A Guide to the Main Provisions of an Availability-based PPP Contract

Public-Private Partnerships in the Western Balkans

2018

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Abbreviations

EU	European Union
FB&H	Federation of Bosnia and Herzegovina
FYROM	Former Yugoslav Republic of Macedonia
HNC	Herzegovina-Neretva Canton
PPP	Public-Private Partnership
RS	Republika Srpska
SPV	Special purpose vehicle
WBIF	Western Balkans Investment Framework

Background Note

This Guide has been prepared by the European PPP Expertise Centre (EPEC) of the European Investment Bank as part of its mandate from the Western Balkans Investment Framework (WBIF) for *Strengthening the Capacity of the Public Sector to Undertake PPPs in the Western Balkans* (Albania, Bosnia Herzegovina, FYROM, Kosovo*, Montenegro and Serbia).

This Guide to the main provisions on an availability-based PPP contract belongs to a series of EPEC guidance documents that aim to strengthen the capacity of the governments in the Western Balkans (the Region) to prepare and procure PPPs (Figure 1).

Additional guidance has been produced alongside this Guide as part of the WBIF EPEC assignment, namely:

- **A Guide to the Qualitative and Quantitative Assessment of Value for Money in PPPs**

  This document consists of three parts. Part 1 provides an introduction to VfM with an overview of the main objectives of VfM assessment. Part 2 focuses on qualitative VfM assessment, illustrating evidence based approaches to examining the suitability of the PPP framework in respect of given project characteristics. Part 3 presents quantitative VfM assessment, providing guidance on quantitative approaches to comparative VfM assessment, including the use of a public sector comparator (PSC).

- **A Guide to Preparing and Procuring a PPP project**

  This document presents good practice from the European PPP market that are relevant to the public officials in the Western Balkan region who are responsible for launching and implementing PPP projects. It provides a framework for making the many decisions that are required by a Public Authority when it is preparing and procuring a PPP project.

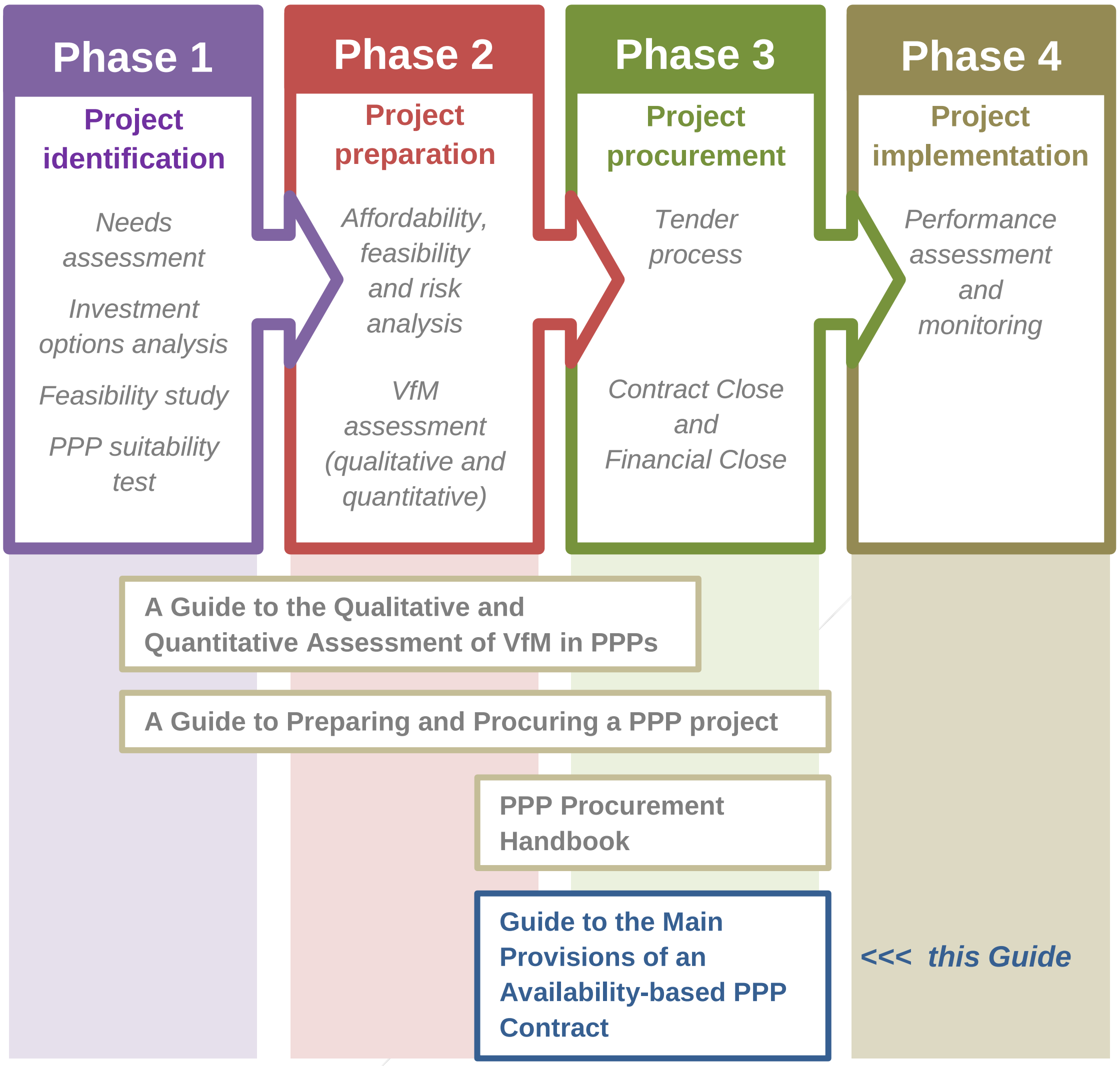
- **PPP Procurement Handbook**

  This document describes in more detail the steps that are normally followed during the procurement phase and, more particularly, the features that would typically be included in the pre-qualification information document and tender invitation document by the Public Authority.

Figure 1 shows the applicability of the various guidance documents that have been prepared under the WBIF EPEC assignment to each of the phases of a PPP project cycle.

* This designation is without prejudice to positions on status and is in line with the United Nations Security Council Resolution 1244/99 and the International Court of Justice Opinion on the Kosovo declaration of independence.

Figure 1 – EPEC WBIF Guidance documents facilitating PPP implementation



1. Introduction

A public-Private Partnership (a *PPP*) is, in simple terms, an arrangement between a public body and a Private Partner to deliver public infrastructure under a long-term service contract.

The main participants in a PPP project are:

a) a public body (the *Public Authority*) procuring the project;

b) a Private Partner (the *Private Partner*), usually a special purpose company set up solely for the purpose of delivering the project;

c) *lenders* providing project financing to the Private Partner under a loan agreement;

d) *sponsors* (i.e. owners of the Private Partner) that provide financial and other support to the Private Partner under a sponsor support agreement (usually in the form of an equity and subordinated debt investment); and

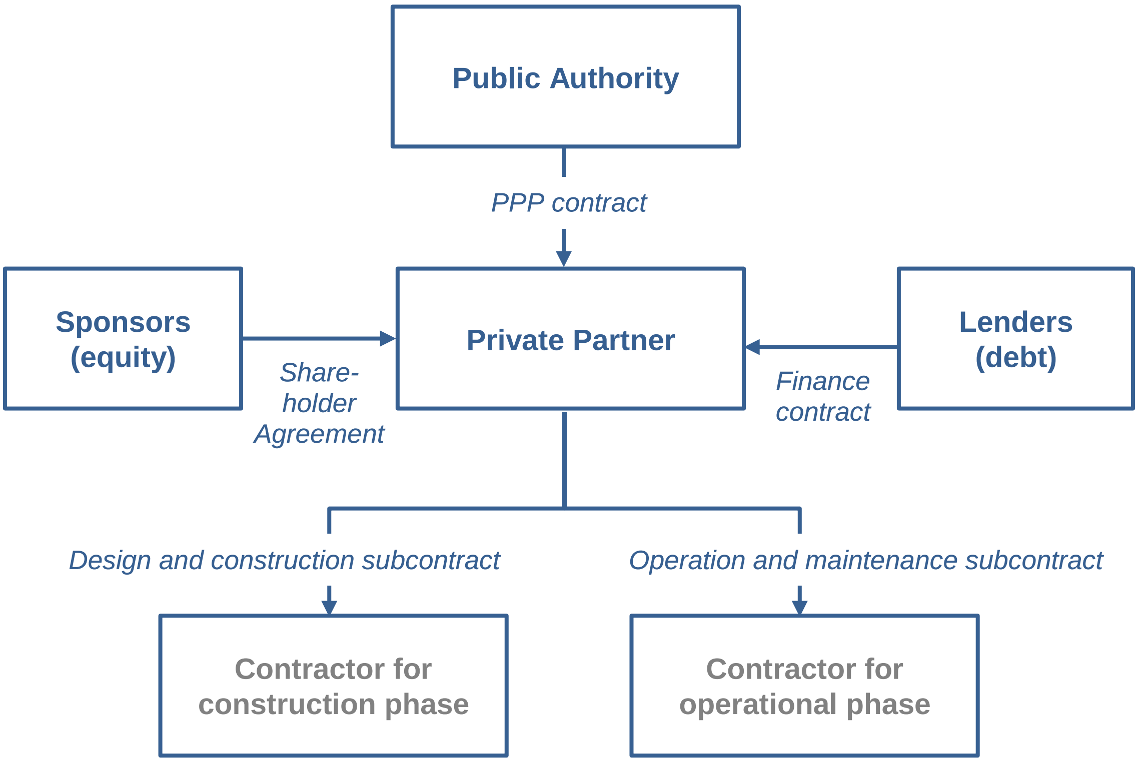
e) project *contractors* (e.g. a construction contractor and a facilities management contractor) that enter into agreements to provide works and services to the Private Partner. The Private Partner's main project contractors usually employ subcontractors. Sometimes the main project contractors are affiliates of the Private Partner. Lenders normally require direct contractual agreements with the main project contractors to enable them to *step in* to the project and replace the Private Partner if necessary.

The key principle of PPP is that the risks associated with the project are allocated to the party that is best able to manage them. Risks are allocated to the different parties involved in a PPP through the various contracts and other project documents. Appropriate risk allocation is a prerequisite for the project to be *bankable*.

The primary document in a PPP is the contract between the Public Authority and the Private Partner (the *PPP contract*, sometimes also called the project agreement). A typical PPP project structure is illustrated in Figure 2 below.

In return for the Private Partner delivering a specific level of service relating to public infrastructure the Public Authority either makes performance-based payments to the Private Partner (e.g. for making a road freely available for safe use), or allows the Private Partner to generate revenues from the provision of the service (e.g. by charging tolls to road users).

Figure 2 – A typical PPP project structure



Under an availability-based PPP contract, the Public Authority makes periodic payments to the Private Partner that are linked to the infrastructure being available for use and the defined services being performed (the *Availability Payment*). In most contracts of this type, the first Availability Payment will be made to the Private Partner only once the construction phase is complete and the services can be performed.

Whilst each availability-based PPP contract is adapted to the nature of project and the relevant jurisdiction of the host country, most contracts of this type share many common characteristics. This means that the main provisions governing the PPP contract are broadly the same in every sector. These characteristics generally apply to either one or both of the two principal phases of the project namely the *construction phase* and the *operational phase*.

The core provisions of a typical availability-based PPP contract will include:

The construction phase

a) an obligation on the Private Partner to build (or renovate) public infrastructure to the standards set out in an *output-based*[1] *specification*;

b) an obligation to build the infrastructure by a fixed date, subject to adjustments for events beyond either party's control (*supervening events*);

[1] An output-based specification indicates the results that a project will achieve (e.g. the type and volume of traffic a road must handle). An input-based specification details exactly how a project must be built.

c) liquidated damages, contractual penalties or termination provisions as remedies for delays in the completion of the infrastructure;

d) a right for the Public Authority to vary the requirements in the specification; and

e) an obligation on the Public Authority to exercise statutory powers (e.g. to provide the land required).

The operational phase

a) an obligation on the Private Partner to provide a specific level of service or availability of the infrastructure;

b) a right for the Public Authority to carry out additional works;

c) a payment mechanism;

d) a transfer of responsibility for the infrastructure back to the Public Authority on expiry of the PPP contract; and

e) an obligation on the Private Partner to return the infrastructure on expiry of the PPP contract in a condition that meets the minimum standards set out in the contract.

Both the construction and operational phases

a) restrictions on refinancing the project and/or provisions for the Private Partner to share any refinancing gains with the Public Authority;

b) risk allocation for supervening events beyond the control of the parties; and

c) early termination rights and associated termination compensation payments.

1.1 Aim and structure of this Guide

This document presents a general guide to the main provisions and key terms commonly adopted to manage the principal elements of an availability-based public-Private Partnership (PPP) contract. These provisions, which are not specific to a particular sector, are considered in the context of the PPP market in the Western Balkans. Where applicable, the guidance indicates specific approaches to those elements under the laws of the Western Balkan countries.

Where local law does not regulate a given aspect of a PPP contract, this document provides an insight into European PPP good practices for this type of contract. In the absence of local law and regulations on a particular matter, reference to the solutions commonly adopted in European PPP practice could serve as a good starting point and model framework for public authorities in the Western Balkan region.

The initial Sections provide an overview of the PPP legislative framework in the Western Balkan countries and of the typical structure and contents on an availability-based PPP contract.

Subsequent Sections then deal with each of the main provisions of an availability-based PPP contract. In each Section an explanation of the underlying issue and provision based on good practice from EU markets is provided. *Coloured areas* in each Section describe how each of the issues is covered under current legislation in the Western Balkan countries. To further aid understanding, some of the terms and concepts that are commonly used in a PPP contract are introduced by *highlighting in italics*.

Acknowledgement

This document has been prepared with the support of Allen & Overy LLP, in association with Karanovic & Nikolic in respect of Bosnian, Macedonian, Montenegrin and Serbian law matters, and Boga & Associates in respect of Albanian and Kosovar law matters.

2. PPP legislative framework in the Western Balkan countries

Most Western Balkan countries already have their own specific PPP legislation and other related laws. The main relevant PPP laws are described briefly below.

Albania

The main piece of legislation regulating PPPs in the Republic of Albania is law No. 125/2013 on Concessions and Public Private Partnerships (the *Concessions and PPP Law*).

Bosnia and Herzegovina

Bosnia and Herzegovina comprises two entities, the Federation of Bosnia and Herzegovina (*FB&H*) and Republika Srpska (*RS*), with Brčko District being an autonomous administrative unit. FB&H is divided into ten cantons, each often having its own set of legislation.

This complex constitutional set-up is reflected in the PPP legislation, which is adopted at various levels. More specifically, at RS level, the RS Law on PPP[2] applies. In FB&H, there is no PPP law at the FB&H entity level[3]. Nine out of ten cantons have their own PPP laws governing the matter. The various PPP laws at canton level are similar. This document refers to the Herzegovina-Neretva Canton (*HNC*) Law on PPP[4] by way of example.

Former Yugoslav Republic of Macedonia (FYROM)

The establishment and implementation of PPPs in the Former Yugoslav Republic of Macedonia (FYROM) are generally regulated by the Macedonian PPP Law[5]. Specific sectoral laws (e.g. local laws regulating water, waste or communal services) may also apply to PPPs. General contract law applies to PPP contracts, while the broad scope of public law provisions (e.g. tax, regulation of public debt) applies to both PPP contracts and projects in general. The relationship between PPP contracts and administrative contracts regulated under the general administrative procedure law is yet to be clarified in law.

Kosovo*

In Kosovo*, the main piece of legislation regulating PPPs is law No. 04/L-045 on Public Private Partnerships (the *PPP Law*).

[2] RS Law on PPP (Official Gazette of RS, No. 59/09 and 63/11, the RS Law on PPP).

[3] For the last few years, discussions have been ongoing regarding the possibility of adopting a PPP law at FB&H level. Currently, however, there are no activities indicating that the PPP law at FB&H level could be adopted in the near future.

[4] Law on PPP of the Herzegovina-Neretva Canton (Official Gazette of Herzegovina-Neretva, no 2/13, the HNC Law on PPP).

[5] The Law on Concessions and PPP, published in the Official Gazette of the Republic of Macedonia no. 6/2012, as subsequently amended (the Macedonian PPP Law).

Montenegro

PPP legislation in Montenegro is at an early stage of development. The rules relating to PPPs are spread across several laws, sometimes creating potential conflicts or leaving much room for interpretation. For this reason, a draft PPP law is due to be considered by the Montenegrin Parliament in 2018.

Serbia

The main legislative act that regulates PPPs and concessions in Serbia is the Serbian PPP Law[6]. It is a relatively new piece of legislation. PPPs have only recently been introduced in Serbia, therefore there is little market practice on the interpretation of the Serbian PPP Law and laws with which it interacts (such as laws regulating public debt, communal services, the budget and budgetary system) depending on the subject matter of the project. Laws regulating matters relevant for PPPs (at a sectoral level) can be inconsistent.

[6] Law on Public Private Partnerships and Concessions ("Official Gazette of the Republic of Serbia" No. 88/2011, 15/2016 and 104/2016; the Serbian PPP Law).

3. The PPP Contract

The PPP contract is the document that defines the relationship between the Public Authority and the Private Partner and their obligations to each other. It is signed at the end of the procurement phase (i.e. at the point in time commonly referred to as Contract Close).

It is good practice to prepare and issue a full draft of the PPP contract with the invitation to tender documents, at the latest. The terms of the contract are then discussed during the dialogue phase of the tender process and a final draft contract is issued when the request is made for final tender offers. (See *A guide to the PPP Procurement Process: Public-private Partnerships in the Western Balkans* EPEC (2018)).

3.1 Overview of the contents of a PPP contract

A PPP contract will cover the following topics at a minimum:

- the risk allocation (this is usually achieved through setting out events which give the private party a right to some relief and/or compensation);
- the Public Authority's requirements for the project, defined by construction and service performance standards and targets. These should be objective and measurable;
- the procedure for permitted changes to the Public Authority's requirements, and the scope and nature of permitted changes;
- the payment mechanism and process for making adjustments to payments in response to various contingencies;
- performance deductions (and possibly bonuses) which have financial consequences or give rise to warning notifications (eventually leading to termination of the PPP contract);
- security and performance bonds;
- project insurances;
- the duration of the PPP contract;
- the conditions for early termination of the contract (categorised by party and type of event) and the compensation payable on termination (for each type);
- step-in rights, both for lenders and the Public Authority;
- the definition and impact of force majeure and changes in law; and
- the dispute resolution procedure.

One of the key purposes of the PPP contract is to identify and allocate the risks involved with the delivery of the infrastructure and services. The standard contract will represent a common risk position that has been developed and agreed by Public Authorities in the relevant country. Table 1 below shows a typical risk allocation matrix for an availability-based PPP.

Table 1 – Typical risk allocation matrix for an availability-based PPP

Risk category	Descriptive summary	Public	Private	Shared
Land/Site	Purchase and provide free access	✓		
Permitting	Statutory licences and approvals			✓
Archaeology	Finds; disruption, delay and costs			✓
Design	Compliance with standards		✓	
Construction	Fitness-for-purpose, liability for defects		✓	
Completion	On time and within cost		✓	
Maintenance	Residual design life protected		✓	
Residual condition	Compliance with minimum standard		✓	
Performance	Services comply with standards		✓	
Inflation	Costs increase more than expected			✓
Force Majeure	Delays/prevents performance			✓
Insurance	No longer available in market			✓
Regulatory/law	Changes affecting PPP projects only	✓		
Environmental	Pollution, ground contamination, hazardous materials			✓
Social/Protestor	Third party interference			✓
Availability	Asset can be used freely and safely		✓	
Demand	Quantity of demand	✓		
Early termination	Monetary consequences			✓
Revenue/income	Third party income, re-financing gain			✓
New technology	Disruptive to established practice, cost	✓		

The PPP contract clauses will address how these risks are allocated and managed between the parties. A number of these issues are common to all PPP contracts, but the particular circumstances of the project, the sector and practice in the jurisdiction mean that most PPP contracts will include specific provisions that will be unique to the project. Table 2 provides a table of contents from a typical standard form PPP contract.

Table 2 – Table of contents for a typical availability-based PPP

Typical clause title	Section of this Guide
Definitions and interpretation	*See main Glossary*
Contract commencement and duration	*[Project-specific]*
Project documents	*[Project-specific]*
General obligations	*Section 3*
Party representatives and liaison	*[Project-specific]*
Land and site access	*Section 4*
Consents and permits	*Section 4*
Design and construction obligations	*Section 5*
Construction programme	*Section 5*
Completion testing	*Section 5*
Service obligations	*Section 6*
Performance monitoring	*Section 7*
Delay, relief, compensation events	*Section 9*
Force majeure events	*Section 9*
Changes in law	*Section 10*
Changes to the contract	*Section 8*
Payment obligations	*Section 7*
VAT and tax obligations	*[National rules will apply]*
Early termination	*Section 13*
Compensation on early termination	*Section 13*
Consequences of early termination	*Section 13*
Step-in Rights	*Section 16*
Contract expiry	*Section 14*
Handback procedure	*Section 14*
Indemnities and warranties	*Section 12*
Insurance	*Section 11*
Financing matters	*Section 15*
Assignation and subcontracting	*Section 16*
Changes in Private Partner ownership	*Section 18*
Information and confidentiality	*Section 18*
Dispute resolution	*Section 18*
Notices	*Section 18*

The detail of specific activities is usually included in annexes to the PPP contract and templates for these annexes are often available with standard contract documents. Examples include annexes that contain drawings that define the site, describe review and certification procedures and set out the Private Partner's proposals that were accepted in the tender offer. Table 3 provides a list of the common contract annexes that are attached to the main contract document.

Table 3 – Contract annexes for a typical draft availability-based PPP

Typical PPP contract annexes
– Site description and plans – Design and construction: Public Authority requirements – Design and construction: Private Partner proposals (*empty in the draft contract; replaced by preferred tenderer's proposals*) – Services: Public Authority requirements – Services: Private Partner proposals (*empty in the draft contract; replaced by preferred tenderer's proposals*) – Design review procedure – Construction completion tests and procedure – Payment mechanism – Insurance requirements – Dispute resolution procedure – Handback requirements and procedure – Calculation of early termination compensation - Template lender direct agreement (*replaced by the final agreements at Financial Close*)

3.2 Standardised PPP contracts and guidance

To avoid repetition and to manage market expectations, a number of European countries have developed standard availability-based PPP contracts. These standard form documents set out the key contractual clauses, many of which follow the precedent set and accepted in neighbouring European markets.

Jurisdictions that use standard PPP contracts often also provide contract guidance and have particular procedures that Public Authorities must follow if they wish to vary the standard text.

Good practice also recommends that experienced legal advisers are involved at all stages of the project preparation and procurement in assisting the Public Authority to prepare and agree its PPP contract.

Reference guidance documents

- *Clausier Type, France (2012) (www.economie.gouv.fr/ppp/clausier-type)*

- *Template Project Agreement for accommodation projects, Ireland (2007) (www.ndfa.ie/tenders/standard-procurement-docs-and-ndfa-template-project-agreement)*

- *Model DBFMO Agreement, Netherlands (2012) (www.government.nl/documents/directives/2012/03/28/model-dbfm-agreement-directorate-general-waterways-and-public-works-2012)*

- *Standard Form Project Agreement (hub DBFM projects) (and other template documents), UK (Scotland), (2018) (www.scottishfuturestrust.org.uk/publications/tag/hub)*

- *Mutual Investment Model technical documents, UK (Wales), (2018) (www.gov.wales/funding/wales-infrastructure-investment-plan/mutual-investment-model/technical-documents/?lang=en)*

- *Private Finance 2 (PF2) Guidance, UK (England), (2012): (https://www.gov.uk/government/publications/private-finance-2-pf2)*

- *Standard hub Project Agreement User's Guide (and other guidance material) UK (Scotland), (2018): (www.scottishfuturestrust.org.uk/publications/tag/hub)*

- *Standard Form Project Agreements User Guide UK (Wales), (2016) (www.gov.wales/funding/wales-infrastructure-investment-plan/mutual-investment-model/technical-documents/?lang=en)*

- *Guidance on PPP Contractual Provisions, Edition World Bank PPPIRC (2017) (https://ppp.worldbank.org/public-private-partnership/library/guidance-on-ppp-contractual-provisions-2017-edition)*

- *Allocating Risks in Public Private Partnership Contracts Global Infrastructure Hub (2017) (https://ppp-risk.gihub.org/)*

4. Site access arrangements

4.1 Overview

The PPP contract will generally define the extent of land (the *site*) to be made available by the Public Authority to allow the Private Partner to develop the project. Plans detailing the boundary lines of the site (which may vary for different phases of the project's construction and operation) are usually included in an annex to the PPP contract.

The site access provisions in a PPP contract indicate the basis for, and nature of, the Private Partner's access rights to the site for the project and regulate the Public Authority's obligations in this respect.

In most cases, the Public Authority will be responsible for identifying and (if relevant) acquiring the site. The Public Authority will, in most circumstances, own (or have a right of access to) the site on the date the contract is signed.

In some instances, for example on large-scale surface transportation projects, the Public Authority may plan to acquire the necessary land or access rights after the contract is signed and in parallel with the Private Partner's development of the project. This might be the case, for example, if it is only possible to obtain access rights over property owned by third parties (e.g. over railway lines) once the Private Partner's design of the project is well advanced. Any delay by the Public Authority in providing the Private Partner with access to the site is, however, likely to give rise to a *compensation event* (see Section 8.2)

Western Balkan laws typically require site access matters to be regulated in the PPP contract.

4.2 Nature of access rights granted

The type of access rights granted to the Private Partner will depend on the nature of the project and the extent to which the Public Authority owns the relevant land. Another influencing factor might be if different types of access right have different cost implications for the project (e.g. different forms of access right may attract different land registry fees or tax liabilities).

In practice, the Private Partner will be neutral as to the basis on which the Public Authority grants access rights. The Private Partner's concerns will be that the rights are clearly defined and sufficient to enable it to fulfil its obligations under the PPP contract and that it has appropriate legal recourse (e.g. through a right to claim compensation) if the access that the Public Authority has undertaken to provide is denied or compromised.

4.3 Ownership

A common issue under the laws of Western Balkan jurisdictions is that a Public Authority cannot transfer ownership of the site to the Private Partner. Consequently, the Public

Authority retains ownership of the site and grants access in one or more of the ways outlined below.

- **Lease**; e.g. in FYROM (in respect of state-owned agricultural land for specified activities such as fish ponds, sports and recreational activities, and rural tourism), Montenegro and Serbia. In projects where the Public Authority occupies the project during its operational phase (e.g. a school or hospital), the Private Partner is usually required to grant access rights back to the Public Authority (e.g. through a sub-lease or licence);

- **Construction rights**; e.g. in Republika Srpska. The Public Authority grants the Private Partner a right to build the project infrastructure under the PPP contract; and

- **Rights of use**; this is a very common basis upon which access is granted to the Private Partner in the Western Balkan jurisdictions. In the PPP contract, the Public Authority simply commits to provide the Private Partner with sufficient access to the site in order to enable the Private Partner to fulfil its obligations under the contract.

On the expiry or termination of the PPP contract, the Private Partner transfers title to the infrastructure built on the site to the Public Authority.

Legislation in the Western Balkan countries

Albania

Lease contracts with a term exceeding nine years entered into as notarial deeds must be registered in the Immovable Property Register[7]. Lease contracts entered into as notarial deeds with a term exceeding one year but not exceeding nine years may be registered in that register[8]. Construction permits are also registered with the Immovable Property Register by the local municipality that issues the permits[9]. Rights of use granted over state-owned land are also registered in the Immovable Property Register[10].

Bosnia and Herzegovina

Rights over real estate granted to the private partner for the purpose of a project, such as a long-term lease, right of use, construction right or concession must be registered in the land register.

[7] Article 51 of Law 33/2012 on Registration of Immovable Properties.

[8] Article 51 of Law 33/2012 on Registration of Immovable Properties.

[9] Article 46 of Law 33/2012 on Registration of Immovable Properties.

[10] Article 56 of Law 33/2012 on Registration of Immovable Properties.

Former Yugoslav Republic of Macedonia (FYROM)

The lease of agricultural land and the long-term lease of construction land[11] must be registered at the Agency for Real Estate Cadastre. In addition, short-term and long-term leases of construction land are also registered in the special Register of Construction Land managed by the municipalities, the municipalities in the city of Skopje and the city of Skopje[12].

Kosovo*

Rights of use for municipal, public, social and state-owned property must be registered with the Immovable Property Rights Register[13]. Lease contracts may also be registered with the Immovable Property Rights Register.

Montenegro

Both leases and rights of use of the land must be registered with the competent land registry[14].

Serbia

A right of use, a lease of construction land for the purpose of construction works, easement rights, mortgage and other rights over real estate must be registered in the land register[15].

11 Article 32 of the Macedonian Law on Agricultural Land; Article 29 of the Law on Construction Land, published in the Official Gazette of the Republic of Macedonia no. 15/2015, as subsequently amended (the Macedonian Law on Construction Land), and Article 170 of the Law on Cadastre of Real Estate, published in the Official Gazette of the Republic of Macedonia no. 55/2013.

12 Article 93 of the Macedonian Law on Construction Land.

13 Article 2, paragraph 2 of Law No. 2002/5 on the Establishment of the Immovable Property Rights Register.

14 Article 49 of the Law on Land Register ("Official Gazette of Republic of Montenegro" No.29/07 and "Official Gazette of Montenegro" Nos.32/11, 40/11, 43/15 and 37/17).

15 Article 77 of the Serbian Law on Land Register ("Official Gazette of Republic of Serbia", 72/2009, 18/2010, 65/2013 and 15/2015).

5. Design and construction

5.1 Overview

Design and construction risk in PPP projects across the EU is commonly approached in the following way:

a) The Private Partner takes responsibility for the project's design and builds the infrastructure for a fixed price and to a fixed timetable. Although the Public Authority will often undertake preliminary design activities in relation to a project, the Private Partner takes responsibility for the adequacy of such design work.

b) The Private Partner agrees to design and build the infrastructure by a fixed date. Liquidated damages may be payable to the Public Authority in the event of late completion. Provision for liquidated damages (or contractual penalties) varies across sectors and projects but is usually only found on projects where the Public Authority will suffer a financial loss from a delay in the project becoming operational. However, in some states where the underlying law allows, the PPP contract might impose liquidated damages (or contractual penalties) even where delay causes no such financial loss.

c) The Private Partner takes responsibility for procuring relevant permits (with the assistance of the Public Authority for permits the Private Partner cannot procure in its own name).

d) The Private Partner takes responsibility for the performance of all members of its supply chain.

e) Any approval that the Public Authority gives to the Private Partner's design for the project does not absolve the Private Partner from its responsibility to ensure that the design meets the specification and the completion tests.

f) Once the completion tests are met and the operational phase of the project has started, the Private Partner continues to take the design risk for the project and will suffer financial deductions under the payment mechanism if the design of the project gives rise to unavailability or performance failures.

g) The PPP contract sets out an exhaustive list of the limited circumstances in which the Private Partner can claim a time extension for delays and/or compensation for increased costs (and/or lost revenue) that arise during the construction phase (Section 5.2 below in relation to retained or shared risks; see also Section 9).

5.2 Retained or shared risks

Although most PPP contracts require the Private Partner to construct the infrastructure for a fixed price and by a fixed date, they also often recognise that it is unrealistic to expect the Private Partner to account for the impact of all potential risks in its fixed price. In particular, a Public Authority may take the view that it is unrealistic (and uneconomic) to expect the Private Partner to price material risks for which it is unable to conduct its own investigation and assessment (or *due diligence*) before signing the contract.

It is important to note that it may not be possible to transfer all construction-related risks to the Private Partner or to transfer them in a way that is economic (or value for money) for the Public Authority. Accordingly, the Public Authority may decide to provide some level of relief to the Private Partner in respect of the financial and delay-related consequences of certain construction risks.

The extent to which the Public Authority does this varies significantly from sector to sector, but the construction risks that the Public Authority often retains or shares with the Private Partner through the terms of the PPP contract can include:

a) unforeseeable geological conditions;

b) archaeological discoveries;

c) unforeseeable environmental contamination on the site or adjoining land;

d) unforeseeable utility relocations;

e) delays in procurement of permits that impact the critical path for the project;

f) unforeseeable latent defects in existing infrastructure that, at completion, is incorporated into the project (if relevant);

g) unforeseeable endangered species;

h) protester action in relation to the project; and

i) delays in obtaining design approvals of third parties (often other public entities, e.g. a national railway operator or the coastguard for bridge crossings).

If the Public Authority retains or shares any of these risks with the Private Partner, the arrangement usually only extends to those risks over which the Private Partner was unable to undertake sufficient due diligence in order to quantify (and price) the relevant risk (as highlighted above).

The extent to which the Public Authority retains or shares certain construction risks will therefore depend on the amount and quality of the information that it can make available to tenderers (e.g. geotechnical surveys, bore-hole data, utility maps and historic data) or that tenderers are given the opportunity to ascertain for themselves.

Before the project tender phase, the Public Authority needs to determine if it is in the public interest for it to provide information to bidders to allow them to price certain risks or, alternatively, to make arrangements for tenderers to carry out their own due diligence.

For further information on the circumstances in which the Public Authority might compensate the Private Partner, see Section 9 (Treatment of Supervening Events).

5.3 Construction completion tests

In the context of an availability-based PPP, the purpose of the completion tests is to determine whether the relevant infrastructure is capable of being used and operated as required by the contract (i.e. *Available*). If the completion tests are satisfied, the Private Partner will start to generate revenue in the form of the *Availability Payment* it receives from the Public Authority (see also Section 7.2).

Completion tests should be objective, reflecting the significant financial consequences that the Private Partner faces if the tests are not satisfied. Broadly speaking, there are two approaches as to how the completion tests are conducted:

a) the Public Authority determines whether the completion tests have been satisfied, with the Private Partner ultimately having the ability to dispute the Public Authority's opinion; or

b) using an independent third party (e.g. a professional engineer) to perform the completion tests, with each party having the ability to attend the tests and make representations to the independent party conducting the tests.

A key point to note is the extent to which satisfaction of the completion tests releases the Private Partner from ongoing design risk (i.e. the risk of any failure to comply with the design requirements of the contract during the operational phase of the project).

Regardless of whether the Private Partner satisfies the applicable completion tests, it has an ongoing responsibility to comply with the performance standards set out in the PPP contract. In other words, the Private Partner continues to take the risk on the effectiveness of the infrastructure design for the duration of the PPP contract.

Legislation in the Western Balkan countries

Western Balkan jurisdictions broadly allow the parties to agree on the mechanism for completion testing, as summarised below.

Albania

The PPP and Concession Law is silent on the methodology for completion tests. The parties will agree on the applicable tests in a PPP contract.

Bosnia and Herzegovina - FB&H (HNC)

The HNC Law on PPP and the HNC Law on Concessions[16] do not contain provisions regulating completion tests. The parties are free to choose these unless provided otherwise by sectoral regulations for a specific type of facility.

[16] Law on Concessions of the Herzegovina-Neretva Canton (Official Gazette of Herzegovina-Neretva Canton, No. 1/2013 and 7/2016, the HNC Law on Concessions).

Bosnia and Herzegovina - RS

The applicable laws regulating PPPs in RS do not contain provisions in relation to the construction completion tests. The parties may freely choose these unless provided otherwise by sectoral regulations for a specific type of facility.

Former Yugoslav Republic of Macedonia (FYROM)

In practice, the approach under point a) of Section 5.3 above may be more common, since project assets can only be put into operation either

- *i) once an operation permit is in place (e.g. in the case of state roads or railways from the Ministry of Transport and Communications) or*
- *ii) once a technical report by a supervisory engineer (in the case of, for example, schools and local roads)[17] has been prepared.*

Third parties are often engaged to supervise and perform completion tests in larger projects. These third party completion tests can serve only as confirmation that a certain phase or the entire project has been completed, not as a confirmation for putting the asset into operation. Therefore, depending on the type of project, there is scope for using the approach under point b) above.

*Kosovo**

The PPP Law does not regulate the methodology for completion tests. The parties will agree on the applicable tests in the PPP contract.

Montenegro

None of the above approaches prevails in Montenegro, since this strictly depends on the terms of each individual contract.

Serbia

The approach depends on the terms of each individual PPP contract. Under the Serbian PPP Law[18], a PPP contract must regulate all relevant procedures employed by the Public Authority to examine and approve the projects.

[17] Article 87 of the Law on Construction, published in the Official Gazette of the Republic of Macedonia no. 130/2009, as subsequently amended.

[18] Article 46 of the Serbian PPP Law.

6. Operation and maintenance

6.1 Overview

The approach taken to operation and maintenance can be very different from sector to sector and project to project. On-going maintenance of the relevant infrastructure is at the core of the PPP contract but, on many projects, the Private Partner is also required to provide additional services.

Some examples from across the EU that illustrate the various approaches to operations and maintenance include:

a) in some prison PPPs the Private Partner is required to operate the prison (including the provision of custodial services), whereas in others the Private Partner's responsibilities are limited to maintaining the prison buildings;

b) in some road PPPs the Private Partner is required to provide *first response services* (e.g. snow/debris clearance and towing services), whereas in others the provision of these services is retained by the Public Authority;

c) some social infrastructure accommodation PPPs (e.g. schools and hospitals) require the Private Partner to provide catering, cleaning, security and/or laundry services (often called *soft services*), whereas others require the Private Partner to provide maintenance only (sometimes called *hard services*);

d) although in many PPP projects the Private Partner's responsibilities are limited to maintenance, the Public Authority may also retain some aspects of the maintenance responsibilities (e.g. in a schools project, the Public Authority may retain responsibility for internal decoration, such as painting); and

e) particularly in the context of accommodation projects, some PPP contracts require the Private Partner to be responsible to provide and maintain the utility services for the facilities (e.g. the water supply or power supplies), whereas in other PPP contracts the Public Authority takes responsibility for this. (See Section 7 for a discussion on payment arrangements and how the underlying payments to the Private Partner are often adjusted to reflect fluctuations in utility costs.)

Legislation in the Western Balkan countries

In the Western Balkan jurisdictions there is little established practice or regulation with regard to operation and maintenance arrangements, as summarised below.

Albania

Under the PPP and Concession Law, the Private Partner may be required to operate the asset, maintain the asset without operation or operate and maintain the asset[19].

Bosnia and Herzegovina - FB&H (HNC)

The applicable laws regulating PPPs in HNC do not recognise different approaches regarding operation and maintenance provided by the private partner in different sectors.

Bosnia and Herzegovina - RS

The applicable laws regulating PPPs in RS do not recognise different approaches regarding operation and maintenance provided by the private partner in different sectors.

Former Yugoslav Republic of Macedonia (FYROM)

There are no specific examples to highlight.

*Kosovo**

Under the PPP Law, the private partner may be required to operate the asset, maintain the asset without operation or operate and maintain the asset[20].

Montenegro

Given the early stage of development of the legal framework, there are no relevant examples on this point.

Serbia

The Serbian PPP Law does not recognise different approaches regarding operation and maintenance of projects.

[19] Article 8 of the PPP and Concessions Law.

[20] Articles 1.17, 1.19, 6.2, and 7.1 of the PPP Law.

6.2 Lifecycle maintenance

Given the long-term nature of PPP projects, the Private Partner is usually required to undertake some renewal or replacement of the infrastructure during the PPP contract. Examples include replacing the boilers in a hospital or school and replacing the surface of a road or the decking on a bridge.

Deductions applied under the payment mechanism (*deductions regime*) are intended to incentivise the Private Partner to maintain the infrastructure in a minimum specified condition. It should minimise the risk of the Private Partner either withholding necessary investment in asset repair, replacement and rehabilitation or, indeed, from deferring maintenance that would lead to a reduction in expected asset performance.

6.3 Third Party use

It is often the case that the infrastructure on PPP projects is capable of generating revenue outside of the provision of the services under the PPP contract. Common examples include:

a) allowing public access to school sports facilities in evenings, weekends and holidays;

b) selling advertising space;

c) providing users of a motorway with access to fuelling stations and restaurant facilities at service stations along the motorway; and

d) leasing retail space in hospitals, courts or other types of government buildings.

PPP contracts mostly take one of the following approaches in the provisions dealing with revenue generation from third party use:

a) the Private Partner is not permitted to use the project infrastructure for any reason other than to comply with its obligations under the PPP contract. This approach prevents the Private Partner from generating additional revenue from the project infrastructure. The Public Authority may itself choose to generate income from the project infrastructure (either directly or indirectly such as granting a concession to a third party) or decide not to do so at all;

b) the Private Partner is permitted to use the project infrastructure to generate additional income, subject to certain limitations (e.g. time constraints and restrictions on the types of use); and

c) as for b) above, but the Public Authority is entitled to share in the revenue or profit generated from such activities. The sharing arrangements differ from contract to contract, but often involve a requirement for the Private Partner to pay a percentage of any revenue generated above a defined level to the Public Authority.

7. Payment Arrangements

7.1 The nature of payments

A PPP contract should set out the payment structure and provisions that regulate the basis for the Private Partner's remuneration under the contract (the *payment mechanism*).

The payment structures used in PPP contracts can be complex, depending on the scale of the project and the nature of services that are to be provided by the Private Partner.

They commonly fall into four broad categories:

a) demand-based (i.e. the payments made by the Public Authority to the Private Partner are linked to the level of usage of the infrastructure);

b) availability-based (i.e. the payments made by the Public Authority to the Private Partner are linked to the infrastructure being available for use and services being performed as defined by the PPP contract);

c) a combination of a) and b); or

d) any of the above with the addition of lump-sum payments being made by the Government during the construction or operational phases of the project.

This guide focusses only on the provisions for availability-based payment mechanisms, in which Public Authority takes the risk of variation in the demand for the services provided under the PPP contract.

7.2 Availability-based payment mechanisms

7.2.1 Overview

In an availability-based PPP, the Private Partner recovers its costs in delivering the project (together with a return on capital invested in the project) through the periodic Availability Payment it receives from the Public Authority (usually payable in equal monthly or quarterly instalments). However, this Availability Payment is subject to deductions for occasions where the infrastructure is unavailable or where the services are poorly performed by the Private Partner.

The PPP contract may require the Private Partner to provide services that go beyond simply maintaining the infrastructure. For example, in accommodation PPPs (e.g. schools, hospitals and prisons), the Private Partner is sometimes required to provide catering, cleaning, security and/or laundry services.

For this reason, it is common for the PPP contract to distinguish between the two types of deduction that can be made from the Availability Payment for non-performance:

- **Availability or Unavailability Deductions**: these are applied when the infrastructure is not considered to be available for use by the public or end users (as applicable). The definition of what *available* means varies from sector to sector. By way of example, a section of the lane of a road is only considered *available* if it is open to traffic, free from obstructions and safe (unless when this is due to pre-agreed maintenance work), otherwise it may be considered as *unavailable*; and

- **Performance Deductions**: these are applied when the quality and effectiveness of the services delivered by the Private Partner fails to meet the standards specified in the PPP contract.

The Public Authority's obligation to start paying the monthly or quarterly Availability Payment instalments typically applies from the completion of construction (i.e. the point at which the infrastructure meets the required standard and can be used for its intended purpose). Tests will normally be carried out to demonstrate to the Public Authority that these standards have been met (see Section 5.3).

7.2.2 Deductions regime for non-availability/unavailability

As outlined above, the Public Authority is entitled to make deductions from the Availability Payment for those occasions that the infrastructure is determined not to be *available* (i.e. is *unavailable*). The PPP contract will typically:

a) provide a definition of either availability or unavailability. This should be capable of being tested and determined through a series of objective tests.

b) state that the availability of the infrastructure should be assessed on an area by area basis and not in its entirety (e.g. sections and/or lanes on a road or individual rooms in a school). Notwithstanding this common approach, some PPP contracts state that if either a particular area of the infrastructure or a group of areas is unavailable, then the entire project should be deemed to be unavailable (e.g. if all the toilets in a school are unavailable the whole school is considered unavailable); and

c) monitor the availability of the various elements or areas of the infrastructure over defined periods (commonly referred to as *sessions*, e.g. daily, half-daily or even hourly for priority areas, e.g. operating theatres in a hospital) and at defined intervals.

7.2.3 Deductions regime for poor performance

The Public Authority is entitled to make deductions from the Availability Payment if the contracted services are not performed to the standards required. There are a number of approaches that are taken in relation to performance deductions:

a) the PPP contract may specify individual performance criteria and a financial penalty that will be applied against the Availability Payment if a performance standard is not met. For example, a penalty of EUR 50 could be applied if a broken window in a PPP school is not repaired within six hours, or EUR 1,000 if a broken-down vehicle is not removed from the PPP road within one hour of it being reported; and

b) alternatively, the PPP contract may allocate *penalty points* to the Private Partner if a performance standard is not met. Each penalty point or group of points is assigned a monetary value and the aggregate value of all penalty points allocated against the Private Partner is deducted from the Availability Payment.

Both of the above approaches to performance deductions ultimately achieve the same commercial outcome. A penalty points regime is often used where the Public Authority wants to include additional performance indicators to assess performance (for example to assess particular types of failure in service).

Legislation in the Western Balkan countries

In the Western Balkan jurisdictions there is little established practice or regulation with regard to payment arrangements or deductions in PPPs, as summarised below.

Albania

Under the PPP and Concessions Law, the private partner's compensation is paid in accordance with and usually relates to the availability of the project[21].

Bosnia and Herzegovina - FB&H (HNC)

The HNC Law on PPP does not regulate these matters.

Bosnia and Herzegovina - RS

There is no prevailing approach to these matters in RS.

Former Yugoslav Republic of Macedonia (FYROM), Montenegro and Serbia

There is no prevailing approach in these jurisdictions.

Kosovo*

There is no prevailing approach. However, payments received by the Private Partner should reflect the availability, demand or construction risk assumed by the Private Partner.[22] In addition, a PPP contract may include provisions for the Private Partner to receive tariffs or fees for the use of the facility or provision of services, as well as indicate how those tariffs or fees should be calculated and adjusted[23].

7.2.4 Excused unavailability and poor performance

The PPP contract typically provides that deductions will not be made in certain circumstances. These might include, for example:

a) planned maintenance;

21 Article 8(d) of the PPP and Concessions Law.

22 Article 7 paragraph 1.2.3 of the PPP Law

23 Article 48 paragraph 2.7 of the PPP Law.

b) Public Authority default (e.g. failure to provide access to the project site as required by the PPP contract);

c) failure of a utility supplier;

d) Compensation Events (see Section 9.2);

e) Relief Events that cannot be insured against (see Section 9.3);

f) Force Majeure Events (see Section 9.4); and

g) uncontrollable third party events where the Private Partner is not expected to provide services.

By way of example, if a lane of a road is closed due to an accident or a vehicle breaking down, deductions are typically not made from the Availability Payment if the Private Partner's responsibilities under the PPP contract do not include the provision of first responder-type services (e.g. clearing debris or removing vehicles). On the other hand, if the Private Partner is required to perform such services under the PPP contract, unavailability and/or performance deductions are typically made if the lane of the road is not cleared and open for use (i.e. made available) within a defined reasonable period.

The PPP contract will acknowledge, however, that there should be no relief from deductions that arise directly from damage caused by an insurable event. The rationale for this is that the Private Partner typically takes out business interruption insurance that will compensate for any lost income (i.e. including through the deductions) during the period of reinstating the damage to the infrastructure.

Legislation in the Western Balkan countries

The above approach to relief from deductions is expected to apply similarly in the Western Balkan jurisdictions. In the case of Kosovo the PPP Law states that the PPP contract may regulate the extent to which either party may be exempt from liability for failure or delay in complying with any obligation under the contract owing to circumstances beyond its reasonable control[24].*

7.2.5 Calibration of the deductions regime

The level (measured in monetary terms) of the unavailability or performance deductions will vary significantly across PPP projects. It is the responsibility of the Public Authority to ensure that the deductions regime is *calibrated* (meaning the setting of the monetary value of each the individual deductions and when measured in their totality), in a manner that:

a) sufficiently incentivises the Private Partner to minimise the instances of unavailability and service performance failures; and

b) gives the Public Authority confidence that it will not (proportionally) be paying for levels of service that it is not receiving. Put simply, the Private Partner should

[24] Article 48 paragraph 2.17 of the PPP Law

not receive any Availability Payment if the infrastructure is not available for use by the Public Authority (and/or the end users).

The way in which the deductions regime operates varies widely in practice. For example:

a) the PPP contract may limit the deductions that can be applied against an instalment (monthly, quarterly, annually) of the Availability Payment at a level lower than the scheduled instalment amount. This mechanism implies that the Private Partner will not (in a worst-case scenario) lose all of the Availability Payment for the defined payment period (month, quarter, year) through the application of deductions;

b) the PPP contract may list circumstances in which unavailability or poor performance can be excused (i.e. deductions not made against the Availability Payment). If this list is too extensive, such a mechanism could imply that there may only be very few circumstances in which the Private Partner could suffer deductions to the Availability Payment;

c) the deductions regime may only be applied to a defined percentage of the Availability Payment (e.g. 40%), albeit that if deductions in a payment period exceed the defined percentage, the Public Authority can carry forward the excess to the next (and subsequent) payment period(s);

d) deductions may be assessed only on an annual basis (with an invoice being sent to the Private Partner by the Public Authority for the payment of the total value of the deductions accrued in the relevant year), notwithstanding that the Availability Payment instalments are paid more frequently; and

e) deductions may be set at a level that, even where the entire project is unavailable for use by the Public Authority (or other end users), the Private Partner may nevertheless receive some of the Availability Payment.

The application of a number of these features in the PPP contract is described here below.

7.2.6 Caps and limits on deductions

The PPP contract will typically include a provision for a financial cap or limit on the level of deductions that can be made to the Availability Payment, for example in a given payment period or within a year.

The nature of any capping arrangement may depend on:

a) how quickly and by how much the Availability Payment will reduce in a single payment period for a range of different levels of unavailability or non-performance. This will depend in part on the value at which deductions are set, but also the number of areas/elements that are measured for availability or performance. (This sensitivity to reduction in the amount paid is sometimes referred to as the *calibration* of the payment mechanism, as described in the previous sub-section); and

b) the nature of the services provided by the Private Partner under the PPP contract.

The following are examples of provisions used to limit the Private Partner's exposure to deductions:

a) limiting the Private Partner's exposure to deductions overall (i.e. both unavailability and performance deductions) over a defined payment period (e.g. a month or a year) at an amount equal to the level of the Availability Payment payable over that period;

b) restricting the Public Authority's right to make deductions from the Availability Payment in a particular payment period to a defined percentage of the Availability Payment, with any deductions that cannot be made in that period (because the maximum percentage allowable is reached) being carried forward to be made in the next payment period. This gives the Private Partner the certainty of a minimum level of cash flow;

c) limiting the amount of performance deductions for a particular service in any payment period at a level that is more closely aligned to the forecast cost to the Private Partner of providing the relevant service (e.g. limiting the Private Partner's exposure to performance deductions relating to cleaning services); and

d) limiting the Private Partner's exposure to deductions in <u>all</u> payment periods to a defined fixed percentage of the Availability Payment for the period. The key difference between this approach and the approach described in b) is that the total Availability Payment can only be subject to a fixed percentage of the payment over the entire contract period.

A key point to note is the relationship between the deductions regime and the Private Partner default provisions. It is quite typical for the Public Authority to include a Private Partner default in the PPP contract for systemic and continuous poor performance. This is often achieved by including Private Partner defaults relating to the level of deductions incurred by the Private Partner over a defined period. By way of example, in the approach outlined in paragraph d) above, the PPP contract also states that a Private Partner default occurs if deductions over a defined period reach the defined limit. In this case, the Public Authority can exercise its right to terminate the PPP contract for Private Partner default. In other words, the limit is linked to the Private Partner default provisions in the PPP contract (see Section 13.1).

7.2.7 Bedding-in or grace periods

Some PPP contracts include provisions that delay the application of deductions until the project has been in operation for a defined period of time (e.g. six months). This is to recognise that in some cases the Private Partner may need a reasonable period of time to achieve optimal operational performance at the standards set in the PPP contract. This type of provision (sometimes referred to a *bedding-in period* or *grace period*) is more common on PPPs with the following features:

a) the scope of the services that the Private Partner is required to perform under the PPP contract is wider than maintaining the infrastructure;

b) the transfer of staff from the Public Authority to the Private Partner who will be involved in the day-to-day provision of services to which performance deductions will apply; and/or

c) the effective performance of the PPP contract requires a significant level of interface between Public Authority and the Private Partner, such that protocols will probably need to be agreed between the parties in order to gather some common understanding of what they expect of each other when co-located on the site and working interactively together.

Bedding-in or grace periods can take various forms. Examples include, for a period of time:

a) suspending the deductions regime for aspects of performance where it is felt deductions will be inevitable until operations reach their planned normal state;

b) ignoring certain categories of deductions for the purposes of determining whether or not Private Partner defaults have occurred. With this approach, the deductions are made to the Availability Payment, but the Private Partner is not exposed to the risk of those deductions leading to termination for Private Partner default for a period of time; or

c) applying reduced levels of deductions.

7.2.8 Rectification of failures

Typically, the PPP contract recognises that the Private Partner should be given a reasonable period of time to respond to the event causing unavailability or non-performance before it starts to suffer deductions. By way of example:

a) in the case of a temporary lane closure caused by a vehicle breaking down on a roads PPP project, the PPP contract may state that the lane will nevertheless be deemed to be available if the vehicle is removed within a defined period (e.g. 60 minutes) of the Private Partner becoming aware of the situation; or

b) in the case of a schools project, the PPP contract may state that if a window is broken during school hours, any unavailability will be deemed not to have occurred if the window is repaired within a defined period of time.

A PPP contract can provide time for the Private Partner to rectify poor performance or unavailability by:

a) including a rectification period in the contractual definition of availability/ unavailability or performance failure, automatically giving every occasion of unavailability or poor performance a rectification period; or

b) specifying particular failures and circumstances in which the Private Partner will benefit from a rectification period and specifying the rectification period at a level that is proportionate to the relevant issue.

7.2.9 Adjustments to the Availability Payment to reflect underlying costs

Most PPP contracts will include provisions that adjust the Availability Payment automatically in some limited circumstances.

The most common examples include:

- **Inflation indexation**: most PPP contracts include some level of adjustment of the Availability Payment for increases in the Private Partner's underlying costs. The part of the Availability Payment that is subject to adjustment is usually limited to those costs that arise during the operational phase. The adjustment is made by reference to an independent index that measures price changes in the relevant category (most commonly a national consumer price index).
- **Insurance premia adjustments** (See Section 9)
- **Benchmarking and market testing**: on PPPs where the Private Partner provides a number of services that are more substantive than simply maintaining the infrastructure (e.g. cleaning services, catering services, laundry services, traffic management services or waste collection services) the PPP contract may include a provision for the cost of those services to be benchmarked or market-tested periodically. See Box 1 below.

Box 1 – Benchmarking and Market Testing

Benchmarking *is a process in which the Public Authority and the Private Partner seek to agree the prevailing market rate for the provision of the relevant service using any data that the parties can access. If the parties fail to agree on the prevailing market rate, the PPP contract typically requires a market-testing exercise for the relevant service.*

Market testing *is a process by which the Private Partner procures the provision of the relevant service through a competitive tendering exercise. The Private Partner is typically required to appoint the successful tenderer as a subcontractor and the Availability Payment is adjusted to reflect the successful tenderer's price.*

Benchmarking/market-testing provisions are typically applied every five to seven years during the operational phase of the PPP contract.

Benchmarking and market-testing provisions aim to adjust the Availability Payment to reflect changes to prevailing market rates for the provision of the relevant services. The decision to include such provisions may be taken for any of the following reasons, driven by value for money in transferring price risk to the Private Partner:

a) the costs of providing the benchmarked service substantially comprise staff costs. These are generally considered extremely difficult to predict over a long-term period such as 25 years;

b) over time, the introduction of new working methods and/or technology may enable the benchmarked service to be provided in a different manner than was envisaged at the start of the PPP contract (including at a lower cost); and/or

c) certain costs associated with providing the benchmarked service typically fluctuate in line with relevant commodity prices (e.g. transportation costs in the context of a waste project where the Private Partner is required to collect waste from around the community).

7.2.10 Utility and commodity costs

The extent to which a project uses electricity, oil, gas or other commodities during the operational phase depends on the nature of the project and the scope of the services that the Public Authority requires from the Private Partner.

In most availability-based PPP contracts, the cost associated with the utilities used is either

a) included as part of the Availability Payment. The Private Partner generally assumes responsibility for placing and holding the contract with the utility provider (acting on behalf of the Public Authority) and is liable to pay the full cost of any amounts invoiced by the utility provider based on usage; or

b) a *pass-through* cost that is separate to the Availability Payment. In this arrangement the Private Partner generally assumes responsibility for placing and holding the contract with the utility provider (acting on behalf of the Public

Authority) but where the Public Authority pays the full cost of any amounts invoiced by the utility provider based on usage. A provision in the PPP contract is often required to provide relief from any deductions to the Availability Payment to the extent that the utility service is interrupted (and so affecting availability) if the Public Authority fails to make the appropriate payment; or

c) a cost met entirely by the Public Authority outside of the PPP contract. In this arrangement the Private Partner is usually responsible for placing the initial contract with the utility provider (acting on behalf of the Public Authority) by the end of the construction phase. The utility contract may then either be held by the Private Partner or assigned to the Public Authority. The Public Authority is invoiced directly by the utility provider and pays the full cost of any amounts based on usage. A provision in the PPP contract is often required to provide relief from any deductions to the Availability Payment to the extent that the utility service is interrupted (and so affecting availability) if the Public Authority breaches the utility contract.

In PPP projects that do not, by their nature, use comparatively high levels of commodities (such as roads PPPs) it is typical for the Private Partner to be responsible for ensuring the supply of the relevant commodity and take on the risk of fluctuations in its price for the duration of the contract. (In this situation the PPP contract does not include any price adjustment mechanism for changes in commodity prices or volumes used by the project).

However, in PPP projects that do, by their nature, involve high levels of commodity use during the operational phase, there are a number of approaches to allocating both:

- **Volume risk**, that is the amount of the commodity is used by the Public Authority and or the Private Authority; and

- **Unit price risk**, that is the market price for the relevant commodity that is charged by the utility provider.

Many projects that involve the use of large quantities of commodities (e.g. accommodation projects, rail projects and/or energy from waste projects) include price adjustment mechanisms that provide for the Availability Payment to be adjusted periodically (e.g. annually) to reflect increases/decreases in the underlying commodity price. In these circumstances the Private Partner assumes all or most of the volume risk and the Public Authority takes the unit price risk.

The contract may also include a mechanism that incentivises both parties to reduce the amount of commodity that is used (e.g. water or energy saving measures), with the benefit of any saving being shared between them.

7.2.11 Impact of late completion on payment of the Availability Payment

The impact of construction delays on the Private Partner's right to start receiving the Availability Payment usually follows one of two commonly adopted approaches:

- **Fixed Contract Duration**: the PPP contract expires on a fixed date that is determined on the basis of a fixed duration for the contract term (e.g. 20 years).

The fixed expiry date is set by reference to the actual date of Contract Close (or Financial Close). This means that, if construction completion is delayed, the operation and maintenance period is shortened by the same period as the delay. The Private Partner will, as a consequence, lose the amount of the Availability Payment that it would otherwise have received had construction been completed on time; and

- **Fixed Operational Period**: where the PPP contract provides for a fixed operation and maintenance period that starts whenever the construction phase is complete. If construction completion is delayed, the Private Partner will still receive the full Availability Payment (subject to deductions) over the same duration of operation and maintenance period, but the instalments will start later than if there had been no delay. The Private Partner will, however, suffer loss in having to cover the cost of the construction period for longer than planned, including any associated additional costs of finance. (Note: In this arrangement, the expiry date of the contract is not fixed at Contract Close or Financial Close, but rather at the actual date of completion of construction.)

Some public authorities prefer the approach of requiring a fixed operation and maintenance period, particularly if significant lifecycle works are expected to be required during the last few years of the PPP contract. This can give a greater certainty of the service life and condition of the infrastructure (and therefore future investment needs) when it is handed back at the end of the contract term.

Other Public Authorities prefer the fixed contract duration approach because the Private Partner's increased financial exposure (which it passes to the construction contractor in the form of higher levels of liquidated damages) can provide an additional incentive to complete on time. It also gives, to some degree, greater certainty as to when the Public Authority must assume the future responsibility for the infrastructure.

The Public Authority will generally take on the risk of certain events during the construction phase (e.g. its own default). If the PPP contract has a fixed expiry date and construction is delayed by such events, then the Public Authority will typically compensate the Private Partner for the portion of the Availability Payments that it loses as a result of the delay. The compensation given by the Public Authority may be either in the form of a payment and/or an extension to the PPP contract term.

Legislation in the Western Balkan countries

In the Western Balkan jurisdictions, the general position is that there is no specific legislation on making adjustments to availability fees, but this is a matter that can be agreed contractually between the parties.

*In **Albania**, the material conditions of the contract cannot be changed if the change is not foreseen in the bid documents [25].*

*In **Kosovo***, any provision for adjustment must be subject to Article 48 paragraph 2.7 of the PPP Law.*

[25] Article 31.5 of the PPP and Concessions Law.

Reference guidance documents

- *SFT Payment Mechanism Model Guidance, UK (Scotland), (2014) (www.scottishfuturestrust.org.uk/storage/uploads/SFT_Payment_Mechanism_Model_Guidence_Note.docx)*
- *Private Finance 2 (PF2) Guidance, UK (England), (2012) (https://www.gov.uk/government/publications/private-finance-2-pf2)*

8. Changes to the project

8.1 Overview

A PPP contract will usually provide the Public Authority with a right to propose changes to the project. Some PPP contracts include provisions that allow the Public Authority to amend the PPP contract unilaterally (i.e. without the Private Partner's consent) on public policy grounds.

The Private Partner will also generally have a right to propose changes to the project. Less commonly, the PPP contract might give the Private Partner a right to require changes (in limited circumstances).

8.2 Changes required by the Public Authority

Some jurisdictions have public laws giving the Public Authority the right to amend the PPP contract on public policy grounds. In practical terms, this means that the Private Partner has no grounds to object to the relevant change, but usually has the ability to claim compensation.

In jurisdictions that do not give the Public Authority unilateral rights of amendment, this right might be regulated by provisions in the PPP contract.

It is commonly recognised that if the Public Authority unilaterally requires a change to the project, the PPP contract should provide suitable protection to the Private Partner. In most circumstances, the PPP contract gives the Private Partner the right to claim compensation or damages from the Public Authority (to cover any increased costs or loss of revenue caused by the change) and request relief from any non-performance of the PPP contract that arises as a direct result of the change.

Similarly, the PPP contract will usually include a mechanism to ensure that the Private Partner does not receive a windfall financial gain from any change that results in a reduction in its costs (or an increase in its revenue).

The PPP contract may set out limited grounds upon which the Private Partner can object to a change that the Public Authority proposes to make to the project. The most common example is that the change would represent a material change to the nature or risk profile of the project.

Legislation in the Western Balkan countries

In the Western Balkans, the only jurisdiction that provides for a similar concept to a statutory unilateral right to amend a contract is Neretva Canton. Under its law on concessions, if, for public policy reasons, it is necessary to limit the scope of the concession or adjust it to a new situation, the Private Partner must take all measures required by the Government for this purpose. In such a case, the private partner will be able to claim damages, but not compensation for lost profits. Rights to amend the project are typically contained in the PPP contract. For example, in Kosovo the* *contract may include provisions allowing the Public Authority to amend its terms unilaterally in the circumstances set out in the PPP contract.*

It is common across the Western Balkan jurisdictions for the Government to have a statutory right to terminate the contract on public policy grounds (e.g. in Albania[26], Republika Srpska, Montenegro and Serbia) rather than to allow the Governments to amend the contract unilaterally.

8.3 Changes proposed by the Private Partner

The PPP contact may include provisions that enable the Private Partner to propose changes. However, the PPP contract typically requires the Public Authority to approve any change proposed by the Private Partner (except, perhaps, if a change is required in order to comply with a change in law or regulation).

The introduction of a change proposed by the Private Partner is, therefore, essentially a matter for negotiation between the parties. PPP contracts that enable the Private Partner to propose changes to the specification sometimes also include provisions that deal with any cost savings that result from any change proposed by the Private Partner and approved by the Public Authority (e.g. provision for cost savings to be shared equally between the parties).

[26] This derives from the standard general terms of concession contracts.

9. Treatment of Supervening Events

9.1 Background

The traditional approach in PPP contracts is that, unless contract law provides otherwise, the Private Partner takes the risk of any non-performance, even if the cause of non-performance is outside the Private Partner's control. Accordingly, much time is spent analysing the risks that could arise during the term of the PPP contract and the extent to which the Private Partner should be relieved from poor or non-performance caused by supervening events, i.e. events that are beyond the control of the parties.

Over time, this has resulted in most jurisdictions adopting a three-tiered approach to risk events, as follows:

a) **Compensation Events**: these are events for which the Public Authority takes the risk. The Public Authority pays compensation to the Private Partner and gives any other form of contractual relief required to leave the Private Partner in the position that it was in before the relevant Compensation Event occurred.

b) **Relief Events** (often called **Delay Events** where they occur during the construction phase): these are events for which the Private Partner is expected (at least to some degree) to take financial risk, but is given relief from other consequences of non-performance that such events cause. Relief Events are, by nature, events that are either insurable or not expected to continue for many days.

c) **Force Majeure Events**: broadly, these are events:

   - beyond the control of the parties; and
   - that render the performance of all, or a material part, of one party's obligations impossible.

   Although legislation and/or case law in some European jurisdictions provide the Private Partner with force majeure protection, the concept is usually also included in the PPP contract. The PPP contract will define events that are considered to be events of force majeure. The definition is often focused on events that are uninsurable, outside of the control of either party and catastrophic in nature, e.g. an earthquake or tornado.

9.2 Compensation Events

9.2.1 Definition of a Compensation Event

Compensation events are defined and listed in the PPP contract. The list of the events included is often very project-specific, but will typically include:

a) breach of the PPP contract by the Public Authority, for example:

- a failure by the Public Authority to provide access to the site or permits that it is responsible for procuring under the PPP contract;
- a delay in the completion of supporting infrastructure for which the Public Authority is responsible under the PPP contract;

b) the discovery of unforeseeable ground conditions. Depending on the nature of the project, this could be focused on, for example, environmental contamination risk, geological risk and the risk of discovering utility-related infrastructure;

c) failure to obtain a key permit for the project that is not attributable to any failure on the part of the Private Partner;

d) changes in national law or regulations; and

e) other project-specific risks for which the Public Authority takes the risk (either fully or on a shared basis) on value-for-money grounds.

9.2.2 Relief granted to the Private Partner on the occurrence of a Compensation Event

The principle that underpins the Compensation Event mechanism is that the Public Authority takes the risk of the event and the Private Partner is protected from the occurrence or continuation of the event. Compensation Events are approached as follows:

a) if the Compensation Event causes delay to the completion of the construction of the project, the Private Partner is excused from paying liquidated damages to the Public Authority (if relevant) and key dates in the construction programme are extended as far as is reasonable in the circumstances (e.g. if the Public Authority has the ability to terminate the PPP contract for failure to complete construction by a defined date, that date is extended);

b) during the operational phase of the project, any deductions under the payment mechanism caused by a Compensation Event are cancelled;

c) the Private Partner has the right to claim monetary compensation from the Public Authority for any increased costs that it incurs as a direct result of that Compensation Event (e.g. increased labour or materials costs); and

d) the Private Partner is compensated for any revenue that it would have received if the relevant Compensation Event had not occurred. The approach taken to determine the compensation will depend on whether the contract has a fixed duration and expiry date or has a fixed operational period. (This is discussed further in the sub-section below).

Legislation in the Western Balkan countries

Albanian and Serbian law provide for the option of including a stabilisation clause in the PPP contract to protect the Private Partner against the consequences of a detrimental change in law. In Albania, providing for a stabilisation clause in the contract requires the consent of the Council of Ministers.

9.2.3 Loss of revenue protection for the Private Partner

If a Compensation Event delays the start of the operational phase of the project, the way in which the Private Partner is compensated will depend on whether the contract has a fixed duration and expiry date or has a fixed operational period (see Section 7 for a detailed explanation of the difference between these two concepts).

- **Fixed operational period**: In a contract that has a fixed operational period, the Private Partner does not suffer any direct loss of revenue as a result of any delay to the completion of the construction phase. It is, however, exposed to a cash flow problem (i.e. the revenue is deferred) and, in particular, may incur additional finance costs as a result of the delay. The Private Partner's equity IRR (*internal rate of return*) may also be reduced as a result of the delay.

  The Private Partner is therefore often reimbursed for any additional costs but (reflecting the fixed operational term feature of the PPP contract) it will not be entitled to receive the full amount of the Availability Payment that it would otherwise have expected to receive during the period of delay.

- **Fixed contract duration** (with fixed expiry date): the Private Partner may claim an amount equal to that part of the Availability Payment that would otherwise have been received over a period equal to the period of delay. Avoidable costs (e.g. costs of operational insurance or maintenance costs that the Private Partner will not incur as a result of the delay) are usually deducted from the compensation payment.

Legislation in the Western Balkan countries

Legal concepts analogous to Compensation Events

There are several legal concepts analogous to Compensation Events across Western Balkan jurisdictions that are relevant for a PPP contract. These include:

a) a principle of protection of the public interest;

b) impossibility of performing obligations; and

c) changed circumstances.

Albania

a) *Protection of the public interest*

Under the general terms and conditions of the standard documents for concessions/PPPs on civil works and services and public procurement, the Public Authority has a right to terminate the contract at any time if it considers that it is in the public interest. If the Public Authority terminates the contract on these grounds, it must pay the Private Partner a) remuneration for all works accepted and performed before termination; and b) compensation for damages caused by termination. The Private Partner must take all measures necessary to mitigate the damage.

b) *Impossibility of performing obligations*

If a contractual obligation of one party has become impossible to perform and it is not that party's fault, the other party may not require that party to perform the contract or pay damages unless otherwise set out in the contract or applicable law.

Each party will have a right to receive from the other party what it has delivered for the purpose of performing the remaining obligations under the contract (e.g. a refund of advance payments).

c) *Changed circumstances*

In some cases, parties to a PPP contract may amend the contract, e.g. when the purpose of the contract can no longer be fulfilled, the asset cannot be used owing to force majeure, the legal framework applicable to the contract has changed or there are other changes affecting the use of the asset or performance of services.

Bosnia and Herzegovina - FB&H (HNC)

a) *Protection of the public interest*

Under local concession law, if for public policy reasons it is necessary to limit the scope of the concession or adapt to a new situation, the Private Partner must take all measures ordered by the Public Authority. In such cases, the Private Partner will be entitled to compensation for damages, but without the right to compensation for lost profits.

b) *Impossibility of performing obligations and changed circumstances*

Under general contract law, if, following the conclusion of the contract:

i. *circumstances that negatively affect the performance of one party arise or if the purpose of the contract cannot be achieved owing to those circumstances;*

ii. *in both cases it is to such a degree that it is obvious that the contract no longer meets the expectations of the parties; and*

iii. *it is generally considered that it would be unfair to keep the contract in force in the present form,*

The party whose performance is negatively affected can request termination of the contract.

However, the contract may not be terminated if the party that claims the changed circumstances was obliged to take into account those circumstances at the time of entry into the contract or the party could have avoided or overcome them. The party requesting termination of the contract cannot rely on changed circumstances that arose after the expiry of the deadline for fulfilment of that party's obligations. The parties may contract out of certain changed circumstances rules, unless this is contrary to the principle of good faith.

A PPP contract must, among other matters, regulate subsequent inability to perform the contract, including details regarding changed circumstances that lead to complete inability to perform the contract.

Bosnia and Herzegovina - (RS)

a) *Protection of the public interest:*

Under local concession law, a concession agreement can be terminated by the Public Authority on public interest grounds for the construction of objects and execution of works on concession property in accordance with regulations on expropriation. The RS Law on PPP[27] *provides for the prohibition of expropriation of the project property, except where it is in the public interest, in which case the Private Partner may seek full compensation for damage suffered.*

b) *Impossibility of performing obligations and changed circumstances:*

Under general contract law:

i. *a debtor will be released from liability for loss if it proves (A) its inability to perform obligations or (B) that its delay in performing obligations is a result of circumstances that occurred after entering into the contract and that it was unable to eliminate or avoid;*

ii. *if, following entry into the contract, circumstances that negatively affect the performance of the contract by one party occur, or if the purpose of the contract cannot be achieved owing to those circumstances, and in both cases, it is to such a degree that it is obvious that the contract no longer meets the expectations of the parties, and that it is generally considered that it would be unfair to keep the contract in force in the present form, the*

[27] Article 17 of the RS Law on PPP.

party whose performance is negatively affected can demand termination of the contract.

However, a party cannot request that the contract be terminated if that party is in delay with the performance of its obligations, if that party was obliged to take into account the changed circumstances at the time of entry into the contract or that party could have avoided or overcome those circumstances. The party requesting termination of the contract cannot rely on changed circumstances that arose after the expiry of the deadline for fulfilment of that party's obligations. The parties may contract out of certain changed circumstances rules, unless this is contrary to the principle of good faith.

Former Yugoslav Republic of Macedonia (FYROM)

a) Changed circumstances – administrative contracts

Macedonian law provides for the possibility of the amendment and termination of administrative contracts in the case of "changed circumstances" (i.e. circumstances that occur after entry into the administrative contract and negatively affect the performance of the contract) or other circumstances as prescribed under sector law applicable to the subject of the administrative contract. Macedonian law does not indicate which of the parties would have a right to amend or terminate the contract on these grounds. Therefore, it could be argued that this option is available for both the Public Authority and the Private Partner.

Although administrative contracts are recognised and regulated under the Macedonian GAP Law[28], while PPP contracts are regulated under the Macedonian PPP Law, it is unclear whether PPP contracts can be deemed to be administrative contracts at the same time. It can be argued that certain PPP contracts construed and entered into in accordance with the Macedonian PPP Law (i.e. for the purpose of performing public services by the Private Partner) can be deemed to be administrative contracts at the same time. Accordingly, the Public Authority would have the right to amend, terminate and annul PPP contracts in accordance with the Macedonian GAP Law[29].

b) Changed circumstances – civil law

Under the Macedonian Law on Obligations[30], the occurrence of circumstances that negatively affect the performance of the obligations of one party, or if owing to those circumstances the purpose of the contract cannot be achieved, the party having difficulties in performing its obligations may request termination of the contract. In each case, the contract will be

[28] Law on General Administrative Procedure, published in the Official Gazette of the Republic of Macedonia no. 124/2015 (the Macedonian GAP Law).

[29] Articles 99, 100 and 101 of the Macedonian GAP Law.

[30] Article 122 of the Macedonian Law on Obligations, published in the Official Gazette of the Republic of Macedonia no. 18/2001, as subsequently amended.

terminated if it does not meet the expectations of the parties and keeping it in force would be unjust.

Termination of the contract may not be requested if the party claiming the changed circumstances had a duty, at the time of entering into contract, to take into account those circumstances, or if that party could have avoided or overcome those circumstances. The party requesting termination of the contract cannot rely on changed circumstances that arose after the expiry of the deadline for fulfilment of that party's obligations. Alternatively, under the Macedonian Law on Obligations, the parties may decide to amend the contract.

If the contract is terminated owing to changed circumstances, the damaged party can request compensation for the loss suffered as a result of the termination.

When deciding whether to terminate or amend the contract, the court will refer to the principles of fair dealing, especially taking into account the purpose of the contract, the typical risks associated with this type of contract, the public interest, and the interests of both parties[31]*.*

c) Impossibility of performing obligations

Under the Macedonian Law on Obligations[32]*, if the performance of an obligation by one party in a bilateral contract becomes impossible owing to an event that:*

i. is not caused by either party;

ii. occurred after the entry into force of the contract but before the date by which that obligation is to be performed; and

iii. could not have been foreseen, prevented, avoided or eliminated by the relevant party,

it will be deemed to be a force majeure event that terminates that obligation.

If one of the parties had performed its obligations, partially or fully, that party may request restitution according to the rules of restitution in the case of unjust enrichment.

In the case of partial impossibility of performing contractual obligations owing to events not caused by either party, one party may terminate the contract if the partial performance does not meet its needs. Otherwise, the contract would remain in force, whilst the other party will be entitled to request the proportionate reduction of its obligations.

The Macedonian Law on Obligations does not indicate what events can be deemed to be Force Majeure Events nor does it provide for any further rules in

[31] Article 124 of the Macedonian Law on Obligations.

[32] Article 126 of the Macedonian Law on Obligations.

this regard. Although the parties to a PPP contract would have the freedom to agree on wording, the force majeure clause would need to be compliant with the general rules on the impossibility of performing obligations under the Macedonian Law on Obligations, as described above.

*Kosovo**

a) *Protection of the public interest*

PPPs are subject to the principle of protection of the public interest[33]*. A PPP contract may indicate circumstances relating to the protection of the public interest. The occurrence of those circumstances would give the Public Authority a right to change the PPP contract unilaterally.*

b) *Impossibility of performing obligations*

If the performance of obligations under the contract becomes impossible for one party owing to the occurrence of an event or circumstance for which no party is responsible, the other party is also not obliged to perform its obligations under the contract (Article 120 of the Kosovar Obligations Law). In such a case, the party that has performed part of its obligations may request restitution according to the rules of restitution applicable to unjust enrichment, i.e. to receive what it has delivered to the other party as performance of the contract or to be compensated for the value of the profit earned by the other party.

In the case of partial impossibility of performing the contract due to events not caused by either of the parties, one party may terminate the contract if partial performance of the contract does not meet that party's needs. Otherwise, the contract will remain valid, while the other party will be entitled to a proportionate reduction of its obligations.

c) *Changed circumstances*

As a general principle of contract law (Article 116 of the Kosovar Obligations Law), if:

i. *after the conclusion of the contract, circumstances that make it difficult for one party to perform its obligations under the contract occur or the purpose of the contract cannot be achieved;*

ii. *it is clear that the contract does not correspond to what was originally expected by the parties; and*

iii. *it would be unfair to keep the contract unchanged,*

the party not able to perform its obligations under or to achieve the purpose of the contract may require the contract to be terminated or amended. The contract will not be terminated if the party claiming the changed

[33] Article 4 of PPP Law.

circumstances had, at the time of entering into the contract, an obligation to take into account those circumstances, could have prevented their occurrence or could have mitigated them.

Parties may waive a right to claim any specific changed circumstances in advance, unless that waiver would conflict with the principle of conscience and fairness.

Montenegro

Under the Montenegrin Law on Administrative Procedure, an administrative contract may be amended or terminated in circumstances occurring after its commencement that could not have been foreseen at the time of entry into that contract and that negatively affect the performance of the contract.

The occurrence of changed circumstances can result in:

a) *suspension of rights and obligations under the concession contract under the Montenegrin Law on Concessions; and*

b) *an amendment to or termination of the concession contract under the Montenegrin Law on Administrative Procedure.*

Serbia

a) *Protection of the public interest*

   The Serbian PPP Law provides a basis for termination on public interest grounds. However, the concept of public interest is not specifically defined nor has there been clear market practice that would shed more light on this matter. This may provide the Public Authority with wide discretion in interpreting the scope of this basis for termination.

b) *Changed circumstances*

   The concept of changed circumstances provides for the possibility of either terminating or amending a PPP contract under certain circumstances.

   If, after entry into a contract:

   i. *circumstances that negatively affect performance by one party occur or if the purpose of the contract cannot be achieved owing to the existence of those circumstances;*

   ii. *to such a degree that it is apparent that the contract no longer meets the expectations of the parties; and*

   iii. *it is generally considered that it would be unfair to keep the contract in force in the present form,*

   the party whose performance is negatively affected can demand termination of the contract.

However, termination of the contract cannot be requested if the party that invokes the changed circumstances was obliged to take into account those circumstances at the time of entering into the contract or the party could have avoided or overcome them. The party requesting termination of the contract cannot rely on changed circumstances that arose after the expiry of the deadline for fulfilment of that party's obligations.

Parties may contract out of the rule on changed circumstances, unless this is contrary to the principle of good faith.

Typically, all payments to be made by the Government (including damages and termination compensation) must be provided for in its annual budget. Therefore, to prevent a situation where the Government would not be able to pay damages or termination compensation to the Private Partner when due and payable, the Government should allocate sufficient funds for the purpose of possible additional payments relating to the project in its budget.

9.2.4 Value for Money-based Compensation Events

The following are examples of provisions that may be devised to deal with particular site-related project risks:

- **Environmental contamination**: the Public Authority may agree to compensate the Private Partner for the costs associated with remediating environmental contamination present on the site, to the extent that the actual cost was greater than a defined amount. This approach might be taken if it is not possible for the Private Partner to make a reasonable assessment (and cost) of the amount of remediation work that is required until the work actually takes place. The Public Authority may believe that it is not in the public interest (value for money) to require the Private Partner to price a risk that it is unable to quantify;

- **Geological conditions**: the Public Authority may agree to compensate the Private Partner if the geological conditions on the site are substantially different to those disclosed to the Private Partner during the bid process and which form the basis of the PPP contract. Where the Private Partner (and the other bidders for the project) is unable to undertake reasonable additional ground investigations during the bid process, the Public Authority may believe that it is not in the public interest (value for money) to require the Private Partner to price a risk that it was unable to quantify; and

- **Access to third party land**: the Public Authority may agree to compensate the Private Partner if certain third parties related to the project (e.g. railway authorities) refuse to grant the Private Partner access to their property in order to build and operate the project for reasons that the Private Partner could not reasonably have foreseen.

It is good practice for the Public Authority to discuss similar project-specific risks with Private Partners and include a mechanism in the PPP contract that enables the Private Partner to quantify its maximum loss in the event that an otherwise potentially unquantifiable risk occurs during the term of the PPP contract.

9.3 Relief Events (Delay Events)

9.3.1 Definition of a Relief Event (Delay Event)

A Relief Event (or Delay Event) is an event that is outside of the control of the Private Partner, but that the Private Partner is considered best placed to manage.

Examples of such events may include:

a) fire, explosion, lightning, storm, tempest, flood, bursting or overflowing of water tanks, apparatus or pipes, earthquakes, riot and civil commotion;

b) accidental loss to (or failure of) the project or other infrastructure that the Private Partner relies on for the project;

c) any failure or shortage of power, fuel or transport;

d) an industry-wide labour dispute, go-slow or strike;

e) delays in procuring permits or authorisations;

f) legal challenge against permits, licences or authorisations for the project; and

g) others that are important to include on a case-by-case basis.

9.3.2 Protection from the financial impact of a Relief Event

Approaches to protecting the Private Partner against the financial impact (i.e. increased costs or loss of revenue) of a Relief Event generally fall into three categories:

a) **No compensation**: The Private Partner is expected to manage and/or mitigate against the financial consequences of such events;

b) **Compensation is only paid after an initial period has passed**: no compensation is paid to the Private Partner for an initial defined period (e.g. 7 days), but after that period the Public Authority compensates the Private Partner for any increased costs and extends the term of the PPP contract by any period of delay to construction completion caused by the event; and

c) **Compensation is paid to the Private Partner**: compensation is usually paid at a lower rate than for a Compensation Event. By way of example, the Public Authority might pay compensation to the Private Partner:

   i. at a rate that is intended to enable the Private Partner to service its senior debt for the period (i.e. at a rate lower than the Private Partner's actual loss of revenue); or

   ii. at a rate that is intended to ensure that loss of revenue risk for the period is shared between the Private Partner and the Public Authority (e.g. the rate of compensation is set at a level that equates to 50% of the revenue that the Private Partner would have otherwise received); or

iii. for any increased costs that exceed a defined threshold (e.g. EUR 50,000).

The Public Authority will not usually pay any compensation if the financial impact of any Relief Event can be insured against by the Private Partner.

9.3.3 Relief from the non-financial consequences of a Relief Event

The Private Partner is typically given a time extension where Relief Events cause delays to construction completion (and therefore the start of operations). The Private Partner is also typically relieved from any obligation to pay liquidated damages to the Public Authority for the delay.

During the operational phase, periods of unavailability caused by Relief Events are often ignored for the purposes of determining whether a Private Partner default (i.e. termination event) has occurred under the PPP contract. The extent to which the Private Partner incurs deductions for the unavailability will depend on the project.

Different approaches taken to this include:

a) on the basis that the Private Partner can either insure against the risk of the event (e.g. physical loss of a bridge caused by an insured peril) or because the event is not expected to continue for long periods of time (e.g. closure of a bridge caused by high winds), the deductions regime continues to apply; or

b) deductions are only made to the extent that the Private Partner can insure against a loss of revenue caused by the deductions; and

c) deductions are made but at a reduced rate. For example, a multiplier that would usually be applied to deductions for prolonged (persistent) periods of unavailability might be not be applied.

9.3.4 Early Termination due to an extended Relief Event

The Public Authority may consider allowing either party to terminate the PPP contract in the event that a Relief Event continues for a continuous and extended period of time (e.g. 180 days).

In these circumstances, termination compensation may be made payable to the Private Partner by the Public Authority. The level of compensation is often the same as that paid in the event of early termination for extended Force Majeure Events, although in some cases a marginally higher level of compensation might be payable. (Nevertheless, this would be less than the amount paid in the event of early termination for Public Authority default).

This latter approach can be achieved in a number of ways; for example, by using a higher discount rate than would be used in a Public Authority default scenario for the purposes of valuing the equity.

9.4 Force Majeure Events

9.4.1 Definition of Force Majeure Event

The concept of *force majeure* is recognised in PPP contracts across the EU (either as a matter of contract and/or in relevant statute or case law).

Where the force majeure definition is drafted into the PPP contract a list of the events that constitute force majeure is provided, usually including some combination of the following:

a) war, civil war, armed conflict, revolution, or terrorism;

b) nuclear explosions, ionising radiations or radioactive, chemical or biological contamination;

c) pressure waves caused by an airplane travelling at supersonic speeds;

d) plane crash;

e) natural disasters such as earthquakes, landslides, lightning, floods, storms, cyclones, and other extreme climatic or environmental circumstances provided they are recognised as a natural disaster by the authorities;

f) fire and explosions (not caused by the Private Partner or any of its contractors or representatives);

g) detonation of explosives; or

h) strikes, protests or riots.

9.4.2 Treatment of non-performance caused by a Force Majeure Event

As with Compensation Events and Relief Events, the Private Partner will be relieved from any breach of contract that arises as a result of a Force Majeure Event. The Private Partner is usually granted a time extension in respect of any consequent delays to construction completion and is relieved from any requirement to pay liquidated damages in respect of such a period of delay.

From a contractual perspective, the main difference between a Force Majeure Event and a Relief Event is that either party has the ability to terminate the PPP contract for an extended Force Majeure Event (either as a matter of contract or as a matter of law).

Accordingly, there are two key features of the PPP contract that will determine the approach that is taken by the Public Authority to providing relief for non-performance caused by a Force Majeure Event:

a) the period of time that a Force Majeure Event must exist before either party can terminate; and

b) the amount of compensation that is payable to the Private Partner by the Public Authority during the subsistence of the Force Majeure Event.

The period of time that must elapse before the PPP contract can be terminated for extended Force Majeure tends to be shorter in contracts where the Private Partner is receiving no financial compensation during the continuation of the Force Majeure Event. In these PPP contracts, the termination right tends to arise when the Force Majeure Event has continued for 180 days (six months) or more.

The extent to which compensation is paid (or relief from deductions under the payment mechanism is granted) during the continuation of a Force Majeure Event will usually reflect the approach taken to the same issue in the context of Relief Events. The approach taken may range from both parties bearing their own losses and costs incurred during the continuation of a Force Majeure Event (prior to termination), through to the Public Authority paying the Private Partner as if it were performing in accordance with the requirements of the PPP contract.

Legislation in the Western Balkan countries

Across the Western Balkan countries, force majeure (or force majeure style concepts) are recognised either in contracts, statute (although with no detailed definition) or case law. The concept of force majeure cannot be strictly differentiated from the doctrine of changed circumstances or the impossibility of performing obligations. Therefore, it may often be the case that a Force Majeure Event will be a changed circumstance or will render the performance of the PPP contract impossible (see also the section above on the impossibility of performing obligations under Macedonian law, under which the impossibility of performing obligations is a Force Majeure Event).

Specific approaches under applicable Western Balkan countries' legislation should also be taken into account.

Bosnia and Herzegovina - FB&H (HNC)

A PPP contract must indicate a definition of force majeure and the consequences of its occurrence. Force majeure provisions usually include a provision stating that neither of the parties will be responsible for the non-performance of its obligations under the contract to the extent that the performance of those obligations has been delayed or rendered impossible by force majeure.

Montenegro

Under the Montenegrin Law on Concessions, in the case of force majeure or an extraordinary event that prevented a party from performing concession activities that could not have been foreseen at the time of the entry into the contract, rights and obligations under the contract are suspended until the force majeure or extraordinary event ceases. The Public Authority decides whether to suspend the contract on the basis of a written request from the Private Partner. However, the Montenegrin Law on Concessions does not define force majeure, or an extraordinary event. It rather requires that the concession contract regulate, among other things:

a) conditions for amendments or termination of the contract in the case of changed circumstances and force majeure;

b) the events that will be considered as changed circumstances and force majeure;

c) conditions for the termination of the concession contract; and

d) penalties and fees for breach of contract.

Serbia

The Serbian Contracts Law does not contain a definition of force majeure. However, under case law, force majeure has been understood as a natural event or non-culpable human act that was unforeseeable and cannot be overcome, as a result of which damage has occurred.

The party that is unable to perform its obligations owing to force majeure will not be liable for damages to the counterparty, i.e. it would not be obliged to perform the contract. In this respect, the Serbian PPP Law indicates that the parties are free to determine the extent to which a party may be released from liability for non-performance or delayed performance owing to circumstances outside its control. This means that the parties may choose to regulate the consequences of the occurrence of a Force Majeure Event to the extent permitted under mandatory legal provisions.

10. Change in Law

Under a PPP contract the Private Partner is required to comply with all laws that apply to it and the project. Given that PPP contracts are often long-term (e.g. 20 to 30 years), there is a high likelihood that they will be affected by changes in national law and regulations, e.g. new taxes that affect the project. A change in law may make the performance of the Private Partner's obligations under the PPP contract fully or partially impossible, more expensive or delayed. It is therefore important to indicate in the PPP contract which of the parties will bear the risk of a change in law. A change in law clause addresses this issue.

Change in law risk typically sits with the Public Authority on the basis that it is an unforeseeable risk that is within its control.

In many PPP contracts, the level of protection available to the Private Partner is qualified, for example:

- **Foreseeable changes in law**: the PPP contract may state that the Private Partner is not entitled to any protection in respect of a change in law that was foreseeable prior to the PPP contract being signed. The PPP contract should define what *foreseeable* means, but the future costs of such changes in law are typically expected to be included by the Private Partner in the contract price.

- **General changes in law**: the PPP contract may seek to qualify the extent to which the Private Partner can claim compensation from the Government in respect of general changes in law (i.e. changes in law that affect all businesses in the relevant country such as an increase in corporation tax). These qualifications could take one (or both) of two forms:

  a) *changes in operating costs* – the PPP contract does not allow the Private Partner to claim compensation from the Public Authority for projected increases in operating costs arising as a result of a general change in law on the basis that the indexation mechanism included in the PPP contract provides sufficient protection against this risk; and

  b) *increases in capital costs* – the PPP contract requires the Private Partner to share the risk associated with increases in capital costs that result from general changes in law. Here, the Private Partner's maximum financial exposure is often limited, enabling the Private Partner to price the risk into its bid for the project.

Legislation in the Western Balkan countries

In some Western Balkan jurisdictions, if a change of law occurs, the Private Partner may be entitled to make a claim or require the contract to be terminated or amended under the doctrine of impossibility of performing obligations or changed circumstances (see Section 8, Treatment of Supervening Events).

A PPP contract could include provisions that ensure that if the Private Partner's costs and/or expenses reduce as a result of a change in law, the Private Partner should not benefit from a windfall gain.

***Albanian** and **Serbian** law expressly provide for the possibility of including a stabilisation clause in the contract to protect the Private Partner against the consequences of a change in law that negatively affects the Private Partner or the project (see also Section 8).*

11. Insurance requirements

The main provisions dealing with insurance in PPP contracts describe what insurance must be taken out by whom, for how much and on what terms and conditions. This part of the contract has many technical aspects that will normally require the advice of a specialist insurance adviser. A separate schedule often accompanies the main PPP contract describing the requirements of specific insurances to be provided by the Private Partner.

11.1.1 Scope of Insurance Requirements

As a general point, the Private Partner has an insurable interest in the project during both the construction and operational phases. This means that the Public Authority can transfer responsibility to the Private Partner for taking out insurance related to the project.

Although the Private Partner is naturally incentivised (based on the risk allocation in the PPP contract) to mitigate certain risks by taking out insurance, the Public Authority may also include provisions in the PPP contract specifying particular insurance that the Private Partner must take out. By describing minimum insurance requirements (sometimes-called *required insurances*) in the PPP contract, the Public Authority can be confident that the project will be adequately protected against the impact of insurable risks.

Required insurances for each of the construction and operational phases of the project may be set out in the PPP contract in relation to:

- **Professional indemnity insurance**: the Public Authority will want reassurance that the Private Partner's construction contractor will have sufficient financial resources to support any liability that it may incur in respect of construction defects. The Public Authority may therefore require the construction contractor to take out professional indemnity insurance that meets a set of minimum specified requirements.

- **Property damage insurance**: although sometimes called *construction-all-risks* insurance during the construction phase, the purpose of this insurance is to give the Public Authority confidence that if the project (or part of it) is damaged or destroyed by an insurable risk, the Private Partner will have sufficient financial resources available in order to reinstate it.

- **Public liability insurance**: both the Public Authority and the Private Partner will have potential legal liabilities to third parties in connection with the project. By way of example, the Private Partner may be exposed to claims from third parties if it carries out the works negligently or breaches statutory requirements. The Public Authority may also be exposed to claims from third parties in relation to an act or omission of the Private Partner. To address this, the PPP contract may require the Private Partner to take out public liability insurance covering both parties.

- **Delay in start-up/business interruption insurance**: if the infrastructure is damaged and requires reinstatement, the Private Partner can typically insure against revenue it loses during the period of reinstatement. This insurance is often referred to as *delay in start-up* insurance (during the construction phase) and *business interruption* insurance (during the operational phase of the project).

The provisions of each of the required insurances should consider the following matters:

- **Named insured**: with the exception of professional indemnity and delay in start-up/business interruption insurance, the Public Authority might require to be named as a co-insured party on each of the required insurances. This requirement reflects the insurable interest that the Public Authority has in the project and gives it the opportunity to make a claim under the relevant insurance in the event of a loss.

- **Non-vitiation protection**: the purpose of this protection is to ensure that a claim made by the Public Authority cannot be rejected by the insurer based on a failure by the Private Partner to comply with the terms of the insurance policy.

- **Waiver of subrogation**: this provision protects the Public Authority against any risk of the insurer pursuing the Public Authority in connection with any claim brought by the Private Partner under the required insurances.

- **Maximum deductibles**: any claim made will often be subject to an amount *(deductible*) that must be borne by the insured party before the insurer will pay insurance proceeds. The level of deductible associated with the relevant insurance policy will affect the insurance premium to be paid. The Public Authority may impose maximum levels of deductible in the contract.

- **Insured Sum**: the PPP contract might state a requirement for the basis of the calculated amount to be insured by the Private Partner. For example, in the context of an accommodation project, the Public Authority might require the full reinstatement value of the property to be insured under the property damage insurance.

Notwithstanding the required insurances set out in the PPP contract, the Private Partner may take out additional insurances, in particular at the request of the lenders to the project.

11.1.2 Reinstatement obligations

The PPP contract will usually require the Private Partner to take out property damage insurance during the operational phase of the project to cover its obligation to reinstate the infrastructure to its original condition in the event of damage.

11.1.3 Circumstances in which the Private Partner is not required to take out insurance

There may be occasions when it is preferable not to require the Private Partner to take out certain types of insurance, for example on the basis that the Public Authority does not think that it represents good value for money.

The contract should also address the circumstances in which the Private Partner cannot obtain insurance (either because the insurance is unavailable or is not available on reasonable commercial terms). If a required insurance becomes unavailable for the project and other comparable projects, this is often treated as a shared risk (and not a transferred risk), similar to the risk of extended Force Majeure.

On the basis that it is not in the public interest for a Private Partner to be operating public infrastructure without insurance, the PPP contract may allow either party to terminate the contract. Alternatively, the Public Authority may decide to continue the PPP contract on the basis that it will act as *insurer of last resort* for those risks that the Private Partner is no longer able to insure.

It is helpful to distinguish in the contract between circumstances where the Private Partner is unable to comply with minimum insurance requirements in the contract because:

a) the insurance is no longer available on the insurance market on terms that fully comply with the minimum requirements of the PPP contract (e.g. the maximum level of deductible set out in the contract is lower than what is available on the market).

   Note: while the Private Partner would not be considered to be in breach of the PPP contract for failing to procure the relevant insurance on the required terms, the Public Authority *should not take on or share any additional risk as a result of the relevant insurance not being obtainable on the terms required;*

b) the insurance is no longer available on the market on any terms; or

c) although the insurance is available, it is not considered commercially viable by reference to, for example, the minimum requirements of the PPP contract, original pricing assumptions, significantly higher levels of deductible, excessive premiums or, more broadly, that commercial enterprises have generally stopped buying such insurance.

   Note: The circumstances in b) and c) where insurance is no longer available to the project are often deemed to constitute Force Majeure (see above).

12. Warranties and Indemnities

12.1 Warranties

A warranty is a contractual promise as to the truth of a statement on a particular date. Warranties will usually relate to matters that either require thorough investigation in order to be verified by a counterparty or cannot be practically verified. Therefore, the risk of a statement made in relation to those matters being true sits with the party making that statement.

Most PPP contracts include warranties of some form or another. The inclusion of certain types of warranties is common in any commercial contract (e.g. warranties from the Private Partner that it has the power to enter into the contract or that it has not made any payments to public officials in connection with the award of the contract).

The warranties granted in a PPP by the Public Authority to the Private Partner are a key component of the risk allocation for the project.

By way of example, if the Public Authority warrants to the Private Partner in the PPP contract that the site is free from environmental contamination, and the Private Partner discovers environmental contamination during the construction phase, the Private Partner is entitled to make a claim under the PPP contract for breach of warranty. Accordingly, assessing the scope of any warranties granted by the Public Authority to the Private Partner under the PPP contract is essential in assessing the extent to which the risks/rewards associated with a project are shared (or not) between the parties.

In practice, Public Authorities are very reluctant to give warranties in PPP contracts. Therefore, the preferred means of protecting the Private Partner in respect of a particular risk item is a contractual mechanism that enables the Private Partner to claim compensation and/or another form of defined relief (e.g. time extensions).

12.2 Indemnities

An indemnity is a contractual arrangement under which one party promises to protect another person against loss or to compensate another person for a specific liability that person incurs.

PPP contracts usually include indemnities, although in most circumstances these are only provided by the Private Partner to the Public Authority.

Public Authorities are normally very reluctant to provide indemnities; in some cases, they are not permitted to provide them as a policy matter or by law.

On the other hand, the Private Partner is often expected to provide far-reaching indemnities to the Public Authority. The Private Partner may be required to accept the legal liability that any owner and operator of infrastructure would be exposed to, and this is reflected in the indemnities granted to the Public Authority by the Private Partner. The categories of loss/claims that the Private Partner is often exposed to include those brought against the Public Authority in relation to:

a) personal injury/death;

b) breaches of the Public Authority's statutory duties;

c) property damage; and

d) other claims brought against the Public Authority by third parties that could otherwise have been brought against the Private Partner,

to the extent that they arise as a result of the Private Partner's performance or non-performance of the PPP contract.

Legislation in the Western Balkan countries: Indemnities

Albania

Given the broad definition of "financial support" under the PPP and Concessions Law, indemnities might be granted as "financial support".

Bosnia and Herzegovina - FB&H (HNC)

Under the HNC Law on PPP, the parties must regulate all matters relating to potential indemnities. In practice, the Public Authority would not be likely to grant any indemnities for the benefit of the Private Partner.

Bosnia and Herzegovina – RS

There is no legal restriction on the Public Authority granting indemnity to a Private Partner. However, such a possibility has not been tested in practice.

Former Yugoslav Republic of Macedonia (FYROM)

There are no restrictions on the Public Authority giving indemnities to a Private Partner. However, Macedonian public authorities are quite reluctant to do so in practice.

Kosovo*

The PPP Law is silent on indemnities. However, there is no restriction on the Public Authority granting indemnities to a Private Partner under a PPP contract.

Montenegro

Although Montenegrin laws do not prevent the Government from granting indemnities to a Private Partner, it would be highly unusual for this type of provision to be set out in a concession contract.

Serbia

There is no restriction under Serbian law on the Public Authority granting indemnities to a Private Partner. Generally, it would be for the parties to negotiate the applicable indemnities. However, in practice the Public Authority would be reluctant to grant indemnities to a Private Partner.

13. Early termination and compensation on termination

13.1 Compensation on termination because of Private Partner default

13.1.1 Definition of Private Partner default

The PPP contract will include an itemised list of Private Partner defaults that give the Authority the right to terminate the contract. It is common for the list to include defaults such as:

- insolvency/bankruptcy of the Private Partner;
- failure to achieve certain construction milestones;
- failure to deliver services to agreed standards;
- failure to take out required insurances;
- breach of restrictions on changes in ownership or assignment of the contract;
- material breach and/or persistent breach; and
- fraudulent or corrupt behaviour by the Partner.

13.1.2 Overview of compensation provisions

There are two principal approaches taken to determine the compensation payments on early termination for Private Partner default in a PPP contract. These are:

a) compensation based on an assessment of the value of the project at the point of termination (based on the remaining value of the contract or value of the assets); and

b) compensation based on the amount of senior debt that the Private Partner owes to its lenders at the point of termination.

Including clear provisions in the PPP contract on early termination compensation gives the parties certainty as to the mechanics and consequences of early termination, without the need to rely on often lengthy and costly legal proceedings. This level of certainty may in turn enable the Private Partner to offer a lower bid price.

Less common approaches to compensation for Private Partner default termination include:

a) the PPP contract stating that no compensation payable. On termination, the Private Partner may make a claim for *unjust enrichment* against the Public Authority with a view to being compensated on the basis of the value of the relevant asset to the Public Authority; and

b) the PPP contract remaining silent on the issue of how much compensation should be payable. This approach can be adopted where, as a matter of law, either the Private Partner is legally entitled to make a claim against the Public Authority, or there is a statutory process for determining the compensation payable by the Public Authority.

Legislation on Compensation on termination

Albania

Albanian law does not provide for rules on compensation on termination for Private Partner default. The standard terms of concession contracts include a provision for compensation on termination by the Public Authority on public interest grounds. In this case, the Public Authority must pay the Private Partner for all accepted works and services performed before termination and for damages caused to the Private Partner.

Bosnia and Herzegovina

Under general contract law, a Private Partner is entitled to claim damages from the Public Authority for actual loss arising from early termination. The level of damages would be determined by the competent court, depending on the circumstances of the case.

Bosnia and Herzegovina - FB&H (HNC)

The payment of compensation on termination is not explicitly regulated by the HNC Law on PPP or the HNC Law on Concessions. However, general contract rules state that upon early termination of a contract, the defaulting party must compensate the non-defaulting party for loss and damage incurred, including lost profits.

Bosnia and Herzegovina - RS

The RS Law on PPP does not contain any provisions regarding compensation upon early termination for the default of the Private Partner. The parties are generally free to agree on compensation for termination for default. The RS Law on Concessions[34] *indicates that the Public Authority may unilaterally terminate the concession agreement for a default of the Private Partner. In this case, the Public Authority is entitled to damages, including loss of profit.*

[34] Article 46 of the RS Law on Concessions.

Former Yugoslav Republic of Macedonia (FYROM)

The compensation approach may vary from project to project but, in general, the Private Partner will not be compensated at all if the contract is terminated for the Private Partner's default. The Macedonian PPP Law requires the rights of the Private Partner to be indicated for cases in which the Public Authority unilaterally terminates the contract[35]. Whether and to what extent the Private Partner will be compensated thus depends on (i) the event of default, (ii) the terms of the contract and (iii) the outcome of any potential court procedure. A PPP contract may provide for zero compensation to be paid to the Private Partner or be silent on the issue. In both cases, there is nothing preventing the Private Partner from initiating court proceedings for potential compensation, but there is no statutory process for determining the compensation that should be paid.

*Kosovo**

The PPP Law does not provide for rules applicable to compensation on termination for Private Partner default. Subject to Article 48 paragraph 2.19 of the PPP Law, the parties to a PPP contract may agree on the calculation of compensation upon early termination of the contract[36]. If early termination of a PPP contract involves payment of compensation to the Private Partner or other financial obligations for the Public Authority, it is subject to the prior approval of the Committee on Public Private Partnerships[37].

Montenegro

Montenegrin regulations do not recognise the concept of compensation on termination *of PPPs, nor are the models described above applied or developed in local practice. Therefore, to apply, a compensation on termination provision must be expressly agreed between the parties on a case-by-case basis. Any amount determined to be payable by the Public Authority to a Private Partner under a PPP contract must be recognised in the Public Authority's budget (either at state, municipal or autonomous province level), otherwise that payment obligation will be unenforceable. Under the general principles of Montenegrin law, a Private Partner is legally entitled to make a claim against the Public Authority for any kind of compensation for actual damage, including in the event of early termination for Private Partner default. The level of damages would be determined by the competent court, depending on the circumstances of the case.*

[35] Article 44 of the Macedonian PPP Law.

[36] Article 48 paragraph 2.19 of the PPP Law.

[37] Article 49 of the PPP Law.

Serbia

A PPP contract[38] must set out the grounds for early termination and its consequences, including the minimum amount that must be paid to the Public Authority or to the Private Partner, the manner of payment of the amount and the funds from which that amount will be paid. If the Public Authority unilaterally terminates the PPP contract, it will be entitled to compensation for damages, including loss of profit[39]. Under the general rules of contract law, a Private Partner is entitled to claim damages from the Government for actual loss arising from early termination. The level of damages would be determined by the competent court, depending on the circumstances of the case.

13.1.3 Methods of calculation

- **Market Value of the PPP contract at termination**

On termination, the Public Authority can (subject to the qualification below) decide either:

- to run an open market retendering of the PPP contract (in which case the terminated Private Partner is paid the amount bid by the highest tenderer); or
- to determine the estimated fair value of the PPP contract by estimating the price that a third party would pay for the PPP contract in an open market tender process (the *Estimated Fair Contract Value*).

Both of these approaches ensure that the compensation paid takes into account any costs that will be incurred by the Public Authority and/or successor contractor to rectify the performance or condition of the project.

The Public Authority's right to decide to retender the PPP contract is generally conditional on there being a *liquid market* (which will be defined in the contract) for PPPs in the relevant jurisdiction or region. This condition reassures the lenders that the Public Authority cannot retender the PPP contract in circumstances where there is no underlying market for PPP projects in the relevant jurisdiction (e.g. owing to government policy). If there is no liquid market, the Public Authority will be required to pay the Estimated Fair Contract Value.

Some PPP contracts do not give the Public Authority any option to retender the PPP contract on the open market. Instead, the Public Authority pays the Estimated Fair Contract Value. This approach is often taken where (at Contract Close) it is felt that the PPP market in the relevant jurisdiction is not sufficiently liquid for the parties to be confident that a retendering process would adequately determine the fair value of the contract.

[38] Article 46 of the Serbian PPP Law.

[39] Article 54 of the Serbian PPP Law.

The Estimated Fair Contract Value approach involves a calculation (on a net present value basis) of the aggregate of all payments projected to be made by the Public Authority over the remaining term of the PPP contract, net of all costs (including any remediation costs) projected to be incurred.

Although this approach is intended to replicate the calculation that a willing bidder would undertake in a tender process, it requires the parties to agree on the method and inputs for such a calculation. The methodology should be therefore set out in the PPP contract and include, if appropriate, the use of an independent expert to make the calculation.

In the event of a dispute between the parties, the actual Estimated Fair Contract Value will be determined by an appropriate expert or, ultimately, the courts.

- **Estimated fair value of the assets at termination**

This approach uses an accounting analysis to determine the value of the infrastructure assets and therefore the level of compensation payable to the Private Partner. While different views exist on the basis for and means of analysis, the use of the book value of the assets minus depreciation up to the point of termination is commonly accepted.

There are two principal approaches taken to assess this value:

- determine the level of capital invested in the asset, i.e. make an assessment of the various sources of capital committed to the project and ultimately invested (this would, for example, include both the equity invested and the senior debt borrowed); or
- determine the costs expended by the Private Partner in constructing the project (e.g. land acquisition, design, construction and permitting costs).

The main difference between the two approaches is that the first allows financing costs incurred during construction to be taken into account, whereas the second does not.

In contrast to estimating the fair value of the contract (described in section A above), calculating the fair value of the assets does not take into account the cost (if any) to the Public Authority of rectifying any performance issues on the project (e.g. costs of rectifying defects in the infrastructure).

Accordingly, in some jurisdictions the PPP contract states that the compensation payable by the Public Authority to the Private Partner should be an amount equal to the book value of the assets minus any costs for rectification of defects, i.e. the cost of bringing the infrastructure up to the required standard (the *Adjusted Book Value Approach*). This formulation attempts to ensure that the Public Authority does not compensate the Private Partner in an amount that is greater than the true value of the assets to the Public Authority at the point of termination.

Legislation in the Western Balkan countries: Valuation of compensation

Albania

The PPP and Concessions Law does not provide for rules on compensation to be paid by the Government in the event of early termination for Private Partner default. The parties may include a provision in the PPP contract on the methodology of calculation of the compensation, such as the Adjusted Book Value Approach referred to in Section B above).

Bosnia and Herzegovina - FB&H (HNC)

The HNC Law on PPP does not contain any provisions in relation to determination of compensation payable on termination of the PPP contract.

Bosnia and Herzegovina - RS

The RS Law on PPP does not contain any provisions in relation to determination of compensation payable on termination of the PPP contract.

Former Yugoslav Republic of Macedonia (FYROM)

In FYROM, there are no statutory provisions in this regard. The parties may agree on the compensation approach in the PPP contract, but the Adjusted Book Value Approach would likely apply in practice.

Kosovo*

The PPP Law is silent in this regard; however, there are no restrictions on using the above formulations for compensation under the provisions of the PPP contract.

Montenegro

Since Montenegrin laws do not specifically address this issue, the parties are free to determine the model for calculation of termination compensation.

Serbia

The amount of compensation payable on termination can be agreed by the parties in the PPP contract. There are no mandatory legal restrictions in this respect.

- **Senior debt-based calculations**

Although not prevalent across the EU, some PPP contracts compensate the Private Partner on the basis of the amount of debt owed to senior lenders. The calculation starts with a percentage of the senior debt outstanding and, in some cases, deduct amounts such as retendering costs and costs of rectifying poor performance.

A senior debt-based calculation should ensure that compensation on termination is never paid to providers of capital other than senior debt (e.g. equity investors or mezzanine debt providers). At the same time, to incentivise the senior lenders to take control of a poorly-performing project, it usually anticipates that the senior lenders would have to write-off some of their debt if the project were to terminate for Private Partner default.

Although senior debt-based compensation calculations provide a higher level of certainty to senior lenders than the market value approach referred to in paragraph A above, the Public Authority can never be certain that it will not pay more than market value. In other words, the Public Authority could, theoretically, be required to pay a higher than equitable amount in certain circumstances.

The likelihood of this scenario arising will depend on the performance of the project at the point of termination, the percentage of senior debt that the calculation uses as a starting point, the gearing of the project and the level of any floor on the compensation amount.

- **Use of caps and floors**

In some PPP contracts, the amount of compensation payable by the Public Authority is subject to a cap or a floor. A floor guarantees the lenders' maximum loss, whereas a cap guarantees the lenders' minimum loss. The following examples illustrate how a cap or a floor may be used:

a) The Public Authority pays the Estimated Fair Contract Value or 80% of senior debt outstanding, whichever is lower.

This ensures that the lenders never receive greater than 80% of the senior debt outstanding.

b) The Public Authority pays the Estimated Fair Contract Value or 80% of senior debt outstanding, whichever is higher.

This ensures that the lenders never receive less than 80% of the senior debt outstanding.

c) The Public Authority pays either i) an amount equal to 100% of senior debt outstanding, minus future projected deductions, or ii) 80% of senior debt outstanding, whichever is higher.

This ensures that the lenders never receive less than 80% of the senior debt outstanding.

13.2 Compensation on termination for Public Authority default and voluntary termination

13.2.1 Definition of Public Authority default

The following are examples of acts or omissions that would constitute a Public Authority default under a PPP contract:

a) expropriation/confiscation of the assets/shares of the Private Partner;

b) non-payment by the Public Authority of amounts due to the Private Partner;

c) transfer by the Public Authority of its rights under the PPP contract in breach of relevant provisions; and

d) breaches of obligations by the Public Authority in a way or to a degree that materially and adversely affects the ability of the Private Partner to perform the contract.

A change in legal status of the Public Authority or a change in its creditworthiness would not usually give rise to termination of the PPP contract.

13.2.2 Overview of compensation provisions

In most PPPs, the Private Partner has the right to terminate the PPP contract for Public Authority default (which should be defined). Where there are no express provisions in the PPP contract, the Private Partner may look to general legal principles or specific provisions in law that lead to an outcome similar to jurisdictions where termination rights are provided in the PPP contract.

The Public Authority will normally also have the unilateral right to terminate the PPP contract either *at will* (i.e. regardless of the performance of the PPP contract) or on public interest grounds.

Compensation to the Private Partner for Public Authority default is often treated in the same manner as compensation for voluntary termination. The compensation arrangement will generally contain the following three main components:

a) senior debt;

b) equity and subordinated debt; and

c) third party costs (subcontractor break costs and redundancy payments).

13.2.3 Method of calculation

- **Senior debt**

  This component includes accrued interest and break costs (including hedging break costs) in addition to other commonly included elements such as default interest accrued up until the date of payment of termination compensation.

Equity and subordinated debt

In most cases, the Public Authority will decide at tender stage how the equity is to be compensated. Alternatively (and much less common) tenderers may be invited to decide on a method of calculating equity compensation. This alternative approach can enhance the value for money in the tender offers.

The amount compensated on termination is usually calculated using either:

a) a **base case IRR approach**. This pays the Private Partner an amount sufficient to ensure that the equity return over the entire term of the PPP contract remains equal to the base case equity return (i.e. the equity return projected at the start of the project); or

b) a **market value approach** (i.e. what a third party would pay for the equity). This calculates equity compensation on the assumed basis that the PPP contract had not been terminated and the equity had been sold in the open market. Ultimately, the amount of compensation payable will require agreement between the parties and, in the absence of an agreement, referral to dispute resolution; or

c) a **future base case IRR approach**. This calculates the value of the equity by using the original base case equity IRR to value the equity for the remaining term of the PPP contract.

The main differences between a), b) and c) can be summarised as follows:

- Option a) values the equity at the value it was expected to create at the outset of the project (the *Base Case IRR*). In other words, if the return on equity investment prior to the point of termination exceeded the Base Case IRR, the amount of compensation payable on termination will be less than it otherwise would have been if the return on equity investment prior to the point of termination had been lower than the Base Case IRR.

- Option b) may be considered to reflect the *true* value of the equity, given that the price paid reflects both the positive impact on value of any strong performance of the project, as well as the negative impact on value caused by any weak performance of the project.

- Option c) ignores the historic performance of the project when calculating the value of the equity. The equity is valued on the basis of the Base Case IRR for what would have been (in the absence of termination) the remaining term of the PPP contract.

Third Party costs

Compensation for Public Authority default or voluntary termination will normally cover subcontractor break costs and redundancy payments for employees of the Private Partner (or its subcontractors) who have lost their jobs.

Legislation on Default/voluntary termination

General: in Albania, Republika Srpska and Serbia, Public Authorities have a right to terminate the contract unilaterally on public interest grounds.

Albania

The PPP and Concession Law provides for early termination by each party, for example in the cases of impossibility of performance or unremedied default. The termination rights of the Private Partner are provided in the PPP contract. General rules on rights of termination for contracts are also set out in the Albanian Civil Code.

The Albanian PPP and Concessions Law and case law are silent on compensation for termination for Public Authority default and for voluntary termination. The Albanian Civil Code states that the damages to be paid in the event of termination of a contract for counterparty default cover all losses in respect of diminution of the relevant property and lost profit that could have been generated in normal market conditions[40]. In the Albanian counsel's view, damages would also include the losses of a subcontractor requiring payment by the Private Partner and redundancy payments for employees.

Bosnia and Herzegovina - FB&H (HNC)

Under the HNC Law on PPP, termination rights are a mandatory element of a PPP contract. Third party costs may be recovered only under general contract law.

Bosnia and Herzegovina - RS

The RS Law on PPP leaves it to the parties to determine the termination rights in a PPP contract. Third party costs may be recovered only under general contract law.

Former Yugoslav Republic of Macedonia (FYROM)

The Macedonian PPP Law provides specific provisions for the termination rights of both parties[41]. In most cases, the PPP contract contains the same provisions or further specifies the grounds for termination. There are no explicit provisions regarding compensation. Any compensation would be awarded based on the general rules on compensation or any applicable provisions in the contract.

40 Article 486 of Albanian Civil Code.

41 Articles 44 and 45 of the Macedonian PPP Law.

Kosovo*

The PPP Law does not provide for rules on the termination rights of the Private Partner. These rights are agreed in the PPP contract[42]. The PPP Law is silent on damages payable upon termination for Public Authority default or voluntary termination.

Montenegro

Termination rights are provided for in the PPP contract. In the absence of contractual provisions, general rules on termination would apply. Montenegrin law does not regulate compensation for third party costs.

Serbia

The Private Partner may unilaterally terminate the PPP contract in accordance with the PPP Law, the PPP contract and the general rules of contract law. Third party costs may be recovered only under general contract law[43].

The reasons for termination and termination rights are usually set out in the PPP contract. The PPP Law[44] contains a non-exhaustive number of grounds for termination for Government default:

a) *expropriation, seizure or appropriation of assets or the stake of the Private Partner by the Public Authority;*

b) *failure of the Public Authority to make payments due to the Private Partner; and*

c) *non-compliance by the Public Authority with its obligations that significantly obstructs or prevents the Private Partner from carrying out its contractual obligations.*

Special rules set out in the PPP contract, as well as the general rules of contract law apply to the consequences of the early termination of the PPP contract for Public Authority default.

13.3 Compensation on termination for extended force majeure in PPP contracts

All PPP contracts recognise the principle of force majeure and protect (to varying degrees depending on the project) the Private Partner from the consequences of non-performance caused by such events.

[42] Article 48 paragraph 2.18 of the PPP Law.

[43] Articles 154 and 158 of the Serbian Contract Law.

[44] Article 55 of the Serbian PPP Law.

To protect the parties against the effects of an extended force majeure event, the PPP contract may provide that each party has a right to terminate the PPP contract in circumstances where that event has subsisted for an extended period (e.g. six months).

If the PPP contract is terminated for an extended force majeure event, the Public Authority is usually required to pay compensation to the Private Partner.

The common approach taken in PPPs is for the Public Authority to pay the Private Partner enough compensation to repay the senior debt, reimburse equity amounts actually contributed by investors and to pay subcontractors' break costs and redundancy costs. However, the compensation amount does not usually reflect any loss of future income or the market value of the project. The reimbursement of amounts contributed by investors may be net of distributions already paid to investors.

Legislation in the Western Balkan countries: Force Majeure

All Western Balkan jurisdictions recognise the principle of force majeure, changed circumstances *or* impossibility of performing obligations*. More specifically:*

Albania

The Albanian PPP and Concession Law is silent on the calculation of compensation on termination for extended force majeure.

Bosnia and Herzegovina – FB&H (HNC) and RS

The Private Partner would probably not be compensated for any loss of future income or for the market value of the project.

Former Yugoslav Republic of Macedonia (FYROM)

The Private Partner would probably not be compensated for any loss of future income or for the market value of the project.

Kosovo*

The PPP Law states that the parties to a PPP contract may regulate the extent to which either party may be exempt from liability for failure or delay in complying with any obligation under the PPP Agreement owing to circumstances beyond its reasonable control.[45]

Montenegro

Provisions of this type can be enforced if expressly agreed between the parties.

Serbia

The Private Partner would probably not be compensated for any loss of future income or for the market value of the project.

[45] Article 48 paragraph 2.17 of the PPP Law.

13.4 Compensation on termination for corrupt gifts and fraud

Most EU jurisdictions recognise that corrupt gifts and fraud by the Private Partner should lead to termination. This is usually treated as a Private Partner Default under the PPP contract.

Legislation in the Western Balkan countries: Corrupt gifts and fraud

Albania

Under the standard general terms of concession contracts for works[46], the Public Authority may make a claim to the court for the invalidity of the contract if the contractor has committed acts of corruption (i.e. the contractor gives or promises to give, directly or indirectly, to an official or employee, any compensation of any form, employment opportunities or goods, services or cash, for inciting the adoption of an act, decision, or procedure that the contracting Public Authority undertakes in procurement procedures). These general terms do not provide for the calculation of the Private Partner's compensation in this situation.

The Albanian Civil Code indicates that any action that is undertaken, among other things, in breach of a mandatory rule of law or fraudulently is void[47]. All subsequent actions would also be void. Consequently, all property given by the parties to each other is transferred to the State budget[48]. However, if one of the parties had acted in good faith, the court may decide that the property should be returned to that party instead of being transferred to the State budget. Corruption and fraud are criminal charges under the Albanian Criminal Code.

Bosnia and Herzegovina - FB&H (HNC)

The laws of FB&H do not explicitly recognise corrupt gifts as a termination event. However, the parties to a PPP contract may provide for corrupt gifts as a termination event. In terms of fraud, the general contract rules list fraud as one of the reasons for annulment of the contract and entitle the deceived party to compensation for damages[49].

Bosnia and Herzegovina - RS

The laws of RS do not explicitly recognise corrupt gifts as a termination event. However, the parties to a PPP contract may provide for corrupt gifts as a termination event. In terms of fraud, general contract rules list fraud as one of the reasons for

[46] Article 4 of the Albanian Standard General Terms of Concession Contracts for Works.

[47] Article 92 of the Albanian Civil Code.

[48] Article 106 of the Albanian Civil Code.

[49] Article 65 of the FB&H Law on Obligations.

annulment of a contract and entitle the deceived party to compensation for damages[50].

Former Yugoslav Republic of Macedonia (FYROM)

Under the Macedonian Law on Prevention of Corruption[51], corruption constitutes standalone grounds for declaring a contract null and void. Any person with legal interest can apply for annulment of corrupt legal acts by submitting a final court decision confirming the existence of corruption. The question of whether the Private Partner would be compensated in such a case remains open.

Kosovo*

The PPP Law is silent on corrupt gifts and fraud as termination events in PPP contracts. Under Law 2004/34 on Suppression of Corruption (Article 7), legal acts that result from acts of corruption are invalid. Any person who suffered damage from corrupt acts may claim compensation.

Montenegro

Montenegrin laws recognise fraud and corrupt gifts as grounds for the annulment of a concession contract. The Law on Administrative Procedure[52] stipulates that a contract entered into as a result of force, extortion, blackmail, pressure or other illegal acts is void. Fraud and corrupt gifts fall within the scope of illegal acts, since both represent criminal activities under the Criminal Code[53]. The consequences of the annulment are (i) restitution and (ii) damage compensation (if any). Only a party that has not been aware of and could not be aware of the grounds for annulment is entitled to claim compensation for damages. Compensation is the sum of actual damage and lost profit.

Serbia

The Serbian PPP Law does not contain provisions in relation to termination of the PPP contract for corrupt gifts and fraud. However, this may be grounds for termination and compensation based on general contract law rules. In terms of fraud, the general contract law rules[54] list fraud as one of the reasons for annulment of a contract, and create a right for the deceived party to claim compensation for damages.

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50 Article 65 of the RS Law on Obligations.

51 Article 46 of the Law on Prevention of Corruption, published in the Official Gazette of the Republic of Macedonia no. 28/2002, as subsequently amended.

52 Articles 28 and 139 of the Montenegrin Law on Administrative Procedure (Official Gazette of Montenegro Nos. 56/14, 20/15, 40/16 and 37/17).

53 Articles 244, 423 and 424 of the Montenegrin Criminal Code ("Official Gazette of Republic of Montenegro" Nos. 70/03, 13/04, 47/06 and "Official Gazette of Montenegro" Nos. 40/08, 25/10, 32/11, 64/11, 40/13, 56/13, 14/15, 42/15, 58/2015 and 44/17).

54 Article 65 of the Serbian Contract Law.

14. Expiry of the PPP contract

A PPP contract will often set out requirements on the handback of the project infrastructure from the Private Partner to the Public Authority at the end of the PPP contract.

These provisions are driven by whether it is the Public Authority or the Private Partner who will take subsequent responsibility for the infrastructure. In most instances (but not all), it is the Public Authority who takes this responsibility. See Box 2.

Box 2 – When the Private Partner assumes responsibility at expiry

In some PPPs (particularly in the accommodation sector), the Private Partner has legal ownership of the project infrastructure during the PPP contract on the basis that the Public Authority will not use the infrastructure when the PPP contract ends.

These types of PPP will often give the Public Authority, at the end of the contract, the right either to extend the duration of PPP contract and/or to purchase the relevant infrastructure. In the absence of the Public Authority exercising any such rights, the relationship between the Private Partner and the Public Authority ends with the end of the PPP contract and the Private Partner has no further obligations to the Public Authority in relation to the infrastructure.

In cases where the Public Authority takes over responsibility for the infrastructure at the end of the contract, it will normally do so without making any additional payment to the Private Partner. The contract will set out provisions to ensure that the infrastructure will be returned to the Public Authority in a condition that it deems acceptable. The effectiveness of these provisions depend on the adequacy of the technical provisions relating to the expected condition of the infrastructure on expiry of the contract. Other important aspects of the *handback provisions* are as follows:

a) the requirement for an independent assessment of the condition of the infrastructure to be undertaken several years (typically 2 to 5 years) prior to the expiry of the PPP contract. The purpose of this assessment is

   - to evaluate the work that will need to be carried out in order for the infrastructure to be handed back to the Public Authority in at least as good a condition as that required under the contract, and

   - to estimate the cost of that work;

b) following the independent assessment referred to in a) above, the Private Partner may be required to establish a fund into which it must pay an amount equal to the estimated cost of carrying out the works established by the assessment. The purpose of the fund is to reassure the Public Authority that there will be sufficient funds available to carry out the necessary works (even if the Private Partner fails to perform them). Accordingly, the PPP contract should state that amounts can only be withdrawn from the fund to pay for work that has been undertaken by the Private Partner for the purposes of complying with the handback-related requirements of the PPP contract;

c) the requirement for any additional security that the necessary funds will be made available (for example, a performance bond or letter of credit); and

d) if the Private Partner fails to carry out the necessary work prior to the expiry of the PPP contract, the Public Authority is permitted to access the funds in the account referred to in paragraph b) or to call in the bond/letter of credit referred to in c) for the purposes of carrying out the this work.

Legislation in the Western Balkan countries: Handback provisions

The extent to which this issue is addressed in the Western Balkan jurisdictions is summarised below.

Albania

The PPP and Concessions Law does not provide for specifics of the hand-over of the project assets after the expiry of the PPP or concession contract. This will be addressed through agreement of the parties in the PPP or concession contract.

Bosnia and Herzegovina - FB&H (HNC)

There are no specific provisions mandatorily required in PPP contracts. However, the HNC Law on Concessions states that in the concession agreement (which may be the underlying contract for the PPP), the parties must, among other things, specify a time and procedure for handing over assets upon expiration of the concession. Similarly, the HNC Law on PPP provides for a provision on the conditions and procedure for handover upon expiry as one of the mandatory elements of a PPP contract.

Bosnia and Herzegovina - RS

There are no mandatory provisions of the RS law in this regard.

Former Yugoslav Republic of Macedonia (FYROM)

There are no specifics mandatorily required under Macedonian PPP law for the handover of project assets after the expiry of the PPP contract. The Macedonian PPP Law[55] only stipulates that the project assets are the property of the Public Authority, unless otherwise agreed in the PPP contract, and the handover of the project assets after the expiry of the PPP contract should be carried out under the terms and in the manner agreed in the PPP contract.

[55] Article 11 of the Macedonian PPP Law.

*Kosovo**

There are no specific mandatory provisions under Kosovo laws with regard to the handover of project assets after the expiry of the PPP contract. Subject to Article 48 paragraph 2.18 of the PPP Law, the PPP contract may provide for the rights and obligations of the parties after the expiration of the PPP contract including the transfer measures.*

Montenegro

Upon the expiry of a concession contract, the Private Partner is required: (i) to perform revitalisation and/or recultivation of the areas degraded by the performance of the concession activity in line with the terms of the concession contract; and (ii) hand over the devices, assets and objects that are built and used for the performance of concession activity in good functional condition and unencumbered, in accordance with the concession contract[56].

Serbia

On termination of a PPP contract, the facilities, equipment, plant and other assets comprising the subject matter of the PPP contract become the property of the Public Authority, unless otherwise stated by the direct agreement between the Public Authority, the Private Partner and the lenders.

The Private Partner surrenders the facility, equipment, plant and other assets, as well as any other facilities that comprise the subject matter of the PPP contract and are owned by the Public Authority, free from any liens and in a condition that provides for their unobstructed usage and functioning[57].

[56] Articles 54 and 55 of the Montenegrin Law on Concessions.

[57] Article 57 of the Serbian PPP Law.

15. Financing matters

15.1 Public Authority participation in financing

Some Public Authorities consider providing some form of financial or credit support to the project in order to:

a) ensure that the project is sufficiently attractive to private investors (i.e. to improve *bankability*);

b) reduce the overall cost of the project to the Public Authority by reducing the overall private financing needs;

c) reduce the Availability Payment (i.e. improve affordability) or

d) address concerns relating to low levels of liquidity in the relevant market (e.g. a concern that there may not be sufficient senior debt, for example from commercial banks, available on the market to finance the project; i.e. improve finance-ability of the project).

The availability of the types of support mentioned above might be limited under applicable laws (including state aid regulations). Common examples of Public Authority participation in the financing of projects include:

a) **milestone payments** to the Private Partner during and/or at the end of construction;

b) provision of a **public-sponsored loan facility** to the Private Partner (potentially on the same terms as commercial bank debt);

c) provision of a full or partial **public guarantee** of some (or all) of the Private Partner's debt, with any subrogated claims of the Public Authority (i.e. claims that the Public Authority would have against the Private Partner if it made a payment under the guarantee) being subordinated to (i.e. having lower ranking than) any claims of the debt providers against the Private Partner;

d) provision of a minimum **revenue guarantee** under the contract, e.g. providing the Private Partner with cash flow certainty through the deductions regime in the context of an availability-based payment structure (see Section 6); or

e) provision of **grant funding** by way of a direct capital payment to the Private Partner. The source of this funding may be from outside the Public Authority (e.g. EU grant).

Legislation in the Western Balkan countries

Albania

Under the PPP & Concessions Law[58], the financial support of the Public Authority is defined as "monetary or non-monetary support and/or financing given from the public sector, including without being limited to subsidies, financial or other guarantees, equity contributions and transfer of ownership rights"[59].

Bosnia and Herzegovina - FB&H (HNC)

Milestone payments by the Public Authority are permissible. Public Authority guarantees are also permitted under the FB&H Law on Debt, Indebtedness and Guarantees to be issued for capital projects, i.e. development projects, and projects for the improvement and construction of infrastructure[60].

Bosnia and Herzegovina - RS

Milestone payments by the Public Authority are permitted by the RS Law on PPP[61]. Exceptionally, the Government may propose another type of contract that will not damage the public interest, in line with the principle of minimal financial exposure of the Public Authority.

Former Yugoslav Republic of Macedonia (FYROM)

All of the above examples of public participation are available under Macedonian law subject to any conditions being set out in the tender documentation, with some of them being subject to the requirements of state aid regulations (e.g. for providing loans and guarantees). In practice, the most likely option is the provision of a minimum revenue guarantee.

*Kosovo**

The Public Authority may grant financial or other support to ensure the sustainability, implementation and/or financial feasibility of the project if it is duly justified and approved in advance by the Public-Private Partnership Committee (PPPC) and by the Minister of Finance. Such support must be specified in the request for proposals[62]. Subject to prior approval by the PPPC, the Government may also provide compensation to the Private Partner if the Private Partner's financial condition is negatively and materially affected by unforeseeable changes in the law

58 Law no. 125/2013, as amended.

59 Article 3.16 of PPP & Concessions Law.

60 Article 53 of the FB&H Law on Debt, Indebtedness and Guarantees.

61 Articles 4 and 10 of the RS Law on PPP.

62 Article 12, paragraph 1 of PPP Law.

that have a direct impact on the public infrastructure or the public services that the Private Partner operates or provides[63].

If the Public Authority is required to incur debt or to provide a guarantee in order to finance any obligations to the Private Partner or state aid rules apply, any such debt or guarantee shall be subject to the Law on Public Debt[64].

Montenegro

The Montenegrin Government can participate in the financing of projects through the options listed under points c), d) and e) above, subject to local state aid rules. While the provision of guarantees and grant funding is directly enabled (with certain restrictions) through the State Aid Law[65], provision of a minimum revenue guarantee under the contract depends on the terms of each individual contract in question. The Montenegrin Law on Concessions[66] is silent on this matter, leaving it to the Public Authority and the Private Partner to negotiate and regulate these matters in a concession contract. In practice, to date none of the options listed above has been commonly used.

Serbia

The conditions under which the Government of Serbia may issue guarantees are regulated by the Serbian Law on Public Debt[67]. The Government may only issue state guarantees for debt arising from the credit arrangements of local authorities and legal entities that are founded by the state. These guarantees must be provided for in the budget for the relevant year and can only apply in respect of loans for capital investments, not for liquidity financing. State guarantees are provided in the form of a law.

The other types of Public Authority participation in financing are available under applicable laws but may be subject to certain restrictions based on other sectoral or state aid laws. However, the provision by the Public Authority of a loan facility to the Private Partner is not common practice in the Serbian PPP market.

15.1.1 Milestone payments

A PPP contract may require the Public Authority to make payments to the Private Partner before construction is completed. *In no circumstances should the Public Authority pay more to the Private Partner than has been expended by the Private Partner.*

63 Article 12, paragraph 3 of PPP Law.

64 Article 12, paragraph 4 of PPP Law.

65 Article 7 of the Montenegrin State Aid Law ("Official Gazette of Montenegro" Nos. 74/09 and 57/11).

66 Law on Concessions (Official Gazette of Montenegro No. 08/09).

67 Article 16 of the Serbian Law on Public Debt ("Official Gazette of the Republic of Serbia", No. 61/2005, 107/2009, 78/2011 and 68/2015).

Examples of approaches to milestone payments include:

a) the Public Authority makes a substantive payment to the Private Partner shortly after Contract Close or Financial Close, to help the Private Partner meet its initial development and mobilisation costs.

b) the Public Authority makes a series of payments to the Private Partner during the construction phase of the project, with each payment being conditional upon the Private Partner achieving clearly defined milestones in the progress of the construction.

c) in a multi-phased project, the Public Authority makes a substantial payment to the Private Partner on completion of each phase and at the end of the construction phase.

15.1.2 Public-sponsored loan facilities

The Public Authority (or perhaps another public body) may consider making a loan to the Private Partner:

a) where there is insufficient liquidity in the senior debt market. The Public Authority (or other public body) will make a loan to the Private Partner at commercial market rates, i.e. on the same terms as the senior lenders.

b) to reduce the overall cost of the financing.

15.1.3 Public guarantees

Three principal categories of public guarantees are commonly used in PPPs:

a) provisions included in the PPP contract that have the effect of guaranteeing a minimum level of revenue to the Private Partner (i.e. the Public Authority does not issue a separate guarantee document, but has an unconditional payment obligation under the PPP contract);

b) where the Public Authority (or other public body) issues a separate guarantee to a third party provider of debt that improves the credit quality of the debt and enables the project to benefit from a lower cost of capital; and

c) (in exceptional cases) the Public Authority may provide a *refinancing guarantee* which provides the Private Partner with protection if it is unable to refinance its debt at a pre-determined price by a certain date.

Legislation in the Western Balkan countries

In relation to guarantees described in paragraph c) above:

Kosovo*

The State (acting through the Minister of Finance) may issue state guarantees in support of the loan obligations of private entities that are financing public infrastructure projects or projects relating to an economic sector of strategic and social importance to Kosovo, including a Private Partner in a project. State guarantees are subject to ratification by a two-thirds majority vote of all members of the Kosovo* Assembly[68].*

Bosnia and Herzegovina - RS

A state guarantee may be issued to a creditor or lender for the loan obligations of a legal entity incorporated in Bosnia and Herzegovina for implementation of priority projects of special importance for the economic stability of Republika Srpska. It might be argued that the Government (the State) could provide a statutory guarantee for the loan obligations of the project Partner if a PPP project satisfied the above criteria.

15.2 Interest rate risk

Interest rate risk generally sits with the Private Partner. To address any exposure that it may have to floating interest rates, the Private Partner will hedge its exposure through the use of long-term fixed/floating interest rate swaps.

The following approaches may be taken to allocating interest rate risk between the parties:

a) the Public Authority takes the risk/reward associated with fluctuations in the underlying *reference interest rate* (i.e. EURIBOR or LIBOR) during the period between the date that the Private Partner submitted its bid and the date of Financial Close. It seems that this approach represents the best value for money. (This appears to be on the basis that, in the absence of such a mechanism, the Private Partner would most likely include a significant buffer in its bid price to protect against what may be perceived as the worst case scenario with respect to fluctuations in interest rates);

b) during high interest rate periods (e.g. during the global financial crisis, when liquidity levels for long-term debt dropped significantly, resulting in consequential increases in the cost of long-term debt), the Public Authority may decide to include the right to require the Private Partner to undertake a refinancing, with any resulting refinancing gain (i.e. a financial gain earned from the lower price of the new debt) being mainly for the benefit of the Public Authority;

68 Article 19 of Law No. 03/L-175 “on Public Debt”.

c) the Public Authority retains the risk/reward of fluctuations in the underlying reference interest rate beyond Financial Close and during the term of the PPP contract. In these cases, the cost to the project of the underlying interest rate is passed through to the Public Authority and the Availability Payment is adjusted to ensure that the Private Partner's revenues provide a natural hedge against fluctuations in the underlying reference interest rate.

15.3 Exchange rate risk

Exchange rate risk can arise where there is a mismatch between cash flows in the PPP project that are in different currencies (for example when Availability Payments are made in the local currency and debt service payments in a foreign currency). This is particularly an issue where there is a lack of liquidity in local currency markets and/or the exchange rate is volatile.

The exchange rate issue is also closely linked to interest rate risk (discussed above). PPP projects typically require debt service payments to be largely fixed (i.e. known) at Financial Close, so as not to expose the Private Partner's financial standing to interest rate movements for the duration of the contract.

Fixing the interest rate on the debt typically involves an interest rate swap arrangement that is put in place at Financial Close. However, the swap markets for long-term debt tend to be very constrained when the debt is not denominated in a major *reserve currency* (e.g. EUR, GBP, USD, JPY). In other words, even when debt can be raised in local currency, the swap markets are often too limited to allow the interest rate on that debt to be turned into fixed rate.

Four principal approaches are generally adopted in European PPP markets to address this issue.

a) The Availability Payment is denominated in the local currency and the project is financed in a reserve currency; long-term currency risk is taken by the Public Authority.

   The PPP is financed in the reserve currency and the Private Partner bears interest rate risk for the duration of the PPP contract. The Private Partner manages that risk through an interest rate swap. The Availability Payment is made in the local currency, but the amount paid (adjusted for any deductions) is reset periodically to reflect exchange rate changes between the local and reserve currencies. The Public Authority therefore takes the risk of any long-term movements in the exchange rate.

b) The Availability Payment is denominated in the local currency and the project is financed in local currency; long-term interest rate risk is taken by the Public Authority.

   The PPP is financed in the local currency, the assumption being that the market will support the full amount of the loan at the required tenor. The Private Partner bears interest risk for a fixed, short-term period (e.g. five years) where hedging is available at an affordable cost. The Availability Payment is also made in the local currency. The amount to be paid is reset periodically after Financial Close (e.g. every three to five years) throughout the duration of the contract to reflect changes in the underlying base interest rate. The Public Authority assumes the risk of any interest rate movements on a periodic basis over the contract term.

c) The Availability Payment is denominated in local currency and the project is financed with shorter tenor finance in the local currency; refinancing risk is taken by the Public Authority.

   The PPP is financed in the local currency, but for a shorter tenor than the contract length, e.g. eight to ten years. The Private Partner bears interest rate risk for the tenor of the loan, assuming interest rate hedging is available at an affordable cost for such a term. The project is refinanced at the end of the initial financing period, with the Public Authority taking the risk of the availability of new debt financing at an affordable cost.

d) The Availability Payment is denominated in both the local and reserve currencies and the project is financed in the reserve currency; long-term currency risk taken by the Public Authority on the reserve currency-denominated portion of the payment.

   The project debt is raised in the reserve currency. The Private Partner bears the interest rate risk on that amount for the duration of the contract (managed through an interest rate swap). The Public Authority assumes the exchange rate risk for the part of the Availability Payment which is related to the project costs denominated in the reserve currency (e.g. debt service). The actual periodic Availability Payment may be made in either the reserve or local currency. If made in the local currency, the Availability Payment is adjusted periodically to reflect the prevailing exchange rate.

   The remaining part of the Availability Payment is denominated in the local currency is paid in that currency. This proportion of the Availability Payment will usually reflect, as closely as possible, the operating costs that are incurred in the local currency so as to create a natural hedge. If this is not possible, some long-term interest rate risk may need to be assumed by the Public Authority (see options b) and c) above).

Depending on the approach adopted, the procurement process may require some adaptation, especially if committed financing is to be required with the final bids. Alternatively a preferred-bidder funding competition could be held after receipt of final bids.

16. Step-in rights

16.1 Overview

Step-in rights make it possible for someone to step into the place of a defaulting party so that it may rectify a default and prevent termination of the contract.

There are two principal types of step-in rights in PPPs:

a) Public Authority step-in rights; and

b) lender step-in rights.

16.2 Public Authority step-in rights

The PPP contract may provide for the Public Authority to temporarily take over responsibility for (or *step in* to) the provision of the services that the Private Partner is responsible for providing under the PPP contract.

Public Authority step-in rights in a PPP contract generally permit step-in for the following reasons:

a) where it is in the public interest to do so, e.g. where there are health and safety concerns, issues of national security and/or the Public Authority needs to step in in order to fulfil a statutory duty; or

b) where the Private Partner is in default of the PPP contract and the Public Authority proposes to step-in to avoid termination of the PPP contract.

Step-in rights in the PPP contract will also require that the Public Authority:

a) provide prior notice to the Private Partner of its intention to step-in (and in some cases, also to the lenders);

b) only to step-in for a period of time that is reasonably to address the issue that gave rise to the step-in; and

c) limit its actions to addressing the issue that gave rise to the step-in.

At the same time:

a) the PPP contract might require the Public Authority to continue pay the Availability Payment to the Private Partner. If the cause of the step-in is the Private Partner's breach of the PPP contract, the Public Authority will be entitled to deduct the costs that it reasonably incurred during the period of step-in from such payments;

b) where the step-in arises as a result of the Private Partner being in default , the Public Authority might be permitted to enter into binding contracts or to use third parties (on the Private Partner's behalf) for works or services during the period of step-in (this right may be time-limited); and

c) where the Public Authority notifies the lenders of its decision to step in to the PPP contract, the lenders may have a right to avoid such a step-in by deciding to exercise their own step-in rights.

Legislation in the Western Balkan countries: Step-in rights

Albania

The PPP and Concession Law does not provide the Public Authority with step-in rights. These rights may be agreed in PPP contracts.

Bosnia and Herzegovina

The relevant laws do not provide the Public Authority with step-in or similar rights.

Former Yugoslav Republic of Macedonia (FYROM)

There are no explicit provisions under Macedonian law in this respect. However, there is no restriction on PPP contracts including those rights.

Kosovo*

A PPP contract may regulate these matters[69].

Montenegro

Montenegrin laws do not provide for Public Authority step-in rights or any similar rights.

Serbia

Under the Serbian PPP Law[70], a PPP contract may enable the Public Authority to suspend agreements fully or partially or assume the relevant obligations of the Private Partner to protect the public interest, public safety, the environment or public health, or if the Private Partner has breached the contract.

16.3 Lender step-in rights

Lender step-in rights can generally only be exercised when the Private Partner has defaulted or is at significant risk of default under the PPP contract, and this is likely to result in termination.

For lenders, step-in rights provide the benefit of time and flexibility to fix whatever the Private Partner has done to risk termination of the project. At best, step-in rights can

69 Article 48, paragraph 2.22 of PPP Law.

70 Article 46 of the Serbian PPP Law.

benefit all parties, i.e. lenders have a chance to protect their investment and the Public Authority and users of the infrastructure may benefit from continuity of the project.

The Public Authority's immediate concern is to ensure that, if step-in occurs, both the risk allocation and the service provision are preserved and that the step-in does not make the situation worse and result in the Public Authority receiving back an asset that it can do nothing with.

In giving lenders step-in right, the Public Authority will want to ensure that:

- someone is still responsible for the breaches committed up to the point of the step-in;
- someone remains responsible for the breaches committed during the step-in period;
- a time limit is imposed on the lenders' attempts to remedy the Private Partner's defaults; and
- limits are placed on the actions that the lenders can take (e.g. in particular on the identity and nature of any temporary or permanent substitutes of the Private Partner that the lenders may put in place).

Lender step-in rights are often facilitated through a *direct agreement* between the Public Authority, the Private Partner and the lenders (or a representative of the lenders).

Where granted the ability to step-in, lenders are permitted to exercise the rights of the Private Partner under the PPP contract, but must also assume certain liabilities of the Private Partner. For example, lenders may be required to pay or ensure the payment of outstanding amounts owed by the Private Partner to the Public Authority.

To incentivise the lenders to step-in, the Public Authority will undertake, in the direct agreement, not to terminate the PPP contract during step-in. This can reassure lenders that they will have a reasonable period to rectify the poor performance issues. The Public Authority will, however, normally reserve the right to terminate the PPP contract for any new breaches that occur during the period of step-in.

The Public Authority's consent is usually required as a condition precedent to the lenders taking action to transfer the PPP contract to a replacement Private Partner or to replace key subcontractors on the project. The Public Authority's right to object to the lenders' proposals to take any such action will be limited and defined objectively in the direct agreement or PPP contract. This allows lenders to understand the circumstances in which the Public Authority's consent would most likely be withheld.

In addition to these step-in rights, lenders will often have the right to take over the operation of the Private Partner by enforcing a pledge over the Private Partner's shares (which is a standard element of a lender's security package in project financing) and replacing the management of the Private Partner.

Legislation in the Western Balkan countries: Lender step-in rights

Albania

Lenders' step-in rights are not specifically covered by the PPP and Concessions Law. However, this law states that the Public Authority may enter into additional agreements aiming to secure the relevant financing of the project[71]. Additional agreements (known as "direct agreements") concluded between the Public Authority, the Private Partner and the lenders typically provide for lenders' step-in rights.

Bosnia and Herzegovina - FB&H (HNC)

The HNC Law on PPP does not provide for lenders' step-in rights. The HNC Law on Concessions provides for the general possibility of transferring the concession rights, but it is questionable whether this possibility could be used to enable the lenders to step in if the Private Partner cannot fulfil its obligations.

Bosnia and Herzegovina - RS

The RS Law on Concessions[72] provides for lenders' step-in rights where the Private Partner cannot fulfil its obligations. The RS Law on PPP[73] also allows the parties to transfer rights and obligations of the Private Partner to a third person, with the consent of the Public Authority.

Former Yugoslav Republic of Macedonia (FYROM)

Under the Macedonian PPP Law[74], a PPP contract may provide step-in rights to the lenders if the step-in does not negatively affect the operation of the project, the quality of services or the price. The Public Authority, the Private Partner and the lenders may also enter into a direct agreement.

*Kosovo**

Under the PPP Law, a PPP contract may regulate all matters that the parties deem appropriate, including lenders' step-in rights[75].

Montenegro

Lenders are not granted step-in rights under applicable law, though step-in rights can be agreed by contract.

71 Article 27 of PPP and Concessions Law.

72 Article 40 of the RS Law on Concessions.

73 Article 14 of the RS Law on PPP.

74 Article 42 of the Macedonian PPP Law.

75 Article 48, paragraph 2.22 of PPP Law.

Serbia

Under Serbian PPP Law[76], the Public Authority may agree that the lenders shall be authorised to take the place of the Private Partner, temporarily exercise all of its rights under the PPP contract and remedy any breach caused by it. However, the Public Authority may unilaterally terminate the PPP contract if the Private Partner transfers its rights under the PPP contract to a third party without the Public Authority's prior approval.

[76] Articles 49 and 54 of the Serbian PPP Law.

17. Government influence

17.1 Overview

From a Public Authority's perspective, one of the most important objectives in the project is to protect the public interest. It will therefore want some degree of influence over the Private Partner's actions and conduct, which it can achieve in two main ways:

- **Influence through the PPP contract**: by incorporating provisions in the PPP contract that require the Private Partner to obtain the Public Authority's approval or consent before taking certain actions. This is the most common approach adopted by Public Authorities; and

- **Participation in the Private Partner's governance or operation**: by investing voting equity in the Private Partner, the Public Authority has the ability to vote at shareholder meetings, to access information relating to how decisions are made and (to the extent that the Public Authority has the right to appoint a member to the board of the Private Partner) involvement in decision-making. This approach is not common and, where used, is usually combined with influence through provisions in the PPP contract.

17.2 Influence through the PPP contract

PPP contracts will normally include provisions that require the Private Partner to obtain the prior approval of the Public Authority for taking certain actions. Although the Public Authority cannot generally prevent the Private Partner from taking action, the Private Partner will be in breach of the PPP contract if it does so without the Public Authority's prior approval. Any such breach will usually constitute a Private Partner default and might allow the Public Authority to terminate the contract.

The following actions would typically require the approval of the Public Partner:

- **Changes to the Private Partner's constitution**: the Private Partner is likely to be a special purpose entity established for the sole purpose of carrying out the project. From a Public Authority's perspective, this means that its counterparty to the PPP contract is not exposed to a risk of insolvency from carrying out any business activity that is not directly related to the PPP project.

  Many Public Authorities believe that this is an important feature of the structure of projects and so are interested in ensuring that the position does not change over the term of the PPP contract. Accordingly, many PPP contracts include provisions that require the Private Partner to obtain the Public Authority's prior approval for:

  a) changes to the Private Partner's constitutional documents;

  b) changes to the Private Partner's tax domicile;

  c) undertaking business that is not related to the project; and

  d) changing the Private Partner's name.

- **Changes to key personnel**: the PPP contract may identify key individuals (representatives of the Private Partner and/or its subcontractors) who will be responsible for delivering the project, and may detail the extent to which they will work exclusively on the project. The PPP contract will require notification and/or the Public Authority's consent to any changes to the key personnel.

- **Amendment, termination and renewal of key subcontracts**: during the procurement of the project, the Public Authority will evaluate the experience and financial standing of the Private Partner and certain members of its supply chain (e.g. its proposed subcontractors). Given the importance of the identity of the key subcontractors to the success of the project, the PPP contract will often include provisions requiring the Private Partner to obtain the Public Authority's prior approval before it:

  a) makes material amendments to key subcontracts;

  b) terminates a key subcontract; or

  c) enters into a new subcontract.

- **Refinancing**: the contract will usually require the Private Partner to obtain the Public Authority's prior written consent (not to be unreasonably withheld or delayed) to any refinancing of its senior debt.

- **Gearing**: most Private Partners finance the project through a combination of debt and equity. The *gearing* of the project is the ratio of debt to equity. (A *highly geared* project will have a high level of debt to equity, e.g. 90%).

  Some PPP contracts restrict the Private Partner's gearing (for example, that gearing must not increase above 90% without the Public Authority's prior approval). In some countries, similar restrictions (e.g. minimum levels of capitalisation) exist in law, but, in contrast to contract provisions referred to above, these are general in nature rather than specific to PPP projects.

- **Change in ownership of the Private Partner**: during the procurement of the project, the Public Authority will have evaluated the experience and financial standing of the Private Partner's shareholders (or equivalent, if the Private Partner is not a company). Once the PPP contract is signed, the Public Authority will wish to ensure that the shareholders as proposed at tender stage do not change to the detriment of the project.

  The Public Authority may be less concerned about changes of shareholders in later stages of the PPP contract, particularly once the construction phase of the project has completed. If this is the case, the PPP contract might, for example, approach changes of ownership in the following ways:

  a) the Public Authority has an absolute right of approval for any change in the ownership of the Private Partner before the end of defined period equal to the construction phase plus a fixed period (usually up to 5 years). After this period, the Public Authority's approval rights focus principally on matters of public policy (see (c) below).

b) Some PPP contracts distinguish between different classes of shareholder in the Private Partner with different approval rights applying for each class. For example, a Public Authority might focus its rights of approval on the disposal of equity interests by shareholders that are also involved in the delivery of the project (e.g. construction contractors), as opposed to shareholders that have no active participation in the project beyond investing equity.

   It is less common for the Public Authority to have rights of approval over the transfer of equity interests by an entity providing long-term FM services to the Private Partner. However, it might look for a right of approval if the transfer of equity would have a material and adverse effect on the Private Partner's ability to perform its obligations under the PPP contract.

c) Many PPP contracts include rights of approval over any change in the ownership of the Private Partner (regardless of the timing of the proposed change) where the proposed shareholder is engaged in business that raises public policy concerns (e.g. involved in weapons manufacture). The concerns should be described objectively in the PPP contract, to provide some certainty to the Private Partner of the circumstances in which the Public Authority's prior approval would be required.

- **Identity of insurance provider**: the Public Authority often has the right to approve the identity of the Private Partner's insurer before placing the relevant insurance. This requirement normally only applies to insurance policies in which the Public Authority is a named insured party.

  This needs to be considered alongside local laws that might require primary insurance to be taken out with local insurers. Where such laws apply, lenders to the PPP will often require additional insurance to be placed on the international market and to be able to have direct access to insurance proceeds through the project security structure if the local insurer becomes insolvent.

17.3 Participation in the Private Partner's governance/operation

A decision by the Public Authority to invest in the Private Partner is generally taken as a matter of public policy.

Although not widespread practice, observations on how this has been approached in some jurisdictions include:

a) the Public Authority has a minority equity stake (ranging from 10% to 30%) but had the right to appoint one member to the board of the Private Partner.

b) The Public Authority invests equity on an arm's-length basis and on terms consistent with those typically required by a commercial party taking a minority equity position in a Private Partner. This gives the Public Authority flexibility to sell its equity investment during the term of the project.

c) a Shareholders' Agreement (or similar document) sets out the rights associated with the Public Authority's interest in the Private Partner, the basis upon which the Private Partner should make decisions and the rights of each shareholder relative to these decisions.

d) The Shareholders' Agreement contains *conflict of interest* provisions, which focus on ensuring that the Public Authority (and its appointed representative(s)) does not have the right to attend board meetings or vote on motions where a conflict of interest arises.

e) Relevant corporate law provides varying levels of protection for minority shareholders, meaning that the protections provided to the Public Authority (in its capacity as a minority shareholder) are often a combination of those set out in the Shareholders' Agreement and those protections provided by law. Examples of Private Partner decisions that require the support of all shareholders (including minority shareholders such as the Public Authority) include:

- changing the Private Partner's constitutional documents;
- publicly listing the company;
- changing the Private Partner's dividend policy;
- buy-back of shares;
- changes to the classification of any shares or the rights attached to any class of shares;
- any increase in the indebtedness of the Private Partner;
- granting of loans or charitable donations by the Private Partner;
- commencement of insolvency proceedings; and
- entering into a contract with a shareholder (or affiliate of a shareholder) that is not on arm's-length commercial terms.

18. Miscellaneous provisions

18.1 Overview

Aside from the specific types of provision addressed in this guide, the PPP contract also includes a series of standard provisions that deal primarily with common legal issues such as:

a) a dispute resolution procedure;

b) managing confidentiality issues and *Freedom of Information (or FOI)* requirements;

c) restrictions on assignment of the PPP contract; and

d) compliance with the prevailing laws.

18.2 Dispute resolution procedures

The PPP contract will include provisions that set out the agreed basis upon which any disputes in connection with the PPP contract are to be resolved or determined.

The approach taken to these provisions will often depend on the Public Authority's broader policies in this respect.

There are two principal approaches to dispute resolution, namely:

a) referral to the courts determine any disputes in accordance with the rules of procedure and any relevant laws; or

b) arbitration as the means for final determination of disputes, with the chosen seat for the arbitration being outside the relevant jurisdiction.

Notwithstanding the use of either the courts or arbitration for the final determination of disputes, the PPP contract might also include alternative forms of dispute resolution procedure. In this case, the parties will seek to use an alternative procedure (e.g. mediation or dispute resolution board) before resorting to the courts or to arbitration.

Dispute resolution boards are commonly used in PPP projects in EU. At the start of the contract, the parties appoint independent experts to a panel (the board) that will, if requested by either party, provide an opinion and or judgment on matters of dispute between the parties. A judgment made by the board is usually non-binding with the referral of any dispute to the board being without prejudice to either party's right to refer the dispute to the courts or arbitration (as relevant).

18.3 Confidentiality provisions and Freedom of Information requirements

It is common for parties to any commercial contract to mutually agree (subject to limited exceptions) to keep all matters related to the contract and the administration of the contract confidential. Both parties to a public contract (including PPP contracts) generally wish to keep all matters related to the contract confidential. This principle of maintaining confidentiality is often subject to national or local constitutional rights of the public, freedom of information or right to know laws of the relevant jurisdiction.

However, there can be exceptions to these types of rights and laws that the Public Authority (and/or the Private Partner) might be able to rely on if it is faced with a request for disclosure of information relating to the PPP contract or project (e.g. interests of national security, trade secrets or business-critical information).

Legislation in the Western Balkan countries: Confidentiality and FoI

In some Western Balkan countries, the right for a person to access information held by the government is a constitutional right, sometimes supplemented by statute. In others, the right to access information held by government is provided through freedom of information and/or right to know laws. Most constitutional or legal rights relating to access to government information reflect the principle that government should be bound by a duty to publish and promote openness and transparency.

Albania

Any person has the right to access public information[77]. This principle is subject to some exceptions[78] (e.g. interest of national security, trade secrets).

Bosnia and Herzegovina - FB&H (HNC)

Generally, every person has the right to access information in the control of a Public Authority, and each Public Authority has a corresponding obligation to disclose such information. However, the Public Authority may exempt certain information from this rule if that information represents the confidential commercial interests of the third party[79].

Bosnia and Herzegovina - RS

As a rule, every person has a right to access information under the control of a Public Authority. Public Authorities are obliged to provide such information upon request from any interested person. However, a relevant Public Authority may exempt certain information from this rule, e.g. if that information represents the confidential commercial interests of the third party. The third party in question must prove that it would suffer damage if that information were revealed[80].

Former Yugoslav Republic of Macedonia (FYROM)

[77] Article 3 of Law 119/2014 on the Right of Information.

[78] Article 17 of Law 119/2014 on the Right of Information.

[79] Article 7 of the FB&H Law on Free Access to Information of Public Character (Official Gazette of Bosnia and Herzegovina, No. 28/00, 45/06, 102/09 and 62/11).

[80] Article 7 of the RS Law on Free Access to Information of Public Character (Official Gazette of Bosnia and Herzegovina, No. 28/00, 45/06, 102/09 and 62/11).

The PPP contract could be made available to the public through the Macedonian Law on Free Access to Information of Public Character[81]. Additionally, a draft contract is available as part of the tender documentation published on the relevant electronic system for public procurement.

Kosovo*

Any person has the right to access official documents maintained by public institutions[82], save for certain exemptions[83].

Montenegro

The Montenegrin Constitution[84] guarantees the right to access information held by Public Authorities, which can be limited only in certain cases (e.g. for the protection of life, public health, morals and privacy).

Serbia

Any person has a right to access information under the control of a Public Authority. Public Authorities are obliged to provide such information upon request from any interested person, unless the Public Authority proves that there is no reasonable interest for requiring the information. Public Authorities may exempt certain information from that general rule, e.g. if that information is of a confidential nature to a third party.[85]

18.4 Restrictions on assignment of the contract

The PPP contract will include provisions relating to each party's ability to assign (or transfer) the PPP contract to a third party. If either party fails to comply with any restrictions on assignment, the other party will have the right to terminate the contract for default. Restrictions on assignment give the parties certainty as to the identity of their counterparty and prevent a situation where the PPP contract could be assigned to a third party less financially or technically capable of performing the PPP contract than the original party.

While the PPP contract will also include an absolute prohibition on the Private Partner's ability to assign the PPP contract to a third party, this does not normally extend to the Private Partner granting security interests to its lenders. It is typically also without prejudice to the terms of any direct agreement entered into between the Public Authority and the Private Partner's lenders.

[81] Law on Free Access to Information of Public Character (Official Gazette of the Republic of Macedonia no. 13/2006), as subsequently amended.

[82] Articles 1 and 2 of Law No. 03/L –215 on Access to Public Documents.

[83] Article 12 of Law No. 03/L –215 on Access to Public Documents.

[84] Article 51 of the Constitution of Montenegro ("Official Gazette of Montenegro" No. 01/07).

[85] Article 4 and 14 of the Serbian Law on Free Access to Information of Public Character (Official Gazette of Republic of Serbia, No. 120/2004, 54/2007, 104/2009 and 36/2010).

Given the long-term nature of PPP contracts, many acknowledge that changes to the Public Authority organisation could result in the need for the PPP contract to be assigned to a successor public entity. The PPP contract might include provisions enabling the Public Authority to assign the PPP contract to a third party, provided that the Public Authority either guarantees the obligations of its successor under the PPP contract or the successor entity is of similar financial standing to the Public Authority.

Despite such provisions in the PPP contract, it is generally recognised by the private sector that government is always at liberty to pass legislation that invalidates the effectiveness and enforceability of such restrictions in the event of an assignment of the contract by the Public Authority to a third party. Accordingly, Private Partners generally recognise the risk of assignment of the PPP contract by the Public Authority to a third party as a normal political risk.

18.5 Compliance with Laws

In most cases, each party to the PPP contract will be required to perform its obligations under and pursuant to the contract in accordance with all relevant laws. If either party breaches such an obligation, the other party may pursue any legal remedies (contractual or non-contractual) that it may have in respect of such a breach.

Glossary of main terms and expressions

Affordability

Affordability relates either to the ability of the Public Authority to make performance-based payments to the Private Partner from the public budget (in *a government-pay PPP*) or the ability and willingness of users to pay the tariffs/tolls charged by the Private Partner (in a *concession*).

Availability payment (and availability-based PPP)

In an availability-based PPP (a type of *government-pay* PPP), the Public Authority pays the Private Partner for the provision and use of public infrastructure and related public services. Payment is linked to the availability of the asset and/or the services for the duration of the PPP contract (the *availability payment* or *unitary payment/unitary charge*). The availability standards and service requirements of the Public Authority are defined in the PPP contract.

In most contracts of this type, payment to the Private Partner only starts once the construction phase is complete and the services can be delivered.

Bankable (and bankability)

A PPP project is considered bankable if lenders are willing to finance it.

Candidate

A company or group of companies (usually in the form of a consortium or joint venture) that submits a response to an invitation to pre-qualify for a project as part of the procurement process.

Concession

A concession (sometimes called a *user-pay PPP*) is a type of PPP in which the Public Authority grants a Private Partner the right to generate revenues from the provision of a service. The Private Partner is paid by the users of the service and normally assumes the risk of any change in the users' demand for the service. The service requirements of the Public Authority are defined in the concession contract. (e.g. keeping a bridge open to traffic, collecting tolls from users of a bridge).

Conditions precedent

Conditions that need to be fulfilled before the PPP contract becomes effective or before drawing on the debt. Either party might be responsible for fulfilling the conditions in a particular PPP contract, but the Private Partner usually has a greater responsibility in this respect.

Contract close (and commercial close)

Contract close (sometimes called *commercial close*) is the point at which the PPP contract is signed by the Public Authority and the Private Partner. The main terms of the PPP contract will be completed at financial close.

Credit enhancement

The credit profile of a project finance structure can be improved by various forms of credit enhancement; for example:

- **credit support** in the form of guarantees by the sponsors relating to the performance of the SPV's obligations, financing facilities that provide temporary liquidity to deal with specific risks and insurance against certain project related risks.
- **public sector support** such as direct funding through a capital contribution (e.g. from national, regional or other funds) or contingent support or guarantees for certain types of risks which cannot otherwise be effectively managed or mitigated by the SPV, lenders or subcontractors.

Default (and event of default)

A material breach of contract by one party (including persistent breach) which entitles the other party to terminate the contract. The PPP contract will often define defaults by reference to precise contractual provisions.

Direct agreement

A direct agreement is a contract, linked to the PPP contract, which creates a contractual relationship between participants in the project whose main contractual relationships are with the Private Partner. The principal direct agreement is between the Public Authority, Private Partner and lender and allows the lender to exercise step-in rights to the PPP contract. The Public Authority may also have direct agreements with the Private Partner's sub-contractors that allow it to step-in to the sub-contract in an event of Private Partner default.

Economic Cost Benefit Analysis (ECBA)

The ECBA assesses whether the benefits brought to society by a particular public investment justify and outweigh the implementation costs. It will usually consider the social, environmental, and economic advantages and disadvantages of the investment as well as to the actual monetary costs and revenues generated by the project.

Equity (and equity investors)

The equity in a PPP is the portion of the project's CAPEX that is contributed as share capital in the SPV (i.e. pure equity) and subordinated debt (usually through shareholder loans and sometimes also called *junior debt*). The equity investors (also sometimes called *equity providers*, *sponsors* or *shareholders*) usually hold both the pure equity and subordinated debt and generally control the SPV. Some equity investors may not take an active role in the management of the PPP contract.

The Public Authority may sometimes provide equity to the SPV, either directly or through a public investment fund. Public participation in the equity of the SPV (including any rights of control) can influence the statistical treatment of the PPP contract.

Financial close

Financial close is the point at which the financing documents for the PPP contract (including the direct agreement between the lenders and the Public Authority) are signed and the financing becomes available for the project. It is usually the point at which the interest rate for the project is fixed using an *interest rate swap*. Financial close usually happens at either the same time as or shortly after contract close.

Fiscal risk

PPPs create long-term financial commitments that could (over time and when considered with other commitments) challenge the coherence of the public budget process and ultimately a country's fiscal sustainability and macroeconomic stability. Fiscal risks can exist when the actual and contingent commitments on PPPs are not clearly recognised or understood and where they have not been reported and budgeted for centrally.

Lenders

The term *lenders* in these WBIF EPEC Guides generally refers to the organisations who provide finance to the PPP in the form of senior debt to the Private Partner. They can include commercial banks, multilateral and bilateral development banks and finance institutions, and institutional investors such as pension funds and insurance companies.

Life-cycle costs (and whole-life costs)

This is the total cost of creating an asset and managing it to the end of its useful life (or for the duration of the PPP contract). It includes the initial cost of construction and the cost of all subsequent maintenance works that ensure that the asset continues to perform at an acceptable or minimum standard. The PPP contract defines the minimum standard of performance to be met by the Private Partner.

Needs assessment

Assessment of the gap between an agreed set of objectives and existing arrangements that the investment aims to address.

Net Present Value (NPV) and discount rate

The NPV is the discounted value of a project's cash inflows minus the discounted value of its cash outflows. It is calculated based on a *discount rate*. This subject is discussed more fully in the *WBIF EPEC Guide to the qualitative and quantitative assessment of Value for Money in PPPs*.

On and off balance sheet (statistical) treatment of PPPs

A public contract is recorded as either on or off the central government's balance sheet according to the national system of accounts (commonly referred to as the *statistical treatment* of a contract). The treatment of a PPP contract within the government's balance sheet can be an important consideration in the preparation of the project.

Optimism bias

Optimism bias is the systemic behaviour of public authorities (based on project experience) to both i) underestimate the duration of the construction phase of a project and its CAPEX and OPEX and ii) to overestimate the benefits/revenues it will produce.

Output specification (and user requirements)

These are the public sector's requirements defined as a clear set of outputs that are directly measurable in accordance with quality performance standards. The output requirements (sometimes also *user requirements* or *authority requirements*) can include technical requirements and service requirements. They are a distinctive feature of PPP projects in comparison to the input requirements normally used in traditional project procurement.

Payment mechanism

The payment mechanism is the principal means or mechanism within the PPP contract for remunerating the Private Partner. In a government-pay PPP the two main types of payment mechanism are

- *availability-based*, in which the payments made by the Public Authority to the Private Partner are linked to the infrastructure being available for use and services being performed as defined by the PPP contract. The *availability payment* is subject to deductions if the infrastructure is unavailable or where the services are performed poorly. The Public Authority takes the risk of variation in the demand for the services; and
- *demand-based*, where the payments to the Private Partner are linked to the level of usage of the infrastructure.

In a concession, the payment mechanism might regulate the basis on which the Private Partner is entitled to charge users and otherwise generate revenues.

Persistent breach

A persistent breach occurs when the Private Partner consistently fails to observe provisions of the PPP contract, e.g. fails to comply with the same provision on a repeated number of occasions or accumulates financial or contractual penalties over a defined period.

PPP contract

This is the main contractual document between the Public Authority and the Private Partner. It sets out the responsibilities of the Private Partner for the design, construction, finance, operation and maintenance of the asset and the delivery of the associated public services. The PPP contract allocates project risks between the parties and contains the payment mechanism.

The PPP contract is described more fully in the WBIF EPEC *Guide to the main provisions of an availability-based PPP contract.*

PPP unit

A specialised public organisation that provides PPP expertise in the public sector. This can include advice and support to public authorities in devising and implementing PPP projects and/or PPP policy. It may also have an assurance or approval role. It is usually a part of a government ministry or central public agency, such as the ministry of finance.

Preferred tenderer

The tenderer who has submitted the best compliant tender for a PPP project and with whom the Public Authority intends to sign the PPP contract. The preferred tenderer becomes the *Private Partner* when the PPP contract is signed.

Private partner

The private sector company that enters into the PPP contract, with responsibility for delivering and maintaining the public infrastructure and related public services for the duration of the contract. It usually takes the form of an SPV.

Procurement procedure

EU Directive 2014/24/EU (the 2014 Directive) provides four procurement procedures:

- the open procedure;
- the restricted procedure;
- the competitive dialogue procedure; and
- the competitive procedure with negotiation.

The 2014 Directive reforms and supersedes Directive 2004/18/EC (the 2004 Directive). It covers public procurement in general, laying down the principles that should apply to all works, supplies or services contracts. Legislation addressing public procurement within the Western Balkans Region conforms, in large part, to the 2004 Directive.

Procurement process

The WBIF EPEC guides use this expression to describe the steps and activities that the Public Authority adopts to implement its chosen procurement procedure. In defining the procurement process the Public Authority will consider matters such as timetable for the procurement (including key milestones), numbers of tenderers to pre-qualify, number and format of meetings with tenderers.

Project cycle

The project cycle is used in the WBIF EPEC guides to describe the series of steps that is followed by a typical PPP project from the time that the project scope is initially defined, through to its completion and delivery of the related services. The project cycle is divided into four phases:

- Phase 1: Project identification phase
- Phase 2: Project preparation phase
- Phase 3: Project procurement phase
- Phase 4: Project implementation phase

Project finance (and project finance structures)

PPP projects are generally financed using *project finance* structures. A project finance structure seeks to optimise the availability of finance and underpin the allocation of risks to the parties best able to manage those risks.

The project assets and revenues are usually ring fenced within an SPV. The SPV's lenders and investors rely either exclusively (i.e. *non-recourse* financing) or mostly (i.e. *limited recourse* financing) on the cash flow generated by the project as their security for the repayment of their loans or to earn a return on their investment. This is in contrast to corporate finance where lenders rely on the strength of the borrower's balance sheet as security for repayment of their loans.

Project identification phase

The identification phase is the first phase of the *project cycle*. At the end of this phase the Public Authority determines whether the selected project can (and should) be further developed as a PPP and whether to proceed to the project preparation phase.

Project implementation phase

The implementation phase is the fourth and final phase of the *project cycle*. It follows financial close and includes the management of the PPP contract and regular monitoring of the Private Partner's performance.

Project preparation phase

The preparation phase is the second phase of the *project cycle.* It includes the development of the potential project in readiness for the project procurement phase. The Public Authority will establish the project's governance structure (i.e. project team and steering committee), conduct further detailed assessments of the project and prepare relevant documents for the procurement phase. The assessments include the detailed affordability analysis, risk allocation and VfM assessment. The Public Authority defines the preferred procurement procedure and process, evaluation criteria and draft PPP contract.

Project procurement phase

The procurement phase is the third phase of the *project cycle.* It follows the preparation phase and starts with the publication of the procurement notice. It includes all the activities associated with the procurement process up to the award of the PPP contract through to contract close, and ends with financial close.

Public authority

The public sector body (sometimes called the *procuring authority* or *contracting authority*) that plans to enter into a PPP contract with a private sector partner. In an availability-based PPP, it is also the public body who is responsible for paying the availability payment to the Private Partner.

Public-Private Partnerships (PPP)

The term PPP describes a long-term contractual arrangement in which a Public Authority and a Private Partner collaborate to deliver public infrastructure (or assets) and related services. Under a PPP contract, the Private Partner bears significant risks and management responsibilities. The two main types of PPP contract are a *government-pay* PPP (which includes *availability-based and demand-based* PPPs) and a *concession* (sometimes called a *user-pay* PPP).

Public sector comparator (PSC)

The PSC is a risk-adjusted cash flow model of delivering a project using a traditional public procurement option (sometimes called the *public sector benchmark, PSB*). A comparison of the net present values of the PSC and PPP options for a particular project may be used as part of a quantitative VfM assessment.

Qualitative and quantitative VfM assessments

A *qualitative VfM assessment* often involves testing the PPP project delivery option against a set of pre-defined suitability (i.e. qualitative) criteria to determine the potential for the PPP option to provide VfM.

A *quantitative VfM assessment* usually involves estimating and comparing the costs of a PPP project delivery option with a traditional public project delivery option (i.e. a PSC) where the project risks have been valued. The estimated cost of each delivery option is calculated on a present value basis using an appropriate discount rate.

This topic is discussed more fully in the WBIF EPEC *Guide to the qualitative and quantitative assessment of Value for Money in PPPs.*

Risk management

Risk management is a process that helps to identify, analyse, price and allocate project risks. It starts during the project identification phase and continues for the duration of the PPP project (including the monitoring and review of risks during the implementation phase). This topic is discussed more fully in the WBIF EPEC *Guide to the qualitative and quantitative assessment of Value for Money in PPPs.*

Senior debt

This is the main form of debt raised by the Private Partner and ranks above other forms of debt (e.g. junior or subordinated debt). The senior debt lenders usually have first priority for loan repayment by the Private Partner and (in an event of default) over its assets or revenues. The senior debt lenders also have priority of decision-making powers if they exercise rights to step in.

Suitability (as a PPP)

Suitability refers to the appropriateness of using the PPP option to deliver a particular project. A project is, in principle, considered suitable as a PPP if it possesses certain project specific characteristics and the national legal, institutional and market environments are supportive. This topic is discussed more fully in the WBIF EPEC *Guide to the qualitative and quantitative assessment of Value for Money in PPPs.*

Special Purpose Vehicle (SPV) or Special Purpose Company (SPC)

See *Private Partner.* A legal corporate entity whose sole purpose is to implement the PPP project and which is generally incorporated in the country where the project is located.

Step-in rights

A step-in right is a contractual provision that allows someone to step into the place of a party that has defaulted on is obligations so that the party *stepping in* may rectify the default (and prevent termination of the contract). The two principal types of step-in rights in a PPP are those given to the Public Authority and those given to the project's lenders.

Subordinated debt

Debt that is generally provided by the shareholders of the SPV and in the same proportion to their respective shareholdings. This debt is subordinated to other debt (i.e. ranks below senior debt).

Supervening event

A supervening event is an event that occurs during the course of the PPP contract that is outside the control of either party. Such events are treated in the PPP contract as either a *compensation event*, a *relief event* (or *delay event*) or as a *force majeure event*. These events are described more fully in the WBIF EPEC *Guide to the main provisions of an availability-based PPP contract.*

Tenderer

A company or group of companies (usually in the form of a consortium or joint venture) that has been pre-qualified (and perhaps also shortlisted) by the Public Authority as a candidate in the procurement process for the PPP project with the intention of being invited to submit a tender.

Traditional public procurement or delivery

A traditional public procurement or delivery approach involves the provision and funding of public infrastructure and related services by the Public Authority. The Public Authority is responsible for the long-term operation and maintenance of the infrastructure. The Public Authority also bears most of the risks associated with the integration and optimisation of the various activities within the project.

The most commonly-used traditionally procured contracts are:

- a build (or construction) only contract (usually with a separate contract for the design of the infrastructure);
- a design-build contract;
- an engineering, procurement and construction (EPC) contract; and
- an operations and maintenance only contract.

Value for Money (VfM)

VfM is considered as the relative balance between the *value* and the *cost* of the different delivery options that are available (i.e. as between a traditional delivery approach and a PPP approach), where:

- the *value* aspect comprises the quality and quantity of the service (i.e. the performance level) of the different options, delivered over the period of the PPP; and

- the *cost* aspect usually represents the cost to the payer (i.e. the Public Authority and/or end-user) over the same period to deliver the different options (including the cost of managing the risks).

A *VfM assessment* will identify the delivery option that represents the best balance of long-term risk-adjusted value and cost.

This topic is discussed more fully in the WBIF EPEC *Guide to the qualitative and quantitative assessment of Value for Money in PPPs.*

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