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Direct Contractual Agreements

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On this page: *Learn more about the Direct Contractual Agreements utilized by public sector entities to monetize brownfield infrastructure assets without losing outright ownership of the underlying assets. Read more below, or visit the Content Outline.*

Description of Direct Contractual Agreements

Direct contractual agreements are utilized by public sector entities to monetize brownfield infrastructure assets without losing outright ownership of the underlying assets. These arrangements include brownfield concession agreements, operations, and maintenance (O&M) concession agreements and / or long-term lease agreements.

For direct contractual agreements, the revenue model for the concessionaire is based on user-pay model, for instance, tolls for road projects and passenger service charges for airports projects.

It is important to note that the direct contractual agreements for asset monetization may also fall under the domain of public-private partnerships (PPPs) in some jurisdictions. The difference between direct contractual agreements for asset monetization and PPPs is elaborated in Appendix B.

Brownfield concession agreements

A brownfield concession is an arrangement that typically involves a private sector entity (concessionaire) to provide the public service for a specified period, against payment of an upfront concession fee to the public sector entity (concession authority). In such a transaction, the private sector is responsible for the full delivery of services, performance-based operations and maintenance, and future development or expansion of the infrastructure assets over an agreed period (concession period).

Under this arrangement, the concessionaire is required to pay the concession authority an upfront concession fee, or a combination of upfront and periodic payments as determined under the concession agreement. The private sector concessionaire is conferred the right to charge fees to the users of the asset (such as toll charges for the use of toll-roads). Typically, revenue and demand risks lie with the private sector.

The concession may present to the concessionaire the opportunity to further develop or expand the asset to enhance revenue generation capacity. In some instances, the concessionaire may be obligated to meet capacity requirements through development or expansion (for instance, in most airport concessions, the concessionaire is obligated to expand the airport’s capacity to meet forecast demand).

Operations and maintenance (O&M) concession agreements

Unlike brownfield concession agreements, in an O&M concession, there is no future developmental or expansion aspect for the asset under consideration, consequently reducing the development and financing risk for the private sector.

Long-term lease agreements

Under a long-term lease agreement, the private sector is conferred rights as a lessee of the site on which the infrastructure asset is located. The private sector, as lessee, is responsible for operating and maintaining the infrastructure facility and services. Depending on the nature of the asset, the private sector may be required to make capital improvements or expand the asset to increase capacity. It is important to note that in long-term lease agreements, the private sector is typically constrained in their use to a specific function or service.

Concession agreements, on the other hand, confer contractual rights to undertake the operations of the infrastructure project. It does not confer any ownership or leasehold rights with respect to the land or assets. It is more typical where there is no long-term commercial development on the site required on the part of the concessionaire which required long term secured tenure for commercial developments.

Example: Examples of direct contractual agreements for asset monetization

Brownfield concession agreement

- National Highways, India: The National Highway Authority of India (NHAI) monetizes the public funded national highways via the Toll Operate Transfer (TOT) model. Under this model, the right to collect fees for selected operational National Highway (NH) projects constructed through public funding is assigned for a pre-determined concession period to concessionaires (developers/ investors) for upfront payment of a lump-sum amount to NHAI. Such assignment of rights is based on toll revenue potential of the identified NH projects. Operation & Maintenance (O&M) obligations of such projects is with the concessionaire over the concession period.

Source: Ministry of Road Transport and Highways (https://morth.nic.in/standard-tot-documents)

Operations and maintenance (O&M) agreements

- Mass Rapid Transit (MRT), Singapore: Under the New Rail Financing Framework, the Land Transport Authority (LTA), responsible for the development of the rapid transit system and the expansion of the rail network, owns the rail infrastructure assets, including civil infrastructure, systems infrastructure and rolling stock. The rail operators are responsible for the operations and maintenance of the rail assets in accordance with the operating performance standards and are effectively paid a service fee that factors in farebox revenue. The private sector is subject to a penalty framework which ensures service quality, reliability, and safety.

Source: LTA (https://www.lta.gov.sg/content/ltagov/en/who_we_are/our_work/public_transport_system/rail/new_rail_financing_framework.h

Long-term lease agreements

- Port of Melbourne, Australia: Under the Australia's Asset Recycling Initiative, the Victorian Government leased Port of Melbourne, the largest container and cargo port in Australia, for 50 years to a private sector consortium for upfront proceeds of AUD 9.7 billion.

Source: Investment Policy Hub, UNCTAD (Australia - Australia sold the Port of Melbourne lease to a consortium including foreign investors | Investment Policy Monitor | UNCTAD Investment Policy Hub)

Objectives of Direct Contractual Agreements

Asset monetization through direct contractual agreements present an alternative source of funding to governments in need of funds to develop greenfield infrastructure projects without the need to raise debt, while leveraging the following private sector efficiencies:

- Leveraging private sector expertise: Under direct contractual agreements, the private sector needs to comply with performance and service standards as set out under the terms of the concession or lease agreements.
- Greater accountability: Should the private sector fail to meet minimum performance requirements or service standards, the public sector entity may subject the private sector entity to a performance abatement regime, or, in the instance of severe and persistent breaches, terminate the agreement. This provides strong incentives to the private sector entity to ensure that performance obligations are met.
- Risk allocation and mitigation: The public sector entity can transfer risks involved in operating and maintaining the asset to the private sector. Two key risks include demand risk (risk that actual demand differs from projected demand) and risks of operating and maintaining the infrastructure asset.
- Retention of ownership: At the end of concession period, the assets are handed back to the public sector. Legal ownership of the asset remains with the public sector all through the term of the concession or lease.

In essence, under a direct contractual agreement, the public sector is able to transfer risks of operating and maintaining the asset to the private sector while achieving upfront monetization of the underlying asset.

Table 4: Key risks managed and mitigated through direct contractual agreements

Risk Category	Risk Management and Mitigation
Inadequate performance	The appointment of a competent operator through direct contractual agreements remediates any inadequacies in performance.
Operations, maintenance, and Environmental & Social risk	The appointment of competent operator and management through direct contractual agreements puts into place timely remedial steps, including passing of increased costs to end-users within the parameters of fee and charges setting regime.
Demand and traffic risk	The risk of demand or traffic being lower than forecast causing a shortfall in actual revenue against budgeted revenue is passed on to the operator through direct contractual agreements. The operator ensures that traffic survey and forecast are conducted by competent advisers during the bidding stage; the operator may also have the right to defer the timing of capacity-driven capital expenditure program, deployment of staff and re-calibration of level and intensity of operational functions to mitigate this risk.
Financial risks (inflation, forex, financial close)	The operator may employ efficient hedging strategies, including financing in local currencies, indexation in fee and charges, and good relationships with credible lenders and financiers.
Strategic control/ hand back	The concession will provide for a hand back provision, whereby the operator is required to return the asset (with specified conditions with regards to the asset) to the public sector after the end of concession period. This ensures that the asset, when handed back, continues to operate without disruption.

Monetization Process and Structure of Direct Contractual Agreements

Monetization process

The process involved in a direct contractual agreement transaction is presented in the figure below.

Figure 6: Activities in a direct contractual agreement model

Stakeholders in direct contractual model of asset monetization

The following table presents the stakeholders, including respective roles and responsibilities, under a direct contractual model of asset monetization.

Table 5: Stakeholders in direct contractual agreements

Stakeholders	Roles and Responsibilities
Public Sector Entity/ Infrastructure Asset Owner	The government is the public infrastructure asset owner which enters into a contractual agreement (either through a concession or a lease) with the private sector in exchange for upfront concession fee or combination of upfront and regular payments.
Special Purpose Vehicle (SPV) / Concessionaire	The SPV is responsible for the day-to-day operations and regular maintenance of the infrastructure asset and for E&S management. It is also responsible for collection of revenue and distribution of cash flows back to the investor.
Investor	Investors invest in the concession or the lease through the upfront payment; usually acting in concert as a consortium of investors. These parties form an SPV that will act as the government's counterparty to the contractual agreement.
Financiers / Lenders	Financiers can be in the form of commercial lenders such as domestic or international banks providing project finance loans to the SPV.
Service Users (of Infrastructure Asset)	Service users of the infrastructure make user payments such as toll for using toll road or passenger service charge for airports. These user payments ultimately form the cash flows to be distributed back to the investor.
Regulator	The Regulator may be responsible for setting applicable tariffs, setting service standards, or ensuring fair and equitable access to the use of asset to third parties.

Monetization structure

The following steps presents the monetization process for a direct contractual agreement model.

- A SPV is set up to undertake the agreement wherein the private investor injects equity and raise debt from financiers.
- The SPV enters into an agreement with the public sector entity to obtain the rights to operate and maintain the asset in exchange for a lump-sum upfront concession fee, or a combination of upfront and regular payments.
- The SPV collects revenue from service users of the infrastructure.
- The cash collected is used to meet operational expenses, debt obligations and the remainder is distributed back to the investor.
- The Construction and O&M work is subcontracted to third-party contractor and operator, respectively.

Figure 7: Indicative structure of direct contractual agreements

Activities in a direct contractual agreement model

Investor Class in Direct Contractual Agreements

In a direct contractual agreement, the counterparty to the public entity is likely be a sector specific strategic investor, with a strong track record of delivering certain infrastructure asset classes. These investors possess the relevant expertise required to deliver services successfully and meet performance standards.

The financial and institutional investors are less likely to be the direct counterparty in direct contractual agreements with the government as their interests are primarily driven by financial returns and their fiduciary responsibility to their shareholders.

Table 6: Examples of strategic investors in direct contractual agreements

Asset Classes (Sectors)	Examples of Strategic Investors
Roads	Cube Highways, EcoRodovias, Atlas Alteria, Gavio Group
Rail	Ferrovial, Keolis, Ferrovie dello Stato (FS), Canadian Pacific Railway, Sheltam Corporation, Aurizon
Airports	Changi Airports International, VINCI Airports, Zurich Airports, Aéroports de Paris (ADP)
Power and Utilities	KEPCO, TEPCO, HEPCO, Athena Energy, Sembcorp, EDP Brasil, Spark Infrastructure
Multi-sector	Acciona, Adani Group, Mitsubishi Corporation, Marubeni Corporation, Palisade Investment Partners, Plenary John Laing GIC

Required Setting for Direct Contractual Agreements

Macro-economic considerations and legal environment

- Legal and political stability: Due to the long-term nature of direct contractual agreements, strong rule of law and regulatory stability provide confidence to private investors / developers that successive governments will honor the contractual agreement and discharge their obligations. The terms and conditions of agreements between the government and public sector should not be changed unilaterally due to a change in government policy (without due compensation). The contracts should also provide for an impartial and robust dispute resolution provision through third party arbitration. In some instances, the private sector may require that the dispute resolution forum be located in a third-party country (such as the Singapore International Arbitration Centre (‘SIAC’)).
- Presence of clear framework and legislation: Clear and transparent legislation are important to regulate direct contractual agreements. Broadly, there are five attributes for clear framework and legislation
    - the authority has the requisite power to confer and manage the direct contractual agreements
    - the law allows for private sector delivery of services and operations (and if relevant, allows for foreign entities to delivery such services and operations)
    - performance of the operators is governed by law or under a performance regime under the direct contractual agreements
    - the private sector is empowered and authorized to collect user fee and also to enforce payment
    - any disputes between the parties can be resolved in an impartial court or an arbitration forum that is the choice of the parties and that any decision of such tribunal would be upheld and enforced

Example: Examples of legal and regulatory frameworks for direct contractual agreements

The World Bank Group: PPP Legal Resource Centre (LRC)

- The World Bank’s PPP LRC resource contains snapshots of legal and regulatory frameworks, agreements and concessions, checklists and sample clauses, terms of reference, risk matrices, and standard bidding documents developed by and for government agencies pursuing direct contractual agreements.

Financial and market conditions

- Availability of long-term project financing: Access to long-term project financing through various financing sources such as commercial loans and debt capital markets is important to attract strategic equity investors. There should be sufficient liquidity for debt raising through bond issuance or project finance loans.
- Restrictions on foreign investment: Limited restrictions on foreign investment in infrastructure is important to attract foreign strategic investors interested in participating in the direct contractual agreements. In developing countries where domestic investors may not have the appetite nor liquidity for large infrastructure projects, foreign investors can provide the required equity funding.
- Private sector participation in infrastructure: Strong private sector participation in infrastructure will create demand for infrastructure assets and contribute to a competitive bidding process for direct contractual agreements.
- Availability of risk mitigation / hedging instruments: The availability of hedging instruments such as interest rate swaps and foreign exchange swaps to mitigate interest rate risk and foreign exchange risk are necessary to attract foreign investment and financing.

Nature of assets

- Operational efficiencies: There should be scope for improvement or innovation by the private sector partner in terms of operational efficiency or effectiveness. Service delivery can be improved by leveraging on the private concessionaire’s expertise and experience to enhance revenue stream/s.
- Demand and cash flow stability: The infrastructure asset should have a demonstrated history of stable and growing cash flows. There should be predictable demand for the services of the underlying infrastructure assets.
- Length of remaining life: As concessions tend to have a medium to long-term duration, the infrastructure asset should have a remaining life adequate to support the asset recycling transaction by providing a sufficient period for the private sector to earn sufficient returns on its investment.
- E&S risks: Consider whether assets come with so many material risks to address that these affect the ability to monetize the asset.

Operational control and ownership

- Over the concession period, governments can choose to retain ownership of the infrastructure assets but not operational control. The agreement gives the private sector the right to operate, maintain and collect user charges over the concession period in exchange for a lump-sum upfront concession fee, regular payments, or combination of both.

Key Features

Monetization Models	Key Objectives	Model Structure	Key Stakeholders	Investor Class	Required Setting	Consideration for choice of model
Direct Contractual Agreements						

• Brownfield Concessions • O&M Concessions • Long-term Lease	Private sector operational efficiency through service standards/ KPIs, risk sharing with private sector, up-front and/ or annual proceeds, knowledge transfer, flexibility in terms of ownership of asset, attracting upfront investment from private sector	A long-term contract conferred on private sector to operate and maintain infrastructure with the right to charge user fees. The private sector typically finances the concession through debt and equity structure with project finance structure	Government Contracting Agencies (public sector entities), Developers/ Operators (private sector entities), Financiers (lenders), End Users, Regulator (if any)	Predominantly strategic investors (such as sector-specific developers, operators)	Clear regulation/ law on concession, availability of local currency financing and risk mitigation instruments, strong historical precedence of concessions	Suitable where asset ownership needs to be retained by the government, leveraging private sector efficiencies and transfer of revenue risk to the private sector

Case studies

Find examples for Direct Contractual Agreements - Case Studies.

Related Content

- **The PPPRC Asset Recycling Section**
- **Executive Summary: Asset Recycling**
- **Asset Recycling Projects**
- **Asset Recycling Programs**
- **Table of Contents for Asset Recycling**

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The PPPRC Asset Recycling Section

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Asset Recycling Projects

This section has not been prepared with any specific transaction in mind and are meant to serve only as general guidance. It is therefore critical that the content will be reviewed and adapted for specific transactions.

This is a new section of the website and is currently in draft form. For feedback on the content of this section or to suggest additional links or materials, please contact the PPP Resource Center using the feedback form.