Renegotiating Contractual Terms under PPPs- moral hazard or practical solution?

CRISIL Young Thought Leader

Meenal Pravin Raje

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Executive Summary
Indian infrastructure has witnessed slowdown and several projects are currently delayed or have become unviable due to various reasons such as slowdown in economy, delays in environmental and regulatory clearances, lack of adequate credit support, inadequate fuel supply for power projects, etc.

This paper stresses upon the criticality of private sector investment in infrastructure, examines the developments surrounding revision of contractual terms in ultra-mega power projects and premium payments on highway projects and hence seeks to lay down the importance of renegotiation of public-private partnership contracts to secure India’s infrastructure needs.

The paper draws upon the global experiences in renegotiating PPP contracts, their frequency, underlying triggers and outcomes. It does not support the idea of rejecting renegotiation as principle and lays down certain triggers and indicators when renegotiations would be permissible.

Finally, the paper makes a few prescriptions for an efficient renegotiations framework and suggestions for efficient contract design that reduce the need for renegotiations, discourage frivolous demands for renegotiations and streamline the process to make it more efficient and maximize welfare.
Introduction

The importance of infrastructure development for the economic growth of a country is a well-established. The existence of adequate hard infrastructure such as highway and rail networks, power plants, cold chain facilities, etc. have a direct and significant impact on the productive capacity of an economy. Several studies commissioned by government agencies and development bodies illustrate the direct bearing of infrastructure development on the economic growth. Caldersen and Serven (2003) estimated the impact of 1% growth in infrastructure assets on the GDP growth as below:

Table 1: Effect of 1% growth in infrastructure assets on GDP growth rate (%)

<table>
<thead>
<tr>
<th>Type of Asset</th>
<th>Direct Effect</th>
<th>Indirect Effect</th>
<th>Total Effect</th>
</tr>
</thead>
<tbody>
<tr>
<td>Power generation capacity per worker</td>
<td>0.07</td>
<td>0.02</td>
<td>0.09</td>
</tr>
<tr>
<td>Paved Road per worker</td>
<td>0.05</td>
<td>0.02</td>
<td>0.07</td>
</tr>
<tr>
<td>Telephone lines per worker</td>
<td>0.14</td>
<td>0.05</td>
<td>0.19</td>
</tr>
</tbody>
</table>

Note: The indirect effect refers to impact via capital accumulation
Source: Calderon and Serven (2003)

India is projected to grow to US$6 tn and become the world’s fifth largest economy by 2020. Heavy investment in infrastructure is imperative for the achievement of this growth. India relies heavily on the Public Private Partnership model of investment for fuelling its infrastructure growth. According to a World Bank Report on PPP in infrastructure, India has been the top recipient of public private investment in infrastructure since 2006, the single largest market for private participation in infrastructure in 2011 and accounted for almost 50% of new PPI projects in developing countries in 2011.

The Twelfth Five Year Plan envisages an investment of Rs. 55,75,072 crore in infrastructure, about 8.18% of India’s GDP. Of this, 48.12% of investment is targeted to come from private sector through Public Private Partnerships as well as through direct investment, significantly higher than 36.61% share of private sector envisaged in the Eleventh Five Year Plan. Achieving the scale of private investment envisaged would require enabling regulatory environment and policy reforms.

Current Status of PPP projects in India and Need for Renegotiations

Infrastructure projects in several sub-sectors have witnessed severe stress and bottlenecks in the recent years on account of several factors. 215 infrastructure projects with an investment of Rs 7 lakh crores are currently delayed or have become unviable due to various reasons such as slowdown in economy, delays in environmental and regulatory clearances, lack of adequate
credit support, inadequate fuel supply for power projects, etc. This has resulted in massive losses for private infrastructure companies, putting several companies under immense financial stress. Two of the typical problems that have necessitated change in contractual terms have been discussed in detail below:

**Premium Payment in Road Projects**

Public Private Partnerships in highways can take two forms – Build-Operate-Transfer where the National Highways Authority of India (NHAI) awards concession contracts to private players to build, maintain and operate highways and collect toll from users during the concession period in return for annual payments to NHAI (known as premium). At the end of the concession period, the infrastructure asset is transferred back to the government. The other form of PPP are the Engineering-Procurement-Construction contracts where the highway is developed by a private player and transferred back to the government at the end of its construction.

In 2011-12 the government awarded 27 projects on the BOT basis of which 24 projects have already been delayed on account of delay in environment clearances or inability to tie up financing. The road developers, notably GVK and GMR, expressed inability to pay the premium payments to the government and requested a recast in the terms of payment. For a long time, the NHAI and various finance ministries have been uncomfortable with the idea of renegotiating previously awarded contracts with private players, resulting in a crisis in the road sector.

**Fuel Supply Constraints for Power Projects**

Several ultra-mega power projects have been set up in recent years by companies such as Tata Power, Adani Group and Reliance Power. These power projects initially relied on supply of coal from captive coal mines in Indonesia. However, an abrupt change in Indonesian regulations increase the tax manifold on coal exported from Indonesia. This coupled with inadequate or low grade supply of coal by Coal Authority of India, the public sector coal monopoly, has resulted in massive accumulation of losses for the power companies. The companies appealed to the Central Electricity Regulatory Commission (CERC) asking for revision in power tariffs. After a bitter legal dispute with the purchasing states, Tata Power and Adani were awarded a revision in the tariff for the Mundra ultra mega power project in Gujarat in April 2013.

Several such appeals by power developers seeking revision in tariff prices from purchasing states such as Maharashtra, Rajasthan, Gujarat, Andhra Pradesh and Punjab, citing unexpected increase in coal prices are now pending before CERC. The basic premise/concern remains the same – whether a renegotiation in pricing terms of the contract due to unforeseen circumstances is permissible.
The resultant cascading effect of problems in infrastructure on the other sectors of the economy, mainly banking and financial services, retail, agriculture, manufacturing, etc coupled with a sluggish world economic growth environment has contributed to a slowdown in the Indian economy. Global rating agencies have raised fears of credit default by private sector leading to a banking crisis.

The magnitude of losses suffered by power developers and the rising non-performing assets on the balance sheets of Indian banks have made the renegotiating of PPP contracts one of the most crucial issues for India today. The debate centers on whether renegotiation of PPP contracts is permissible and if yes, what kind of regulatory mechanism or contract designs should be put in place to protect interests of the tax payers.

Examining Global Experience in Renegotiations of PPP Contracts

A comprehensive analysis of the renegotiation dilemma would be incomplete without examining the experience of renegotiation of PPP contracts around the world, their frequency and the outcomes.

PPP contracts, due to their very nature as long duration contracts, extending upto 20-30 years, often require revisiting the terms of the contract due to bounded rationality and the inability to predict changes in project environment. A very popular World Bank study by Gaush(2004) on more than 1000 PPP projects in Latin American from 1985-2000, found that almost 41.5% of all PPP projects had to be renegotiated. The study states that most renegotiated contracts underwent negotiation within 2.2 years of their award, 85% of renegotiations occurred within 4 years of the initial award of contract. This fact is particularly rich in insights: renegotiation within such short period of contract award is indicative of aggressive bidding by the private player or fault in the contract design itself.

The negotiations in most cases were initiated by the private player (61% of total renegotiation incidences). Renegotiations incidences were higher in contracts with price cap features, (42%) investment obligations by the private players (73%) and in contracts based on lowest tariff rather than highest transfer fee.

Experience in other regions of the world is slightly varied. A study on PPP awarded in UKI reported that 22 % of all projects were renegotiation on the initiation of the government. Conversely, 6 of 21 transportation projects were renegotiated in the United States between 1991-2000 and mainly favored the concessionaire.
The outcomes of renegotiation were revision in tariffs, changes in annuities paid to the government, changes in investment quantum and schedules, changes in rate of return of the project and were mostly favorable to the concessionaire.

Trebilcock and Rosenstock (2013) classified the reasons for renegotiation into 4 categories: low-balling by private players in the competitive bidding stage, opportunism, lower than expected demand and unforeseen changes in project environment. Gaush (2004) highlights further reasons based on anecdotal evidence such as faulty contract designs, failure on the part of the government to honor contract clauses, defective regulation and its effects.

The private sector players have generally argued that unforeseen changes in the environment had resulted in making projects commercially unviable. The government and regulators generally contested on the basis of protection of public welfare, unfair profit seeking, claimed inefficiency and/or mismanagement of projects.

Several reports document the concerns with renegotiation. Opportunistic behavior by private players, increase in tariffs, especially on contracts which have initially been awarded to lowest tariff bidder based on competitive bidding, loss of sanctity of contracts, undermining of competitive bidding principles applied in the initial award of the contract due to the bilateral nature of renegotiation and reduction in general welfare of the people due to increase in costs of goods and services are some of the major concerns.

There have also been instances where the governments used the bilateral renegotiation processes as a means to grant unfair benefits to private players at the cost of the welfare of the general public or for political gains. Engel et al (2006) argue that governments use renegotiations as a means to evade budget scrutiny of increase in infrastructure spending. This facade of paying adequate attention to public welfare by increase in infrastructure spend increases the government’s popularity among the electorate and by extension, its chances for a re-election. Thus, renegotiations can be used as means to appropriate unfair gains not just by the private operator but by the government as well.

**Framework For Renegotiations Of PPP Contracts**

It is amply clear that several complexities are involved in renegotiations of PPP contracts. As argued often in contract theory, PPP contracts are by nature incomplete contracts and hence lend themselves to renegotiation. Given the critical importance of private investment to meet India’s infrastructure needs, it is essential to put in place, appropriate remedial measures and
ensure equitable justice to private players in case of genuine commercial unviability of contracts. However, it also evident from the global experience of PPP renegotiation, that it can be used by both parties to make opportunistic gains from the contract.

Keeping these concerns in mind, I propose the following framework for renegotiation of PPP contracts. The framework builds upon the underlying causes of renegotiation identified by Trebilcock and Rosenstock (2013) and Gausch (2004) to identify those contracts that justify renegotiation. The second step would involve setting up of appropriate renegotiation mechanisms, identification of risks involved in renegotiation and putting in place appropriate safeguards to prevent the same. We will finally examine contractual design features that can minimize the need and discourage opportunistic or frivolous renegotiation.

<table>
<thead>
<tr>
<th>Underlying Trigger</th>
<th>Indicators (Not a comprehensive list)</th>
<th>Renegotiation Permissible?</th>
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| Aggressive and unrealistic bidding by concessionaire | o losses incurred by the project in normal project environment and in absence of adverse external factors right from start of the contract  
  o renegotiation within a short period from award of concession or even before project commences,  
  o low bailing of tariffs or high-balling transfer fees by the winning party; this can be identified by comparing the winning bid with average of the losing bids or historical bids | No |
| Opportunistic behavior by the concessionaire or the government | o renegotiation within a short period from award of concession or even before project commences  
  o renegotiations initiated close to elections or when the government is under fiscal stress  
  o unfair or inconsistent application of amendment in regulations or terms to similar projects  
  o disproportionate increase in returns to the private player  
  o history of renegotiation by private player  
  o renegotiation benefits demanded in excess of losses incurred due to adverse developments in project environment | Permissible when injured party demands just compensation for the loss caused by opportunistic behavior |
| Failure of the government to honor clauses | o Inefficiencies or corruption  
  o Lack of fiscal capacity to honor contract clauses  
  o Lack of technical expertise and knowledge | Permissible if project is unviable or will cause loss |
Inter-ministry co-ordination issues of public welfare

<table>
<thead>
<tr>
<th>Macro-economic shocks, force majeure and other unforeseen factors</th>
<th>o Financial or credit crisis</th>
<th>Permissible if contract becomes impossible or commercially unviable</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>o Currency and commodity price shocks</td>
<td></td>
</tr>
<tr>
<td></td>
<td>o Adverse regulatory changes in foreign countries affecting project performance</td>
<td></td>
</tr>
</tbody>
</table>

| Defective Regulation                                           | o Legal, institutional, administrative and enforcement related problems | Will require more intensive analysis and depend on situational peculiarities |
|                                                               | o Lack of maturity in regulatory framework or governing laws |                                           |

| Faulty contract design                                         | These would be much more difficult to identify and subject to peculiarities of each situation. However, anecdotal evidence suggests faulty contract designs or regulations lead to renegotiation within a short duration of contract award. |                                           |

The overarching theme is that renegotiations should not be ruled out in principle. A case-by-case analysis is warranted given the unique nature of each PPP contract, and both parties should have right to seek renegotiations, if the contract results in losses. However, renegotiations should also not seek to protect parties from normal business risks. Hence, adverse developments in project environment which are beyond the control of the entity and result in less than significant (or normal) business losses should not warrant renegotiation.

**Institutional and Legal Set Up for Renegotiation of PPP Contracts**

Gaush (2004) suggests that the renegotiation mechanisms should be embedded in law rather than the contract or decree, as law is more difficult. A legal framework for renegotiation also implies that change in government regimes would not result in overturning or dismantling of renegotiation committees set up by the previous government. The most effective way would be to set up/identify an independent quasi-judicial regulator for every sector to examine renegotiations on a case by case and act as mediator and a judge. In India, inter-ministry conflicts have also resulted in frustration of several PPP projects. Hence, there should be an additional regulatory or a nominee from the government who could ensure resolution of disputes among various ministries. Finally, India already has adequate institutional framework for administrative and dispute resolution issues. Thus the renegotiations framework should have adequate power to recast contracts rather than being limited to an administrative or dispute resolution body.

**Effective Contract Design Measures**

Gaush (2004) and Engel et al (1998,2000) have described the ‘Canon Based Concession Awarding Criteria’ and ‘Least Present Value of Revenues’ as efficient forms of contract design.
The following indicative list includes features/clauses that can be incorporated in contracts to reduce the need for renegotiations, streamline the process and discourage frivolous renegotiations:

1. Financial criteria such as tariffs or premium payments for selection of bidder in a competitive process should be applied once initial selection has been made based on technical expertise, reputation and past experience.

2. Minimum viable tariff structure and schedule should be established to prevent extreme low bidding by parties who seek to win the contract and then renegotiate tariffs. Phased tariff revision scenarios and mechanism should be built into the contracts.

3. Triggers for renegotiation should be laid down in the contract

4. Provisions for competitive re-bidding along with/in lieu of renegotiations contracts should be built in to discourage parties from using renegotiations as a bilateral negotiations process for mutual benefits, within a short period of initial award of contract

5. Imposition of heavy fines on frivolous or opportunistic renegotiation attempts.

6. Specification of the regulatory mechanism to be used for the purpose of renegotiation.

**Conclusion**

The Indian infrastructure sector is poised at crucial and interesting point with regards to renegotiation of PPP contracts. Several recent developments have indicated the willingness of the government to explore renegotiations as a means to revive growth in the infrastructure sector. This is evidenced by the Planning Commission’s proposal to add renegotiation clauses to PPP contracts and the C. Rangarajan’s committee final decision on January 3, 2014 expected to revise premium payments for road projects. As the country with one of the world’s largest share of private sector investments, India is being keenly monitored by the world and would do well to use this opportunity to devise best practices for renegotiation of PPP contracts and set global standards.
References

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