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for Reconstruction and Development

EBRD PPP regulatory guidelines collection
Volume III

# Chapter 3.
# Structuring and negotiating PPP contracts

## Contents



## Appendices

## (A) Introduction: public-private partnerships and PPP contracts

The subject of this chapter is the structuring, drafting and negotiation of public-private partnership (PPP) contracts. Along with the other chapters in Volume III of the EBRD PPP Regulatory Guidelines Collection, it is hoped that this, too, will help to facilitate the development and management of infrastructure and public service projects with the commercial and financial participation of the private sector. The focus is principally on assisting emerging markets (and especially EBRD economies) in their first approaches to structuring and negotiating PPPs and PPP contracts, typically in the context of project financed transactions.[1] The practices of developed economies are discussed when relevant, as they can provide useful insights into many of the issues at stake. Possible responses to those issues are suggested, in particular with respect to the crafting of frequently recurring provisions at a practical and commercial level, and the protections, undertakings and guarantees needed to promote a project's "bankability".

The chapter also draws on recommendations and policy papers on this subject developed by international organisations active in this area, including the United Nations, the Organisation for Economic Co-operation and Development (OECD), the EBRD and the World Bank as well as the European Union (EU) and various government agencies, and some of the leading textbooks on the subject.[2] It is not primarily an academic exercise, however. It has been written by practicing lawyers with wide experience (30 years and more) advising real participants in real PPP projects all over the world, and so is designed to offer practical, realistic guidance.

It is beyond the scope of the chapter to discuss the meaning of PPPs in any detail. (This has been done at length in other chapters of the PPP Regulatory Guidelines Collection and in many other publications.) Nevertheless, it might be worth briefly reminding the reader of some of their salient features. PPP is essentially just a procurement tool; it is one of a number of different methods available in a government's "toolkit" to procure infrastructure assets and/or related services. Many more or less similar definitions are available these days. For example, the EBRD-United Nations Economic Commission for Europe (UNECE) Model Law (discussed in Chapter 2, Volume I) defines them as "an undertaking ... involving a long-term, cooperative relationship between a public and private partner, on the basis of a PPP contract, with shared risks and responsibilities throughout its term, for the design, development, construction, reconstruction, rehabilitation, operation and/or maintenance of public infrastructure (whether new or existing) and/or the provision of public services or services of general interest".

The United Nations Commission on International Trade Law (UNCITRAL), the World Bank Guide to PPP Contracts and various UNECE documents[3] use very similar language. Key characteristics of its life are (a) its long-term nature; (b) genuine risk-sharing between public and private sectors throughout its life; (c) the public infrastructure/public service element and (d) usually, but not always, the use of private finance. The private sector brings to bear its capital, professional skills, capacity for innovation and ability to deliver projects on time and within budget. The public sector retains its underlying responsibility to ensure that services of the requisite standard and quality are delivered to the public, in ways that offer genuine benefits and contribute to economic growth and an improved quality of life. Each is doing what it does best, in other words, under the umbrella of a long-term partnership.

Whatever exact definition one adopts, and whatever the idiosyncrasies of individual project structures, PPPs are almost invariably creatures of contract. They are created by a contract between the public authority (called the "contracting authority" in this chapter) and the private sector entity – usually a company – participating in the partnership (called the "private partner" in this chapter). This contract could then be defined as the long-term agreement between

[1] The focus of this study is "emerging market" projects. It is by no means easy, however, to make hard and fast distinctions between practice in this area in emerging markets, on the one hand, and the so-called developed economies, on the other. Differences of approach will obviously be found. They will differ from place to place and time to time, however. It is notoriously difficult to generalise at any level about emerging markets as a whole, let alone the precise ways in which they differ from their OECD neighbours. Many, if not most, of the issues discussed here apply equally to the latter as the former. Where the authors believe there is a clear difference in approach between the two, they bring this out in the text. The text also contains references to practice in developed countries, primarily by way of contrast.

[2] It is based on two previous studies commissioned by the EBRD in the past 10 years and an article originally published by Christopher Clement-Davies in the Journal of the IBA in 2006, updated to take account of the huge increase in available know-how in this area in recent years, including in particular the World Bank Guide to PPP Contracts (rev.2019) and the textbook Project Finance by Graham Vinter & colleagues (4th edition, 2014). See also Chapter 2, discussing the legal framework for PPPs and the list of sources it contains.

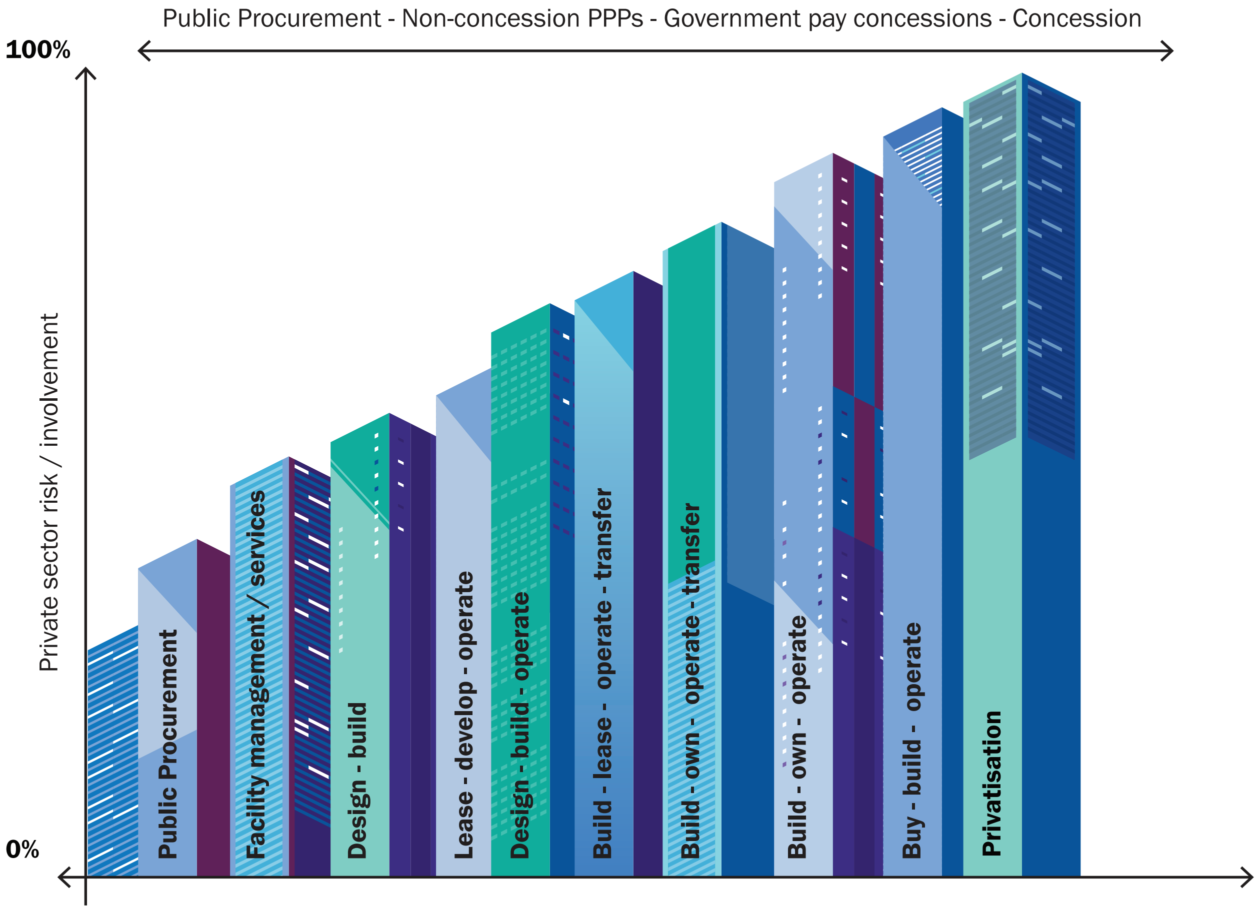
[3] Such as the Guidebook on Promoting Good Governance in Public-Private Partnerships, 2008.

the contracting authority and the private partner for providing an infrastructure-related asset or public service in which the private partner bears significant risk and management responsibility throughout, with its remuneration being linked to its performance.

Once relatively simple and straightforward documents, especially in (mainly civil law) countries with well-defined concepts of "concession", PPP contracts have become far more complicated, as the markets for them have evolved. The explosion of PPP activity around the world in the past 20 years has changed and developed their terms, so they can now represent among the most lengthy and intricate forms of commercial agreement that one can encounter – as well as the most heavily negotiated. "Best international practice" now has clear connotations in terms of the sorts of provision they need to contain, the ways project risks are addressed and allocated, and the requirements of international financial markets if they are to be "bankable".

The range of sectors and jurisdictions where they are used and the wide disparities between different forms of PPP project, however, mean that standardised PPP contracts are still an elusive concept.[4] There is just so much variety. Nevertheless, it is becoming steadily easier to recognise the types of provision which parties and markets will or will not accept, as a broad understanding of market norms in this field steadily gains ground. It is therefore perfectly feasible to describe and discuss the central clauses they typically contain, and the issues to which they frequently give rise, as we seek to do in this chapter.[5]

PPPs have come to embrace a wide variety of contractual structures and arrangements over the many years that they have been used. A plethora of acronyms and industry terms has grown up to describe them (not always reflecting clear conceptual differences between them). They include BOO (build-own-operate), BBO (buy-build-operate), BOT (build-operate-transfer), BOOT (build-own-operate-transfer),




[4] Although several countries have effectively standardised the agreements used within their PPP industries, at least for certain sectors and types of project, including the United Kingdom (before the formal cancellation of the PFI in 2018), the Netherlands, Australia, South Africa and Portugal.

[5] As the World Bank has done in its 2019 Guide to PPP Contracts.

BOLT (build-operate-lease-transfer), DBFO (design-build-finance-operate), operational licence, franchise and others. Traditionally, they would typically involve a relatively wholesale assumption of cost and risk by the private sector, with user charges levied directly on the public, as in the French model developed generations ago for highway and similar projects and widely imitated since in many other civil law jurisdictions. More recently, risks have at times come to be more narrowly and closely defined, especially in the government revenue stream style of PPP project, pioneered by the British government under the aegis of its Private Finance Initiative (PFI) programme, adopted in 1992 and since emulated in numerous other countries around the world.

The degree of risk and responsibility transferred to the private sector where it participates in infrastructure development can vary widely from one contractual structure to another. It can range from the simple, traditional form of public procurement, on the one hand (which may not involve a PPP in a true sense at all), to a full-blown "concession" on the other, where the private sector takes extensive responsibility for most risks over the life of the contract, to an outright privatisation, where the assets are simply transferred to the private sector, which then becomes fully responsible for them. The table below, created by the EBRD, illustrates this spectrum in summary (and inevitably a somewhat imprecise) form. PPPs cover most of the structures mentioned.

The table is imprecise, as the categories of project structure to which it refers are not really susceptible to very exact or consistent definition, and their characteristics, attendant risks and responsibilities are more fluid and shifting in practice than it suggests. It should be seen as illustrative rather than definitive. It is also worth remembering that the terms PPP or concession have a wide range of meanings in practice (as we explain in more detail below). In the practical PPP universe and business environment in which we all operate – as opposed to the jurisdiction-specific area of legal technicalities – the terms PPP and concession are often treated as largely interchangeable and can be used to connote the whole gamut of project structures of this kind. Too many business executives, on the other hand, in particular in the French and civil law context, they tend to imply sharply distinct structures. Some jurisdictions (EU countries, for example) make formal, technical distinctions between them. These distinctions are often not entirely consistent across or even within different jurisdictions, however, and sometimes have as much to do with legal traditions as logic.

Whatever the distinctions made between different types of PPP, it is usually helpful to remember the importance of long-term collaboration between public and private partners to manage assets on a risk-sharing basis as being central to any PPP (as the name suggests). While allowing for a degree of "shade" at the edges of these somewhat imprecise categories, PPPs in the end are not the same as the simple contracting out of certain services by the government, as in a consultancy agreement or design and/or build contract, at one end of the spectrum, or a full-scale transfer (usually sale) of assets and associated responsibilities to the private sector, as in a privatisation, at the other. There must be a real element of long-term partnership involved.

We do not make clear-cut distinctions between the different forms of PPP in this chapter. Whichever structure is used, the PPP contract will typically underpin it,[6] as we have said, defining the relationship between public and private sectors, allocating risks and responsibilities, and representing a vital part of the lenders' security package. Several other contracts or sets of agreements will, of course, also form important parts of the wider structure. These may include a shareholders' agreement, construction contract, supply agreements, perhaps a separate off-take contract, lending and security documents, and often a direct agreement. (A simplified diagram showing these arrangements is set out in Appendix II). Nearly all of them will include the project company – the private partner as a party, making it in every sense the centrepiece of the whole contractual matrix. The PPP contract will typically constitute the "cornerstone" document of this matrix, its terms setting out the core commercial components of the deal and therefore determining much of the contents of the remainder.

What follows in this chapter is a brief description of the typical contents of a PPP contract, followed by a discussion of what the authors see as some of the main legal and practical issues to which these agreements can give rise as they are structured and negotiated. Contrasts in approach between common law and civil law jurisdictions, where they exist, are brought out (drawing in particular on UK and French law). We also offer some preliminary thoughts on the meaning of the legal concept "concession", on the legislative framework for PPPs, and the differing purposes and objectives these agreements serve, which the parties to them should keep in mind as they are negotiated. It is hoped that this will contribute to an understanding of the broader challenges involved in implementing PPPs.

[6] Except in those civil law countries where a separate formal contract is unnecessary, as its contents are prescribed by statute. See further below.

## (B) Classifying a PPP and PPP contract

In conceptual legal terms, PPPs, concessions and the contracts for them can be a little tricky to classify. One of the first tasks for a lawyer advising on a PPP project is to establish whether the local jurisdiction has a recognised jurisprudential concept and definition of concession or PPP, and to ascertain any rules and restrictions that apply specifically to them as a matter of law.

Many civil law jurisdictions place concessions in legal categories of their own, often within the area of public administrative law, which governs the provision of public services by the government, with clear statutory definitions (see further below). Common law, on the other hand, does not treat them as a separate species of contract distinct from ordinary commercial agreements. The Oxford Companion to Law describes a concession as the "grant by a public authority to a person of authority to do something, such as to work the land, extract minerals, operate an industry, or the like". But this is not a case law or statutory definition. Under UK law, a concession is essentially a contractual licence.[7] It will entitle the private partner to make use of certain facilities (often including real property) and to develop and implement a project during the life of the PPP. It may or may not be formally linked to a separate interest in land (such as a site lease or outright title to the land). It can be granted by either public or private bodies. In many civil law jurisdictions, on the other hand,[8] particularly France (and countries with legal systems derived from it) the term tends to connote the provision of services to the public which have typically or historically been provided by the public sector. In a concession, those services are then formally delegated to the private partner on a substantial risk-bearing basis. A public sector entity will therefore usually be a party to it.

Apart from the jurisprudential classification of concessions, some civil law countries (such as France and Brazil, the EU at the procurement level and the countries that have acceded to it) then apply slightly differing rules and principles to the different forms of contract that can be used in a PPP, distinguishing, for example, between public works or services procurement, concessions involving public user charges and PFI-style government revenue stream contracts (sometimes called PPPs just to distinguish them from concessions), and subjecting them to different legal treatment. Where this is the case, understanding the full ramifications of the legal category into which the project agreement falls will be a vital aspect of the preliminary structuring or due diligence work.

One clear difference in the approach of civil and common law jurisdictions (respectively) to PPPs can readily be discerned in relation to risk sharing between the parties to a PPP contract. In many civil law countries that follow the French model, risk allocation tends to flow to a greater extent from the application of a number of legal and regulatory rules and principles to the PPP, enshrined in statute or administrative case law, whereas in common law countries it is essentially a matter of drafting and negotiating the terms of the contract. In the former, there tends to be less scope for negotiation and "departures from the norm". Their status as PPP public law contracts which may involve public service activities means that, in those jurisdictions, concession contracts usually must comply with a range of general rules from which the parties cannot derogate in the terms of the contract. Examples of such rules include the following:[9] (i) the contracting entity should always be entitled to amend or terminate the contract for public interest reasons, (ii) the contract assets necessary for the performance of the public service activities are deemed to be public property as soon as they are built or bought by the private partner and (iii) the compensation to which the private party may be entitled for the assets necessary for the performance of the public service activities on a termination of the contract shall not exceed the net book value of those assets at the termination date. It is therefore crucial to verify, in drafting or reviewing a PPP contract, whether and to what extent the parties are free to derogate from these general rules.

This disparity in legal classification partly explains why there are now so many different labels for what is fundamentally the same form of agreement; "concession contract", "project agreement", "development agreement", "implementation agreement" (at least in certain respects), "franchise", "affermage" and "licence" are all in many ways largely interchangeable terms. Their use is sometimes preferred to avoid the confusion "concession" can give rise to, given its specific meaning and categorisation

[7] The Channel Tunnel PPP contract, signed in the late 1980s, was one of the first, well-known examples in the United Kingdom of a PPP contract for a major project. (There have since been hundreds, of course, in the PFI field and around the world.) If the agreement ever has to be litigated (at least to a judicial conclusion), it will be interesting to see what consequences flow from the differing legal classification of concessions under UK and French law, given that both systems of law seem to apply to it.

[8] At least those that follow the French model, where this jurisprudence is most highly developed

[9] Except as otherwise expressly provided under applicable law

in certain jurisdictions. However, in substance, the agreements to which these labels refer are often very similar, in terms of the legal, commercial and practical issues to which they give rise. For the purposes of this paper, they will all be referred to as “PPP contracts”.

## (C) Legislative background

An established legislative framework for PPP contracts, and the projects to which they relate, may be in place in jurisdictions where PPPs are being implemented.[10] The contents of any PPP contract must always be viewed firmly in that context. It may be necessary for constitutional or public law reasons for enabling legislation to be introduced to allow the private sector to develop major infrastructure projects in the first place and to transfer what would otherwise be governmental powers and responsibilities to it. (Local legislation may have previously limited the right to develop certain types of infrastructure to the public sector.) In many jurisdictions, especially civil law ones, the scope and fundamentals of PPPs may be established, and their principal terms and conditions allowed for, in a PPP law. Even where this is not the case, legislation may have to be brought into effect to underpin individual projects – to update applicable laws, for example, or clarify aspects of the contracting authority’s capacity or legal powers. PPP legislation, where it exists, can create a clear framework for PPPs, providing ready-made solutions for what could otherwise prove difficult questions of scope and structure, or it can be unhelpfully limited and inflexible.[11] Indeed, as Chapter 2 explains, the wider regulatory environment is often critical to a successful, wide-ranging PPP programme. Ideally, a clear and transparent legal and administrative regime needs to be in place and conducive to PPPs in all their aspects, from design and procurement to contractual award and implementation. It is often set out these days in a comprehensive PPP law.

There are certain differences in approach to the statutory and regulatory framework for PPPs, however, as between common law and civil law systems, respectively, which can impinge on the structure and content of PPP contracts. In many of the former (such as the United Kingdom), it has generally not been necessary to bring special legislation into effect, although there are examples of “hybrid bills” being introduced in relation to individual projects.[12] The latter, on the other hand, usually need to introduce PPP laws, regulating the structure and scope of PPPs and their award, and the contracts that underpin them. Some civil law jurisdictions will simply list in their PPP laws the provisions that need to be addressed in a detailed agreement, leaving the parties free to settle their exact terms. Sometimes, however, their actual content or language is prescribed, which may leave too little or even no room for adaptability or negotiation.[13] PPP contracts may therefore be short and incomplete in these jurisdictions, perhaps containing cross-references to a specific statute that directly applies to the project in hand.[14]

In France, concessions historically were not governed by a specific law, but by the case law of the Conseil d’Etat (French administrative supreme court), except for the rules of the bidding process involved, which were the subject of a focused piece of legislation passed in 1993 (the Loi Sapin). No other statute was formerly thought to be necessary to implement the traditional concession model in France.

However, to widen the scope of PPPs in France and deploy some of the newer concession forms and structures being successfully used elsewhere,[15] and to maximise the use of private finance without necessarily delegating the full management of the public service itself (which would be the case with the country’s traditional concession form), a new body of PPP legislation was then put in place.[16]

[10] This subject is discussed in detail in the Legislative and Regulatory Framework Chapter (Chapter 2). The remarks contained in this section should therefore be seen as introductory only.

[11] See further in Chapters 1 and 2 (Volume III of the PPP Regulatory Guidelines Collection).

[12] In relation to the Skye Bridge and the Channel Tunnel Rail Link projects, for example. In addition, very specific legislation had to be introduced in the PFI context to address concerns about local authority powers.

[13] A well-known example of this problem until recently was the concessions law in force in Türkiye, which classified BOT and concession projects as a dimension of public administrative law and therefore (according to the Constitutional Court) subject to Turkish administrative jurisdiction, rendering their international arbitration clauses invalid. International lenders frequently expressed the view that this made them unfinanceable. After several years of lobbying and debate, the law was eventually modified.

[14] For example, in Portugal, when the government plans to develop PPP projects in a certain sector, it first establishes sector-specific PPP legislation and then specific regulations for the individual project.

[15] Such as under the United Kingdom’s PFI system.

[16] For a time, this allowed authorities to choose between a variety of contractual forms, depending on the sector and type of PPP in question: for instance, the “affermage” (roughly equivalent to a lease), “contrat de partenariat” (partnership agreement), “bail emphyteotique” (long-term lease) and so on. However, the 2003 legislation only concerned marchés de partenariat. Bail emphytéotique contracts may no longer be used as a substitute for PPP contracts and affermage contracts have not been the subject of any specific legislation.

This made possible "deferred payments" for infrastructure, linked to performance; these were not permissible under French administrative law, which prohibits shifting the burden of public investment onto future generations. The new PPP contractual structures introduced as a result, unlike traditional concessions, allow the private partner's revenues to be received in the form of "rents" from the public authority, without an accompanying transfer of full operational risk to the private partner. This would not have been possible under the traditional concession structure in France and would have led to the project's disqualification as a concession and its reclassification as public works or services under French public procurement rules.

In addition, where intergovernmental arrangements are involved, a PPP may also be the subject of a specific treaty, which may shape some of the contractual terms (for example, the Channel Tunnel project). This is often the case with pipeline or large energy projects that cross national boundaries (for example, the Nam Theun II hydropower project in Laos, which provides electricity to Thailand, or the Manantali joint-venture project between Mali, Senegal and Mauritania). International conventions of this kind must be reviewed with special care, as they typically prevail over any national laws, including PPP laws.

The question sometimes arises whether a separate agreement is needed at all where the PPP has a clear statutory framework? The answer is usually yes.[17] The PPP law will tend to establish the conceptual viability of PPPs, some of the main parameters of the projects, the basis on which they are awarded and perhaps some of their central terms. The project-specific details can then be left to the parties to agree among themselves. These will be set out in a separate PPP contract. Apart from questions of detail, there will be considerations of certainty and privity. The sponsors (and their lenders) will want a stable and reliable legal document which sets out their rights and remedies. A PPP law can always be amended without the project's participants being consulted. And while the relevant legislation may provide for compensation to be paid to the private sector in certain circumstances where it is deprived of the benefit of the PPP (for example, in the case of a "convenience" termination), the sponsors and their lenders will usually regard this as insufficient, preferring to set out their remedies more exhaustively in a contract on which they can sue.[18]

A PPP contract will also represent a more flexible instrument for coping with changes in the project's circumstances during its life, and will contain a number of provisions designed to achieve this (see further below). This is why it is rare to come across a PPP law that represents a sufficient legal document for the purpose of giving effect to PPP projects; a separate agreement is almost always needed.

## (D) Functions and objectives

PPP contracts tend to be heavily negotiated documents. This is largely because they reflect several distinct (if closely related) objectives and purposes which the parties to them will be seeking to achieve. The interplay between these objectives and functions creates a complex dynamic as these agreements are being structured. It is important for lawyers and other professionals advising on them to appreciate the significance of each of them. These include:

- **Project development and implementation – basic rights and obligations:** The project sponsors will need clear, reliable rights and obligations to implement and manage the project on the basis envisaged – to finance, develop, build, operate and maintain it (for example) and, of course, to be paid for these services. This will have to constitute a robust entitlement and duty throughout the life of the PPP, and their exact meaning, in terms of the powers and responsibilities they bestow, as well as their limits and parameters, will have to be spelled out in detail.

Conversely, the contracting authority will want assurances from the private partner, in exchange for the relinquishment of public-sector operation and (in part) control, that the project will achieve the expected results – that design and construction standards will be met, that the completed facility operated and maintained to the agreed standards, and so on. In the event of a failure to achieve these objectives, it may ultimately want to be in a position to take the project back into public hands and terminate the PPP.

- **Commercial incentives**: The public partner will also need to offer commercial incentives to developers to attract investment in the project. The PPP contract will provide for them. In addition to a government revenue stream or right to levy user charges, constituting the private partner's basic income for due performance of its services, these may include property development rights, retail facilities, additional government funding,

[17] But not always. Solar independent power projects (IPPs) in Spain, for example, signed in the early 2000s, relied simply on the new feed-in tariff and statutory framework for them. The large-scale arbitration claims which were brought a few years later when the Spanish government unilaterally changed the tariff structure were based on the Energy Charter Treaty.

[18] The lenders will typically take an assignment of the benefit of the PPP contract as part of their security package. Restrictions or prohibitions on such assignments, which are not infrequently encountered in some jurisdictions, may prove an impediment to the financeability of a project.

subsidies or even guaranteed rates of return or levels of demand. Tax exemptions or "holidays" and the preferential treatment of certain customs duties are another common example. Conversely, the public partner will sometimes demand the payment of a "concession fee'" (or equivalent) itself from the private partner. In any event, the agreement will establish all the principal commercial terms of the PPP, as between the public and private sectors, including in particular the basis on which the private partner will charge for its services.

- **Risk allocation:** Any public-private partnership will involve a pattern of risk allocation between the public and private sectors (and, of course, between the various private sector participants), with specific responsibilities and powers being identified and shared among them. The risk-allocation profile adopted on each deal will depend on its particular features and idiosyncrasies, and will vary widely from project to project. The famous formula for both project finance and PPPs is that risks should be allocated to the party best able to manage them – or best incentivised to bear them. This means both managing the likelihood of their occurrence and their impact if they do occur.

The PPP contract is the primary vehicle for achieving this risk allocation. There is, of course, no simple test to determine how exactly that is achieved contractually. Some risks will need to be addressed in much more detail than others, depending on their nature, importance, complexity and potential impact.[19] A combination of the terms and conditions of contract and the technical and supporting schedules will accomplish it, with lawyers, financial advisers and technical consultants working together to complete them. The end result will need to be sufficiently clear, precise, consistent and legally robust for all its provisions to be treated as "valid, binding and enforceable",[20] bankable and – increasingly – consistent with international best practice (including environmental, social and governance [ESG] norms).

- **Public sector support:** As part of the process of risk allocation, there will always be certain undertakings which the government will be willing (or may need) to give, and therefore risks it is willing to take on, to enable the successful implementation of the project. These will be set out in the agreement in the form of "government support" provisions. Examples may include the issue of a range of subsidiary licences, authorisations and consents needed in connection with the project's implementation, the provision of a project site, perhaps the underwriting of certain fundamental project risks (for example, demand risk or public protest risk) or even (where municipal or local governments are involved) a government guarantee. "Investment protection" rights may also need to be set out or reinforced in the agreement, depending on how effectively the country's existing legal framework protects them, although this area is becoming of more questionable importance as governments around the world build up a network of bilateral investment treaties and multilateral investment treaties (such as the Energy Charter Treaty) and adhere to international conventions (such as the 1958 New York Convention on Arbitral Awards and the 1965 Washington Convention creating the International Centre for Settlement of Investment Disputes [ICSID]).[21]

- **Funding**: The PPP contract will also play a critical part in promoting the successful financing of the project, whatever its financing structure. This will be true for equity investors, commercial lenders, multilaterals and political risk guarantors alike. The (anticipated) sources and structure of the project's funding will therefore have to be taken into account as the agreement's terms are negotiated. Its duration is the best known example of this; it will have to be sufficiently long to allow lenders to be repaid and investors to earn an acceptable return before the facility is returned to the government (if that is part of its structure). There are many other instances, however. Provisions may be included relating to (for example) the right to maintain onshore and offshore foreign currency accounts, convertibility of revenues, availability of foreign exchange, repatriation of profits, the use of insurance proceeds, protection against political risks or governmental interference, and the ability to pledge and transfer shares in the project company. If the financing is "multi-sourced", the task of making the agreement bankable can be complex, as the particular (and in many ways differing) requirements of each source of finance are met.

- **Regulatory mechanism**: The regulatory regime in the host country may be underdeveloped or evolving. There may not yet be an independent regulator of any kind in the relevant sector. When this is the case,

[19] The technical standards to be met by the design and construction process, for example, or the key performance indicators (KPIs) applicable to operational performance, will need pages of detail in the "output specification" schedules, while responsibility for (for example) third-party claims against the site may need no more than a paragraph or sentence in the terms and conditions.

[20] The lenders will require confirmation of this from local counsel in a formal legal opinion.

[21] For more on ICSID, which is under the supervision of the World Bank, see the Law and disputes section below.

the PPP contract can "plug the gap", providing a mechanism for economic regulation of the completed facility by the government.[22] This would usually be regarded as a temporary and contingent arrangement only, however, with allowances being made for the full incorporation of a proper regulatory structure in the future.[23]

**Bankability.** Although a full definition of "bankability" is beyond the scope of this chapter (discussions of it can be found in some of the leading textbooks on project finance),[24] it must always be kept in mind that the finalised PPP contract will also need to be "bankable" at every level. In simple terms, this means that its provisions will need to be entirely acceptable to the banks funding it, whether commercial, investment or development banks, or a combination of them. The lenders will need to be confident that the private partner will be able to service the debt raised to carry out the project.

PPPs are usually project-financed, which means the great majority of the funding will come from bank lenders on a limited-recourse basis (that is, essentially dependent on the cash flows to be generated by the project). Making an agreement bankable in the end means little more than ensuring that its terms are sufficiently clear, transparent and consistent, and structured in a way which lenders and their advisers will recognise as being an adequate basis for financing, consistent with international norms. Above all, they will need to reflect a pattern of risk allocation that banks know they can live with as the project is implemented, with as many key risks as possible being parcelled out and allocated to the parties best able to manage and control them (see further under 'Issues' below).

There is no magic formula for achieving this. The concept of bankability is a fluid one, its precise implications changing in line with market sentiment and norms. It is also fairly project-specific, with differing requirements for different structures, sectors, markets and jurisdictions. The sponsors will need to be confident that their professional advisers (financial and legal) understand exactly how to satisfy these expectations and have the requisite experience and judgement to know which clauses will be acceptable to the lenders and their credit committees, and which will not. A decision is sometimes made to bring in the lenders and their advisers at an early stage of a project, to express their own views on this question. But this can lead to a tripartite negotiation process, which other parties may see as both too slow and too expensive. The preferred route is usually to keep the banks at one remove until the parties are ready to embark in earnest on the funding process, often after the PPP contract has been signed. That leaves the onus firmly on the sponsors' shoulders to get these judgements right at the outset, although it is also the responsibility of contracting authorities to be mindful of bankability requirements during procurement and negotiation of PPP contracts. Failure to do so adequately may make the projects they award unfinanceable, or undermine the tendering process from the outset.

**The wider context: ESG and sustainability.** To meet these objectives successfully, the contracting authority will need to place the proposed PPP and its contract squarely in the context of the broader considerations which will apply to any form of infrastructure procurement. A truly "holistic" approach is necessary. These considerations will include the host country's wider strategy for economic growth, investment and infrastructure development, taking account of applicable budgetary and fiscal constraints.[25] But they are also likely to take in the policy goals and ethical standards grouped together these days under the broad rubric of ESG and sustainability. These represent the principles, values and objectives relating to the environment, society and governance, which have grown dramatically in importance in recent years in many different contexts (reinforced by popular sentiment) and are increasingly at the forefront of much financial, commercial and regulatory thinking

[22] Examples include the water treatment concessions for Sofia, Bulgaria, and Bucharest, Romania, signed in the early 2000s.

[23] It should be noted, though, that in countries lacking an established culture of independent regulation, sponsors and lenders may actually prefer contractual regulation through the PPP contract to institutional regulation, where the independence of the regulators may be questionable.

[24] In particular, Graham Vinter and colleagues, Project Finance, 4th edition (2013), which devotes a chapter to its meaning.

[25] Once upon a time, governments tended to jump at PPPs for the off balance sheet advantages they offered. It was thought that both the debt and contingent liabilities involved could be left off the public sector balance sheet. Lately, this approach has met with growing scepticism, with accounting bodies concerned about the inappropriate by-passing of government spending controls, notwithstanding the considerable risks and potential liabilities involved. Eurostat, the International Monetary Fund and some national accounting bodies have devised new accounting standards for PPPs (such as ESA 2010) that make this more difficult, at least for government-pay projects. User-charge concessions still tend to be treated as off balance sheet. Governments generally now treat the crucial quality offered by PPPs as value for money, not their accounting implications. Under the influence of ESG values, this is in turn segueing into "value for people".

and decision-making, including in the infrastructure field. They have mounting profitability and reputational significance for businesses. Increasingly, governments aim to give effect to them at a policy level, corporates to be compliant with them, investors to insist on them and lenders to translate them into their investment criteria and loan covenants.[26] All PPP participants are therefore likely to need to take account of them, to a greater or lesser extent, as they go about or negotiate their involvement in projects. This includes contracting authorities, private partners, sponsors, lenders, contractors and other relevant authorities.

Numerous influential public documents with "global reach" capture the principles. The United Nations Sustainable Development Goals (SDGs), to which all member states are now in theory committed, to an extent defined and laid the foundations for them. The SGDs explicitly endorse PPPs: SDG 17 seeks to "encourage and promote effective public, public-private and civil society partnerships, building on the experience and resourcing strategies of partnerships". The G20 Principles for Quality Infrastructure Investment set out in the communiqué of the 2019 G20 Summit in Japan also reflects many ESG values.[27] They are also very much at the heart of the documents Guiding Principles on People-First Public-Private Partnerships (PPPs) for the United Nations Sustainable Development Goals and Women's Empowerment in PPPs, published by UNECE.[28]

These principles and values impinge closely on PPPs, as PPPs often directly affect those areas of activity with which they are most concerned – the environment, economic growth, public services, social impact and development, inclusivity, local communities, knowledge transfer and so on. PPPs can play a positive part in advancing them in constructive and innovative ways: upgrading deficient infrastructure, building new assets, providing new services, creating jobs, teaching skills, stimulating businesses and linking local communities.[29] In this way, they can help to reduce poverty, advance equality and promote integration – all fundamental aims of the SDGs. The size and long-term nature of PPPs also mean they can involve major sustainability challenges that need to be suitably addressed. In any event, these ESG values can now influence every stage of a PPP's life: the wider procurement strategy and project pipeline; the choice of structure for the PPP; the output expectations and technical specifications set out in tender documents, and the criteria used to evaluate them; the performance standards and risk allocation set out in the PPP contracts; the manner of the PPP's implementation; and the management, monitoring and information supply arrangements which apply throughout its life. One way or another, they are likely to inform many of the contract terms under discussion in this chapter.

Some of these principles will already have been translated into the domestic laws of host countries, or may soon be. If so, they will bind PPPs in any case where they affect them, as PPP contracts invariably oblige private partners to comply with domestic law at all times. Others have not, however, and may never be, as they simply amount to values and priorities which are exerting increasing influence across the political, commercial and financial worlds. The picture is also a fluid and fast-changing one.

The expectations and demands to which they give rise will keep changing in an ever-faster changing world, as thinking evolves. For that reason, it is not possible to be narrowly prescriptive about the ways they can impinge on the structural or contractual requirements for PPPs. Nevertheless, it is worth highlighting a few that are perhaps most relevant:

- **Human rights.** Businesses generally have wide-ranging responsibilities these days to avoid human rights abuses in their activities and to mitigate and overcome any affecting them when they occur. These include PPP project companies and their contractors. The United Nations Guiding Principles on Business and Human Rights (2011) cogently describes the expectations.

- **Social and environmental impact.** Particular care needs to be taken when PPPs are being designed and prepared to assess their potential impacts at a social and environmental level, to review these impacts in feasibility studies and then to address them appropriately in tender requirements, output specifications and the applicable evaluation and weighting criteria. The most efficacious and innovative

[26] See, for example, the Equator Principles (4th edition, 2020) incorporating the International Finance Corporation's (IFC) Performance Standards. See, European Bank of Reconstruction and Development, Environmental and Social Policy (April 2019)

[27] A copy is attached to the chapter on the statutory and regulatory framework for PPPs

[28] Guiding Principles on People-First Public-Private Partnerships (PPPs) for the United Nations Sustainable Development Goals (UN SDGs), UNECE (2018); Women's Empowerment in People-First Public-Private Partnerships, UNECE (2020). See the further discussion of this subject in Chapter 1.

[29] As the World Bank has emphasised in its contractual guide.

tender proposals in response are likely to attract higher marks.

- **Climate change.** Climate change represents a steadily growing risk, attended by mounting uncertainties about both its impact and the remedial measures that may be necessary to mitigate it. This represents a clear challenge for the sustainability of PPP projects, especially in those regions most vulnerable to extreme weather or the degradation of their natural habitat. How could climate change and the innovations in law and practice which might result from it affect a PPP project over its life? What resilience to this risk can be built into the contract's change-management clauses and how can the parties be best incentivised to take appropriate steps in mitigation? These measures may lead to higher up-front costs, but those costs should hopefully convert into greater value for money over the project's life cycle. All the same, if the problems prove too intractable, a PPP with a long-term contract may not in the end be the most suitable procurement option for the project in question.

- **Sustainability and value.** Sustainability has become a critical test of major development projects and investments. In practice, that means not just long-lasting, but also giving effect to ESG values in the long term. As the World Bank states in its PPP contractual guidance, "Investment in quality infrastructure is crucial to achieving sustainable development and empowering communities around the world." Value for money over a project's life cycle has been an acid test of PPP viability for many governments for years, but this is now being given an increasingly explicit sustainability interpretation, with an ESG dimension. The recent UNECE papers (mentioned above) argue for a "value for people [and the planet]" test to be applied, rather than "value for money". This thinking will probably feature ever more prominently in the design, evaluation and award of PPPs, as well as their contractual terms. The importance of PPPs to infrastructure development as an engine of recovery from the impact of the Covid-19 pandemic and economic crisis is likely to reinforce this.[30]

As can be seen, then, a broad range of differing objectives must be satisfied as the PPP contract is structured. The tensions between them can make the process of negotiating and finalising the document a protracted one, and go far to explain the lack of standardisation to these agreements from project to project.

## (E) Principal terms of a PPP contract

For the benefit of readers who are not familiar with this form of agreement, it might help to summarise some of the provisions typically found in a PPP contract.[31] A list of the main clauses often included is attached as Appendix II.

### Parties

There will usually be only two parties to the agreement: the public-sector entity awarding or granting the PPP, and the private-sector one developing and operating it.[32] The former may be a government department, a ministry or minister acting on behalf of a ministry (such as a secretary of state in the United Kingdom) or a local authority or municipality. The latter will usually be a special purpose vehicle, typically incorporated in the jurisdiction where the project is being developed, in which the sponsors and investors will become shareholders and which will constitute the borrower for the purposes of any limited-recourse finance. Occasionally, however, the PPP contract will also create step-in rights in favour of the lenders, who will not be parties to it, but will usually take an assignment of its provisions. A more appropriate vehicle for step-in rights is, of course, a direct agreement between the lenders and the host government, but direct agreements can sometimes be extremely difficult to negotiate with governments (as we explain in more detail below). If the PPP contract contain any step-in rights, the lenders may be able to place at least some reliance on them by virtue of their security package.[33]

The project sponsors will, of course, usually not be party to the PPP contract either, although there are examples of them taking on certain limited obligations

[30] See Chapter 5 for a detailed discussion of this subject.

[31] Readers should also look at the two chapters in Volume I of the PPP Regulatory Guidelines Collection that summarise two typical forms of PPP contract as heads of terms, namely Chapters 14-15, and the accompanying commentaries. Detailed guidance on these agreements is also available from a number of other sources, such as the World Bank, the UK Treasury and other PPP units around the world, including in Australia, Canada, the Netherlands and South Africa.

[32] In this chapter, the public sector entity is referred to as "government (entity)", "public sector (entity)" or "contracting authority", the private sector participant as the "private partner" or "project company".

[33] An example of this was the Second Stage Bangkok Expressway project in Thailand, where the lenders' step-in rights were created – not just referred to – in the PPP contract. For this to be feasible, local law will have to permit contracts to which the third parties are not signatories to create enforceable third-party rights (as can now be done in the United Kingdom).

(especially in the early, development phase). They will almost certainly be shareholders in the special purpose vehicle, which enters into it as private partner. However, the contracting authority (and the lenders, for that matter) will normally want to ensure that they – or at least the leading "shareholder of reference", with its proven expertise in the operation of projects of the same kind – are bound into it for a sufficient period to provide comfort and confidence that the contracted performance levels and standards will be met. The sponsor(s) in question may seek direct undertakings to that effect.

### Definitions and interpretation

The defined terms will be exhaustive and often voluminous, given the usual complexity of this type of agreement. Most will be self-explanatory and straightforward, though some may need careful thought – such as "project", definitions relating to debt and equity, and those governing the calculation of any termination payments (especially if they are tied to the project financial model). The permanent assets of which the PPP consists also frequently need to be defined (for example, contracted assets) and listed.[34] The project may also be divided into different phases needing definition.

### Conditions precedent

Conditions precedent (CPs) to the agreement's effectiveness (in whole or part) will usually be necessary in some form – frequently extensive ones. A PPP contract is typically signed before the other project contracts or financing agreements have been settled. A broad range of governmental consents and approvals may have to be obtained following signature, for example. Enabling legislation may have to be enacted. Finance will have to be raised. The site may have to be cleared and connecting infrastructure put in place. (The agreement may provide for a distinct development phase as well as construction and operational phases to deal with this, perhaps necessitating different CPs to each.) Both parties will typically take on an obligation to use reasonable endeavours to satisfy the conditions precedent (and, individually, the conditions for which each is responsible) by an agreed "drop dead" date. The question arises as to whether the sponsors (or even the contracting authority) should be entitled to recover any of their development costs where the agreement never becomes unconditional and has to be terminated, especially where this is attributable to the actions or inactions of the contracting authority or public sector it represents.[35]

That can sometimes place the PPP contract, at a conceptual level, in a somewhat ambivalent or uncertain position. It may have been signed and entered into, but it will only become fully effective once the conditions precedent have been satisfied. Where exactly does this leave any obligations and liabilities of the parties until they are met, or if they are never met? To what extent can they be enforced? A poorly drafted agreement may give rise to certain doubts in this context (even though the principle of the autonomy of an arbitration provision is widely accepted in most legal systems, thus usually vitiating concerns that it may not be enforceable if other parts of the agreement are not yet in effect). This could lead to arguments about its interpretation and application that may only be resolved in full-blown legal proceedings. A well-drafted and structured agreement will circumvent such uncertainties, however, making it perfectly clear which obligations become immediately binding and effective and on whom (such as the obligation to use reasonable endeavours in good faith to satisfy the CPs), and which are subject to the agreement's wider effectiveness (such as the obligation to design and build the works).

### "Grant of concession"/PPP scope

There is often a general scoping or "grant of concession" provision (to use somewhat old-fashioned terminology). This will describe the basic elements of the PPP in summary terms (such as the right and obligation to "develop, finance, design, construct, complete, operate and maintain" the project, hand it back to the contracting authority at the end of the term (where is a "T" (transfer) obligation is involved), and saying this must all be "at the private party's own cost and risk", save where otherwise expressly provided in the agreement. This kind of headline provision is perhaps more unusual these days in PPP contracts, especially where there is no single defined term "concession" – or even a legal concept of one – which needs to be reflected in their terms.[36] Nevertheless, the basic assumption will still

[34] See, for example, the Equator Principles (4th edition, 2020) incorporating the International Finance Corporation's (IFC) Performance Standards. See, European Bank of Reconstruction and Development, Environmental and Social Policy (April 2019)

[35] The sponsors will usually aim to recover at least some of these costs if early termination is attributable to government failures tosatisfy the CPs, although this can be difficult to achieve in practice. The contracting authority, on the other hand, will often be in a position to call a bid bond in these circumstances (whether fairly or not).

[36] It perhaps springs from the civil law tradition of moving in contracts from general principles to specific provisions, an approach that is not always followed in common law countries.

be a transfer of project-related risks to the project company, except to the extent specifically retained by the contracting authority, or otherwise excluded.

### Term and development phase

Like most commercial contracts, a PPP contract will normally be expressed to remain in force for a specified term, at the end of which it will expire automatically. Project economics will largely drive the agreement's duration. It needs to be long enough for the lenders to be paid out, the investment assets amortised (or depreciated) and a reasonable return made by the sponsors. The term may be either fixed or variable. A long-term fixed duration (anything between, say, 15- and 30 years – and occasionally significantly longer) is much the most common arrangement, although there may be a mechanism for extending it for a still longer period, to compensate the private partner for the impact of risks it is not prepared or able to bear. The parties (or one of them) may also have an option to extend the agreement for a limited additional period, on certain conditions (for instance, effecting further improvements or revising the financing terms). Some jurisdictions put legal qualifications on any such extensions to prevent their abuse.

There are isolated examples of agreements whose term is left open at the outset, their duration determined over time by reference to the date of recovery by the lenders of their principal and interest, and by the investors of a certain level of return (subject to the agreed pattern of risk allocation and perhaps also to a "long-stop" date). A variable term model of this kind is more likely to be encountered where the project company has a "pinpoint" equity structure (that is, little real substance), but the uncertainty and complexity it involves are likely to limit its appeal for all concerned. Many PPP laws in any case provide for a maximum term for any PPP, including any renewals. The term may be calculated from the date of effectiveness of the agreement or from the start of operation (thus avoiding the impact of any construction delays).[37]

A separate "development period" is often included to deal with the phase before financial completion when the parties are clearing and handing over the site and lining up all the CPs. This can last from a few months to a year or two. The sponsors may have to spend significant sums during this phase, especially in finalising their due diligence, carrying out further environmental and feasibility studies, completing their financial model and negotiating and signing all the other project contracts and financing documents. If financial close has still not been achieved at the end of that period, by any specified drop dead date, and the agreement is terminated as a result, the sponsors may seek recovery of at least some of those costs from the public partner where they are not themselves at fault. If they are at fault, they are not likely to recover anything.

### General obligations

The contract will often contain some general obligations with which each of the main parties will (respectively)[38] need to comply. These may include such matters as compliance with applicable law, the private partner's duty to carry out its activities in accordance with good industry practice or GIP (as defined – usually in terms of the equivalent of recognised best international practice),[39] responsibility for permits and consents, a duty on the contracting authority to use all reasonable endeavours to assist the private partner to perform (certain of) its responsibilities and not to interfere unduly with its activities, phasing arrangements, subsidies, tax and duty exemptions, and so on.[40] There may also be certain local content requirements requiring the private partner to use local materials and labour where feasible.

### Exclusivity

The private partner will often try to obtain a certain level of protection from competition by third parties in the agreement. A project finance structure may reinforce the importance of protections of this kind. Their exact basis and scope can be difficult to define, as they may impose constraints on the contracting authority's wider statutory powers. On the other hand, there is also likely to be at least some risk of disruptive interference in the private partner's activities by third-party "competent authorities" with powers and responsibilities relevant to the project under construction or operation. This, too, is likely to be provided for, largely to protect the private partner's position.

[37] See also article 8 of Chapter 3 (Volume I of the PPP Regulatory Guidelines Collection) on the Model PPP Law, where the calculation of statutory maximum terms is discussed in more detail.

[38] Most of them will not, of course, be the same for both.

[39] And the skill, care and diligence to be expected of an experienced international developer discharging similar responsibilities.

[40] Some of these may call for agreements with other government agencies, as well as or instead of the contracting authority.

### Corporate structure

If the private partner takes the form of a special purpose vehicle, as it almost invariably does, the contract is likely to contain certain provisions relating to its existence and ownership. The extent to which, and time for which, some or all of the sponsors are bound into it will be a matter for negotiation, as will the freedom to admit or dispose of other shareholdings. The project company would usually be precluded from engaging in any activities outside the scope of the PPP except with the contracting authority's consent. If it has been incorporated offshore, as it occasionally is, it is likely to have to establish a subsidiary in the host country jurisdiction as well; relations between parent and subsidiary will need to be carefully provided for.

### The site

The parties' respective responsibilities for the acquisition, condition and development of the project site will need to be addressed. Typically, its acquisition will be the responsibility of the public-sector entity, which is likely to be better placed to exercise any compulsory purchase powers than the project company. Occasionally, however, the private partner will be constituted as the government's agent for this purpose, charged (for example) with the task of handling certain potential and administrative aspects of the exercise of these powers.[41] These days, lenders – at least in the case of international financial institutions – are also likely to have tough ESG requirements, affecting the ways that land is compulsorily acquired and conserved, and local communities affected by the process. These requirements may be stricter than local law in this context.

A lease of the site may (or may not) be granted to the private partner in addition to the PPP contract.[42] If the project is to be transferred back to the public sector at the end of the term, the private partner's right to occupy it will by definition be temporary, with suitable contractual limits. If not, the private partner may be granted permanent ownership of it, as in a BOO (build-own-operate) structure.[43] Note that, in many civil law jurisdictions, if the PPP contract relates to the operation of a public service activity, the site as well as the other contracts assets necessary for the performance of the service will be considered public property ("domaine public" in France) and subject to specific rules. In each case, the private partner would usually expect the contracting authority to warrant title to the site and deliver it with "vacant possession", for instance, free and clear of any liens or competing or third-party claims which may interfere with the private partner's right and ability to use it for the intended purpose. Undertakings as to its physical condition can be more problematic.

An environmental due diligence report is also usually recommended to assess the state of contamination (if any) of the site. This is often the responsibility of the contracting authority, but may give rise to clean-up obligations on the private partner at both the inception and close of the PPP, coupled with a duty to return the facility and the site to the public sector in no worse a condition than that in which it had enjoyed it throughout. Again, lenders are likely to look closely at this report, the conclusions of which will need to comply with their ESG standards.

### Design and construction

Where the project involves a large initial capital outlay (for instance, a greenfield project), the project company will be obliged to design and construct the project facilities by a specified date, in accordance with specified standards. A technical specification setting these standards will be attached to the document. The private partner may be liable to pay liquidated damages if the works are not completed on time.[44] There may also be a "backstop" date (for example, perhaps 12 months from the target completion date) on which the contracting authority will be entitled to terminate the agreement if completion has not been achieved. An extension of the time mechanism will obviously need to be included in relation to a completion obligation. A large, complex PPP may also be divided into distinct phases, some of which may be contingent, their implementation subject to satisfying certain conditions (for instance, a level of throughput and further government approvals).

[41] This was the case with the Channel Tunnel Rail Link project, for example. In emerging markets, the exercise of these powers can be politically very sensitive. A fully developed procedural mechanism for questioning or challenging them will not always be available. An "agency" arrangement of the kind referred to is therefore fairly unusual.

[42] The grant of a lease is rarely more than a legal formality which may be required as a concomitant to the PPP contract. Any lease of this kind should ideally be as simple as possible, as all the relevant commercial provisions should be set out in the PPP contract. The two documents will, of course, need to be fully consistent.

[43] These structures seem to be increasingly rare these days.

[44] Arguably a pointless provision, at least where the private partner has project-financed the PPP and so has a very clear incentive and need to start generating revenue as soon as it can to repay the debt.

The nature and scope of the works and services to be provided will, of course, be specific to the project, but defined in terms of "outputs" rather than "inputs". In other words, the PPP contract will establish the obligations of the private partner very much on the basis of the end results to be achieved and the works and services to be delivered, as opposed to the detailed aspects of how that is to be achieved. (See below, in Section (F), under Public sector control.)

Where the PPP is purely operational (as in the case of a lease or affermage, to use the French term), however, design and construction obligations may not be capable of such clear-cut definition. They may be altogether more contingent in nature, their scope and timing dependent on rehabilitation needs identified over time, and revenues generated by user charges. The boundaries between the respective responsibilities of the parties, or the basis for defining them, will nevertheless need to be specified as clearly as possible. Where the contracting authority, for example, takes on primary responsibility for heavy maintenance or repair works, any delay or default in their discharge will impinge, potentially very seriously, on the private partner's operational performance. This will need to be equitably addressed.

French concession law traditionally classifies délégation de service public into three categories: (i) concessions (that is, contracts whereby the private partner is responsible for building the facility and operating the service), (ii) affermages (that is, contracts whereby the private partner is solely responsible for operation and maintenance of the service, as the facility is made available by the contracting authority to which a rent is paid),[45] and (iii) régies intéressées (that is, contracts whereby the private partner is only responsible for operating the services and is paid a variable price directly by the contracting authority, depending on the nature and scope of the services).

### Public sector monitoring and supervision

The PPP contract will create certain rights in favour of the contracting authority to monitor and inspect the design and construction works, and perhaps to approve certain elements of them, as they progress. It will want rights of access to the site, perhaps a site office of its own, the right to attend certain inspections and to receive various categories of document and information. The exact scope of any such powers often can prove a difficult area in negotiation (see below). Appropriate procedures and mechanisms will also need to be in place during the operational phase to ensure that the contracting authority is kept fully informed about the discharge of the private partner's duties during that period, and its compliance with the agreed levels and standards of service. The satisfaction of key performance indicators (KPIs) will be vital. Precise tests and procedures are often put in place to verify them.

### Change orders

The contracting authority may insist on a right to issue variation or change orders, giving it the power to modify the specification, design and/or scope of the works if it chooses (although it is not unusual for the public sector to decide to dispense with this right). A power to modify the operational regime may also be sought, although this is perhaps rarer.[46] In each case, the private partner will seek the usual entitlements to adjustments to the programme and to compensation for its additional costs if these powers come to be exercised.

The more contentious areas in this context relate to the raising of the additional funding likely to be necessary to finance the variation, and the exact form that any such compensation takes. The private partner may sometimes be asked to absorb a proportion of the cost of a variation, until a specified threshold has been reached. The private partner may need to be in a position to refuse a variation which cannot be funded on a basis consistent with the agreement's wider terms. It is also likely to insist on a right of refusal where a variation would be inimical to the project's wider design or standards (such as GIP) or otherwise incompatible with the contract's requirements.

### Utilities and supporting infrastructure

Various supporting facilities and infrastructure may have to be put in place for the project to be successfully implemented. Essential utilities, such as water and electricity, may have to be supplied, for example, or connecting roads or transportation links constructed. The site may have to be cleared as it is acquired, or a connection point or transmission line built between a power plant and the national grid. These responsibilities not unusually fall outside

[45] Affermage contracts were particularly common in the water distribution sector. The term has never been precisely defined, however. In line with EU directives, it is now generally accepted that such contracts should be referred to as service concession contracts. Nevertheless, in many civil law countries, local PPP laws still refer to this traditional classification. We believe such a reference is not relevant and may be misleading in a modern PPP law where PPP/concession contracts are being broadly defined.

[46] This perhaps highlights a contrast between emerging markets and the advanced economy contexts. In the latter, it is not unusual for the granting authority to be empowered to impose modifications to operational levels and standards. This is still rare in the former.

the scope of the PPP (in whole or in part), with the contracting authority taking on responsibility for procuring some or all of them, or at least assisting in their procurement. The consequences of its failure to do so may need to be explicitly addressed in the agreement. Timing will obviously be a critical consideration in this context. The contracting authority's obligations will have to be discharged in time for the private partner to start construction or operation of the facility when envisaged.

### Ancillary facilities

A PPP will often give rise to incidental commercial opportunities outside the scope of the main infrastructure project, such as the right to develop unused land or put in place subsidiary retail facilities (shops, restaurants, hotels, etc.). The PPP contract may need to address each party's respective rights to initiate and benefit from developments (often referred to as "ancillary facilities") of this kind.

### Financing and security agreements

Responsibility for raising the necessary finance for the project will have to be addressed, primarily or entirely by the private partner in most cases. The contracting authority will want to ensure that this has been satisfactorily achieved. It will often try to reserve at least certain rights to approve financing documents (both debt and equity) as they are entered into by the private partner, and subsequent modifications to them. The extent of any such rights can, again, be a contentious issue (discussed below). A balance needs to be struck between the government's right to ensure that the project company is adequately capitalised and funded, and the private partner's need for flexibility and control over its own financial arrangements (for which it will be fully responsible. Typically, the lenders will have no direct financial recourse at all to the government, unless, of course, a government guarantee is required, which is unusual (as it would undermine one of the principal purposes of a PPP). The right and power to grant security over the PPP assets and rights in favour of the lenders is typically addressed as well.

### Operation

The PPP contract will address the private partner's operational powers and responsibilities in relation to the completed project. The range or scope of the tasks it is expected to perform will be described, and applicable standards specified. The extent to which the contracting authority will be entitled to approve, modify or even participate in those responsibilities will be a matter for discussion (see Public sector control in Section (F) below). The agreement may set out minimum resources required, performance levels and objectives, KPIs and penalties for substandard performance.

### Maintenance standards

Similarly, the agreement will lay down certain maintenance standards and requirements for the completed project, which the private partner will be expected to satisfy during the life of the PPP. The contracting authority will retain certain rights of access and inspection. A question that often arises in this context is how the parties should allow for the project's diminishing design life and asset value, and the maintenance implications of having to hand over the assets in a particular condition (with a remaining useful life) on transfer, at the end of the PPP.

### Tariffs, tolls and charges

The private partner's rights to charge for its services will, of course, need to be addressed – whether by way of tariffs payable by the contracting authority,[47] in the case of a "government revenue stream" PPP, or charges or tolls levied directly on users or beneficiaries of the facility, in the case of "user-charge" concessions. Sometimes, there will be a combination of the two, where, for example, the government subsidises the private partner's user charges. User-charge structures are adopted where it makes sense for the project company to bear at least an element of demand risk, and their use is considered politically acceptable (such as a toll road), government-pay ones where that is not the case (as in a prison or hospital, for example) or the demand involved is too unpredictable to estimate long-term revenue with confidence, and the contracting authority is able to stand behind its commitments for the life of the project. (The private partner and its lenders will be exposed to its credit risk, which they will need to assess carefully.) In the latter case, the private partner is paid for making the facility or service available for use, regardless of actual usage levels. The tariffs are accordingly termed availability payments. In each case, however, there will usually be at least an element of linkage to performance involved – either in practice, where the project company takes demand risk and its revenues depend on the numbers of users using the facility or service, or contractual, where the tariffs or subsidies payable are conditional on the quality of performance.

[47] Often called shadow tolls and/or availability payments.

If a separate off-take contract is involved – as, say, in the case of a power project with a separate power purchase agreement – this may be done in the off-take agreement.[48] Usually, however, the PPP contract will provide for the calculation of tariffs and the private partner's ability to revise them during the life of the PPP, or may simply confirm that the private partner is free to determine them, either at its discretion (if that is the position) or subject to certain constraints. If a government revenue stream is involved, provision will often be made for deductions from it as a performance penalty, where the private partner is failing to meet its KPIs. If operation or maintenance standards are not being met, for example, the availability payments or shadow tolls otherwise payable may be reduced.[49]

Open-ended discretion on the part of the private partner to determine and revise its charges would be unusual,[50] the assumption being that the government is content to allow market forces alone to constrain them. Typically, especially where services to the general public are involved, a combination of caution, political sensitivity and the need for consistency between different projects means the contracting authority will insist on appropriate conditions and rights of approval in the contract – at the very least, a reasonableness test.[51] And in the case of government-pay PPPs, the charges will, of course, be prescribed by the contract and any revisions subject to it terms.

Civil law can be rather more prescriptive here than common law. In some civil law countries, tariffs must usually, as a matter of law, be expressly determined in the PPP contract, any modifications to them requiring the approval of the contracting authority (or deemed approval, where they are determined in accordance with the contract's express conditions). When related to a public service, tariffs must also be determined on a non-discriminatory basis and based on the actual costs incurred by the private partner for the service provision, plus a fair level of remuneration or return. (Case law tends to allow slightly more flexibility in this context, however, and regularly focuses on the broader concept of the value of the services rather than costs.)

The agreement may also provide for payment by the private partner of a PPP or concession fee of some kind. This can take a variety of forms. It may be a lump sum up front, an annual fee or rent, or even a profit-sharing mechanism.

## Force majeure, change in law and exceptional events

As with many long-term commercial agreement, the parties will need relief from potential liability when they are prevented from performing by unforeseeable events beyond their control. This is, of course, the basic function of any force majeure provision. Sometimes there will be a separate subcategory of force majeure circumstances (perhaps called risk events or compensation events in the PFI context), in relation to which the private partner may be entitled to compensation as well as relief from liability. This is likely to be combined with the "exceptional events" clause summarised below.

Given the long-term nature of a PPP contract and the restrictions on the project company's activities that it may contain, there will frequently also be a need for a "change of circumstance" or "stabilisation" clause of some kind, allowing the agreement to be modified when significant changes in circumstances occur that affect the project in unexpected ways. The changes in circumstance can range from changes in law, to modifications to licences and permits, to social or economic disruption or the loss of basic investment protection rights, affecting the economic balance of the agreement. (This is why these provisions are sometimes also called "financial balance" clauses). Various forms of government action or interference are also often included. They may make the performance of certain obligations more difficult, onerous or expensive, or obstruct or prevent it altogether. When the PPP is project-financed, the precise and highly structured assumptions and allocations of risk that underpin this financing methodology will tend to reinforce the need for a provision of this kind. Lenders will therefore also attach great importance to these provisions (and in a civil law context insist on protections that go beyond the narrow definitions of force majeure typically provided by statute or administrative case law).

Whether one labels them exceptional events, force majeure events, financial balance provisions or something else (such as in PFI documents), the clauses addressing them will always call for careful and detailed provision, covering the broad range of events of this kind that can occur and making appropriate allowance for the different ways they can impinge on the agreement and the project, sometimes triggering compensation. There will be

[48] Some independent power projects will effectively split the PPP contract between a purchase power agreement with the off-taker and an implementation agreement with central government. An example would be the IPPs in Pakistan signed in the early 1990s.

[49] See, for example, the sophisticated mechanisms of this kind which evolved in the British PFI context.

[50] Although there are examples, such as certain types of port or rail project.

[51] For example, revisions subject to the approval of the contracting authority, not to be unreasonably withheld.

questions about whether the provisions are limited or open-ended in scope, the risks identified in any list of events forming part of them, the nature of any exclusions and the ways any compensation is calculated and paid. Treatment is likely to differ depending on whether the relevant events occur during the construction or operation phase, whether physical damage is involved, whether political or natural events are at work, whether insurance is available and so on. The structuring of these clauses is therefore rarely straightforward and is discussed in more detail in Section (F) (Force majeure and financial balance provisions).

Once again, the approach may be slightly different in some civil law countries, at least under administrative law in the French tradition. If the contracts are classified as PPP contracts rather than concessions, the analysis may be much the same as that described above. If they are concessions and classified as public law contracts, on the other hand, administrative case law often applies a number of different concepts to unforeseeable events. Under French law, for example, it may treat them as:

- **Force majeure:** Any external, unforeseeable and irresistible event. In this case, the private partner is excused from performing its obligations and entitled to compensation for the extra-contractual costs it incurs as a result.

- **Imprévision:** Any unforeseeable event that distorts the economic balance of the contract – that is, a party's obligations can continue to be performed, but only at significantly higher cost than originally envisaged. In this case, the private partner must continue to perform the contract, but is entitled to compensation for up to 95 per cent of the extra-contractual costs incurred as a result.

- **Fait du Prince:** This applies to any unforeseeable, material adverse action taken by a relevant authority, other than the contracting authority. (In the latter case, the imprévision theory applies, in addition to any available remedies for breach of contract). In this case, the private partner is entitled to full compensation.

The scope of these theories, and the compensation to which they may give rise, are not always precisely defined by case-law, nor necessarily in line with international best practice. They consist of principles of law, which give rise to certain entitlements. As such, particular attention should be paid at the structuring/due diligence stage to (i) verifying whether and to what extent they may be derogated from under local law and (ii) if so, setting out a precise definition of compensation events and the related compensation in the PPP contract. In other words, in many cases, the parties may end up in much the same position as in common-law jurisdictions – setting out comprehensive, detailed mechanisms and their consequences in the PPP contract.

The impact of the Covid-19 pandemic in 2020 and the extraordinary restrictions imposed by governments all over the world in response to it, with their devastating repercussions for ordinary commercial and economic activity in many countries, have added a new dimension to the importance of force majeure, change in law and exceptional event clause, and a new urgency to the attention they receive. Chapter 2 on the legislative and regulatory framework for PPPs and Chapter 5 (on the impact of Covid-19) contain further discussion of this subject and the steps that the parties to PPP contracts should consider taking to allow for similar events in the future.

### Termination

The agreement will almost invariably contain a termination clause. There is sometimes a suggestion that sponsors and lenders on a project financing may be prepared to do without such a clause on the basis that they would want to avoid termination of the project at all costs or that the host country legal system provides for termination rights anyway (as most will do in certain circumstances, particularly civil law countries). A comprehensive termination clause will offer certainty and therefore stability, however, and this is likely to benefit of all parties, especially in light of the huge sums of money involved in PPP projects. There may well be circumstances in which the private partner is left with no option but to terminate, reluctant though it may be to do so (and its lenders to allow it), in which case its position and interest, including those of its lenders, will have to be clearly and adequately protected.

Unremedied material breach of contract (as defined) by either party will typically be one ground of termination, the project company's insolvency another. Other – and more precise – grounds will be a matter for discussion. In reality, the termination clause is an important dimension of the agreement's risk allocation. The project's lenders will also closely scrutinise the scope of any termination rights, as they will underpin the financing arrangements; on project financing, the early termination of the PPP contract will also put an end to their ability to recover their debt and interest from the project's future cash-flows. Mainly for this reason, the principal issue in the negotiation of any termination clause is usually the compensation payable to the private partner and its lenders if it comes to be exercised (see more below).

### Lender's step-in rights

As mentioned above, the PPP contract is likely to acknowledge or even create lenders' step-in rights. Their purpose will be to forestall a possible termination of the agreement by the contracting authority and to allow the lenders to keep the project alive for enough time to cure any default and restore normal operation.

### Public sector step-in rights

The contracting authority may also insist on retaining certain powers to take over the operation of the completed project temporarily in defined circumstances. (Local law may give this power to a number of relevant authorities, in fact.) National security, suitably defined, may be one such ground, the need to respond quickly to emergencies potentially affecting the public another. The private partner will naturally be concerned to place suitable limits on any powers of this kind.

### Sharing refinancing gains

It is increasingly common these days for PPPs in emerging markets to provide for the sharing of some of the gains accruing to the project on a refinancing of the PPP during its life. This is perhaps another example of a device pioneered during the explosive growth of PPPs in Europe and other developed economies that has been emulated elsewhere. A project's initial financial structure will often be designed to incentivise and prompt a refinancing during the operational phase once the relatively high-risk design and construction phase are successfully behind it.[52] At that stage, if its cost of debt or cost of capital can be significantly reduced, it will often make sense to allow the contracting authority to share in the gains. The more difficult question is how exactly and to what extent?

### Retransfer of project

If the project is being developed on a BOT/BOOT or similar basis, the agreement will contain a provision setting out the private partner's obligations to retransfer it, and the completed assets, to the contracting authority as the agreement expires. The private partner's potential liabilities for the condition of the assets over their remaining useful life at the time of transfer can be a difficult question. There is often also a set of "ramp-up" obligations and procedures which apply immediately before expiry of the PPP to cover this, perhaps during its final year. Inspections, training of public officials and staff, data provision and other matters may be allowed for.

### Insurance

The project company will usually have to take out insurance policies and maintain them throughout the term of the PPP. The contracting authority's main concern will be to protect the physical assets which the PPP comprises and ensure that the project company will be in a position to continue operating and providing any public services following an insured event. In practice, this usually boils down to a group of policies recommended by GIP, where they are available in the market on reasonable commercial terms.

### Law and disputes

The agreement will usually contain a governing law provision and an appropriate dispute resolution clause. The system of law applicable, the dispute-resolution mechanism adopted and the application of jurisdiction provisions can be complex questions (see the Dispute Resolution section below).

### Miscellaneous

Finally, there will be the usual tail-end provisions and boilerplate clauses, such as confidentiality, notices, mutual indemnities, amendment and waiver, assignment and so on. Certain representations and warranties will always be included and need careful thought; the enforceability of the agreement's clauses under applicable law and waiver of sovereign immunity will usually be critical.

[52] As, for example, where so-called mini-perm structures have been used.

## (F) Principal issues

### Bespoke contracts – precedents and standard forms

Various issues can arise as PPP contracts are negotiated. That is not surprising, given the significance of this type of agreement to any PPP, its complexity and range of objectives, and the extent to which infrastructure projects differ from another. It can often take six months or more for the document to be finalised (although in theory it should be possible to sign one within a much tighter time frame). There have been repeated requests for standardised PPP contracts to be adopted internationally, but real progress on this front has been limited.[53]

PPP contracts are therefore often viewed as documents that need to be tailor-made for the project in question, in contrast with, say, construction contracts for which international organisations such as the International Federation of Consulting Engineers, the International Chamber of Commerce, the Joint Contracts Tribunal and the Institution of Chemical Engineers long ago evolved widely accepted standard forms. The absence of internationally recognised model contracts for PPPs tends to reinforce that perception. Nevertheless, experience shows that appropriate precedents can quickly establish themselves as unofficial standard or model forms in a given jurisdiction for what is basically the same type of project.

Examples of this would include, in the United Kingdom, the DBFO road contracts and the project agreements developed for hospitals, prisons or the water sector (respectively), the contracts drawn up in France for the road and prison sectors, and the implementation agreements and power purchase agreements used for the independent power project (IPP) programme in Pakistan. Similarly, the forms inspired by the United Nations Industrial Development Organization (UNIDO) for the first BOT power plant in China (Laibin B) were adopted for several subsequent Chinese power projects, but then also adapted for some road and water projects as well (such as Chengdu). UNIDO then exported the same skeleton concession provisions to Africa for use on the first BOT satellite project, RASKOM. The explosion of PPP activity around the world in the past 20 years has inevitably led to a great deal of imitation and repetition of clauses, giving practitioners a clear sense of what amounts to international best practice and market standard these days.

Contracting authorities should be mindful of the vital importance of using contract forms that are thought to be acceptable to the (relatively small) universe of established sponsors and the international financing community, including commercial lenders, investment banks, international financial institutions, export credit agencies and political risk insurers. In the absence of established standard forms, it will obviously make sense to use the most relevant available precedents signed for similar projects in similar jurisdictions and which have already been tested by the financial community on deals that have reached financial close. This applies to developed economies as much as emerging markets. Extensive use was made a few years ago in France, for example, of precedent provisions from Hungary and the Czech Republic for the purposes of France's project-financed highway concessions (including the north Lyon Périphérique and the A28 extension), in place of the old concession forms, which consisted of little more than 10 pages, developed by the French school of Ponts et Chaussées and used on earlier highway concessions for decades.

Helpful precedents and standard or model form contracts are one thing, however, mandatory contractual provisions another. As mentioned in Section (C) above, attempts to prescribe the exact contents of clauses in PPP contracts by law are usually counterproductive and can even be disastrous. The parties must always be free to adjust provisions to the needs and characteristics of a specific project as appropriate. The more constructive guidance that can be made available to them by the market and by know-how centres within particular jurisdictions, the better. Well-established and familiar precedents will always help to shape a deal, put helpful parameters on the negotiation process, and reduce costs. Even where they are not formally binding, their status as widely accepted norms, or perhaps government-endorsed model clauses, can still be very persuasive.

### Development and transaction costs

It is worth saying a word in this context about cost control. The development and transaction costs associated with successfully concluding PPPs can obviously be very high, especially in the early stages of a country's PPP programme, before structures, documents and processes have been well thought through and streamlined, and relevant experience collated and focused. Indeed, finding ways to mitigate and reduce these costs is usually one of the main preoccupations of the governments attempting PPPs.

[53] In the British domestic context, the Treasury Taskforce made a sustained attempt over a long period to standardise most of the provisions of PFI contracts. This eventually made great headway. See the Treasury publication Standardising PFI Contracts, issued early in 2000, and subsequent editions. Where clauses cannot be fully standardised, the taskforce's published guidelines have still led to much greater consistency of approach in agreements. Many other countries have also published model clauses of one kind or another for their PPP systems. The World Bank has published an extensive set of model clauses (World Bank Guide to PPP Contractual Provisions, revised in 2019).

This can represent a particular challenge for emerging-market economies, which often have far fewer resources to spare for expenses of this kind and where other factors may compound any in-built inefficiencies already affecting the system. In fact, it would not be an exaggeration to say that these costs can represent a major potential impediment to any PPP programme. Governments need to be properly advised, but may be reluctant to commit to the fee levels demanded by top-tier, suitably experienced international advisers (of the kind they should always aim to use, if possible). Equally, sponsors may hesitate to incur the huge advisory fees – technical, legal, financial, ultimately including the lenders' costs – that are often necessary to take a major project through to financial close (especially a project-financed one), unless they have a high degree of confidence in its ultimate success and fair treatment of their proposal by the government.

This, of course, greatly reinforces the case for standardisation. A PPP contract that is well-drafted, balanced, robust and based on appropriate, bankable precedents will greatly accelerate the negotiation process and thus reduce transaction costs. Similarly, efficient processes can mitigate development costs. These costs will also be held down by ready access to local experience and expertise in this field. Enhancing the available expertise and capacity in government should be an ongoing exercise, as it takes years to develop it. Indeed, capacity-building is now widely recognised as one of the most urgent priorities for governments in emerging markets and developing economies. Many countries implementing PPP programmes have therefore set up "expertise centres" (along the lines of the UK Treasury's teams in this field, such as Infrastructure UK, Partnerships UK and, formerly, the Treasury Taskforce), where precedents, know-how, expertise and experience can be marshalled and organised, and then quickly made available to help contracting authorities and their counterparties structure and negotiate PPP projects. Similar steps have been taken by international bodies, including the EU, the EBRD, UNIDO, the World Bank and, of course, the UNECE Group.[54]

The EBRD's Project Preparation Facility is a case in point. It seeks to assist governments with the early stages of project selection and preparation, with the aim of ensuring that only viable, well-conceived projects are taken to the next stage of implementation and that costs are not wasted on projects that are likely to go nowhere. The EBRD has a panel of outside advisers committed to this programme who it brings in and funds as necessary to help with this initial phase.

The following section summarises some of the major issues typically encountered in negotiation, focusing on themes that are specific to PPPs.

### Public sector control

One area that can be highly contentious in negotiation is the degree of control exercised by the public sector over the private partner during implementation of the project, whether before or after completion. The private partner will usually try to obtain as much autonomy as it can over its activities. Obviously, the PPP contract will contain undertakings detailing the standards applicable to the project. There is likely to be a "minimum requirements" document, or specification, setting out the basic parameters for design, construction and operation. Certain rights of access and supervision will be given to the contracting authority. It will usually be entitled to copies of design and construction documents for its review. It may even have a seat at board level in the project company. There will also be extensive reporting requirements.

The private partner will often regard these protections as sufficient. Yet the public sector will frequently demand a greater degree of control than this. It may insist on a right to approve any change or modification to the private partner's equity structure, for example. It will often expect to have broad rights of approval over the design documents as they are produced. It may demand the power to supervise and certify (or even direct) the construction works on site. It may seek to participate in the negotiation of the project documents and approve their final terms. It is also likely to want a significant say in the contents of the private partner's operational activities.

The private partner will usually try to resist or limit these demands. It will argue that to discharge its fundamental undertakings to government and manage the risks impinging on his activities, it will need a high degree of freedom from interference. Excessive government control may prevent the private partner from performing as well as it otherwise might. After all, the government is transferring the project to the private sector to benefit from its managerial and creative skills. Flexibility and the ability to innovate will be important to its ability to do so. If additional finance has to be obtained because the project is not going according to plan, it will be up to the private partner to find it, and its equity investments that will stand to lose most up front as a result. The private partner's lenders will also be very concerned about the possibility of too much government interference. In the end, the public sector will be protected by its rights to sue under the contract and eventually to terminate it if the private partner fails to deliver.

[54] See also the longer discussion of this subject in the chapter on legal frameworks for PPPs.

The contracting authority, however, may feel that it has a residual role to discharge as guardian of the public interest, perhaps together with certain continuing statutory duties (to the extent these have not been delegated to the private partner). Public sector bodies can sometimes find it hard to adapt to the cultural changes and differences of approach that a PPP project entails (especially where one is dealing with local government or municipal bodies which may not have had exposure to a structure of this kind before). They may view a PPP as just another form of public procurement; they will often have been used to close and detailed management in the past of a contractor's activities as the employer under an EPC (engineering, procurement and construction) contract, and it may take time to understand all the subtleties of the very different role that a contracting authority enjoys under a PPP contract.  Moreover, the political sensitivities often associated with high-profile projects can increase the temptation to micromanage.

The private partner's human and financial resources will obviously play a central part in this discussion. Where the private partner has extensive resources available (including considerable equity and a sophisticated management team), there will be less scope for argument about its ability to perform autonomously. Conversely, it may have a "pinpoint" equity structure, where only minimal equity is contributed, and an almost nominal management team,[55] in which case it could actually be in the best interests of all concerned (including the lenders) for the government representative to take a more extensive and active role in obtaining approvals and monitoring and supplementing the private partner's activities.

The outcome is often a heavily negotiated compromise. There are legitimate concerns on both sides. The objective should be to strike a suitable balance that reconciles the private partner's need for autonomy and managerial freedom with the government's desire for an adequate degree of supervision and involvement. One general rule should always be kept in mind, however: the more control the contracting authority asserts over the private partner's activities and third-party agreements, the more it qualifies or even undermines the risk transfer that justifies the PPP in the first place, and the less scope it leaves for the project to benefit from the innovation and managerial skill which the private sector is bringing to bear.

Some examples of the specific areas on which this discussion tends to centre include the following:

#### (i) Standards and objectives

The government entity should focus on the results to be achieved and standards to be met by the private partner, rather than how the private partner achieves them (on the "output specification" rather than the private partner's "input" methods, in the language of PFI; the "what" rather than the "how"). In practice, this means drawing up a detailed technical specification and set of operational standards setting out the relevant objectives. It may make use of relevant KPIs to do this. In most cases, it will be inappropriate for the government to approve the detail of the project contracts (other than the PPP contract itself and, of course, any other agreements to which it is a party) or the operational regime. These are generally best left to the private partner's judgement. They effectively represent a form of subcontract of the private partner's responsibilities in the PPP contract, and it is the private partner who takes the risk of performance during both the construction and operational phases.

#### (ii) Approval of design and construction

It should usually be sufficient for the contracting authority to receive copies of design documents as they are produced and to have discretionary rights of inspection over the works as they progress. There is often an obligation on the private partner to produce progress reports during construction. The contracting authority will also usually be entitled to attend the commissioning tests and certify (or counter-certify, or confirm) completion. It would be unusual for the public-sector to need more than this. Detailed rights of approval can be difficult to operate and even counterproductive in practice (although see comments in the introductory paragraphs to this subsection in relation to private partners with limited resources).  Lenders will also require a clear and robust commissioning process, ensuring that the private partner will be granted the right to start operation forthwith upon satisfactory completion of the relevant tests, with the risk of delay attributable to undue interference by the contracting authority (or other authorities) minimised or nullified.

#### (iii) Identity of shareholders

Having selected and negotiated with a group of shareholders, it would be surprising if the contracting authority did not want to place at least some limit on subsequent shareholder changes. Those restrictions are likely to have more significance during the comparatively high-risk, pre-completion phase, than after it, however. Once a stable operational level has been reached (perhaps a year or two after completion)

[55] As was the case with the Skye Bridge project in the United Kingdom, for example.

and a successful track record established, it may not matter if a shareholder wishes to sell down its interest, as this may not lower confidence that the performance standards can still be met. The government will continue to have the benefit of its contractual rights. Any need for services or resources from individual sponsors can be addressed in other project contracts. A more liquid equity market in infrastructure projects may actually be in everyone's interest. Finally, flexibility in the financing arrangements may make it easier for the sponsors to offer attractive commercial terms in the first place. In each case, however, both parties need to decide which key sponsors can and should remain locked into the project company and for how long.

#### (iv) Identity of lenders

The identity of the lenders should not usually be a matter of great concern to the government entity. There may be occasional political concerns (relating to national security, for example), in which case narrowly drafted provisions dealing with them may be appropriate. The government may also wish to specify minimum criteria for credit standing or infrastructure-finance experience. It should normally be possible to address confidentiality concerns with suitable confidentiality clauses. In any case, the contracting authority will usually know precisely who the lenders are from the outset and be aware of any proposed change to them, which gives it a considerable degree of de facto control in practice. Formal de jure control may be unnecessary.

The terms of the financing documents, however, may be a different matter. The government entity will want to satisfy itself that the private partner has obtained the necessary finance to perform its obligations before the agreement is entered into, or at least becomes unconditional. The terms of the senior debt finance are likely to be relevant to its potential liability on a termination. For these reasons, at least certain rights of approval of the initial funding agreements may be unavoidable. The more difficult question relates to refinancing. The private partner's ability to refinance may, in the end, be in both parties' interests. What formal limits should be placed upon it, if any? How should any refinancing gains be shared?

#### (v) Insurance

The contracting authority should not usually try to prescribe the private partner's entire insurance programme. This is an aspect of management of the private partner's business and risks. It makes sense for it to seek assurances as to certain categories and perhaps minimum amounts of insurance relating to areas which impinge directly on its interest (for example, physical damage, third-party claims or employer's liability). Other areas (for instance, business interruption, latent defects) should be at the private partner's discretion. An obligation to insure in accordance with good industry practice can be a helpful test. Requirements as to the application of insurance proceeds, to reinstate damaged works, may have to be subject to a project economic test, allowing the lenders to be paid out as a priority in exceptional circumstances (the lenders usually have tight restrictions on the use of insurance proceeds).

### Risk allocation

To a large extent, the underlying theme throughout the negotiation of the agreement will be the question of risk allocation. As mentioned above, one of the functions of a PPP contract is to allocate the project risks between private and public sectors. Yet the starting point of many PPP projects in emerging markets will be a wide-ranging assumption of risk by the private sector, especially if a full-blown concession is involved. The private partner will obviously have to bear and manage the risks that, in general terms, are central to its activities: design, construction, funding, performance, operation, maintenance, perhaps market or revenue risk, and so on. The agreement will often have a clause providing that the private partner undertake to "finance, design, construct, complete, operate and maintain [the facility] at its own cost and risk, without recourse to government funds or guarantees". However, it will inevitably be qualified by the words "save where otherwise provided in this agreement". The real question, then, is what risks will the contracting authority shoulder or retain and what protections will it offer the private partner against them?

The answers to this question will vary widely from project to project and depend on many factors. Government risks may include some or all of the following:

- vires and legislative authority
- site acquisition and delivery/basic rights of access
- unforeseen/unforeseeable site conditions such as pre-existing contamination or archaeological finds
- (certain) fundamental licences and permits
- timely provision of utilities (such as water and electricity) and connecting infrastructure
- certain general financial safeguards (such as investment protection rights, currency convertibility)
- political events/government disruption
- nationalisation/expropriation

- certain strikes/protester/trespass (squatter) risk
- change of law/fiscal regime (in part)
- (possibly) inflation, exchange-rate risk and major economic disruption
- competition from other facilities
- variation orders (cost and economic consequences)
- force majeure (in part)
- other exceptional events (if any).

In each case, there may be ways to share the risk between government and private partner so that incentives to find constructive solutions to unforeseen circumstances are maximised. The consequences for the agreement of any risk will obviously depend on precisely how it arises and affects either side's performance of its responsibilities. Its insurability, or otherwise, will be a vital consideration, as will the ability to pass it on to third parties (such as an off-taker, users or taxpayers). For that reason, it can be unhelpful to discuss the subject of risk allocation outside the context of specific clauses. Most of the remaining issues elaborated below involve some element of risk allocation.

A detailed discussion of the process of risk allocation is beyond the scope of this study, though the subject is discussed at length in other parts of. There has been a marked increase in recent years in the sophistication of the methodologies used by both public and private sectors in their approach to it in the context of PPPs. (See, for example, the many papers published on the subject by government bodies in a range of jurisdictions. Indeed, guidance on risk allocation has perhaps been one of the central themes of published advice of this kind to date.)[56]
It is now a truism of project finance that the party best able to manage risks should bear them. As a risk allocation tool, however, this principle does little more than provide general guidance. Governments, sponsors and lenders all have their own methods of identifying, measuring and allocating project risks. Lenders, in particular, will take a rigorous, systematic approach to satisfy themselves that the pattern of allocation makes sense and does not leave the project (and therefore their loans) unduly exposed. Unfortunately, at an international level, there is still perhaps less consistency of approach than might be wished. This seems to be especially true of emerging-market projects, where the need to "reinvent the wheel" arises just a little too often.

One of the central objectives in structuring a PPP contract should always be to strike a suitable balance in terms of risk allocation.[57] The truth is, the final pattern of risk allocation adopted will be driven as much by the dynamics of negotiation, with its patterns of compromise and "horse trading", as by any scientific or impartial process. There is often a temptation for each party to try to induce the other to shoulder as much risk as it possibly can. For example, the contracting authority will sometimes try to back away from taking on obligations which no other party should rationally accept (the authors have seen unsuccessful attempts to draft PPP contracts without any clear-cut government obligations at all), while the private partner may ask for protection against unforeseen developments of almost any kind (for example, any material adverse event beyond its control).

The question of the private partner's control over its charges or tariffs should play a prominent part in determining the pattern of risk allocation. Where the private partner is free to set and revise its tariffs at its discretion, charging the public directly for use of the completed facility, it will often be in a somewhat better position to absorb and manage the impact of events beyond its control than would otherwise be the case. Its position will in some respects resemble that of any other entity doing business in a particular country. This contrasts with many PPPs based on government revenue streams, where tariffs will be determined from the outset by agreement with the public sector and cannot be revised except in closely defined circumstances (subject to any "market-testing" mechanisms). Emerging-market projects often (arguably) tend towards the former model, partly because there is often less government inclination – or ability – to pay the private partner directly for its services, although even then, government is likely to seek tight controls over steep tariff rises given the sensitivity of public service provision and the issue of affordability. The difference between the two can lead to very different approaches towards risk allocation in the agreement.

In many ways, it is in this context that the contrasts between PPP projects in developed economies and emerging markets are most striking. Sponsors and their lenders will often be in a stronger position to seek broader protections in emerging markets,

[56] See the list of papers on this subject published some years ago by the UK Treasury. In particular, the Guidance Note on Public-Sector Comparators explains the more technical aspects of the British government's approach to risk transfer and value for money.

[57] An interesting illustration of this was the shift of language in official PFI guidance in the United Kingdom away from the principle of risk transfer and towards risk allocation. The UK government's initial assumption when PFI got underway seemed to be that the private sector could absorb almost any risk provided the price was right. That is not the case, and is not helpful to the public-sector position.

given the very different risk profiles to which they are likely to be subject, at both a micro and a macro level. That broad basket of risks and considerations, sometimes referred to as country risk, will be more of a challenge in emerging markets. A country's political and economic stability, the quality of its wider legal system, the maturity of its markets, the nature of international investment protections, its currency strength, its investment grade status and so on will all affect the approach of sponsors and lenders to the subject – and the protections they seek in the PPP contract. Indeed, if a country is perceived as being too risky, neither PPPs nor project finance lending may be feasible at all. Its projects may not have appeal compared with more attractive lending and investment opportunities elsewhere. A sufficiently stable political, economic and legal regime is necessary. Developed economies with large-scale foreign direct investment, by contrast, will raise fewer concerns of this kind. Many countries with evolved PPP systems have also published detailed guidance as to what allocation is appropriate for their PPP schemes.

Nevertheless, it is important to avoid the temptation to ask for too much in emerging-market deals. The danger is that, if either side pushes too hard in negotiation, the project stands to suffer as a result. Prices may rise excessively, for example, if sponsors have to factor excessive contingency into them, or the private partner is left without redress in a situation where the public sector could easily have permitted an adjustment to the agreement. Conversely, the government may be asked in effect to indemnify the private partner against any force majeure event, or to make compensation payments on a termination which effectively guarantees the sponsors a healthy investment return, no matter how badly they perform, or what sort of state the project assets may be in. (Again, the authors have seen attempts to adopt this position in negotiation). Provisions of this kind can risk precipitating a collapse of relations between the parties, or at least a continuing pattern of tension and confrontation. They are also likely to lead to poor value for money for the public sector (not to mention overly protracted negotiations).

Ultimately, the most constructive approach is to adopt a flexible and reasonable attitude towards risk allocation, leaving risks where they can be managed and controlled most effectively. If the agreement is structured with fairness and flexibility, in a way which fosters a spirit of partnership and cooperation, the project stands a greater chance of succeeding. This applies at the tender stage as well as during any contract negotiations: a rational, constructive approach will attract higher-quality bids, willing lenders and more competition, probably leading to more competitive bids and pricing, which will create better value for money. The opposite will put off experienced sponsors and may deter lenders. Equally, a well-conceived pattern will produce a more sustainable project, as it will need to apply for the life of the project. The parties will, by definition, be "in for the long haul".[58] Unanticipated difficulties are bound to occur over the life of the project. If the agreement encourages "win-win" solutions to problem solving, allowing both parties to benefit where possible, the project as a whole will be strengthened. How exactly this is achieved in each PPP contract will be a matter of detailed structuring of the clauses.

Remember that both works and services are closely interrelated under a PPP, with long-term operation and performance being fundamental. Repayment of the investment only starts when the facility is put into operation. Payment levels will depend on the availability of the assets, the services supplied and the levels of performance achieved. This is, of course, not the case with traditional public works or services, where payment for construction works is made on an interim basis as the works proceed and the "concrete is poured", so to speak. These are much more short-term arrangements. The sponsors and their lenders under a PPP, by contrast, will have essentially long-term interests, as does the contracting authority, and must rely on the long-term operation of the facility for the revenue stream and dividends. In that sense, the interests of the main participants are very much aligned.

## Involvement of lenders

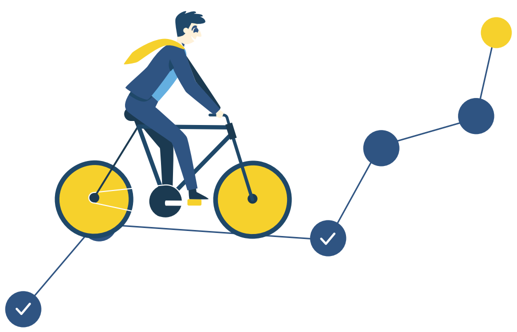
Another difference compared to traditional government procurement projects, and which can strain negotiations, is the need to involve the lenders (to a greater or lesser extent) from the early stages of a PPP project. The sponsors must be very confident of a project's bankability from the outset, and will not waste time and money on complex and protracted negotiations unless they are. This inevitably means they must be mindful of (and well-informed about) lenders' anticipated requirements throughout the process. This can often be achieved by using the right financial and legal advisers to the sponsors, but sometimes it necessitates the active involvement of the banks and their advisers from an early stage. This can be contentious for contracting authorities, however, who may not have had to deal directly with international lenders in the past and may be reluctant to do so now. They may regard the lenders' requirements as a matter for the sponsors, not for them, and resist arguments based on the legitimate

[58] See the remarks about the meaning of PPP above.

expectations of the financial community. Contracting authorities will usually accept that achieving financial close has to be made one of the conditions precedent to the PPP contract's wider effectiveness. Sometimes, however, they do not, insisting that it is simply the project company's problem and risk and that if it fails to achieve it, the authority should be entitled to call a default, draw on the bid bond and terminate the project.

This again highlights the need for rational balance. If the private partner fails to achieve financial close and the PPP contract is terminated, the project will either collapse or be delayed for years and the contracting authority will not get the new infrastructure and services it needs so badly, with all the attendant political and social sensitivities that such a failure would entail. Everyone stands to lose as a result. The vast majority of PPPs over the past 20 years have been project-financed, and where this is the case (or indeed, where a simpler financing structure is involved), the legitimate requirements and expectations of lenders obviously must be recognised and met. The sooner they are factored into the negotiation process, the better, especially where they include potentially contentious components, such as limited government guarantees, direct agreements and robust comfort letters. If the lenders and their advisers play at least some part in the negotiation of the PPP terms, or approve those terms as they are being finalised, it is much less likely that they will attempt to renegotiate or reopen issues afterwards as the financial documents are drawn up.

Again, it is helpful to think in terms of a long-term alignment of interests. In the end, all the principal participants in a PPP – contracting authority, project company, sponsors, lenders and financial guarantors – will depend on the project's long-term success, as will its ultimate beneficiaries, the public. (With a project-finance structure, the lenders will generally not, of course, have recourse to the balance sheet of either the government or the sponsors if things go wrong). Their interests should be reconciled and balanced fairly and transparently from the beginning.



### Change orders

A PPP contract may or may not contain a variation mechanism. The contracting authority may not be interested in including one, and the private partner may prefer it not to have one. In some cases, however, it will probably be sensible to include one.[59] Major alterations to the scope of the construction works or services to be provided are very possible over the term of the PPP in response to technological changes (for example) or changes in demand for the services on offer. If the parties are going to have to agree each time about how they are introduced, there may be too great a risk of major disputes in the absence of a clear framework for effecting them.

Where a variation clause is to be included, the main questions tend to relate to (a) what parameters or limits are placed on each party's power to effect variations (for instance, does it apply during both the construction and operational phases, or just the former? Should the private partner have the right to refuse a variation where warranties or permits would be adversely affected?) and (b) how the costs (or savings) associated with them are allocated – both capital and resulting operational costs and savings.

The subject is complicated by the fact that (in contrast with conventional construction contracts) the private partner will usually have primary responsibility for raising the additional finance needed to give effect to a variation. This may not be possible, however. It may not be available on reasonable terms or acceptable to the existing lenders, for example. The parties will sometimes agree to make termination rights available when extra funding cannot be found (unless the government entity can act as lender of last resort). The interrelationship of any such new finance with the private partner's existing funding arrangements will have to be considered. If the project is being project-financed, the variation may have to lead to the generation of additional revenues if it is to be feasible. The parties will need to work out how any adjustments to the tariffs are made to recover the cost of the variation. It is likely to be in the interests of both to agree in advance on a clear methodology for doing this (for instance, so rates of return or financial ratios are protected). The same methodology may apply to the financial balance and change-of-law clauses (see below under the subsections with these headings). For these reasons, a variation mechanism in a PPP contract will likely have to be subject to much greater conditions and qualifications in favour of the private partner than is the case with simple construction contracts (where the employer automatically picks up the bill for one).

[59] UNCITRAL Legislative Guide on Privately Financed Infrastructure Projects also recommends using one.

Note that, in many civil law countries, at least where administrative law concessions are involved, the public partner has an automatic legal right (which it is not allowed to waive) to modify certain terms of the PPP contract unilaterally – namely, those relating to the conditions of performance of the relevant public service (if there is one). If it does so, the private partner is entitled to be fully compensated for the costs it incurs because of the amendment. Where this principle applies, the parties often prefer (and would be well advised) to set out in the contract the exact basis on which this right might be exercised and the way compensation is calculated to avoid uncertainty and minimise the scope for dispute.

### Tariff structure

One area where the subject of the public sector's control over the private partner's activities can become particularly sensitive relates to the private partner's tariffs or charges for the services it provides. The initial charges the private partner levies can be contentious enough in themselves; they may involve charges to the public for services that previously were free. Even where this is not the case, a sizeable increase in charges may be necessary so new facilities to be financed and built.[60]

The more difficult area, however, concerns tariff increases over the life of the PPP. In what circumstances should this be allowed to happen, and within what parameters? Where the public sector provides the revenue stream (which is only rarely the case with PPPs in emerging markets, in contrast with many PPP projects in Europe, where it arguably has become the norm), the government entity will by definition have considerable control over any increases. The more problematic situation is where the private partner directly charges third-party users of the facility (the general public, for instance) – such as tolls on a motorway or charges for clean water. Here, the private partner will often seek at least some discretion to make increases over time which it regards as necessary.

The government, however, may see it as critical to prevent undue tariff rises, especially given their political sensitivity. If a well-developed regulatory system is in place, this may be the mechanism by which any increases are controlled, making it perhaps unnecessary for the PPP contract to address the subject. There are many examples, however, of PPPs being awarded in countries where a regulatory regime is underdeveloped or even non-existent. In that case (as mentioned above), the PPP contract may itself represent the government's regulatory tool (which, as we have noted, may actually be preferable to sponsors and lenders if they lack confidence in the host country's regulatory regime).[61] This can lead the parties to draw up regulatory principles applicable to tariff setting and any revisions. Either way, the private partner and its lenders will often seek adequate scope to pass additional costs on to customers in response to given events – for example, resulting from economic dislocation, inflation, changes in law, requirements for additional investment and other exceptional events.

Structuring a mutually acceptable tariff will obviously raise much broader issues than ones of control. It will be fundamental to the agreed pattern of risk allocation.[62] For example, how exactly will the tariff be structured in a mechanical sense (as a series of discreet charges or a single charge)? How can a practical, meaningful link be established between the tariff and the private partner's performance? To what extent will the tariff be a fixed price one, and to what extent will the private partner simply be allowed to pass on certain costs? (It is rare for the private partner to be able to pass its final construction costs on to the contracting authority, for example. Any pass-through would usually to be on a fixed-price basis, agreed at the outset). Is the private partner taking demand risk? To what extent? Is it being paid for "availability" as well as operational performance?[63] How exactly will any performance penalty regime work? How will any indexation provisions work, and so on? The private partner's financing structure will play a prominent part in these discussions. If the private partner's entitlement to its revenues is too conditional and, therefore, too uncertain, the bankability of the project may be prejudiced. The riskier the emerging market, the greater this concern will be.[64]

[60] For example, the M1 road project in Hungary or the Second Stage Bangkok Expressway in Thailand.

[61] The operational concessions signed in the water sector in Romania a few years ago are examples of this.

[62] As the Treasury Taskforce emphasised in relation to PFI projects. See above for more.

[63] The tariff for the recently completed Maribor project in Slovenia, for example, had both an availability and a take-or-pay element.

[64] Performance penalty regimes have been designed to a high level of sophistication on many government-pay PPP projects, such as in the PFI context. They were used less extensively in the past in emerging-market concessions, where patterns of risk allocation tended to be simpler and more general. That is now changing. Effective monitoring of KPIs is perhaps a more familiar problem now.

It is worth saying a brief word about benchmarking and market testing in this context. Put simply, these are mechanisms[65] for periodically testing and re-establishing the consistency of the private partner's tariffs, and the assumptions of risk they represent, against the market norms for similar services being offered in the same sector or industry at a particular time. They are a device limit the impact on both parties of excessive risks and returns. They raise complex questions about timing, practicality and risk management, however. As far as the authors are aware, few examples of provisions of this kind are being adopted on PPP projects in emerging markets. That is perhaps not surprising, in that they presuppose a relatively high degree of stability in the risks to which a project may be exposed over the life of the concession if they are to be workable, as well as a market against which the private partner's services and prices can be tested. This will often not be the case in some emerging-market countries, which may have only started to use PPP structures recently.

## Penalties for late completion

Structuring penalties for late completion and any supporting guarantees can be something of a challenge. The contracting authority may insist on liquidated damages in the PPP contract. The private partner will certainly include them in the EPC contract. Typically, the contractor must issue a performance bond in favour of the private partner. The contracting authority may also seek one of its own under the PPP contract, or try to take the benefit of the private partner's. Yet the lenders will insist on an assignment of the benefit of all the private partner's agreements and instruments as part of their security package. In any event, how is the quantum of any penalties for late completion to be calculated? Should the EPC contractor have to cover all the lost revenues of the private partner, together with any additional interest payable under the loan facility? Will this be commercially feasible, and subject to what caps? What about the contracting authority's losses in the event of delay, if there are any? How exactly are these determined?

The relationship between the penalties for late completion under the different agreements and the instruments securing them (bonds) always needs careful thought. Contracting authorities should be mindful of the fact that appropriate incentives to complete on time (such as a right to early or higher revenues) can operate just as powerfully as disincentives for failing to do so in the form of penalties. Late completion will delay the private partner's cash flow and expose it to potentially disastrous consequences. Conversely, completion on time will generate revenue and signal the project's progress and success. A contracting authority may not need more than this.

## Quality of service/performance standards

The subject of the private partner's quality and level of service during the operational phase has attracted more attention in PPP contract discussions in recent years than in the past. There used to be a tendency to express standard of service goals in relatively summary and general terms. Attention tended to be focused much more on the specification for the physical assets to be built. That has changed in many ways, however, particularly in the context of European government revenue-stream projects, where sophisticated penalty regimes (for instance, based on performance point systems and deductions) can apply. Standard of service requirements tend to be defined more precisely and may be coupled with performance or availability penalty regimes. Questions include:

- How is "availability" defined?
- How exactly are any penalties structured (for example, how are they weighted between the private partner's different responsibilities?) How exactly will any deductions be applied?
- What are the quantitative and qualitative service level objectives?
- What is the distinction between wholly unavailable and merely substandard service levels?
- What are the monitoring and measuring arrangements (such as objectivity/self-monitoring mechanisms)?
- What are the tolerance levels and cure periods?

This area will likely need fuller development in the case of a PPP involving a government-sourced revenue stream than one where the facility users are being charged directly. With the latter, at least where a thoroughgoing free-market approach has been adopted, the private partner's revenues will be partly self-policing. Revenues should to some extent rise and fall with levels and quality of service. A performance penalty regime may be unnecessary or unworkable. In the former, however, the public sector will be paying the private partner to provide a service. The payment mechanism may therefore be conditional on the private partner attaining stipulated performance

[65] Originally developed in the context of PFI projects in the United Kingdom.

criteria. As already noted, PFI-type projects tend to involve the former model,[66] projects in emerging markets the latter.

### Force majeure and financial balance provisions

A PPP contract will usually contain different clauses and provisions designed to protect the private partner (principally) and the contracting authority (secondarily) against the impact of unforeseen risks. They are designed to protect the private partner because it bears most of the project risks under the agreement terms and therefore needs more protection. Variation clauses, extension of time provisions, indemnities and indexation clauses all have this effect to some extent, reflecting the private partner's exposure to different risks and the most appropriate response to them. It can help, however, to draw at least some of these threads together in the same provision, often referred to as a financial balance, change of circumstance or exceptional event clause. To the extent they may give rise to the same consequences under the agreement, and the application of the same change-management provisions, it can make sense at a drafting level to include them all in a single extended clause.[67] They tend to be among the most difficult and contentious of the agreement's provisions to structure and negotiate.

In broad terms, this kind of clause aims to put the private partner (typically) or both parties (more unusually), as far as practicable, in the same net position as before the relevant event occurred[68] – to restore the financial balance of the agreement, in other words.[69] Put more crudely, its main objective will usually be to protect against risks that the private partner cannot absorb. It will do this by setting out a basis for modifying or adjusting the agreement terms to allow for the impact of these events[70] – for instance, by increasing tariffs or extending deadlines for the performance of certain tasks (a force majeure clause may also do the latter, of course). Hence the contentiousness of these provisions in negotiation.

The public sector may initially assume that, as the private partner is agreeing to perform its role essentially "at its own cost and risk", there should not be any scope to change the agreement as a consequence of any risks. And as the clause will be directed at events many of which will be beyond either party's control, the idea of having to pay the private partner compensation for any of them can be highly controversial. It can take time for the rationale for a clause of this kind to be fully appreciated.

The need for it arises from the very long-term nature of a PPP contract, coupled with the fact that certain objectives and standards will need to be met, while tariffs may be fixed or regulated under the agreement's term. This may leave the private partner far less able than parties to many other types of commercial contracts to manage risks beyond its control, for example, by transferring their economic impact to third parties. This in-built rigidity in PPP contracts has recently become the subject of much debate, intensified by the impact of the Covid-19 pandemic and economic crisis. Conversely, where the private partner has full and discretionary control over its tariffs and can modify its services as it thinks best, the need for such a provision diminishes. This question about control over tariffs and services should therefore be the starting point of any discussion of provisions of this kind (see tariff structure section above).

There is obviously a considerable degree of overlap between a financial balance clause and a force majeure provision. The two are often combined, at least in some respects, particularly in the ways their consequences are provided for. Traditionally, a force majeure clause would relieve a party from liability for (certain) events beyond its control, but would not entitle it to compensation. A financial balance clause will also do the latter. In fact, in the PFI context in the United Kingdom, a distinction tended to be made between three different kinds of "relief event":

[66] "The negotiated performance regime will form a key element of the risk transfer mechanism." (UK HM Treasury, Standardisation of PFI Contracts, 2007). The structuring of performance penalties was, indeed, a central part of the negotiation of most PFI projects, it seems.

[67] Many PPP contracts use different clauses for force majeure, material adverse government action and change of law. But the overlap between these provisions means it may be more convenient to group them together.

[68] The contracting authority may also seek tariff reductions or a shortening of the concession period for events which operate to the private partner's benefit. While this may be "symmetrical", it is often staunchly resisted. Is there much point? How exactly, and to what extent, will it be achieved?

[69] Note that restore does mean restore in this context, but rather restoring the private partner to its net financial position before the impact of the event, not restoring it to a state of overall financial health. If it was struggling financially before the event occurred, the clause cannot be used to turn its fortunes around – an argument which is still not infrequently run by sponsors in this situation.

[70] It will not necessarily formally amend the contract, at least not the terms and conditions, inasmuch as the change is made under and in accordance with its terms, although the net result will obviously be an alteration to certain of the contract's provisions (such as design/time/cost/charges).

(**a) Compensation events:** Events (occurring mainly during the construction phase) that are clearly at the public sector's risk and for which the private partner should be entitled to compensation (basically, variation orders, breach of contract and certain changes of law).

(**b) Relief events:** Events arising at any time during the contract term that should entitle the private partner to relief from liability for failure to perform and which the private partner should manage at its own financial risk, but which should not give rise to any compensation or rights of termination.

(**c) Force majeure events:** Events arising at any stage of the contract that are best managed by the private partner, but in respect of which rights of termination can arise (for example, truly cataclysmic events, which are either wholly uninsurable or uninsurable on normal commercial terms).[71]

This (somewhat cumbersome) methodology does not yet seem to have been widely adopted outside the United Kingdom. A simpler, more integrated approach is generally preferred these days, in both common law and civil law jurisdictions. In principle, there is no overriding, cogent reason why force majeure events should not entitle a private partner to compensation as well as relief from potential liability in appropriate circumstances.

To some extent, financial balance clauses are already enshrined in many civil law systems, at least those influenced by the French tradition, particularly where administrative law requires the preservation of an agreement's economic balance.[72] Indeed, the very concept of financial balance almost certainly originates in French jurisprudence. In countries where the law already provides for it (such as France), it may not be necessary to include it in the agreement, although modern financing structures and expectations are likely to prompt its explicit treatment anyway. In common law jurisdictions, where it does not, it would be considered vital to set out the mechanisms concerned clearly, precisely and comprehensively in the PPP contract to make them workable, so that all project participants (including the lenders) know exactly where they stand. To avoid uncertainty and ensure compliance with best international practice and lenders' expectations, the parties in civil law countries may take much the same approach in the end.

Under French administrative law and many other civil jurisdictions influenced by it, the concept of financial balance is an old and well-respected principle.[73] It has been invoked primarily to provide a rationale for the compensation payable to the private partner when the contracting authority (or the public sector it represents) modifies or "tilts" that balance. Examples are the fait du prince theory and the right to compensation in the event of a unilateral change to the contract imposed by the contracting authority. In both cases, the private partner is entitled to full compensation. Administrative case law refers extensively to the concept of distortion of the economic balance of the contract (bouleversement de l'équilibre économique du contrat). The concept derives from the general rule (the imprévision theory) according to which public services must be performed continuously, with the consequence that, in the event of a distortion of the contract's economic balance, the private partner is entitled to compensation – although only to the extent strictly required to ensure the continued performance of the public service activities.

There are really three distinct, if overlapping, areas that a financial balance clause should therefore address, each of which can be difficult to finalise and agree: (a) which events should lead to an adjustment? (b) how should the impact of these events be measured? (c) what form should any adjustment or compensation take?

The subject of which events should trigger the provision, potentially giving rise to an adjustment, is clearly a question of risk allocation.[74] Certain events, such as political force majeure[75] and change of law, are certain to feature (at least in some form). A separate clause may sometimes cover natural events of force majeure, in that they involve relief from liability, but not necessarily compensation. The private partner and its lenders will need some protection against the risk of political interference with the project—for instance, nationalisation, expropriation, loss of key permits and consents, or policy changes affecting the operational regime. Change of law will

[71] For example, nuclear explosion and contamination, pressure waves caused by aircraft acts of terrorism, war and hostilities.

[72] See below.

[73] Although its implications and consequences at a practical level have not been extensively examined in case law.

[74] The private partner's ability to insure these events will obviously be a relevant factor. The discussion may be complicated by the possibility of insurable events becoming uninsurable at some stage during the term of the agreement, or vice-versa. This is likely to become a very real question in the context of Covid-19-type pandemics and their impact, as many insurers are likely to exclude it from their policies.

[75] Sometimes referred to instead as material adverse government action.

generally need to be addressed as well, especially in relation to new legal requirements involving the private partner in additional capital expenditure or a drastically modified operational regime. Variation or change orders and breaches of contract by the contracting authority are also commonly included (as the same methodology can apply to them).

The clause will be more contentious in relation to risks going beyond this relatively narrow scope – non-political events of force majeure, for example, such as severe economic dislocation, the effect of competing facilities, failures of raw material supplies, interruptions in other necessary supplies and utilities, or changes in the fiscal regime. There is much discussion in today's market about the extent to which climate change and Covid-19-related events should be expressly addressed and how. (There are many possibilities, depending on the nature of the project and the precise occurrence.)[76] If the PPP is essentially an operational one (that is, the private partner is taking over and developing an existing facility), there may be great uncertainty at the outset about the real nature of the system's existing deficiencies and where capital improvements should be focused. This can reinforce the importance of this clause.

Again, the scope of financial balance clauses tends to differ sharply between emerging-market projects, where risks may be much harder to predict, quantify and manage, and developed economies, with their more stable and familiar business environments. In emerging markets, the private partner will usually press for the broadest possible protection against unforeseen risks. Sometimes, it will even be entitled to seek an adjustment for any material adverse event beyond its control. PFI projects in the United Kingdom, by contrast, often gave the private partner only very limited protection of this nature (limiting change of law to discriminatory and specific changes, for example). In the end, the critical factors will be the perception of risk in a particular environment and the private partner's ability to manage and absorb it (taking account of the lenders' expectations) within the commercial framework it controls.

The second question is about the basis on which the impact of these events is measured and quantified. What criteria should be applied – reduction in cash flow, effect on the private partner's "net financial position" (which may need to be defined) or some other basis? The public sector will justifiably be concerned about any basis which allows the private partner to claim losses too readily or too subjectively. It is common (as it is with PPPs in the United Kingdom) to oblige the private partner to absorb certain losses up to a given threshold, a certain amount per event and/or per annum, for example. This would represent a risk-sharing approach between the parties, which in some ways is the fairest way to deal with events beyond the control of both. It is common practice to link these calculations to the project's financial model (or one of them), and its assumed rates of return, to determine both losses and the necessary compensation.[77] In addition, what, if any, allowance should be made for windfall benefits derived by the private partner from unforeseen events? How should these be netted off against any adverse consequences? Any insurance proceeds available to the private partner in relation to the event in question should also, of course, be factored in to these assessments.[78]

Finally, there is the question of how the private partner should be compensated and its financial balance restored. How, exactly, are any remedies to be applied? Commonly, the agreement should leave considerable flexibility as to how this is done, as an overly prescriptive approach may be difficult to apply. The private partner will often be entitled to an increase in tariffs, an extension of the term of the PPP contract, an alteration to completion milestones or capital expenditure requirements, a cash payment or a combination of all these. When it comes to applying these remedies, the clause will often leave scope for the parties to determine and apply them by agreement, if possible.

This may not be forthcoming, however. The agreement's dispute-resolution mechanisms will be of vital importance in this context. The agreement

[76] See Chapter 5 on the impacts of Covid-19 on the legal framework for PPPs.

[77] Using the financial model to calculate the private partner's compensation is not always straightforward, however. The formulae used in the model may be opaque, which can obscure the process followed in achieving the end result. There is likely to be contention about how exactly certain events are modelled. The process may call for access to more confidential data than the private partner is willing to provide. And, in any event, if two of the main parameters of the exercise are preserving the loan life cover ratios and equity returns of the project, there may be several different ways to achieve this. In general, there is much to be said for simplicity of approach.

[78] There was a tendency for a while in the PFI context in the United Kingdom to try to carve out insurable events altogether from the scope of these provisions. That approach came to be regarded as too crude and impractical, however, and has not gained much wider currency. In most cases, an explicit carve-out should be unnecessary. If an event was actually foreseen and insured against, it should not be possible to invoke the clause and the private partner should not need any compensation if it has not suffered any loss. It should still need relief from potential liability, though, under force majeure, if it has been prevented from performing a material obligation by the event.

should ideally lay down an agreed, objective basis for determining how any adjustments are to be made, with remedies listed as a series of options, which the dispute-resolution procedures can give effect to, in the absence of agreement. The more precision that can be applied to the methodologies and procedures involved, the better the chances of an acceptable solution being found, which avoids a wider dispute; the parties should give careful thought to this when the contract is being structured. As an alternative, however, the parties may simply prefer to retain a right to terminate when agreement on the subject cannot be reached and the procedures do not produce an acceptable solution.

The question sometimes arises whether there are ever circumstances in which the contracting authority should actually pay the private partner compensation, rather than just extend the concession term. After all, extending the term should always put it in a position to recover losses eventually by earning additional revenue. The answer is, almost certainly, yes. (This is likely to be so in most cases, in fact). First, there are at least certain circumstances in which delay in recovering losses may be unacceptable to lenders and equity investors. Loan life cover ratios and rates of return over assumed time periods would otherwise be prejudiced. The lenders' expectations in this context will always have to be taken into account. They will attach great importance to the clause and would usually insist on the private partner continuing to receive sufficient revenue at least to cover debt service during any period of operational force majeure.

Secondly, there is the advantage of simplicity. Working out exactly how to adjust a concession period to compensate the private partner for losses can be far from straightforward. The project company's financial computer model is often worked into the contractual mechanisms, simplifying the process of calculating the impact of certain additional costs and providing a fair, objective basis for doing so, which can reduce the scope for disagreement. Finally, there is the matter of incentives. The contracting authority should try to manage and overcome certain risks as quickly as possible. There may be some indifference towards events that trigger an extension of a 30-year concession period.[79]

When should cash compensation be paid, and when should the private partner have an adjustment to its charges? Practicality and judgement are likely to be key tests here. What cash resources and credit standing does the contracting authority actually have? Is the private partner's loss a "one-off", or recurring? Is a tariff increase viable in the circumstances? It often makes most sense for the form of compensation to match the form of additional cost or loss incurred as closely as possible – for instance, cash compensation for up-front capital cost, adjustment to tariffs for operational costs. If the contracting authority asks the private partner to raise the necessary finance for a major capital investment, a further tier of complexity can be added to the discussion. If the private partner cannot so on acceptable terms, it may need to be able to terminate the agreement. A right to terminate is also commonly included for events which cannot be adequately remedied or compensated, such as a prolonged or cataclysmic, unremedied event of force majeure or a change in law which renders performance illegal and the project unviable.

## Change of law

It is worth briefly looking at the questions raised by the structure of a change-of-law clause, which usually represents an important category of the change management and exceptional event provisions described above.[80] They illustrate several of the points made in the preceding paragraphs. The private sector tends to assume almost instinctively that the contracting authority should bear the risks associated with changes to them because a country's laws are a matter of government control. The government entity will respond that, as a mere government department or even local authority, it may have limited control over such changes and that all companies doing business in the country in question face this risk, usually without any recourse to the public sector. The reality, though, is that PPP contracts are unlike most other forms of large-scale commercial contracts in that they are very long term and structured on the basis of risk allocation and pricing assumptions that have been agreed with the public partner at the outset. The private partner often has limited ability to revise these terms unilaterally if changes of law occur which have cost or performance implications. If it is forced to bear that risk and price it into its charges up front, the result may be excessive expense and lower value for money. In the end, both parties will, in reality, be signing up in the contract to a value for money

[79] To paraphrase John Maynard Keynes, in the end, we are all retired. To borrow from Samuel Johnson, in contrast, a potential liability to make cash contributions "concentrates the mind wonderfully".

[80] At a drafting level, a change of law provision will usually be drafted as a separate clause for the purposes of its definition and scope, but the mechanism used to address any consequential changes to the agreement and compensation arrangements is likely to be the same as for force majeure and other exceptional events.

concept over the project's life cycle that the lenders will also need to regard as bankable. This means that some protection against unforeseeable changes in law make sense.

The definition and scope of the clause will need careful thought. It usually starts with broad definitions of applicable law and change in law, followed by a narrower one of those types of change in law which may trigger the adjustment mechanisms. In nearly all cases, there will need to be at least some limits on the private partner's ability to seek redress. A distinction usually has to be made between the more general changes of law in the country, potentially affecting anyone, and the more specific ones that are likely to have a direct impact on the concession project in question or PPPs as a whole. Only material changes which the private partner cannot readily absorb above a certain threshold are likely to be included. (The agreement should not seek to impose an effective freeze on the country's legal regime at the date of signature for the private partner's benefit, even though the attempt sometimes seems to have been made.)

Which changes of law, then, should entitle the private partner to relief and/or compensation? In the British context, as we have said, compensation was typically restricted to a narrow range (discriminatory and specific changes of law, for example). In a rapidly changing emerging-market country, however, this is unlikely to be sufficient for the private partner. The legal system in the jurisdiction in question may be subject to numerous uncertainties. It may be undergoing rapid, radical transformation (as in most countries of Central and Eastern Europe, for example, at least over the last quarter-century). How reliable are foreign investment-protection laws? How well-defined are the country's security laws (from the lenders' perspective, in particular)? Are radical changes in environmental protection laws likely? Will changes in tax law be covered? Will a new regulatory regime be introduced, and with what effect on the PPP, and so on? Because changes in law may also benefit the private partner and the project, the clause is sometimes also structured as a reciprocal one, allowing the contracting authority to share in some of the benefits (for instance, cost savings that make a reduction in tariffs possible).

Certain provisions of the PPP contract are likely to give the private partner at least some de facto protection against changes in law in any event. The private partner may be able to insist on a variation order for design changes required during the construction phase, for example. A tariff index will represent a certain ability to pass through higher costs attributable to changes in law, although this will not cover the cost of any major capital expenditure. Grandfathering provisions (assuming they are feasible under the wider legal system) may also be included to protect aspects of the project or operational regime against subsequent changes in regulation. The private partner will also typically be given an obligation to take all reasonable steps to mitigate the impact of the relevant change of law.

Having decided which categories of change in law will entitle the private partner (or the parties) to some form of redress, the parties will need to agree on how any losses, savings and adjustments are to be determined. If the private partner is free to set its own tariffs, perhaps without restriction, what sort of protection, if any, does it really need? Will it be in a position to pass on all or part of its additional costs to end users? If not, should there be a threshold amount which the private partner must absorb before it can seek redress – thus building an element of risk-sharing into the clause?[81] Should changes of law requiring capital expenditure be treated differently from operational costs? Who should be responsible for obtaining any additional finance needed for the former? What if it cannot be obtained? What, if any, changes of law will entitle either party to terminate the agreement? There are no ready-made answers to these questions. Mutually acceptable solutions will have to be found in negotiation.

### Maintenances

Closely related to the operational requirements are the maintenance standards. In general terms, it will be up to the private partner to define, plan and cost its own maintenance programme, working within the broad parameters laid down by the public sector. (For example, "all maintenance to be carried out in accordance with applicable laws and good industry practice", so standards of service can be met and the assets' useful economic life preserved.) However, it may be necessary to negotiate and agree the duration and timing of any maintenance "outages" or reduced service levels. The more problematic areas relate to the following:

- The definition and application of major maintenance obligations, which should not, of course, amount to a forced outage (or equivalent) provision, potentially exempting the private partner from performance penalties.

[81] The preferred approach on PFI projects was for any entitlement to compensation to be subject to a "stepped" or "banded" series of thresholds, so the recourse available depends on which "band" the additional cost falls into. This is a good example of a risk sharing mechanism. The idea is to maximise the private partner's incentives to manage this risk.

• Maintenance requirements towards the end of the project's life. The risks and responsibilities taken on by the private partner may need closer definition in relation to this phase, when the project assets may be approaching the end of their useful life.

• In particular, will the private partner have restoration and rebuild obligations, to ensure that the project still satisfies certain standards and quality tests as it is handed over? How will the costs of this be borne?

• Pre-transfer surveys. Will there be a mechanism for carrying out detailed, formal inspections and surveys of the project, either just before handover or at regular intervals? If so, when and in what depth? What consequences will they have in terms of any rebuild responsibilities of the private partner? Will a third-party expert or group of experts be used for this purpose and, if so, what powers will it have?

The nature and extent of any residual value risk assumed by the private partner will affect these questions. Special payment provisions may also come into play towards the end of the term to address them. Occasionally, the agreement may provide for a "balloon payment" by the granting authority at the end of the term, or conversely, for the build-up of a retention to guard against defects.

## Termination and compensation

A PPP contract will typically contain a termination clause. Some of its contents can prove highly contentious. If exercised, it would trigger the unravelling of the matrix of agreements underpinning the whole project and put the project assets (on which tens or hundreds of millions of dollars may have been spent), if they survive at all, back into government hands.

**Grounds and procedures.** The exact grounds on which termination rights can be exercised, and the procedures involved, may be one area of disagreement. They are often somewhat broader and more easily invoked in emerging markets than developed ones. Some will be almost unavoidable. From the public sector's perspective, they are likely to include the insolvency of the private partner, abandonment of the project and prolonged material breach of contract (which often has to be defined). Equally, the private partner will need the protection of rights of termination based on effective annulment of the PPP (expropriation of essential assets, for example, or withdrawal of certain permits and consents) or, again, unremedied breach of contract.[82] Rather than – or perhaps in addition to – having an open-ended, general ground based on unremedied breach of contract, the agreement may spell out which breaches are to be treated as events of default; they may extend to breach of any of the contract's clauses which are considered of critical importance to the project and its standing.

Other grounds of termination will be more debatable. Persistent or repeated breach may be specified (and defined), for example, or accumulated penalty points for poor performance over a certain threshold and period of time. Occasionally, a right of termination at will or for convenience is sought; this will only be acceptable (if at all) against the payment of full compensation to the private partner, its lenders and investors. The private partner may want to use the clause to reinforce the agreement's protections against political and country risk, or changes of law for which the private partner cannot be adequately compensated. Prolonged or devastating force majeure is likely to feature as well, if the parties can agree about the applicable tests. Local law may also give the public sector a right of termination on grounds of[83] public interest (which may be the same as a right to terminate at will) or otherwise impose restrictions or conditions on the applicable grounds for termination and procedures involved, which will need to be carefully examined as part of the due diligence exercise (it may not be possible to derogate from them).

The procedures applicable on a termination of a PPP contract tend to be lengthy and precisely defined. There is often a need for a warning of intent to terminate, followed by a first termination notice, a long rectification period during which the default can be put right (which would cancel the right to terminate), and then a final termination notice if it is not. The lenders' step-in rights under their direct agreement must be factored into these procedures and fully integrated with them. The agreement's handover and training procedures also need to be considered

[82] In some civil law countries, it is mandatory to lodge a claim before a court of justice to terminate a PPP contract in the event of a contracting authority's event of default. This can be very problematic for the private partner and its lenders if they are trying to contract out of the jurisdiction of the local courts. It should always be checked at due diligence stage.[80] At a drafting level, a change of law provision will usually be drafted as a separate clause for the purposes of its definition and scope, but the mechanism used to address any consequential changes to the agreement and compensation arrangements is likely to be the same as for force majeure and other exceptional events.

[83] Not uncommonly, government-owned utilities which are subject to privatisation or restructuring plans themselves at a later date enter into PPPs. The private partner may feel certain aspects of these plans should also trigger termination rights.

(see below on both subjects). The whole process may take six months to a year, or even longer. This may seem excessive, but sufficient time should always be permitted to correct a default or breach that can be remedied, incentivise the parties to try to negotiate mutually acceptable solutions, to give the lenders a real opportunity to protect their position, and to allow for the practical realities of a final termination which takes effect. PPPs are large and complex projects, often involving important public services, which demand continuity. It may also make sense to oblige both parties to act reasonably in relation to the exercise of their termination rights.

**Termination payments.** The question of the termination payments payable in these circumstances tends to be the subject of greatest contention in this area. This raises issues about incentives as well as payment for assets transferred (assuming they are transferred. If the private partner can retain them following termination, the discussion will take a very different course. It is unlikely to be able to do so, however). The private partner and its lenders and investors will expect as much compensation as possible when the government entity is in default or a political risk event, change of law or public interest/convenience termination is involved; they would expect this to be sufficient to cover the private partner's senior and junior debt and to allow the investors an adequate return. Market practice in these cases tends towards the position that the payments should be made on the same basis as if the project had been fully performed. They are therefore likely to allow for the full value of assets transferred back to the government, as well as at least a proportion of revenues foregone, together with unwinding costs. Calculations may be based on an accounting valuation of those assets (such as book value or replacement value) or on the cost of paying out senior and subordinated debt and third-party creditors, followed by equity at the assumed internal rate of return or market value (as defined). Alternatively, the net present value of the envisaged future revenue stream (minus operational costs) may be used as a basis. The project base case financial model with its assumed rates of return is often made part of the determination. A calculation based on financing arrangements rather than asset valuations is generally considered more certain and reliable.

Many agreements will put compensation payments following natural (that is, non-political) force majeure in a different category. By definition, neither party will be at fault in this situation. It would be hard to argue against some compensation for assets installed and investments made. The usefulness or otherwise of any assets transferred to the public sector will be very relevant. Yet full compensation may be hard to justify, as its effect would be to transfer much of that force majeure risk to the public sector.

The more challenging question relates to a termination where the private partner is at fault. The contracting authority will usually hold that the private partner should get no compensation in such circumstances. This argument may be reinforced if the government has agreed to step-in rights and termination has proceeded after an unsuccessful attempt to exercise them. The project company's shareholders may be prepared to live with this approach and to forgo any return on equity (or other compensation) in this event.

The lenders will be reluctant to do so, however. They are likely to have provided most of the project's finance (perhaps 70-80 per cent or more). They will usually oppose the idea that most of this funding should simply be written off and the public-sector receive a large windfall benefit (that is, the completed infrastructure) as a result of a default which they may not have been in a position to address. Their aversion to risk, reinforced when they are lending to an emerging-market project, will make it difficult for their credit committees to approve a project which incorporates this feature.[84] The aggregate value of the project assets handed back to the public sector on termination may exceed any losses actually suffered by it as a result of the private partner's default – by a large margin. Yet the lenders will have financed the bulk of those assets and will recover only a small proportion of their funding unless compensation is paid. This is why the private partner may be in a position to mount a legal challenge to the provisions on the basis that it constitutes a penalty clause (where a common law system is involved) or an inequitable or unconscionable one (where a civil law system applies), unjust enrichment or expropriation without compensation. The sponsors and lenders are unlikely to be satisfied with these highly arguable and uncertain remedies, however.

The outcome of these discussions will not be easy to predict. The issue tends to be highly emotive. The public sector may find the notion of compensation on default deeply unacceptable.[85] At the very least, it will want to ensure that the private partner has

[84] Although international financial institutions' development banks seem to be more willing than commercial banks to accept a "haircut" in this situation

[85] There have been examples in the United Kingdom of projects being financed without it, although they appear to be rare.There seem to be very few examples in emerging-market countries. .

appropriate incentives to perform and it stands to suffer substantial losses if it fails to do so. A compromise solution that has been applied on a number of projects in emerging markets is to provide for full compensation for transferred assets to be paid as a starting point in these circumstances, but to allow the public sector to deduct its actual losses (such as rectification costs or the additional cost of hiring in another operator) attributable to the private partner's default from any equity payments. (There are likely to be deductions anyway for credits available to the private partner, such as amounts standing to the credit of its project accounts and available insurance proceeds.) Alternatively, assets taken back into public hands may be valued on a different basis than where the government is at fault (such as a proportion of historic cost, as opposed to a depreciated replacement value).

Lenders, however, will often refuse to finance the project unless they are assured of being paid out, to a large extent at least, no matter what the reasons for termination.[86] They usually insist on a finance-based approach to termination payments, with its clarity and precision, as opposed to an asset valuation-based one, with its attendant uncertainties. The ability of the government to re-tender the project following a termination (and to factor any termination payments into the purchase price) can be a relevant factor in this discussion, as should its ability to continue to operate the project to generate revenues. Yet rational analysis will only take the discussion so far. The conclusion will ultimately depend on the give-and-take of commercial negotiation.

There was a trend in the PFI market in the United Kingdom a few years ago towards a more open-market-based approach.[87] Essentially, this involves paying the private partner the market value of the unexpired term of the project agreement, where a termination follows from a private partner default. In theory, this has the appeal of fairness to both sides and avoids the almost arbitrary discrimination between debt and equity funding structures of a senior debt-based approach. It remains to be seen whether this approach will gain much ground in emerging markets (or the United Kingdom, for that matter). It presupposes an available market for the distressed project, which may simply not be the position in a newer PPP market. Lenders may also simply refuse to tolerate it if there are wider concerns about the bankability of the project.

There may also be greater concerns in an emerging-market context about the contracting authority's ability to stand behind its potential liabilities for termination payments, which, as we have seen, could be very large. Its credit standing may need to be reinforced, perhaps by a central government guarantee (if it is not automatically backed by the government's balance sheet, as it often will be) or some form of multilateral support. In some jurisdictions, the contingent liabilities and their budgetary implications may also need parliamentary approval. Ideally, both the government and private-sector participants should think these questions through early in the project's planning, as bidders and lenders may be deterred if they look too intractable. Credit risk concerns may also lead to a right to make any termination payments over a period of time, rather than in one instalment, although the private partner and its lenders will inevitably prefer a single lump-sum payment.

Whichever solutions are adopted, it is likely to be helpful to all concerned to provide for termination payments and liabilities precisely and simply in the PPP contract, to minimise the scope for uncertainty and dispute. Simple and objective calculation methods should be the aim. References to other agreements, such as the credit documents, equity subscription agreements and/or financial models, should be appropriate and exact, bearing in mind that the contracting authority will probably insist on approving the documents being referred to, and any subsequent amendment to them, or at least those provisions which affect its potential liability.

## Step-in rights

**Lenders' step-in rights.** When a PPP project is project-financed, the lenders are likely to insist that step-in rights be granted to them in relation to it. These will allow them, in effect, to take over the project and, if necessary, bring in a substitute private partner to forestall a termination of the PPP contract following the private partner's default. They will suspend the operation of any termination procedures and ultimately allow a novation to the project contracts to a third party to take place. The PPP contract will normally acknowledge rights of this kind, although they are likely to be set out in detail in a direct agreement between the lenders and the host government (to which the private partner will usually also be a party). For all intents and purposes, however, they will effectively form part of the PPP contract.[88]

[86] This will, in turn, lead to discussion of the definition of senior or recoverable debt in these circumstances. Subordinated sponsor debt – or quasi-equity (if that is what it is) – is likely to be excluded, for example. Rights of set-off may also have to be negotiated.

[87] See the recommendations in the UK Treasury publication Standardising PFI Contracts.

[88] See also Chapter 2, which explains them in more detail.

Their rationale is, put simply, to provide a form of substitute security to the lenders. Project finance lenders will take the most wide-ranging package of security measures they can over the project assets.[89] Yet this will be virtually worthless if the PPP contract is no longer in place. The sale of the project assets to third parties on a break-up basis will have very little value. If the agreement is terminated, the ability and right of the sponsors and the private partner to generate the cash flow on which the lenders will depend for repayment will be lost; the collapse of the other project contracts is likely to be triggered as well. This is why the lenders will regard it as essential to keep the PPP alive, as it were, and give the project company (or a substitute entity) an opportunity to cure the default and so continue generating revenues. Step-in rights are designed to achieve this.

Almost invariably, however, at least in emerging markets, these rights prove controversial. For government bodies which have not encountered them before, the underlying principle can require a great deal of explaining and justification. They may feel that, because the private partner will have failed to perform (or become insolvent) when these rights come into play, there is little logic or equity to the suggestion that they should relinquish their resulting termination rights just because the private partner has chosen to use extensive debt finance to fund the project.

In addition, the lenders will often need a power to modify or replace any of the project contracts if their step-in rights are to be meaningful, as well as to replace the private partner's shareholders (and will therefore also enter into similar agreements with the parties to the other principal contracts). This, too, can seem a bizarre requirement in relation to a project that the government may have spent months or years developing and which has then been awarded perhaps after an intense competitive tender. The political dimension adds still further to the concerns. Consequently, negotiating such rights can be difficult and time-consuming.[90] Mutually acceptable conditions will have to apply to them. In the end, though, the contracting authority is likely to prefer to see a project saved than collapse. To that extent, it aligns the public sector's interest with that of the lenders. The more awkward questions include the following:

(a) **Trigger events.** In what circumstances, exactly, should these rights be allowed to come into play? The issue of a termination notice under the PPP contract, or an event of default under the financing documents, are typically specified. Will any kinds of default be exempt from them?

(b) **Cure periods and procedures.** For how long will the government's termination rights be held in suspense as the lenders attempt to cure a default and/or find a substitute private partner? What procedures will have to be followed as step-in rights are exercised? How long should step-in periods be allowed to last? (Periods of six months to a year are not unusual.)

(c) **Project restructuring.** How extensive should the lenders' rights be to restructure the project, replace the shareholders, modify the project contracts and change the parties to them? (The lenders will also have to negotiate such rights directly with the contract counterparties, of course.) When should they be entitled to use a substitute entity? What approval rights should the government have in relation to any new participants in the project?

(d) **Limitation of liability.** What responsibility should the lenders (or their step-in vehicle) have for the existing liabilities of the private partner – full, limited or none? How should liabilities incurred during the step-in period be treated? Will the contracting authority require a step-in undertaking from the lenders and, if so, containing what assurances?

(e) **Step-out.** Apart from the time limits mentioned in (b) above, in what circumstances should the lenders be allowed or obliged to abandon their attempt to step in to the project? For example, should a further default have this effect?

(f) **Insurance proceeds.** What obligations should the lenders have to apply insurance proceeds to rebuild, repair or replace defective works? In what circumstances can they simply apply them to reduce outstanding debt? The contracting authority will obviously expect the proceeds of physical damage insurance to be used to reinstate damage and maintain the project's viability. The lenders, however, may insist that, notwithstanding such use, the project may no longer be viable from the perspective of security for their finance. How is project viability defined and measured in these circumstances? A detailed test related to certain financial ratios may be provided for.

[89] Lenders will also take an assignment of the PPP contract and other project contracts as part of their security package. On the one hand, this will give them no better claims than the private partner under those agreements. On the other, it may have little real value following a termination. Hence, the importance of a direct agreement giving them distinct contractual rights and remedies in addition to their security.

[90] One of the authors recently advised on a BOT project in Eastern Europe where financial close was delayed for a year by discussions between the lenders and the contracting authority on this subject.

**(g) Interrelationship with termination payments.** If the lenders have negotiated extensive termination payments on a private partner default, do they also need step-in rights, and vice versa?

Step-in rights are now a well-recognised and understood mechanism under British law and other common law jurisdictions. Perhaps first devised for the Channel Tunnel project, they have since come to be regarded as an almost invariable component of a project finance structure on a PPP in most jurisdictions. (Although the authors are unaware of any instances where they have actually had to be used, their very inclusion in the project documentation can play a significant part in keeping a project alive and incentivising the resolution of disputes.)

The direct agreement setting them out will, in theory, be subject to the same system of law as the other financing documents (although governments may insist on local law, which can make sense, as it is effectively a form of extended qualification to the PPP contract). However, the viability of such rights in the host country always must be thought through carefully. There may be aspects of local law or legislation which vitiate or qualify them and obstruct the contracting authority from signing up to them. If so, this may ultimately prejudice the bankability of the project. This is why PPP laws often confirm the viability of step-in rights.

**Contracting authority step-in rights.** The contracting authority may insist on step-in rights of its own in the agreement. This often makes sense. These rights may already be provided for by statute. The PPP may cover an essential public service for which the authority is ultimately responsible, both as a political imperative and a matter of legal duty. If the private partner is failing to perform or prevented by circumstances from doing so (as in the case of an emergency of some kind, threatening public health or safety or the continuity of service provision, which the private partner cannot deal with satisfactorily), the authority may have no alternative but to step in itself for a limited period and take over management of the facility (in whole or part) to overcome the problem and ensure the continued provision of services to the public to the requisite standard.

There is often a fierce debate between the parties in negotiation about when these powers can be exercised, for how long and subject to what obligations in favour of the private partner. If they are abused, the private partner and its lenders risk losing everything. The conditions of exercise, the standards applicable to their exercise, the obligation to hand the facility back to the private partner once the crisis is over and the (perhaps limited) cost and loss protections given to the private partner while these powers are in play will all need to be closely defined, both to protect the sponsors and make the powers acceptable to lenders. There should be a clear obligation to step out once the problem has been resolved and normality returns, failing which the private partner should have a right of termination. In principle, the latter should be compensated for any resulting (direct) costs or losses it incurs, to the extent it is not itself at fault, as a result of the public sector step-in. If its breach has necessitated the step-in, on the other hand, it should not receive any compensation.

## Refinancing

PPPs in developed markets often provide for an element of sharing of any financial gains flowing from a refinancing of a PPP during its life. There can be numerous reasons for a refinancing. The project may have been structured in the first place with one in mind-as when bridge financing or a "mini-perm" has been used; the market itself may have shifted – either the PPP market, the commercial environment in which the project operates (that is, with higher or lower demand) or the financial markets, perhaps making debt less expensive; or the project may have become a distressed one, necessitating a restructuring of its financing arrangements. In any case, the term usually refers to the reworking of a PPP's debt finance, which may result in higher equity gains for the sponsors. In advanced PPP markets, this has led to widespread demand for those equity gains to be accompanied by the passing back of some of the benefits to the public sector, particularly in relation to the very precisely structured documents used for government-pay PPPs, where the private partner has very little scope to modify its revenue stream. If it is used, there will be detailed questions to answer about what amounts to a refinancing, how any gain is measured, what proportion is shared with the contracting authority, what form its share takes (such as a lump sum payment, periodic payment, reduction in availability payment or user charge) and over what period.

The mechanism is far more unusual in emerging markets,[91] where user-pay PPPs are more common, market risks are generally higher and the project as a whole is likely to be attended by considerably more uncertainty. This makes contracting authorities more reluctant to pursue refinancing gains and private partners more reluctant to agree to them. If the latter take demand risk and the contracting authority has certain regulatory or contractual controls over toll revisions anyway, the logic of allowing the sponsors to retain any gains they may make from renegotiating the

[91] Although arguably becoming less so.

project's debt is fairly compelling. They would argue that this is just one aspect of the broader project risk they are taking. A compromise alternative is perhaps to give the contracting authority a simple power to approve any changes to the financing documents which will have a material impact on its potential liability for termination payments and the private partner's revenues, subject to a reasonableness test. The other questions can then be left to impromptu negotiation.

### Retransfer provisions

Common sense might suggest that a PPP contract needs to contain only a short and simple clause dealing with the obligation to transfer the facility back to the contracting authority on its expiry or termination, in good condition and free of any liens or encumbrances. The picture is rarely quite so simple, however. After all, important public infrastructure and/or public services will usually be involved. The private partner will have been allowed to earn a significant return from the project during its control of it, and the contracting authority is entitled to be in a suitable, functioning, lasting condition when it is handed back. Thought will have to be given to a number of questions this generates.

It is not unusual to need a page or two to cover the ground in the contract. The exact assets to be transferred (contracted assets) will need to be identified, leaving the private partner free to retain and remove others. The remaining useful life of those assets will need to be specified with precision, as they will dictate the life-cycle maintenance sums that must be spent during the agreement's term. The meaning of "good condition" on handover will accordingly need some precision. A joint inspection by the parties of the facility, and/or a condition survey by an independent surveyor, is often provided for well in advance of the transfer date, with the private partner obliged to correct any deficiencies from the agreed standard before termination. A maintenance fund or performance bond to secure these obligations may also be required. A defects liability or warranty period for the transferred assets may also be imposed on the private partner, obliging it to return to site following termination and put right any defects which do appear during that period.

The records and documents to be provided with the transferred assets should be listed, including as-built drawings, repair schedules, detailed operating manuals and the benefit of any extant contractor warranties. Assets should be transferred free of any right, title or interest claims (such as intellectual property) and any security charges or liens. The private partner may have to train the contracting authority's staff for a given period before transfer, so that a fully functioning team is ready to take over operation immediately. At the very least, there should be arrangements for meetings and exchanges of information between the parties in the closing stages of the project, and a general duty of cooperation and transparency. Some of the private partner's staff and personnel may also need to transfer to the contracting authority. Taken together, the importance and logistical implications of all these requirements mean they need to take place over a lengthy period before termination – perhaps two or three years. The extent to which they can all be made to work on an early termination of the agreement is another difficult question.

### Law and disputes

The structuring of dispute resolution mechanisms in PPP contracts needs careful thought – more so, in some respects, than in many other forms of commercial agreement. This stems partly from the long-term nature of these agreements, partly from the importance of the interrelationship between the PPP contract and the other project and financing documents, and partly from the complexity of the patterns of risk allocation reflected in the agreement. In fact, three different forms of dispute resolution mechanism will usually be needed, relating to:

(a) disputes about the interpretation and application of the agreement's provisions, where a breach of contract is alleged. Which system of law will apply? Should proceedings be litigated or arbitrated, and in what form?

(b) questions about minor adjustments to the agreement (such as replacement of the component of an index) where expert determination can be used.

(c) disputes about modifications to the agreement, in connection with the operation of a "change of circumstance" provision (for instance, modifying deadlines or adjusting tariffs), where a mechanism for effecting significant alterations to a contract is needed.

There is frequently fierce disagreement between the parties to emerging-market projects about whether local law, the local court system or local arbitration should be used. Governments will often push strongly for the use of indigenous law and court systems. They may see a high-profile PPP as an opportunity to foster recognition of these systems, and may find it difficult for policy reasons to agree to anything else. Investors and lenders, on the other hand, may regard this as unacceptable. They may have concerns about the impartiality of local systems where a major government body is concerned, and may try to impose a foreign system of law with which they are familiar and comfortable (British, US, French or even Swiss law, for example).

International arbitration, in a neutral location and under one of the more familiar international systems (for example, UNCITRAL, the International Criminal Court [ICC] and/or the ICSID) often becomes the compromise solution as a disputes procedure. In most cases, however, sponsors and lenders alike will eventually accept the choice of local law to govern the agreement. Not unusually, the relevant legislation will, in fact, require it. Even if it does not, local enforcement considerations, public law issues and security considerations may make this a perfectly rational end result.[92] After all, local law will usually govern the public responsibilities, property, assets and many personnel contained in the PPP anyway.

International arbitration, then, is usually the choice of sponsors and their lenders as a disputes procedure under a PPP contract. In its absence, a project may be regarded as unfinanceable. Largely for that reason, contracting authorities can often be persuaded to sign up to it. However, it is not always that straightforward. Sometimes (as we have seen) they are precluded from doing so by local law. This has been a particular issue for civil law countries which deem concessions and PPPs to be subject to administrative law, and therefore subject to the jurisdiction of the administrative courts. If this is the case, a formal derogation or new legislation may have to be introduced to overcome it. For example, the Euro-Disney Park project outside Paris had to be the subject of a special law providing for a derogation from French administrative law and permitting the use of international arbitration. If it had not been, the project may have had to have been sited outside France. As we have seen, a similar issue obstructed Türkiye's BOT programme for years.

Fortunately, many countries are now also signatory to the 1965 Washington Convention creating the ICSID under the auspices of the World Bank, the rights and protections under which normally override any conflicting requirements of local law. This contains an international arbitration procedure, based in Washington, DC, where it is managed and maintained. It can apply even between two locally established legal entities in the same state (for instance, contracting authority and private partner) to the extent that foreign ownership of one of them, in whole or part, allows the system's mechanisms to be brought into play.

Occasionally, a further compromise position may be taken. The parties may decide to use international arbitration only for major, unresolved disputes that potentially have a serious impact on the investment, leaving more minor ones concerning the project's day-to-day business to mediation or even the local courts. Besides keeping legal costs down, this will help avoid the political fallout sometimes associated with a major claim in an international forum, which can have a damaging or even paralysing effect on the project (some African water concession projects took this approach, for example). Some of the leading international arbitration systems also contain mechanisms for dealing with these less material disputes (for instance, the ICC International Centre for Expertise or its pre-arbitration referee procedure).

This is only part of the picture, however. There will always be ready-made mechanisms, as it were, to resolve disputes about breach of contract, whether through the courts or in the tried-and-tested arbitral systems in the international community. Essentially, it is simply a matter of choosing between them. Disputes about how to make fundamental revisions to the PPP contract, on the other hand, to give effect to "exceptional event" or financial balance provisions, will be less susceptible to resolution in this way. It is a fundamental principle of British contract law, for example, that courts will not rewrite the parties' agreement for them. Similarly, French law prohibits judges and arbitrators from "filling in the gaps" and substituting themselves for the parties to a contract. An arbitration forum would need to be specifically empowered to do so, and its powers may anyway be limited. In any case, the parties will be reluctant to go through full-blown legal proceedings to address the consequences of a force majeure event or a change of law (for example) if they can avoid it. They will want an efficient, impartial mechanism for reaching a fair commercial result, based on a firm grasp of the "exceptional events" in question and the intent of the agreement.

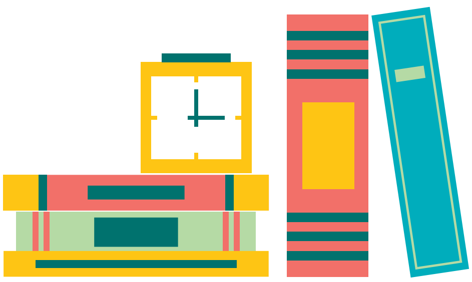
How exactly the parties will allow the PPP contract to be altered to give effect to clauses of this kind, in the absence of agreement between them, is likely to vary from project to project. In general terms, however, the mechanism chosen tends to involve a form of refined expert determination mechanism, with more extensive powers than an expert would usually have. For example, the PPP contract may provide for a panel of three experts, with appropriate experience and qualifications, to be constituted at signature, with power to apply the financial balance provisions

[92] The project company's lawyers may have to do exhaustive due diligence on the local courts and arbitral systems, as well as on all aspects of local law relevant to the PPP.

when they arise. It is always possible, of course, for experts of this kind to be selected on an impromptu basis as and when disputes occur, or by reference to an available procedure offered by the wider arbitration system selected (such as the ICC).

The advantage of having a standing (or at least rapidly available) body of experts or panel, however, is that the individuals chosen can spend as long as they need familiarising themselves with the agreement and its provisions at the outset (in particular, the financial balance clause) as well as providing continuity and consistency in relation to the decisions they make. The main disadvantage, on the other hand, is likely to be the cost of maintaining it, which may well be seen as prohibitive. Some agreements will also provide in detail for the procedure applicable to a submission of a dispute to a panel.[93] A panel may also be used in the first instance as a form of alternative dispute resolution, or mediation, before any final action is brought in the courts or arbitration forum.

PPP contracts are anyway likely to contain a number of the recognised mechanisms for dealing with certain questions of fact, minor amendments to the contract or a decisions about specific issues, even if they do not adopt a full-blown panel system. These include expert determination (for instance, to apply an index or a new technical standard), independent engineers to certify progress and milestones (such as completion or the achievement of certain KPIs) and independent auditors (for example, to value assets or calculate termination payments). Again, all these devices are designed to avoid disputes, achieve fair results and keep things going under the contract, so to speak. Arbitration or litigation should be seen as the “nuclear option” – a last resort used to resolve major disputes about legal remedies, where the parties cannot agree and third-party determination is not appropriate.



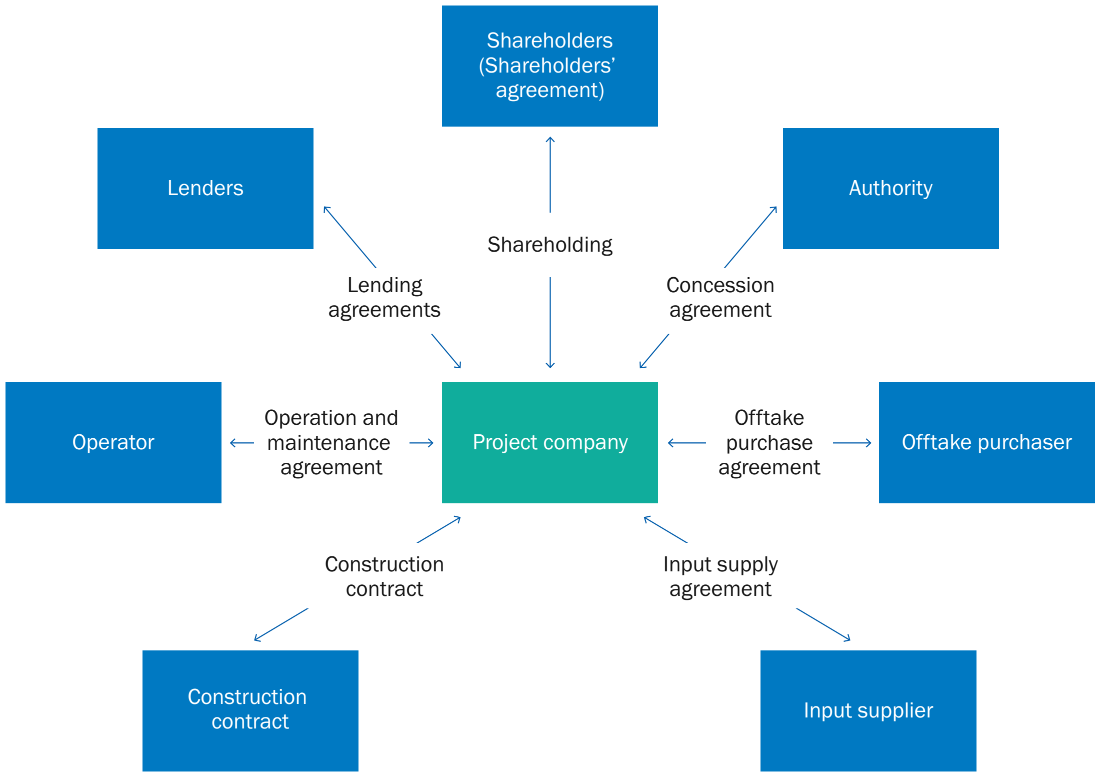
## (G) Conclusion

As this study has tried to suggest, the issues thrown up by the structuring and negotiating of PPP contracts for emerging-market projects can be as broad and diverse as the projects themselves. There is remarkably little consistency. For lawyers and others working on these agreements, and of course principals negotiating them, this reinforces the need to be flexible and creative. Innovative solutions frequently have to be found which take account of the idiosyncrasies of the particular project and the differing expectations of its participants. Precedents and guidance materials can be helpful, but should not be used thoughtlessly. In the words of the old PFI mantra, the emphasis should be on deals, not rules. As familiarity with this type of agreement grows in the international legal and financial community, however, greater consistency and predictability of approach are bound to follow. It remains to be seen whether international organisations will make further attempts to standardise PPP contracts or clauses. The authors strongly support and encourage any attempt to do so (UNECE or UNCITRAL might be an appropriate body for this). In the meantime, much can be gained by simply disseminating information about these agreements and the issues that typically affect them.

The exponential growth of PPPs around the world over the past 30 years has inevitably led to far greater awareness of PPP contracts and the issues affecting them than was the case even a few years ago. Many countries have now embraced them, growing indigenous professional industries in this field, developing knowledge centres and expertise, and evolving model forms and precedents of their own. This will continue to happen, in the authors’ view. Some regions – Africa, China, parts of Central Asia, eastern Europe and the Caucasus , the Middle East and even some countries in Latin America – have only started to use them recently and are likely to embrace them on a far larger scale in the years to come. As they do so, new and different issues to the ones discussed in this paper will come to light, calling for new and different solutions. In the meantime, we hope this paper (and of course the PPP Regulatory Guidelines Collection as a whole) will serve to make a significant contribution to a better understanding of PPP contracts, and how to structure and negotiate them.

[93] This was done on the Second Severn project in the United Kingdom, for example. The expertise needed for each member of the panel is likely to be specified. It would usually consist of a combination of legal, financial, technical and accounting skills.

## Appendix I – simplified PPP contractual structure




This diagram presents a very simplified depiction of the contractual matrix on a typical PPP project. Many of the contractual arrangements concerned can become extremely complex, especially when subcontracts, security documents and direct agreements are factored in. As a starting point, however, this gives a helpful introduction to the main participants and legal documents involved

Source: World Bank, PPP in Infrastructure Resource Centre for Contracts, Laws and Regulation (PPP IRC).

## Appendix II – sample index of PPP contract terms

1. Parties
2. Recitals
3. Definitions and interpretation (including document precedence)
4. Conditions precedent
5. Scope of PPP/Grant of "concession"
6. Term and development period
7. The project company and shareholders
8. General provisions (exclusivity/compliance with law/ reasonable assistance/permits and consents/phasing/ local content requirements/ tax concessions, etc.)
9. The site
10. Design and construction (including warranties of quality/KPIs)
11. Phasing
12. Monitoring and supervision
13. Change orders
14. Utilities and supporting infrastructure
15. Ancillary facilities
16. Financing, credit agreements and security (incl. direct agreement)
17. Operation and maintenance
18. Tariffs/charges (incl. any concession fee)
19. Performance penalty regime
20. Contracting authority's step-in rights
21. Force majeure
22. Change of law
23. Change of circumstances/exceptional events – "financial balance" provision
24. Sharing of refinancing gains
25. Termination rights and procedures
26. Lenders' step-in rights
27. Termination payments
28. Transfer procedures
29. Insurance
30. Law and disputes
31. Liability
32. Miscellaneous (including confidentiality/ assignment/reps and warranties)