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Achieving Transparency and Accountability in the Renegotiation of Public-Private Partnership Contracts

Presentation to ADB Staff

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Outline of the Presentation

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Transparency and Accountability in the Renegotiation of PPP Contracts

- The Prevalence of PPP Renegotiations
- Issues and Concerns with Renegotiation
- Case Study - the Melbourne Train/Tram Franchise Renegotiation
- Nine Proposals for Governments on PPP Renegotiations
- Renegotiations During the Pandemic

The Prevalence of PPP Renegotiations

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PPP contract renegotiations occur frequently, particularly in certain regions and in certain sectors

- by definition, a renegotiation of a PPP transaction involves a change to the original contractual terms and conditions, as distinct from an adjustment – such as a payment increase – that takes place pursuant to a mechanism defined in the contract
- a significant number of PPP infrastructure transactions have been renegotiated
- these renegotiations often occur within a short period of time following financial close
- renegotiations are particularly frequent in certain sectors, notably transport and water, and in certain regions, notably Latin America and South Asia
- the majority of renegotiations are initiated by private sector Project Companies, but there are also many instances of government-requested renegotiations

The Prevalence of PPP Renegotiations (cont.)

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The Global Infrastructure Hub report on *Managing PPP Contracts After Financial Close presents the most recent data on renegotiations***

*available at https://managingppp.gihub.org/

- the data in the GI Hub report is based on a representative sample of 250 projects randomly selected from the 3736 PPP projects which, globally, achieved financial close from 2005 through 2015

- out of this sample group of 250 projects, information on renegotiations was available for a total of 146 projects

- in those 146 projects, there were 48 instances of renegotiation, i.e. renegotiations had taken place (as of mid-2018) in 33% of the PPP projects that were studied

- the true prevalence of renegotiation is likely higher, since many of the 146 projects were still at an early stage (for the 51 projects that had reached their tenth year after financial close, 45% had been renegotiated)

The Prevalence of PPP Renegotiations (cont.)

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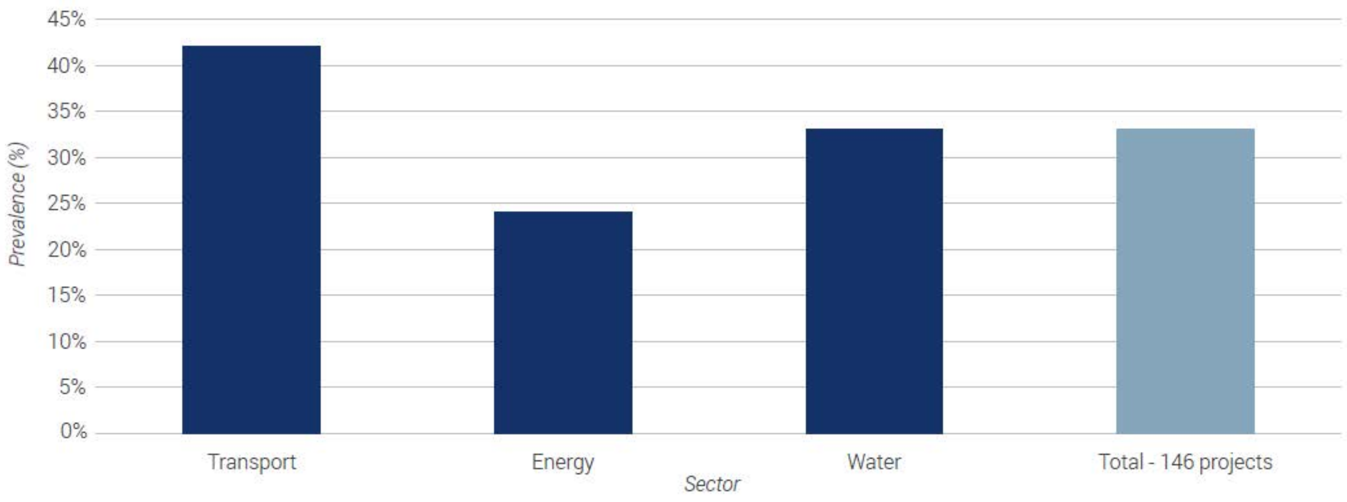
In terms of sectors, the GI Hub data indicates that PPP renegotiations occur most frequently in transport and water projects



The Prevalence of PPP Renegotiations (cont.)

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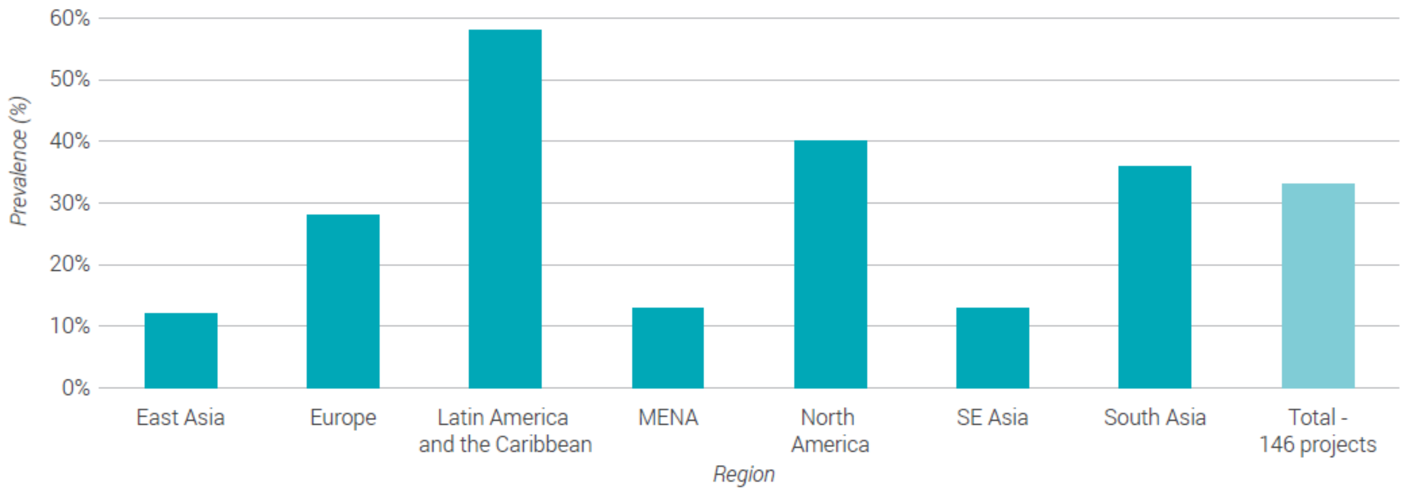
Within Asia, the data indicates that the highest percentage of PPP renegotiations takes place in the South Asia region



***the high incidence of renegotiation in Latin America is partly due to the Brazilian government unilaterally changing electricity tariffs in 2012, which led to the renegotiation of many PPP energy projects**

The Prevalence of PPP Renegotiations (cont.)

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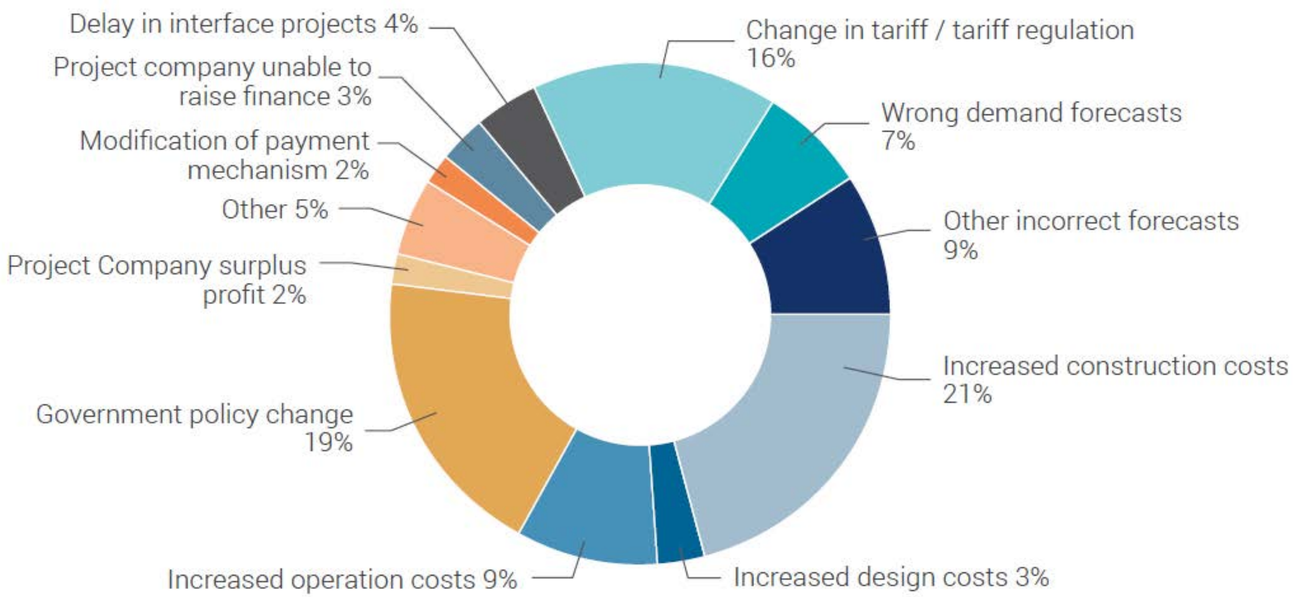
The GI Hub report identified various drivers of renegotiation within the dataset, with the most common being construction cost overruns and government policy changes



Issues and Concerns with Renegotiations

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Renegotiations are sometimes necessary but, frequently, they could have been avoided

- as noted in the GI Hub report, renegotiations can arise from many causes
- occasionally, economic conditions will change unexpectedly due to conditions beyond the control of the parties (e.g. global pandemics)
- more commonly, demands for renegotiation arise due to poorly drafted contracts, or poorly prepared bids
- another major cause of renegotiation is opportunistic behavior on the part of Contracting Authorities or Project Companies:
  - governments may decide to expand the scope of the project, adjust tariffs, or unilaterally act to capture 'windfall profits'
  - Project Companies may believe that the circumstances give them considerable leverage over the government Contracting Authority

Issues and Concerns with Renegotiations (cont.)

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Renegotiation may help to save a failing PPP Project, but the process can be problematic

- the high incidence of renegotiation calls into question the credibility of the process for awarding PPP transactions
- it distorts the bidding process, by rewarding bidders who are not necessarily efficient project developers but who are skilled (re)negotiators
- a key concern is that renegotiations take place without the competitive pressure of the bidding process

Issues and Concerns with Renegotiations (cont.)

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The renegotiation of a high-profile PPP project can be especially challenging, as was the case in Portugal's Vasco da Gama (Lusoponte) Bridge Project

- in 1995, the Government of Portugal signed the Vasco da Gama Bridge concession agreement with Lusoponte
- following a series of 'economic rebalancings', the government initiated, in 2000, a major renegotiation, to eliminate the need for further changes
- under intense political pressure, the government conceded significant benefits to Lusoponte, including:
  - direct financial compensation of € 306M
  - an increase in the concession period
  - a favourable change in the risk allocation matrix
  - elimination of O&M responsibilities for an adjacent bridge
  - compensation for any future corporate tax rate changes
- in 2008, another renegotiation gave Lusoponte more benefits
- many critics have described this as a case of serious government mismanagement

Vera-Cruz Pinto, E. (2012), *The Lusoponte Concession: Case Study* available at: http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.823.4749&rep=rep1&type=pdf

Issues and Concerns with Renegotiations (cont.)

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Another significant example of problematic PPP renegotiation is the massive Oderbrecht corruption scandal

- **in a case brought by the US Department of Justice, Oderbrecht (a Brazilian construction company) was found to have systematically engaged in corrupt practices on more than 100 large infrastructure projects (PPP and non-PPP) in ten Latin American and two African countries**
- **on PPP projects, Oderbrecht frequently won contracts by submitting very low-priced bids – and then bribed the officials responsible for handling subsequent renegotiations**
- **in 2016, Oderbrecht was fined a total of USD 2.6 billion, and numerous government officials have since been arrested**

Campos, N (2019), *Renegotiations and Corruption in Infrastructure: the Oderbrecht Case*, available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3447631

Melbourne Train-Tram Renegotiations Case Study

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The 2003-04 renegotiation of the PPP Contracts for Melbourne's train-tram system has been well-studied, and is generally regarded as being successful

- **the Melbourne Train/Tram franchise renegotiation process is generally regarded as a good example of a well-managed and mutually beneficial renegotiation**
- **a significant amount of information on the process is publicly available, due to the PPP transparency initiatives of the Government of Victoria, and the existence of a comprehensive public report on the renegotiation, prepared by the Auditor General of Victoria***
- **there is also a World Bank paper that discusses the transaction, in the context of other privatizations and PPP transactions in the regional rail sector: *Results of Railway Privatization in Australia and New Zealand*****

*available at https://www.audit.vic.gov.au/report/franchising-melbournes-train-and-tram-system

**available at https://openknowledge.worldbank.org/handle/10986/17403

Melbourne Train-Tram Renegotiations Case Study (cont.)

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Background of the initial PPP contracts awarded in 1999

- in 1992, a conservative coalition government came to power in the Australian State of Victoria, and it took measures to improve the efficiency of the state-owned tram and train services in and around Melbourne, which were heavily subsidized by the state government
- as a result, staff levels were cut from 18,000 to 8400, and the level of government subsidy was significantly reduced*
- to continue the reform process, the government decided, in 1999, to enter into a series of PPP transactions, splitting the system into four franchises (two for rail services and two for tram services), thereby creating a system whereby the private operators could be compared to one another
- the franchises were to be for 12 to 15 years

*source: G. Currie, *A Review of Melbourne's Rail Franchising Reforms*, November 2009
https://pdfs.semanticscholar.org/8cdf/94789f4ed6fc3d4619713080aac1bcb9de5a.pdf

Melbourne Train-Tram Renegotiations Case Study (cont.)

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Key parameters of the initial PPP contracts

- a competitive tendering procurement process was followed, with the main bidding parameter being the amount of subsidy that would be paid by the government to the winning bidder (the operator) in the form of fixed annual payments
- in addition, each operator would be able to earn a variable payment, based on farebox revenue, split between all of the operators according to a ridership formula (with user fares tied to inflation)
- each operator was required to commit to an extensive investment program, including new and refurbished rolling stock

Melbourne Train-Tram Renegotiations Case Study (cont.)

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Results of the initial PPP tender process

- three firms won the four franchises on offer:
  - National Express Group (a UK-based firm) won one of the rail and one of the tram franchises (plus a separate country rail franchise)
  - Connex Melbourne (a subsidiary of the French firm Veolia) won the other rail franchise, which it operated as Melbourne Trains
  - MetroLink Victoria (an Australian consortium, later becoming TransdevTSL) won the other tram franchise, which it operated as Yarra Trams

Melbourne Train-Tram Renegotiations Case Study (cont.)

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The government's view of the tender process

- **the government was very pleased with the outcome of the tendering process, announcing that the new arrangements would:**
  - **achieve cost savings of some AUD 1.8 billion, including a substantial reduction in government operating subsidies to almost zero by the end of the franchise period**
  - **cut the cost of operations (relative to the public sector system) by a further 24%**
  - **increase ridership by 40-84% over the length of the franchise period***

*source: G. Currie, *A Review of Melbourne's Rail Franchising Reforms*, November 2009 (see above)

Melbourne Train-Tram Renegotiations Case Study (cont.)

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Problems during the initial years of operation

- by 2002, each of the franchisees were in severe financial difficulties, primarily due to
  - unrealistic revenue and cost estimates
  - flaws in the innovative contractual arrangements such as, for example, the infrastructure maintenance provisions
  - the complexity of the farebox revenue sharing scheme, which led to numerous disputes
  - delays in the introduction of the new electronic ticketing system
- in December 2002, National Express withdrew from its contracts, forfeiting performance bonds with a value of AUD135 million and writing off approximately AUD300 million in losses*

*source: G. Currie, *A Review of Melbourne's Rail Franchising Reforms*, November 2009 (see above)

Melbourne Train-Tram Renegotiations Case Study (cont.)

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The decision to renegotiate

- the new government (from the Labour Party) decided to restructure the system into a single train franchise and a single tram franchise, and award these two new franchises to the remaining franchisees, pursuant to a bilateral negotiation process – i.e. a renegotiation
- the renegotiation involved a new allocation of risks, with the Government of Victoria accepting many risks previously assigned to the operators – including risks associated with the condition of the infrastructure
- the new franchise agreements were for a shorter period of time, lasting only until November 2008

Melbourne Train-Tram Renegotiations Case Study (cont.)

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Principal tools used by the government

- the principal tools which the government used during the renegotiation process were two financial models (one for the train system and one for the tram system) in the form of "public sector benchmarks"

- using these models, the government was able to assess
  - whether the offers submitted by the franchisees provided 'value for money', and
  - whether the offers were financially sustainable

Melbourne Train-Tram Renegotiations Case Study (cont.)

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Additional tools used by the government

- in addition to the use of the two public sector benchmarks, the government also employed a number of other techniques during the renegotiation process, including
  - undertaking an analysis of the comparative profits earned by operators engaged in similar activities in other countries;
  - requiring the franchisees to allow 'open book' evaluations of their prior financial records in advance of receiving their offers
  - attempting to replicate competitive tension by conducting the renegotiation process in a way that would have allowed for a competitive tender should the renegotiations have failed (by, for example, establishing a comprehensive data room)
  - having government staff develop a 'dummy offer', which could be compared with the actual offers received
  - requiring profits in excess of 125% of forecast levels to be shared with the government

Melbourne Train-Tram Renegotiations Case Study (cont.)

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Results of the renegotiations

- some commentators have suggested that the Melbourne experience is an example of opportunistic bidding by the original franchisees, since the renegotiations resulted in an increase in the government subsidy and the fares paid by end-users

- however, there were also service quality enhancements during the term of the renegotiated franchises, and continued growth in the number of passengers

Melbourne Train-Tram Renegotiations Case Study (cont.)

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Subsequent review of the performance of the rail franchisee (Connex)

- in July 2008, a benchmarking study of urban rail systems in Australia* compared the Connex system with the publicly-owned CityRail system in Sydney (now Sydney Trains), with the following conclusions
  - Connex had annual rolling stock costs that were 40% less than CityRail
  - Connex had crewing costs which ranged from 17-29% less than CityRail
  - Connex's operating costs per train station were 43% better than CityRail
  - Connex's overhead costs per employee were less than 50% of CityRail
  - Connex's employees per service kilometer were less than 50% of those of CityRail

*source *Cost Review of CityRail's Regular Passenger Services*, LEK Consulting Report for the Independent Pricing and Regulatory Tribunal, Sydney, New South Wales, at www.ipart.nsw.gov.au/files/sharedassets/website/trimholdingbay/lek_cityrail_efficient_costs_final_public_report_-_06_june_2008.pdf

Melbourne Train-Tram Renegotiations Case Study (cont.)

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Key 'lessons learned' from the case study

- in retrospect, it is clear that the subsidies requested by the bidders in 1999 were unrealistically low, and reflected an 'optimism bias' in favour of unrealistic demand growth
- the government could have refused to renegotiate (in which case the two remaining franchisees would likely have gone into administration and the PPP contracts terminated) or it could have simply increased the level of subsidy – instead, it chose to enter into bilateral renegotiation discussions
- a subsequent 2007 Report prepared for the government by Deloitte* concluded that the "*performance of the incumbent operators has been sound when assessed against the 2004 tender evaluation criteria and KPIs in each franchise Business Plan*"

**Refranchising Melbourne's metropolitan train and tram networks*, available at https://library.pppknowledgelab.org/documents/1369/download

Melbourne Train-Tram Renegotiations Case Study (cont.)

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Developments since 2009

- in 2009, the Victoria government decided to have a full competitive tender for new eight-year contracts
- both of the incumbent franchisees participated in that tender process but lost to other bidders:
  - Metro Trains Melbourne, a Hong Kong/Australia consortium, was awarded the rail franchise (under the name Metro Trains)
  - KDR Melbourne, a French/Australia consortium, was awarded the tram franchise (keeping the name Yarra Trams)
- following a 2016 assessment by the Victoria Auditor-General*, the government allowed the incumbent operators to bid, on a sole-source basis, for seven-year extensions of their franchises, if they accepted new performance targets
- new contracts are now in place, expiring in 2024**

*available at http://www.audit.vic.gov.au/publications/20161107-Rail-Franchisees/20161107-Rail-Franchisees.pdf

**see https://www.theage.com.au/national/victoria/tough-new-conditions-fines-for-metro-trains-and-yarra-trams-20170912-gyfjiv.html

Nine Proposals for Governments on PPP Renegotiations

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The GI Hub report on *Managing PPP Contracts After Financial Close* sets out nine proposals for governments in regard to PPP contract renegotiations – these are the first three

- introduce policies to limit frequent renegotiations
  - a high frequency of renegotiation can encourage opportunistic bidding and corruption
  - Chile's 2010 PPP reform legislation created a Technical Experts Panel which assesses whether renegotiations are fair*
- be mindful of opportunities that may be available through renegotiation
  - renegotiations can be mutually beneficial , as was the case in Jordan's Queen Alia Airport Expansion Project
- fully assess the appropriateness of a renegotiation
  - is the request for renegotiation related to a risk that was evident at the time of bidding**

*discussed in *When and How to Use PPPs in Infrastructure* (2020) Engel *et al.*, available at https://www.nber.org/chapters/c14362.pdf

** see Section 4 of the OECD ITF report on *Renegotiations, How to Approach Them and Economic Outcomes*, available at http://www.internationaltransportforum.org/jtrc/DiscussionPapers/DP201425.pdf

Nine Proposals for Governments on PPP Renegotiations (cont.)

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These are proposals four through six in *Managing PPP Contracts After Financial Close*

- **consider termination as an alternative to renegotiation**
  - **if a PPP project has become unviable, termination may be preferable to renegotiation, but the full costs of termination (including reputational costs) must be examined**
- **ensure that there is adequate resourcing for the renegotiation**
  - **renegotiations require the same level of financial, legal and technical expertise as was used to develop and procure the initial PPP contract**
  - **Project Preparation Facilities may not have a mandate to provide such support**
- **consider the transparency of the process**
  - **governments should be able to demonstrate to the public the costs, risks and benefits of a renegotiation**
  - **if a renegotiation is needed to expand the scope of the original PPP, an auction process should be considered***

***discussed in *When and How to Use PPPs in Infrastructure* (2020) Engel *et al.* (see above)**

Nine Proposals for Governments on PPP Renegotiations (cont.)

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These are the final three renegotiation proposals in *Managing PPP Contracts After Financial Close*

- **ensure compliance with the governing regulatory framework**
  - ensure that fiscal authorities and other relevant agencies are aware of the implications of the renegotiation (in the Philippines, for example, the Investment Coordination Committee evaluates major infrastructure investments)

- **consider the impacts on other private sector affected parties**
  - lenders and key contractors may be impacted by a renegotiation, and their interests need to be considered

- **be aware of the broader implications**
  - if the risk allocations on a particular project need to be renegotiated, it may be appropriate to re-examine similar arrangements on other PPP projects in the country

Renegotiations During the Pandemic

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Recommendations from the Multilateral Development Banks

- in a May 2020 ADB blog post*, it was noted that:

  > *While renegotiation should be avoided if possible, it is likely that due to the long-term time frame of PPP contracts, or due to a crisis such as COVID-19, some renegotiations and contract adjustments will be inevitable...*

- similarly, in a June 2020 World Bank blog post**, the following comment was made in regard to addressing the impacts of the pandemic on PPP transactions:

  > *These impacts can be mitigated with modest success through force majeure and compensation clauses, using bridge financing, capital injections, renegotiation of key project parameters, and introduction of regulatory flexibility on performance indicators, among other measures.*

* https://blogs.adb.org/another-covid-19-challenge-saving-asia-s-crucial-infrastructure-deals
** https://blogs.worldbank.org/ppps/how-world-bank-looking-covid-19-and-public-private-partnerships-right-now-and-post-crisis

Renegotiations During the Pandemic (cont.)

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The OECD *Report on Public Procurement and Infrastructure Governance: Initial policy responses to the Coronavirus (Covid-19) crisis*

- **in July 2020, the OECD reported* on the different approaches being taken by various OECD member countries in managing ongoing infrastructure contracts during the pandemic:**
  - **the UK issued guidelines** for its PFI contracts which encouraged government contracting authorities to consider "*revising contract requirements/standards (including scope changes were necessary) and moderating payment and performance mechanism regimes where appropriate*"**
  - **governments in the civil law countries of France, Spain and Portugal issued guidelines to contracting authorities on how to apply the 'economic rebalancing' provisions in their concession agreements**

* http://www.oecd.org/coronavirus/policy-responses/public-procurement-and-infrastructure-governance-initial-policy-responses-to-the-coronavirus-covid-19-crisis-c0ab0a96/

** https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/878059/2020_04_02_PFI_and_COVID19_final.docx.pdf

Renegotiations During the Pandemic (cont.)

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A Proactive Approach by the Government of the Philippines

- in response to concerns regarding the impact of the pandemic on the infrastructure projects in its "Build, Build, Build" program, the Government of the Philippines suggested in July that the projects could be renegotiated
- given that the Build, Build, Build program focuses on Operation and Maintenance concessions, the proposed renegotiations included arrangements for:
  - extending the term of the concessions, so as to give the private sector more time to earn a return; and
  - deferring the obligations of the concessionaires to share project revenues with the government
- on 26 October 2020, the Presidential Advisor on Flagship Programs and Projects indicated, during a media interview, that these 'sweeteners' were currently being discussed with the private sector*

* https://business.inquirer.net/310452/more-ppps-eyed-to-expand-dutertes-infra-pipeline

Renegotiations During the Pandemic (cont.)

Some Concluding Observations

- the pervasiveness of the COVID-19 crisis is such that it may impact multiple projects in every country with PPPs – placing an exceptional burden on capacity-constrained line ministries and fiscal authorities
- in response, a 'triage' approach (as discussed in recent academic literature*) may be appropriate, to identify different categories of PPP transactions:
  - transactions that do not require assistance;
  - transactions that require renegotiation; and
  - transactions that should be terminated
- if pandemic-related renegotiations become necessary, have regard to the nine proposals discussed above, especially those proposals regarding 'transparency' and 'broader implications'

* https://www.mdpi.com/2071-1050/12/13/5253

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