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## Adjustment Mechanisms

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PPP projects are long-term, and are often risky and complex. For example, a new toll highway faces obvious risks such as fluctuations in demand, but also hidden risks such as demand to provide more interchanges in the future, or install new traffic management technologies. More complex PPPs, such as water concession contracts, are even more exposed to unpredictable changes. Network assets may last more or less time than assumed. Demands for changes in treatment and distribution technologies may flow from new health research, while urban growth may create large investment demands, sometimes in unpredicted locations.

This means PPP contracts are necessarily incomplete—that is, they cannot fully specify all future possibilities. The PPP contract therefore needs to have flexibility built in—to enable changing circumstances to be dealt with as far as possible within the contract, rather than resulting in re-negotiation or termination. Such adjustment mechanisms typically aim to create a clear process and boundaries for change.

The concept of financial equilibrium, common in civil law systems, provides a broad mechanism for dealing with several different types of change. Other mechanisms are more specific—such as mechanisms for changes to service requirements, changes to tariff formulae, other cost adjustments in response to market changes, or dealing with refinancing gains.

As described in the **EPEC Guide to Guidance** ([EPEC 2011b](#), 37–38), the administrative arrangements and processes for handling change are often further defined as part of the contract management framework and

materials (see [Establishing Contract Management Structures](#)). While rules and processes can be specified for changes, room for discretion is likely to remain. The contract therefore needs to define a process that gives both public and private parties confidence that their interests will be respected.

### **Financial equilibrium clauses**

Civil law systems commonly espouse a concept of financial equilibrium in contracting, which may be established in general administrative law, or defined in more detail in PPP-specific law or a particular contract. Financial equilibrium provisions entitle an operator to changes in the key financial terms of the contract to compensate for certain types of events beyond their control. Adjustments are based on a mutually-agreed financial model that is maintained over the lifetime of the contract. Three causes of unexpected changes that merit financial equilibrium revisions are typically defined as *force majeure* (major natural disasters or civil disturbances), *factum principis* (government action) and *ius variandi* (unforeseen changes in economic conditions). The **PPPLRC Website** ([PPPLRC](#)) provides more information and references on financial equilibrium clauses in its section: *Key Features of Common Law or Civil Law Systems*.

### **Changes to service requirements**

It may be difficult for the contracting authority to accurately anticipate service requirements over the duration of the contract. Contracts typically build in approaches for handling changes to service requirements in response to changing circumstances (which could also include changing technology). For example, the **Hong Kong PPP Guide** ([HK 2008](#), 68–71) describes how changes in circumstance can be dealt with. The **South Africa standardized contract provisions** ([ZA 2004a](#), Part K: 50) provide for four categories of variation:

- Variations with no additional cost
- Small works variation
- Institutional variations (changes in service requirements), and
- Variations requested by the private party

### **Changes to tariff or payment rules or formulae**

Tariffs or payments are often specified by formulae, as described in [Adjustment Mechanisms](#), to allow regular adjustments for factors such as inflation. The PPP contract can also include mechanisms for reviewing these formulae—whether periodic, or one-off changes in extraordinary circumstances (with specified triggers). Since these processes are analogous to regulatory tariff reviews, regulatory guidance material may be useful. The **World Bank's body of knowledge on infrastructure regulation** ([PURC 2012](#)) section on price level regulation describes key issues in tariff regulation, and guides readers in accessing a wide range of references.

### **Market testing and benchmarking operating costs**

Some PPP contracts require periodic market testing or benchmarking of certain sub-services in the contract, to allow costs to be adjusted to market conditions. This is typically done where a PPP includes provision of a long-lived asset (such as a school or hospital facility) together with soft services where market contracts are typically of shorter duration (such as cleaning). This approach is most common in PPP contracts in the United Kingdom Private Finance Initiative (PFI) tradition. One objective is that the price charged for the soft services should be kept in line with market conditions, through periodic challenges or benchmarking exercises. The other reason for market testing “soft” services is that service providers would normally be reluctant to provide a fixed price (with simple inflation indexation) for such services over a long period of time, because the actual costs are likely to get out of line with the indexation.

A **United Kingdom Operational Taskforce note** provides detailed guidance on benchmarking and market testing approaches ([UK 2006a](#)). The **United Kingdom's Department of Health** has also produced a code of best practice on benchmarking and market testing in hospital PFIs ([NAO 2010b](#)). This code provides guidance on how to manage the market testing process, focused on health facilities contracts—see also ([NAO 2011](#)).

## Refinancing

During implementation, changes to the project risk profile or in capital markets may mean the PPP company can replace or renegotiate its original debt on more favorable terms. As described in [How PPPs Are Financed](#), many PPP contracts set out rules for determining and sharing the gains from refinancing. For example, in 2004 the United Kingdom's Treasury introduced into its standard PFI contracts a 50:50 split of any refinancing gain between the investors and the government. The **EPEC Guide to Guidance** on PPPs ([EPEC 2011b](#)) also provides a succinct summary of how refinancing can be treated in the PPP contract.

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