MASTER CLASS

PREVENTING RENEGOTIATION, FOSTERING EFFICIENCY

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Lawyers usually say that "the best contract is the one you never have to pull out of the drawer"—a view that focuses on trust, common understanding, and mutual advantages. And then they will add that PPP contracts, even with the best government–business relationship, are a bit more complex. That's because they are based on incentive mechanisms that require not only regular monitoring, but also some degree of cooperation and a modicum of strategic management—the three components of PPP contract management.

The ultimate success of a PPP contract depends on effective service delivery under conditions of sustained efficiency. The efficiency comes from linking private operator rewards to performance over the long-term (output focus), and from providing credible commitment by the private partner through private finance (or, as it's known in some circles, "hostage capital").

There are many cases, as seen in previous issues of *Handshake*, of PPPs providing high-quality reliable service to users at a reasonable cost for users and taxpayers. But there is also recognition that, over the long-term, PPP efficiency may be jeopardized by contract renegotiation—by necessity renegotiation under no competitive pressure, with asymmetrical information. This sort of renegotiation creates a risk of breaking the initial commitment, changing rewards and risk allocation. Though theoretical economists would say that "in the long-term" renegotiation of incomplete contracts is unavoidable, PPP practitioners should do their best in order to avoid the need for renegotiation, while simultaneously preparing for renegotiation when it is the best solution in terms of public interest.

This requires distinguishing from among the several different sources of renegotiation: poor contract management, poor contract design, poor project selection, or simply the opportunistic behavior of myopic public authorities.

WHY RENEGOTIATION HAPPENS

A recent OECD publication addresses several different contexts and characteristics

of PPP renegotiation. This reflects a roundtable discussion connecting PPP practitioners and researchers, where the focus moved from the mere characterization and classification of renegotiation processes to the much needed recommendations on how to prevent unnecessary renegotiation.

Few renegotiations result from the dynamic inconsistency that game theory warns about—governments signing a contract allocating risks and rewards to the private partner, and later trying to grab part of the upside when projects are successful due to private sector efforts. But the fact that this kind of opportunistic behavior is rare demonstrates that PPP contracts have been successful in preventing that behavior.

There is a common realization that a large class of PPP renegotiations result from another type of opportunistic behavior, in this case shared by both parties. Here, for budgetary reasons, or due to rent-seeking, public authorities do contract PPPs for a part of what is needed, they then renegotiate the contract to enlarge its scope, in a non-competitive process that usually results in rents (extra profits) for the incumbent private operator enjoying superior information about the project and a long-term mandate for managing it. In this case, renegotiation does not result from exogenous change, and both parties are glad to renegotiate: the public authorities in order to introduce the additions that they choose to keep out of the contract when they originally closed the deal; and the private operator because they will discuss the cost of those additions under no competitive pressure. No improvement in the contracts, or in contract management, can avoid renegotiation in this case.

The obvious solution lies in improvements in the public investment management (PIM) process (better scrutiny), in the procurement framework (less acceptance of changes to project scope, and more transparency on renegotiation), and in the fiscal framework (due consideration to medium- and long-term infrastructure and service needs, and added fiscal transparency).

Another large class of renegotiation processes results from poor contract design. In this case, contracts are more "incomplete" than what actual uncertainty would suggest. The reasons range from too much pressure for fast results (having the deal closed, even if all risks were not dully considered), or from sweeping the difficult issues under the carpet, simply transferring them from the tender phase (under competitive pressure) to the construction or operational phases (when there is no competition, and when the private operator has a maximum of bargaining power). For these cases, the obvious solution is allowing more time for project preparation or for competitive negotiation during tender, and investing more on high-quality transaction advisors.

THE ECONOMIST'S VIEW

From an economist's perspective, PPP contracts are incomplete contracts, in the sense that they cannot stipulate the responsibilities of the parties in each "state of nature", i.e. for each possible future occurrence. In fact, they will be subject to change (technological, demographic, or commercial change, but also legal change and policy change), and so they require a process (by agreement, or by unilateral decision with or without compensation) for adapting the project to exogenous shocks and policy changes, keeping in mind the public interest and the contractually defined allocation of risks.

To learn more, see the PPP Reference Guide.

A component missing from many of these contracts where renegotiation is unavoidable, is a proper assessment of all the risks that the project may conceivably face. This assessment defines mitigation measures for some and prescribing courses of action for the others. Another component often missing in these cases is a good financial model that allows for risk impact to be evaluated. These are models that procuring authorities should build and use for structuring the project, and models that bidders should be required to build in order to demonstrate the ability of their proposals to satisfy the contract and face risks.

A minor but still relevant class of renegotiation processes results from poor contract management by the public partner, building an overload of disputes and miscommunication that allows the project to underperform and leads to renegotiation or contract cancelation. Many public authorities are strengthening efforts towards improving contract management practices.

Another still relevant class relates to poor private sector performance—in practice, cases where the private operator is able to convince the public authority that it pays to renegotiate the contract instead of canceling it. This class should be considered a sub-class of that which was previously referred to, as only poor contract management practices can allow for underperforming private operators to co-opt public authorities into a renegotiation process.

The last class of renegotiation processes, a very small one, deals with cases where there was a real significant change in the conditions for project implementation that precludes the normal execution of the contract, and so forces renegotiation because the options are contract collapse or underperformance. These cases, the ones that are truly unavoidable, will have a significant probability of happening during the life of a long-term contract, but a small probability of happening in each year of the contract.

Identifying and analyzing the myriad reasons behind renegotiation is the first step toward preventing renegotiations from taking place. Indeed, much can be done to reduce the prevalence of PPP renegotiation, which in turn will allow PPPs to demonstrate their potential efficiency. Improving the public-sector governance of PPP processes and the quality of project structuring has the potential to improve the quality of life for many people around the world.

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CONTRACT RENEGOTIATIONS VERSUS ADJUSTMENTS

RENEGOTIATIONS	
Change in risk assignment and/or in the conditions of the contract	• Reduction in the level of service quality provided. • Deferral or advancement of investments by several years. • Extension of the contract term. • Reduction of the guarantee requirements for the private side (financial bonds). • Increase in the level of guarantees provided by the public side (to pay lenders). • Delays to a reduction of tariffs (tolls). • Reduction of fees for the public side. • Changes in any of these conditions to avoid bankruptcy of the operator.
Change in project scope (if this was not covered in the contract)	• Public side requests for additional investments. • Private side proposals for additional investments. • Grant of additional land for development serviced by the infrastructure. • Requests from the public side for additional inter-connections with public (untolled, road) network.
ADJUSTMENTS	
Adjustments in line with the contract provisions	• Adjustments to tariffs in line with a formula set in the contract or indexed by inflation. • Activation of triggers, which make predefined investments become mandatory. • Payments to the operator provided for in the contract.

Source: Guasch et al 2014. Full report: Public Private Partnerships for Transport Infrastructure: Renegotiations, How to Approach Them and Economic Outcomes