
Renegotiations in PPP Projects – Summary of Findings

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Summary of results from the research project "Renegotiations in PPP Projects"

Sponsor:

German Federal Ministry of Transport, Building and Urban Development

Project monitoring for the research initiative "Future Building":

Federal Office for Building and Regional Planning

(Reference number: Z 6 – 10.08.18.7-06.15 / II 4 – O 1557-221/7)

Full responsibility for the content of the report lies with the authors.

1st of February 2009

1 Research objective

In Germany and internationally, a growing number of public authorities use so-called Public Private Partnerships (PPP) for infrastructure projects. PPP is a procurement option in which several elements of service delivery for such projects – i.e. planning, construction, maintenance, and operation of the facility – are bundled in a long-term contract and are provided by one private contractor. These characteristics contrast with the conventional approach to public procurement in which the individual services are contracted separately in short-term contracts or are provided in-house by the relevant agency or a public enterprise.

PPP projects usually have contract durations between 20 and 35 years. As theoretical approaches maintain, contracting parties cannot anticipate all possible contingencies that may arise during these long contract terms. Hence, it is likely that original contract provisions are incomplete and contracting parties need to amend them in the course of the project. From an economic perspective, such contract amendments are labelled “renegotiations”. Whereas the economic literature up-to-now primarily analyzed renegotiations initiated by the contracting parties with opportunistic motives, the research project focuses on renegotiation that are started with non-opportunistic motives. The public authority as well as the contractor may approach the other party for a contract amendment.

The objective of this research is to analyze the importance of renegotiations for the success of PPP projects. Furthermore, factors driving the results of renegotiations are identified. In particular, the focus is on the design of contractual rules governing renegotiations (“contractual renegotiation design”).

2 Methodology

The study has been conducted in the period between February 2007 and January 2009. The analysis is based on the so-called New Institutional Economics. In particular, frameworks from Contract Theory are applied. Moreover, empirical evidence is taken into account. Evidence on contractual renegotiation design in practice was collected by analyzing contracts (standard and model contracts, sanitized contracts from real-life projects) as well as by conducting some 35 interviews with people in charge of projects and other PPP experts. Based on this, the report presents renegotiation provisions currently used in projects in the United Kingdom as well as in Germany. Furthermore, evidence from Chilean projects is taken into account.

3 Summary of results

3.1 Importance of contractual renegotiation design

Theoretically sound considerations regarding the renegotiation probability in long-term contracts are confirmed by experiences in practice where contract variations were necessary in most PPP projects. The majority of contract amendments can be traced back to new or modified authority requirements. Therefore, the focus of the report is on adequate rules for the implementation of such variations. As

compared with conventional procurement, variations are likely to be more costly in PPP projects, in particular, if remuneration is – as in many real-life cases – based on contractor's estimates or costs that have been actually incurred. Through the design of adequate contractual provisions, it is possible to reduce the cost gap between the conventional and the PPP approach for the implementation of variations and, thereby, increase the flexibility of PPP projects.

Beside contractual rules governing the implementation of new authority requirements, optimization potentials identified by the contractor are considered as well. If this optimization has no influence on authority's position in the project, the contractor should be able to implement it without consulting the buyer. If, however, provisions from the original contract are affected, e. g. quality specifications, the authority needs to be involved. Respective provisions are analyzed using the example of so-called refinancings, i.e. a re-design of the project's private financing structure.

3.2 Normative discussion of contractual renegotiation rules

3.2.1 Renegotiations initiated by the authority

An essential element of renegotiation provisions in PPP projects is an unfettered right of the authority to request changes. The contractor is allowed to object only in limited circumstances. With this, the discussion can be focussed on the determination of an appropriate compensation. The level of compensation in a variation should reflect the cost of efficient implementation.

Renegotiation provisions used for the determination of contractor compensation consist of process and calculation rules. Process rules describe conditions for the use of a particular clause, process steps, responsibilities, and time frames. Calculation rules define the basis for the determination of contractor's compensation. Process and calculation rules are used on three stages which form an overarching renegotiation process:

- **Variation procedures:** As a matter of principle, it is efficient to include differentiated variation procedures in the contracts since the appropriateness of particular provisions depends on the characteristics of the variation (and its environment). For example, prices for variations or respective inputs may be agreed in the original contract if these options exhibit low complexity and (environmental) uncertainty and are of relatively low risk as well as cover a high (expected) value of variations. Furthermore, a tender of the variation as well as a negotiation between authority and contractor may be appropriate methods for determining prices for variations under particular circumstances. Additionally, provisions for appropriately involving capital providers in the variations negotiations as well as clauses governing contractor compensation for administrating variations should be included in the original contract.
- **Dispute resolution:** If the contracting parties are not able to reach agreement on the compensation for a variation on the first stage of the renegotiation process, dispute resolution mechanisms can be used on the second stage. Often, several mechanisms are combined to

form a multi-stage dispute resolution process in which project-internal mechanisms are used before so-called alternative dispute resolution procedures or judicial proceedings are invoked.

- **Termination:** Termination rights are the third and ultimate stage in the renegotiation process. Frequently, termination rights are exclusively characterized as part of the incentive system which is aimed at ensuring contract compliance. Beyond this purpose, it is reasonable to contract upon a unilateral and unconditional termination right for the authority in order to be able to respond to (possibly large) changes in the project requirements. Contractor's compensation in case of authority voluntary termination should be based on the risk-adjusted present value of outstanding cash flows from the project. Furthermore, contractor's compensation should take adequate breakage costs, contractor-financed variations as well as the structural asset quality at the time of termination into account. Essential parameters for the determination of contractor's compensation should be agreed upon in the original contract. Additionally, it may be reasonable to contract on a fixed compensation amount for particular dates during the contract term.

Whereas variation procedures are frequently used in real-life projects, dispute resolution mechanisms are applied rarely, and projects are terminated only in very exceptional circumstances. Nevertheless, the design of subsequent stages in the renegotiation process is important, since the project parties anticipate outcomes from stages that are eventually used after negotiation failure on the first stage. The total system of renegotiation provisions should exhibit an appropriate degree of clarity, detailedness, and completeness.

3.2.2 Refinancings as an example of renegotiations initiated by the contractor

A refinancing is a redesign of the financial structure of a project while maintaining the rest of the contractual agreements. Firstly, a refinancing is a contractor's optimization potential with which he reduces his procurement costs for financial services. A refinancing does also affect authority's position in the project since it may decrease flexibility of the financial structure and may involve new capital providers with a lower reputation. For potential cost increases, it is justified to grant the authority an approval privilege. Furthermore, it is reasonable to compensate the authority for potential flexibility reductions. From an economic perspective, it is difficult to draw a general conclusion on the level of authority's share. Based on transaction costs arguments, it is sensible to agree upon a simple sharing rule. A refinancing should not be implemented if (long-term) cost effects exceed (short-term) benefits.

3.3 International comparison of currently used renegotiation rules

Typical renegotiation rules exhibit a diverging degree of sophistication in the countries analyzed in this study. It is theoretically plausible and empirically observable that contract provisions are refined with accumulating experience in the respective market. In Great Britain, where the PPP approach is applied already since the early 1990ies in public procurement, many of the recommendation presented above have been introduced into the contractual rules. In Chile, many renegotiation provisions and, in

particular, pre-priced options are defined by the authority in the tender specifications which can be efficient given that the PPP approach is primarily used in the road sector in Chile. Advances in renegotiation provisions can also be observed in German PPP projects. For example, tender requirements for variations as well as authority voluntary termination rights are agreed in some projects. However, a more systematic agreement and application of renegotiation provisions is possible.

3.4 Policy recommendations

For future projects in Germany, it is particularly recommended that variation procedures are differentiated in accordance with characteristics of the adjustment and its environment. Furthermore, clauses governing the involvement of capital providers in variations as well as provisions regulating the compensation for administrating variations should be included in the original contracts. Finally, the introduction of authority voluntary termination rights should be considered.

The project-spanning program level may support the implementation of PPP projects. In particular, the central provision of standard contracts is advised. With respect to the renegotiation provisions that have been examined in this study, dispute resolution mechanisms as well as termination clauses appear to be well standardisable whereas no single rule can be generally used as variation procedure. Rather, recommendations for the application of particular rules can be derived.

For the development of rules that can be applied in real-life projects, knowledge from different areas of expertise is necessary. For adequate contractual design, legal and economic know-how should be combined. Furthermore, engineers and other technical experts have to be involved, in particular when designing calculation rules.