The PPP Certification Program Guide

The PPP Certification Program Guide, referred to here as the PPP Guide, is the Body of Knowledge (BoK) detailing all relevant aspects of creating and implementing efficient, sustainable public-private partnerships (PPPs). It is intended for use by PPP professionals, governments, advisors, investors, and others with an interest in PPPs. The PPP Guide is part of the family of CP^{3}P credentials that, once obtained, allow individuals to use the title "Certified PPP Professional," a designation created under the auspices of the APMG PPP Certification Program. The APMG PPP Certification Program, referred to here as the Certification Program, is an innovation of the Asian Development Bank (ADB), the European Bank for Reconstruction and Development (EBRD), the Inter-American Development Bank through its Multilateral Investment Fund (IADB through its MIF), the Islamic Development Bank (IsDB) and the World Bank Group (WBG) funded by the Public-Private Infrastructure Advisory Facility (PPIAF).

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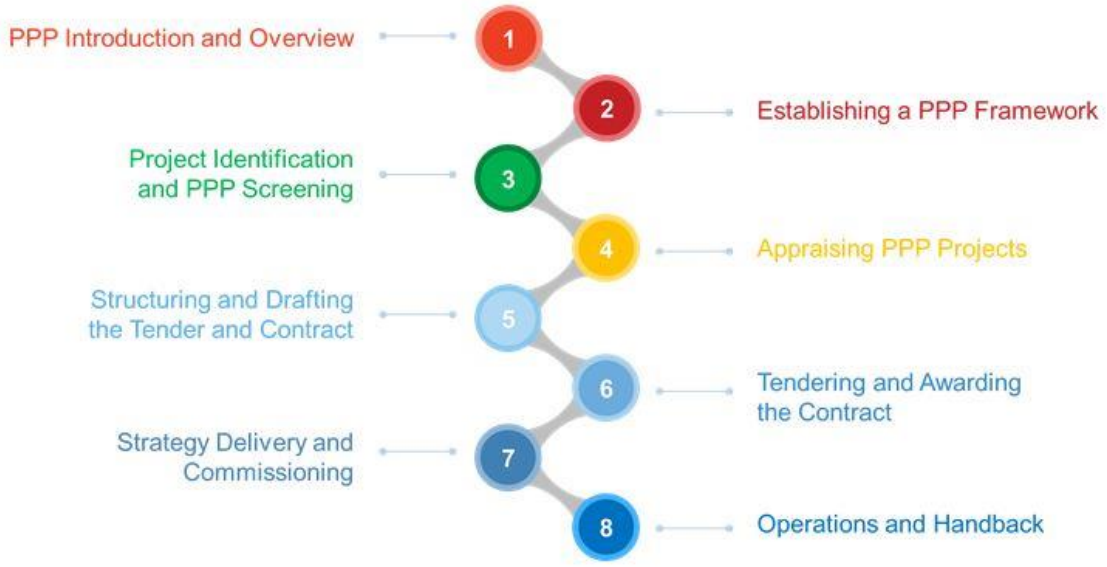
Chapter 8: Operations and Hand-Back



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1. Introduction

In this chapter, the focus will be on the contract management of the Operations Phase. Although the Operations Phase contains different aspects in comparison with the Construction Phase, the mechanism for applying good practice contract management therein does not differ significantly from the Construction Phase. Therefore, the introductory part of chapter 7 must be read in conjunction with this chapter.

This chapter will describe the contract management mechanisms that need to be put in place to monitor the private party's performance, legal, and financial changes that might happen over the Operations Phase. The Operations Phase in this context is taken to be the contract duration from the time that the asset has been constructed and commissioned, right through to the project exit and hand-over of the asset back to the government.

Therefore, this chapter deals with the contract management activities required by both parties during the Operations Phase. See box 8.1.

BOX 8.1: Learning Objectives

After studying this chapter, the reader should understand the following procedures.

- Monitoring of non-compliance and under-performance of the private partner against the output specification under the contract.
- Changes in ownership and/or transfer shares.
- Refinancing and how refinancing gains are shared.
- Oversight of the renewal plan, renewal investments, and renewal fund management.
- The exit and hand-over strategy.

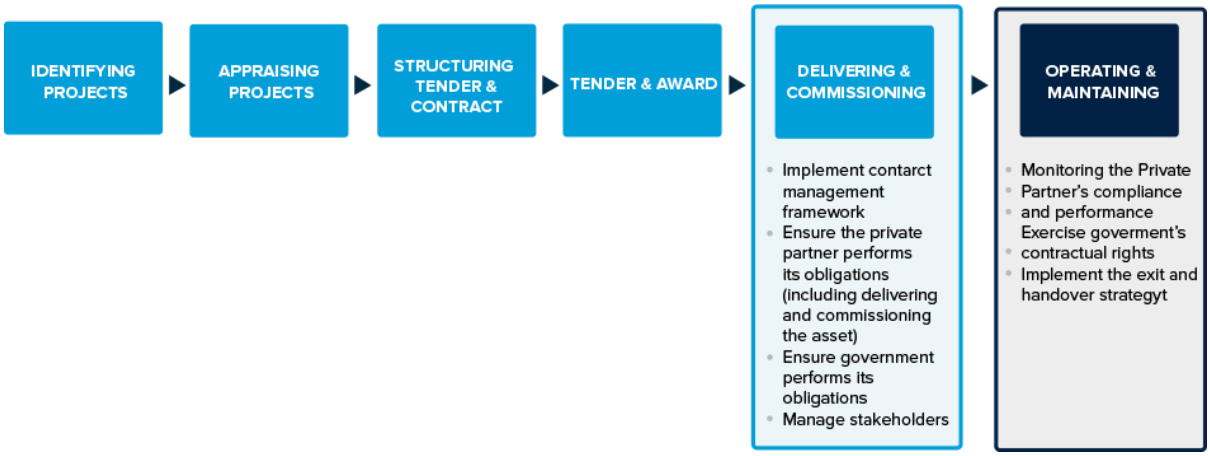
Where are We in the Process Cycle?

In the previous phase, the private partner delivered and commissioned the different components of the project. The government implemented its contract management framework, ensured that both the private partner and the government performed their obligations, and managed stakeholder interfaces.

In this phase, the private partner delivers services in accordance with the output specification in the PPP contract and maintains the project assets. The government monitors the private partner's compliance and performance against the contract. The government also exercises its contractual rights in relation to such matters as changes in the project and services, changes in ownership and/or transfer of shares in the private partner, refinancing, and infrastructure renewals. In the lead up to termination or expiry of the contract, the government implements its exit and hand-over strategy.

At the end of this phase, the PPP reaches the end of the PPP process cycle. See figure 8.1.

FIGURE 8.1: Where We are in the Process Cycle



1.1. Transition from the Construction to Operations Phase

Between the end of an asset's construction and the beginning of its operation, there is a substantial transition period where most, if not all, of the professionals who designed, installed, and verified the initial condition of the asset cease to be involved. A new team of people begins to run the asset, taking on the phase with far greater costs and environmental impact. This shift in personnel presents one of the greatest risks to the parties' ability to bridge the gap from construction to efficient operations.

Additionally, assets naturally trend toward "performance decay", a phenomenon responsible for as much as 30 percent in efficiency loss in the first four years of operation in buildings such as offices, schools, and hospitals.

Today, many new assets follow a decade old approach to the design and construction process, particularly with regard to the contractual agreements binding the teams and the protocols of communication between team members. Most importantly, the typical roles represented at the table have not changed in a very long time, although assets such as buildings have become far more technologically complex and are delivered in less relative time for ever decreasing fees.

In this model, during the earliest and most critical phases of planning and design, not all members of the ideal team are present. Of particular note, the facility manager is rarely present during design discussions. Yet the person expected to manage operations and maintenance staff and effectively uphold the performance of a facility should clearly have input during the design phase. In addition, the facility manager should play an important role in ensuring that the trade-offs between construction costs and operating and maintenance costs are fully considered (it may be beneficial to spend more up front on higher quality construction, as this may reduce operating

and maintenance costs over the long term, or vice versa). However, this person is only consulted much later in the process.

A further weakness in this model is that it is common for design roles to remain segregated and communication kept to a minimum with all parties — with work being pushed to be "done" in order to preserve profit. Everyone involved up until the completion of construction essentially leaves, turning over the facility to an entirely new group of professionals. Even assuming the facility is in top shape upon delivery, the new staff lack the history of why systems and settings were designed the way they were.

Without this knowledge, the operations and facility management staff cannot be expected to achieve the performance set forth in the design. Therefore, the government should ensure that its project plan includes the work to be undertaken to prepare for the transition period after post preferred bidder stage. The plan, referred to as the transition plan, should include dependencies, time scales, and resources. The plan should also be updated regularly. See box 8.2.

BOX 8.2: Transition Plan

The transition plan should cover the following (to the extent relevant to the project):

- Details of the government resources (internal and external – who, what and when they will be in place).
- Plans for the move to appropriate accommodation (including making sure services/equipment/software is in place).
- Establishment of the help desk (the help desk is the contact point for users and other stakeholders to notify the private partner of issues associated with the operation and maintenance of the infrastructure).
- A list of contact details for the key personnel within the government, key stakeholders, contractors, and sub-contractors, as appropriate.
- An agreement on methods and lines of communication among the parties.
- Finalization of the contract management documents.
- A familiarization program for users so that they understand the services they can expect.
- Post-contract signature start-up meetings.
- Resolution of issues that were not resolved prior to contract signature.
- Identification of any milestones.
- Assembling a library (Data Room) of project information.
- Timing for the trial running of the payment mechanism/performance monitoring system.
- Confirmation from the Facility Management (FM) contractor that they are capable of delivering either the interim or full operational services.

The transition plan should link to the communications plan to ensure that the timing is appropriate and that stakeholders have been prepared for the changes. It is essential that the contractor is not delayed by any action, or lack of action, on the part of the government. The PPP contract also sets out processes and time scales for actions by the government. The government needs to have the appropriate staff in place as well as the systems up and running to comply with its obligations. In addition, it is essential to have a full-time, competent, knowledgeable and respected senior staff member on site leading up to and through the transition plan period; this helps ensure a smooth transition.

2. Contract Management and Monitoring during the Operations Phase

2.1. Importance of Contract Management and Monitoring

The previous chapter (sections 3 and 4) explained the importance of: the contract management and monitoring; providing for the governance, structure and function of contract management; and the contract management team. The principles of the governance, structure, and function remain the same throughout the Operations Phase. However, during the Operations Phase, key actions for the contract monitoring team change, covering areas such as managing payment regimes, including insurance and utilities, acting on the results of customer surveys, looking for continuous improvement in the service, and performance monitoring.

Sound contract management throughout the operational phase will have the following traits listed in box 8.3.

BOX 8.3: Operational Phase

- Maximize the chances of contractual performance in accordance with contractual requirements by providing continuous and robust contract management which supports both parties.
- Optimize the performance of the project.
- Support continuous development, quality improvement, and innovation throughout the life of the contract.
- Ensure delivery of best value.
- Provide effective management of commercial risk.
- Provide an approach that is auditable.
- Support the development of effective working relationships between both parties.
- Encourage effective and regular communications underpinned by clear communication mechanisms.
- Allow flexibility to respond to changing requirements.
- Demonstrate clear roles, responsibilities, and lines of accountability.
- Ensure that all works and services are in compliance with legislation, relevant health and safety requirements, and council procedures.

2.2. Reasons behind Unsuccessful PPP Projects during the Operations Phase

Failure to implement an adequate contract management system could result in the following outcomes.

The government paying for services which are not being received or are not being performed satisfactorily.

Any lack of government involvement and monitoring of private party delivery could lead to a sense of complacency by the private partner; this can lead to the delivery of sub-standard services while government payments or user fees continue to be paid. This can occur in those accommodation projects in which facilities management plays a big role in the Operations Phase and the public party is not closely linked to the users of the facilities.

The project not performing as anticipated, thus jeopardizing project benefits.

In many cases, particularly in transport sector projects where user payments are crucial for realizing project benefits, possible failure points exist where high user charges and/or poor service or asset standards deter users and diminish project returns. This is the highest risk where the government has assumed some demand risk through, for example, minimum revenue guarantees.

Changes to the balance of risk negotiated in the contract.

Sometimes the government, through inappropriate involvement in various stages of the PPP lifecycle, can reverse the risk transfer and assume risks allocated to the private party. Usually, this happens due to lack of knowledge by the public officials. For example, if the procuring authority implements its own minor modifications during the Operational Phase outside of the contractual modification process, it may take back risk associated with the life-cycle costs and the condition of relevant parts of the facility.

The government is unable to foresee operations and management (O&M) contractor failure or put in place contingency measures.

At the time of the signing of the PPP contract, the future cannot be told with certainty. The procuring authority should be vigilant in monitoring the financial and performance aspects of the O&M contractor over the whole Operations Phase. Events such as solvency of the O&M contractor, or changes in the ownership or business direction of the contractor, could hamper the success of the PPP and cause major failure.

A breakdown in relationship with the O&M contractor

As in any relationship, collaboration and understanding are fundamental to a successful PPP. Simple issues such as contract misunderstandings, failures to gain stakeholder buy-in, and abusing certain situations can lead to a breakdown of the relationship and failure of the PPP.

Table 8.1 analyzes a selection of projects that cancelled during the Operations Phase.

TABLE 8.1: Projects Cancelled during the Operations Phase

Project	Reason	Reference
London Underground PPP (UK)	The responsibility of infrastructure maintenance and rehabilitation of the London Underground system was given to the private sector, and it received annual grants from the government. The PPP arrangement was for a period of 20 years, beginning in 2004. Yet by early 2010, the control of infrastructure was returned to the government. This research highlights the reason the project was cancelled as problems in consortium management, a lack of government control, incompleteness of control, and a lack of appropriate risk transfer.	http://academiceventplanner.com/EPOC2010/Papers/EPOC_2010_Williams.pdf
Victoria Trams and Trains (Australia)	The government awarded a series of franchises for Victoria's trams and trains to the private sector for operation and maintenance, in which demand risks were primarily borne by the private parties. Demand turned out to be lower than expected, resulting in financial difficulties for the companies. However, the government's risk monitor was unable to identify the deteriorating financial performance. The private parties had to walk away from the contract, leading to renegotiations on the government's part.	**Avoiding Customer and Taxpayer Bailouts in PPP projects** - https://openknowledge.worldbank.org/bitstream/handle/10986/14300/wps3274bailouts.pdf?sequence=1
Water Services for Metro Manila	The Manila Water Supply System was privatized in 1995, and	http://jica-ri.jica.go.jp/IFIC_and_

(Philippines)	Maynilad Water Services (MWSI) won a 25-year concession to operate the services for the west area, while the Manila Water Company (MWCI) was successful for the east area. However, due to the Southeast Asian economic crisis, the cumulative debts in the Philippine peso swelled by 60 percent. The MWSI was obliged to raise the tariffs. Later, the government declared a freeze on water tariff hikes. In response, MWSI revoked its operation rights on grounds of breach of contractual terms for tariff revisions.	JBICI-Studies/english/publications/reports/study/topical/progress/pdf/01.pdf
Dar es Salaam Water Distribution Project – DAWASA (Tanzania)	The project was awarded to City Water for billing, collecting revenues from customers, making new connections, and performing routine maintenance. However, the contract was terminated within two years of operation, followed by complex arbitrations between the government of Tanzania and City Water. City Water was found to be highly inconsistent in its operations. The project had suffered from weak risk mitigation measures, inefficient contract monitoring, and improper bidding procedures.	http://ppptoolkit.icrc.gov.ng/ppp-project-case-studies/

3. Contract Management and Administrative Process

3.1. Introduction to Contract Management during the Operations Phase

During the Operations Phase, key activities that must be included in managing the PPP contract are: monitoring and managing project delivery and performance against service outputs; monitoring and managing changes; managing disputes; and managing handover processes at the end of the contract.

During the Operations Phase, a change in the level and nature of stakeholder involvement will become evident. On the private partner's side, the role of the construction companies will shift from construction management and cost control to one of maintenance and risk mitigation. Overall, their level of involvement will decrease (or cease), especially if they sell down their levels of equity and ownership.

Conversely, the role of the operator will increase as the assets are commissioned into service. Performance management is the key activity, followed closely by asset management with a view to maximizing revenue and reducing performance-related penalties. On the side of the public partner, the role changes from oversight of construction and commissioning of the asset to performance oversight. In some cases, the public party may change from an implementation department to an agency with long-term statutory duties related to the services provided under the PPP (for example a transit authority).

Most importantly, in terms of introducing a new stakeholder, is the involvement of the users who are typically members of the public who rely on the performance of the assets to derive the benefits promised to them in the earlier stages of the project development. In cases where the user fees provide all or part of the revenue earned by the private partner, the number of users can also impact on the asset usage and wear, with an impact on life cycle, renewal, and refurbishment costs.

Another major change is the end of the involvement of the Independent Engineer, leaving the private and public partners to engage directly with each other without the intermediation of the objective and neutral third party.

3.1.1. Monitor and Manage Project Delivery and Service Outputs

Performance monitoring procedures can include self-reporting procedures, independent audits, regular meetings and reports, and the use of intelligent systems that automate data collection and reporting processes. The monitoring system implemented must be sound and constantly used in order to deliver Value for Money (VfM).

The monitoring performance system is primarily focused on the service performance (the level of achievement of the service levels or output specified in the contract), but it will also track and monitor other breaches of contract.

If the level of service performance is under the required standard, penalties and/or deductions or abatements might be implemented. Direct penalties are used in some user-pays projects. In government-pays contracts, the financial penalization due to poor service performance (failure to meet the service levels or output required) is commonly by means of payment reductions or adjustments, in addition to the accrual of performance points (see chapter 5.9.3).

Performance points are mainly used to track and record breaches: once non-compliance or performance points reach a specified level, they can result in increased oversight, work by the procuring authority at the private partner's expense, suspension of work, or termination of the contract under the persistent breach consideration. However, many other methods for determining penalties, deductions and abatements, and for tracking breaches are possible. The contract management team should ensure that they understand the particular method used in their contract. For an in-depth analysis of the performance and reporting please, refer to section 4 of this chapter.

3.1.2. Manage Changes Permitted in the Contract

Well-developed PPP frameworks provide flexibility within the contract in order to accommodate changes that might occur during the Operations Phase. Foster Infrastructure (2012)[1] states that the need for flexibility to implement variations in a PPP typically arises due to one of the following causes.

- The government wishes to implement a new policy initiative.
- The specific needs of the government's project change.

As a norm, the PPP frameworks will provide for the common features of variation clauses, such as the following:

- The government has a right to request variations to the works and services provided under the contract;
- The contract includes limits on the size or nature of variations that the government can request or require the private party to implement;
- The contract includes a process for the private partner to consider and respond to variation requests;
- The variation process includes mechanisms by which the government can determine whether variation costs represent Value for Money (VfM);
- The contract specifies how costs and savings arising from variations will be allocated between the parties;
- In some PPP frameworks, streamlined processes are provided for small variations;
- Some PPP frameworks contemplate the parties agreeing to the terms of foreseeable variations at the time that the original PPP contract is agreed; and
- PPP contracts also contain other clauses that provide flexibility, for example, a change in law clauses and government unilateral termination clauses.

Such variation clauses can provide efficiency for the government in implementing changes. However, the government should ensure that any changes are subject to the same degree of scrutiny and control as would apply to any similar government investment or action that was implemented outside of a PPP contract. The change process in the PPP contract should not be regarded as a way of circumventing ordinary government processes, and care should be taken to ensure that any changes offer Value for Money.[2]

In certain countries, there is a perception that PPP contracts do not provide long-term flexibility and can impose significant costs on the government (if there is a need to modify the asset or vary the services provided by the private partner at some point

[1] Foster Infrastructure 2012, Comparative Study of Contractual Clauses for the Smooth Adjustment of Physical Infrastructure and Services through the Lifecycle of a PPP Project, Foster Infrastructure Pty Ltd.

[2] For a discussion of approaches to ensure that changes offer Value for Money, see Foster Infrastructure 2012, Comparative Study of Contractual Clauses for the Smooth Adjustment of Physical Infrastructure and Services through the Lifecycle of a PPP Project, Foster Infrastructure Pty Ltd.
Physical Infrastructure and Services through the Lifecycle of a PPP Project, Foster Infrastructure Pty Ltd.

during the life cycle of the project). Recent case studies[3] highlight the need for enhanced contractual flexibility, primarily dealing with possible changes in user needs, which, in the presence of rigid contracts, have sometimes triggered very costly contract renegotiation processes.

Enhanced flexibility, in particular directed to accommodate changes in user needs, is important for the long-term projects typical of PPP. It may be achievable through well designed change management contractual clauses necessary to limit potential abuses. However, enhanced flexibility will inevitably come at the cost of lower predictability, a higher risk for the investing private sector party, and reduced effectiveness of the competitive selection process. If the government seeks too much flexibility in the contract, the risk of change may be unacceptable to bidders. Indeed, if the government needs a very high degree of flexibility for change in the project, this suggests the project was not suitable to be a PPP in the first place.

The detail of change management and dealing with variations in PPP contracts is further explained in section 7 below.

3.1.3. Managing Changes not Provided for in the PPP Contract

As previously mentioned in this PPP Guide, in cases where changes of the PPP contract occur and are not provided for in the contract itself (which often happens due to the lengthy duration of PPP projects), the processes and procedures must be clearly stipulated and followed by both the government and the private partner. Questions (such as what is the procedure, who needs to be responsible for initiating, signing off on, and delivering the decisions that stakeholders need to be consulted on) must be stated in the contract management manual (chapter 7.4.2). Therefore, during any change process, the contract management team needs to address these issues and strike a satisfactory balance between:

- Encouraging the private partner to manage its risks; and
- Preventing poor performance by the private partner from endangering the viability of the PPP contract.

While contract renegotiations triggered by changes that are not permitted in the PPP contract may be a common feature of PPPs in some countries, the associated risks should be acknowledged and mitigated. PPP contracts can be designed to minimize major renegotiations at a later stage.

Contract renegotiations require careful analysis and a dialogue between the parties before contract changes can be agreed on and implemented. The use of an experienced, trusted, and neutral facilitator may be beneficial. Whereas some renegotiations are efficient, others represent a form of rent-seeking opportunism and should be discouraged. Renegotiations of significant aspects of the PPP contract have considerable implications for the parties and are, in principle, forbidden under

[3] Iossa, Spagnolo and Velez, *Contract Design in Public-Private Partnerships – Report prepared for the World Bank* (September 2007), page 57 (available at http://www.gianca.org/PapersHomepage/contract20%design).

certain laws. They are generally regarded as undesirable due to the following reasons:

- Competitive bidding may be distorted and the most likely winner is not the most efficient company, but the one most skilled in renegotiation;
- As renegotiations are carried out bilaterally, the positive effects of competitive pressure are lost; and
- Renegotiations often reduce the overall economic benefits of PPP contracts and might have a negative impact.

Where the rent seeking is on the part of the government (that is, the government seeks to renegotiate the contract to secure a better deal), a broader reputation risk arises for the entire PPP program, as potential bidders will not be confident of getting their expected benefits from future projects and hence may not bid at all.

In some cases, the changes that are not envisaged within the PPP contract are dealt with by agreeing that the private partner may perform the work, subject to certain conditions, such as providing the service at cost in addition to an agreed mark up. If this is not to the satisfaction of the government, an external bidding process should preferably be implemented. If the cost of the change exceeds a certain amount (for example, a specified percentage of the government payments under the PPP contract), consent from a regulating party or the lenders may be required.

3.1.4. Dispute Resolution

PPP contracts typically specify dispute resolution processes to reduce the risk of legal conflict over technical issues or differences in contract interpretation. Alternative dispute resolution processes may include mediation and third-party arbitration (following a period of time allowed for both parties to make good faith efforts to resolve the dispute themselves).

Prior to mediation or arbitration, dispute resolution processes often define tiered systems of problem identification and resolution through negotiation to encourage problems to be resolved at the lowest levels. For example, the contract may specify a process whereby the parties to a dispute are given a set time period to seek ways to resolve their dispute before it is elevated to their respective managers (see section 11).

3.1.5. Exit and Hand-Back of the Asset to Government

PPP contracts generally specify the required condition of the facility at the end of the contract term. They also normally time the contract term with the full amortization of the capital value of the assets so that there is no obligation for the public partner to reimburse the private partner for any unamortized value at the end of the contract term.

The condition of a facility at hand-back depends on the maintenance and operation procedures employed throughout the life cycle of the facility. Therefore, the private partner is typically required to develop a capital replacement or asset management plan for equipment, systems, and assets. To manage the financial risks associated

with hand-back, some PPP contracts require the private partner to establish a hand-back reserve account that begins to accrue toward the end of a contract. This may be used for unplanned repairs required prior to or shortly after hand-back of a facility to the government (see section 14 for more detail on managing hand back).

4. Managing Private Partner Under-performance and Non-Compliance

As in the Construction Phase, during the Operations Phase, the immediate mechanism to deal with non-compliance and contract breaches is typically a mechanism that has financial consequences for the private partner. However, the system and instruments for managing under-performance (by providing incentives for performance as required by the contract) have a higher complexity in this phase than during construction, as a wide and complex set of service requirements must now be monitored.

A contract breach is a failure to observe a provision of the contract. For the purpose of this chapter, a distinction may be made between breaches of the service performance requirements (that is, not meeting the service targets or standards) and the breach of other contractual provisions.

The distinction is useful, as the financial consequence imposed by the contract for a service performance failure or under-performance situation may take the form of payment deductions (or abatements) in government-pays contracts. However, in user-pays contracts, the financial consequence due to the lack of performance (as well as other non-compliances or contract breaches) will most often result in a direct penalty or a Liquidated Damage (LD) amount through the penalty system[4].

The regime for financial penalizations is a simple principle of imposing a financial consequence in specific areas of non-performance and non-compliance (that is, contract breaches).

Simply put, the worse the performance the larger the financial penalization, and the longer the non-performance persists the larger the penalization. An additional variation is to identify core performance areas and to have larger penalties for non-performance in these areas. An example of the principle, as applied in a government-pays PPP contract for a hospital, would be that non-performance leading to the non-availability of an operating theatre would attract a much larger financial consequence than the failure to meet the food quality standards required for wards.

The concept is relatively simple for government-pays PPP contracts, but it can also be applied to user-pays PPP contracts: the government may also apply the financial penalization by means of deductions from a payment that is due to the private partner (an example would be of a minimum revenue guarantee or operating subsidy payment). Where there is no payment stream to the private partner from the

[4] As described in chapter 4.9.3, the scheme that defines categories of breaches and levels of penalties described in the contract is called a penalty system.

government, more artificial structures of performance reserve accounts — funded by the private partner but controlled by the government — may be used.

In addition to the financial penalizations, another mechanism has to be in place to control and monitor non-performance and non-compliance: it is necessary to track the breaches, which is usually done under a “performance points regime”. This mechanism will serve to trigger other remedy actions against non-performance as it becomes more serious.

The non-performance may be recurrent and result in a specific financial consequence (by means of increasing audits at the cost of the private partner, or by increasing the penalties or deductions through a ratchet mechanism), or may become so persistent that it is not sustainable to continue with the PPP contract. To effectively control this issue of the occurrence of severe and persistent breach, the contract may allow the government to levy performance points on the private partner for any single breach. When a certain threshold of such points is reached, the government partner is typically entitled to impose further or incremental financial penalizations as discussed above, exercise its right to step in, or even terminate the PPP contract.

Since termination is the last resort, the specific thresholds for the right to terminate are set high enough that termination will not happen without a chance for the private partner to remedy its deficiencies and start to perform in accordance with the specification again. In fact, it is common for a remedy period to precede termination even when the threshold has been reached.

4.1. Performance Monitoring Methodology

The performance monitoring methodology in a PPP contract typically contains a performance management model, comprised of three key elements.

- **The level of performance required to achieve the output specifications**: The levels should be set such that the standards are reasonable and objectively measurable;
- **The means that the institution will use to monitor private party performance**: The monitoring methodology included in the PPP contract should occur at three levels, such as a systematic self-monitoring by the private partner through a Quality Management System (QMS), a review of the private party’s QMS by the procuring authority or an independent third party, and end-user feedback on the quality and effectiveness of service delivery. The PPP contract must also specify the way in which performance is reported for monitoring purposes; and
- **The consequences for the private partner of a failure to meet the required level**: The consequences of poor performance on the part of the private partner must be handled in accordance with the PPP contract, which should contain provisions for a number of responses to performance failure, ranging from formal warnings, penalties, and/or payment deductions to eventual termination for private partner default.

As described in chapter 7 in the context of relief and compensation events, to the extent that the private partner is prevented from achieving the required performance levels by specific events outside of its control (as described and defined in the contract), or even by the public partner itself, the penalty regime and payment mechanism (in government-pays) should provide adequate and appropriate relief to the private partner.

Performance monitoring systems should be established to enable the PPP contract management team to do the following tasks.

- Check that all performance conditions and clauses in the PPP contract are acted upon;
- Develop effective mechanisms for obtaining feedback from end users and other key stakeholders;
- Review third party monitoring reports;
- Inspect deliverables to ensure inferior goods or services are not accepted; and
- Maintain comprehensive documentation on performance monitoring.

The PPP contract must specify the date by which the performance levels are to be achieved. In some projects, such as information technology (IT) projects, it is recognized that problems are inevitable in the settling-in period, and thus the private partner may be afforded a degree of flexibility in achieving the agreed performance levels. In other projects such as roads and prisons (where the safety element is crucial), it is essential that the private partner ensures that there are no settling-in problems and that the full performance level that the parties agreed upon are delivered from the outset, even if the road or prison is opened in phases. In the case of such phased service commencement, the amount of any government payments must be ramped up proportionately to reflect the phased service commencement.

Effective monitoring should provide the basis for reviewing actual private partner performance against the output specifications and other obligations contained in the PPP contract. As in the case of monitoring, reviews can be carried out by the government and/or independent third parties.

The action taken by the government to correct private partner performance must be in line with the provisions in the PPP contract and commensurate with the severity of the transgression. The application of formal warnings, penalties, and payment deductions or abatements, step-in and other responses should be undertaken in a manner that is likely to achieve the best result from the institutional point of view. An overly rigid approach may jeopardize continued service delivery to end users, while too much lenience could encourage the private partner to commit further breaches.

4.2. Quality Control and Quality Assurance Procedures

In order to encourage innovation and optimize risk transfer, the PPP contract should specify the required performance level through output specifications and not required inputs, that is, the manner of the services delivery. Suitable performance levels need to be worked out carefully by both the government and bidders during the

competitive stages of procurement. The negotiated performance levels will form a key element of the risk transfer mechanism[5].

The monitoring requirements should be set out in a Request for Proposal (RFP) and a full methodology must be included in the bid. The methodology will normally include a substantial element of self-monitoring by the private partner, subject to periodic review by the government. Additional monitoring by the government may also take place depending on the nature of the project, for example, clinical staff in a hospital identifying and reporting performance failures.

The periodic reports to be provided by the private partner are key to the management of the PPP contract and to the payment mechanisms, and they should be specifically tailored to meet these monitoring requirements. A distinction must be made between the monitoring mechanism formulated and implemented by the private partner and any actual monitoring undertaken by the government, as and when it deems it necessary in accordance with the PPP contract. The private partner should have the primary responsibility for the former, and the PPP contract should clearly provide how it will conduct this self-monitoring which will constitute the basis for the calculation of performance penalties or deductions.

Objective performance criteria should always be used as far as is possible, but other methods of measuring performance may be appropriate in certain projects. For example, there may be qualitative aspects of performance to which it may be difficult to apply penalties or deductions objectively, but which are nevertheless important to the users of the services such as the helpfulness of staff or the quality of catering. Three possible approaches for measuring these aspects of performance are the use of end-user satisfaction surveys, the use of “mystery shoppers”, and sampling, as discussed in table 8.2.

TABLE 8.2: ***Benchmarking of Services during the Operations Phase***	
End-user satisfaction surveys	It is difficult to base financial compensation on end-user satisfaction surveys because they are based on individuals’ perceptions rather than on objective, measurable facts. The results of such surveys may therefore vary. However, over time they are a useful way of monitoring performance. The questions should be carefully drafted in order to achieve a meaningful response. The private partner could be obliged under the PPP contract to improve end-user satisfaction and, where a survey reveals that a particular aspect of the services falls below the agreed level, a rectification plan should be required and agreed with the procuring authority. The advantage of such a system is that if end-users clearly understand the quality of services contracted for, the feedback obtained can be very useful.

[5] South Africa. National Treasury Standardized PPP Provisions: First Issue, 11 March 2004.

Mystery shoppers[6]	A similar approach could be adopted with "mystery shopper" surveys, which is the use of qualified individuals to test aspects of the services. This removes the perception aspect of testing since the relevant individuals will apply the same objective standards to all aspects of the services tested.
Sampling	Where monitoring is to be done on a sampled basis, the methodology for sampling, including sample size and frequency, should be agreed prior to the signature date.

Certain projects do not lend themselves particularly to any of these approaches. Regardless of which method is used, the quality of services must be considered in detail by both parties and included in the PPP contract.

4.3. Penalizations and Incentive Schemes Provided for Monitoring Purposes

The PPP agreement must clearly stipulate the consequences of any failure by the private partner to perform to the minimum standards of the required output specifications. The principle should be that penalizations (either penalties or deductions) are applied in a manner that is appropriate and proportional to the non-performance of the private partner. The ultimate threat of termination is reserved for very severe cases of non-performance by the private partner.

The value of the penalizations should be set based on commercial considerations, rather than the cost of providing the services. The PPP contract would in this case include a schedule detailing the level of penalties imposed for each failure to meet a required output specification. Alternatively, the payment mechanism must be clear as to how to calculate the deductions or abatements.

There should be a clear link between the seriousness of the failure, the value of penalties or deductions accrued, and the potential financial impact on the private party. For example, a failure to clean the exterior of the windows in a hospital should not accrue as high a penalization as a failure to maintain the operating theatre in the specified condition. Similarly, different failures in respect of the same part of the services may also incur different financial penalizations depending upon the context in which they arise. For example, a failure to deliver food in a suitable condition is a more serious failure than a failure to serve food wearing a waiter's uniform.

In government-pays contracts, where the penalization is applied in the form of deductions or abatements, depending on the specific payment mechanism used, a failure may or may not have an immediate financial impact on the payments payable by the procuring authority. It is possible for payment deductions to only start once performance deteriorates below a particular level or alternatively for them to accrue on the first failure.

In some projects, it will be appropriate to have a ratchet mechanism to deal with a recurrent failure to render a particular aspect of the services. A simple ratchet mechanism could involve increasing the level of penalties or deductions awarded for a particular failure in the services that recurs too often within a specified period. For example, if deductions equal to x are made for a failure to achieve a particular output specification, then deductions equal to (x+3) may be made for each failure over and above a specified maximum number of failure repetition within a pre-defined period.

The ratchet mechanism can be useful where the financial cost of penalizations, which accrue in respect of each such failure, is insufficient to provide an appropriate incentive for the private partner to rectify the failures. A key advantage of the ratchet mechanism is that poor performance which continues for a significant period will be more difficult for other project participants (for example, sub-contractors and the funders) to ignore, thereby encouraging early action by the private partner.

It must be noted that seeking improvements is not about extracting more from the private partner against its will, but about working together to improve quality, performance, Value for Money, or other aspects in a way that benefits both parties.

Given the length of time over which a typical PPP project will run and the difficulties of predicting technological and other productivity improvements that may occur, it is important to ensure that adequate attention is devoted to the issue of performance improvement. Ideally, the requirement for improvement should be embodied in the terms of the PPP agreement or in the role of a sector regulator.

The payment mechanism contained in the PPP agreement provides some incentive for the private partner to seek improvements in performance. If prices are fixed, they can increase their profit by improving efficiency. If profits are shared, they are motivated to improve economy. The procuring authority can also provide incentives to the private partner for early commencement of services if this is affordable and provides Value for Money.

It is important that the government does not take all of the benefit of performance improvements for itself, as this will deter the private partner from identifying such improvements. The PPP contract (or sector regulatory regime) should provide incentives for performance improvement, which could be both financial and non-financial. In this context, they should also be affordable for the procuring authority.

The improvements should be introduced through the variation procedures. The incentives should also be linked to circumstances in which the private partner can provide added value. Added value means bringing something to the partnership that is genuinely worthwhile to the procuring authority and beyond what was originally envisaged in the PPP agreement. Some examples of adding value are listed below.

- Eliminating aspects of the service that are no longer required;
- The use of new technologies that would provide a cheaper and more effective service;
- Changes in procedures or working practices that provide more efficient ways of delivering the service; and

- Opportunities for innovation, where the private partner is given the chance to implement or devise new solutions that will improve the performance of the service.

5. Managing Finances

5.1. Payment Mechanisms

The mechanism by which the private partner receives revenue with which it covers its costs, services its debt obligations, and generates a profit must be linked to the performance of its obligations under the PPP contract. The very heart of risk transfer and, therefore, Value for Money lies in the degree to which the private partner is incentivized to deliver the required services so as to receive the maximum amount of revenue.

The payment mechanism should incentivize the private partner to deliver the right level of performance, without unnecessary and costly over-performance, and penalize it if it fails to do so (European PPP Expertise Centre [EPEC] 2014).

In its broadest terms, the payment mechanism could either incentivize the private partner by increasing the revenue it receives when the services are delivered optimally (usually up to the maximum payment defined in the contract as a ceiling, but sometimes with a certain bonus that may go above the ceiling), or by dis-incentivizing the private partner from poor performance by means of reducing the revenue by applying penalties or abatements (see below).

In considering a penalty mechanism to dis-incentivize poor performance, a distinction must be drawn between government-pays PPPs and user-pays PPPs because the source of revenue, and thus the payment mechanism, differs between the two. In government-pays PPPs, the revenue stream almost exclusively comprises regular payments from the government (there may be some minor exceptions in the form of limited rights for the private partner to generate other income through commercial activities such as retail or advertising opportunities). The government also has the contractual rights to apply deductions that reduce the amount of the unitary payment (see chapter 5.10 and specifically 5.10.3).

In user-pays PPPs, the source of revenue is predominately the users of the infrastructure, such as a port, toll road, or airport. These users do not have the contractual right to make any deduction to the toll or tariff they pay in the event that performance is below that specified in the PPP contract. The contractual right to impose a financial penalization (a penalty or a LD amount) must therefore reside with an entity that represents the user's interests in performance of the private partner. This entity might be the government itself or an independent regulator acting in terms of a legislative mandate. The most common sectors that have independent regulators are telecommunications, ports, electricity generation, transmission and distribution[7], and water.

[7] See Reference literature on Economic Regulation of PPPs at the end of this chapter.

This PPP Guide focuses on the role of the government in imposing financial penalizations on a private partner in either type of PPP where the government has the explicit contractual right to impose a financial penalization for poor or non-performance by the private partner.

5.1.1. Features of Revenue Regimes and Payment Mechanisms

There are two primary types of revenue regimes. The first is one in which the government pays the fee on a regular basis for the provision of the facilities and services stipulated in the contract, with or without deductions being made for performance (government-pays PPPs[8]), and its structure and process of calculation is referred as "payment mechanism". The second is that used when the revenue for the private partner is primarily from user fees (user-pays PPPs).

For government-pays systems, when designing the payment mechanism (besides taking into account risk transfer, Value for Money, and affordability), three other factors need to be taken into account: performance indicators and the initial performance targets for those indicators; regular measurement during the Operational Phase and the link between those indicators; and the appropriate payment deductions.

The payment mechanism should be built on clear performance measures linked to the service performance and key performance indicators. They should be simple and objective, as well as linked to penalty deductions that are equal to the private partner's under-performance. They should not be linked to profitability and should not unduly affect the viability of the project.

If the private partner in a user-pays PPP under-performs, it faces reduced demand and will be penalized by a corresponding loss of revenue. However, a public partner may contractually define some penalties, and such penalties may still be applied if the partner fails to comply with a contractual obligation. Examples include not providing information on time, or if the private partner under-performs on specific obligations such as road maintenance.

For a government-pays PPP, there are certain essential elements of a payment mechanism.

- There should be no payments made until service commencement, and no payment should be made in advance of a service being delivered;
- The unitary payment should not be split into categories based on how it will be used by the private partner. This means that the unitary payment is not divided into amounts that would be applied, for example, to service debt or to fund maintenance by the private partner. This is the concept of a single and

[8] These may generally also be classified into two types: availability (or quality) payments and volume-linked payments. This chapter will assume an availability payment under a unitary approach as a default scenario. Most of the intelligence and knowledge provided here is also applicable to other payment mechanisms. See chapter 4.4 for more information on revenue regimes and payment mechanisms.

indivisible payment for full availability and performance of the services by the government;

- There should be an appropriate indexation of the unitary payment on an annual or semi-annual basis. The term “appropriate” is used here to reflect the underlying cost inputs of the private partner for a particular type of PPP. The default should be the relevant consumer price index (CPI), as this reflects the overall indexation normally applied to the government’s budget. There may be valid reasons as to why this would not provide Value for Money in the context where the private partner is exposed to significant cost components that historically deviate from CPI. These could include fuel or labor costs where the private partner would price in risk of above CPI increases into its base unitary payment. As payments to lenders are generally unaffected by the CPI, the proportion of the unitary payment related to debt service should generally not be indexed;
- There should be a mechanism for penalizing partial or complete failure of the availability and performance of the service by means of payment deductions. This requires a scale of deductions that reflects the severity of the performance failure. Too harsh a penalty for relatively minor failures may lead to adverse outcomes and disputes. Too lenient a penalty may leave the government with continuing failures that the private partner is not incentivized to remedy. Sector specialists and experts should be used to determine this proportionality for each project;
- Generally there should be no limit to deductions for non-availability[9]. Notwithstanding the fact that the private partner has fixed costs that include the servicing of its debt; the government should not be in a position to pay for services that are not available. The negative political and public perception of a project in which the government pays for services not provided in cases of fault by the private partner would be a significant challenge to overcome;
- There should be a mechanism for dealing with changes to service requirements. As stated in section 6, a variation or change mechanism must be built into the payment mechanism;
- There may be a need for a mechanism to deal with pass through costs for items, services, or consumables where the government has control over usage levels (or where usage is dependent upon demand for service and outside the control of the private partner), and where it is inappropriate to place risk for usage and cost of supply with the private party; and
- In many PPPs, there are costs that do not relate to the provision and maintenance of the assets, but rather to the services, such as cleaning or catering, where there can be variations of costs over time (so called ‘soft services’). The United Kingdom’s HM Treasury Standardization of PF2

[9] An exception may be some structures/projects in emerging and developing economies (EMDE) countries, with immature PPP programs where there may be limits to deductions in order to ensure commercial feasibility and especially bankability (see box 11 in chapter 4).

Contracts[10] describes two ways of implementing a value testing procedure to apply at regular intervals (for example every five years) allowing for the soft services to be re-competed or re-priced. The government will take comfort that there is some means of ensuring that the price it has agreed to pay in future years will not be in excess of future market prices for such soft services. The two methods are: (i) market testing or re-tendering by the private partner of a soft service to ascertain the market price of that service; and (ii) benchmarking by which the private partner compares either its own costs or the cost of its sub-contractors for providing certain services against the market price of such services. Any increase or decrease in the cost of such services, following market testing, will be reflected in a revision to the unitary charge. This is known as market testing or benchmarking.

For user-pays PPPs, many of the characteristics of a government-pays PPP penalization approach for poor performance may be included when the government has an obligation to make payments of, for example, a minimum revenue guarantee. Alternatively, in some user-pays projects, a mechanism can be created whereby penalties are payable to the government, refunded to users, or (with the government's consent) reinvested in the asset to provide additional services or amenities.

One additional consideration for user-pays PPPs is a sharing of returns between the public and private parties above a benchmark or base case return on equity. The reasoning is that it is appropriate to incentivize the private partner to benefit from its efficiencies while permitting the government to benefit from financial efficiencies that arise from economic factors that are outside the control of the private partner, but have resulted in a financial benefit (for example, revenue may be higher than expected because general growth in the economy has been higher than expected). A common argument raised is that this is one-sided in that the pubic partner does not share in the down-side risk. However, such arguments ignore the strong role and implicit support provided to PPPs by governments.

5.2. Managing the Budget during the Operations Phase

When considering the budget and its management during the Operations Phase of a PPP contract, one of the most important tools needing to be taken into consideration, as well as managed and updated throughout the phase, is the financial model. The financial model is used by both parties in order to manage budgets as well as to quantify the effects of variations and external events on the parties.

The financial model forms a critical component of a PPP project throughout its life cycle. Initially, a model is developed by the government or its appointed advisor in order to predict the private partner's costs, financing structure, and other outputs in order to assess the acceptability of the cost to the government. During the bidding

[10] United Kingdom (UK), HM Treasury, Standardisation of PF2 Contracts, December 2012, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/207383/infrastructure_standardisation_of_contracts_051212.PDF

(procurement) stage, the preferred bidder will have developed its own financial model and reflected the specific cash flows required to deliver its proposal. The preferred bidder's financial model ultimately becomes the base case financial model and part of the PPP contract (the preferred bidder's model is used rather than government's model, as the preferred bidder's model reflects the actual base case for the project, whereas the government's model was a model of a hypothetical bid for the project that does not reflect the solution being delivered by the private partner).

The financial model continues to be used throughout the actual period of construction and operation by the private partner and the government to review long-term prospects and risk exposure. It is also used to consider price variations and compensation payments in terms of the PPP contract, to calculate any potential refinancing gain (if the contract requires the private partner to share this with government), as well as the amounts payable in the event of variations.

In government-pays PPPs, the unitary payment will need to be adjusted on a regular basis to take into account inflation- and performance-related deductions and penalties. Occasionally, the payments will need to be adjusted in specific circumstances, such as delay or additional cost risks not borne by the private partner, force majeure events, and so on. In all such cases, the adjustments, the budgets, and even long-term sustainability assessments are based on the financial model. All changes to the financial model need to be recorded accurately and agreed between the parties.

5.2.1. Managing Contractual Payments

Effective financial administration involves the development of systems and procedures to make and receive financial payments and to keep records of financial transactions.

In preparing the PPP contract, the government should include procedures for making unitary payments and additional payments to the private partner, administering penalties and/or deductions, calculating inflation, dealing with late payments, and receiving reports linked to unitary payments and additional payments.

The contract should also require the private partner to prepare financial statements and enable the government to monitor key financial indicators, such as gearing, debt cover ratios and internal rate of return, as well as calculation of the compensation sums due by the government in the event of an early contract termination (for example, following a serious default or a mutual desire to terminate the partnership early).

The government should also ensure that during the Operations Phase, the management of contractual payments takes into consideration forecasting values with the actual values, resetting the assumptions used to update forecasts based on actual data, restoring key historic data (both financial- and performance-related), and performing financial control analyses.

5.3. Contingency Planning

Contingency planning is one of the most important steps within the contract management and financial allocation for PPPs. Both the government and the private partner should undertake contingency planning, albeit for different reasons.

The private party will, within its cost baseline, set aside contingency reserves as a budget allocated for identified risks which it has accepted and for which contingent or mitigating responses are developed. Contingency reserves are often viewed as the part of the budget intended to address the "known-unknowns" that can affect a project. For example, the re-work of some project deliverables could be anticipated, but the amount of this re-work may be unknown. Contingency reserves may be estimated to account for this unknown amount of re-work.

Such reserves can provide for a specific activity, for the whole project, or both. The contingency reserve may be a percentage of the estimated cost, a fixed number, or may be developed by using quantitative analysis methods. As more precise information about the project becomes available, the contingency reserve may be used, reduced, or eliminated. Contingency should be clearly identified in cost documentation and is part of the cost baseline together with the overall funding requirements for the project.

For the government, contingency planning is related to the risks it retains, for example, land acquisition or for funding of variations it requires. It is unusual for the government to maintain explicit reserves, as this is generally discouraged under public budgeting rules. Instead, budget adjustments are made on an annual or semi-annual basis for contingencies that have been realized.

A contingency plan should be developed as part of the contract management manual. This plan covers what happens if the private partner fails in its duty to deliver the services, whether as a result of an external emergency or due to issues within the private partner and its sub-contractor group. It should include emergency planning measures that should be implemented in the event of a major incident that affects the unavailability of all or a large part of a facility. The plan should not be over complicated or extensive because if it needs to be implemented, it is likely to be during a period of high pressure. As a result, it needs to be accessible and easy to implement effectively.

Box 8.4 describes a typical contingency plan that should be developed by the government contract management team during a PPP.

BOX 8.4: Contingency plan

The plan should identify the following information:

- Events that will lead to service failure and/or default.
- Impact on the services, both short- and long-term.
- Remedies and time scales in the contract.
- Emergency planning measures in the event of a major incident.
- Communications strategy (internal and external).

- Staff and resources and how these will be mobilized at short notice.
- The steps needed to return the project to normal monitoring post-crisis.
- Any consent that may be required and from whom it is needed.
- A list of key personnel, including their contact information and each person's role and responsibility.

5.3.1. Force Majeure

Although it is highly unlikely, some form of contingency planning for force majeure events needs to be put in place because such events are significant in terms of their impact — and because the associated risk is shared between the private partner and the government.

Estimates for the amount of contingency reserves that a party should set aside for force majeure events must be based on the probability of the risk occurring and on the amount of likely shortfall that would arise from insurance proceeds (or the time taken before any such proceeds are received).

The focus should be on continuing the services as much as possible after such an event, with the contingency reserve covering the costs of acquiring additional resources to do so.

For the government, it is likely that any contingency reserve to meet the government's costs associated with force majeure events would be part of a larger government-wide contingency reserve managed by the finance department/ministry. As such, the procuring authority should keep the finance ministry/department informed of any increased force majeure risks.

The private partner would more typically maintain some sort of access to additional (stand-by) equity or debt facilities, and pay some availability fee to maintain such access. It generally does not make sense to maintain a large contingency reserve in the form of cash as this is an expensive use of funds.

5.3.2. Termination

Although compensation payable upon termination is a significant amount in most PPPs and almost always requires disbursement by the government (see section 10 below), it is not the norm for the government to maintain any contingency reserve for termination payments. This is partly because the probability of termination is generally very low and partly because the causes of termination are often under the control of the government. Therefore, maintaining a contingency reserve would be unnecessary.

Instead, the risk of termination following a breach by the private partner should be regularly monitored and reported to the relevant ministry/department.

5.4. Managing Renewal Funds

The revenue collected by the private partner by way of a unitary charge payment, user fees, or a combination of user fees and government payments will include amounts to cover the private partner's anticipated future expenditures on maintenance and renewal of assets over the life cycle of the PPP. The obligation to do such maintenance, overhauls, and renewals remains with the private partner. The public partner, as well as the lenders, requires that money needed for such maintenance, overhauls, and renewals not be paid out as distributions to shareholders. The financial model will have provided for the anticipated costs in accordance with a schedule prepared by the private partner and monitored by the lenders and the government. The risk of adequate life-cycle arrangements for the assets remains with the private partner.

The funding of renewals is enabled through building up a life-cycle renewal fund over some years. This should be done in anticipation of the significant capital expenditure that such renewals require in future periods. A renewal fund is drawn down at times of such renewals (and overhauls of existing plant and equipment), and then refunded (topped up) on an ongoing basis.

The need for a life-cycle renewal fund is related to the concept of depreciation. Depreciation is recognition from an accounting perspective that the value of an asset declines over time, while the life-cycle renewal fund is recognition from a practical perspective of the need to build up cash to meet the costs of periodically renewing the asset to restore its value and functionality.

In this regard, the private partner is rewarded for efficiency in managing such a fund in that at the end of the PPP contract period, the cash balance remaining usually belongs to the private partner.

The government needs to ensure that the assets are maintained and renewed. It should therefore have the ability to conduct a final survey toward the end of the contractual period. At that time, it needs to either withhold payment of the unitary charge or require that the private partner put a performance bond in place if the assets are not restored to the required standard (normally of remaining residual life at the end of the contract period). The private partner should also prepare a maintenance and renewals report which shows the costs incurred and payments made to and from the renewals fund, any deferrals of maintenance and renewals, and a revised and updated renewals plan for the remainder of the contract period.

6. Regulatory Requirements

6.1. Standard Regulations when Dealing with PPPs

As discussed in chapter 2 of the PPP Guide, most jurisdictions have a regulatory framework that is applicable to PPPs in general as well as PPP contracts for specific projects. The regulatory framework has a number of objectives, one of which is to permit the government to consider and make rational choices as to which projects to implement as PPPs.

As a rule, various tests or standards are set, mainly to ensure that the PPP is affordable to the country and the users. The second test would be to ensure that the execution of the works under the PPP provides greater Value for Money then if done under traditional procurement method. This standard will also ensure that risk transfer to the private partner is both substantial and appropriate.

In the Operations Phase of a project, the decisions to implement are already made and the focus of the regulatory framework must shift to the following areas:

- Making sure that the project meets the objectives of a net public benefit and Value for Money (VfM);
- Ensuring that risks are identified and managed;
- Ensuring that changes in the form of amendments and variations are implemented on the same basis as the original project — in other words, that they too offer Value for Money and risk transfer;
- Ensuring that reporting is transparent, timely and accurate; and
- Examples of specific regulatory requirements applicable to the Operations Phase are detailed below.

Chile

In 2010, Chile established a new normative framework for PPPs by sanctioning the Law on Concessions of Public Works (*Ley de Concesiones de Obras Públicas*), which modified the original legislation on concessions dating from 1996 (*Ley de Concesiones, Decreto Ministerio de Obras Públicas* no. 900). The Ministry of Public Works is the responsible authority, and contracts must be awarded through competitive procurement channels which are open to any firm, either national or foreign.

Institutionally, while the Ministry of Public Works leads, awards, and administers PPPs, the Ministry of Finance has an important counter balancing role in providing key approvals and monitoring of the PPP process, including bidding conditions, amendments to the concession contracts, dispute resolution settlements, and others. To provide reassurance that the PPP program fits within the governmental fiscal program, an officer from the Ministry of Finance sits within the Ministry of Public Works and has the authority to stop any project.

The Chilean PPP unit is located within the Ministry of Public Works and consists of approximately 300 staff with specialized knowledge. In addition, the 2010 modified Concession Law allows several changes (Vittor 2011).

- The Technical Panel established by the 2010 Concession Law creates a quasi-independent regulator capable of making recommendations on matters arising between the parties during the execution of the PPP contract;
- Bidding rules, pre-project documents, background studies, and other technical project documents, as well as side letters, changes to the tariff system, and changes to the contract must be made public by law; and
- Technical monitoring reports produced monthly by contract managers on performance assessment, and containing information on services, accidents, user feedback, among other things, are disclosed regularly for all projects. The private operators provide financial information periodically to the public authority.

The Ministry of Public Works supervises the construction and operation of the project and is allowed to fine, suspend, or even terminate the concession should the franchise holder fail to meet obligations. The law also establishes a dispute resolution mechanism to review conflicts between the government and private party.

United Kingdom

In June 2010, a new entity, Infrastructure UK (IUK) was formed in the Treasury and the PPP program became known as PF2.

The core mandate of IUK is to provide greater clarity and coordination over the planning, prioritization, and enabling of investment in UK infrastructure and to improve delivery of such infrastructure through achieving greater Value for Money. It was established as a separate unit within the Treasury, providing advice to the Commercial Secretary to the Treasury who leads on infrastructure issues and reports to the Chancellor of the Exchequer.

HM Treasury is responsible for setting PPP policy for England, which is devolved in Northern Ireland, Scotland, and Wales. The Treasury publishes key policy, guidance, and statistics on PPP projects. It also provides advice to departments undertaking or wishing to undertake PPP projects. The Treasury's focus is on ensuring that public sector asset and service investment programs maintain momentum, unlock Value for Money, sustain market confidence, and deliver improved project operational performance.

There is no formal mandate granted by legislation for the PPP program. As a result, there are no PPP specific approvals. Instead, all projects follow what is known as the 'Gateway Approach', whereby projects must have their feasibility (financial and economic) tested and reviewed by agencies (including the Treasury).

The change mechanism for UK projects is set out in Operational Taskforce Note 3: Variations Protocol for Operational Projects of 2008 and Standardization of Private Finance Initiative (PFI) Contracts 4 (SOPC4) of 2007. The objective thereof is to have well-developed change mechanisms written into the contract to achieve at least the following four outcomes.

- Clear process with clearly defined roles, responsibilities, and time scales;

- Quick and efficient procedures (appropriate to the scale and complexity of the change required), with transaction time and cost kept to a minimum;
- Transparent pricing; and
- Value for Money (VfM).

The UK has a strong disclosure framework with reporting to the authorities, as well as to the HM Treasury and Parliament. All PFI contracts are subject to audit by the National Audit Office (NAO). In addition, the NAO undertakes regular audits on matters such as the achievement of Value for Money across sectors and the overall PFI program.

South Africa

South Africa has an elaborate and robust PPP legislative and regulatory framework. The legislative and policy framework for PPPs is described in the following documents:

- The Republic of South Africa Constitution Act, 1996;
- The Public Finance Management Act (PFMA) 1 of 1999 and Regulations issued in terms of the Act;
- Treasury Regulation 16;
- The National Treasury Regulation Practice Notes on PPP; and
- The PPP Standardized Terms of PPP Contract ("Standardization").

At the national and provincial levels, legislation governing PPPs is contained in the PFMA and Treasury Regulation 16. These sections require the Accounting Authority to have an appropriate procurement and provisioning system in line with the constitutional principles that is fair, equitable, transparent, competitive, and cost-effective. Treasury Regulation 16 prescribes that all PPPs conform to the requirements of affordability, Value for Money, and adequate risk transfer from government to the private party.

Treasury Regulation 16 also prescribes the procedures and approvals required throughout the procurement phase. In particular, Clause 16.8 deals with amendments and variations to PPP contracts. Any material amendment due to renegotiations must meet the scrutiny and obtain the approval of the relevant treasury in terms of:

- Value for money (VfM);
- Affordability; and
- Substantial technical, operational, and financial risk transfer to the private party.

The mechanisms to seek this approval are prescribed in Treasury Regulation 16. There is no specific regulatory framework for disclosure in South Africa. The Treasury requires reporting in the Estimates of National Expenditure every year for every PPP. These are then audited and presented to the National Parliament annually.

7. Variation Management

Variation management is closely connected with PPP agreement management and relates to the creation of mechanisms to enable changes to the PPP agreement. Such changes may be necessary as a result of a change in circumstances that could not be anticipated or quantified when the PPP agreement was signed. Variations may involve changes to works, services or the form of delivery.

The four main categories of variation types include:

- Variations that involve no additional costs;
- Small works variations;
- Government variations; and
- Private party variations.

There are procedures for all of these categories, which must be applied in cases of changes to the PPP agreement regarding works, services, and the means of delivery. Given the length and complexity of PPP agreements, it is likely that these procedures will be invoked from time to time to deal with changing project needs.

Variation procedures must be used effectively to ensure that other important functions, such as performance management and risk management, continue to operate in line with contractual requirements and changing service delivery imperatives. The contract management team must become familiar with all of the intricacies of each variation procedure and ensure that the correct steps are followed whenever the need for change arises.

7.1. Variations that Involve No Additional Cost

In circumstances where a proposed variation involves no additional costs for either party, no formal variation procedure is required. The procuring authority and the private partner should meet to discuss the best way of implementing the proposed change. If the variation will result in a reduction in costs, then the two parties will need to reach agreement about how to distribute such savings. In the case of a variation proposed by the procuring authority, savings should accrue to the procuring authority and/or end users, while savings derived from a variation proposed by the private partner should be divided between the procuring authority, the private party, and end users. The two parties would be expected to reach agreement on implementing this category of variation without recourse to dispute resolution procedures.

7.2. Changes in Small Works

Some PPP contracts include a small works variations procedure, designed to provide an efficient mechanism for dealing with minor additional capital works required by the government. For example, the PPP agreement can require the

private partner to provide a schedule of rates for a range of likely small works at the beginning of each year.

Any dispute between the parties relating to small works variations must be determined in accordance with the dispute resolution procedures.

7.3. Managing Government-Initiated Variations

Government variations should be limited to changes to the services requirements, the specified constraints on inputs, and the limits or scope of the project insurances. If the government wishes to make a change to the project deliverables, it must first submit a variation proposal to the private partner. The variation proposal must describe the nature of the variation and require the private partner to provide an assessment of the technical, financial, contractual, and timetable implications of the proposed change within a specified period.

After meeting with the private partner to consider its response, the government must decide whether it or the private partner should finance the variation. Depending on who provides the funding, payment for the variation should be made by any necessary adjustments to the user fees or unitary payment (if the private partner is financing the variation) or other forms of payment. Disputes between the parties relating to a variation (which does not involve a decrease in the scope of the service or adversely affect the private partner's risk profile) must be resolved in accordance with the dispute resolution procedure.

In situations where the government's requirements for variations can be foreseen to a reasonable degree before the signing of the PPP agreement, the government should explore the feasibility of requiring the private partner to commit to pricing pre-specified variations as part of the PPP agreement. This would provide for an accelerated variation procedure after the PPP agreement has been signed.

7.4. Managing Private Partner-Initiated Changes

If the private partner wishes to introduce a variation, it must submit a private partner variation proposal to the procuring authority, setting out the details of the variation and the likely impact thereof on the PPP agreement — particularly in relation to unitary charge payments. After meeting with the private partner and providing it with an opportunity to modify its variation proposal if necessary, the procuring authority must decide whether to accept it.

Generally private partner-initiated changes should be at no cost to the government or end-users, although there may be cases where the change is beneficial to both parties and the government is willing to contribute to the cost or increase the user fees. If the procuring authority decides to accept the proposal, it will need to make any necessary arrangements for payment depending on the funding regime that has been agreed.

7.5. Managing Interfaces and Required Changes

Although PPP contracts allow flexibility for changes in the physical infrastructure or the services, this flexibility is only effective if the government appropriately manages the variation process. Foster Infrastructure (2012) [11] states the following key principles that are applicable to managing variations.

- **Understand the contract**: The government's contract management team should ensure that they understand the PPP contract. This is essential not only to ensure that rights and obligations in relation to variations are being honored, but also to verify that a variation request is actually a change and not covered under the existing agreement and pricing structures;
- **Adopt a strategic approach to variations**: The government should adopt a strategic approach to variations. It should control the flow of variations to avoid overstretching resources on either the government side or private partner side of the contract. For example, the government can consider bundling similar variations together to reduce costs, or plan a variation program based on anticipated needs;
- **Ensure variation requests are clear and comprehensive**: The government should provide its private sector partners with proper briefs to make it clear what it wants done. This is especially important for larger, more complex variations. For complex variations, the government should consider initially having informal non-binding discussions with the private partner in order to better understand its ability to implement the variation prior to issuing a formal variation request. These informal discussions can enable the government to prepare a formal variation request that gives the private partner the information it needs to enable it to fully evaluate the variation and provide a detailed implementation plan;
- **Establish clear and appropriate roles and responsibilities for requesting and assessing variations**: The government should ensure that the appropriate staff has the authority to request and authorize variations, and that the staff *without* the authority to request variations understand this. Potential variations should be assessed thoroughly by suitably experienced personnel who should consult with relevant stakeholders; and
- **Maintain good record-keeping practices:** The government should keep good records of the variations and payments made, and it needs to ensure that agreed variations are clearly documented with the private partner. It should ensure that robust methods for costing are demonstrated by the private party for all variations (such as benchmarking and market testing), and that they have signed up to the governmental procedures when providing quotes for works of any significance. The government should further challenge information provided by the private party to ensure it is satisfied with the ability of the partner and also to demonstrate that they are achieving

[11] Foster Infrastructure (2012), Comparative Study of Contractual Clauses for the Smooth Adjustment of Physical Infrastructure and Services through the Lifecycle of a PPP Project, Foster Infrastructure Pty Ltd.

best value. The government should also ensure that they have a register in place through which to record all variations to the service. This will enable it to manage budgets, and understand any changes to cost provided during benchmarking and market testing. It will also provide an audit trail of variations to the contract.

7.6. Benchmarking and Market Testing

The aim of benchmarking and market testing is to ensure that best value and service performance is maintained for services during the Operations Phase. This is done by adjusting the government payments to reflect the current cost of providing services (see section 4.10.10 of chapter 5 for further discussion of payment adjustments). If a decision is made to use benchmarking or market testing[12], appropriate provisions should be drafted into the contract. It is important to ensure that these exercises are carried out in accordance with the contract, and that the agreed drafting properly reflects the needs of the service/project.

The government is used to performing benchmarking for services, and many have such a procedure in place. The contract may include an obligation for services to be benchmarked and/or market tested at intervals, and defined in the contract during the operational period. Both benchmarking and market testing should be implemented to demonstrate long-term best value of service provision in PPP contracts. This is commonly referred to as “value-testing”.

In PPP contracts there is a requirement for the private partner to manage these value-testing processes and bear the cost of running the process. However, the private partner and the government should carry out the benchmarking and/or market testing as a joint exercise, as there would be little value in the private partner performing the exercise and simply reporting the results as they both must agree on a Value for Money outcome. Therefore, the main focus of this exercise should be on the private partner demonstrating Value for Money and the government using value testing as a means of securing the best deal. Value testing is an ideal opportunity to review the output specification and to adjust service levels to better meet the authority’s requirements for the future, subject to cost implications.

Similar PPP projects (in size, complexity, and service level) should be benchmarked against other standard benchmark data. Good practice is to establish a project team comprising representatives from the private partner and the government to oversee the benchmarking exercise. Practical arrangements for this should be drawn up in conjunction with the private partner well in advance of the actual benchmarking and market testing.

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[12] Market testing and benchmarking are the two most common approaches to “value-testing”. Contract management (and the contract) may apply only one of the two approaches, or may allow both. To learn more about each of these procedures, refer to *Standardization of PFI2 contracts* (HMT, 2012), Schedule 2 in page 366.
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/207383/infrastructure_standardisation_of_contracts_051212.PDF

The contract will set out the timing of the benchmarking or market testing process. Typically it is conducted every 5 to 8 years. Governments that have gone through such exercises suggest that from initial discussions to final agreement, benchmarking may take a minimum of nine months. If it is followed by market testing, or if market testing alone is conducted, the process could take up to two years. The government therefore needs to employ project management disciplines from the outset and produce a project plan to cover the following considerations.

- Reassessment of requirements and possible changes to the specification;
- The schedule including agreement on milestones;
- Definition of respective roles including agreement around responsibilities;
- Methodology including agreement with regard to the approach to be employed; and
- Communications through which everyone remains informed.

A clear plan, agreed from the outset, that has a timetable allowing adequate time for iteration, clarification, and negotiation, is required. Procuring agencies should be involved early in the process, and all relevant legislation and appropriate guidance relating to employee rights must be fully complied with.

Specialist technical, financial, and legal advice may be required by the government, and it should be noted that benchmarking and market testing can be a resource intensive activity. The government needs to plan its budgets carefully for these exercises.

Both parties should independently collect data to be utilized for comparative purposes in the value-testing exercise. The private partner will utilize their data to identify a benchmark cost for the services, and the government will utilize their data to examine, interrogate, and validate the results of the exercise. Comparative data should be valid and is required to be transparently compiled. The private partner's own costs of providing services are not a valid comparator. The data compiled will need to be adjusted to be project specific, taking specific aspects of service provision and factors, such as regional variations, into account.

Openness and fair competition are key aspects of any market testing activity. As such, a government needs to encourage an active bidding market while avoiding potential conflicts of interest between the private partner and its bidding sub-contractors.

7.7. Changes in Ownership

During this phase, changes in ownership may occur, as can be the case during construction. In some jurisdictions, changes in ownership during the Operations Phase may be subject to fewer limitations than those during construction. Refer to chapter 7.8.2. for a description of this change event and its management issues.

7.8. Refinancing

The EPEC PPP Guide defines refinancing as one of or a combination of the following:

- A reduction in the debt pricing;
- Extension of the debt maturity;
- An increase in the gearing (that is, the amount of debt relative to equity). This is possible when lenders are prepared to relinquish some of their contractual protection as the perceived project risks are reduced;
- Lighter reserve account requirements; and
- The release of guarantees provided by the shareholders, sponsors or third parties of the private partner.

The underlying commercial rationale is that, by restructuring its financing arrangements, a private partner is able to raise more debt for the same debt service amount. This typically reflects the fact that, once a project has successfully reached its Operations Phase, the risks for lenders are lower and banks will accept a lower interest rate. The financial benefits derived from this additional debt and/or cheaper debt then becomes a refinancing gain that, under some PPP contracts, is shared between the private partner and the government. Where taken by the private partner, the refinancing gain is in the form of increased or accelerated distributions to the equity investors, for example. In this case, they are paid out as an extraordinary dividend or an early prepayment of shareholder loans at the time of refinancing.

Where the government receives a share of the refinancing gain, this is typically as a once-off capital amount paid by the private partner or, in the case of a government-pays PPP, possibly as a decreased unitary charge payment over time. In a few rare cases, the benefit is taken “in kind” as a pre-funded variation financed with the government’s refinancing gain share. This is rare because of the difficulty in estimating the value of the variation at the time of entering into the PPP contract.

7.8.1. Benefits of Refinancing

Refinancing gains can be significant for large infrastructure PPPs. The benefits of refinancing contract clauses are as follows.

- The private partner is incentivized to perform well under the PPP contract so as to increase the confidence of refinancing investors and to maximize the refinancing gain;
- The government is also incentivized by the prospect of a refinancing gain share to cooperate with the private partner, and to deal with potential risks to the PPP that are in its control, as well as potential increased risks not under its control; and
- A refinancing can make the financing much more efficient and transfer value that would otherwise have gone to lenders, project sponsors, users, and taxpayers.

7.8.2. Risks of Refinancing

While refinancing gains can be large, they are often forgotten about in developing PPP markets because the emphasis is on reaching the implementation stages of the project. As experienced in more developed PPP markets, refinancing does come with some risks.

- A refinancing that incurs additional debt may also increase the contingent liability of the government in an event of private partner default if a percentage of the outstanding debt has been guaranteed by the government;
- Refinancing that involves re-gearing of the debt equity ratio may change the risk profile for the project. This may reduce the equity sponsors' incentive to stay in the project and see it through difficult times after the refinancing;
- Refinancing gain shares that inappropriately understate the risk taken by the government or overstate the efficiency of the private partner lead to negative public perceptions about PPPs, and therefore a gain sharing that cannot be justified as being in the public interest; and
- In some countries, refinancing has become a highly regulated activity with regulatory approvals and prescribed methods of calculating the refinancing gain share[13].

There are three fundamental issues that have to be determined in a refinancing.

- What approval rights should the government have in a refinancing?
- How is the refinancing gain calculated? and
- How is the refinancing gain shared?

There is, unfortunately, no simple answer to each of these questions. Each PPP jurisdiction will have different economic and market conditions from the other, and each project will have different risk profiles. Although an oversimplification of the factors to be considered, the risks assumed by the private partner must be the foremost consideration of the government in establishing the refinancing gain share mechanism for the PPP contract in the bidding stage.

For user-pays PPPs where the private partner takes full demand and revenue risk (and in some jurisdictions there is no compensation on termination for private partner default), there will be a strong argument for a refinancing gain share to be heavily slanted in favor of the private partner. However, the economic factors that may increase the financing gain are seldom in the control of the private partner (for example, low interest rates as a result of a national or regional central bank policy), and yet these factors are material to the success of the refinancing.

In UK, for example, a refinancing market has matured since the beginning of PFI. It went from 70 percent of the refinancing gain to the private partner before the standardization of PFI contracts in 2002 to a 50 percent gain share with prescribed methods of calculation in Standardization of PFI Contracts (SoPC) post 2002. More recently, the amendments to SoPC4 in April 2012 state that the government is entitled (in the event of a reduction in the margin of the debt to be refinanced) to a 90

[13] United Kingdom Treasury (2007), *Standardisation of PFI Contracts Version 4,* http://www.hm-treasury.gov.uk/ppp_standardised_contracts.htm [accessed: 02 March 2015].

percent share of the portion of the refinancing gain arising from the decreased margin.

Similarly, in South Africa, the refinancing gain share of the government was set at 50/50 after 2004 when the National Treasury introduced the Standardized PPP Provisions. Prior to this, there was no refinancing gain share prescribed for South African PPPs. See box 8.5 for lessons learned from refinancing.

BOX 8.5: Lessons Learned in Refinancing

- Refinancing should be contemplated and planned for at the time of the Bidding Phase by the Government.
- The refinancing gain calculation and gain share must be prescribed in the PPP contract, as post-implementation negotiation is likely to result in disputes or excessive gains by the private partner.
- The government should have a right to refuse consent in the event of any risk increase to the government.

7.8.3. Calculating Refinancing Gains

Refinancing gains are generally calculated by comparing the distributions that are payable with refinancing to those without refinancing. Distributions generally take the form of dividends paid to shareholders or repayments of shareholder loans. As such, the gain is not simply the amount of additional finance raised, but rather the calculation is an artificial construct calculated from the perspective of the equity provider and based on the extent to which the refinancing provides a return above the base case return.

The refinancing gain is normally calculated as a net present value of the projected equity cash flows using a discount rate that reflects the nominal, post-tax internal rate of return (IRR) of shareholder equity used in the base case financial model.

As the South African Standardized PPP Provisions points out in paragraph 80.2.1, changes in the distributions forecast to take place after the refinancing can be negative and positive. For example, if the private partner raises additional amounts of debt that is paid out as an immediate distribution, this will be an increase compared to the pre-refinancing position, while the debt service payments after the raising of the additional debt will be greater and future distributions lower than the pre-refinancing position.

It is a complex set of assumptions and scenarios, and the government is advised to prepare well with financial and legal advisors prior to any refinancing.

Many details (for example, the discount and interest rates to be used in the calculations, treatment of the possible impact of a refinancing on the termination payment that the government might have to make in the future) need to be addressed in the PPP contract to avoid subsequent negotiation and possible disputes. As with many other aspects of PPPs, it is important to anticipate the issues as much as possible and set out detailed provisions in the PPP contract.

7.8.4. Payment of Refinancing (approvals required)

It is a recommended practice that the government and the government entity in control of contingent liability and fiscal risk management provide separate approvals before the refinancing occurs. The obtaining of such approvals as early as possible in the process also assists the private partner in its engagement with potential refinancers because the support of the government will be considered as a strong positive by the market.

The government should ask itself the following questions when considering its approvals.

- How much is its likely refinancing gain share?
- How much additional debt will be incurred by the private party?
- What is the change in risks for the project and the government?
- What is the risk of termination of the project and what is the net increase in any contingent liability?
- What is the impact on the private partner's ability or capacity to manage and mitigate the risks under the PPP contract?
- What are the incentives for the private partner to maintain service standards after the refinancing? and
- Will the refinancing undermine the financial stability of the private partner?

After obtaining quantified answers to these questions from expert advisors, the government should objectively assess the private partners' proposals. If so justified, the government may, for good reasons, refuse to approve a refinancing despite the opportunity to share in the refinancing gains.

This right to approve a refinancing does not extend to cases where the refinancing takes place in the regular execution of the PPP contract or the loan contracts. These include cases where the refinancing:

- Is a sale or cession of the whole or any part of equity or the shareholder loans or
- Was taken account of fully in the base case financial model and approved as such or
- Arises solely from a change in taxation or accounting treatment;
- Occurs in the ordinary day-to-day administration of the loan contracts; and
- Affects any syndication, sell-down, cession or grant of any rights of participation or security held by the lenders.

8. Relationship Management, Issue Management, and Dispute Resolution

8.1. Effective Relationship Management

In chapter 7, relationship management was clearly established as being a collaborative working relationship, together with systems and communications that

actively support and enhance the relationship throughout the life of the project. Due to the nature of PPP projects, this item might be one of the most important elements when managing and delivering the project. It is therefore important that policies and procedures are clearly established, as are lines of reporting and when and how to raise an issue. The sharing of knowledge and information also needs to be addressed. If this is not implemented, issues and disputes might arise. The following sections describe how to deal with such situations.

8.2. Issue Management

Research[14] has shown that there are two key sources of conflict.

The first source of conflict relates to situations that arise where there is potential for significant financial impact or unforeseen cost burdens that can shape government VfM outcomes. Examples of these types of disputes, relating particularly to the delivery of services for social infrastructure projects, occur where:

- The government rigidly applies abatement for delay or under-performance during the transition phase into operations, that is, when systems and processes are still being established, which results in resistance from the private partner;
- Decisions taken by the government hinder the private partner in some way. For example, double bunking in prison cells due to over-capacity that leads to higher operational costs (such as energy consumption) being absorbed by the private partner; and
- Where there is non-performance or under-performance by the private partner for the delivery of defined services.

The second source of conflict relates to the failure of one party to meet the expectations of the other where:

- The intent of a service specification has been misunderstood; and
- Where a key performance indicator (KPI) has not been adequately defined.

Disputes can occur because the private partner has a different understanding of the service it is supposed to be delivering — or over how wording contained in contractual clauses should be interpreted. Different perceptions and interpretations can therefore have a profound effect on achieving VfM outcomes where the ‘word’ can outlive the ‘intent’ in agreements.

Before enacting formal dispute resolution mechanisms, partners should make sufficient attempts to resolve the issue and at least develop a shared understanding of what the facts are and what the consequences should be under the contractual framework. The degree to which the partners are able to do this may come down to the type (or quality) of relationship that the partners have, and the level of confidence

[14] Steven McCann, Guillermo Aranda-Mena and Peter J. Edwards (2014), Managing Partnership Relations and Contractual Performance in the Operating Phase of Public Private Partnership: Interview Findings, *International Public Management Review* Vol. 15, Issue. 2, www.ipmr.net

and capability that government employees possess in dealing with their private partner counterparts.

Within this context, having the right experience can be crucial to achieving positive outcomes, as less experienced employees tend to seek expensive legal advice too often. They do this without first considering what the government's position should be, and then attempting to reach that desired outcome through negotiation with the private partner.

8.3. Dispute Resolution

As with other issues and areas of management, the key issues and good practices associated with dispute resolution are much the same in the Operations Phase as in the Construction Phase. The reader may refer to chapter 7.11.2.

9. Managing Expiry, Default, and Early Termination Processes

Early termination of a PPP contract is truly a last resort and must follow a whole range of processes, commencing with an act of default by one of the parties or some continuing force majeure.

From a contract management perspective, the focus should be on avoiding termination by managing performance adequately, identifying and mitigating risks that might lead to a default, dealing with defaults in good time and in accordance with the PPP contract, and managing disputes in accordance with the Dispute Resolution Process (DRP).

9.1. Processes for Different Ways of Ending a PPP Contract

9.1.1. Expiry of the PPP Contract

The expiry of a PPP contract is inevitable and yet the lack of preparedness by many governments in managing this expiry leads to difficult and costly transition periods at the end of the PPP. At least three years prior to the expiry of the PPP contract, the government should start to examine its options. Should it re-tender the PPP? If so, on what terms? What services will be required and what capital investment is required to enable those services? All of these questions need to be answered in a rational manner in the same way as the original feasibility study was done prior to the Tender Phase. This must be followed by the preparation of tender documentation for the preferred solution.

At the same time, the contract management team should begin to assess the asset's condition, comparing it to the residual life required in the PPP contract for assets that continue to be part of the PPP. If the condition of the asset is below that required, a remedial plan including the calling of asset condition security must begin.

The operational standards of the private partner must also be assessed so that a new operator can step in at the expiry date. A Transition Program must be devised to ensure continuity of services.

The performance management regime will also require close attention as the private partner will not be focused on the long-term sustainability of services. At this late stage in the life of the contract, termination is not a useful remedy for breach of obligations and the lender oversight will have disappeared once the debt is paid off by the private partner.

Transfer of all intellectual property rights that belong to the government on expiry will also be necessary, particularly in cases of PPPs with high-technology requirements or unique technology solutions, such as fare collection systems in rail and toll road projects.

Transfer of employees may also be required, be it from the private partner to a new operator or to the government. As such, legislation governing such transfers must be followed. This can be time-consuming and should be initiated in a timely manner so as to provide adequate time for staff consultation before the expiry date.

9.2. Reasons for Early Termination

9.2.1. Government Default

Termination for government default indicates a severe failure of the contract management system. It triggers substantial compensation payments from the public purse and leaves the government with an asset for which it may have no operator.

The events that are considered as government default are those events that are so severe that they completely frustrate the private partner's ability to perform its obligations under the PPP contract. These include non-payment of monies owed to the private partner, expropriation of the right of use of the assets, and actions that prevent the private partner from performing its obligations.

Government default is triggered by a breach notice from the private partner and would have a remedy period. Such a notice must trigger alarm at the highest levels in the government together with immediate action to avert termination.

9.2.2. Private Partner Default

It is essential that the government is highly aware of and monitors all potential events of private partner default. There are a large number of potential defaults, which range from performance defaults to insolvency of the private partner and even cross-defaults under the loan agreements. The government need not be caught unawares provided it monitors the performance and financial indicators of the private partner.

Private partner default will lead to termination if the government is not satisfied that the steps taken to remedy the defaults are adequate. This may be avoided by the government being explicit about its requirements for remedial plans in such events, and then the close monitoring of such plans.

Lenders should be given every opportunity to step in and even to exercise preemptive rights to dispose of the private partner rights and re-tender these to a new private partner.

The government should thus carry out continual assessments of the likelihood of termination and, if termination becomes a real possibility, communicate with lenders and government stakeholders, including the relevant ministry/department. Decisions to terminate the PPP contract should be taken after consideration of the financial and non-financial consequences of doing so.

9.2.3. Force Majeure

Termination for force majeure would arise from events beyond the control of either party. Upon occurrence of the force majeure event, both parties must mitigate the losses and attempt to keep the PPP contract intact.

If the force majeure event continues for a period of time specified in the contract (typically 6 or 12 months), then either party may terminate the agreement.

The amount of insurance proceeds is also an important consideration, and care must be taken in lodging the insurance claims and receiving the maximum proceeds from such a claim.

9.2.4. Unilateral Termination

Unilateral termination or “termination for convenience” has the same effect and financial consequences as government default because the government causes it. The process is, however, different because it involves the government making a conscious decision to terminate the PPP contract early, to pay the significant compensation, and to assume the operational responsibility for providing the services.

Unilateral termination would have to be carefully planned in the same way, as would the case of expiry of the PPP contract with consideration of assets, operations, intellectual property, and continuity of services. In addition, it would require the budgeting for the compensation payments that would become due on termination.

9.3. Effects of Termination

The effect of termination is that the contractual relationship between the parties comes to an end, as does the provision of the services. Assets are divided between the two parties, and there is a settling of all outstanding obligations and a calculation of the compensation payable on termination.

In such a case, the following should be governmental priorities.

- Continuity of service by (if appropriate in the circumstances) securing continued obligations of the private partner and its operating sub-contractors and the continued payment of these contractors;
- Securing all assets that belong to the government partner against loss;

- Ensuring continued supply of spares and consumables to maintain operations;
- Securing all intellectual property required to operate the assets;
- Transferring all employees necessary for continued operations to a suitable entity;
- Calculating all liabilities for settlement of claims;
- Preparing claims for any amounts owing;
- Appointing qualified persons to calculate compensation amounts; and
- Liaising and communicating with all stakeholders continuously

9.4. Compensation on Termination

The compensation that is payable depends on the type of termination and the requirements of the PPP contract. Broadly speaking these are described in table 8.3.

TABLE 8: Types of Termination and Compensation	
Reason for Termination	**Description of Payment**
Expiry	Nil
Government party default	Debt plus equity (including shareholder loans), plus return on equity, plus breakage costs on hedges.
Unilateral termination	Debt plus equity (including shareholder loans), plus return on equity, plus breakage costs on hedges.
Private party default	Depends on the regime, but typically the market value of the remaining period of the PPP contract, or a percentage of the outstanding debt at the time of termination.
Force majeure	An amount equal to the debt and all breakage costs, shareholder loans less any interest on the shareholder loans already paid to the shareholders plus equity, less dividends and other distributions already paid to the shareholders.

Of these, the most complex from a contract management perspective is the termination for private party default. In cases where the amount payable is a percentage of outstanding debt, this is easily calculated. The more difficult calculation is the market value of the remaining period of the PPP contract. To obtain the true value, the remaining period should be re-tendered in an open and competitive market. This is often difficult, especially in the case of small PPP program jurisdictions with illiquid markets.

An acceptable alternative (although not without high risks of a dispute between the parties) is the appointment of an expert to calculate the market value, based on the financial outcomes and the asset conditions.

10. Managing Fiscal Risks

10.1. Fiscal Risks in the Context of PPPs

The overall objective of fiscal risk management for PPPs is as follows.

- Ensure that government decision-makers are aware of net long-term fiscal costs through good information and advice on benefits and costs of governmental commitments;
- Create systems for the monitoring of outstanding obligations and ensuring that obligations can be met; and
- Disclose obligations to the public in accounts or budget documents in an accurate and transparent manner.

In order to meet these objectives, the public partner and the government department responsible for fiscal liability management (usually the ministry of finance) should ensure that the following basic process (in table 8.4) is applied throughout the PPP project life cycle.

TABLE 8.3: Fiscal Risks Management Process

Phase	Fiscal Risk Management Process
Project identification and selection	Ensure that projects have an explicit risk assessment to identify likely fiscal risks, for example, demand for the services, land availability risk, comparison of likely revenue, and likely costs leading to a funding gap.
Feasibility study	Ensure that there is an explicit quantification of all fiscal obligations with an assessment of their affordability.
Procurement	Ensure that the procurement documents reflect the feasibility study assessment of fiscal obligations and that bidders are required to explicitly assume the risks allocated to them.
Contract award	Ensure that all fiscal risks are identified and generate a risk register for monitoring.
Construction Phase	Monitor and report against the fiscal risk register.
Operations Phase	Monitor and report against the fiscal risk register.

Defining fiscal risks

A contingent liability is “a possible obligation depending on whether some uncertain future event occurs, or a present obligation but payment is not probable or the amount cannot be measured reliably[15]” (International Accounting Standards – IAS 37.10). It states that an entity must recognize a provision if, and only if:

- A present obligation (legal or constructive) has arisen as a result of a past event (the obligating event);
- Payment is probable ('more likely than not'); and
- The amount can be estimated reliably.[16]

In PPPs, there are a range of financial obligations that the government will incur that fall outside of this definition. In addition to contingent liabilities, PPPs should include the following fiscal obligations. See also box 8.6.

- Obligations to pay fixed and certain amounts under the PPP contract (for example, capital grants, unitary charge payments, shadow tolls, and availability payments); and
- Obligations that are dependent on a future event where the obligation to pay exists but the amount and timing may or may not be known.

BOX 8.5: Examples of Fiscal Obligations

Fiscal obligations in PPPs include minimum revenue guarantees for which the amount cannot be estimated reliably, payments upon termination for force majeure, credit guarantees, and financial instruments such as obligations denominated in a foreign currency.

Explicit fiscal obligations include availability payments, unitary charge payments, government grants, shadow tolls, and even works completed “in kind” by the government.

10.2. Dealing with Contingent Liabilities, Fiscal Obligations and Risks

The following principles should be applied by the government[17].

- Cost-Benefit Analysis (CBA) should be used to select projects, and VfM analysis should be used to choose between PPPs and public finance;
- PPPs should be approved by the cabinet, the minister of finance, or some other body with an interest in future spending. The relevant ministry/department should review proposed PPPs;

[15] Definition provided by the International Accounting Standards (IAS). IAS 37.10.

[16] International Audit Standards clause 37.14.

[17] Irwin, Timothy (2009), Government guarantees: An analysis of the allocation and valuation of risk.

- Governments should bear only those risks that they can best manage, which are generally those that they can control or at least influence;
- Modern accrual accounting standards for financial reporting should be adopted to reduce the temptation to use PPPs and associated contingent liabilities to disguise fiscal obligations;
- PPP contracts, or summaries thereof, should be published along with other information on the costs and risks of the financial obligations they impose on the government;
- Budgetary systems should be modified so that they capture the costs of more contingent liabilities;
- A guarantee fund should be used to encourage recognition of the cost of guarantees when they are given or to help with payments when guarantees are called; and
- Governments should charge fees for guarantees.

It may also be prudent for the government to impose limits by way of a governmental target for liabilities, as in the case in Brazil, Chile, Hungary, and Pakistan.

Governments must also determine when and how PPP projects should be recognized as creating government liabilities and thereby contribute to public debt. See chapter 4.12 of this PPP Guide for further information on the circumstances in which PPP liabilities should be treated as public debt.

11. Exit and Hand-Back Strategy

The exit strategy should be based on the provisions contained in the PPP agreement in relation to termination and expiry. It should also demonstrate the institution's capacity to bring the project to an end efficiently and ensure ongoing service delivery. This may be achieved either by continuing the functions in-house or by setting up a process to outsource these functions.

The exit strategy should include the following:

- An analysis of options, within the parameters of the PPP agreement, for continuing the service after termination or expiry, and an initial recommendation on the preferred option;
- Plans for organizing a post-implementation review of the project, which should:
    - assess key deliverables, Value for Money, quality, and project innovation; and
    - be carried out within six months of the expiry or termination date.
- The steps that will be taken to integrate the lessons of the project into the day-to-day work of the institution;
- An implementation plan based on the hand-back procedures set out in the PPP agreement;
- Plans to deal with the implications of any employee transfers from the private party to either the institution or a successor body;
- An estimate of the resources and personnel that the institution will allocate to managing the exit strategy; and

- Plans for a closure event to celebrate the achievements of the project and prepare PPP agreement management staff and end users for their new role.

Some PPP contracts include options for the government to extend the contract. In these cases, exercise of that extension right should be one of the options considered in the exit strategy analysis. The government should not adopt a default position of exercising the extension right without first considering whether it offers better value than other options.

The exit strategy should be reviewed at appropriate points throughout the term of the contract. It should be revised as necessary to ensure that robust plans are in place three years in advance of the expiry of the project term.

11.1. Ensure Compliance with Required Asset Hand-Over

The expected condition of the project assets on expiry of the PPP agreement must be agreed with the private partner and provided for in the agreement. In so far as the institution requires the use of the project assets (in order to continue the performance of the services either by itself or by engaging another private partner after the expiry date), provision should be made for the transfer of possession of (and unencumbered title over) the assets to the institution on the expiry date. At the signature date, the parties must agree which assets will be required by the institution at the end of the project term.

The private partner has an incentive to reduce its maintenance effort in the later years of the contract as the money saved will boost investment returns. To prevent this from occurring, the PPP agreement must provide for a procedure to be followed prior to the expiry date; the procedure will determine the condition of the project assets and whether the private partner has complied with the obligations in relation to the condition of the assets.

The procedure should include a survey that is conducted to:

- Examine the assets;
- Prepare a schedule that details all items that require remediation;
- Develop a program for remediation;
- Ascertain the costs of such remediation; and
- Undertake inspections to ensure that the remediation work is properly completed.

As a means of ensuring that the private partner complies with its obligations in relation to the condition of the assets at the expiry date, it is not uncommon to require that the private partner provides the government with acceptable security. The requirement to provide this security should have been included in the PPP agreement. As explained in chapter 5.9.10, one approach is to require the private partner to retain funds equal to a percentage of the yearly revenues (or the payments); this is used to fund a reserve for any necessary investment to meet the obligations in relation to the condition of the assets at the expiry date.

11.2. Prepare for Continuity of Operations after Asset Hand-Over

If the assets are to be transferred to the government on the expiry date, they must be in a condition in which they have some remaining useful life in order to enable the government to provide the services.

The intention is not for the private partner to ensure that the government may use the assets indefinitely, but merely to ensure that the government is not in the position, at the expiry of the project term, where all of the assets required for the services have to be replaced simultaneously. The assets must therefore have some residual life at the expiry date.

Toll road projects have, for example, required that at the expiry date, the road be in a condition in which it could be used for at least three years, while a hospital project can require that categories of equipment have a remaining average useful life of at least one-third of the original useful life.

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National Treasury PPP Manual Module 6: Managing the PPP Agreement	South African National Treasury (2004).	Provides detailed guidance on contract management in PPPs.	http://www.ppp.gov.za/Legal%20Aspects/PPP%20Manual/Module%2006.pdf
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