fee for any renegotiation request. Such fee would only be reimbursed if the renegotiation is decided in the operator's favor.
- e Detailed analysis of seemingly aggressive bids should be required before a concession is awarded. Operator should be required to post performance bonds of significant value.

Contract provisions aimed at securing good implementation and force compliance

- a Quickly organized concession programs should be avoided.
- b Infrastructure concessions should be awarded through competitive bidding rather than direct or bilateral negotiations, and only after qualifications of bidders have been screened.
- c An appropriate regulatory framework and agency should be in place prior to the award of the concession, with sufficient autonomy and implementation capacity to ensure high quality enforcement and deter political opportunism. Performance objectives should be used instead of investment obligations.
- d Proper regulatory accounting of all assets and liabilities should also be in place to avoid any ambiguity about the regulatory treatment and allocation of costs, investments, asset base, revenues, transactions with related parties, management fees, and operational and financial variables.

Although the above recommendations are aimed at restoring confidence in “the concession model”, it should be stressed that there is not one concession model worldwide, but a wide number of variations depending on the countries or legal systems concerned of a concept which remains loosely defined.

Renegotiation of concessions remains a major issue in countries such as in Latin America, where a concession is considered, legally at least, more as a commercial contract between parties of equal strength and which is destined to evolve through negotiation between the parties. Only in such countries does renegotiation constitute such an issue and a threat.

There are other countries or legal systems where the issue is rather that of adaptation of the concession to changes of circumstances rather than renegotiation.

Adaptation or renegotiation

In some countries or legal systems which have a long tradition of concessions in public infrastructures, a concession contract is not a standard commercial contract between parties of equal strength, but rather a hybrid instrument combining features of a contract and of a regulation. In such countries, it is called an administrative contract, is governed by specific laws, and enforced by dedicated administrative courts. Renegotiation is not an issue because the public authority does not need to negotiate as it can impose its requirements under certain conditions to its private concessionaire, who has no option but to perform.

The first and main reason has to do with the fact that the parties are not on a level playing field. One party is a public authority which represents the public interest, and has therefore certain rights that allows it to impose unilateral modifications to the contract, without the consent of the private party. There is therefore a certain imbalance between the parties which must however be made good when the financial equilibrium of the contract has been affected by the unilateral actions of the public authority, to the detriment of the private concessionaire. The consequence of such an extraordinary right is an automatic compensation of the concessionaire, so that the financial equilibrium of the contract is restored.

In addition, the nature of the contract, which concerns the provision of a service to the public, serves to reinforce its specificity by the requirement to adapt to the need of such public service.

Finally, being in most instances a long-term contract, the risk of having to adapt to changed circumstances is even higher.

The effect of such a system is that the public authority knows it will be able to impose the contract changes that may be required in the public interest without having to “renegotiate” them and run the risk of opposition and failure inherent in the processes of contract review and extraordinary reviews that form part of “private law concession contracts”, while the private concessionaire is confident that whatever changes and unilateral modifications are imposed on him, the financial equilibrium of the contract will be maintained and his profit with it.

This produces a climate of mutual confidence that allows long-term partnership to develop for the benefit of private concessionaires and of public infrastructures. France is one example of such a system.

Circumstances leading to contract adaptation

There are two broad categories of circumstances that may lead to an adaptation of the contract. The first category is changes in conditions, either legislative and regulatory changes, or changes in economic conditions.

Of the legislative and regulatory changes only those specifically related to PPP projects or one particular project would lead to adaptation, as opposed to other general legislative changes which would be considered as normal business risks.

Of the changes in economic conditions only those that must have been beyond the control of the concessionaire and of such nature that the concessionaire could not reasonably be expected to have taken into account at the time that the project agreement was negotiated, would lead to adaptation. For example a toll road operator holding an exclusive concession might not be expected to assume the risk of traffic shortfall caused by the subsequent opening of an alternative toll free road by an entity other than the contracting authority. However he would normally be expected to take into account reasonable labor cost increases over the life of the project, thus the fact that wages turned out to be higher than expected would not be sufficient to justify an adaptation of the contract.

The second category of changes result from modifications required by the contracting authority, such as revised construction design specifications or additional operational requirements. In both instances the concessionaire would be under the obligation to perform as required subject to adequate compensation for the additional financial burden resulting from the changes.

Condition for successful project completion and concession implementation

Rather than a strict application of contractual provisions, experience shows that the success of PPP contracts lies with the mutual trust that the parties have in one another, together with their will to act as partners in carrying out a project for their mutual benefit.

In countries like the United Kingdom, where PPP contracts are private law contracts, as described above, studies carried out after 10 years of experience of successes and failures of the PPP program (Private Finance Initiative) advocate moving from a strict policy of contract enforcement towards a more partenerial approach, in which public authorities and private concessionaires are encouraged to work closer together to share a common project, which, after all, should be the aim of a true partnership.