Managing Public-Private Partnership (PPP) Renegotiation

Introduction
Public-private partnership (PPP) renegotiations of infrastructure projects have the potential for abuse, as evidenced in Brazil, which was the epicenter of one of the largest corruption scandals in history. The scandal centered around bribes and the use of renegotiations. The firm at the center of this scandal, Odebrecht, obtained contracts through competitive processes but underbid the contracts. Once Odebrecht won with a lowball bid and came to commercial close, it was able to renegotiate the contracts. In fact, PPPs are not different from traditional provision, but are renegotiated much more often than similar private contracts.\(^4\) PPP renegotiations can allow governments to elude spending controls and defer costs to future administrations, while companies can use renegotiations and bribery to build market share. While renegotiation should be avoided to the extent possible, it is likely that due to the long-term time frame of PPP contracts, renegotiations will from time to time be needed, and governments will benefit from understanding good policy for conducting them. The following examples of good practice demonstrate the importance of appropriate transparency and accounting for any additional fiscal costs related to renegotiation in the public sector budget. Significant additional investment due to renegotiation should be subject to an independent review outside the procuring agency and subject to cost benefit analysis like other public investment projects.

Opportunities and risks of using PPPs to finance public infrastructure

PPPs constitute a relatively small percentage of overall infrastructure investment. A recent World Bank paper\(^5\) shows that the public sector clearly dominates, with the private sector accounting for only 9 to 13 percent of total infrastructure investments (14 to 31 percent without China). However, there is considerable variation across regions, from a low of 2 percent in East Asia and the Pacific to a high of 35-46 percent in South Asia. Even though private investment represents a relatively low percentage of infrastructure investment, PPPs are often used in the larger and more complex and strategically important projects, and therefore receive more attention from policy makers than the actual percentage of projects would suggest. Governments may also be tempted to use PPPs to get around the fiscal constraints of big and politically important projects by not including PPP liabilities in the national accounts.

Renegotiation refers to changes in the contractual provisions of a PPP contract, when these changes are negotiated between a project company and the government\(^6\) outside rather than through the adjustment mechanisms contemplated in the contract.\(^7\) Renegotiation is something to avoid where possible. Misuse of the renegotiation process...
The impact of contract renegotiations on good governance

While some renegotiations are efficient and carried out for valid reasons and according to the change management provisions within the contract, others are opportunistic.

• Renegotiations have the potential to reduce the transparency that existed during competitive bidding, which may also be controversial in terms of public perception.

• Competitive bidding may be distorted, and the most likely winner is not the most efficient company, but the one most skilled in renegotiation.

• Where a contract is renegotiated and the agreed risk allocation changes after the preferred bidder has been selected, it is no longer obvious that the project company that was awarded the project offers the most cost-effective solution. This is because the originally tendered project and the renegotiated project are in essence two different projects.

• A project’s value for money becomes less clear in the absence of competition for any additional works required. Renegotiations have the potential to reduce the overall economic benefits of PPP arrangements by changing the tendered and agreed risk allocation and revenue.

• A government is often under political pressure to deliver on the promised infrastructure, and a delay in construction puts power into the hands of the project company that can enable monopolistic pricing. This pricing power can be exacerbated if PPPs are off-balance sheet transactions and not counted as public debt, thus less subject to public oversight and accountability.

PPP contracts typically include several mechanisms, such as scope change provisions for minor scope changes and claims procedures, to manage circumstances that were not fully understood or envisaged at financial close, without the need for a renegotiation. Simple correction of errors or clarification of contract drafting can also typically be dealt with under existing provisions in the PPP contract and do not require renegotiation.

The World Bank Guidance on PPP contractual provisions\(^5\) provides sample standard language for PPP contracts that govern change management. This includes best international practice for provisions related to force majeure, material adverse actions by government, dispute resolution and contract termination. The actual provision will depend on the regulatory framework in each jurisdiction. Contractual clauses may specify under what conditions a renegotiation takes place and what the process will be.
Economic rebalancing refers to the practice of modifying the financial conditions (i.e. ‘economic equilibrium’) that were agreed as part of the original contract, with the intention of preserving or restoring the original economic equilibrium (rate of return) of the PPP contract. This can occur after a risk borne by either party has materialized and is claimed to have economic consequences. For example, a force majeure event, a scope change, a change in macro-economic conditions, a change in law, or a major change to demand. Rebalancing provisions may potentially be abused as it shifts demand risks to the government and private sector claims may be based on changes that are subject to change over the life of the contract. The type of renegotiation is specific to some civil law jurisdictions (e.g. several countries in Latin America) and differs from the provisions of a typical common law PPP contract. In common law jurisdictions, events such as scope changes and changes in law are typically managed under specific scope change provisions and claims procedures. Rebalancing may also be activated in favor of the Procuring Authority. For example, if the construction of an adjoining bypass increases demand and therefore toll revenue on a PPP road project, the PPP contract could be rebalanced in favor of the government with reduced tariffs, sharing excess profits with the government, or a reduction to the contract period.

Global data on PPP renegotiation

The Global Infrastructure Hub (GIH) carried out a global study on renegotiation and found 48 instances of renegotiation in the 146 projects for which data was available, or approximately one in every three projects (see Table 2.1). Contract renegotiation is particularly prevalent in Latin America (58%) and in the transport sector (42%). The average period of time after financial close for renegotiation to occur was 3.6 years. Where the renegotiation occurred during the construction phase, it occurred on average 2.5 years after financial close. Where it occurred during the operations phase, it was on average 5.0 years after financial close.

In addition, the most common cause of renegotiation was found to be increased costs in construction or operations, while the most common outcome of a renegotiation was a change in tariffs. Given the timeframe for the study (projects that reached financial close between 2005 and 2015, inclusive), almost all the projects are still in progress, and therefore may incur further renegotiations in the future. This suggests that renegotiation is likely to be higher than was found in the study.

<table>
<thead>
<tr>
<th>Region</th>
<th>Project with Data</th>
<th>Renegotiation Events</th>
<th>Percentage</th>
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</thead>
<tbody>
<tr>
<td>East Asia</td>
<td>17</td>
<td>2</td>
<td>12%</td>
</tr>
<tr>
<td>Europe</td>
<td>43</td>
<td>12</td>
<td>28%</td>
</tr>
<tr>
<td>Latin America and the Caribbean</td>
<td>43</td>
<td>25</td>
<td>58%</td>
</tr>
<tr>
<td>Middle East and North Africa</td>
<td>8</td>
<td>1</td>
<td>13%</td>
</tr>
<tr>
<td>North America</td>
<td>5</td>
<td>2</td>
<td>40%</td>
</tr>
<tr>
<td>South Asia</td>
<td>14</td>
<td>5</td>
<td>36%</td>
</tr>
<tr>
<td>South East Asia</td>
<td>8</td>
<td>1</td>
<td>13%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>146</strong></td>
<td><strong>48</strong></td>
<td><strong>33%</strong></td>
</tr>
</tbody>
</table>

Source: Global Infrastructure Hub, PPP Reference Tool, Renegotiation, Chapter 4, 2018
These findings for Latin America in the GIH study correspond to an earlier landmark study on PPP renegotiation, which also showed pervasive renegotiation of PPPs in Latin American countries, particularly ones where the PPP model is that of user-pays rather than government-pays PPPs. Of a sample of over 1,000 concessions granted in the Latin America and Caribbean region between 1985 and 2000, Guasch found that 10 percent of electricity concessions, 55 percent of transport concessions, and 75 percent of water concessions were renegotiated. These renegotiations took place an average of 2.2 years after the concessions were awarded. Guasch suggested the high rate of renegotiation so soon after concession award may reflect poorly designed tender processes, weak regulation, or opportunism on the part of the government or the private sponsors. Most renegotiations were favorable to the operator—for example, resulting in increased tariffs, or reduced or delayed investment obligations.

In Figure 2.7, the GIH report shows that the reasons cited for renegotiation vary, with the most frequent cause being increased construction costs (21%) followed by government policy change (19%) and change in tariff or tariff regulation (16%). The reasons given in the figure below for a renegotiation may be legitimate. While not feasible within the scope of this paper to analyze individual contracts, it is reasonable to suggest that at least some of the reasons given for renegotiation may mask more opportunistic behavior by the private sector and their government counterparts to obtain an additional benefit not envisioned in the original contract approved by government.
**Country experience in managing renegotiation risks**

**Brazil** allows economic rebalancing to manage changes in a PPP contract. While this allows a renegotiation within the framework of a competitively bid contract, it has the potential for abuse as evidenced in Brazil, which was the epicenter of one of the largest corruption scandals in history. The Odebrecht Construction Company scandal left one former president in jail; another is on the run; another resigned; and another one committed suicide before he could be arrested. It affected a Vice President, ministers, senators, and billionaires. Around 200 politicians and public officials were bribed. It affected 12 countries in Latin America and Africa and delayed many large infrastructure projects. While the scandal relied on an elaborate bribery scheme involving public officials and the media, the bribery is also linked to renegotiations. Odebrecht obtained contracts through competitive processes but underbid the contracts, and in at least one case, its bid was under the next lowest technically qualified bidder by 25 percent. Once Odebrecht won with a lowball bid and came to commercial close, it was able to renegotiate the contracts. In fact, PPPs are not different from traditional provision, but are renegotiated much more often than similar private contracts.58

Some countries, such as Colombia and Peru find it helpful to impose a moratorium on renegotiation during the first three years of a project to address lowball bids.59 **India** has few renegotiations due to a strict framework for PPP contracts, which only allows changes due to a defined change in law and force majeure events outside the control of the concessionaire. **South Africa** has a robust PPP framework that requires the procuring authority to obtain Treasury approval for any material amendment in terms of an amendment agreement that must be approved by the Ministry of Finance. The Ministry of Public Works and the Ministry of Finance. Conditions for the amendment include that (i) the facts and circumstances causing the amendment to occur after contract award could not have been foreseen upon its awarding, and (ii) any other factor of the concession’s agreement upon the contract to enter into a stage of liquidation without the government stepping into the contract. The “let the market work” approach enabled the lenders to step in and sell the concession through competitive bidding rather than the government renegotiating the contract with the project company and bailing out shareholders. Nevertheless, if the PPP market is relatively undeveloped, as in many developing countries, there may not be other parties willing to take over the project through such a process, and it may be necessary for the government to take measures to prevent a complete failure of the project.61

**Chile** has one of the most developed regulations concerning renegotiations. It permits changes to contracts for works and services that raise the service levels and technical standards by up to 15% of the approved capital value. If there is no cost to the government, then no agreement is necessary. If additional investment by the private partner is required due to conditions that occur after contract signing, the government and the private partner may increase the additional investment value by 20 percent in terms of an amendment agreement that must be approved by the Ministry of Finance. The Ministry of Public Works must be able to justify the changes in a public report. To avoid monopolistic pricing by the contractor, if the price increase exceeds 5 percent of the approved capital works, it must be put out to open and competitive tender by the private partner. The private partner is then compensated by one or a combination of subsidies provided by the state: a voluntary payment made directly to the concession holder by third parties interested in the development of the works, a modification to the current amount of the concession revenues, a change in the concession term period, a modification to the rates of return, or any other factor of the concession’s agreed upon economic regime.

During the construction phase, if a variation exceeds 25 percent of the capital budget, the amendment agreement must be approved by the Ministry of Public Works and the Ministry of Finance. Conditions for the amendment include that (i) the facts and circumstances causing the amendment to occur after contract award could not have been foreseen upon its awarding, and (ii) the new works to the original concession holder is more efficient than granting a new concession, for reasons including expertise, behavior, performance, social and environmental impacts, management economies or economies of scale. The technical
Transparency in Renegotiation

Many countries have access to information laws requiring public disclosure of contracts, project summaries and pipelines, but few publish information on contract variations that occur as a result of a renegotiation. Two notable cases are South Africa and the United Kingdom. South Africa provides full disclosure upon request of all documents in the possession of the government, except confidential information relating to trade secrets, proprietary information or other information which cannot be disclosed. Material changes to contracts are called “variations” and must be approved by the National Treasury and like all information in possession of government can be accessed by the public by making a request under the Promotion of Access to Information Act. In the United Kingdom, the public has access to all documents held by a public authority, under the provisions of the Freedom of Information Act of 2010. The transparency regime requires that variations to contracts, including for renegotiations need to be published when the variation changes the contract significantly resulting in a new contract.

Source: Disclosure of Project and Contract Information in Public-Private Partnerships, World Bank Institute, January 2013

BOX 2.5

Transparency in Renegotiation for Public-Private Partnerships

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guidance is suggested to reduce the probability of opportunistic renegotiations.

Avoid renegotiation to the extent possible:

- Good project preparation requires up-to-date technical, financial and economic, environmental, and social feasibility studies that can help avoid the need for renegotiation by identifying risks upfront and allocating these risks to the parties best able to manage or mitigate the risks. It is important that risks are identified and costed out upfront and updated as more information becomes available over the project cycle from planning and feasibility to the design and structuring of the contract. This goes hand in hand with the need for transparency, competition, and public disclosure of the award of all PPP contracts, as these can also help reduce renegotiation.

- PPPs should be on the government balance sheet and not off-budget. This includes renegotiated amounts that should be accounted for as current public investment with a dollar for dollar impact on the deficit. This will help avoid incurring future liabilities without the knowledge of the budgetary authorities.

- Project contracts should provide mechanisms to address conflict and changes. As noted above, the World Bank publication entitled Guidance on PPP Contractual Provisions offers standardized contractual language based on international best practices for PPPs to cover areas that lead to contractual changes, such as force majeure, material adverse actions by government, dispute resolution, and contract termination. These clauses define under what conditions a renegotiation takes place and what the process will be for resolution.

- Bids should be evaluated based on the best overall economic offer rather than the lowest price, taking into account the overall lifecycle cost of the project. This will help avoid the problem of lowballing and deliver better value for money.

If significant changes are to be made in the scope of works:

- Significant works agreed to through a renegotiation must be tendered competitively, as in the case of

Present Value of Revenue Contracts in Infrastructure Partnerships

In the standard fixed-term highway PPP contract with tolls, the concessionaire bears the risk if traffic volume is low. Low traffic volume often triggers renegotiations for increased tolls. On the other hand, a flexible-term contract, where the winning bidder proposes a fixed amount in user fees in present value terms, eliminates demand risk of the concessionaire. These Present-Value-of-Revenue (PVR) contracts are a type of built-in renegotiation, extending the contract term when the traffic volume is lower than expected, thereby avoiding that source of opportunistic behavior. Chile began using PVR contracts for most transportation PPPs in 2007 and reformed its PPP legislation in 2010. The reform created the independent technical panel that reviews and authorizes renegotiations and requires the owners of the Special Purpose Vehicles to compete for additions to the initial project. The combination of both policy innovations was followed by a reduction in renegotiations, as a fraction of investment, of more than 90 percent.

Chile, to avoid the private sector partner abusing the renegotiation process to generate work for itself on a sole source basis. It has also started using present value of revenue contracts for transport projects to automatically adjust the length of a contract when low demand reduces revenues and shorten the contract period when demand exceeds the contractual provisions for revenue.

- The government should provide a full justification and consider a forward-looking audit of the PPP to avoid unforeseen effects on other contractual provisions that could affect the public interest.

- The government should establish a defined and transparent process and framework for renegotiation subject to external audit. As we have seen in the case of Chile, Australia and the EU, the case for a renegotiation should be made explicit and recorded so that the decisions are made in a rational and defensible manner.

- The government should disclose evidence to demonstrate that project distress is material and likely to result in default under the PPP contract and cause adverse outcomes for the public sector and/or users of the service. The final decision on a renegotiation should be based on full disclosure of long-term costs, risks, and potential benefits.

- In developing markets with weaker institutional frameworks, or where renegotiation is a persistent problem, the government should consider, as in the case of Colombia and Peru, banning renegotiations during the first few years after commercial close to avoid lowball bids. This approach, however, runs the risk of failing to address justifiable contract modifications that may occur and cannot replace the importance of sound project preparation and risk allocation.

- Involvement of independent monitors, such as a technical panel of experts in the Chile case study or a requirement for Cabinet approval as in the case of Australia, can help the government respond to a request for changes. If the private partner perceives the government as open to renegotiation, this may encourage opportunistic private sector behavior, submitting low bids in the hope of renegotiation after financial close.

<table>
<thead>
<tr>
<th>Key Messages for Policy Makers</th>
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<tbody>
<tr>
<td>Fiscal Transparency</td>
<td>Renegotiated amounts should be counted as current public investment and expenditure and accounted for in the budget of the country. Significant additional investment should be subject to an independent review outside the procuring agency and subject to cost benefit analysis like other public projects.</td>
</tr>
<tr>
<td>Project Preparation</td>
<td>Sound project preparation can mitigate risks through robust cost benefit analysis, social and environmental impact, economic and financial and technical feasibility studies. Project preparation should include a competitive and transparent procurement process based on value for money and not on the lowest cost bids</td>
</tr>
<tr>
<td>Expert Advice</td>
<td>Renegotiations can cover complex financial and economic issues which can be a challenge for new PPP units and governments without the necessary experience and expertise. It is in the interest of the government to have the best expert advice for these negotiations with the private sector.</td>
</tr>
<tr>
<td>Be Proactive</td>
<td>Do not wait for problems to grow and become more costly. The procuring authority should establish mechanisms for two-way communication with the private partner to catch disputes as early as possible when the opportunity for resolution is higher.</td>
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