PPPs in Infrastructure

Day 1

Session 3.2

Renegotiating PPPs: Key Issues for Policy Makers

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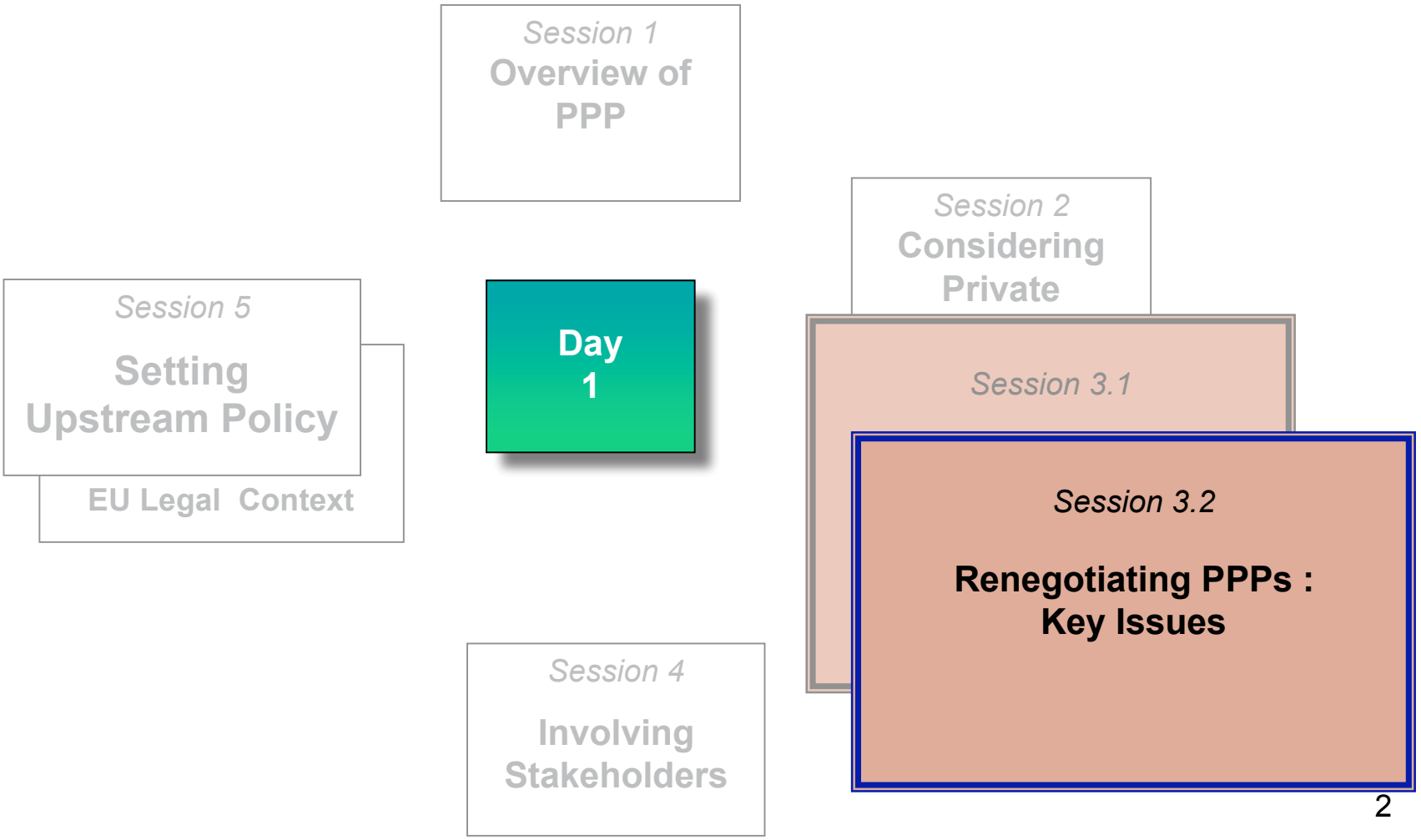
Session 3.2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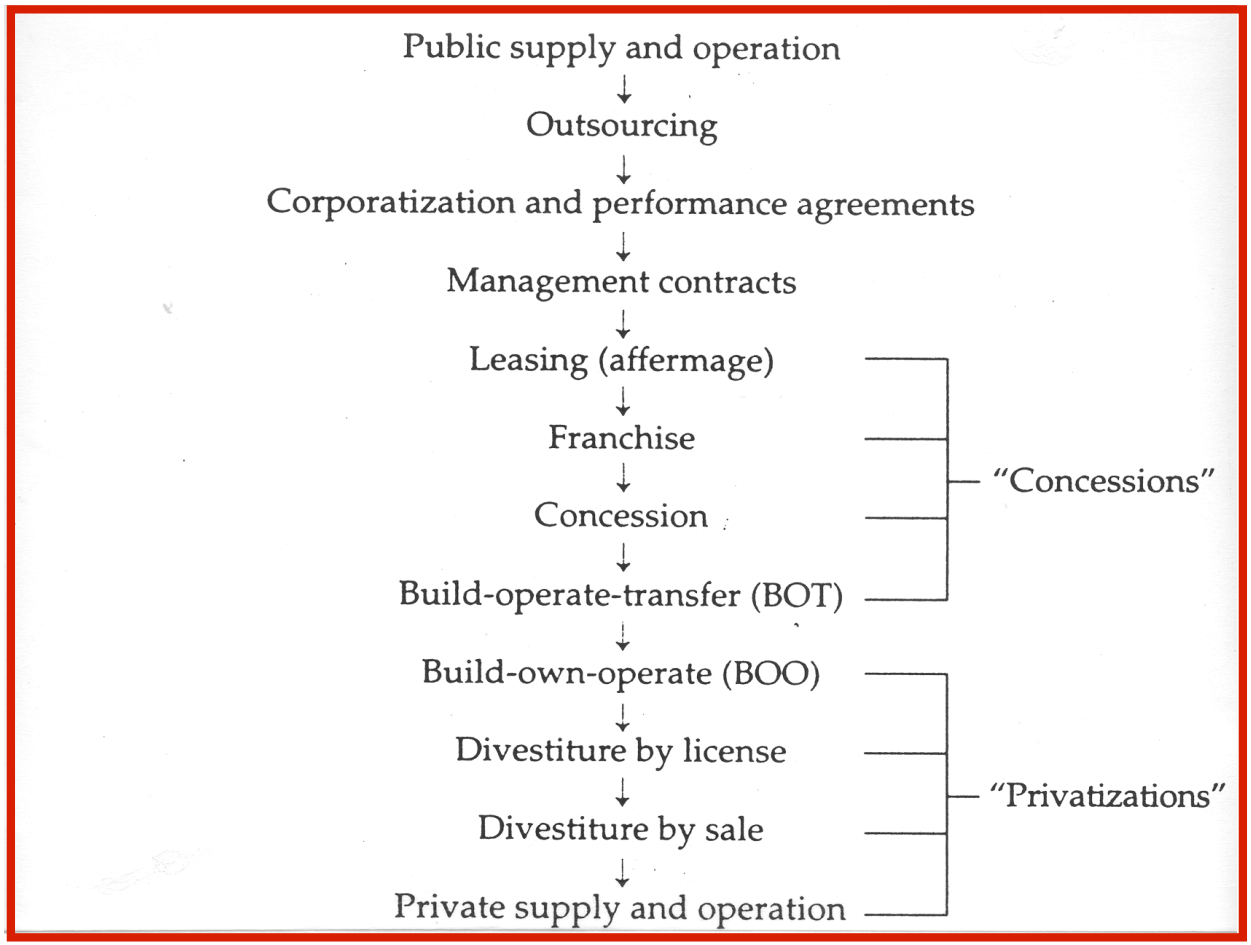
Involving Stakeholders

OUTLINE

- Motivation
- Data Set of Analysis
- Why are we concern about renegotiation?
- Evidence and Results: Why it matters?
- Determinants of Renegotiation
- What to do about: Recommendations

Types of Private Participation in Infrastructure



Salient Choice: Concessions/ PPPs

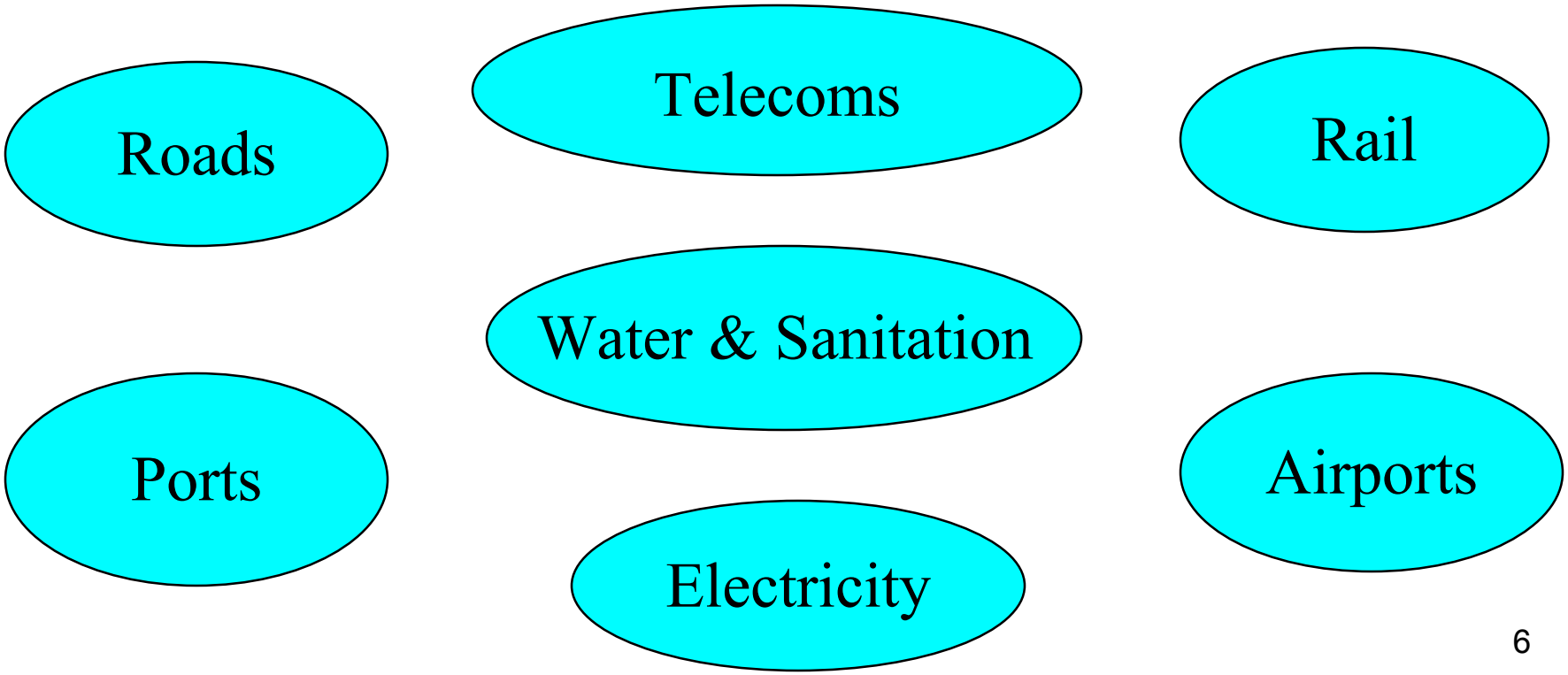
- Concessions or PPPs → instrument mostly utilized for private participation in infrastructure services: (75% total, 98% transport, 89% water and sanitation)

- Privatization → mostly used in the Telecom, and in Electricity - Generation sectors

- Concessions and PPPs: conceptually similar, often differentiated by financial viability: Concessions viable, PPPs not viable & requiring government financial contribution. Fiscal issue-asymmetric-debt vs revenues

Data Set

Based on the analysis of more than 1,300 concessions in the infrastructure sector awarded since the 1980s to date, in Latin America and Caribbean (Guasch 2004).



Data Set

Based on the analysis of more than 1,300 concessions in the infrastructure sector awarded since the 1980s to date, in Latin America and Caribbean (Guasch 2004).

The data set has seven blocks describing:

(i) country characteristics;

(ii) type of project or transaction;

(iii) award and bidding details;

(iv) regulatory environment;

(v) concession details;

(vi) renegotiation details; and

(vii) risk bearing details

WHY ARE WE CONCERNED ABOUT RENEGOTIATION?

- It eliminates the competitive effect of the auction for the concession: questions the model's credibility
- Renegotiation takes place away from competitive pressures in a bilateral - government/operator – environment
- Competitive bidding distorted
- Decreases benefits of concession and welfare of users, usually have fiscal impact, contributes to backlash
- Most likely winner is not most efficient operator but that most skilled in renegotiation
- While some renegotiations are efficient, many are opportunistic and should be deterred

RENEGOTIATION:

The Norm rather than the Exception (1 of 2)

- Violation of the sanctity of the contract
- Rational expectations: evidence of governments willing to take renegotiation demands
- That in turns leads to vicious cycle
  - To pervasive renegotiation demands
  - Low balling bids, with the intention to win the concession or PPP and then renegotiate better terms
  - Low balling bids: R= PQ-0C-T-D<rKi

RENEGOTIATION:

The Norm rather than the Exception (2 of 2)

- Correlation between renegotiation and profitability
- Correlation between aggressive bidding and renegotiation
- Aggressive bidding-low profitability-renegotiation
- Aggressive bidding: **PQ-OC-T-D<RK**
- Financial equilibrium issue

Incidence and Time of Renegotiation of Infrastructure Concessions in Latin America 1988-2005

	Renegotiated Concession	Average Time to Renegotiation
All Sectors	68%	1.8 years
Electricity	41 %	2.1 years
Transport	78%	2.9 years
Water	92%	1.3 years

Source: Guasch (2004) updated

Very Low Incidence of Cancelled Concession

1990-2001

Total World Infrastructure PPI Projects	Cancelled	Percentage
2,485	48	2.1%
	Composition	***By Sector***
	19 toll roads	5.8%
	9 energy	
	7 water & sanitation	3.5%
	8 telecom	

Source: Harris (2002)

CORRELATION BETWEEN RENEGOTIATION INCIDENCE AND PROFITABILITY

Average Profitability by Sector of Privatized and Concessioned Firms and the Cost of Equity in Latin American and Caribbean Countries 1990 – 2002 (per cent)

Sector	IRR (adjusted) [a]	Initial Cost of Equity [b]
Telecommunications	21.0	14
Water and Sanitation	**11.0**	**15.5**
Energy	14.5	14
Transport	**11.5**	**13.5**

a. The IRR has been adjusted to incorporate management fees.
b. Cost of equity is evaluated at the time of the transaction.

Contract Award Processes for Concessions in Latin America and the Caribbean by Sector. Mid 1980s - 2005

Award process	Telecom	Energy	Transport	Water and sanitation	Total	Share of total (percent)
Competitive bidding	245	95	231	125	696	78 (46% renegotiated)
Direct adjudication (bilateral negotiation)	15	143	37	4	199	22 (8% renegotiated)
Total	260	238	268	129	895	100

Source: Guasch (2004)

Distribution of Concessions by Type of Regulation

Price Caps	**56%**
Rate of Return	**20%**
Hybrid*	**24%**

*Hybrid regimes are defined when, under a price cap regulatory regime, a large number of costs components are allowed automatic pass through into tariff adjustments

Source: Author's calculations

Distribution of Concessions by Existence of Investment Obligations in Contract

Investment Obligations in Contract	**73%**
No Investment Obligations in Contract but Performance Indicators	**21%**
Hybrid	**6%**

Source: Author's calculations

HYPOTHESIS FOR RENEGOTIATION

- Adjustments to macro shocks
- Changes in governments or in priorities
- Take advantage of lack of credible commitment to no-renegotiation
- Aggressive/Opportunistic biding
- Securing additional investment or projects bypassing due diligence
- Abusing financial equilibrium principle
- Exploiting leverage opportunities-political capital
- Perceived opportunities for corruption
- Fear of corruption attacks dissuades disqualification of aggressive/opportunistic bids

Typology of Renegotiation

Initiated by Government

- Opportunistic (politically)
- Change in priorities

Initiated by Operator

- Opportunistic (rent seeking)
- Shock related

Ambiguous

Who initiated the Renegotiation?(% of total requests)

	Both Government and Operator	Government	Operator
All sectors	**13%**	**26%**	**61%**
Water and Sanitation	**10%**	**24%**	**66%**
Transport	**16%**	**27%**	**57%**

Source: Author's calculations

Who Initiated the Renegotiation, Conditioned on Regulatory Regime?
(% of Total Requests)

	Both Government and Operator	Government	Operator
All sectors			
Price Caps	**11%**	**6%**	**83%**
Rate of Return	**39%**	**34%**	**26%**
Hybrid Regime	**30%**	**26%**	**44%**

Source: Author's calculations

What Are the Outcomes of the Renegotiation Process?

- On average the terms of the contract improved for the operator/investors
- Efficiency gains are reduced
- Users are on average worse off
- Adverse fiscal impact, including increases in contingent liabilities, are common

Common Outcomes of the Renegotiation Process

	Percentage of renegotiated concession contracts with that outcome
Delays on Investment Obligations Targets	69%
Acceleration of Investment Obligations	18%
Tariff Increases	62%
Tariff Decreases	19%
Increase in the number of cost components with automatic pass-through to tariff increases	59%
Extension of Concession Period	38%
Reduction of Investment Obligations	62%
Adjustment of canon-annual fee paid by operator to government Favorable to operator Unfavorable to operator	 31% 17%
Changes in the Asset-Capital Base Favorable to Operator Unfavorable to Operator	 46% 22%

Source: Guasch (2004)

Contract Features and the Incidence of Renegotiated: Determinants

Feature	*Incidence of renegotiation (percent)*
Award criteria	
Lowest tariff	60
Highest transfer fee	29
Regulation criteria	
Investment requirements (regulation by means)	70
Performance indicators (regulation by objectives)	18
Regulatory framework	
Price cap	59
Rate of return	16
Existence of regulatory body	
Regulatory body not in existence	62
Regulatory body in existence	23
Impact of legal framework	
Regulatory framework embedded in contract	61
Regulatory framework embedded in decree	41
Regulatory framework embedded in law	18

Source: Guasch (2004).

Summary of the Results

Determinants of Renegotiation- Significant Variables:

- Award criteria
- Grounding of regulatory framework
- Existence of proper regulatory body
- Autonomy of regulatory body
- Type of regulation
- Nationality of concessioner
- Number of bidders
- Duration of the Concession
- Extent of Required Investment
- Political Cycle
- Macro Shocks

Other significant variables

- Existence of investment obligation increases the probability of renegotiation
- The longer the duration of the concession the lower the probability of renegotiation
- The stronger the legal groundings (law, decree, context) of regulatory framework the lower the probability of renegotiation
- Reputation effect:
  - ➔ As the country has renegotiations incidence the probability of renegotiation increases (there might be also a learning effect)
- Competition- number of bidders:
  - ➔ The greater the number of bidders the higher the probability of renegotiation

ISSUES ON RENEGOTIATION

- Financial equilibrium
- Sanctity of the bid:

$$R = PQ - 0C - T - D < rKi$$

- Regulatory accounting
- Incomplete contracts
- Informational assymetries
- Contingent events

Common Questionable Actions That Need To Be Addressed Through Regulatory Accounting

- Management fees often equivalent to half of the firm's net profits
- Contracting subsidiaries or related companies to provide services or equipment at significantly higher prices than standard market prices
- Accuracy of reported investments
- Transfer of accumulated profits into the regulated capital base
- Transfer of capital in non-regulated areas of the firm into the regulated capital base of the firm
- Valuation of pre - privatized assets at replacement costs
- Using, when convenient, past performance as justification for demands for future higher tariffs
- Financial equilibrium, yes, but based on best practices and the sanctity of the bid

Lessons: New Efforts Should be Placed in Properly Addressing:

I. Pre-Concession Issues

II. Concession Design Issues

III. Concession Award Issues

IV. Regulatory Issues

   a) Institutional
   b) Economic/Technical
   c) Administrative Procedures

RECOMMENDATIONS (1 of 2)

- Contract design avoiding ambiguities and incorporating proper contingencies
- Extensive use of regulatory instruments, particularly regulatory accounting, clarity on treatment of assets and liabilities
- Reputation matters: establish early on a reputation for not easily conceding renegotiation demands
- Scrutiny of aggressive bids
- Clarity on context and application of financial equilibrium clauses
- Clause about any contract modification should not change expected return

RECOMMENDATIONS (2 of 2)

- Contract should stipulate approach to renegotiations
- Credible commitment to no-renegotiation beyond contract clauses
- A freeze period on demands, five years or more
- Sanctions against frivolous demands-requesting a large fee to accompany demand to be lost if denied and considered frivolous
- Panel of experts to advise

Contacts

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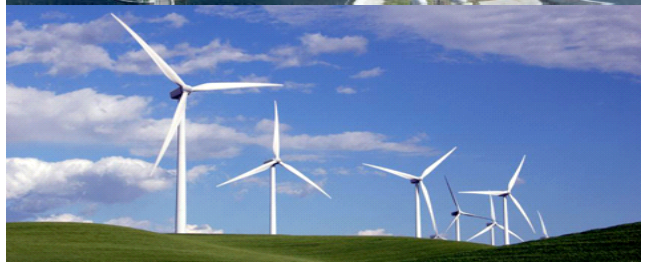

THANK YOU!