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Termination Provisions

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In most cases, PPP contracts have a defined term. The contract typically sets out the contract termination date and arrangements for contract close and asset handover. The PPP contract, or in some cases the relevant PPP Law, should also specify circumstances in which the contract may be terminated early, and the consequences of termination in each case.

Contract term and asset handover

The PPP contract typically defines the contract term, and arrangements for any handover of project assets to the government. The most common approach is for the government to choose the contract term, in the draft contract, as the best estimate of the time needed for the private party to achieve its required return, at reasonable tariffs or payment levels. A second option, with a similar result, is to define tariffs or annual payments, and enable the contract length to be determined by bidders as one of the key bid variables. This approach was used, for example, in **Mexico's toll road program** (Fisher and Babbar 1996), where concessions were awarded to the bidder offering the shortest term.

A third alternative is to let the length of the concession be determined endogenously, as described by **Kerf et al** (Kerf et al. 1998, 83), by inviting bids on the basis of the **least present value of revenue (LPVR)**. This means the concession terminates when that value is reached—the higher the traffic, the sooner the concession terminates. This approach was set out by **Engel, Fischer and Galetovic** (Engel et al. 2002) to manage the risk of fixed-term concessions and has been used for toll roads in Chile and Colombia.

Kerf et al (Kerf et al. 1998, 81–82) and **Iossa et al** (Iossa et al. 2007, 73–78) both describe the trade-off between a shorter concession term—enabling the government to go back to the market to re-tender the concession—against the disincentive this can create for concessionaires to invest, particularly towards the end of the concession.

Given this disincentive, PPP contracts need to clearly define the approach to transition of assets and operations at the end of the contract. This typically includes defining how the quality of the assets will be defined and assessed, when and how to review asset condition ahead of the end of the contract (ideally several years prior), whether a payment will be made on asset handover, and how the amount of any payment will be determined. It can be particularly challenging to define handover standards at the start of a long-term contract. In addition, it may be difficult to get the private party to fulfill its investment commitments towards the end of the concession period. The following resources describe some possible approaches:

- The **World Bank’s toolkit for PPPs in roads and highways** (WB 2009a, Module 5, Stage 5) describes how asset standards at handover can be defined in terms of the remaining useful life of different parts of the asset.
- **Australia’s standard commercial principles** (AU 2011b, 120–124) specify use of an independent assessor, appointed near the end of the contract term, to assess the quality of the assets, and define the required handover condition.
- **The United Kingdom’s standard PFI contract** (UK 2007) requires inspection around two years before the end of the contract, on the basis of which any work required to bring the facility up to the required standard is specified. Fee payments may be withheld by the contracting authority and released only when the required work is carried out.

EPEC Guide to Guidance (EPEC 2011b, 42) describes how bonds or guarantees can be used to ensure asset quality at handover.

Provisions for early termination

The PPP contract needs to set out the conditions under which the contract may be terminated early, in which case the ownership of the project assets typically reverts to the public sector. This includes who may terminate and for what reason, and what if any compensation payment will be made in each case.

There are three broad possible reasons for early termination:

- Default by the private party
- Termination by the public party, whether due to default or for reasons of public interest
- Early termination due to an external reason (*force majeure*)

In each case, the government typically makes a payment to the private party and takes over control of the project assets, which may be re-tendered under a new PPP contract. Contractually-defined termination payments typically depend on the reason for termination, as summarized in Types of Early Termination and Termination Payments.

Some of these approaches to defining the termination payment—particularly when linked to the value of the project assets—require careful definition.

The following resources provide more guidance on termination causes, arrangements, and payments:

- **EPEC Guide to Guidance** (EPEC 2011b, 40–42) describes each of these causes of termination and the options for defining termination payments in each case.
- A more detailed **EPEC publication on termination provisions** (EPEC 2013) provides a review of current European practice and guidance on termination and force majeure provisions in PPP contracts.
- **Yescombe** (Yescombe 2007) also describes termination causes and options for termination payments, in greater detail.
- **Ehrhardt and Irwin** (Ehrhardt and Irwin 2004, 46–49) note that many PPP termination clauses protect lenders from any losses (that is, do not allow the PPP company to go bankrupt)—they describe why this can cause problems, and how bankruptcy could be a realistic option.
- **Clement-Davies on PPPs in Central and Eastern Europe** (EBRD 2007, 46) provides more information on lenders' step-in rights.

The standardized contracts listed in Examples of Standardized PPP Contracts and Contract Clauses also provide further examples of termination clauses in practice.

Notwithstanding careful provisions in the contract, early termination is typically costly for both parties, and is a last resort when other avenues have been exhausted. As described in the **EPEC Guide to Guidance** (EPEC 2011b, 40), this means the contractually-defined termination payments are important even if termination does not happen, since it defines the fallback position of each party in any dispute resolution or renegotiation.

Early termination payments are usually tailored in such a way that debt providers always have an interest in keeping the contract alive and services operational, thereby inducing them to step-in before issues of poor performance lead to default by the private party.

Types of Early Termination and Termination Payments

TERMINATION	TYPICAL TRIGGERS	DEFINING TERMINATION PAYMENT

Private party default	• Failure to complete construction • Persistent failure to meet performance standards • Insolvency of project company Lenders are typically given step-in rights to enable them to remedy problems due to an under-performing contractor—termination only occurs if this is ineffective, or if lenders choose not to do so	Termination payments are typically defined to ensure equity-holders bear the burden of default. Lenders may also be exposed to some possible loss—to strengthen their incentives to rectify problems—although this can affect bankability. Options include: • Full value or a specified proportion of outstanding debt • Depreciated book value of assets • Net present value of future cash flows (subtracting costs of rectification) • Proceeds of re-tendering the concession on the open market—thereby also overcoming the possible difficulty of finding budget space for termination payment obligations that are realized unexpectedly
Public party default	Public party fails to meet its obligations under the contract	A fair contract should ensure the private party does not lose out if the public party chooses to default. Termination payments in this case are typically set to the value of debt **plus** some measure of equity, and may also include lost future profits (if any)
Termination for public interest	Many PPP or public procurement laws allow the contracting entity to terminate for reasons of public interest	Typically, should be treated in the same way as public party default; otherwise creates perverse incentives to voluntarily terminate instead of default (or vice versa)
Prolonged *force majeure* damage	Should be carefully defined in the contract and limited to uninsurable, prolonged force majeure events that preclude performance of obligations	Typically, in between the two options above, since neither party is at fault

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Additional Resources

- Achieving Contract Effectiveness and Financial Close
- Key Issues in Developing Project Financed Transactions

Find in pdf at PPP Reference Guide - PPP Cycle or visit the PPP Online Reference Guide section to find out more.

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