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Risk Matrix and PPP Contract Standardization, Best Practice, and Gap Analysis in Brazil

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DISCUSSION
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ACRONYMS

BNDES	The Brazilian Development Bank
CAF	The Charities Aid Foundation
CAOPL	Court of Auditors Organization and Process Law, "Lei de Organização e Processo do Tribunal de Contas"
CCP	Código dos Contratos Públicos, Public Procurement Law
CEPAL	Economic Commission for Latin American and the Caribbean, also known as ECLAC
CPO	Compulsory Purchase Order
DL	Decree-Law
EIP	Expression of Interest Procedure, "Procedimento de Manifestação de Interesse"
EPEC	The European PPP Expertise Centre of the European Investment Bank
HDI	Human Development Index
IFC	The International Finance Corporation
IPA	Infrastructure and Projects Authority
IPP	Investment Partnerships Program, "Programa de Parcerias de Investimento"
IRR	Internal Rate of Return
KPI	Key Performance Indicator
LAC	Latin American and the Caribbean
MoU	Memorandum of Understanding on Specific Economic Policy Conditionality
OECD	The Organisation for Economic Co-operation and Development
OVE	The Office of Evaluation and Oversight, IADB
PF2	Private Finance 2
PFI	Private Finance Initiative
PIE	Private Interest Expression, "Manifestação de Interesse Privado"
PPP	Public-private partnership
SPV	Special Purpose Vehicle
Troika	The European Commission, the International Monetary Fund, and the European Central Bank
UTAP	Unidade Técnica de Acompanhamento de Projetos, the Portuguese PPP Unit
VfM	Value for Money

EXECUTIVE SUMMARY

Public-private partnerships (PPPs) have been used to address the need for the implementation of huge investment programs and to bridge the infrastructure gap that exists in Latin American and Caribbean (LAC) countries. As is explained throughout this paper, under certain circumstances, PPPs represent an important tool to help governments implement their investment programs, thereby benefiting not only from private investment (which often includes foreign investment) but also from the various advantages that are typically associated with the PPP model. However, the need to secure financing for investment needs, especially in a situation of scarce public resources and fiscal constraints, should not be the only reason for choosing the PPP model.

The objective of this paper is to highlight that the PPP model can be a valuable tool for undertaking public projects in an efficient and innovative manner and that it can provide more efficient and innovative public services in certain circumstances as well. In addition, when correctly used, it can generate public savings and create the fiscal space that LAC countries need to carry out their investments. However, this tool cannot be regarded as a "magic bullet" suitable for all projects and in all circumstances. It is emphasized that any decision regarding PPP implementation should be supported by a robust, rigorous, and transparent screening process, as well as by a transparent and accurate fiscal affordability analysis, taking into account the public capacity to bear the costs of PPPs, not only in the short-term but also over a longer period.

This paper also intends to highlight some specific characteristics of the PPP model which indicate that this model would only be valuable to a country when it is used in the appropriate manner. The PPP model is based on outputs rather than inputs. As a result, the most important task to perform during the preparation phase of a PPP[1] is the definition of the outputs that the private partner must achieve and how much should be paid for them. This is because the risks, ulti-

[1] The preparation phase is of primary importance for the success of the PPP, since it is the phase when the PPP model is evaluated as to whether it is the best model for the specific project. It is also when all the conditions are established that must be met in order to ensure that the PPP will represent Value for Money over its lifetime.

mately, remain the responsibility of the private partner. The price to be paid for the outputs should be consistent with the project risk matrix, which, in turn, should be drafted taking into consideration the risk allocation between the parties that best maximizes the Value for Money of the PPP (meaning that each risk has a price and should be allocated to the party that is able to bear it in a more efficient way).

This paper therefore highlights the importance of the design phase of a PPP. This is the phase during which the contractual terms and the risk matrix are prepared (which are interrelated[2]) and when the basis for a valuable PPP contract is created. PPPs are exposed to information asymmetries, to the potential inadequate alignment of interests between the parties, and also to possible incidents of corruption (particularly when transparency and public disclosure mechanisms do not work properly). As a result, the standardization of both the PPP contract and the risk matrix is a way of reducing the probability of the occurrence of these risks. In addition, standadization is a necessary step for improving the transparency, the efficiency, and the effectiveness of a PPP. It helps ensure that PPP contracts are drawn up in such a way as to appropriately reflect the best risk allocation for each project in an objective, predictable, rigorous, and transparent manner.

The main objective of this paper is therefore to emphasize the importance of harmonized guidelines as a necessary condition to ensure that PPPs are rigorously prepared, which implies that risks are efficiently allocated, and that the PPP contract is well drafted. Only under these circumstances can the Value for Money of a PPP be achieved during its useful life. Even when there are no conditions that call for the formal adoption of the standardization of the PPP contract, it is crucial to work on the standardization and harmonization of principles and procedures. This is to ensure that all PPP implementation processes (carried out either by central or local governments) are conducted in a transparent, consistent, efficient, effective, and rigorous way. In addition, it will ensure the best possible delivery of public services, proper accountability in public accounts (considering present and future impacts, as well as contingent ones), and an adequate and clear risk distribution between the parties. This thereby avoids the potential for corruption or future contract renegotiation (which is often a route to the elimination of value).

Prior to any standardization or harmonization process, a sound PPP institutional framework must be developed, with clear ownership responsibilities. This is in order that PPP stakeholders are fully aware of the exact structure and responsibilities of all parties under the PPP. A strong institutional framework, with a clear and sound governance system, and very well-defined ownership of each responsibility, is a condition precedent to any standardization process. Centralized PPP Units can function as a way of not only ensuring the centralization and ownership of the standardization process, but also of accumulating the technical capabilities, lessons learned, and experience needed to internalize PPP structuring skills.

[2] The risk matrix, which should be the result of a sound, balanced, and rigorous risk allocation process between the parties, must always be accurately and unequivocally reflected in the contractual terms.

These Units may also minimize overreliance on the work of external consultants, with its associated risk of subverting the development of critical analysis capacity within the public sector.

Throughout this paper, we try to highlight how the issues of governance, transparency, the impact of PPPs on public accounts, and the adequate distribution of risks within PPP contracts are considered crucial in order for PPPs to be part of the solution to the investment needs in LAC countries. It will also be stressed that standardization (at least of principles and guidelines) can have an important role.

This paper is particularly focused on the situation in Brazil, which was analyzed in order to understand the bottlenecks that already occur in that country in the PPP field, and it looks closely at how best practices can be adopted. However, the lessons learned, and the key messages of this paper, can be applied to LAC countries as a whole.

Brazil was selected for the purposes of this paper because of its long tradition of PPPs and the relevance of its PPP experience to the total LAC PPP market.[3] Brazil has relied heavily on PPPs to close its infrastructure gap: it has a range of types of assets and services that have been delivered by the PPP model, and it has seen extensive participation by subnational governments in the development of PPP projects. Among the challenges Brazil is facing is the need to increase the participation of commercial banks in PPP financing (which requires a suitable risk allocation mechanism between private and public partners), as well as to increase the development of technical capacity at the subnational level (Infrascope, 2017).

With regard to the topics covered in this paper, Chapter 2 highlights the role that PPPs have played in bridging the infrastructure gap, particularly in LAC countries where the implementation of investment programs has been increasingly conducted using the PPP model. Chapter 3 defines what a PPP is and what its potential advantages are, analyzing also the crucial importance of both the PPP contract and risk matrix as instruments for achieving potential PPP benefits. Chapters 4 and 5 present the UK and Portuguese models, which can be considered best practice examples in terms of both the PPP regulatory framework and the implementation of the contract and risk matrix drafting rules (although each has different approaches to PPP standardization issues). Chapter 6 analyzes the Brazilian PPP model, namely the framework that is in place there and the current state of the risk matrix and PPP contracts in Brazil. It discusses the main challenges identified and some recommendations for improvement. Chapter 7 presents some conclusions about the crucial role of the PPP contract design phase and the most efficient process for risk allocation. It also highlights the importance of a standardized approach (centralized on a specialized unit) for both the risk matrix and the PPP contract, in order to achieve a more transparent, efficient, and effective PPP program.

[3] Brazil is the country with the largest market share, in terms of the number of PPPs, in Latin America (for the period 1995 and 2017). It has more than 20 years' experience in PPPs, first in economic infrastructure and later in social infrastructure, with the law on public-private partnerships being published in 2004. Brazil has been perfecting its PPP framework, both nationally and subnationally, although it still displays some lack of technical capacity, especially at the subnational level.

1 INTRODUCTION

There is a broad consensus that, to ensure the adequate and sustainable development of any country, there is a need for good-quality basic infrastructure. A country's infrastructure network is usually regarded as a proxy for its level of economic and social development.

There are many examples of essential infrastructure which have a bearing on the functioning of a country, such as transport and urban mobility networks, logistical and energy networks, communications, infrastructure for water supply, sanitation and waste treatment, as well as social infrastructure, such as hospitals, schools, and prisons, amongst others.

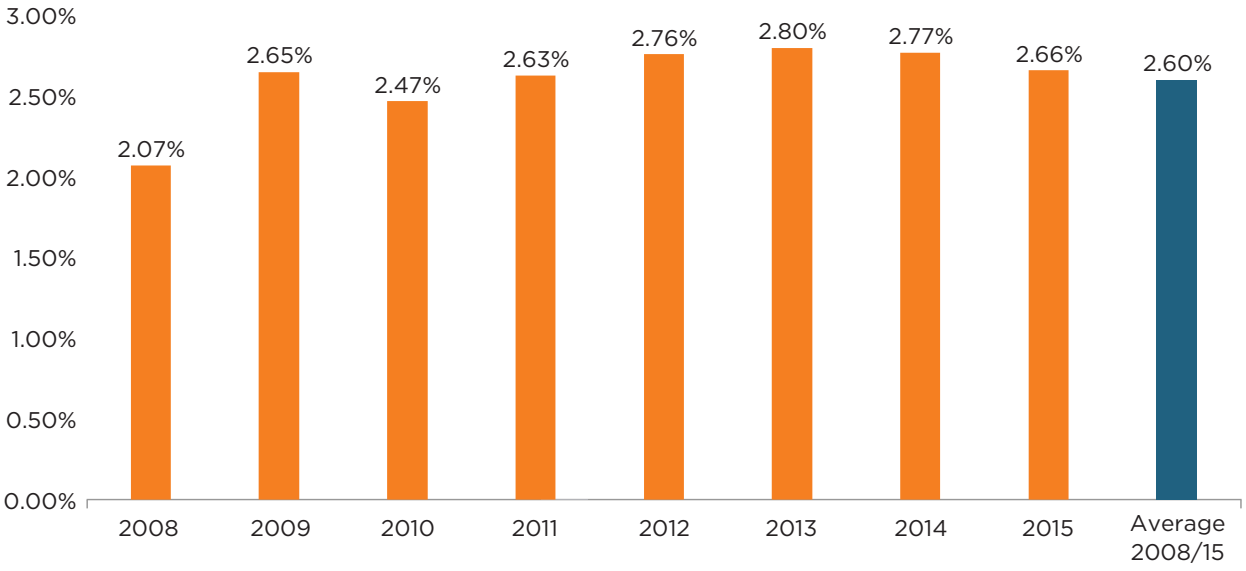
Infrastructure investment is thus an engine and an accelerator of a country's economic and social development, generating direct and indirect benefits through a multiplier effect that is mirrored in the dynamism, competitiveness, and productivity of the country's overall economy.

Although this crucial role of infrastructure investment in promoting economic growth is recognized, the capacity to implement such investment is limited and is subject to the public resources available to each government for this purpose. This poses a great challenge to the governments of different countries, especially of developing countries. There is a need to manage scarce public resources, and the fiscal space that is available at each moment, without destroying their future capacity to close the infrastructure gap which hinders economic growth and development.

This challenge is even more critical given that, despite the investment programs that have been carried out, infrastructure needs in LAC countries remain considerable. According to some available estimates, in order to cope with the long-acknowledged infrastructure gap in Latin America and the Caribbean, it would be necessary for these countries to invest an amount in infrastructure equivalent of at least 5 percent of their GDP over a long period of time, representing a clearly more ambitious objective in terms of investment than has occurred so far, which has been in the order of 2 to 2.5 percent of GDP (Prats, 2016).

According to Infralatam data, between 2008 and 2015, public investment in infrastructure represented on average 2.6 percent of GDP (Figure 1), which is well below the estimate threshold of 5 percent of GDP

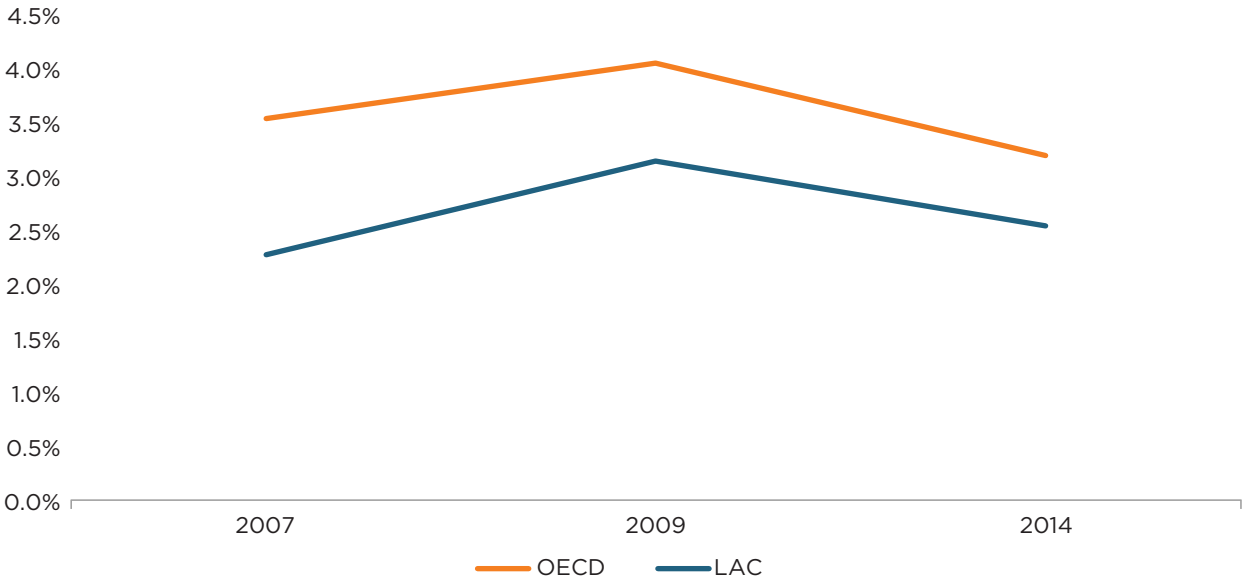
FIGURE 1. PUBLIC INFRASTRUCTURE INVESTMENTS IN LAC AS A PERCENTAGE OF GDP, PER YEAR, 2008–2015



Source: Author-prepared, based on Infralatam[a] data (covering 19 countries), the infrastructure database prepared by CAF, CEPAL and the IADB, available at: http://www.infralatam.info.

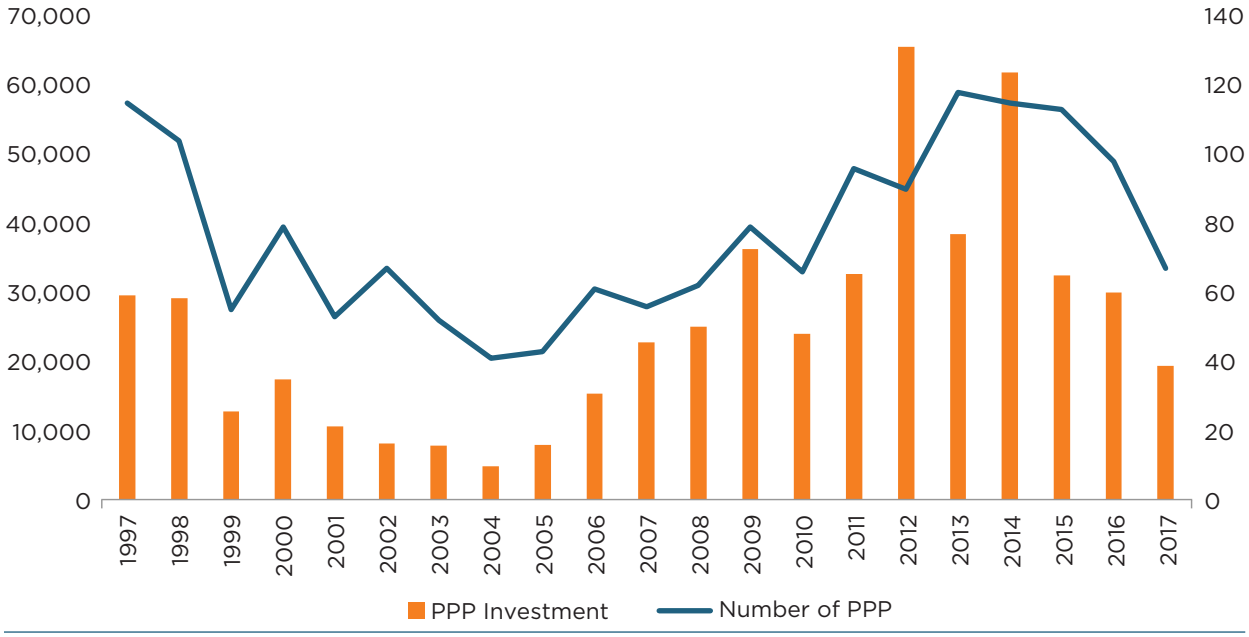
[a] Infralatam reports investment in economic infrastructure (defenses against floods, energy, irrigation, telecommunications, transportation, and water and sanitation), aggregating data from three government levels (national, regional and local) and from State-Owned Enterprises in 19 countries of Latin America.

FIGURE 2. GOVERNMENT INVESTMENT AS A PERCENTAGE OF GDP



Source: Author-prepared, based on OECD data available at: http://www.oecd.org/latin-america/data/public-sector.htm.

FIGURE 3. PPPS IN LAC, 1995–2017



Source: Author-prepared, based on World Bank PPI Database, available at: https://ppi.worldbank.org/.

mentioned above, and also below the OECD figures (Figure 2). According to the OECD, public investment in LAC countries has been low, especially considering that this is a developing region (OECD, 2016).

Given this context, one of the great challenges the governments of LAC countries are facing is the need to secure the financing for these vast investment needs, especially in a situation of scarce public resources and fiscal constraints. Moreover, governments are also faced with the need to ensure that these investments are implemented efficiently and effectively, which is fundamental for the achievement of the objectives intended and for the realization of the full benefits associated with infrastructure investments.

It is in this context that PPPs have increasingly maintained their position as an important tool in the implementation of the investment programs of LAC countries in particular. In these countries, the PPP market, although more recently established and in some cases still somewhat immature, has grown considerably (Figure 3). It seems consensual that the use of PPPs can serve not only as a method of attracting private funding for public investment, but also as a way of achieving the desired results in a more efficient manner.

Considering the immediate budgetary benefit of using the PPP model, the choice of this model often tends to be justified, mainly, or even solely, on the inability of the public authorities to finance the necessary public investments, due to a lack of fiscal space. It is important, therefore, to point out that this should not be the only (not even the main) objective guiding the decision-making

process of a public authority regarding the launching of a PPP. In fact, the PPP model should be regarded as one model of public procurement amongst others. Governments should bear in mind that before deciding whether or not to use the PPP model, there should be a rigorous process of analysis of the investment on its own merits, in the context of an accurate cost benefit analysis exercise. The PPP model option should be adopted, within the context of the public procurement model decision, only after the decision to proceed with the investment has been taken. At that stage, the use of the PPP model should be analyzed, but any decision about the selection of this model should always be preceded by a rigorous process of studies on the effective advantage of the PPP model, in terms of Value for Money, versus alternative forms of public procurement for the particular investment in question. Additionally, any decision about PPP implementation should be preceded by a rigorous fiscal affordability analysis: it is very important that the decision-making process takes into consideration the fiscal impact of PPPs (in terms of both public debt and the future public budget), considering, in particular, the future contingencies that could arise during the PPP lifecycle and their impact on a country's fiscal position. It is not possible to proceed with the implementation a PPP without previously analysing, in a rigorous way, all the implications that could arise in the future from the impact of that PPP on the public accounts (PPPs are not a magic solution for implementing an investment program when there is not the fiscal space for it).

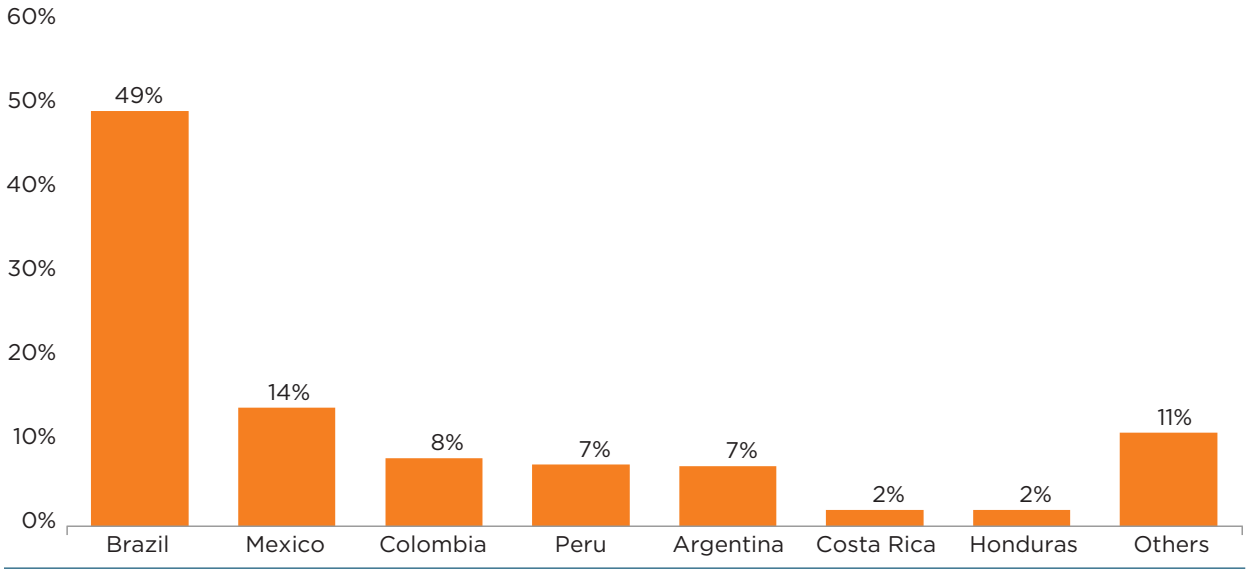
Taking the aforementioned premise into consideration, this document aims to contribute to the discussion, reflection, and decision-making process regarding the merits of the risk matrix and PPP contract standardization in LAC countries, by presenting an assessment of the PPP environment in Brazil, the biggest PPP market in LAC, as well as a description and comparative analysis between the situation in Brazil and that of some mature PPP markets in terms of PPP contract and risk matrix standardization. Brazil, Mexico, Colombia, Peru and Argentina are the countries with the largest market share in terms of the number of PPPs in Latin America (Figure 4).

Despite the PPP's contribution, and even considering private investment, in the period between 2008 and 2015, the average value of total investment (public and private) in infrastructure remained at around 3.51 percent of GDP, which is still below the advisable 5 percent threshold referred to above (Figure 5).

In terms of distribution by country, however, the situation in Latin America is quite heterogeneous: in some countries, such as Honduras, the investment as a percentage of GDP is well above the average; in others, the weight of investment in infrastructure in relation to GDP is very small, especially in Brazil.

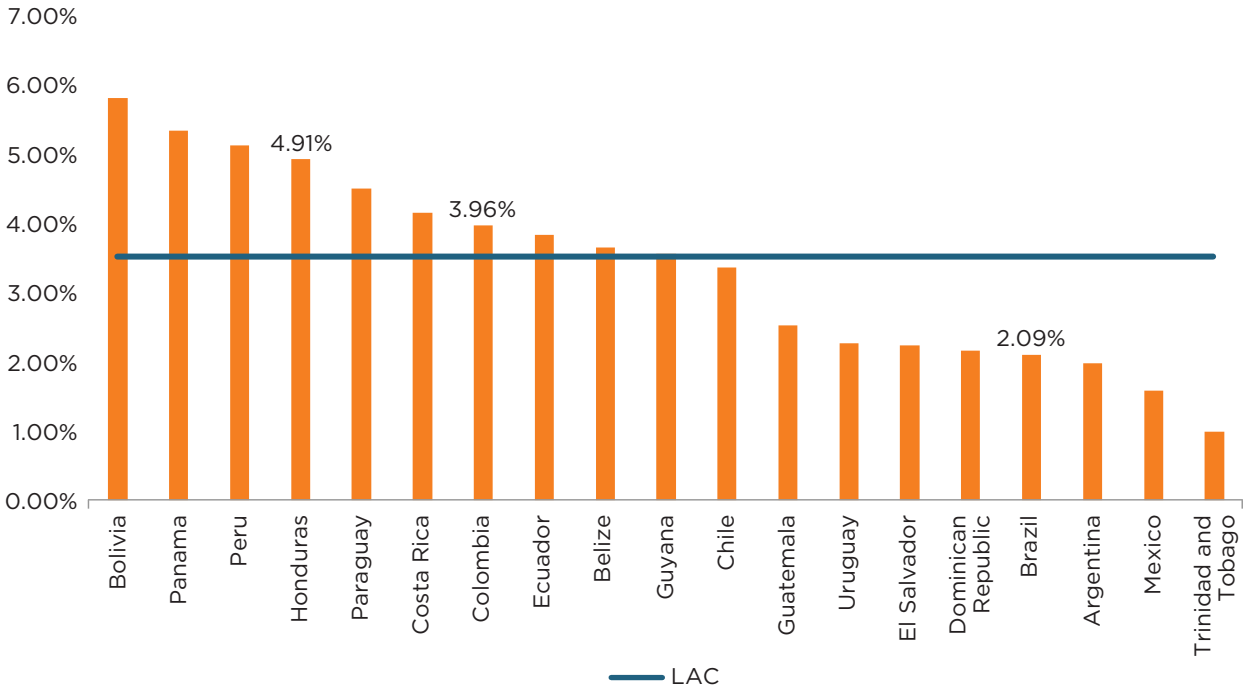
Despite being the main country in Latin America in terms of income and size, as well as the leader in terms of PPP numbers, Brazil stands out as one of the countries in the region with the lowest investment in infrastructure as a percentage of GDP. By contrast, Honduras, one of the smaller Latin American countries with lower income, is notable as one of the countries with the largest investment in relation to GDP, with a value of investment in infrastructure of 4.9 percent in the period 2008–2015, above the LAC average of 3.5 percent.

FIGURE 4. NUMBER OF PPP IN LAC: DISTRIBUTION BY COUNTRY, 1995–2017



Source: Author-prepared based on World Bank PPI Database, available at: https://ppi.worldbank.org/.

FIGURE 5. PUBLIC AND PRIVATE INFRASTRUCTURE INVESTMENTS AS A PERCENTAGE OF GDP, IN LATIN AMERICA, BY COUNTRY, 2018–2015



Source: Author-prepared, based on Infralatam data (covering 19 countries), the infrastructure database prepared by CAF, CEPAL and the IADB, available at: http://www.infralatam.info.

As stated before, PPPs have been recognized as a valuable instrument in providing public services and infrastructure, in an efficient and innovative manner, and, when correctly used, can generate public savings and the fiscal space that LAC countries need for their investments. It is very important, however, that investments carried out using PPPs can be implemented while maintaining the fiscal sustainability of LAC countries[4]. Therefore, there is only one way to achieve such a goal: by preserving the advantages of PPPs and ensuring that their Value for Money[5] is always properly measured and protected, not only from the commencement of the PPPs' implementation, but also throughout their entire lifecycle. This is only possible if the PPPs are adequately structured and the contracts are properly drawn up. To achieve this goal, it is necessary to establish clear rules regarding the government's ability to accept risks and the design of PPP contract clauses.

The process of designing and structuring the PPP contractual framework for a specific project is a tough, time-consuming job, demanding technical capabilities and specific skills that, in some cases, the government authorities do not have. This lack of technical capacity, particularly in the case of subnational governments in LAC countries, is a huge obstacle to the adoption of best practices in the PPP implementation process. Without clear rules on contract design, it is very difficult to ensure the transparency needed to avoid allocating excessive risks to the public partner. Despite this, the definition of contract clauses is a preliminary and necessary step for the minimization of future litigation between the parties and for the avoidance of potential renegotiations (with their associated negative fiscal impacts), both of which sometimes occur during the contract lifecycle.

This document aims, therefore, to contribute to the recognition of the importance of correctly predefining: the PPP risk matrix (always taking into consideration that each risk has a price and therefore should be allocated to the party that can better manage it, this risk allocation being on the basis of the remuneration/penalization scheme); and contract clauses, which should in turn reflect (and be the result of) the risk allocation process. The final objective of this paper is to define some guidelines to help LAC governments structure PPP processes in a quicker and more transparent and efficient manner.

[4] PPPs are a way of financing infrastructure investment and are consequently a way of overcoming the scarcity of public resources and of improving the fiscal space available at the time of project implementation. However, it should be taken into consideration that the PPP has a cost that is borne by the public sector during the life of the PPP contract (which is usually very long-term). Therefore, it is important not only that this cost (as well as the potential contingencies) should be reflected in the public accounts (PPP debt should be accounted for, on an accruals basis), but also that the annual cash flows associated with public sector payments during the life of the contract should also be accounted for in annual budgets. It is advisable, every year, that the government analyse the projected cash flows associated with the PPP and adjust the liability associated with it.

[5] It is important to mention that the Value for Money concept should be present in any government decision that involves the use of scarce public resources, which means that any public decision should always respect the principles of economy, efficiency, and effectiveness. The principle of economy requires that the resources be made available in a timely manner, in the appropriate quantity and quality, and at the best price. The principle of efficiency implies that the best relationship between resources employed and results achieved is ensured. The principle of effectiveness implies the achievement of the specific objectives and desired results.

For the purposes of this report, the example of Brazil was selected, as this country has a long tradition of PPP implementation and has demonstrated a strong commitment to PPP framework improvement. Brazil, Mexico, and Colombia are the countries with the most PPPs implemented in LAC (Figure 4).

In order to have a reference for comparison with Brazil, this document presents the examples of the UK and Portugal, which could be considered two models of best practice, albeit with different approaches. In relation to these two countries, the following is set out: i) the PPP framework and regulation; ii) the definition of a PPP; iii) the PPP structuring and procurement process; iv) the monitoring of PPPs; v) the risk matrix; and vi) the PPP contractual framework (including the approach to standardization and the treatment of the main contractual clauses).

2 PPP CONTRACTS

Taking into consideration the importance of PPPs in the context of public investment implementation, it is essential to understand what a PPP is and what its main attributes are. In terms of definition, there is no single worldwide PPP definition. Different definitions are used across the countries that are already applying and benefiting from this tool. Therefore, and for the purposes of this document, the PPP Reference Guide definition is being adopted, which defines a PPP as a "*a long-term contract between a private party and a government entity, for providing a public asset or service, in which the private party bears significant risk and management responsibility, and remuneration is linked to performance*" (PPP Reference Guide, 2017).

According to this definition, a PPP may be understood as an instrument through which a government authority transfers the responsibility and risks inherent in the implementation and execution of a particular investment in public service infrastructures to a private partner. This partner, in turn, assumes the responsibility for achieving the previously-defined outputs in return for a remuneration over a period of time that is sufficient to compensate it for its investment, with the public assets reverting, at the end of this period, to the public partner.

PPPs can effectively constitute an important tool for governments to implement their investment programs and improve the infrastructure gap that is present in LAC countries. They thereby benefit not only from private investment (which often includes foreign investment), but also from the various advantages that are typically associated with the PPP model, namely:

- Greater predictability of public sector expenditures throughout the duration of the partnership, particularly in cases where the public entity can accurately estimate those costs. When a PPP contract is correctly prepared (with a precise risk matrix), the public sector party can estimate, from the outset and in a transparent manner, the costs inherent in the operation and maintenance of the infrastructure on a whole-of-life basis, based on the contractually-established private partner remuneration mechanism[6];

[6] However, this would be not the case when "the public sector seeks to radically innovate on public service

- Greater efficiency in the management and allocation of resources, through the possibility of allocating the risks to the party most capable of managing them, and of allocating each of the responsibilities to the party most qualified to assume them in the most efficient manner possible. An efficient allocation of risk constitutes a clear method of ensuring that the desired results are achieved at the lowest possible cost (there is always a price for bearing a risk);
- The guarantee of a high standard of quality in the service provided, either by virtue of the contractual obligations established or by indexing the remuneration mechanism to quality standards (through the penalties' mechanism provided). This is expected to promote a clear alignment of interests between the parties, which is considered essential in a long-term relationship such as that existing in a partnership agreement;
- Greater incentive for innovation: since the objectives of the private partner are essentially defined in terms of the desired output, and considering the strict and ambitious quality standards demanded of the same, there is a natural incentive for innovation in terms of means and processes; and
- Greater incentive and focus on achieving results and efficiency in the provision of services, insofar as the remuneration mechanism provided for in the PPP contract, and the associated payment deductions mechanism, permits not only the control of the overall performance of the private partner but also ensures an interdependence between this performance and the private partner's remuneration system[7].

There could in fact be a number of advantages associated with the choice of a PPP model for implementing a specific project. However, the use of the PPP model should always be preceded by a rigorous process of studies (a screening process) that should prove the real Value for Money of the PPP model for each specific investment.

This concern, of guaranteeing the Value for Money as a prerequisite to the launching of a PPP contracting process, must always be present in the decision-making process of any government, since, although the effective achievement of Value for Money for a PPP only occurs during the execution phase of the contract, it depends unequivocally on the appropriate definition of the operating rules of the partnership, implicit in the PPP contract design and in its risk matrix.

provision or to introduce new services where it lacks the knowledge or expertise to anticipate the impact of the innovative design/procedure/technology on the cost of operations. PPPs are less likely to deliver efficiency gains for highly innovative and complex services where risks are high and it is difficult for the public authority to commit to transfer such high risks to the private sector" (Iossa and Martimort, 2012).

[7] This can be an advantage of the PPP model, but it requires that, at the very beginning, the contract should be well drafted, and the risks very well addressed and balanced according to a rigorous risk matrix that should be built in a comprehensive manner. Furthermore, all of the procurement process should be transparent and it should be easy to identify what the potential benefits of the PPP are in order to verify (in the future, during the operational phase) that they have been effectively achieved. When PPP contracts are not well drafted, or the risks are not well identified/allocated, PPPs can have huge contingencies/cost overruns that could overcome the potential benefits identified at the beginning (as has been the case in LAC countries).

Considering that any contractual relationship between the public sector and the private sector is coupled with a certain "agency cost", due not only to the inevitable information asymmetries that exist, but also to the potentially inadequate alignment of interests between the parties, it is necessary at the start of the process of defining the PPP contract to identify and define, in a clear and objective manner, the quality requirements to be met by the private partner, as well as the results to be achieved.

The PPP model is based on outputs rather than on inputs,[8] which means that when preparing the PPP contract, the public partner should define not only the amount of the output that has to be achieved (the service to be delivered by the private partner) but also the service standards that the private partner must meet. It should simultaneously define the risk allocation between the parties (that maximizes the Value for Money of the PPP), creating the appropriate incentives to align the interests of both parties (namely through the payments/deductions mechanism).

Therefore, one can identify two critical aspects in the context of PPP implementation: the risk allocation process and the definition of the PPP contract clauses (both being interconnected). Given the importance of these two aspects, it is fundamental to include some risk mitigation features in the PPP framework governance model in order to address the possibility of these aspects not being adequately addressed by the public partner when drafting the PPP contract. The lack of inclusion of such features could translate into future problems, litigation, and increased costs and, consequently, in the undermining of the Value for Money of the PPP.

Recognizing these issues, some countries (like, for example, Portugal, the UK, Australia, Belgium, Korea, and Ireland) have decided to implement specialized PPP Units, which in some cases are those ultimately engaged in PPP contract preparation. This constitutes an accumulation of the technical capabilities and experience needed to internalize PPP structuring skills, or, at least, a minimizing of the risk of overreliance on external consultants' work (or even on private sector work) which may result in a lack of any critical analysis capacity being built up in the public sector.

There are, however, other countries where the public sector's technical expertise is still in the process of consolidation, and where recourse to external consultants, or even, in some cases, to unsolicited proposals[9] is essential, as a form of guaranteeing the preparation and structuring of PPP contracts. Although recourse to external expertise may be a solution to address the government's

[8] Under the PPP model, the public partner defines the outputs that it wants the private partner to achieve, namely the services to be provided by the private partner. This differs from the traditional manner of contracting works, where the public entity defines how the service is to be delivered (the inputs).

[9] "An unsolicited proposal (USP) is a proposal made by a private party to undertake a PPP project, submitted at the initiative of the private firm, rather than in response to a request from the government. By managing USPs appropriately, governments may benefit from this approach while reducing potential risks. However, unsolicited proposals may also create challenges that risk providing poor value for money, particularly if the government chooses to negotiate a PPP directly with the project proponent; and they may risk diverting scarce financial resources to non-priority projects" (PPP Reference Guide, 2017).

lack of technical capacity, it is still important to ensure that the public authorities are able to guide or critically review the work of these consultants (EPEC, 2015).

The lack of technical capacity that still exists in some LAC countries, especially in subnational entities, represents a major limitation to guaranteeing the success of PPPs in achieving the resolution of the infrastructure gap and the promotion of economic development. Indeed, the inadequate technical preparation of public teams, coupled with a lack of clear rules regarding the principles to be followed when drawing up PPP contracts, can lead to an increase in the likelihood of poor contractual specification, a consequent increase in transaction costs, and a potential dilapidation of the Value for Money anticipated under the partnership. In addition, it may create greater scope for possible incidents of corruption, given the less transparent process.

In this sense, the development of standardized approaches to PPP contracts (as established, for example, in France and in the United Kingdom) can function as part of the solution to the problem of poor PPP contract preparation. This standardization can serve as a method of improving the quality of contractual documents, guaranteeing consistency between the different projects, improving the transparency of the market, reducing the time and costs of the preparation and launch of PPPs, and minimizing the potential for future conflicts between the parties through greater clarity and objectivity in the definition of contractual clauses (EPEC, 2015).

Nevertheless, it should be noted that such advantages associated with the standardization of PPP contracts will always depend on the technical and institutional capacity of governments to draw up, implement, and put into practice the standardization process itself, and also on their institutional capacity to create the conditions for all stakeholders to comply with the approved PPP rules and standards. Hence, any standardization process implies that, as a prior condition, public agents have accumulated enough knowledge and experience to take into account the lessons learned, both within their country and externally. It also implies that, on the basis of these, they are able to perceive the best practices to be implemented, considering their specific situation, so as to avoid standardization based on the wrong practices (which may jeopardize the safeguarding of both the PPP's Value for Money and the public interest). Moreover, and as a condition precedent to the implementation of a standardization process for PPP contracts and their risk matrices, governments must establish an adequate institutional framework that creates the necessary conditions to ensure the standardization of PPP contracts and their implementation.

An appropriate PPP institutional framework must always establish: (i) the definition of the PPP process, that is, the steps that the PPP structuring process must contain (defining the studies and analyses to be carried out and the respective methodology); (ii) the clear allocation of the responsibilities and institutional roles of the different actors involved in the implementation and management of PPPs throughout their lifecycle; and (iii) the creation of structures or centres of technical competence (PPP Units) capable of developing and accumulating

the necessary skills and expertise to ensure the success of the country's PPP program. Only after properly implementing the PPP institutional framework is a country able to successfully proceed to a standardization process.

PPP Implementation: The Importance of PPP Contracts

Given the investment needs of LAC countries, and in view of the scarcity of their public resources, there is a consequent and inevitable need to ensure that these investments are carried out in the most efficient way possible, in order to obtain the expected results and maximize their public utility, with the public resources available. It is therefore fundamental that governments, for each investment, evaluate the best contracting option based on the objective of maximizing Value for Money, that is, the value added brought about by the said option in terms of the net benefit to the public sector.

However, before assessing how a particular public investment should be achieved and financed, it is important that an in-depth and robust analysis of the merits and added value of the investment in question is undertaken in advance, taking into account its associated costs and always with the objective of guaranteeing an efficient allocation of resources. Thus, international good practice recommends that any investment decision be preceded by a cost benefit analysis, which should be the first step in any decision-making process for a public investment. Therefore, before anything else, any government must carry out a diagnosis and hierarchy of needs process, as well as the planning for an investment program that assertively responds to those needs.

A cost benefit analysis thus constitutes an essential tool in the decision-making process of any government, since it allows the real added-value associated with a given investment project to be estimated. This is done by carrying out a process of identification, quantification, and comparison of the project's costs and benefits (including not only economic and financial costs and benefits, but also social and environmental ones, amongst others).

Considering that these are public projects, financed in a context of scarce resources, this type of preparatory analysis assumes even greater importance, it being fundamental that any investment decision be analyzed in advance and are appropriately justified. This is in order to ensure that, on the one hand, the resources are applied in the sense of creating value, and, on the other hand, that, in order to satisfy a certain essential need, the alternative that maximizes the net benefit to the public purse is chosen.

Once the investments to be carried out have been chosen and justified, then the manner of their implementation and financing should be evaluated. In this respect, two possibilities are identified: the choice of a traditional contracting model; or the choice of a PPP model.

In a context of scarce public resources and a lack of fiscal space, PPPs have naturally become a model widely used by governments to implement their pipeline of infrastructure projects. There is the possibility that they may introduce a greater temporal dilution on the cost of public investment, and have a consequently lower fiscal impact

(at least in the short-term)[10]. The use of the PPP model is thus often justified by the need for governments to attract private funding for large public investments, given their inability to cover these investments solely with scarce public resources[11].

Besides the possibility of attracting private investment, it is relatively consensual that the use of the PPP model can bring several benefits to society, in terms of promoting efficiency and innovation in the provision of public services and, consequently, potentially maximizing social well-being. Moreover, in traditional models, the risks associated with the project (both in the construction phase and in the operation phase) are all assumed by the public sector, so costs are often higher than expected, with slippages often occurring in relation to the investment values budgeted. By allowing for greater risk-sharing with the private sector, PPPs have the advantage of ensuring a greater predictability of charges for the public sector by transferring to the private sector the burden of maintaining that investments are carried out within the estimated time and cost.

However, the PPP model should not be seen as the model for any public investment, as it is not always the option that presents the greatest value. In fact, the PPP model should only be chosen where it proves to be the most advantageous, that is, when it maximizes Value for Money for the public sector and for the end users of the public service concerned (EPEC, 2011).

Thus, the option of the PPP model should be adopted only when it appears to be the most appropriate to achieve the desired ends of economy, efficiency, and effectiveness in the allocation of public resources. Only in this case will it represent effective added-value for the public purse compared with other alternatives (that is, a higher Value for Money).

As pointed out by McKinsey, "PPPs are a tool for financing infrastructure projects that work well when particular conditions exist: the project makes economic sense; there is a clear and efficient process to select a partner;

[10] However, governments should forecast (and account for) the long-term costs of PPPs. When a decision is taken, all the costs associated with the PPP (during its contract life) should be determined, and the public authority should conduct a fiscal affordability analysis in order to decide whether to carry out the project, based on its capacity to bear the costs, not only in the short-term but also over a longer duration. In addition, the time-cost effect on PPP cash outflows should be calculated in order to effectively compare the PPP with other alternatives, in terms of total cost (and benefit). Compared to a traditional contracting model, in the PPP model, there is usually no upfront payment for the investment. The investment cost is paid during the life of the PPP contract. However, the government should calculate the present value of future cash flows associated with the PPP (associated with its payments to the contractor), in order to calculate the impact of the PPP on public debt. In most cases, governments do not calculate the effect of this debt, but only account for annual payments on the PPP contract. This is not best practice, since it is important to bear in mind all the expected payments associated with the PPP (including an estimation of contingencies), in order to effect an efficient decision-making process.

[11] A PPP can be a complementary and useful tool for implementing government investment programs (particularly when it is important to attract private investment and/or when it is advisable to utilize the technical capacity of private partners). However, it is always advisable that governments invest in institutional capacity, in order to build an efficient public capacity to implement and deal with the necessary investment programs (to address the infrastructure gap). Even when a PPP model is used, to ensure that the Value for Money of the PPP is indeed achieved during its life, it is crucial to develop strong public institutions with an effective capacity to monitor PPP contracts.

there is appropriate risk transfer between the government and the partner; and there is a revenue stream to provide appropriate risk-adjusted returns.

As it is a much more complex model than the traditional model for contracting public services, the PPP model requires much more care and preparation by governments in their implementation. In the PPP model, the public partner defines the objectives and results that it intends to achieve, and it is up to the private partner to decide the means through which it intends to achieve those results and outputs. Thus, in the case of PPPs, instead of contracting the construction of a particular infrastructure, the contracting authority contracts the provision of a public service for a certain period of time, with the private partner being responsible for carrying out and financing the investments necessary for the implementation of the public infrastructure. In addition, the private partner provides the public service that is inherent to the operation and maintenance of the public infrastructure during the contractual term agreed, earning a remuneration indexed to its level of performance.

This greater focus of PPPs on the results to be achieved (to the detriment of the means) is a potential advantage of the PPP model, since it allows the public partner to design a remuneration system through which it only pays for the services actually rendered (not taking responsibility for any operational deficits of the project) and provided that they are rendered according to the conditions it has contracted. In other words, when well-structured, a PPP allows for greater effectiveness, that is, a greater capacity to meet the (specific) objectives and achieve the expected results (in terms of public service). However, the results and objectives that the contracting authority expects of the PPP, although defined at the time of the studies and when structuring the contract, can only be truly proven at the contract execution phase, when it is possible to observe the actual results achieved and to measure to what extent these are in line with the initial expectations underlying the decision of the public partner to contract the PPP.

This specificity of the PPP model creates a context of uncertainty for the public authority, since this entity chooses the PPP model based on the conviction that it will provide a higher Value for Money, that is, a superior benefit (in relation to the traditional contracting option); however, the materialization of these benefits can only be demonstrated ex-post, in the execution phase of the contract, and always depending on the behaviour and performance of the private partner.

As a result, the PPP model has an associated agency cost for the public entity, derived from the inevitable asymmetries of information that exist between the parties[12], but also mainly from the misalignment of interests between the parties[13]. It is therefore crucial, right from the earliest stages of the

[12] Of course, during the execution phase of the PPP contract, the private partner has greater and better access to information, and is better able to observe the contracted services that are being provided and the extent to which the results are being achieved.

[13] The objectives of the public entity, of maximizing citizens' well-being and guaranteeing their needs with certain standards of quality, may not necessarily be in line with the interests of the private partner, which is governed, a priori, by the principle of shareholder value maximization.

PPP contract process, to identify the quality requirements to be met, and the results to be achieved, by the private partner, and to create a remuneration and penalties mechanism that maximizes the alignment of the interests of the parties. Consequently, in order to achieve the benefits associated with the PPP, and given the existing agency costs referred to, it is essential that the PPP contract be well-constructed, with its clauses clearly defining and quantifying the results and objectives to be achieved by the contracted party, as well as there being a mechanism included to ensure that the private partner achieves them. For this, a Key Performance Indicators (KPIs) system could be used, with an associated penalties regime, which would be capable of incentivizing the desired alignment of interests between the parties.

The KPIs should be defined and detailed immediately upon the initial structuring of the contract, and they should: (i) be designed in such a way as to enable the actual objectives of the public authority to be properly captured, taking into account the specificities of the project in question; ii) be adjustable over the contract period, not only on the basis of a logic of continuous improvement, but also in view of the changes that may occur in the services provided (granting contractual flexibility); and iii) be easily quantifiable and controllable.

The PPP remuneration mechanism also assumes a key role here, since it is through this that the enforceability of the performance indicators is ensured. As is stated by EPEC, "A sound payment mechanism is, together with risk allocation, at the heart of the PPP contract" and "the payment mechanism should incentivize the private partner to deliver the right level of performance" (EPEC, 2014).

However, it is not sufficient to clearly foresee the obligations and the consequences of non-compliance with these obligations. It is also necessary to ensure that the contractual clauses ensure the appropriate operation of the PPP management mechanisms, creating the necessary conditions for the public authority to exercise, throughout the life of the contract, its contractual supervisory and monitoring role. This oversight and monitoring of the contract - be it supervising the provision of the services in question, or anticipating problems, or keeping the private partner perfectly in line with the obligations entailed in the contract and the application of penalties where necessary - is essential to ensure the effectiveness of the PPP, so as to achieve the desired results. But, for this to be possible, at the drafting stage of the PPP contract, it is also necessary to introduce reporting obligations by the private entity that permit the public partner, during the life of the contract, to have access to relevant, timely, and sufficient information so as to be able to evaluate the performance of the private partner and the strict fulfilment of its obligations. The reporting of information is a necessary condition to reduce information asymmetries between the parties, to minimize agency costs, and to ensure the effective materialization of the Value for Money expected from the PPP.

As is stated by EPEC, "Without relevant information, the Authority will be unable to make sound decisions, monitor the private partner's performance, comply with its contractual obligations or manage project-specific risks." It is up to the public authority to

verify that the information is accurate and consistent (EPEC, 2014).

As mentioned above, in addition to the PPPs allowing for greater effectiveness, another of the advantages usually associated with the PPP model is the greater efficiency that this model permits in the use of public resources throughout the lifecycle of public projects. When well-structured, the private partner remuneration mechanism and the risk matrix allow the PPP costs for the public sector to be more predictable and stable (compared with the traditional contracting model), since it is possible to estimate, with some reliability, the future budgetary impacts associated with the PPP. Since the construction, operation, and maintenance risks are generally transferred into the private partner's sphere of control, when contracts are well-structured, the public partner assumes no responsibility for any deviations in the costs or operational efficiency of the private partner. This is contrary to the situation in the case of traditional contracting, where, in addition to there often being difficulties in estimating the future costs of operating the investment (as only the budgetary impacts of the infrastructure's construction are estimated), the actual risk of operating inefficiencies remains with the public sector, with possible deviations only later reflected in future public budgets.

This transfer of the operation and maintenance risk to the private partner means that, when well-structured, the PPP creates incentives for the private partner to optimize the construction process of the infrastructure, in order to minimize the costs of operation and maintenance. However, to ensure efficiency throughout the lifecycle of PPPs, it is absolutely essential that contracts be well-designed and that risks be allocated as thoroughly as possible.

The importance of the entire process of structuring a PPP being prepared in a rigorous, conscious, and cautious way, and of the PPP contract and risk matrix being robust and consistent, is unequivocal, since they comprise the main tools for preserving Value for Money during the contract execution phase. A poorly constructed or incomplete contract and inadequate risk allocation can generate potential future conflicts, renegotiations, and additional and unexpected costs for the public sector.

PPPs can be a good method of overcoming the infrastructure gap[14] (at least in certain circumstances), as they can help decrease the cost of investment (smoothing its budgetary impact) and improve the efficiency gains. However, in order to achieve their benefits, it is crucial that, first of all, the project be well-selected, and then that the PPP be well-structured; otherwise, the PPP might result in additional fiscal contingencies in the future. A good contract design (as well as a well-designed risk matrix) is a paramount condition to avoiding these contingencies; a well-drafted contract can align the incentives between the parties (contributing to the attainment of the desired objectives and results) and mitigate the risk of future additional costs for the public entity derived from renegotiations and potential litigation. Therefore, in order to maximize the benefits of PPPs, it is necessary that their implementation follow a very robust, structured, and

[14] This infrastructure gap is noted by Prats (Prats, 2016). The role of PPPs in addressing this infrastructure gap is pointed out by McKinsey (McKinsey Global Institute, 2016).

well-defined process: plan; evaluate; analyse different options; calculate and balance benefits and costs; structure; align incentives; draft contracts' regulating rights and obligations; allocate risks, preserving Value for Money and the project's bankability; and promote market competition through the bidding process. It is also important that this whole process be carried out ensuring the principle of transparency, thereby reducing the probability of corruption occurring and minimizing transaction costs and the time spent on the entire process.

Currently, one of the problems that LAC countries face is the high rate of PPP contract renegotiations, linked in part to poor project preparation. These renegotiations, mainly due to risk misallocation, incomplete contracts, or regulatory weaknesses, considerably alter the desired project results. Another of the challenges facing LAC countries is the need to improve transparency and public disclosure regarding the PPP launch process, particularly in light of recent corruption cases (OVE, 2017).

Having recognized the potential advantages of PPPs and the important contribution they can make to the reduction of the infrastructure gap in LAC countries, especially in the context of large project pipelines and limited public resources, it is important to bear in mind some important considerations:

- PPPs are only a method of contracting an investment. Upstream of any decision to implement a PPP should be a process of planning the infrastructure needs and selecting the priorities of the country. Efficient mechanisms for project selection, based on cost-benefit analyses, should be implemented. Before any investment decision is made, it is essential that governments select appropriate projects, ensuring that only good projects are undertaken and that there is appropriate project prioritization among sectors. PPPs often tend to be seen as a "free" means of implementing investments, so there is not always an alignment between PPP policy and national infrastructure plans;
- PPPs should not be seen as a way of managing public budgets, but rather as a form of procurement that in some cases is more efficient and presents higher Value for Money. Hence, governments must, in the first instance, implement robust methodologies for each project, in order to evaluate whether the PPP model is the one that generates a greater net benefit for the public sector; and
- PPPs are a much more complex and time-consuming contracting model, in terms of implementation, than the traditional contracting model. The signing of a PPP contract implies the assumption by governments of long-term financial commitments with a private entity. This relationship between the public and private partners, in addition to being long-term (implying, therefore, greater uncertainty about the future), has, underlying it, a number of asymmetries of information and possible misalignments of interests. It is therefore vital that PPP contracts be very well prepared (in order to ensure that the results are achieved, future tax contingencies are minimized, and renegotia-

tions and litigation between the parties are avoided) and that the commitment made by governments is that which generates greater efficiency (greater Value for Money). To this end, it is also fundamental that the procurement process is sufficiently competitive (attracting many interested investors) and conducive of this efficiency.

Considering the complexity associated with the implementation of a PPP program, it is clear that: (i) on the one hand, public officials must have sufficient technical capacity and experience to be able to properly assess and safeguard the public interest in all the phases of a PPP process, retaining the bargaining power of the public sector; and ii) on the other hand, there is a strong and stable political commitment to PPPs and institutional, legal, and regulatory frameworks are implemented that favour and support the whole process inherent in the PPP lifecycle.

In fact, in order for PPPs to be an efficient and effective means of solving the infrastructure gap problem, and for governments to take advantage of the benefits associated with this contracting model, it is important that, prior to the implementation of a PPP program, governments ensure the development of an adequate legal and regulatory framework (which defines the rules and guiding principles of the PPP universe), as well as an institutional framework (which supports the process and allocates specific responsibilities). The existence of a clear, adequate, stable, and politically-supported framework is a necessary (although not sufficient) condition to ensuring the success of any PPP program, granting credibility and boosting the attraction of foreign investors.

However, although the institutional framework is essential, it is not in itself sufficient, since it is still necessary to ensure that the public actors involved in the entire PPP process have the technical capacity and skills to accurately carry out all the necessary processes throughout the lifecycle of the PPPs (EPEC, 2015).

The technical capacity of the public agents is crucial, as they are the ones who put into practice the rules and procedures defined in the PPP framework. They also ensure the effective implementation of PPPs, including contract drafting, the definition of the risk matrix, and the management and monitoring of contracts. As the public sector is much more fragmented and disorganized than the private sector, this is a major challenge facing countries. That is why, according to the conclusions of Infrascope, in LAC countries "there is still an important gap between legislation (what is on the books) and the maturity of the sector in terms of PPP projects implemented (what occurs in practice). Countries may score high in "Regulations" and "Institutions" but still lag behind in "Maturity"." Thus, a great challenge facing these LAC countries is to successfully implement their project pipeline (Infrascope, 2017). This lack of capacity of the public agents in the LAC countries is especially evident in some countries at the subnational governments' level (such as in Brazil).

Despite the governments of LAC countries having attempted to mitigate this shortcoming of technical capacity, through the use of both external consultants and unsolicited proposals, this cannot be seen as the

solution to the problem. This is because, although recourse to the private sector may be necessary and useful, it is always essential to ensure that public agents have critical analytical capacity. This is the only way to avoid asymmetry of information, resources, and technical capacity between public and private partners which may result in poor project preparation and misallocation of risks between the partners. When this occurs, it frequently leads to contract renegotiations and to fiscal contingencies.

Therefore, it is important to develop, within the public sector, the know-how and technical capacity needed to support the structuring and launch process of PPPs (the ability to develop and apply rigorous technical methodologies and criteria). It is also important to develop the decision-making process of governments, the ability to have control over the fiscal outcome of PPPs, and an improved capacity to accumulate experience, assess lessons learned, and implement better solutions.

Considering the diversity of contracting authorities that usually exist within a country (at national and subnational authorities), even when there is a single framework, the risk of inconsistency in the practices followed by these entities is high. There is also the risk of a higher probability of occurrences of corruption, primarily when transparency and public disclosure mechanisms do not work properly. Thus, in order to ensure consistency in the application of best practices, to avoid deviant behaviour, and to make processes more efficient and expeditious, it is advisable to create technical expertise centres within the public sector capable of accumulating the skills, know-how, and experience necessary to ensure the implementation and management of PPP programs throughout the project lifecycle.

As stated by EPEC, "A central source of technical expertise, such as a PPP Unit, can support policymakers and procuring authorities in acquiring a clear understanding of capacity requirements from the beginning. Such central expertise may also be able to develop strategies to help build up the depth of the advisory market itself and capitalize on lessons learnt" (EPEC, 2015).

Portugal is an example of the successful implementation of a PPP Unit (as better explained in chapter 5). In 2012, Portugal implemented a new PPP framework, which included ambitious legal and structural reform, as well as the creation of the UTAP, the Ministry of Finance's PPP Unit. One of the key objectives of this PPP reform was the reinforcement of the participation of the Ministry of Finance in all phases of the contracts' lifecycle, in order to enhance its capacity to control the fiscal outcome of PPPs. The PPP Unit assumed responsibilities for PPP project appraisal, structuring and tendering, reporting, contract renegotiation, legal and financial technical support to government members and other public institutions, budget process support, and PPP know-how development. The PPP Unit started to take a very active role in the PPP structuring and launch processes. Although there is no formal PPP standardization framework in Portugal, the existence of a PPP Unit has greatly contributed to the standardization of the principles used in contract drafting.

PPP Units can, in fact, contribute very positively to public sector capacity building, which is essential to ensure the efficient implementation of PPPs. The centralization

of knowledge and experience in a competency centre, such as in a PPP Unit, can be a way of responding to poor contract and risk matrix preparation, the lack of transparency involved in the PPP implementation process, and the lengthy process of PPP implementation, given the huge amount of time spent in designing and negotiation the PPP contract.

In this respect, the situation in LAC countries is quite heterogeneous. There are countries (such as Chile or Peru) which have already introduced PPP Units, which have a prominent role throughout the project lifecycle, and there are other countries where the process is more decentralized, with a broad set of entities involved in the PPP process, structuring, launch, and management (Prats, 2016).

Despite this heterogeneity, common problems have been identified in these countries, such as the inadequate preparation of public procurement contracts, often due to the lack of capacity of public agents, as well as a high proportion of renegotiations, often resulting from poor allocation of risks or ill-defined contractual clauses. In view of the foregoing, it is evident that the PPP contract is undoubtedly the key factor of any PPP program, and the most valuable tool in guaranteeing the preservation of value and the advantages that are usually associated with this contracting model.

As mentioned, the advantages associated with PPPs are unequivocal. It is consensual that this contracting model allows public entities not only to boost their investments and to cope with the infrastructure gap (benefiting from private investment and thus better managing their budgetary resources), but also to obtain greater advantages. These may be either in terms of improved social well-being (because, under certain conditions, the PPP allows for better service, with increased quality and greater innovation), or in terms of lower costs for the public purse, through the sharing of risks with the private partner. There is also greater control over, and predictability of, the budgetary impacts throughout the life of the contract.

However, PPPs are not always the solution to the problem. Even when a PPP seems to be the best solution, it should be borne in mind that this is a much more complex model, the implementation of which requires adequate prior preparation by governments. Its success is not guaranteed, with it depending on a set of conditions that must be ensured by public authorities, namely: i) the creation of a robust and well-structured regulatory and institutional environment; and ii) the existence of technical capacity within the public sector[15].

Last, but not least, it is necessary to point out that this complexity associated with the PPP model often creates the risk of corruption. There is the danger that the public interest will not be safeguarded, either during the preparation of contracts or during their execution phase, and this may not be evident, at least at first sight. Thus, ensuring transparency throughout the process can act as a deterrent to the risk of any deviant

[15] The Portuguese and UK models are good examples of how the PPP framework should be addressed in order to ensure a robust and well-structured regulatory environment, that allows a capacity-building process within the public sector. The existence of a PPP Unit, or an entity that concentrates knowledge, public technical capacity, and experience (in order to implement the lessons learned) is of utmost importance.

behaviour, such as corruption. Transparency clearly improves control over the results of PPPs, making the costs associated with PPPs and the quality of the services provided explicit and, therefore, less subject to deviations or corruption. Public disclosure is the tool to ensure transparency, for which reason public entities should always, as far as possible, make all documents public, reporting not only how the PPPs are structured and the documents that support the decision-making process but also the bidding documents and the signed contracts, as well as the results of the PPP monitoring process by the public entity throughout the PPP's lifecycle.

During the PPP structuring stage, while it is more difficult to ensure public disclosure (taking into account the secrecy of some phases of the public tender), public authorities may be able to create ways to minimize the occurrence of deviant behaviour. The existence of centralized PPP Units with functions throughout the entire lifecycle of the PPPs, the adoption of a PPP contract standardization process, and the development and publication of clear guidelines and principles to guide the PPP process for the study and preparation of contracts are, undoubtedly, examples of mechanisms that can contribute to the promotion of transparency. They allow for greater clarity and predictability in the structuring and drafting process of the risk matrix and contracts. In addition, they facilitate the monitoring of the entire process by the supervisory authorities (such as the Court of Auditors).

When considering the structuring of PPP contracts, one of the most controversial aspects is the decision on whether to standardize contractual clauses. When looking at international experience, there is no single trend evident in this regard. There are countries (such as the United Kingdom, New Zealand, and the Netherlands, for example) where contracts are standardized[16], and there are other countries where contract drafting is done on a case-by-case basis (such as Brazil, especially at the subnational level). There are even intermediate cases where, although there is no standard contract, there is a set of principles that govern the design of contracts, granting consistency (as is the case in Australia) to the contracting process. There are also other cases where, although there is no standardization, some specific clauses are included in the PPP legal framework (this is the case in Chile, where the dispute resolution mechanism is established in the Concessions Law).

In view of the aforementioned complexity of PPP contracts and the length of the structuring process, the standardization of contractual clauses can be seen as a way of bringing efficiency to the process of structuring and launching PPP contracts. In addition to reducing the length of time between concept design and the awarding of projects, the standardization of contracts can also act as a form of quality assurance in the drafting of PPP contracts. When there are clear rules for the design of the contract, it is easier to ensure that it is well-constructed, thereby reducing the likelihood of future renegotiations or litigation. In LAC countries, most of the renegotiations are due to the fact that

[16] According to the World Bank, "only one-third of the economies have developed standardized PPP model contracts", based on 135 economies included in its study (World Bank, 2018).

contracts are incomplete or poorly constructed (OVE, 2017).

On the other hand, even though renegotiations may occur (because sometimes they result from necessary changes to the project), standardization facilitates the process of renegotiation between the parties; it is easier and clearer to understand the mechanisms included in the contract, in order to restore the economic-financial balance, when there is standardization. There are sometimes cases of renegotiation where it is not even clear how compensation to the private partner should be calculated in the event of rebalancing, which naturally undermines the negotiation process, delays the completion of the renegotiation process, and can lead to unexpected budgetary contingencies for the public partner.

As stated by the World Bank, "The lack of standard provisions for renegotiations for the parties in the PPP contract could mean that approaches to renegotiation remain ad hoc and consistency is not preserved. This gap may be filled by standardized PPP contracts that guide parties through the renegotiation process while still allowing them flexibility to address the project's specific needs. However, among the countries that consider renegotiation a contractual issue, only 14 percent clearly use standardized contracts, including India, Japan, Kazakhstan, and South Africa" (World Bank 2018).

Another advantage of standardization is the guarantee of greater consistency between different projects. This consistency is important, not only because it enables international investors to more easily anticipate and understand the rules underlying the various public tenders, but also because it fosters transparency and reduces the likelihood of occurrences of corruption during the PPP structuring and public procurement process. When there are clear rules about PPP contract drafting, it is easier to ensure that procedures are carried out in order to safeguard the public interest, with the whole process being more easily audited.

Ensuring consistency is even more difficult in large countries, with multiple governments and where there are no entities that centralize technical expertise (such as Brazil, where there is no consistency between national and sub-national practices). In these cases, the standardization of contracts is a way to guarantee consistency in the contracting of projects in the PPP modality.

Furthermore, there is still an inadequate level of technical capacity of public agents, which explains the significant recourse to private agents in the preparation of PPP contracts, whether in the form of contracting external consultants, or in the form of unsolicited proposals. This situation, however, creates greater difficulty in ensuring that the PPPs are structured in a way that safeguards alignment with the strategic objectives of the public authorities, and in ensuring the contract serves as an effective tool for guaranteeing the Value for Money expected from the PPP. Thus, and especially in these cases, it may be useful to develop some kind of contract standardization or at least to create guidelines that guide these private agents in the contract structuring and drafting work. In this manner, it will be easier to ensure that the structuring of contracts is done in a way that aligns the incentives of the future private partner with those of the public partner. "Standardizing the PPP process helps ensure

that all PPPs are developed in a way that is consistent with the government's objectives. It also helps achieve coordination between the various entities involved" (PPP Reference Guide, 2017).

An additional advantage of the contract standardization process is the reduction of the transaction costs of both the public and private partners related to the PPP structuring and procurement process. When the regulatory and contractual architecture is coordinated, known, and predictable, it is easier for the public authority to control the work of its external consultants. It is also easier for potential bidders to perceive the scope of tenders and to prepare their proposals, with the due diligence processes, mainly legal, being simpler, more straightforward, and, therefore, cheaper.

As stated by McKinsey, "Greater standardization would help to attract funds into smaller infrastructure projects, where high due-diligence costs relative to the total investment frequently deter investors. When possible, governments, multilateral development banks, and other institutions should promote the standardization of project preparation and evaluation, by, for instance, using common risk assessment frameworks and documentation" (McKinsey Global Institute, 2016).

In spite of the advantages associated with the standardization process, especially in terms of stability, consistency, and reduction of both the time spent in structuring PPP transactions and transaction costs, it is important to take into account the following aspects:

- Standardization, although facilitating the PPP contract structuring process, does not solve the problem of the lack of technical capacity of the public agents, since it will be these entities that will ultimately ensure that the core principles defined as standard are fulfilled in the PPP structuring process. Even when the technical work is carried out by external consultants, it is essential that the public authority be able to guide and validate the work of these consultants. Even so, it will naturally always be more advantageous if the work of external consultants is guided by a set of concrete and well-defined guidelines, aimed at ensuring that the government's strategic objective with the project is achieved;
- The process of PPP contract standardization implies the existence of previous experience in the countries in the management of PPPs, since only then will it be possible to evaluate best practice and incorporate the lessons learned in the standardization process. While it is possible and even desirable to draw upon international experience and on those that have applied best practice in other countries, the specificities of each country, its legal framework, and its specific situation, should also be considered; and
- As a rule, PPPs are used in several sectors, with specific and different characteristics. Thus, the standardization process must safeguard these differences, and a correct balance must be made between the advantages of standardization and the risk of limiting the flexibility of contracts. Even within each sector, although there is more homogeneity among the projects, there are, nevertheless, specific characteristics of

each project which must be properly safeguarded in the design of the contract. Thus, for certain aspects of the contract, such as the definition of its objective or the quality/service standards to be achieved by the private partner, instead of defining standard clauses, only the core principles that need to be respected may be identified. Even at the level of the definition of the risk matrix, it would be very difficult, or even impossible, under a standardized process to identify and quantify all the specific risks that each project may have.

Thus, in spite of the specificities which should be considered in different sectors and different PPP contracts, there are clear advantages in the standardization of the core principles to be considered in the structuring of PPPs. Since the PPP structuring process is very complex and time-consuming, and often very dependent on the work and expertise of external entities (external consultants), and since the PPP contract is acknowledged as the main tool public authorities have for the preservation of Value for Money associated with the PPP, it is highly desirable that the PPP structuring process be guided by very concrete, clear, and rigorous rules, principles, and guidelines based on good practice. While it is difficult to ensure the complete standardization of all contractual clauses, with tailor-made provisions being required to regulate some project specificities, it is recommended that, even so, core principles should be followed to define all the important aspects of the contract, with the explicit definition of the concrete terms of some clauses that reflect common mechanisms between the various contracts (such as contract termination provisions, compensation events, etc.).

It is essential, however, that this standardization process be integrated into a well-defined institutional framework, which allocates concrete responsibilities to the various agents and provides political and legal support for the implementation and practical application of this standardization. This would ensure that best practice is applied consistently across all the PPP contracts of the country, at both the national and subnational levels. Furthermore, and because it is recommended that the standardization process benefit from the accumulated experience of the country and its lessons learned, it is important that the standardization process be centralized and formulated under a team of dedicated public agents (a technical skills centre) in order to ensure the internalization of know-how and experience within the public sector.

The Risk Matrix

One of the major differences between the PPP model and the traditional contracting model is that PPPs allow for a significant transfer of project risk to the private partner, so that the consequences and impacts of the potential risks it assumes under the PPP contract fall under the private partner's sphere of influence. Thus, the PPP model allows both the public sector and the private sector to play the roles they are each more able to perform in a more efficient manner. This is particularly important in the case of infrastructure, which generally involves very high investment levels and a very long time hori-

zon (of useful life). Of note among the main risk categories are technical, construction (including environmental and expropriation), operation and maintenance, demand, financing, and political and regulatory risks.

Risk allocation is one of the basic principles of a PPP, since, when carried out efficiently, it generates value and is responsible (along with the clauses of the contract) for a large part of the Value for Money associated with a PPP. Thus, one of the conditions necessary to maximize the Value for Money of a PPP is to be able to ensure an optimal allocation of the project risks. As stated in OVE 2017, in PPPs, "contract design and risk allocation are crucial for achieving the expected benefits".

Risk-sharing between the public and private sectors, when accomplished properly, can effectively contribute to increasing project efficiency and may translate into a number of advantages, namely:

- It allows for greater control of investment costs by attributing the responsibility for meeting deadlines and the budget to the private sector[17]. In the PPP model, and when good practices are followed, the public sector only starts paying the agreed payments after the completion of the construction and in accordance with the achievement of the contractually-established performance standards. The public sector party may participate in the financing of the infrastructure (when this is necessary to guarantee the bankability of the project), but, even so, the contract should normally establish thresholds for public authority contributions, always ensuring that the construction risk remains with the private partner;
- The reduction of infrastructure maintenance costs over the period of the PPP. In a PPP, given that the entity that builds the asset is also responsible for its maintenance, there is a natural incentive to reduce the overall cost of the construction and maintenance of the buildings and equipment throughout the life of the concession. This incentive does not occur in the case of traditional contracting, in which the entities responsible for construction and maintenance are different; and
- Increased control of operating costs through the contractual definition of the prices to be applied, the quantity and quality objectives to be fulfilled, and the price revision mechanisms to be used throughout the partnership period. As the risk of operating the infrastructure is transferred to the private partner, any operational inefficiencies throughout the PPP lifecycle are reflected only in the private sphere, while the public authority payments remain unchanged. This circumstance therefore allows for a significant decrease in the degree of uncertainty regarding the future evolution of public sector costs associated with the project.

[17] Although in certain circumstances it may be justified for the public partner to assume part of the construction risk, for example, when, due to expropriation procedures, it is concluded that the cost of transferring this risk to the private partner is too high, thereby destroying value, in the majority of cases, the risk of construction is transferred to the private partner, as it is usually the entity that has the greatest capacity to manage it.

The risk-sharing mechanism of a PPP can be a source of value creation, but it may also be a route towards value destruction, if the risk matrix is either not well-defined or if it is not properly reflected in the remuneration/penalty scheme. Public authorities should keep in mind that risk always carries a price, since the private partner always demands a premium for bearing a certain risk. Therefore, the main rule for defining the risk matrix of a PPP should be that each risk should be allocated to the party that can manage that risk in the most effective way, in order to achieve the desired Value for Money of the PPP. At the same time, it is also important to ensure that the price of the PPP is well-calculated, taking into account the cost of all the risks and their respective allocation between the parties.

Government entities should avoid the temptation to allocate all risks to the private partner, since this could imply an increase in the overall cost of the PPP and could therefore jeopardize its Value for Money. On the other hand, they should also avoid the allocation of all risks to the public partner without a corresponding reduction in the cost of the PPP contract to the government.

There could be some situations in which there are strong arguments in favor of allocating important risks to the public partner (where, for example, the private partner has no control over the circumstances related to one particular risk or when there is huge uncertainty about the probability of that risk occurring). Under these circumstances, the allocation of risks to the public partner should be reflected in the cost of the PPP, through the remuneration scheme of the private partner, to avoid the PPP contract being used as an instrument of rent-seeking. Furthermore, if during the life of the PPP contract it is necessary to introduce some adjustments to the contract, the impact of those adjustments should be calculated and taken into consideration, always considering the risk matrix defined at the beginning (which should not be materially changed and, if it is changed in any way, the PPP price should be adjusted accordingly).

It is therefore not only important that the risk allocation is well-apportioned between the parties, but also that the risk matrix is well-reflected within the PPP contract, in order to avoid situations where the PPP is overpriced (the public party should not pay for a risk that is not borne by the private partner) or where the PPP is frequently subject to contract renegotiations.[18] It is important to ensure a complete PPP contract, which, by providing better indemnity, could help to provide stronger incentives for operational effort. In addition, incomplete contracts may favor corruption (Iossa and Martimort, 2016).

Within this context, it is necessary that, during the PPP structuring process and before defining the contractual clauses, a rigorous evaluation and identification exercise of all the risks of the project is carried out, as well as an allocation of these risks to the most qualified of the parties undertaking the project. This process is a pre-condition for the later definition of the contractual clauses, which should incorporate allocation of the risks.

[18] "With a more efficient risk allocation, the advantages of bundling in terms of greater design effort and lower operational costs are boosted" (Iossa and Martimort, 2012).

In the PPP model, the private partner generally assumes the responsibility, not only for the construction and financing of the infrastructure, but also for its operation and maintenance over a certain period: it assumes responsibility for the provision of a particular service, ensuring previously defined specific standards of quality, availability, and use. Thus, based on the definition of the private partner's responsibilities and the allocation of risks between the parties, a remuneration model based on the performance of the private partner is then defined, considering the extent to which it achieves the objectives set for it. Risk allocation should be seen as an integral and crucially fundamental part of the PPP contract, ensuring a perfect and interdependent correspondence between the contract provisions and the risk matrix that is drawn up for the project in question. It is not possible to design a PPP contract without properly identifying all the risks of the project and allocating each of these risks to the party better able to manage each efficiently, that is, to better mitigate its impacts and minimize the potential consequences of the risk.

Thus, one of the central aspects in the PPP structuring process is the construction of the risk matrix, which must be built based on the results of a prior exercise of identification, mitigation, and allocation of risks between the parties. The risk matrix, once created, should be reflected in the contractual clauses[19], with it being recommended that the risk matrix itself contain express references to the contractual clauses that reflect each of the risks and their allocation. This is so that, in the execution phase of the contract, the allocation of responsibilities and risks between the public and private partners is indisputable.

A thorough and efficient allocation of risks is one of the ingredients necessary to ensure the success and Value for Money of the contract, but it is not enough. It is also important that, in addition to the risks being well-allocated, these be well-reflected in the risk matrix and, above all, directly reflected in the contractual clauses. It is essential that there be coherence and a clear correspondence between the risk matrix and the contractual provisions since this is the only way to minimize the likelihood of future litigation. Moreover, even when PPP contracts are renegotiated, it is essential that there be clarity in the allocation of risks, to avoid distorting the grounds of the contract and changing the contractual equilibrium anticipated when the PPP was launched. Where the risk matrix is not clearly and unequivocally reflected in the text of the contractual clauses, there is the possibility that, in a renegotiation, there may be misinterpretation which may lead to a change to the initial risk allocation and to a consequent decrease in the Value for Money of the PPP, with possible additional budgetary contingencies for the public sector. When the risk matrix and the contractual clauses are not coherent and in perfect correspondence, there is also a greater probability of deviant behavior, such as incidents of corruption, which could result in more (and unexpected) costs for the public sector.

[19] Special care should be given to the alignment between the risk matrix and: i) the definition of responsibilities; ii) the remuneration mechanism; and iii) the definition of service standards and the respective penalties system.

The importance of ensuring consistency between the risk matrix and the contractual clauses being clear, it is also necessary to ensure maximum efficiency in the risk allocation process itself. The idea, sometimes defended, by public opinion or even by public actors, that in a PPP the risks should, as much as possible, be transferred to the private sector is wrong, since risk has a price and, therefore, excessive risk always translates into unnecessary costs for the public sector and the destruction of value for taxpayers.

In this context, the definition of a clear risk matrix and one that allows investors to estimate with some degree of certainty their risk-return binomial, seems to be decisive in ensuring the Value for Money of any PPP. When the project's risk matrix allocates risks to the private sector that it cannot correctly quantify or mitigate, this translates unequivocally into an increase in the PPP price, even in the context of maximum competition in the procurement process. A misallocation of risk generally leads to an excessive risk perception by bidders, which will therefore require a higher rate of return. This would translate into an increase in the PPP cost for taxpayers, and a consequent reduction in the Value for Money associated with it.

Good practices thus dictate that risks that are difficult to quantify should be allocated to the public partner, as uncertainty always creates difficulty in establishing adequate pricing by the private partner and, inherently, results in a higher risk premium being paid by the public partner. In addition, when risks allocated to the private partner are difficult to quantify, or when it is not possible to control for or mitigate them, this circumstance tends to translate into lower project bankability, or at least to an increase in the financing cost imposed by the funders, a situation which also results in greater costs for taxpayers. An optimal allocation of risk is one that ensures the maximization of the Value for Money associated with the PPP and should never be considered as the one that ensures the transfer of the maximum number of risks to the private sector, since this approach will certainly tend to bring about an increase in project cost and destruction in the PPP's potential value.

Moreover, a poor allocation of risk also tends to increase the likelihood of contract renegotiations, very often because of difficulties in implementing the partnership in the way it was established. In LAC countries, the rate of contract renegotiation is very high and "risk misallocation tends to be at the heart of renegotiation processes" (OVE, 2017).

In this context, it is important that special attention is paid, during PPP structuring, to the risk matrix construction process, a process that must undergo several stages, including: i) the exhaustive identification of project risks and their potential impacts; ii) the allocation of the identified risks to each of the parties; and iii) the definition of the risk matrix and the respective correspondence of each element with the contractual clauses (PPP Reference Guide, 2017).

The project's risk identification exercise should be carried out considering not only those that are generally the main risks associated with similar projects, but also the specific characteristics of the project in question, so as not to underestimate or neglect any of the risks of the project. Once the risks have been identified, the process of allocating

these to either the private or public partner should follow; some risks may be shared by both parties. The allocation of risks should be made in such a way as to ensure that each risk is allocated to the party that has: i) the most appropriate instruments to manage the probability of their occurrence; ii) the greater capacity to manage the damages that may be caused to the project by that risk; and iii) the greater flexibility to minimize the potential consequences (costs) of that risk (PPP Reference Guide, 2017).

Thus, a good allocation of risks is one that guarantees not only the lowest cost of the project, but also the one that creates incentives for an appropriate alignment of the parties' interests. The risks allocated to the private partner should be those which it has the greater capacity to manage, and therefore the greater capacity to avoid their occurrence or to reduce the severity of their consequences. However, in some countries there are certain risk allocations which are already legally defined, hindering, in these cases, a different allocation, even if this could be justified based on efficiency.

If the probability of occurrence of a risk, or the materiality of the potential damages arising from it, depends mainly, or even exclusively, on public sector decisions or actions, it should not, as a matter of principle, be transferred to the private sector. This is because the private entity will have less capacity to manage or mitigate such a risk and would consequently charge a higher risk premium to assume it.

The result of the risk allocation process is, as a rule, transposed into a risk matrix, which should, in turn, serve as the basis for the definition of contractual clauses. This will ensure consistency between the factors anticipated in the risk matrix and the body of the contract.

The risk matrix represents an essential tool for analyzing and managing the partnership, allowing, in a simple manner, for: i) the presentation of the main risks of the project; ii) the itemization of those areas of the project where such risks may have the most impact; iii) a representation of the previously-defined risk allocation scheme; iv) the detailing of the risk mitigation strategies allocated to the public partner and the characterization of the risk management capacity allocated to the private partner; and v) the identification (where possible) of the contractual clauses where the allocation of each of the risks is reflected.

The risk matrix should serve as a basis for the definition of contractual clause. This is to make sure that the various mechanisms introduced in the contract that are aligned to performance standards, specifically the remuneration and penalties mechanisms, are designed to ensure consistency and coherence with the previously defined allocation of the different risks.

The preparation of the risk matrix is a core part of the PPP structuring process. It is complex and time-consuming, as it includes the identification and allocation of risks, the quantification of the respective impacts, and the analysis of eventual mitigation measures, as well as the transposition of the output of the whole process into the contractual clauses, always with the aim of ensuring the consistency, clarity, and auditability of the whole process. Due to this complexity, the structuring process is lengthy and involves strong technical capacity by the public

agents. In many cases, governments assure these tasks with recourse to external consultants, this being, in some countries, the only way to handle this. Although the complexity of the subject can indeed justify the use of specialized external consultants, this does not obviate the need for governments to be able to critically analyze the work of these consultants, especially since this is central to the success of the PPPs and to their future sustainability in the context of the public budget.

In order to safeguard that the PPP is a valid and efficient instrument in implementing country investment programs and in solving the infrastructure gap, it is important to ensure that: i) this contracting model reflects lower costs for the same service, that is, that it represents the highest Value for Money; and ii) the estimated costs (whether direct or contingent in nature) of the PPP throughout its lifecycle represent the best estimate of their total budgetary impacts in the future, guaranteeing their predictability and minimizing the probability of the occurrence of unforeseen future contingencies. To that end, it is important not only to define contractual clauses correctly (as already mentioned in the previous chapter), but also to determine a complete and efficient allocation of risks, ensuring that this is reflected, in turn, in the contractual clauses. When risk allocation is incomplete, or where the public sector assumes risks for which it is not the most capacitated entity, the likelihood of additional contingencies occurring in the future increases considerably, with, in some cases, the budgetary impact of the PPP becoming much higher than estimated and, possibly, even unsustainable.

Hence, it is therefore essential that public authorities have the capacity to be able to identify, allocate and quantify the potential impacts of the risks remaining under their sphere of influence during the PPP structuring process. It is also important that they rigorously monitor the development of these risks and their impacts throughout the lifecycle of the PPPs, as this is the only way to avoid unexpected budgetary impacts and preserve the Value for Money of PPPs[20].

To guarantee this objective, it may be justified to implement risk matrix standardization mechanisms. Furthermore, this may help avoid several eventualities: i) that the external consultants in charge of defining the risk matrix may not guarantee the identification of all the risks of the project and/or the optimal allocation of those risks; ii) that the allocation of risks is not carried out efficiently due to corruption; or iii) that, for similar projects, completely different risk allocation strategies are employed. The standardization of the risk matrix ensures that best practice solutions for each of the risk typologies are used (at least for those risks that are relatively common to the various projects). In addition, within the context of the legal limitations in force in the country in question, it would allow the process to be more transparent (since the rules are pre-defined), which reduces the likelihood of corruption, as well as the time spent on these tasks, increasing the efficiency of the whole process.

[20] To ensure this monitoring, it is necessary, of course, that governments introduce effective reporting systems, which should permit a full and transversal view of current and future (including contingent) commitments undertaken by the public sector, both at the national and subnational level.

Moreover, when standard risk matrices are defined, it is possible to test more rigorously to what extent the allocation regime designated for each risk does not jeopardize project bankability and ensures market interest, in addition to it not jeopardizing the competitiveness of the procurement process or increasing the final cost of the PPP.

As stated by EPEC, "In some PPP programmes, use is made of standardised contracts to help bring greater consistency to risk allocation across projects and, because such contract terms are already tested in the market, provide confidence that the allocation of risks will be both acceptable to the market (that is, bankable) and represent VfM" (EPEC, 2015). However, it must be considered that it is not possible to standardize all the risks, since each project has unique characteristics that distinguish it from others. Thus, limiting the risk matrix to a standardization exercise would naturally be reductive and incomplete, or even inaccurate, given that in each project there are always specific risks or risks for which the approach must be customized. Nevertheless, it is possible, and even desirable, to standardize for some aspects which are typically common among the various projects. Some examples of clauses that can be standardized are force majeure, early termination, compensation calculations in the event of financial rebalancing, step-in rights[21] and other provisions related to financing arrangements, changes in the law, dispute resolution mechanisms, and guarantees provided by private partners.

[21] Step-in rights are the rights of one party to intervene to satisfy an agreement in the event the other party fails to perform its obligations and commits a serious and unremedied breach of contract.

3 THE UK EXAMPLE

- In this section, details are given of the approach taken in the UK, which has been considered a best practice example in terms of the PPP regulatory framework and also in terms of the implementation of contract and risk matrix drafting rules.
- The UK has created a specialized entity that works as a center of expertise, allowing for knowledge accumulation, the collation of lessons learned, and the dissemination of best practice concepts on risk assessment and allocation (Iossa and Martimort, 2012).
- The UK was also able to implement a standardized approach to PPP contracts, which has been regarded as a key aspect of the success of its PPP market. Contract standardization is a key factor for ensuring transparency and stability, which, in turn, are important ingredients for attracting investors, to ensure project bankability, and to increase the efficiency of all PPP project lifecycles (allowing a more efficient implementation process but also a more effective contract monitoring process).
- The UK standardized PPP contract incorporates a risk matrix in order to identify the risks that may arise under a specific project and to establish how they should be shared between private and public partners. Besides appropriate risk allocation, the standardized process allows for a more consistent approach and pricing among similar projects, and a reduction in the time and cost of negotiation, given the predetermined standardization (HM Treasury, 2012b).
- Furthermore, the use of a centrally-produced guide on PPP contracts (built to deliver best Value for Money), and the setting out of provisions to be included by all central and local public sector bodies when drafting contracts, is also be a way of both reducing the probability of corruption and decreasing the subjectivity implicit in each PPP contract (Iossa and Martimort, 2016).

PPP Framework and Regulation[22]

Instead of a framework based on specific legislation, the UK had developed a detailed guidance-based framework for PPPs (PF2[23]) to ensure that the key principles of fairness, transparency and competition were preserved, including standardized evaluation processes (Value for Money analysis, for example) and contract templates. The PPP model is also encompassed under the following:

- the 'Green Book' (adopted in 2003 and updated in March 2018)—a standard guidance document issued by HM Treasury[24] for public sector bodies, which sets out a framework for the appraisal and evaluation of proposals before committing funds to a policy, program, or project. It also provides guidance on the design and use of monitoring and evaluation before, during, and after implementation of the policy, program, or project; and
- The 'Treasury approvals process for programs and projects' (November 2016)—a guide for Treasury approval stage processes and arrangements for the scrutiny and approval of major project and program spending, also issued by HM Treasury, since each privately financed project is subject to the Treasury's assurance and approval arrangements.

PPP Definition

HM Treasury defines PPPs as long-term contracts where the private sector designs, builds, finances, and operates an infrastructure project (HM Treasury, 2012a). There are several forms of PPP used in the UK, namely: private finance initiatives (PFI and its successor, PF2, implemented in 2012/2013); concessions; strategic infrastructure partnerships; public delivery organizations; regulated asset-based structures; direct procurement; joint ventures; government-owned contractor-operated companies; and hybrid projects.

The PPP Structuring and Procurement Process

Who Decides to Launch a New Project?

Given that the UK has no specific PPP law, there are no general overarching provision in law to grant all public bodies the power to enter PPP arrangements. Powers usually derive from a public body's incorporation documents or from specific legislation.

In that sense, in the UK, the procuring authority of a PPP contract (which is responsible for monitoring its implementation) might be a central government department, a local government authority, or certain other public-sector bodies.

[22] In this chapter, the example of the approach taken in the UK is presented, focusing on the PF2 regulation that was in force until the end of 2018 when the government decided to no longer use Private Finance Initiatives for new projects. In parallel, the Brexit developments should also be highlighted, as this may significantly impact local law given that EU directives may no longer apply in the future (some EU laws have been retained after the UK exited the EU).

[23] In 1992, the Private Finance Initiative (PFI) was introduced. In 2012, a revised PFI model was launched, which the government called PF2. The PF2 model was in place until the end of 2018.

[24] HM Treasury is the UK government's economic and finance ministry, maintaining control over public spending, setting the direction of the UK's economic policy, and working to achieve strong and sustainable economic growth.

Following the implementation of PF2, national level procurement agencies for some sectors (such as, for example, the Education and Skills Funding Agency) have been established by the government to centralize PPP procurement. Other government agencies may conduct their own programs, if there is consistency with a standard centralized approach, such as PF2.

In connection with procurement related to the strategic roads network in England, the procuring body would be either the Department for Transport or Highways England, a government company responsible for operating, maintaining, and improving England's motorways and major A roads. In addition to the procuring authorities listed above, there is a specialized government entity that facilitates the PPP program, the Infrastructure and Projects Authority (the IPA), the UK government's center of expertise for infrastructure and major projects. It is responsible for overseeing major government projects, including those procured under the PF2 initiative. It was formed by the merger of Infrastructure UK and the Major Projects Authority, and reports to both the Cabinet Office[25] and HM Treasury.

The choice of whether to use the PPP model in a particular project is made by the procuring authority and there is no standard structure or approach to apply when procuring a project. In the UK, PFI/PF2 projects must be approved before procurement and the framework for approval usually entails the following steps:

- the Cabinet Office must approve the procurement route and the IPA must operate a staged assurance process that the project must go through before procurement; and
- HM Treasury must approve the "strategic outline case" at the beginning of the project, the "outline business case" at the pre-market stage, and the "final business case" before any final negotiations begin.

Each procuring authority must follow its relevant approval process, and local government bodies and other public bodies usually require sign-off from their sponsoring central government department. Irrespective of the procurement procedure, the EU directives lay down clear requirements for the equal treatment of all bidders, the transparency of the procurer's requirements, the decision-making processes for bidders, and non-discrimination. Common practice in the UK for PPPs has oscillated over the years between the negotiated procedure and the competitive dialogue procedure. Between 2006 and 2015, competitive dialogue was the most common procedure for PPP tenders, which enabled negotiations with the various bidders until the submission of final tenders, following which some negotiation is still allowed but only if there is no material modification.

The Treatment of Unsolicited Proposals

Unsolicited proposals are not allowed in the UK and are therefore not considered in its legal framework.

[25] The Cabinet Office is a department of the Government of the United Kingdom, responsible for supporting the Prime Minister and ensuring the effective running of the government. The Cabinet Office is also the corporate headquarters for government, in partnership with HM Treasury, and takes the lead in certain critical policy areas.

The Role of External Advisors

The Public Contracts Regulations 2015 allows contracting authorities to obtain advice from independent experts or authorities, or from market participants, in the planning and conduct of the procurement procedure. In this regard, it is recognized by HM Treasury that the early appointment of suitably qualified advisors by the public sector is crucial to the success of PFI/PF2 projects. The appointed advisers should use the PF2 Guidance as the basis for the development of the project contract.

Criteria for Bidder's Evaluation and Selection Process

The evaluation criteria should be defined at the outset in the procurement documents and are intended to identify the 'most economically advantageous tender'. This will be identified based on the price or cost and may include the best price-quality ratio, considering the relative weighting attributed to each of the criteria.

Transparency

Procuring authorities are subject to freedom of information laws[26], and prepared contracts are usually published, with access to commercially sensitive information being restricted in line with the confidentiality restrictions set down in the final contract. The scope of the information to be treated as commercially sensitive is agreed between the contract parties.

There are also a significant number of measures required by the government to create transparency for PF2 arrangements, such as: achieving project transparency through public sector co-investment; publishing private sector equity rates of return (actual and forecast); increasing transparency of the government's business case approval process; improving transparency of off-balance sheet liabilities; and increasing the accessibility and usability of project information.

PPP Monitoring

PF2 Guidance and the standardized contracts recommend a substantial element of monitoring, with the right approach depending on each specific project. Monitoring should occur at three levels:

- a systematic monitoring by the contractor through a quality management system measuring availability and performance;
- a review of the quality management system of the contractor by the authority, with certain planned and random spot checks (with the ability to increase monitoring based on repeated failure or poor performance); and
- the possibility for users to report failures (e.g., doctors, teachers, and service personnel).

Since monitoring usually requires the use of information that can only be collected with

[26] The Freedom of Information Act 2000 provides public access to information held by public authorities, in two ways: public authorities are bound to publish certain information about their activities; and members of the public have the right to request information from public authorities.

the cooperation of the contractor, in many cases such monitoring is self-assessed by the contractor (at its expense) and is subject to periodic audit procedures by the procuring authority which has the right to investigate complaints.

The procuring authority is required to have a contract management team which should be brought into the procurement process from the project planning stage. There are examples of the authority using members of its own day-to-day personnel or appointing an external advisor to carry out contract management.

Under PF2 contracts, there must be a mechanism to enable the authority to monitor the contractor's performance against the payment mechanism so that the payment mechanism can operate effectively. The authority should also be able to identify other performance problems so that any other remedies for poor performance can be pursued, if necessary.

Risk Matrix

Risk allocation is made on a case-by-case basis and PPP arrangements should provide cost-effective and efficient risk management through risk transfer and sharing. The objective is the optimal allocation of risk, and not the maximum transfer of risk, it being recognized that not all risks can be transferred.

There are, however, certain risks that are managed by the public sector to improve the Value for Money of the projects, including:

- the risk of additional capital expenditure being required as a result of an unforeseeable general change in law occurring during the operational period of a project;
- the contracting authority demonstrating good title to any property which it employs, and providing expert consultants' reports on contamination and ground conditions;
- the utilities' consumption risk, subject to a two-year handover test, and the utilities' tariff risk; and
- the risk-sharing of mandatory core insurances during the operational phase of projects, to allow the procuring authority to take on a more appropriate share of the risk and thus reduce the contractor's need to build up reserves against increases in insurance premiums.

It is also not usual for the contractor to take on demand risk in PFI/PF2 projects, although in certain projects this may be appropriate.

Regarding risks related to supervening events: (i) the contracting authority usually retains risks related to compensation events and changes in law; (ii) the contractor normally manages risks associated with relief events[27]; and (iii) both parties retain the risk of occurrence of force majeure events.

To ensure transparency throughout the entire risk allocation process, in the UK, a detailed risk matrix is prepared during the design phase (not only following the central guidelines but also taking into consideration the specific project characteristics).

[27] Relief events are generally events with an external cause which have a negative impact upon the project company's capacity to perform its obligations under the project agreement and which are beyond the control of the project company.

It describes every project risk and how it is allocated between the private and public partners. This risk matrix is then appended to the PPP contract, which ensures transparency throughout the life of the PPP, but also facilitates the monitoring of the contract during the operational phase. Describing all the risks and how they are allocated facilitates the monitoring of the contract and eases the resolution of any disputes between the parties.

Standardization

In the UK, PPP contracts used in PFI/PF2 projects have been standardized by HM Treasury in 'Standardisation of PF2 Contracts' (PF2 Guidance)[28], a guidance on the main issues that arise in privately financed PPP projects carried out by HM Treasury (HM Treasury, 2012b). This sets out drafting provisions to be used by public sector bodies when drafting contracts. These drafting provisions are to be included in PF2 contracts either on a mandatory basis (where exact wording must be used), or on a recommended basis, to encourage the attainment of commercially balanced contracts and deliver the best Value for Money.

Application of the PF2 Guidance is mandatory for all PF2 projects in England, and its derogations for approved sector-specific contracts[29] are only made in exceptional circumstances on project-specific grounds and must be approved by the IPA.

[28] Issued in December 2012, the PF2 Guidance applies to all PF2 contracts in England (except to ICT - information and communications technology - projects). This version of standard wording and guidance is to be used by public sector bodies when drafting PF2 contracts, reflecting the current model of contracting for projects for the delivery of infrastructure and services using public-private partnerships. It replaces the 'Standardisation of PFI Contracts' (version 4), issued in March 2007, which was applicable to all PFI contracts in England and Wales (except for IT projects).

[29] Some PPP contracts consider the PF2 Guidance as a starting point but use their own specific standard documents, as is the case for some of the Education and Skills Funding Agency and the Ministry of Defence project agreements, for example. The Ministry of Defence and the Department for the Environment, Food & Rural Affairs have implemented model contracts that include all the contractual documentation required for implementing the PPP structure.

4 THE PORTUGUESE EXAMPLE

- In this section, details are given of the approach taken in Portugal towards PPPs, which can be considered an interesting example of how prospects within the PPP environment can be significantly enhanced through an improvement or change in the PPP regulatory framework. The Portuguese example shows that the establishment of an adequate institutional framework is in fact a condition precedent to the implementation of a standardization process for PPP contracts and their risk matrices.
- In Portugal, although there is no formal PPP standardization as yet, the establishment of a centralized PPP Unit is an effective way of implementing the principles of standardization on contract drafting (including the risk matrix). It is also a way of increasing the depth of technical analysis carried out to support any PPP implementation or any PPP renegotiation (the PPP Unit also participates in PPP renegotiations).
- Until the establishment of the PPP Unit, there was a lack of clear ownership of specific PPP issues on the public sector side in Portugal. This lack of ownership was one of the main reasons why the implementation of a number of PPPs without a clear Value for Money analysis became problematic (resulting in renegotiations and contingencies). The establishment of a new institutional framework and the PPP Unit (which was created at the same time) led to a strong increase in public sector technical capacity and to an improvement in and standardization of contract drafting.
- Moreover, there has been an improvement in transparency surrounding the PPP model, with not only the contracts being made public, but also the forecast annual costs of PPPs during their whole life, including the contingencies associated with them.

PPP Framework

PPP Regulation

In 2012, a new PPP legal framework was established, with the publication of a new directive, Decree-Law no. 111/2012, of 23 May (DL 111/2012), that revoked Decree-Law no. 86/2003, the first directive to transversally regulate PPPs in Portugal. In the context of this new PPP framework, a central role was given to the Ministry of Finance in the implementation of PPPs right from the first stages of the process, with the Ministry having a crucial role in terms of project appraisal, structuring, and the tendering process.

Decree-Law no. 111/2012 has as its objective to define general rules applicable to the intervention of the government in the different stages of the formation and execution of the PPP contract: *definition, design, preparation, launch, award, amendment, supervision, and overall monitoring of PPPs*[30]. It is, therefore, the main decree consolidating the regulation of PPPs under the Portuguese legal system.

However, the PPP regime should not be reduced to this single directive, on the one hand, due to the history of the subject and its regulation in law under this legal system, and,

[30] As per article 1 of DL 111/2012.

FIGURE 6. THE MAIN LEGAL DIRECTIVES RELATED TO PORTUGUESE PPP CONTRACTS

Date	Legal Document	Main features
2001	Law no. 91/2001	Budgetary Framework Law. This was the first directive to mention public-private partnerships and to establish that the partnerships should demonstrate their associated Value for Money.
2002	Decree-Law no. 185/2002	Established the legal regime for health partnerships with private management and financing, which set the theme for partnerships contracted as from that date.
2003	Decree-Law no. 86/2003	First PPP Law. This was the first PPP legal initiative, with a transversal scope in the PPP universe in Portugal. This directive aimed to enhance the public sector's ability to take advantage of the private sector's management capabilities, improving the quality of public services rendered and generating savings in the use of public resources.
2006	Decree-Law no. 141/2006	Amended the PPP Law. This directive introduced several amendments in two main areas: in the procedural part of the preparation of PPP processes; and in respect of the rules for the execution of the respective contracts.
2008	Decree-Law no. 18/2008	Public Procurement directive. This decree specifically regulates the contractual procedures of PPPs, namely the decision to undertake contracts, the power to appoint a tender evaluation panel, and the rules regarding the execution and modification of PPP contracts.
2012	Decree-Law no. 111/2012	This directive revised the PPP legal framework in Portugal (revoking Decree-Law no. 86/2003) and created the PPP Unit (UTAP), under the Ministry of Finance's tutelage.
2017	Decreto-lei no. 111-B/2017	This revision of the Public Procurement edict entered into force in 2018.

Source: Author prepared.

on the other hand, because of the limitations of the application of this directive[31].

Briefly, it can be said that the first initiative, with a transversal aspiration[32], in the PPP universe in Portugal corresponds to Decree-Law no. 86/2003, of 26 April. This directive aimed, in the first instance, "*to enhance the public sector's ability to take advantage of the private sector's management capabilities, improve the quality of public services rendered and generate savings in the use of public resources*"[33].

Subsequently, Decree-Law no. 141/2006, of 27 July, introduced several amendments, in two main areas: in the procedural part of the preparation of PPP processes; and in respect of the rules for the execution of the respective contracts.

The decrees that regulate and regulated the PPP's legal regime in Portugal had, initially, a common purpose, that is, to strengthen the tutelage of the public financial interest, through the rules, assumptions, procedures, and powers of the entities involved. This aspect is clearly more visible in DL 111/2012, the objective of which was to put into effect the objectives and measures provided for in the Financial Assistance Program agreed with the European Union, the International Monetary Fund, and the European Central Bank. More specifically, about Portugal's obligation to introduce into the legal system a strengthened legal and institutional framework within the scope of the national Ministry of Finance, the aim was to allow for the effective and rigorous control of public liabilities (both direct and contingent liabilities), as well as control of the risks associated with PPPs.

The objective of reinforcing control over the fiscal impact of PPPs was detailed in several of the legislative options set out in DL 111/2012, the particulars of which will be explored further below. The following amendments and reinforcements were introduced by this decree-law:

a. The internal organization of the public sector, through the clarification of the competencies of each of the entities involved, and, principally, the creation of a central unit to assume a role in the preparation, development, execution, and especially in the overall monitoring of PPP processes. This unit would provide the State and other public entities with the necessary specialized tech-

[31] DL 111/2012 revoked: (i) Decree-Law no. 86/2003, of 26 April, without prejudice to the enforcement of Order no. 13208/2003, published in the 2nd series of the Diário da República (Government Gazette), of 7 July 2003, until the determination of a new discounting rate to be used in the evaluation of partnership projects, based on a proposal from the PPP Unit (UTAP); (ii) articles 3, 4, 6, 7, 11 through 13, 18, no. 3 of article 19, articles 20 through 23, 32, 33, no. 4 of article 35 and articles 37 and 38 of Decree-Law no. 185/2002, of 20 August. The application of DL 111/2012 neither resulted in changes to the partnership contracts already in force, nor derogations from the rules established therein, nor modifications to partnership procedures launched up until the date of its entry into force.

[32] It should be recalled that, with a purely sectorial scope, Decree-Law no. 185/2002, of 20 August, had already established a few years earlier the legal regime for health partnerships with private management and financing, which set the theme for the partnerships contracted as from that date. This decree was subsequently amended and partially repealed, with this legislative technique not being exempt from criticism inasmuch as it gave rise to doubts as to which regime was effectively applicable, particularly as regards matters of a substantive nature in PPP contracts in the health sector.

[33] As per Preamble of Decree-Law no. 111/2012.

BOX 1. INSTITUTIONAL ARRANGEMENT OF PPPS IN PORTUGAL: BEFORE AND AFTER THE NEW PPP LAW

Portugal was one of the most active European countries in the PPP market from the 1990s until 2011. PPP activity was mainly manifested in motorways and the health sector. During the financial crisis that began in 2008, a number of PPPs were put into action in Portugal in these two sectors (in the road sector alone, 8 PPPs were launched).

Until 2012, despite there being specific regulations for PPPs in Portugal, the PPP institutional framework still suffered from weaknesses and problems. The PPP structuring process was led by sectoral ministries, relying fundamentally on the use of external consultants and lacking a coordinated and centralized public effort, given the lack of a centralized unit of expertise and know-how (a PPP Unit).

The public teams involved in the PPP structuring process were under-sized and/or poorly prepared, which lead, in some cases, to projects being launched without the necessary studies having been carried out to justify either the project (cost-benefit analysis) and the use of the PPP model. This circumstance led to some projects being initiated without adequate preparation and with an inappropriate sharing of risks between the public and private partners. The absence of a Public Sector Comparator in some cases, and the use of inadequate methodologies in different studies in other cases, jeopardized the quality of public decision-making. Some audit reports from the Court of Auditors provide clear evidence of this problem.

Moreover, the reduced capacity of the Ministry of Finance lead, in some cases, to it neglecting to carry out long-term budget planning, fiscal affordability, and Value for Money analyses on the projects. In addition, there was poor control of the risks and associated contingent liabilities affecting long-term budget planning, and a lack of effective analysis of the contractual performance of the private party. In addition, there was poor contract supervision (both by line ministries and the Minstry of Finance), with weak control of the fulfilment of the contract conditions (UTAP, 2015).

Indeed, and for a long time, PPPs were often seen as a way of overcoming budget constraints. In this context, projects for which there was no budgetary affordability were transferred to the PPP model (without this being the result of a rigorous Value for Money analysis), on the assumption that the liabilities with these PPP projects would not be recorded in the public debt.

In 2011, due to the economic and financial crisis faced by the Portuguese economy, a Memorandum of Understanding on Specific Economic Policy Conditionality ("MoU") was signed between Portugal and the Troika (the European Commission, the International Monetary Fund, and the European Central Bank). At that time, it was clear that Portugal would not be able to meet the commitments it had made to the different private partners. Although several projects were launched between 2008 and 2011, notably in the road sector, in many of which the public partner payments had not yet been initiated, it was anticipated that these would be unsustainable in light of the country's situation at that time. The need to renegotiate the PPP contracts was thus evident, especially the road sector projects which imposed the greatest burden on the public budget.

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BOX 1. INSTITUTIONAL ARRANGEMENT OF PPPS IN PORTUGAL: BEFORE AND AFTER THE NEW PPP LAW *(continued)*

Under the MoU signed with the Troika, and given the unsustainability of the PPPs, the Portuguese government agreed not to launch any new PPP contracts before completing both the revision of the existing PPPs and the legal and institutional reforms that had become imperative.

In this context, a change in the legal and institutional framework of PPPs was envisaged, in order to ensure the strengthening of the role of the Ministry of Finance in the assessment of the ex-ante fiscal risks associated with the PPPs and in the monitoring of their execution. Improvements were also planned for the PPP reporting process (allowing for the identification of the budgetary impacts of these contracts).

The reform of the PPP regime provided for in the agreement with the Troika was thus implemented through the publication of DL 111/2012 (which revoked the previous PPP Law), which introduced the following changes in the Portuguese PPP framework:

- The establishment of a PPP Unit (UTAP) directly supervised by the Ministry of Finance. The objective behind the creation of a specialized PPP Unit was to generate internal PPP capacity within the public sector (accumulating data, experience, and know-how). This would provide both quality control and specialized technical assistance to the public entities, thereby reducing the Public Administration's dependence on external consultants and, consequently, reducing costs. The UTAP was also intended to contribute to the development and effective application of more rigorous technical methodologies and criteria in structuring and launching PPP projects. In addition, it would improve the drafting of PPP contracts, which would minimize the room for unilateral decisions by public partners (and the associated contingencies);
- Reinforcement of the Ministry of Finance's role (through the UTAP) throughout the PPP lifecycle. The strengthening of the financial and fiscal control capacity of the Ministry of Finance would enable it to perform ex-ante analyses concerning PPP risks, as well as to conduct monitoring. An objective was to implement some fiscal control measures, even in the early stages of PPP implementation; and
- Improved PPP transparency, with the adoption of greater principles of disclosure. The new decree introduced obligations on the UTAP in relation to information gathering and reporting, as well as in respect of the publication of all relevant documents and data in an electronic platform under its management (including PPP contracts and annexes). The fiscal affordability analysis, performed during the structuring phase of any PPP project, must be published (including a sensitivity analysis). Additionally, the UTAP assumed the obligation to issue quarterly and annual reports regarding the cash flows and fiscal obligations of the PPPs (including contingent liabilities that could arise from litigation processes underway).

In addition, a renegotiation program was launched. This aimed to reduce the future public payments of PPPs (particularly in the case of motorways) and ensure their sustainability.

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BOX 1. INSTITUTIONAL ARRANGEMENT OF PPPS IN PORTUGAL: BEFORE AND AFTER THE NEW PPP LAW *(continued)*

Under this institutional rearrangement, the process of structuring and launching the PPPs was altered, in order to place more focus on the role of the Ministry of Finance, which, through the UTAP, now takes an active and leading role from the initial preparatory phases of the projects. It also now takes responsibility (together with the respective sectoral ministries) for preparatory studies (namely, cost benefit analysis, Value for Money analysis, affordability analysis, and market appetite assessment), as well as for the drafting of contracts and the definition of the risk matrix. This institutional change made it possible to concentrate the whole process of studying, preparing, and structuring PPPs within a specialized public unit, composed of a multidisciplinary team capable of assuming all the work previously contracted out to external consultants. In this manner, it was possible not only to reduce the cost of launching PPPs, but also to ensure greater consistency in the drafting of contracts. The PPP Unit functions as a specialized skills centre that contributes to the development and accumulation of knowledge, which includes the design of methodologies and a degree of standardization in the principles underlying the main contractual clauses.

nical support (UTAP – Unidade Técnica de Acompanhamento de Projetos)[34,35];

b. The strengthening of monitoring, by the national Ministry of Finance, of the development of projects and, in particular, of PPP contracts already drawn up. This objective was achieved through the creation of the UTAP, under the tutelage of the Ministry of Finance;
c. The introduction of mechanisms to ensure transparency, namely through the publication of PPP contracts[36]; and
d. Greater emphasis on *budgetary affordability analysis*, both regarding decisions that are likely to generate costs, as well as whenever a new partnership is prepared or an existing one is modified. Additional in-depth studies are to be conducted, both on the launching of new partnerships, as well as in the event of possible unilateral determinations announced by partners, by carrying out a *sensitivity analysis*, with a view to assessing the sustainability of each partnership in light of demand varia-

[34] And, thus, "the need to improve and optimize the technical and human resources available to the public sector in supporting this complex form of contracting justifies, as in many European Union countries and in the rest of the world, the concentration in a single unit of a remarkable set of responsibilities and competencies, thus eliminating the dispersion of multiple tasks through different public entities" (Preamble of DL 111/2012).

[35] It should be recalled, and emphasized, that there was no single entity in the State to carry out this mission within the PPP area. Procedural and execution management was excessively dispersed between sectors and between public and private entities (including consultants, essentially focused on financial and legal aspects, that externalized the know-how acquired over time outside of the State). This was all to the detriment of the public interest, of the standardization of documentation, of knowledge acquired by the public sector, and, in particular, of coordinated and integrated management of this contractual modality in the public sector.

[36] Please see Box 4 where it is explained which documents are publicly disclosed.

tions and macroeconomic changes. In addition, there will be the clear introduction of best practice concepts (including from the European Community), already noted as being of fundamental importance, such as the use of *cost-benefit analysis* and the preparation of a *risk matrix* which clearly identifies the types of risks to be assumed by each of the partners, as well as the terms of their sharing and allocation[37].

However, DL 111/2012 contains limits in its applicability. If the scope of the decree is extended to contracts of public companies and their incorporated entities, with these being considered public partners for the purposes of the directive, it is to be emphasized that the decree's applicability does *not* extend to[38]:

a. Partnerships involving, in provisional terms, and for the entire duration of the partnership, a gross cost to the public sector of less than Euros 10 million and an investment of less than Euros 25 million. These values are discounted to the instant prior to the decision to launch the partnership, in accordance with the discounting rate set by the Minister of Finance covering the evaluation of this type of project[39];
b. Concessions of multi-municipal water supply systems for human consumption, wastewater sanitation, and urban solid waste management; and
c. Concessions attributed by the State, through legal decree, to entities of a public nature or with exclusively public capital.

PPP Definition

From DL 111/2012, the definition of a PPP is as follows: a "*contract or a union of contracts by means of which private entities, designated as private partners, are obliged, on a long-lasting basis, before a public partner, to ensure, against consideration, the development of an activity tending to satisfying a collective need, in which the responsibility for the investment, financing, operation, and associated risks lies, wholly or in part, with the private partner*" (article 2).

In detail, breaking down the specifics of the clause, PPPs can be defined by the following elements:

a. A contract or a union of contracts[40];
b. By means of which a private partner is obliged to ensure the development of an activity tending to satisfy a collective need (provision of public services);
c. On a long-lasting basis[41];
d. For a public partner[42];

[37] As per Preamble of DL 111/2012.
[38] As per no. 5 of article 2 of DL 111/2012.
[39] The maintenance, conservation, repair and replacement costs of the assets allocated to the partnership are considered investment for this purpose.
[40] In the health sector, the partnership model implicit in contracts currently in force implies the existence of two private partners: one responsible for the infrastructural part and another responsible for the provision of clinical services. Although there are two PPPs with different objects, they are regulated by a union of contracts (two contracts in one).
[41] DL 111/2012 does not set a minimum or maximum duration for PPPs, defining only that the duration be appropriate to the specific circumstances and characteristics of each project, taking into account the repayment period of the financing, the scheduling of payments from the public partner, and the useful life of the corresponding infrastructure.
[42] As per no. 2 of article 2.

e. For remuneration[43]; and
f. In which the responsibility for the investment, financing, operation, and associated risks lies, wholly or in part, with the private partner (including, for example, the mode of the conception and allocation of revenue, the investment, the start-up costs, the remuneration, and extraordinary expenses, amongst others).

However, it should be noted that this definition suffers from the insufficiency of being *solely for these purposes under the present directive*. This means that another contract may qualify as a PPP (such as a concession with a local authority or an autonomous region), but not be subject to the DL 111/2012 regime, at least not *directly.*

Indeed, in these cases and in others, the above-mentioned defining elements of the PPP may be fulfilled, with these cases taking the form of PPP contracts, not from the strictly legal definition (which derives from the applicability of the decree), but in the context of a PPP definition that is broader and more comprehensive. This broader definition covers the project both in practice and, above all, by the contractual conditions and the terms of the allocation and management of the risks under the partnership in question.

The definition of risk allocation envisioned by the national legislator, as being the typical arrangement regarding the risks of a PPP contract between the two partners involved, should be revisited. Thus, for the fulfillment of a PPP contract, it should be incumbent upon:

a. the public partner to monitor, evaluate, and control the execution of the object of the partnership; and
b. the private partner to exercise and manage the activity contracted, under the terms and conditions agreed, as well as its financing (wholly or in part)[44].

The PPP Structuring and Procurement Process

Project Prioritization: Who Decides to Launch a New Project

It could be said that the skills associated with launching a new project are shared between Minister of Finance and the Line Minister (e.g. public works, health, internal administration, maritime, amongst others), it being up to the latter to initiate the process.

In detail, in the context of the PPPs covered by DL 111/2012[45]—that exclude, as mentioned, other PPP contracts or concessions such as those instigated at the initiative of municipalities or autonomous regions, at least based on a strict application of the decree—it is up to the public service of the public authority (a ministry or other entity) to present a duly substantiated proposal to the government member responsible for

[43] It should be noted that the concept of remuneration established in section 1 of article 2 does not necessarily have to consist of a direct financial responsibility for the public partner, in that it can be reflected in the configuration of the contractual relationship. For example, it could relate to the period of operation, to the attribution of certain revenues, or even to the development of certain activities. Thus, in the specific case, although these benefits do not represent a direct financial charge for the public partner, they nevertheless have an intrinsic economic-financial value that is appropriated by the private partner as consideration.
[44] As per article 5 of DL 111/2012.
[45] As per articles 9 of DL 111/2012.

the respective area, indicating: the object of the partnership; the objectives intended to be achieved; the economic rationale; and the financial viability of the partnership. It is then up to the government member responsible for the area of the project in question to decide on whether to begin the studies and prepare the partnership. If the said member decides that this should proceed, the government member responsible for the finance area must be notified with a view to setting up a project team.

To complete this first step of the launch, the UTAP is involved by the government member responsible for the finance area and is responsible for completing the procedures for the constitution of the project team, typically formed of members of this unit and

BOX 2. THE PORTUGUESE PPP FRAMEWORK: THE ROLE OF THE UTAP IN THE PPP LIFECYCLE

In 2012, a new PPP legal framework was established and, within that new environment, a central role was given to the Ministry of Finance in the implementation of PPPs from the initial stages of the process. The Ministry of Finance currently has a crucial role in the PPP appraisal, structuring, and tendering process.

With the publication of the new PPP regulation, a specialized PPP Technical Unit (the UTAP) was created, to which was delegated the Ministry of Finance's obligations within the PPP area. The creation of the UTAP contributed to the reinforcement of the Ministry's intervention at an even earlier stage of the instigation of a PPP, enhancing its role in the oversight and control of PPP projects throughout their lifecycle.

The UTAP, holding administrative autonomy and being directly supervised by the Secretary of State for Finance, is the specialized unit that concentrates all the knowledge and expertise acquired within the PPP universe in Portugal. The UTAP is involved in the PPP implementation process from the start; members of the UTAP lead the teams (composed of both UTAP members and appointed line ministry members) that are appointed to carry out the study, structuring, and launch process of each PPP, as well as to lead the teams appointed for PPP contract renegotiations.

Under this "governance" structure, it is guaranteed that the Ministry of Finance is not only involved in all the phases of the process of launching a PPP, but also in assessing and measuring the fiscal risks on an ex-ante basis (before governmental commitment to PPP liabilities).

The main responsibilities of the PPP Unit include: i) providing technical (financial/fiscal and legal) support with the launch, tender, execution, monitoring and evaluation of PPPs; ii) informing the Ministry of Finance on the economic and financial state of PPPs; iii) participating in PPP renegotiation processes, iv) providing advisory services to the government and other public entities on PPP matters; and v) producing annual and quarterly reports on PPP financial commitments and costs borne by the public sector.

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BOX 2. THE PORTUGUESE PPP FRAMEWORK: THE ROLE OF THE UTAP IN THE PPP LIFECYCLE *(continued)*

The UTAP is therefore involved in the entire lifecycle of the PPP, its mandate being essentially based on four pillars:

- Technical support: it provides in-house technical and specialized advisory services to support the government's decision-making process. This has permitted a reduction in governmental dependence on external consultants in PPP matters, concentrating knowledge within the public sector;
- Capacity building: being a centre of technical expertise in PPP matters, the UTAP contributes to the improvement of the government's bargaining powers in its relations with private partners;
- Best practice implementation: the UTAP has a very active role, not only in the structuring process of PPPs (including contract drafting and risk matrix definition), but also in renegotiation processes during the contract's life, which allows it to implement a certain level of (informal) standardization on PPP contracts so as to conform to best practice. Furthermore, the UTAP contributes to the implementation of appropriate transparency, ensuring the disclosure of PPP contracts and the evolution of the fiscal burden of PPPs through its periodic reports; and
- Budgetary impact: the UTAP participates in the budgeting process, preparing a multi-annual budget for PPPs (based on the inputs from different public authorities), which provides a global picture of the government's commitments under PPP contracts over their life. Additionally, the UTAP also reports the contingent liabilities that could arise from litigation processes involving public and private partners.

The UTAP's Organizational Structure

The UTAP has a multidisciplinary team composed of a staff of 10 members which includes both financial/fiscal and legal experts. Technical expertise lies with the line ministry teams that are responsible for the day-to-day management of the PPPs. When necessary, these teams work closely with UTAP members in project-specific appointed teams.

The UTAP has a Coordinator (appointed by the Ministry of Finance government member), who leads the team of 9 technical members, divided into three levels of seniority: level 1 consultants (the most senior consultants); level 2 consultants; and level 3 consultants (the junior consultants).

The PPP Launch Process

Under the new PPP legal framework, line ministries are responsible for the preliminary studies of new PPP projects and also for defining which projects should be launched (project planning and selection). Once this stage has been completed, the project structuring process is allocated to a team appointed by the UTAP Coordinator, including members from line ministries as well as the UTAP, where the UTAP members are in the majority. Under this process, the Ministry of Finance (through the UTAP) is involved in the entire PPP launch process.

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BOX 2. THE PORTUGUESE PPP FRAMEWORK: THE ROLE OF THE UTAP IN THE PPP LIFECYCLE *(continued)*

The appointed team is responsible for performing all the studies and calculations (including the Public Sector Comparator) needed to evaluate whether the project should be structured as a PPP. For each project, the team performs a strategic analysis (in order to justify the scope of the project and the needs that project should address), a cost benefit analysis, a Value for Money analysis, and a fiscal affordability assessment of the PPP project, as well as a market-sounding exercise (in order to test the bankability of the PPP). The team is also responsible for drafting all the bidding documents to support the tender process and the risk matrix that is included in the bidding documentation.

After finalizing its work, the team prepares a final report, where it presents the conclusions of the studies performed, determining whether and why the project should be launched as a PPP (according to the results of the Value for Money methodology). In the final report, the team also justifies all the options that it has selected for the drafting of the PPP contract clauses (the contract duration, scope, and payment and deduction mechanisms) and the risk matrix. After completing its work, the team submits the report, with its conclusions and with a recommendation in terms of an action plan, to both the Ministry of Finance and the respective line ministry for joint approval.

Execution of PPP Contracts

Besides the PPP launch process, the UTAP is also responsible for supervising and monitoring the execution of PPP contracts (but not for the contract's daily management), including an analysis of the financial performance of the PPPs and of the contingencies associated with the contracts.

Moreover, any PPP contract renegotiations are led by the UTAP, even if they are due to financial rebalancing events caused by unilateral changes by the public entity. Renegotiation teams are appointed by the UTAP Coordinator and include line ministry-appointed members as well as UTAP members. The functioning of the renegotiation teams is similar to that of the teams appointed to prepare, structure, and launch the PPPs. Under a renegotiation process, the team leads the negotiations with the private partner and prepares a final report to submit to government members (in both the line ministry and the Ministry of Finance) in which the team explains the merits of the renegotiation process and proposes a final decision.

Reporting System

The UTAP's reporting system comprises quarterly and annual reports (which are publicly disclosed on the UTAP's website). Under its reporting system, the UTAP is also responsible for the public disclosure of the financial flows, contingencies, and multiannual expenses associated with PPPs, with the aim of providing transparent, up-to-date, and accurate information on PPPs.

In its reports, the UTAP presents the financial performance and fiscal results of each PPP contract, comparing the actual fiscal burden of the PPPs with the forecasts published in the National Budget. The UTAP reports also present the potential fiscal risks identified and the relevant events that occurred during the reporting period.

of members appointed by the government member responsible for the area of the project in question.

The Treatment of Unsolicited Proposals

Given the legal framework established by DL 111/2012, which provides for a specific procedure for the development of the partnership contracting process, unsolicited proposals are not permitted. Likewise, even in cases not covered by the scope of DL 111/2012, the process of launching a project, or the elaboration of a contract of a public-administrative nature, presupposes compliance with a set of procedural steps that must observe the applicable legal regime, namely, the provisions deriving from the Administrative Procedure Law ("Código de Procedimento Administrativo") and the Public Procurement Law ("Código dos Contratos Públicos"). This is under penalty of them being invalid and of being contested by a wide range of interlocutors (competitors, other entities, the Court of Auditors, amongst others).

The PPP Structuring Process – Who is Who

As expounded upon above, one of the main objectives of the legislative reform promoted in the PPP sector in Portugal is specifically related to the creation of the Unidade Técnica de Acompanhamento de Projetos (the Technical Project Oversight Unit, or UTAP), the PPP Unit.

The creation of a unit with the characteristics of the UTAP is related to the two primary objectives of the "new" way of thinking about public projects in general and PPPs, which are as follows: (i) to strengthen financial control of public projects; and (ii) to concentrate, in a single public authority, the competencies related to the development of the partnership contracting process and its launch. This includes any renegotiation, if justified during the period of the contract, as well as the monitoring of the contract's execution, given the various vicissitudes associated with contracts that are typically long-term and that involve considerable complexity. The creation of the UTAP was therefore intended to respond to the previous environment that involved the distribution of responsibilities through multiple entities, and to the lack of a coherent and integrated vision for, and management of, public contracts.

In greater detail, at its origin, the following are the competencies attributed to the UTAP[46] which, as can be seen, are very broad:

a. To participate in the preparation, development, execution, and overall follow-up of partnership processes, as well as to provide technical support to the Ministry of Finance and other entities;
b. To ensure that the experience and knowledge acquired by the public sector in matters related to partnerships remain, in general, in the public sector, and, in particular, in the UTAP, thereby making such knowledge available to other public entities;

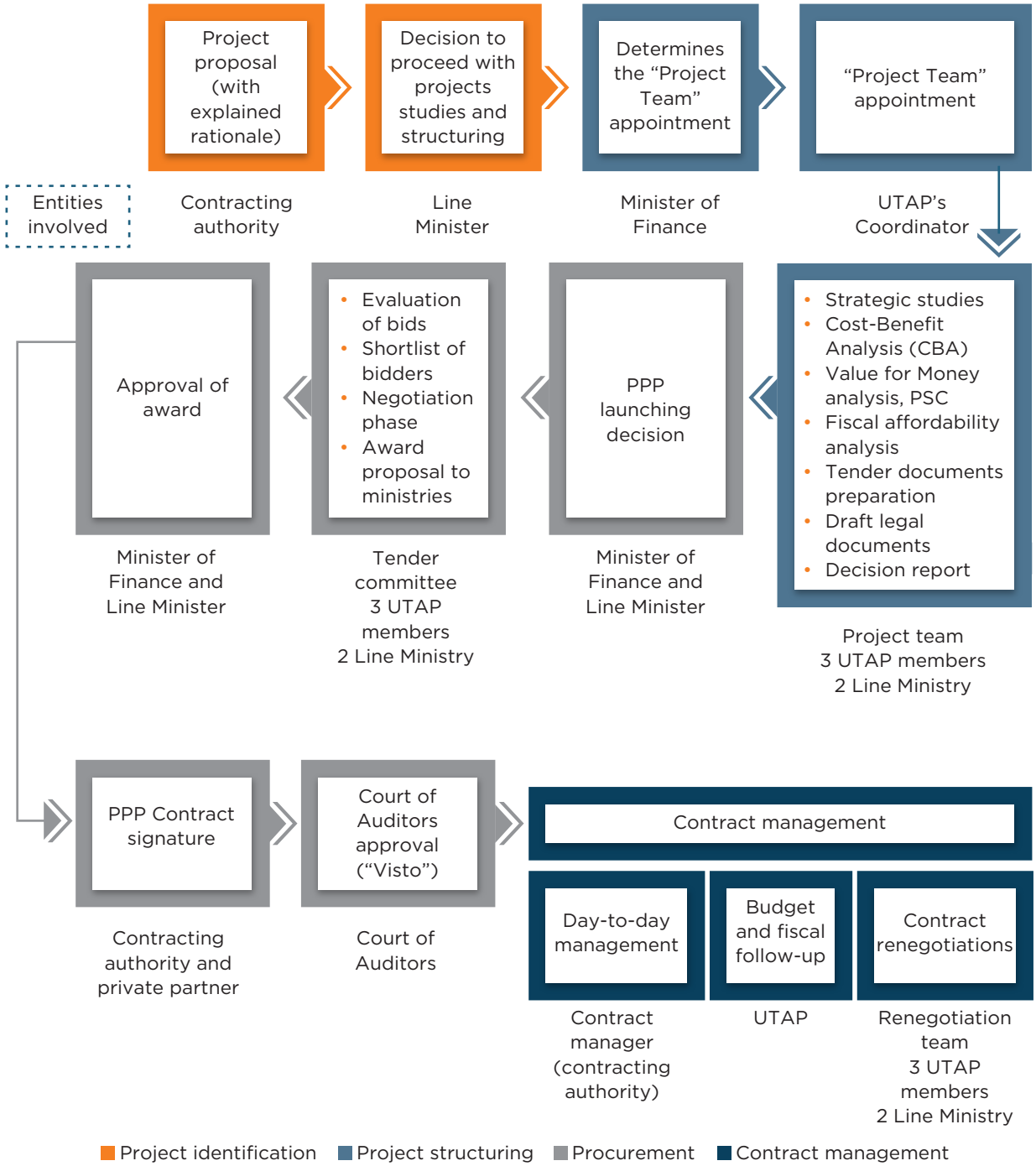
[46] As per article 35 of DL 111/2012, and without prejudice to the competencies legally attributed to other entities, these are to inspect, as well as to control the execution and audits of, the partnerships.

c. To prepare the studies for, and launch processes of, PPPs;
d. To provide technical support to national government members and to other public entities, within the field of PPPs[47];
e. To carry out the overall monitoring of partnerships in respect of economic and financial matters;
f. To assign the project teams for the study, preparation, and launch of partnerships, as well as the teams to oversee the initial stage of the execution of partnership contracts, alongside the public representatives responsible for the area of the project in question;
g. To appoint members for juries and negotiating committees related to partnership processes;
h. To provide technical and administrative support to project teams, juries, and commissions;
i. To present quarterly, annual, and other PPP monitoring reports, as well as other studies requested of it in relation to partnerships;
j. To issue the opinions requested of it and execute the tasks assigned to it by the government member responsible for the finance area within the scope of the partnerships;
k. To assume the role of partnership contract manager;
l. To monitor arbitration proceedings related to partnerships, making available the technical support requested by the representatives of the public partner;
m. To inform the government member responsible for the finance area of the economic and financial situation of the partnership contracts and their evolution;
n. To identify situations likely to contribute to a possible worsening of the financial standing of the public sector;
o. To gather, process, and centralize economic/financial and risk-sharing information related to partnership contracts already in effect or those yet to be launched;
p. To prepare document templates and present recommendations that may be useful to the various entities that are involved in both establishing partnerships, as well as in their management and monitoring;
q. To promote the publication, on an appropriate site, of matters of interest related to partnership processes;
r. To organize and manage training activities, in particular those aimed at the technical staff of public entities that participate in partnership processes;
s. To optimize the technical resources available in the public sector, contributing to the reduction of recourse to external consulting; and
t. To monitor international experiences in the field of partnerships, establishing relations with European Community and international entities that operate in this area.

These may be considered the *natural* competencies of the UTAP. However, the UTAP's activities may assume an *ad hoc* char-

[47] The UTAP provides technical support and advice mainly to the national government, but, when required, it can also provide advice to regional or local governments (as was the case in respect of regional PPP renegotiations, in which UTAP members participated, contributing their skill and accumulated experience).

FIGURE 7. STRUCTURING AND LAUNCH PROCESS OF A PPP: ROLES AND RESPONSIBILITIES



Source: Author prepared.

acter in cases where, by ministerial decision, it is requested to provide technical support in the development, contracting, and monitoring of major infrastructure projects that are not necessarily covered by the concept of a PPP under DL 111/2012, but which are likely to be financed by the public sector or to generate charges for the same[48].

The Role of External Advisors

The context which led to the creation of the UTAP, especially the budgetary constraints and the use of external consultants (largely specified by the Financial Assistance Program), determined that, in its formation, the UTAP would accumulate within itself all the material and human resources that could provide the technical support that was expected of this new unit.

The UTAP had (and has), in this manner, the challenge both of internalizing the know-how associated with the field of PPPs and of replacing the growing tendency of making the public partner excessively dependent on external consultants. For this reason, the UTAP must include, in the formation of its teams, professionals with the technical competence, aptitude, professional experience, and training appropriate to the areas of attribution of the unit, most specifically legal and financial professionals.

The UTAP does not rely on external consultants in practice and its existence has allowed public entities involved in these matters to obtain, without encumbrance or cost, specialized technical support, reducing the external consultants' bill.

This framework does not, however, prevent public entities, especially sectorial ones, from involving advisors specialized in the development of the respective tasks. It should be recalled, for example, that it is the responsibility of the ministry of the area of the project in question, or of the entity that assumes the role of public partner, to define the technical specifications to be included in the parts of the respective tender procedure to be launched for the selection of the private partner. The development of such specifications may justify the involvement of external consultants specialized in the sector in question, the contracting and costs of which are exclusively assigned to the head of the sectorial body that contracts the consultancy.

The Procurement Process of a PPP in Portugal

According to the new PPP framework implemented in 2012, the process of structuring a PPP is carried out by a multidisciplinary team ("the Project Team"), integrating members of the UTAP and the line ministry. The Project Team is responsible for: i) preparing the necessary studies to determine whether a project should be structured as a PPP or by using the traditional contracting model; and ii) preparing the documents of the public tender if such is the conclusion of those studies.

[48] According to DL 111/2012, large projects are those involving, "in provisional terms, for the entire duration of the partnership, a gross charge for the public sector equal to or greater than Euros 10 million or an investment equal to or greater than Euros 25 million, at values discounted to the moment prior to the decision to launch the project, according to the discounting rates set by the government member responsible for the finance area for the purpose of evaluating this type of project." As per no. 3 and 4 of article 35 of DL 111/2012.

After completing its work, the Project Team submits the final report with its proposed decision for joint approval by the Minister of Finance and the Line Minister. Following the Ministers' analysis and decision on the procurement model and the tender launch, the contracting authority announces the public tender by way of publication on an electronic platform, as well as in the European Union Official Journal. This announcement represents the start of the PPP process, which, according to the Public Procurement Law in Portugal, is always subject to a competitive bidding process.

The PPP procurement process is regulated by the Public Procurement Law ("Código dos Contratos Públicos"[49] (CCP)), applicable to all public tenders issued by public authorities, which defines the following types of procedures that can be used for public procurement: direct agreement ("ajuste direto"); prior consultation ("consulta prévia"); public tender ("concurso público") with or without an international notice; a pre-qualification limited tender ("concurso limitado por prévia qualificação"); a negotiation procedure ("procedimento de negociação"); or competitive dialogue ("diálogo concorrencial"). In the case of PPPs, as a rule, considering the value of the contract, it is not possible to choose the direct agreement and prior consultation procedures, and a competition-enhancing procedure is always used.

According to the CCP, each public procurement process has a base price (which represents the maximum amount payable by the contracting authority for the services it intends to contract), which in the case of PPPs is established according to the Public Sector Comparator.

In general terms, and according to both DL 111/2012 and the CCP, the PPP procurement procedure should have the following phases (when considering a public tender):

- Joint approval by the Finance Minister and the Health Minister of i) the procurement model; ii) the tender launch ("decisão de contratar"); and iii) the bidding documents;
- The issue of a public procurement notice (using the electronic platform), including an international notice, if applicable;
- The formation of the bid evaluation committee, which in the case of PPPs is composed of UTAP members (who are in the majority) and line ministry members. The President of the committee should be a UTAP member;
- The publication of bidding documents, and documents for the consultation phase for interested bidders;
- The submission (and elucidation) of questions to clarify the public procurement documents (the procuring authority discloses the questions and clarifications to all the potential bidders);
- The correction of errors and omissions in the technical specifications;
- The submission of bids by competitors;
- Publication of the list of competitors;
- Analysis and evaluation of the proposals by the bid evaluation committee (the proposals' evaluation must be according

[49] Approved by Decree-Law no. 18/2008, of 29 January, amended and republished through Decree-Law no. 111B/2017, of 31 August (rectified by Rectification Statements no. 36-A/2017, of 30 October and no. 42/2017, of 30 November).

to the criteria specified in the bidding documents);

- The issue of the preliminary report by the bid evaluation committee;
- The prior hearing (after the preliminary report has been sent to the competitors, they have a period—exceeding 5 days—to opine on the conclusions of the bid evaluation committee);
- Publication of the final report of the bid evaluation committee. This report is sent for joint approval by the Minister of Finance and the Line Minister;
- The issue of the public procurement award notice;
- Presentation of the enabling documents by the winning bidder;
- Provision of guarantees by the private partner; and
- The signing of the PPP contract.

According to the CCP, the Court of Auditors' approval is a mandatory and precedent condition for the start of public payments to the private partner.

Criteria for Bidders' Evaluation and Selection Process

PPPs are contracts of a long-term nature and with considerable complexity, requiring that the private partner assumes a set of responsibilities. These may comprise the design, construction, management, maintenance, and provision of services with a view to the satisfaction, under the contract, of the subjacent public interest. PPPs—as is also the case for all public-administrative contracts—are based on a decision made by the public body after it has determined that the public interest in question is more efficiently met through an outsourcing solution.

Based on this complexity, the criterion of price as the sole and exclusive element to evaluate and compare proposals is insufficient and may be misleading as a factor in the selection of the private partner. Inspired by European Community directives, the Portuguese authorities have preferred the solution of the criterion "*most economically advantageous bid*"[50]. This measure is based on an analysis of the best quality-price relation which, in addition to price and cost considerations, evaluates additional relevant factors related to the execution of the contract to be drawn up. These factors include, amongst others, the technical, aesthetic, or functional quality of the project, and the organization, qualifications, and experience of the staff appointed to carry out the project, as well as other related aspects, such as how the private partner proposes to provide the service.

The PPP Auditing Process

The Court of Auditors has a key role in the context of the audit and supervision of PPPs, both in respect of contracts of this nature that fall within the applicable scope of DL 111/2012, as well as other PPP contracts, concessions, and public-administrative contracts in general. The Court of Auditors supervises the legality and conformity of public revenues and expenditures, appraises the financial management for soundness, and enforces the penalties for financial infractions, having powers of jurisdiction and

[50] As per article 74 of the CCP.

BOX 3. THE PPP PUBLIC PROCUREMENT PROCESS: THE CASE STUDY OF HOSPITAL LISBOA ORIENTAL

Following a long period without new "greenfield" PPPs, the process of launching a new PPP was recently started, related to a healthcare project in Lisbon, Hospital Lisboa Oriental.

As better explained in Box 11, Hospital Lisboa Oriental is an infrastructural PPP, the object of which is the construction, operation, and maintenance of the hospital building over a period of 30 years.

The project was analysed and structured by a Project Team appointed for the purpose by the UTAP Coordinator, as provided for in DL 111/2012 (as explained in Figure 7). The Team concluded that the PPP model presented Value for Money in this case, and recommended to the government members (responsible for the areas of health and finance) the launch of an international public tender for the award of the respective PPP. The Project Team report included (in accordance with PPP Law): i) the analysis of the options that determined the project configuration; ii) a description of the project and its mode of financing; iii) the demonstration of its being in the public interest; iv) the justification of the option for the partnership model (the Value for Money analysis); v) the analysis of the conformity of the partnership project with the launch assumptions provided for in DL 111/2012; and vi) the minutes of the bidding documents ("procedure program" (programa do procedimento) and "technical specifications" (caderno de encargos)) to be adopted to set up the partnership contract (decision no. 10268/2017, published in Diário da República (Government Gazette) no. 228/2017, Series II of 2017-11-27).

In its final report, the Project Team concluded that the construction of the new hospital would permit significant savings in terms of public sector charges by concentrating, in a single hospital, the hospital supply currently dispersed over 6 older hospitals scattered across the city of Lisbon. It also determined that it would provide an improvement in accessibility and the quality of care.

In November 2017, after analysing the Project Team's final report, the Assistant Secretary of State and of Finance, together with the Secretary of State for Health, approved: i) the launch of the PPP; ii) the launch of the public tender procedure, with international notices issued, to choose the private partner; and iii) the selection of the members and the president of the bid evaluation committee. At the same time, through a Resolution of the Council of Ministers, authorization was granted to incur the expenses inherent in the preparation of the PPP contract for the Hospital Lisboa Oriental.

Subsequently, in December 2017, the public tender for the PPP was announced, and the international tender notice was issued. The PPP contract for Hospital Lisboa Oriental has not yet been signed, since the tender process is still ongoing (it is in the submission of proposals stage). According to the bidding notice, the contracting authority granted the potential bidders a period of 180 days to submit their bids. This period was then extended by a further 180 days. During that period, the bidders could submit questions to clarify the public procurement notice. The procurement model chosen for this PPP does not include any pre-qualification stage. The contracting authority always has an option on whether to include a pre-qualification phase.

(continued on next page)

BOX 3. THE PPP PUBLIC PROCUREMENT PROCESS: THE CASE STUDY OF HOSPITAL LISBOA ORIENTAL *(continued)*

The inclusion of this phase allows the public authority, through objective financial and technical criteria, to select the shortlist of potential competitors that may submit a proposal in the next phase.

In the case of Hospital Lisboa Oriental, the criteria defined for evaluating the bidders (specified in the tender documents) was based both on price and on the project's technical quality. In terms of price, the highest evaluated bidder is the one that presents a lower amount of public authority availability payments. According to the CCP, only the technical quality of the proposals can be evaluated during the bidding process and not the technical capacity of the bidder (since this is only possible in a pre-qualification phase).

The financing of the project is the responsibility of the future private partner, and the winning bidder must submit a firm financing proposal before signing the PPP contract. Also before signing the contract, the winning bidder must present a financial model prepared in accordance with the assumptions contained in the bidding documents ("technical specifications" (caderno de encargos)).

After the competitors' proposals have been presented, the bid evaluation committee will evaluate them according to the defined bid evaluation criteria, selecting, for the negotiation phase, two or three competitors and submitting their preliminary report. This report may be reviewed by all the competitors ("prior hearing" (audiência prévia)) over the subequent 10 days. Following that analysis, the bid evaluation committee will send the final report to the members of the government who will approve the selection of the competitors for the negotiation phase, with the competitors being notified of this decision.

The negotiation phase of the tenders follows, and will focus on all the elements of the bids submitted by the bidders. Minutes of the negotiation sessions will be produced (which will not be made public during the negotiation phase), and all competitors will be given equal opportunity to propose, accept, and counter-propose modifications to their proposals during the negotiation sessions.

When the bid evaluation committee considers the negotiation has concluded, it will notify all competitors to submit their final proposal within a specified period. Once the final proposals are submitted, the bid evaluation committee will evaluate them, producing a new preliminary report, subject to the prior hearing of the competitors, and then a new final report.

The bid evaluation committee's report shall be sent to the members of the government responsible for the areas of finance and health, who will study the report and issue a joint decision within a period of 30 days from its receipt. The contract award notice is then communicated to the competitors.

The winning bidder will then be required to present the enabling documents and the respective security deposit, with the PPP contract being then signed and sent for appraisal by the Court of Auditors. Only after its respective approval by the Court of Auditors will the contract take effect.

financial control under the Portuguese legal system, both nationally and abroad. It has its headquarters in Lisbon, and there are two regional departments in each of the autonomous regions.[51] The universal character of the Court of Auditors is emphasized by the coverage of its jurisdiction, with contracts subject to its authority and powers of financial control being those incurring public expenditure that are initiated by a diverse set of entities[52].

Briefly, as regards public contracts such as PPPs, the intervention of the Court of Auditors may occur after the contract has been signed, before the contract enters into force, or during its subsequent duration. Initially, a *prior inspection* may be imposed, the purpose of which is to verify whether the acts, contracts, or other instruments that generate expenditure or represent direct or indirect financial liabilities, are in conformity with the laws in force, and whether the respective charges are contemplated in a specific budget line entry[53]. The rule regarding submission to prior inspection by the Court of Auditors applies both to the original initiation of the PPP contract, as well to its amendment during its subsequent period of validity, provided any alteration constitutes an objective modification of a certified contract that would result in a worsening of the respective financial charges or financial liabilities.

As regards the effects of the prior inspection[54], it is important to note that PPP contracts that exceed Euros 950,000 (which will all be covered by DL 111/2012) do not produce any effects prior to their certification or declaration of conformity. Therefore, in these cases, after the PPP contract is signed, the contract must be submitted to the Court of Auditors and can only enter into force following the Court of Auditors' approval ("Visto"). Until approval is obtained, the public authority's payment obligations are not enforceable. As part of its analysis, the Court of Auditors evaluates whether all the required procedures to implement the PPP have been carried out correctly (such as completion of a Value for Money analysis) and that an adequate affordability assessment (and budget allocation) has been made for the project.

The intervention of the Court of Auditors in respect of PPPs may arise, and has frequently arisen, in the context of a *concomitant inspection*[55], that is through audits initiated by the Court of Auditors of the execution of the certified public contracts. More importantly, however, intervention may arise in the context of a *successive inspection*[56], under the purview of which the Court of Auditors verifies the private entities' accounts, assesses their respective internal control systems, appraises the legality, economy, efficiency, and effectiveness of their financial management, and ensures the inspection of the national co-participation in European Community funds, as well as the application of financial resources from the European Union. In the context of its periodic inspections of the State's direct public debt, the Court of Auditors inspects whether the

[51] As per the Court of Auditors Organization and Process Law ("Lei de Organização e Processo do Tribunal de Contas" - CAOPL), in particular, articles 1 through 6.
[52] As per article 2 of the CAOPL.
[53] As per articles 44 of the CAOPL.
[54] As per article 45 of the CAOPL.
[55] As per article 49 of the CAOPL.
[56] As per article 50 of the CAOPL.

debt limits and other general conditions laid down in respect of each financial year were observed.

Regulatory Agencies

Typically, it is the private partner that executes the contract and carries out the activity (construction of works, provision of public services, or other) under the terms and in accordance with the applicable legislation in force at any specific time. The contract's monitoring and supervision is carried out by the contracting authority, which is the entity responsible for determining and applying the penalties on the private partner in the event of non-fulfilment of the service standards determined in the PPP contract. On a periodic basis, the contracting authority reports the monitoring indicators to the UTAP, which is the entity responsible for the disclosure of these results.

Given this context, the regulatory agencies do not assume any counterparty role in PPP contracts, and do not regulate them directly. They only regulate the sector in which the execution of the PPP is to be integrated and, in that sense, they touch on the sphere of management and execution of the PPPs in question. Regulatory agencies have no direct role in relation to PPPs.

Transparency

Among the various amendments introduced by this new PPP regime, the adoption of measures aimed at making PPP processes more transparent are also worth noting. The immediate effect of this objective was to make it obligatory to publicize various documents related to PPPs and to endow the PPP Unit with the means and powers to that effect.

Under DL 111/2012, the UTAP has its own on-line site for the publication of all documents that are deemed useful related to partnership processes, with it being mandatory to publish the following[57]:

a. Quarterly reports, once approved by the government member responsible for the finance area;
b. The composition of the project teams, procedure juries, negotiation committees, and monitoring teams for the initial stages of contract execution;
c. The procedures program, technical specifications, and corresponding annexes for partnerships covered by DL 111/2012;
d. The final evaluation reports on the partnership proposals covered by DL 111/2012;
e. PPP contracts already in effect and their respective annexes, as well as amendments to existing PPP contracts, in all cases except when they contain legally protected material, in which case their disclosure must be made in a censored or partial manner; and
f. The identity of experts appointed for arbitration proceedings.

PPP Monitoring

Contract management is, generally, and in the first instance, carried out by the services (designated for this purpose) of the line ministry. It should be noted, however, that the UTAP may be called upon, in some spe-

[57] As per articles 32 and 33 of DL 111/2012.

BOX 4. TRANSPARENCY MEASURES INCLUDED IN THE NEW PPP FRAMEWORK

The new PPP regime includes several provisions aimed at improving the transparency of the sector. For instance, in order to ensure more transparency in the awarding, management, and negotiation of PPPs, it is now mandatory to publish all relevant documents and data concerning this type of contract on an electronic platform managed by the UTAP (www.utap.pt). All contracts are disclosed, as are the contract annexes, notwithstanding that no confidential commercial or industrial information is revealed. The limits for disclosure are set by national legislation and, in order to assess the extent of the information to be published, the UTAP consults with the private partners regarding their PPP contracts and those annexes containing commercially-sensitive material, aiming to maximize the amount of publicly disclosed contractual information.

Another transparency measure is the disclosure of periodic information regarding the financial state and fiscal implications of PPP contracts, using the UTAP's quarterly and annual reports (also published on its website). Although this was in place before the entry into force of DL 111/2012, the UTAP has reformed this reporting system in order to make the documents more accessible, transparent, and detailed. Additionally, the UTAP issues occasional technical notes on specific subjects in order to clarify aspects of a legal and financial nature linked to PPPs.

It should be stressed that promoting competition in PPP tenders was also an objective of the 2012 PPP sector reform in Portugal. In fact, DL 111/2012 issued a new compulsory step before the tender launch, which is the compulsory "sounding of the private sector" regarding the availability of private parties willing to engage in a potential project. Indeed, the more thorough the process of disclosing project objectives is, and the more transparent and open the tender is, the higher the chances are of attaining a high level of competition among qualified bidders, thereby enhancing the probability of achieving higher Value for Money.

cific circumstances, to execute the role of contract manager[58], although typically neither the UTAP nor, in general, the Ministry of Finance assume this function, as this is not their most direct purpose.

As regards the overseeing and monitoring of PPP contracts over their duration, the role of *Contract Manager* in the most recent version of the Public Procurement Law has been reinforced, in line with European Community trends in public procurement and concessions directives. The Public Procurement Law determined in its most recent version that the *"public contractor shall designate a contract manager, with the function of permanently monitoring the execution of same"* and, in the case of PPPs, given that these are contracts with special characteristics of technical or financial complexity and are long-lasting, that manager shall *"draw up appropriate quantitative and qualitative performance indicators for each type of contract, which allow, inter alia, to measure the co-contractor's performance levels,* [and] *the financial, technical and material perfor-*

[58] To date, the UTAP has not been involved in the contract management of any PPP.

mance of the contract" (article 290-A of the CCP). In addition, as is also required of the UTAP[59], such a manager is required to signal to the public partner as soon as any deviation, defect, or anomaly in the execution of the contract is detected, proposing, if necessary, the appropriate corrective measures for each case.

It should be noted that the national legislator is very aware of the importance of monitoring and of the need for *prior notice* by the entities that are most directly in contact with the day-to-day oversight of the contract. Therefore, a general rule in the management of public contracts was made that if the public partner, or the entity representing the public contractor in the execution of a PPP contract, *"take*[s] *cognizance of situations likely to create additional charges for the public partner or the State, namely those arising from delays attributable to public entities involved in the respective implementation or execution"* (article 339 of the CCP), it has the duty to report these facts to the Minister responsible for the finance area and the line minister in question, indicating, whenever possible, the estimated amounts involved.

As is clear from these provisions, the fact that an extremely important monitoring and oversight function has been centralized in the UTAP (as per articles 26 through 30 of DL 111/2012 and 34 et seq. of the same law) has not exempted the remaining entities—and especially those entities that are closer to the execution of the PPP contract in their day-to-day activities—from the duty to *signal* and quantify unfavorable impacts which require a public partner to take a position. It should also be pointed out that DL 111/2012[60] created a monitoring function, with what appears to be a more temporary nature, for the initial phase of the project, whenever the complexity, the value, or the public interest of the partnership warrants it, with the members of this functional group being jointly appointed by those responsible for the areas of finance and for the project in question.

One final note on this matter is that oversight and monitoring can also be supported by (second line, independent) audits carried out by the Court of Auditors in a subsequent inspection of the contracts or of the public entities responsible for the expenditure associated with those contracts. These kinds of second line inspections are made when these public entities consider them necessary. In any event, every year the Court of Auditors produces a report on the fiscal liabilities of the government, in which it comments on PPP commitments.

Risk Matrix

The mandatory existence of a risk matrix in the contracting and management process of PPPs assumes special emphasis under the DL 111/2012[61] regime. Clearly aware of the importance of having a document outlining the risk allocation between the private and public partners in a more schematic form, and of it being influenced by best practice, primarily at the European Community level, the national legislator designated a risk matrix as an integral part of PPP contracts. It was determined that it would be *"in table format*

[59] As per articles 26 and 34 of DL 111/2012.
[60] Article 19.
[61] As per article 7 of DL 111/2012.

or another of a similar nature"[62] and describe a summary of the risks, clearly identifying the type of risks to be assumed by each of the partners.

From a legal perspective, this solution has two principal advantages. The first relates to the ability to overcome some of the lacunae arising from the contractual clauses. By laying down in a schematic manner whether a particular risk is assumed by one or other partner or is shared, and on what terms, it will certainly help the interpretation of the contract and the clearer identification of the will of the parties (and of the public partner, in particular) at the time of the launch of the procedure for the preparation of the contract.

Secondly, by making the risk matrix one of the documents annexed to the Technical Specifications included in the bidding documentation, the measure has a very positive impact; at the time of the launch of the procedure, for all intervening parties and for the market in general, it makes clear the specific risk that is expected to be assumed by or shared with the private partner. However, the advantages of this approach are even greater, in terms of transparency, contract management, and risk-sharing management, both by the private partner and, mainly, by the public partner.

In drawing up the risk matrix, in the context of the legal framework, in particular DL 111/2012[63], and of the Portuguese experience, consideration should be given to the following:

a. the risk matrix is mandatory, resulting from law;
b. it is an integral part of the contract to be drawn up (and, at the same time, of the technical specifications included in the bidding documents);
c. it should mirror exactly the contractual clauses, presenting the risks and their allocation between the partners in a schematic and logical manner;
d. it is possible for it to be *standardized*, or for there to be a combination of aspects that are common across all PPP contracts. The risks can be grouped together with respect to their subject (public works contract, public service provision, or other) or the sector in question (there will be a tendency for the contracts of each sector—health, internal administration, infrastructures, amongst others—to have a very similar risk matrix). The standardization thus becomes a gain both for the management of the contract by the public authorities responsible for monitoring its execution, as well as for the most productive application of the principle of "*lessons learned*" by the public manager;
e. the allocation of different risks inherent under the partnership must be based on a criterion related to the ability of each of the partners to manage those risks, and the establishment of the partnership must imply a *significant and effective* transfer of risk to the private sector[64];

[62] As per article 7 of DL 111/2012.
[63] As per articles 6 and 7.
[64] This aspect is intended to avoid all the risks being borne by the public partner. There should be an effective risk transfer to the private partner, notwithstanding the preservation of the criterion related to the ability to manage the risks (balancing the risk premium to be paid by the risk transfer and the benefit obtained through the bundling of the design and operation of the project).

f. the risk of the partnership being financially unsustainable, for reasons not attributable to the public partner or the situation of force majeure, must, to the extent permissible, be transferred to the private partner; and
g. in the cases where, within the tender documents, proposals are submitted with variations based on different assumptions from those on which the environmental impact statement is based, all the risks inherent in those variations must be borne solely by the private partner.

The CCP also provides, with incisiveness, that in the public contracts for public works or public services, the contractual framework allows for a *"significant and effective transfer to the concessionaire of the operational risk of those works or services, which translates into the risk linked to the demand or the supply, or both"*[65]. To that end, it presents two indications that help determine whether the concessionaire assumes the operational risk, namely:

a. Under normal operating conditions, there is no guarantee that it will recover the investments made or the expenses incurred in the scope of the operation of the works or services that are the object of the concession; or
b. The part of the risk transferred to the concessionaire involves a real exposure to the unpredictability of the market, implying that any potential losses incurred by the concessionaire are not merely nominal or insignificant.

On nearing the completion of this analysis of the relevance of a risk matrix in PPP contracts, it should be emphasized that the risk matrix should follow the dynamics of the contract itself, changing when the contract is amended or when there is a circumstance that results in a weighting of the risk that is different from that originally allocated and/or described. The risk matrix should also be reviewed during the period the contract is in force if, for any reason, it is believed that new risks have arisen, affecting one or other partner, that may require new contractual modelling and, at the same time, a *new* matrix.

Lastly, the Portuguese experience has also revealed as essential the regulation of the counterweight to risk, that is the existence of benefits. Thus, as required under the law, it is common to specify in PPP contracts that, in the event of an abnormal and unpredictable increase of financial benefits to the private partner, which has not been derived from its efficient management and the opportunities it alone created, those benefits are allocated between the two partners in an equitable manner. This is achieved either through a price revision, or through the private partner's assumption of the obligation to provide the public partner with the amount corresponding to the increase in revenue or to the decrease in charges anticipated during the execution of the contract, or through another form permissible and agreed by the parties when the contract[66] is drawn up.

Standardization of PPP Contracts

The practice of PPP contract standardization does not exist in Portugal. However,

[65] As per article 413 of the CCP.
[66] As per article 341 of the CCP and articles 21 and 45 of DL 111/2012.

one of the objectives of the creation of the PPP Unit was precisely to centralize in a single entity the structuring of PPP contracts to guarantee consistency among different PPP contracts in terms of contract clauses and the risk matrix. Although this process of contract structuring always involves the contribution of the representatives of line ministries, by virtue of the UTAP leading the process, it is possible to guarantee greater uniformity in the treatment of the various themes in the structuring of each of the PPP contracts.

Despite this standardizing role of the PPP Unit, and its contribution to increasing the efficiency of the process, it is important to bear in mind that the PPP Unit is only involved in the structuring of the projects defined under DL 111/2012. Therefore, several PPP contracts are excluded from its purview, namely those launched by the municipalities. As a result, it is only possible to ensure informal standardization of PPP contracts where the UTAP has structuring responsibilities, with the PPP contracts launched by regional and local governments being excluded from its remit.

5 THE SITUATION IN BRAZIL

- In this section, the status of the Brazilian PPP market is presented, with an assessment of the framework as well as the current state of the risk matrix and PPP contracts in the country. Finally, the main challenges are identified and some recommendations are made for improvement.
- Brazil is the LAC country with the largest number of PPPs, having more than 20 years' experience of using this contracting tool. It has been largely applied in the country as a way of addressing investment needs, both nationally and sub-nationally.
- Although the Brazilian PPP framework has substantially improved, there are still some challenges that should be taken into consideration in relation to PPP contract and risk matrix standardization. These include the need to: i) increase the participation of commercial banks in PPP financing (which requires a proper risk allocation mechanism between private and public partners); ii) develop the necessary technical capacity at subnational level; and iii) improve the transparency and accountability standards for PPPs (in order to avoid incidents of corruption such as that which affected the infrastructure market in 2016) (Infrascope, 2017).

The PPP Context

In Brazil, the legal framework in place provides for a distinction between what are called PPPs and projects that are concessions based on the remuneration of the private partner[67]; there is a narrower definition of a PPP than that provided by the PPP Reference Guide. The Brazilian PPP concept only includes concession types that involve some amount of government payments, excluding those that are exclusively based on user payments, which are designated as Common Concessions ("Concessões Comuns"). For the purposes of this report, it was decided to use the PPP definition that is included in the PPP Reference Guide, which means that the term 'PPP' is not

[67] This dual regime already exists in other countries, such as Argentina and France.

BOX 5. THE PPP GOVERNANCE MODEL IN BRAZIL

Brazil presents a decentralized model, where the process of structuring, deciding, launching, and monitoring PPPs is dispersed over several entities with, for example, there being no federal PPP unit that centralizes such competencies at the national level. At the federal level, there is a PPP unit (the Special Secretariat of the Investment Partnerships Program) that is involved in the planning, disclosure, and approval of projects, and which also issues good practice guidelines. However, this unit is not charged with the structuring of projects, which continues to be carried out by sector entities. These very often rely on external consultants.

The unit responsible for PPPs at the federal level has authority in respect of federal projects, but does not have jurisdiction over projects developed (independently) by subnational governments, except when federal government resources are required for their development. Under normal circumstances, the central government cannot veto or interfere in the preparation, contracting, or execution of projects undertaken by governments at the subnational level.

At the subnational level, some states also have their own PPP units (such as, for example, in the State of São Paulo or in the State of Minas Gerais) which have independent and autonomous structures to carry out their own PPP projects, and to define their own rules and guidelines.

Thus, in terms of PPP governance, Brazil (like Colombia and Mexico) has an open model in which the contracting authority is the primary entity responsible for promoting the respective PPP and for structuring it, without the specialized support of a centralized unit created for that purpose. This model is characteristic of countries with a federal system, where subnational governments have their own jurisdiction and autonomy (Prats, 2016).

The fact that Brazil is a federation with 26 states, 5,570 municipalities, and one federal district introduces a potential problem in ensuring transparency and consistency in terms of PPP implementation, particularly in a context where there are many different rules for structuring and implementing the same kind of projects within a single country. This lack of coordination and centralization of the procedures and governance framework of PPPs creates some constraints in terms of: i) the harmonization of the principles followed throughout the PPP lifecycle; ii) developing and accumulating the necessary capacity and expertise to deal with such a sophisticated contracting model (a prerequisite to benefitting from the experience curve provided by previous projects); iii) designing the PPP contracts well, which is a necessary condition to avoid renegotiations, litigation, and the consequent dissipation of the Value for Money envisaged at the start; iv) monitoring and controlling the direct and contingent liabilities associated with all the Brazilian PPPs (since there is no centralized process for data gathering); and v) attracting foreign investors, given their difficulties in understanding the (different) legal PPP frameworks in Brazil.

In this context, considering that most of the PPP projects are carried out by different local governments, and although there are some PPP units in some Brazilian states, there are no guidelines or common procedures to ensure consistency in implementation. It would be most advisable to have a standardized approach to PPP matters in Brazil.

used here in the same way as in the Brazilian PPP definition but in a broader sense.

Although there is a federal-level legal framework for PPPs in Brazil, based on national laws applicable to all governments (federal, state, and local governments) with different rules for Common Concessions and for PPPs, each state or municipal government can produce its own specific legislation, institutional environment, and project prioritization. As a result, there is no standard PPP practice applied in a transversal way within the country.

Under the current framework, in Brazil there are three kinds of partnerships between the public and private sectors, although only two of these are considered PPPs under Brazilian law:

a. Common Concessions ("Concessões Comuns"), which are governed by Federal Law no. 8987/1995 (the Concessions Law) and are not considered PPPs under the Brazilian legal framework;
b. Sponsored Concessions ("Concessões Patrocinadas"), one of the two types of PPPs covered by the Brazilian legal system, governed by Federal Law no. 11079/2014 (the PPP Law); and
c. Administrative Concessions ("Concessões Administrativas"), the other type of PPP covered under Brazilian law, governed by the same law as in b).

The difference between these models is mainly related to the remuneration of the private partner. Whereas in Common Concessions the remuneration scheme is based solely on user payments with no commitment from the public budget[68], in the other two concessions, that jointly constitute the Brazilian PPP model, there is always a payment from the granting authority. In the case of Sponsored Concessions, although it is possible to collect tariffs from users, these are insufficient to make the project viable, and, therefore, there is a mixed payment structure that involves both user and public payments. In the case of Administrative Concessions, the granting authority is the (direct or indirect) user and therefore the remuneration of the private partner is exclusively based on public payments. Furthermore, while in the case of Common Concessions the only contingent liability the public sector can have is related to the compensations that must be paid in the event of early termination (since the project risks are all passed on to the private partner), in the case of Administrative and Sponsored Concessions there could be many more contingent liabilities, given the allocation of risks between the parties allowed under the PPP Law.

Common Concessions were the first type of concessions to appear in the country, in 1995, and were, for almost 10 years, the only form of partnership existing in Brazil. The Concessions Law constituted the first step taken to promote the private financing of public investments, introducing both the possibility of long-term contracts being signed between public and private partners[69] and the introduction of risk allocation into the contract struc-

[68] In this case, the only payment from the contracting authority to the private partner occurs in the event of early termination of the contract, when, according to the Concessions Law, the private partner is entitled to receive a compensation based on the book value of the assets (the amount of the investments not yet amortized).

[69] Until that point, contracts between public and private parties were limited to a maximum period of 5 years, according to Federal Law 8666/1993.

ture. However, this legal framework did not permit any payments by the granting authority to the concessionaire, it being, therefore, only suitable for the development of financially viable projects, and, as a result, it excludes any social infrastructure partnerships.

The PPP legislation was first introduced in the State of Minas Gerais (with the publication of State Law 14868/2003) in 2003, and then in the State of São Paulo in 2004 (with the publication of State Law 11688/2004). Also in 2004, a framework was finally created for the bidding and contracting of PPPs in the country, through the publication of Federal Law no. 11079/2014, which enabled all levels of government (federal, state, and municipal) to implement PPPs involving government payments.

The PPP Law was introduced at that time because it was recognized that the country needed to further stimulate private investment to address its infrastructure needs. The PPP Law was regarded as a method of promoting some investments that were not self-sustainable, and which were, therefore, not possible to implement under the Concessions Law. The PPP Law opened the possibility of the participation of private investors expanding into sectors where user payments are insufficient to ensure the financial viability of projects, or are even impossible to collect, and where payments by the granting authority are the only (or almost the only) type of remuneration of the private partner (as is the case with social infrastructure projects).

This law introduced specific rules governing the institutional framework of PPPs and defined the role of the different entities across the several phases of the lifecycle of the PPP contract. For the first time, there was also an obligation, in the contract, to objectively allocate to each partner all the risks involved in the performance of the project.

Some Features about the PPP Law in Brazil[70]

PPP Definition

The current legal framework includes in the concept of PPPs both Sponsored Concessions and Administrative Concessions, but excludes Common Concessions, which are not regulated by PPP Law but only by the Concessions Law.

Limitations

The PPP Law defines limitations on the application of the framework and is not used when:

a. the contract is for an amount less than 10 million Reais;
b. the contract duration is less than 5 years or more than 35 years; or
c. the contract scope is limited to the contracting of manpower, the supplying of equipment, or the execution of civil works.

Requirements to be Observed in a Public-Private Partnership

In a PPP, the following must be observed:

a. The efficiency of the allocation of public resources must be guaranteed;

[70] Taking into consideration its successive amendments, introduced by various laws, namely Law no. 12766, of 2012, Law no. 13137, of 2015 and Law no. 13529, of 2017.

b. The government cannot delegate its regulatory or jurisdictional activities, or even its exercise of police powers;
c. The PPP procedures must be carried out in a transparent manner and the fiscal responsibility of awarding and executing the PPP contracts must be maintained;
d. The project risks must be correctly allocated between the parties; and
e. The financial sustainability and socio-economic value of the PPP must be demonstrated.

What Should be Included in a PPP Contract

Under PPP Law, several issues are defined that should be included in PPP contract clauses. Nevertheless, the law does not state how these issues should be considered, which allows for different solutions and approaches to be followed for the same issue.

In terms of scope, the PPP Law not only regulates all federal PPPs (both Sponsored Concessions and Administrative Concessions) but also sets out general rules for the PPPs of states and municipalities. Notwithstanding this wide coverage of the application of the PPP Law, some states have decided to initiate their own PPP laws, which results in greater complexity and an increased struggle for foreign investors to understand the PPP universe and environment in Brazil and compare different projects within the country.

By introducing the possibility of partnerships incorporating a grantor-payment remu-

THE CLAUSES OF PUBLIC-PRIVATE PARTNERSHIP CONTRACTS[a] SHALL DEFINE[b]:	
1	The **contract duration**, which shall be in line with the amortization of the investments to be made by the private partner, being no shorter than 5 (five) and no longer than 35 (thirty-five) years, including possible extensions[c];
2	The **penalties** applicable to the public administration and to the private partner in the event of non-compliance with the contractual obligations, which shall always be determined proportionately to the magnitude of the offence committed and to the obligations assumed;
3	The **sharing of risks** among the parties, including those that refer to acts of God, force majeure, acts of state, and unforeseeable events;
4	The types of **remuneration** and **adjustments of contractual values**;
5	The **mechanisms to ensure** the **service provision** is updated and adjusted to needs;
6	The factors that trigger **public sector payment default**, the means and terms for reestablishing the payment stream and, if applicable, the **form whereby guarantees are enforced**;
7	The objective criteria for **evaluating the performance** of the private partner;
8	The **provision by the private partner of performance guarantees** compatible with the responsibilities and risks involved, subject to the limits established in Federal Law 8666/1993 (the "Public Procurement Law"), and also subject to the provisions of Federal Law 8987/1995 (the "Concessions Law"), in the case of Sponsored Concessions;
9	The **economic gains of the private partner to be shared with the public administration** that result from the reduction of credit risk related to funding contracted by the private partner; and
10	The **inspection and due diligence of the assets to be transferred to the public sector**, which shall enable the public authority to withhold payments to the private partner, in the amount necessary to remedy any irregularities that may be detected.

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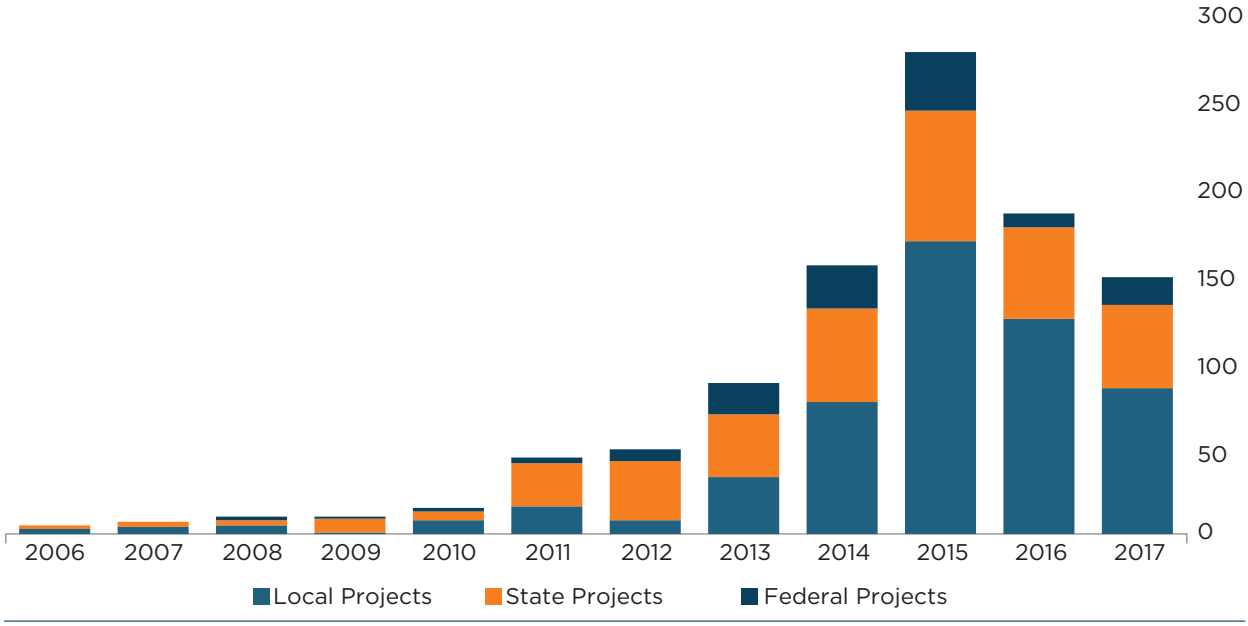
CLAUSES THAT HAVE TO BE INCLUDED IN CONTRACTS FOR ADMINISTRATIVE CONCESSIONS, SPONSORED CONCESSIONS, AND COMMON CONCESSIONS[d]:	
11	The **object**, area, and **period of the concession**;
12	The procedure, form, and **conditions for rendering services**;
13	The criteria, indicators, formulae, and parameters defining the **quality of the service**;
14	The **tariffs to be charged** to users and the criteria for the **adjustment and revision** thereof;
15	The **rights, guarantees, and obligations of the parties**, including those related to the foreseeable need for future changes and expansion of the service, and the consequent modernization, improvement, and expansion of equipment and facilities;
16	The **rights and duties of users** to obtain and use the service;
17	The **form of supervision to be carried out on installations**, equipment, methods, and the manner of service execution, as well as indicating the relevant competent bodies to execute this;
18	The contractual and administrative **penalties** to which the concessionaire is subject and their application;
19	The conditions for the **contract's termination**;
20	The **revertible assets**;
21	The criteria for the calculation and definition of the respective forms of **remuneration** due to the concessionaire, when applicable;
22	The conditions for the **contract's extension**;
23	The obligation, method, and periodicity of concessionaire **reporting** to the granting authority;
24	The requirement for the concessionaire to **publish periodic financial statements**; and
25	The jurisdiction and the means for settling out-of-court **disputes** in connection with the contract.

IN ADDITION, ADMINISTRATIVE CONCESSIONS AND SPONSORED CONCESSIONS CONTRACTS MAY PROVIDE FOR[e]:	
26	**Step-in-rights** conditions in favor of financial institutions, with the objective of promoting the financial restructuring of the Special Purpose Vehicle (SPV) and ensuring the continuity of the service provision;
27	The possibility that public-sector **payments** may be made **directly to project lenders**; and
28	The possibility of **compensation for early termination of the contract**, as well as payments by funds and state-owned enterprises acting as guarantors of public-private partnerships being paid directly to the project lenders.

[a] These contracts include both Administrative Concessions and Sponsored Concessions.
[b] According to what is stated in PPP Law.
[c] Even after considering a potential extension, the final contract duration cannot be longer than 35 years.
[d] According to what is stated in both PPP Law and Concessions Law.
[e] According to the PPP Law, these provisions are not mandatory, but can be included in the contract.

neration system, the PPP Law has widened the possibility of the partnership concept also being implemented at the subnational level. In the case of municipalities, it is more difficult to ensure the feasibility of projects solely based on user tariffs. As a result, public-partner payments, only permitted following the introduction of the PPP Law, are more necessary. At the federal level, the scenario is different, with the potential for the development of self-sustaining projects. This, naturally, explains why, to date, it has been almost

FIGURE 8. PROJECTS STARTED BETWEEN 2006 AND 2017



Source: Prepared based on Radar PPP data.

exclusively Common Concessions[71] that have been implemented at this level, that is partnerships where the remuneration of the private sector consists solely of tariffs collected from users.

The introduction of the PPP Law, in 2004, thus led to the spread of the use of the PPP concept with payments from the grantor (Sponsored and Administrative Concessions), especially at the state and municipal levels. Between 2006 and 2014 of the total PPP projects developed, 39 percent were under municipal responsibility and 55 percent were initiatives by states (Siqueira Moraes and Reyes-Tagle, 2017).

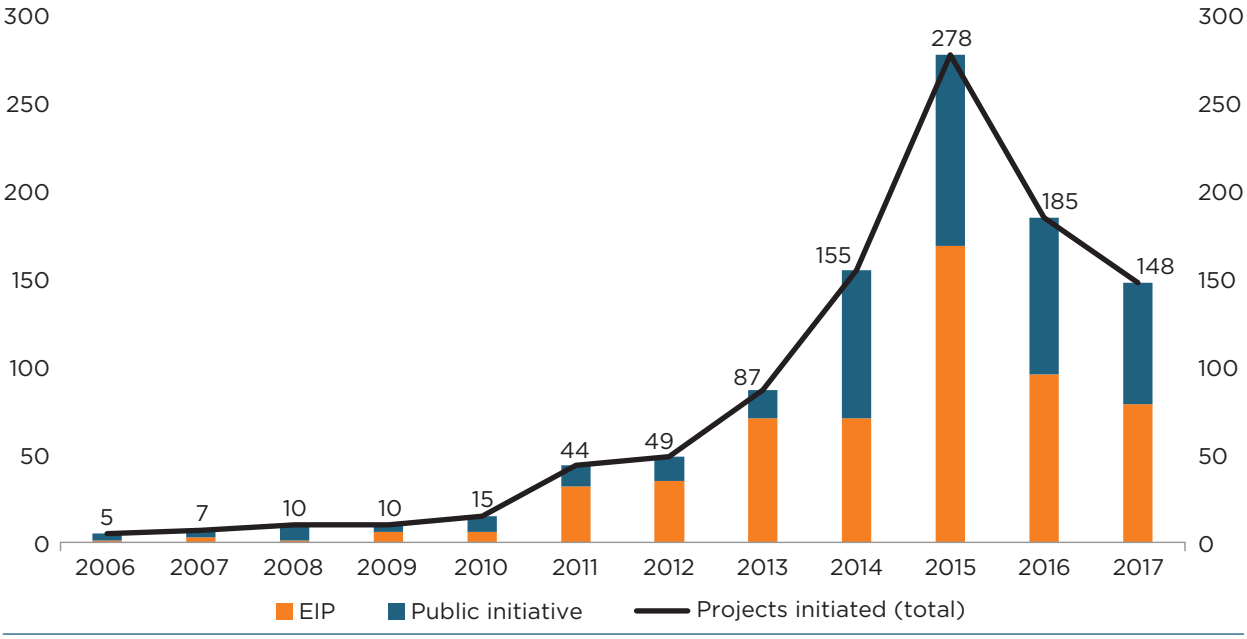
In addition to using the specificities of their own legal frameworks, municipalities do not yet have the necessary technical capacity to develop and structure PPPs. Therefore, the dominant contribution of local governments in terms of total PPPs implemented has resulted in huge diversity in both the assessment and the allocation of risks between the public and private partners, as well as in the defining of PPP contract clauses, even in cases where projects are similar.

It is important to mention, moreover, given the local governments' lack of capacity, that the proliferation of local PPPs occurred mainly using the "Expression of Interest Procedure" ("Procedimento de Manifestação de Interesse" or EIP)[72], which is a mechanism like the model for unsolicited proposals used in other LAC countries. In both cases (EIP and unsolicited proposals), studies prior to the

[71] The only PPP with public payments implemented at federal level (under the PPP Law) was Datacenter, a PPP jointly contracted by Banco do Brasil S.A. and Caixa Econômica Federal in 2010.

[72] Regulated by Decree no. 8,428/2015.

FIGURE 9. PROJECTS STARTED BETWEEN 2006 AND 2017 (UNDER EIP AND PUBLIC INITIATIVE)



Source: Prepared based on Radar PPP data.

launch of a PPP bidding process are carried out by the private sector and the costs of these studies are not supported by the public administration (in the case of EIPs, the costs are borne by the future concessionaire) (Siqueira Moraes and Reyes-Tagle, 2017).

However, the two models (the EIP and the unsolicited proposals) differ in the following:

a. Under the EIP, the initiative to carry out the project is not taken by the private entity, but is a formal request from the Public Administration, which gives authorization for the presentation of projects, defining the characteristics of the project from the start. Thus, unlike with unsolicited proposals, in the case of the EIP, there is no freedom for the private partner to propose projects; and

b. With EIPs, there is competition between the various entities that can submit proposals, and in the bidding process on the selection of the concessionaire for the project (Siqueira Moraes and Reyes-Tagle, 2017).

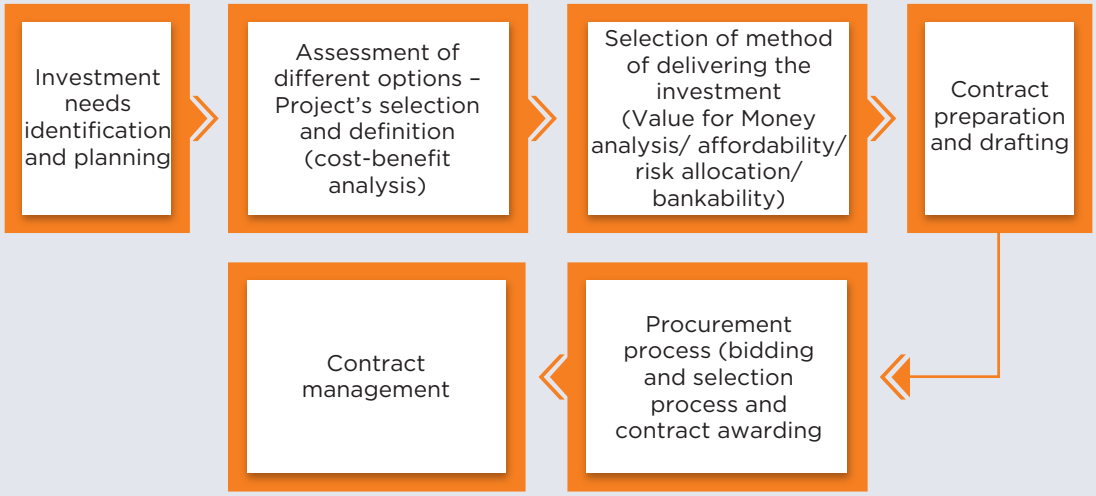
Given the lack of technical capacity for structuring projects and the difficulty of contracting external consultants (due to the rules of the Public Procurement Law), the EIP mechanism has been the main method of structuring projects, especially in the case of municipalities (Figure 9). Of the total of 993 projects initiated in Brazil between 2006 and 2017, over half were under the EIP methodology. At the same time, federal public banks have also participated in the structuring of the projects, specifically BNDES and Caixa, with the Brazilian governments also benefit-

BOX 6. THE EXPRESSION OF INTEREST PROCEDURE ("PROCEDIMENTO DE MANIFESTAÇÃO DE INTERESSE")

In accordance with international good practice, any investment decision must be preceded by a thorough and robust analysis of the merits and value added of the investment in question, taking into account the associated costs, always with a view to ensuring an efficient allocation of resources.

The process of implementing an infrastructure investment program is usually quite complex and time-consuming, requiring a strong technical capacity from public entities. This is because, in the case of public resources, the decision-making process requires a set of rigorous technical analyses and complex studies in order to identify the aforementioned merits and added value.

The infrastructure decision-making and implementation process on the part of public entities is thus composed of several stages, as follows:



Once the project is selected, and when choosing the method of implementation, Brazilian governments have, essentially, two alternative models for contracting their projects: the "traditional" contracting model (as provided for in the Public Procurement Law), which is the model generally used to acquire the assets (the infrastructure), but not provide the services associated with the same; and the concession/PPP model, where the government not only contracts the acquisition of the asset, but also the associated service provision (operation). In the case of concessions, the contracting model can take three different forms according to the remuneration model applied by the private entity: Common Concession (regulated by the Concessions Law); Administrative Concession; and Sponsored Concession (the latter both primarily regulated by the PPP Law).

The PPP model is much more complex than the traditional contracting model, requiring greater technical capacity and skill from the public teams than in the case of traditional

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BOX 6. THE EXPRESSION OF INTEREST PROCEDURE ("PROCEDIMENTO DE MANIFESTAÇÃO DE INTERESSE") *(continued)*

contracting, especially in terms of the preparation and structuring of the project, in the design of the contract (including selection of a proper risk allocation, so as to protect the public interest but not jeopardize project bankability), and in the management of the procurement process.

In order to handle the structuring of PPPs, Brazilian governments have three options: (i) carrying out the PPP preparation and structuring work internally; ii) contracting external consultants to complete the work (on the terms provided for in the Public Procurement Law); or iii) resorting to the Expression of Interest Procedure mechanism.

The EIP is a mechanism that allows for the studies and preparatory projects necessary for the structuring of PPPs to be carried out by companies and consultants, at their own cost (which may be reimbursed in the future to the winning bidder). At the federal level, the EIP has its legal basis in article 21 of the Concessions Law and article 2 of the PPP Law. This allows private entities to request permission from public entities to carry out projects, studies, surveys, or investigations to be used in the structuring process of PPPs which have already been identified as priorities by the government. These are regulated by Decree 8,428/2015 (which revoked Decree 5,977/2006), although there are also other decrees that apply at state or municipal level.

In essence, Decree 8,428/2015 provides that the EIP is composed of three stages:

1. the procuring authority issues the public call for proposals;
2. the procuring authority issues the authorization to present projects, surveys, investigations, and studies; and
3. the procuring authority assesses and evaluates the studies presented by the private parties, and decides whether to proceed with a competitive procurement procedure in order to choose a concessionaire (if the decision is not to proceed, this stops the process).

If the public authority decides to implement the project, it proceeds to the bidding process, after having made any necessary adjustments to the bidding documents resulting from the public consultation process. Even if the EIP mechanism is used, the awarding of the PPP contract is preceded by a competitive bidding process.

The private entities participating in the EIP are only reimbursed if their studies are approved (and in the respective proportion of the approval), with the payment of these costs being the responsibility of the future private partner that signs the PPP contract with the procuring authority. In general, private entities participating in the EIP may also participate in the PPP bidding process, except when expressly prohibited under the EIP public call for proposals.

Among the various characteristics of the EIP mechanism, the following stand out: i) non-exclusivity in the authorization for the presentation of studies, with the possibility of studies being presented by several entities. This makes it difficult for the public sector to analyse the proposal and reduces private individuals' potential interest in participating, given the risk

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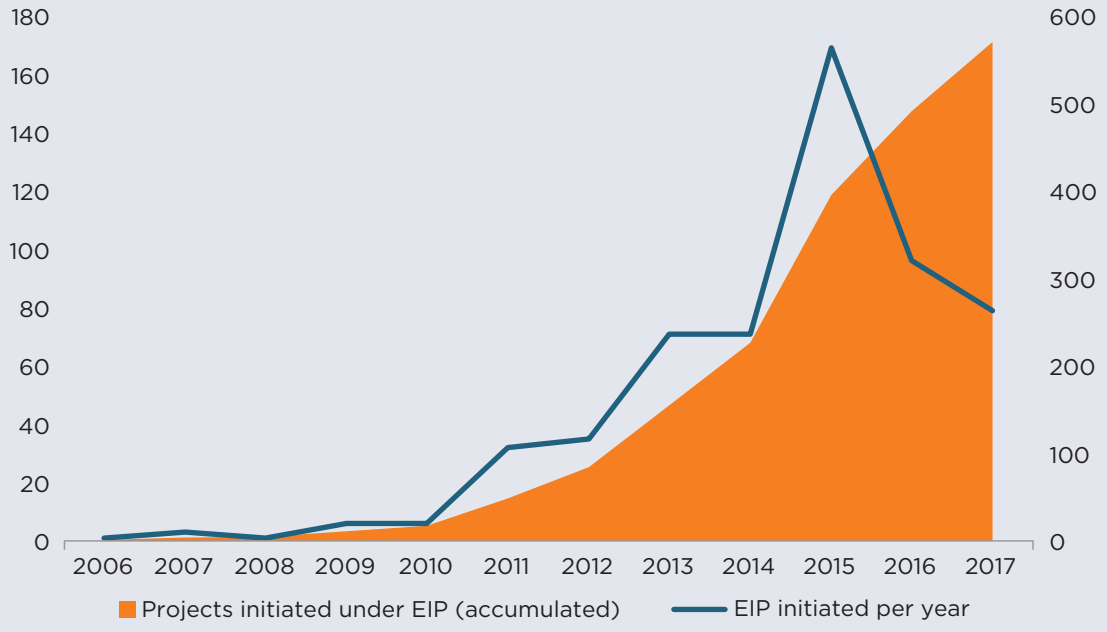
BOX 6. THE EXPRESSION OF INTEREST PROCEDURE ("PROCEDIMENTO DE MANIFESTAÇÃO DE INTERESSE") *(continued)*

of not being reimbursed the costs of the studies if they are not selected; (ii) the EIP can be initiated by private individuals, but the public call for proposals must still be published so that other private individuals may submit proposals; and iii) there is no obligation on the procuring authority to carry through with the bidding process after the completion of the EIP; the project may be cancelled, in which case the project's author(s) will not be reimbursed for their preparatory work.

Although Brazil currently stands out as one of the leading Latin American countries (together with Colombia, Chile, Mexico, and Peru) with more experience in PPPs, be it by volume or years' of experience, the country does not yet have the technical capacity required to appraise and structure PPP projects, especially at the local level, where the PPP market has been most active (Infrascope, 2017). In this context, and in order to accelerate the implementation process of their investments, Brazilian governments have relied significantly on the Expression of Interest Procedure mechanism, and the number of EIPs has grown over the years, with 570 of the projects registered in the last 10 years having been initiated through the EIP mechanism.



Source: Prepared based on Radar PPP data.

ting from the support of development banks (namely the IADB and the IFC).

The use of the EIP mechanism has gained popularity and importance in the implementation of the country's investment program, especially at the state and municipal levels, given that it has been accepted as a method of overcoming some of the problems that governments have faced, such as: i) the lack of technical capacity to carry out preparatory studies and the structuring of PPPs; ii) the greater difficulty public entities have (in relation to private entities) in contracting consultants under the Public Procurement Law; and iii) the fact that these allow for the costs associated with the studies and structuring of PPPs to be passed on to the winning bidder (IFC, 2015).

According to the opinions of different stakeholders involved in PPP matters, although the EIP mechanism has been widely used, it has, in fact, brought disadvantages and potential problems, namely:

a. The absence of clear guidance and guidelines for structuring projects has in some cases led to poorly structured contracts, with the public authority often not having the critical capacity to evaluate the different proposals under the scope of the EIP;
b. Since it is not certain that the private entity that presents an EIP will be reimbursed its costs, and given that it is possible that several entities present proposals, not all of which can be selected, the quality and effort applied in the execution of the studies by the private entities is not always as desired, increasing the likelihood that poorly structured PPP contracts may result; and
c. The fact that the EIP allows for the presentation of several proposals means that this mechanism does not translate into a reduction in time taken by the public sector parties in analyzing the projects and making decisions before the bidding process. As a result, a high EIP project mortality rate has been observed.

The mortality rate of the projects in Brazil has been high. According to data from RadarPPP[73], in 2017, of the 281 initiatives to launch new projects, only 3 were successful and resulted in signed contracts. In 2016, the situation had been similar, with only 13 projects realized out of 183 initiatives[74].

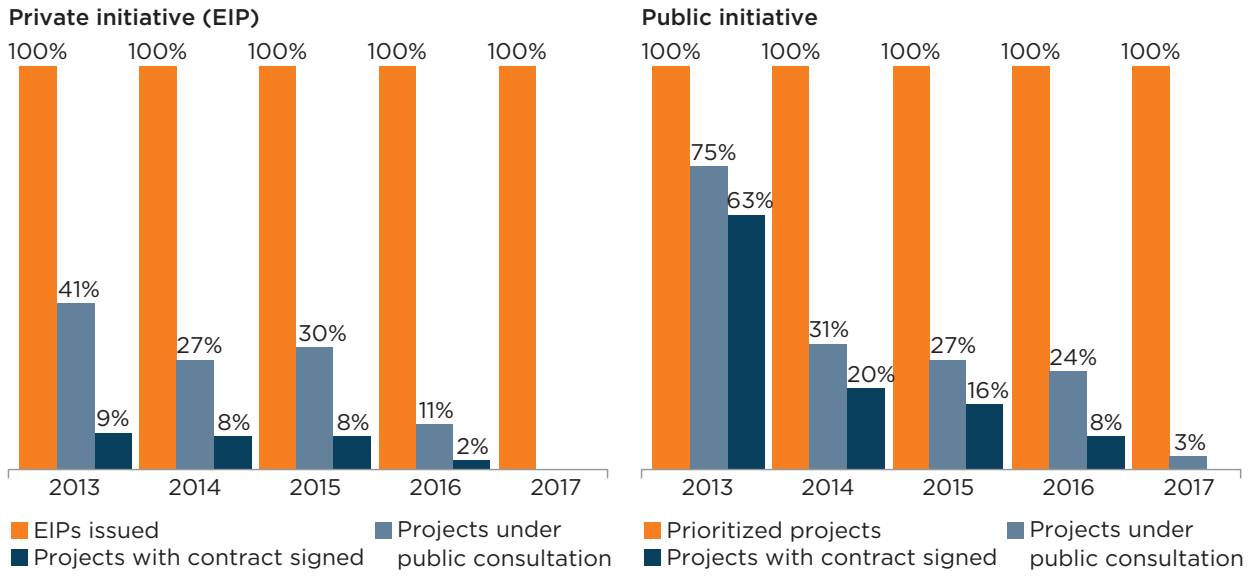
As shown in the following figure, between 2013 and 2017, of the total EIPs initiated, less than half reached the public consultation stage and only a very small percentage resulted in signed contracts.

The PPP Law, introduced in 2004 (together with the subsequent amendments made to this law), implied a real change in the infrastructure market paradigm in Brazil. Compared with the previous scenario, which only allowed for Common Concessions, there were changes in several aspects, namely:

a. The introduction of the possibility that the remuneration of private partners may include payments from the grantor and not just the collection of tariffs from

[73] An independent consultancy company in Brazil, which collects data about the PPP universe.
[74] Information available at: https://www.valor.com.br/brasil/5239665/ppps-tem-recorde-de-projetos-mas-apenas-tres-avancam

FIGURE 10. MORTALITY RATES OF EIPS BETWEEN 2013 AND 2017



Source: Prepared based on Radar PPP data.

users of the infrastructure. This aspect, in turn, allowed for the expansion of partnerships to sectors where recourse to private investment was not possible until 2004, due to a lack of viability;

b. The proliferation of PPPs at the state and municipal levels, due to the expansion of the PPP concept to projects that are not self-sustaining;

c. The introduction of risk-sharing between the private and public partners, and the consequent appearance of the concept of contingent liabilities for the Public Administration. Until the appearance of the PPP Law, the existing partnerships were only those regulated by the Concessions Law, which provides that the risks are fully allocated to the private partner, and, therefore, there are no financial responsibilities for the public partner, except for the possible need to pay the value of the investments not amortized in the event of early termination of the contract;

d. The contribution of the public partner to the financing of part of the concessionaire's investments, through the mechanism of "contribution of resources" ("aporte de recursos"); and

e. The emergence of the contracting authority's need to provide guarantees to the private partner. The entry into force of the PPP Law, which envisaged the possibility that the remuneration of private partners may be based on payments from the grantor, led to the need for the introduction of state guarantees, to mitigate the credit risk associated with Brazilian governments (federal and subnational governments), to which the private partners of the Administrative and Sponsored Concessions are exposed.

The need for the provision of state guarantees in the case of PPPs is a specificity of the Brazilian market (and some other LAC countries) which is not found in other jurisdictions, such as, for example, Portugal, the United Kingdom, France, or Australia. This need for state guarantees has often been a great obstacle to the successful implementation of projects, especially considering the history of noncompliance of some of the public entities in administrative contracts and the difficulty involved in the enforcement of these guarantees (Werneck and Saadi, 2018).

The awarding of contracts is an additional issue in the Brazilian market. Although the legal framework allows bidder selection to be made based on price *and* technical criteria, the practice has been to only consider the price criterion (based on the lowest price or on the highest offers). This is a peculiarity of the Brazilian market which differs, for example, from the practice in Portugal and in most European countries. In some cases, this may lead to difficulties in capturing the value associated with increased innovation and the efficiency that the private partner may bring to the project. Furthermore, the use of a price-only criterion implies that bidding documents (specifically regarding the definition of service standards) must be well-constructed, given that the private sector is not given the opportunity to improve on these standards.

Another of the characteristics of the Brazilian market relates to the issue of PPP financing. Traditionally, and until 2016, infrastructure financing in Brazil was mainly provided by BNDES, as its cost of funding was subsidized by the Brazilian Treasury. This made it incomparably cheaper than the funding of any private bank and meant that the long-term financing of projects was virtually always secured by BNDES. Commercial banks only participated in the granting of bridge loans (usually covered by corporate guarantees from the shareholders of the SPV participating in the PPP contract), which would eventually be repaid after achieving financial and technical completion, at which time BNDES was able to commit itself to the long-term financing.

This feature of the Brazilian market ended up hampering the development of the project finance market[75] in Brazil. Thus, in contrast to other countries with a strong PPP tradition, such as the United Kingdom, Australia, Portugal, and France, in Brazil, few PPPs were financed using a project finance-type structure (São Paulo Metro Line 4 is one of the few examples of PPPs financed through project finance in Brazil).

The financing of a PPP using a project finance structure (which is financing with solely project guarantees), although more costly, could be an important and useful way of aligning the interests of the private partner throughout the useful life of the PPP. Through a rigorous risk assessment exercise carried out by banks before the financial close (with the usual requests being for independent technical, legal, market, and financial due diligence), banks have an important

[75] This is a non-recourse-type of finance, designed specifically to fund a project, without any recourse to the SPV shareholders, and in which the debt service payment is ensured solely by the cash flow generation capacity of the project itself (usually not involving corporate guarantees, but only collateral related to the assets of the SPV itself).

BOX 7. THE SÃO PAULO METRO LINE 4

With a view to extending the coverage of the São Paulo metro network, and in particular to catering for connections between important commercial (Paulista and Faria Lima) and residential (Higianápolis, Pinheiros and Vila Sónia) areas of the city, the State of São Paulo decided to construct a new line, Line 4, with connections to the remaining metro lines already in operation and to five bus terminals being constructed by the State of São Paulo. To this end, over 2005 and 2006, the state government launched a public open international tender for the commercial operation of the metro line for a period of 32 years.

As a result, the concession of Line 4 of the São Paulo metro was awarded to the consortium ViaQuatro, and the bid from the only other consortium competing (consisting of the Brazilian construction companies Odebrecht, OAS, and Queiroz Galvão) was rejected. The concession included the payment of financial compensation to the concessionaire by the state; the winning bid was determined based on the level of payments required of the grantor (75 m $R in the case of ViaQuatro).

Line 4 was designed to accommodate a capacity of 970,000 passengers/day, connecting the Historical Centre to the commercial and financial areas of Avenida Paulista and Faria Lima, as well as to more residential areas, such as Morumbi and Butantã. The Line was to be extended by a total length of 12.5 km and include 11 new stations. The implementation of the project was structured in two phases:

- Phase 1: the construction of 6 stations (Luz, República, Paulista, Faria Lima, Pinheiros, and Butantã) which were planned to be fully operational in June 2011; and
- Phase 2: the construction of the remaining 5 stations (Higienópolis, Óscar Freire, Fradique Coutinho, Morumbi, and Vila Sóni) four years after the start of the phase 1 operation, and the introduction of between 5 and 15 new trains. After this phase, the concessionaire would also transport passengers by bus on the route between Vila Sónia and Tabuão da Serra.

According to the concession contract, the concessionaire was entrusted with the acquisition, installation, and operation of the carriages and control systems, with the public authority being responsible for the construction works and the installation of the railway infrastructure. In this context, the project was exposed to interface risk, since the installation of the equipment and the start of operations by the concessionaire could only happen after the public authority had completed the construction phase under its responsibility.

In order to mitigate possible delays by the public authority in the construction of the metro line, the concession contract provided that the concession term could be extended to 35 years in order to guarantee the minimum operation period of 30 years, counting from the start of the commercial operation of the first phase.

The project was structured as a Sponsored Concession, as it involved the collection of user tariffs and payment by the grantor of a monetary counterpart.

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BOX 7. THE SÃO PAULO METRO LINE 4 *(continued)*

The remuneration of the private partner was structured according to the following components:

- User payments: calculated based on the number of Line 4 users and the base fare (defined in the contract). Two types of passengers have been envisioned: 'exclusive' passengers, who will only use this metro line, and 'integrated', who use Line 4 together with other transport options within the overall São Paulo transport network. The defined base fare (2.14 $R, at 2006 prices) was to be updated until the 15th year of operation, applying an updating rate with 50 percent being determined by the IPC-Fipe (Consumer Price Index of the Municipality of São Paulo (Índice de Preços ao Consumidor do Município de São Paulo)) and 50 percent by the IGP-M (General Price Index). After the 15th year of operation, the fare would be adjusted based solely on the IPC-Fipe. The amount of revenue related to user payments thus depends on the type of passenger: for each exclusive passenger, the concessionaire is entitled to the full fare and, for each integrated passenger, it receives 50 percent of that value. These revenues are subject to penalties based on the concessionaire's performance. According to the concession contract, deductions would be applied to the fare whenever the performance of the concessionaire was lower than expected, in terms of service quality and the quality of infrastructure maintenance, and penalties could reach a maximum of 20 percent of the fare. The measurement of the quality of both service and maintenance was based on performance indicators defined in the contract;
- Advance payments: the ViaQuatro consortium proposal provided for a governmental contribution of 75m $R to finance investments. The contract defined that this contribution would be paid in two stages: 24 instalments of 1.56m $R after the start of commercial operation of phase 1, and another 24 instalments after the start of operation of phase 2. The amounts of the instalments were indexed to inflation, according to a mechanism similar to that adopted to update user fares; and
- Ancillary revenues: the concession contract provided for the possibility of the private partner deriving other revenues, namely related to advertising and the rental of commercial spaces.

Investment in the project was initially expected to be 392m $USD for phase 1, having been financed by shareholders' equity and senior debt in a proportion of 20:80. The project was not considered eligible for BNDES long-term financing, as the metro carriages were purchased outside of Brazil. Thus, the construction of the tunnels (the public investment) was financed by the World Bank and the Japan Bank for International Cooperation, while the financing of the private investment was assured by the IADB together with commercial banks, in an A/B Loan structure (the A Loan being provided by the IADB and the B Loan by commercial banks), under a project finance regime.

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BOX 7. THE SÃO PAULO METRO LINE 4 *(continued)*

One of the possible obstacles to the financing of the project was that the concession contract obliged the private partner to operate two phases; however, given the uncertainties regarding the second phase, it was not possible to close the financing for the two phases at the outset. This risk was, however, mitigated as: i) the IADB immediately approved the A loan for the two phases; and ii) the shareholders pledged to cover the financing needs if the B loan could not be guaranteed for the second phase. Furthermore, the concession contract provided that, in the event of contract expiration caused by the private partner failing to guarantee the financing for the second phase, the public authority would undertake to pay compensation in the amount of the financing.

This project was a success in financing terms, since it was possible, through the appropriate allocation of risks, to ensure project bankability. The main risks of the project, and their respective mitigations, were as follows:

i. Demand/revenue risk: the concession contract provided a mechanism for the sharing of this risk with the public authority, it being defined that variations in traffic exceeding 10 percent would generate public partner compensations or the sharing of the revenue with the public partner;
ii. Interface risk during the construction phase: with the construction being the responsibility of the public partner, the project was exposed to the risk of delays by the grantor. In order to mitigate this risk, a sponsor-support agreement was drawn up, whereby shareholders committed to providing additional funds in the event of any cash flow shortage until the start of operations; and
iii. Exchange rate risk: this risk stemmed from the fact that the receipts are in Reais and the debt service is in US Dollars. The mitigation was by a sharing mechanism with the public partner (the public partner has undertaken to support 50 percent of the exchange rate differences up to a limit of 40 percent of the debt), as well as the drawing up of a hedging mechanism.

role in impeding private partners from taking inappropriate risks, as well as in incentivizing the implementation of diverse risk mitigation. Ultimately, banks always try to ensure that the private partner has the capabilities to deal appropriately with the risks assumed under the PPP contract (Iossa & Martimort, 2012).

One example of best practice (in terms of risk management) that is the norm in project finance arrangements is to request that construction contracts be structured as turnkey contracts, to pass the construction risk on to a third party that is better prepared, than the concessionaire, to deal with this risk. In Brazil, construction contracts are not commonly drawn up as turnkey contracts, as would be desirable, which has often resulted in overrunning both cost budgets and deadlines.

Furthermore, it is important to mention the importance of banks in project monitoring. Usually, banks are better than governments at monitoring projects, which contributes to PPP value improvement (Martimort and Menezes, 2015).

The strong economic and fiscal crisis that plagued Brazil from 2015 made it untenable for the government to continue the policy of subsidizing BNDES's financing. There was a need to reduce BNDES's dominant role in the financing of infrastructure in Brazil and, consequently, to enhance the participation of private banks and other institutional investors, particularly foreign investors. From 2016, this adjustment was reflected in a change to its financing rate[76].

Also in 2016, there was a change in the institutional framework related to infrastructure in Brazil, with the creation of the Investment Partnerships Program ("Programa de Parcerias de Investimento" or IPP)[77]. This program was aimed at expanding and strengthening the interaction between the State and private initiatives, through the development of partnership contracts particularly for the implementation of the most critical new infrastructure needed within the country[78].

In contrast to the PPP Law, the IPP Law encompassed the three types of partnerships, that is Common Concessions, Administrative Concessions, and Sponsored Concessions, and created a central department to manage these within the presidential office (the IPP Secretariat). The IPP Secretariat encourages international investment through improved institutional stability, support for procuring authorities, and improved technical capacity within the governments. The IPP also aims to: strengthen the regulatory role of the government and the autonomy of State regulatory agencies; ensure the legal stability and security of contracts; and expand the volume of quality public infrastructure.

Under the IPP framework, different projects can qualify to receive special priority and treatment, in legal and institutional structure terms, to attract the private sector. IPP entities have been recently established, and important improvement measures have been implemented, aimed at improving the attractiveness of partnerships to investors, particularly international investors. These new measures aim to facilitate and smooth the PPP implementation process, improve transparency, reduce legal uncertainty (clarifying and refining certain rules), and speed up administrative processes. Examples of specific measures implemented by the IPP include: i) the publication of tender doc-

[76] BNDES ceased to apply the TJLP, and started applying the TLP, in January 2018. The TJLP was the rate at which BNDES granted its financing, being set by the government every 3 months based on the inflation target for the year, and incorporating a subsidy from the Brazilian State, in order to encourage economic growth. The TLP is based on the 3-month average of the real interest rate of the 5-year public bond NTN-B and a smooth transition from the TJLP to the TLP over the next 5 years is planned.

[77] Through Federal Law no. 13334/2016 (the IPP Law).

[78] With the establishment of the IPP, two new entities were created in the Federal Administration: the IPP Council and the IPP Secretariat. "The Council is the collegiate body that evaluates and recommends to the President of the Republic the projects that integrate the IPP, deciding, also, on the issues related to the execution of the contracts of partnerships and de-statizations. The Secretariat, linked to the Presidency of the Republic, acts in support of Ministries and Regulatory Agencies for the Execution of Program Activities" (published at https://www.ppi.gov.br/about-the-program).

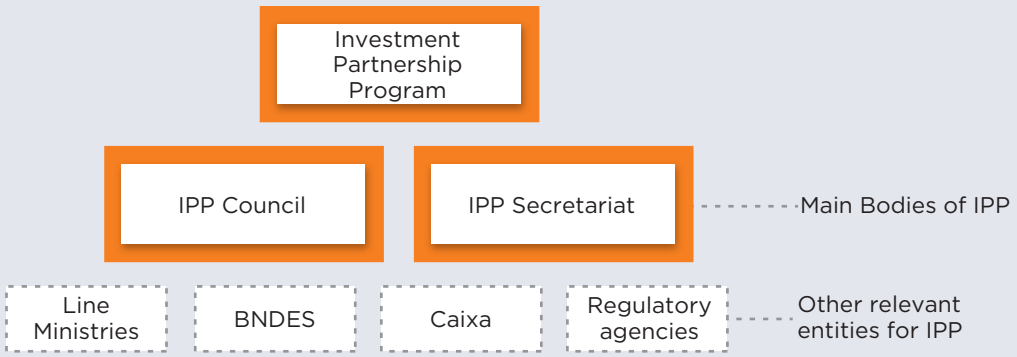
BOX 8. INVESTMENT PARTNERSHIPS PROGRAM ("PROGRAMA DE PARCERIAS DE INVESTIMENTO")

In 2016, the Brazilian government converted Provisional Measure 727 into Federal Law 13,334/2016 ("The IPP Law"), thus creating the Investment Partnerships Program. Its main objective is to improve interaction between the government and private investors, in order to accelerate the implementation of public infrastructure projects, specifically through PPPs. The IPP Law aimed to facilitate the planning and implementation of infrastructure projects through the creation of a centralized monitoring mechanism with a central department for PPPs within the presidential office (the IPP Secretariat). Projects that qualify under the scope of the IPP are now considered national investment priorities.

The objectives of the IPP are therefore to:

- "Expand investment and employment opportunities and stimulate technological and industrial development, in harmony with the country's social and economic development goals;
- Ensure the expansion, with quality, of the public infrastructure, with tariffs appropriate to the users;
- Promote open and fair competition in the celebration of partnerships and the provision of services;
- Ensure legal stability and security of contracts, with the guarantee of minimal intervention in business and investment; [and]
- Strengthen the regulatory role of the state and the autonomy of state regulatory entities" (https://www.ppi.gov.br/about_the_program).

The publication of this Law brought about a reorganization of the institutional framework of PPPs within the country, and two new structures were created in the Federal Administration: the IPP Council, and the IPP Secretariat. In addition to the two main bodies of the IPP, its structure is also composed of a group of entities with capacity for intervention in the program:



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BOX 8. INVESTMENT PARTNERSHIPS PROGRAM ("PROGRAMA DE PARCERIAS DE INVESTIMENTO") *(continued)*

The IPP Council was created to assist the Brazilian President in the decision-making process regarding infrastructure projects, and assumes the responsibilities that were previously assigned to the governing body of the federal PPPs ("Orgão Gestor das PPP"). Its main duties are: i) to consider, prior to formal deliberation by the President of the Republic, the proposals of the Ministries for the inclusion of projects, under the IPP and within federal long-term investment policies, using the mechanism of PPPs; and ii) to coordinate, monitor, evaluate, and supervise the actions of the IPP and to support the sectoral actions necessary for the execution of the projects.

The IPP Council is composed of the following permanent members:

- The President of the Republic;
- The Minister of State Secretary-General of the Presidency of the Republic;
- The Minister Chief of Staff of the President;
- The Minister of Finance;
- The Minister of Planning, Development and Management;
- The Minister of Mining and Energy;
- The Minister of Transportation, Ports and Civil Aviation;
- The Minister of the Environment;
- The President of BNDES;
- The President of Caixa Econômica Federal; and
- The President of Banco do Brasil.

Depending on the projects that are being analysed by the IPP Council, this body can also integrate any ministers responsible for the proposals being assessed as well as the director generals of regulatory agencies.

The IPP Secretariat is responsible for assisting the relevant authorities to bring projects within the scope of the IPP. Its main duties include: i) receiving proposals from ministries and structuring the agenda of IPP Council meetings; ii) advising the President of the Republic on matters related to the IPP, drawing up opinions and studies and proposing standards, measures, and guidelines; iii) coordinating, monitoring, evaluating, and supervising the actions of the IPP, including supporting actions necessary for the execution of the projects by the ministries and regulatory agencies; and iv) publicizing IPP projects and liaising with investors and other stakeholders in the Program, including State and Municipal bodies.

Besides the main IPP bodies, its structure also includes the following entities:

- Line ministries that: i) submit proposals and projects for IPP Council deliberation and inclusion in the IPP; ii) promote technical and modelling studies of the projects under its

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BOX 8. INVESTMENT PARTNERSHIPS PROGRAM ("PROGRAMA DE PARCERIAS DE INVESTIMENTO") *(continued)*

responsibility; and iii) conduct the bidding, and monitor the execution, of projects, with the support of the IPP Secretariat and regulatory agencies;

- Regulatory agencies that are responsible for: i) regulating economic sectors aimed at fostering competition and carefully addressing the quality of the services provided by the private agents; ii) following up on the Ministries' technical and modelling studies upon request and executing technical studies for the projects within their competence; iii) supervising the execution of PPP contracts within their fields of action; and iv) promoting contractual revisions and assessing contractual rebalance claims in partnership contracts within their fields of competency;
- BNDES which supports the IPP by: i) assessing the bankability of projects included in the Program; ii) offering financing lines according to applicable credit requirements; iii) managing the Partnership Structuring Support Fund, which will procure advisers for the integrated structuring of IPP projects; and iv) managing the National Privatization Fund and performing the privatization procedures of the state-owned enterprises included in the IPP; and
- Caixa Econômica Federal (a bank) also plays an important role in terms of IPP project financing.

During the first two years of the IPP's operation, 193 projects were classified as priority projects, of which 106 were completed.

uments in both the Portuguese and English languages; ii) the structuring of hedging mechanisms (already applied in recent airport concessions for Salvador, Fortaleza, Florianópolis, and Porto Alegre); and iii) the increase in the notice period for bidders to present their offers, from 45 to 100 days.

In addition to addressing concerns regarding the launch of new projects, the IPP also focused on solving the problems that are evident in concessions already underway. These relate to difficulty in obtaining financing due to the involvement of shareholders of the concessionaires in corruption, "Operação Lava Jato"; the economic crisis (and consequent deterioration of demand risk); or the need for new investment not foreseen in the contract. In this context, Federal Law no. 13448/2017 was published which provided for the renewal of, or re-bidding for, contracts in force in the rail, road, and airport sectors. Renewal (applicable only to the rail and road sectors) is aimed at catering for the introduction of unforeseen new investments, considered priorities by the IPP. In the case of re-bidding (which covers the rail, road, and airport sectors), the objective of the law is to allow for "friendly termination" in order to solve problems more rapidly (in the case, for example, of an "expiry" situation), such as the

inability of the concessionaire to obtain the necessary financing for the project. In this case, the new law allows the concessionaire to be indemnified and the concession placed on the market for a new bidding process.

Analysis of the Current State of the Risk Matrix and PPP Contracts in Brazil

Due to the nature of the country and because it is distributed over several autonomous states, Brazil has a great diversity of institutional environments for PPPs. Throughout this section, the focus will be on the PPP framework at the federal level, while indicating, whenever relevant, some specific characteristics of the states, namely of the State of São Paulo which has the most PPPs (followed by Minas Gerais).

The PPP Framework and Regulation

The PPP institutional framework in Brazil has, over the past 10 years, been essentially defined by two federal laws:

- The Concessions Law: this established the concession regime and grants permission for the provision of public services; and
- The PPP Law: this established general rules for public procurement and the contracting of public-private partnerships within the public administration.

The PPP Law identifies some of the themes that should be included in PPP contracts related to the Sponsored and Administrative Concessions, and provides for an objective sharing of the risks of the project between the parties. However, the Law does not specify the details of how this sharing should be carried out, nor how different matters should be treated within the contracts, leaving the definition of both the risk matrix and the contractual clauses open.

In the case of Common Concessions, which are regulated by the Concessions Law, the level of statutory provision of details is even lower, with the risk-sharing between the parties not even being contemplated (since the Concessions Law provides that the private partner operates the concession at its own risk).

Due to the federative nature of the government system in Brazil (which implies that there are different autonomous state governments), there is a great heterogeneity of the processes and procedures involved in the structuring of the contracts of PPPs[79] in the Brazilian market. Not only is this due to the autonomy given to states to define their own rules, but it also results from the different levels of knowledge and technical capacity that characterize the various state and local public players.

There is significant information and knowledge asymmetry in the different Brazilian regions. Coupled with local-level governments in particular tending to resort to the expression of interest mechanism, this makes it difficult to guarantee homogeneity in the practices followed for the definition of contractual clauses and the risk matrix.

[79] Considering the PPP concept assumed in the present document, which includes all concessions (Common, Sponsored and Administrative) and not only those the Brazilian law classifies as PPPs.

BOX 9. THE MAIN DIFFERENCES BETWEEN THE PPP LAW AND THE CONCESSIONS LAW

Within the Brazilian legal framework, there is a narrower definition of the PPP than that provided by the PPP Reference Guide (which is the definition assumed for the purposes of this report), with a concession contract only being considered a PPP when at least a certain percentage of the private partner remuneration is paid by the contracting authority. Therefore, when the remuneration of the concessionaire is only based on user payments, that concession is not included within the Brazilian PPP concept.

As a consequence, in Brazil, PPPs are regulated by two different laws, depending on the private partner's remuneration type: in Administrative and Sponsored Concessions (where the remuneration of the concessionaire includes, or is solely composed of, public payments), the contracts are mainly regulated by the PPP Law; in Common Concessions, the contracts are regulated by the Concessions Law (with the PPP Law provisions not being applicable in this case).

The Concessions Law was the first law to be issued, in 1995, followed by the ratification of the PPP Law in 2004. The PPP Law opened up many more possibilities for structuring PPPs in Brazil and allowed for the extension of the application of public procurement, under a concession mode, to many more sectors. These particularly included those that could not be structured as Common Concessions because the user payments (the only kind allowed under the Concessions Law) were insufficient to achieve the financial equilibrium the project required to attract private investment.

The PPP Law is regarded as a positive step in terms of attracting private investment to major public projects in infrastructure. The PPP Law is complementary to the Concessions Law, given that:

- It introduced the possibility of a risk allocation mechanism between public and private partners, while, under the Concessions Law, the risks must all be borne by the private party;
- It opened the possibility of user payments (in the case of economic concessions) being complemented by public payments (in terms of either service/demand/availability payments or advance payments) when user payments are insufficient to ensure the financial equilibrium of the concession. Furthermore, PPP Law allowed for the extension of the concession contracts concept to social infrastructure projects, where the remuneration of the private partner has to be paid by the contracting authority. This introduced the prospect of the government also benefitting from the potential increased efficiency of the private partner in constructing and operating non-economic public infrastructure. It should be noted that, under the PPP Law, public authorities were allowed to introduce the advance payments mechanism for the circumstance when concessions involve a substantial investment amount and the bankability of the financing required was difficult to secure; and

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BOX 9. THE MAIN DIFFERENCES BETWEEN THE PPP LAW AND THE CONCESSIONS LAW *(continued)*

- PPP Law has introduced the possibility of the public partner offering guarantees to the project financier, reducing the risks associated with financing and thus increasing the bankability of investments. In addition, the PPP Law also introduced the concept of the sharing of earnings between the private and the public partners, when these earnings derive from the reduction of the credit risk of the private partner's financing.

There are thus several novelties introduced by the PPP Law, with the following table presenting the main differences between these two laws:

Issue	Concessions Law (Common Concessions)	PPP Law (Administrative and Sponsored Concessions)
Concessionaire remuneration	User payments + ancillary revenues	User payments and/or public payments + ancillary revenues
Risk allocation	All risks are borne by the public partner	Risk is allocated between the parties (the public party takes on some risks but also shares some upside)
Contract duration	Not defined	Between 5 and 35 years
Procurement process	Competitive tender	Competitive tender
Amount of investment	Not defined	Cannot be less than 20 million Reais
Guarantees from the public sector	Not allowed	There are public guarantees to cover public payments
Special Purpose Vehicle (SPV)	Not mandatory by law (only when strictly allowed for in the bidding documents)	The SPV is mandatory by law

Moreover, since the EIP provides that several players may submit proposals and later participate in the bidding process, the use of this mechanism can generate not only heterogeneity, but also the possibility of biasing the distribution of risks in favor of the private partner. This eventuality is even more significant given the lack of technical capacity that still exists, especially in local governments (that capacity being required to ensure that different EIP proposals are critically analyzed), as it is local governments that have been the most active entities in launching new PPPs (Infrascope, 2017).

In 2016, with the previous legal regime relatively unchanged, Law no. 13,334 was published, creating the Investment Partnerships Program, the IPP, as well as the two bodies responsible for its implementation: the IPP Council, and the IPP Secretariat. The IPP sought to attract institutional investors, to guarantee the successful financing of these investments, especially in a context in which the state's policy of subsidizing

BNDES was being modified with the objective of gradually reducing the level of subsidy and the weight of public bank infrastructure financing in the country.

With the strategic decision of the Brazilian government to reduce the participation of BNDES as the main financier of infrastructure projects, and to gradually reduce the level of subsidy implicit in the rates that the bank charged its clients, a void has been created in the market for financing these assets that needs to be filled, either by encouraging greater participation by the commercial banks, or by attracting international investors and boosting the capital market. However, it is relatively consensual that despite the advances and maturation of the Brazilian legal and institutional climate in the field of PPPs, there are still several obstacles that need to be addressed to promote access to financing in ways that are closer to those seen in other more developed countries.

It is due to the needs in this area that the IPP bodies have been making efforts to bring greater clarity, transparency, stability, and legal certainty to PPP contracts, having already issued various guidelines and recommendations regarding rules to be observed in contracting PPPs[80]. To date, the IPP has already completed 32 projects, of which 12 are on a PPP[81] basis (all of these being Common Concessions, there being no projects yet completed under the Sponsored or Administrative Concessions regimes). Among the main positive points to note in relation to the IPP and the performance of its constituent bodies are:

- The existence of a more centralized selection and planning process for priority projects, at least at the federal level;
- That the related entities form a PPP central unit which has specialized technical teams. These can take ownership of the procedures for launching tender calls for the establishment of partnerships, counting on the support of Empresa de Planejamento e Logística, S.A. and the regulatory agencies,
- The possibility of developing better practices and ensuring their application in a more homogeneous manner at the federal project level, including for all PPPs in their broadest sense. For the first time, the creation of the IPP has led to the integration into the same PPP unit of the two partnership types included under the PPP Law as well as Common Concessions, which naturally brings about learning economies of scale and a greater ability to standardize contracts;
- The increase in the visibility of projects vis-à-vis international investors, through a site where relevant information is disclosed, in Portuguese and English, and the updated pipeline of priority projects can be consulted; and

[80] One of the decisions taken in the projects launched after the creation of the IPP was the modification of the concession model of the last airport concessions (those of Florianópolis, Salvador, Fortaleza, and Porto Alegre). Of note is that Infraero was not included in the concessionaires' share capital, as had been the case in previous concessions. Previously, Infraero had had a stake of 49 percent in the share capital of the SPV, and it had assumed a share of the investment and, of course, part of the risk of the project.

[81] Considering the PPP definition in the PPP Reference Guide assumed in the present document, rather than the more restricted PPP concept used in Brazil .

- The analysis of the market carried out by the IPP entities and the use of international benchmarking, which have together enabled the rethinking of the projects' risk matrix to incorporate lessons learned and best practice.

However, and despite the merit of the work that has been carried out, mainly at federal level[82], by the IPP entities in improving PPP contracts, the need to harmonize the different rules and practices at the federal, state, and municipal levels persists.

In countries with a federal system such as Brazil, the PPP governance model typically tends to be more decentralized, given the autonomy of subnational governments. In such a context, a greater level of contract standardization, or at least the definition of general principles to be considered by the different public players involved in the contract structuring process, should be considered to ensure the predictability and consistency required by institutional investors, especially international investors (Prats, 2016).

Even in countries where the PPP institutional framework implies greater decentralization, it is important to ensure that some functions are centralized. It is only then that a stable and favorable framework for the development of projects can be created, through the establishment of partnerships that allow not only for the country to benefit from private investment, but also from the maximization of the associated Value for Money. Among the aspects where greater centralization is recognized is the need to issue guidelines and principles that should guide the performance of the different public authorities in the country (including subnational governments) in the structuring of their PPP contracts (Australia is an example of this).

In addition to defining the principles and guidelines to be followed by the various public agents in the structuring and definition of PPP contracts, it is also important that the different national audit bodies (namely the Court of Auditors[83]) are in line with these principles of good practice. If this were not the case, the effectiveness of their implementation would eventually be reduced.

The PPP Structuring and Procurement Process

Project Prioritization: Who Decides to Launch a New Project

Since the introduction of the IPP, at federal level, proposals to carry out new projects are forwarded by the respective sectorial ministries to the IPP Council which evaluates the priority of the projects and decides whether to include them in the IPP (where the projects included are those considered priorities for national policy). This is then validated by the President of the Republic.

At the level of the states and municipalities, the governance model is not uniform; there

[82] Given that only the "infrastructure projects which, by delegation or through support from the Union, are carried out through partnership agreements" are covered by the IPP.

[83] In Brazil, in addition to the Union Court of Auditors ("Tribunal de Contas da União"), there are courts of auditors in the different states. As a result, there is no aligned practice between the various control bodies of the country. For example, while the Union Court of Auditors approves the processes before the public tender is launched, this practice is not always followed at the state level, because of insufficient specialized resources.

are specific PPP programs in states such as São Paulo, Minas Gerais, Pernambuco, and Bahia. In São Paulo, which is the state with the most PPPs, the PPP State Program has a PPP Management Committee ("Conselho Gestor de Parcerias Público-Privadas") as the highest decision-making body and counts on: (i) a PPP Unit, (ii) the Paulista Partnership Company ("Companhia Paulista de Parcerias"); and (iii) the PPP Contract Monitoring Committee ("Comissão de Acompanhamento de Contratos de PPP").

While at the federal level new projects can only be proposed by public entities (although they may later be subject to an EIP for structuring by private entities), in São Paulo any public or private entity may submit proposals for new projects. In addition to the EIP, there is also the PIE mechanism, "Private Interest Expression" ("Manifestação de Interesse Privado"), which is similar to the international concept of unsolicited proposals. However, even in the case of PIEs, after a private entity presents an idea for a future project, and after it has been analyzed by the competent bodies, an EIP process is initiated for the preparation of studies and the structuring of the project. Moreover, assuming the project gets the go-ahead, to select the private partner with which the PPP contract is to be signed, a bidding process is always necessary, guaranteeing a competitive process even when the idea originates from a private entity.

The PPP Structuring Process – Who is Who

At the federal level, when a project is proposed by the line ministry for inclusion within the national priorities of the IPP, the project is analyzed and submitted for approval by the IPP Council[84]. No project can be put forward for the bidding process before the approval of this body.

After IPP Council approval, to structure the PPP, the contracting authority is allowed to use different strategies, such as: i) using the internal capacities of the public administration; (ii) contracting specialized professional technical services; (iii) opening a public call for interested bidders (EIP); or iv) contracting the provision of specialized professional technical services directly from the Partnership Structuring Support Fund.

Within this context, the federal government recently created a Program (under the administration of Caixa) to develop the provision of technical and financial advisory services to local governments, since, at that level, there is insufficient technical capacity to deal with the structuring process of PPPs. Even if the local governments could always outsource the structuring of contracts (using external consultants or the EIP mechanism), they would still need sufficient internal technical capacity to scrutinize and evaluate the work done by private entities, to support the decision-making process.

The State of São Paulo is a good example of the structuring process framework, benefiting from the accumulated expertise of its PPP Unit. In São Paulo, after the submission of a project proposal (by a public or private entity), the project documentation is analyzed by the state's PPP Unit, which will

[84] The IPP Council is composed by different public entities, namely the President of the Republic, the President of BNDES, the President of Caixa Econômica Federal, the President of Banco do Brasil and different ministers (including the Minister of Finance).

examine its conformity with all the necessary requirements. Thereafter, a Preliminary Analysis Committee will present a report to the Management Council of PPPs or Destatization Program Board (with the management committee depending on the type of PPP project). This Preliminary Analysis Committee is composed of representatives of different entities, such as the PPP Unit, the specific regulatory agency, the São Paulo Partnership Company, and the State Secretariat. Following the procedure defined by current legislation, if the report submitted by the Preliminary Analysis Committee is approved by the management committee, a working group is formed to coordinate studies and to structure the proposed project.

The Role of External Advisors

Given the still limited technical capacity extant in Brazil, especially at the municipal level, and the low number of project-structuring specialists in the public sector, there is a great need in the country to resort to external support for the structuring of its projects. However, unlike the situation in other countries, such as Canada, New Zealand, and the United Kingdom, the use of external consultants is not the main method of obtaining supplementary support.

In Brazil, the contracting of external consultants requires compliance with the procedures provided for in the Public Procurement Law. This is generally an inefficient process that does not always lead to the contracting of the most qualified professionals and can sometimes be limited by budget restrictions. Therefore, most of the time, Brazilian governments, especially at local level, rely mainly on the EIP, which allows them to obtain the necessary studies to carry out the PPP (with the cost, generally, being borne by the future concessionaire). However, this presents several disadvantages, due to the difficulty of aligning possibly conflicting interests[85] and the lack of capacity of the public agents to analyse the various proposals received in the EIP process (implying a bidding process) (IFC, 2015).

For project structuring activities, in addition to external consultants and the EIP, Brazilian governments also benefit from the support of development banks (namely, the IADB and the IFC) and of BNDES and Caixa, the latter having recently become more involved in project structuring.

The Treatment of Unsolicited Proposals

The concept of unsolicited proposals, as understood internationally, does not apply to the Brazilian market, since it is the State that takes the initiative to decide which projects to carry out. The closest approach to unsolicited proposals is the concept of the PIE created by the State of São Paulo. The PIE involves a private entity being permitted to independently present a project proposal. The proposal still needs to be analyzed by the competent public entities and is subject to the subsequent fulfilment of an EIP, through a competitive process under which other entities are called to present studies for this project.

[85] Often the private entities participating in the EIP represent future competitors in the PPP bidding process.

Criteria for the Evaluation of Bidders and the Selection Process

Within the context of the process of selecting the winner of the tender to instigate a PPP contract, in legal terms, it is possible for several criteria to be used that combine the price (translated into a lower tariff collected from users or higher grant paid) and the technical quality of the proposals. However, it is also possible to rely either solely on one of the criteria (only on price, or only on quality for a certain fixed price) or on both simultaneously, through the application of weighting factors.

In the case of the price criterion, there may be several situations, as follows: i) in Common Concessions, criteria may be selected based on the lowest value of the service tariff to be collected from users (this rule being more commonly used at the federal level), or on the highest value of the grant ("outorga") to be paid to the public partner (this being the criterion used in the São Paulo state concessions); or, ii) in Administrative Concessions, the criterion of the lowest consideration ("contraprestação") payable by the public administration to the private partner may be exclusively used.

In practice, in public tenders for the implementation of PPPs (considering the three types of concessions existing in the country), the price-only criterion has been exclusively used. While the use of this criterion is, apparently, more objective, and easier to assess, by not considering technical or quality criteria, this does not allow for the capture of some of the important non-financial benefits a PPP can bring to citizens, including the capacity for innovation by the private entities and the incentive to maximize service quality. Furthermore, the use of a price-only selection criterion puts more pressure on the necessary quality components of the tender. These must contain concrete and rigorous definitions of the service to be provided by the private entity and their respective quality levels, as it is not possible to encourage the improvement of these aspects through a competitive process and after the awarding of the contract.

The PPP Auditing Process

In Brazil, the supervision of PPPs is carried out in some sectors by the regulatory agencies, whose role in some cases is confused with that of the contracting authority. Both these authorities ensure the monitoring, execution, and enforcement of the contractual obligations of the private partners.

Furthermore, at the federal level, there is a second line of defense, provided by the Union Attorney General's Office ("Advocacia Geral da União"), which ensures the legal compliance of the procedure, and also a third line of defense, provided by the Union Court of Auditors ("Tribunal de Contas da (União")[86]. In the case of federal PPPs, the Union Court of Auditors participates in the approval process of the bids for PPPs, which represents a more intrusive model than is the case in most countries (particularly European countries); elsewhere, the intervention of the court of auditors occurs only after both the selection of the winning bidder and the sign-

[86] The reports of the Union Court of Auditors are published on its site (https://portal.tcu.gov.br/inicio/).

ing of the respective PPP contract, which results in its entry into force.

In the case of state and municipal PPPs, the responsibility rests with the court of auditors of the respective state. At this level, in practice, the local courts of auditors do not always analyse the PPP processes to be launched before the bidding process, in some cases because of inadequate specialized resources to do so.

Regulatory Agencies

The regulatory agencies were created in the 1990s, with the objective of regulating relations between the granting authorities and concessionaires. Currently, Brazil relies on regulatory agencies in several sectors (although not in all). In some sectors, these regulatory agencies play the role of contract manager, which is technically the responsibility of the contracting authority. Although the contract management and enforcement activities should be the responsibility of the Line Ministry and the Executive Secretary, in certain sectors, this role is passed on to the sector's regulatory agency.

This situation may contribute to confusing the role of the agency (responsible for regulation and supervision) with that of the governments (responsible for the execution and monitoring of the contract). This raises the risk of the agency being unable to properly perform its second line of defense, that of validating the execution of the contract and supervising the provision of the public service. Furthermore, this lack of independence of the regulatory agencies is, naturally, perceived as a matter of uncertainty and risk by international investors.

In parallel with the role of the regulatory agency, in some PPP contracts, there is also the role of "independent verifier" ("verificador independente"), which consists of an entity contracted to independently verify the fulfilment of the PPP contract by the private partner. Typically, the independent verifier has the role of: (i) validating compliance with the investment milestones during the construction phase; and (ii) validating compliance with the performance indicators during the operational phase.

The manner of contracting the independent verifier is also not uniform within the Brazilian territory, there being different circumstances in terms of who contracts and who pays the independent verifier (whether it is the private or public partner). This question, naturally, is not innocuous from the perspective of the risk of a potential conflict of interest.

In addition to the regulatory agencies and the independent verifier, there is yet another entity in Brazil, the "expenditure authorizer" ("ordenador da despesa"), which is the entity that authorizes payment by the public sector. This body is responsible for verifying whether the obligations assumed by the public administration are in line with that envisaged at budget level.

It is therefore necessary to distinguish the three functions mentioned; they have different roles and do not replace each other.

Transparency

The Public Transparency Law (Federal Law no. 12527/2011) provides that administrative contracts must be made public by the respective competent authority. At the federal level,

the creation of the IPP enabled an increase in the transparency of processes associated with PPPs, which are now published, in Portuguese and English[87]. In São Paulo, there is also transparency in the disclosure of contract information, which is available on the PPP Digital Platform ("Plataforma Digital de Parcerias")[88].

Notwithstanding the above, in Brazil, like in many countries, there is, yet no centralized database containing important information regarding PPPs throughout their lifecycle. It would be most valuable to have an organized database, not only of the federal projects, but also of the projects and PPPs launched by all the states and municipalities.

Transparency and disclosure of information are important aspects for guaranteeing and preserving the Value for Money of PPPs, since these allow for better control and monitoring of the results of PPPs. They also act as a deterrent to behavior contrary to the public interest (such as corruption) and as a method of reducing agency costs that result from the fact that there are asymmetries of information between the public and the private partners.

Furthermore, transparency is important to ensure the success of any PPP program, given that it is only in the context of total transparency in the structuring, contracting, and execution of PPP contracts that conditions can be created to attract private investment. Such transparency reduces investor uncertainty and, consequently, the return required in relation to the risk perceived by investors (these conditions being necessary to guarantee the Value for Money of PPPs). In Brazil, despite improvements, especially in the implementation of the IPP, there is still some way to go to promote full transparency, especially within local governments.

In practical terms, the existence of different public entities at a subnational level results in there being no centralized unit in the country to manage, consolidate, and disclose all information regarding the PPP universe in Brazil. It would be important to have, not only a centralized database incorporating the information (including PPP contracts, risk matrices, contingencies either already materialized or projected, and updated projections of the public expenses and debt for PPPs), but also a centralized expertise center. Such a unit could accumulate experience and incorporate lessons learned to increase the efficiency and value for money of PPPs, and to ensure the transparency and accountability of all the processes involving PPPs.

PPP monitoring

PPP contract management and supervision is usually carried out by the competent ministry (by a specially designated representative of the procuring authority) or regulatory agency[89], with the PPP contract defining the entity responsible for its monitoring. There is no central unit responsible for contract management, nor is there either a governance structure or guidelines defining how PPP contract managers should perform their roles.

[87] At https://www.ppi.gov.br/.

[88] Available at http://www.parcerias.sp.gov.br/Parcerias/.

[89] In the case of federal highways, for example, the monitoring of contracts is the responsibility of the National Land Transport Agency, "Agência Nacional de Transportes Terrestres".

In São Paulo, in general, for the management and monitoring of each PPP contract, a management unit is created within the respective Sector Secretariat; however, there are no rules or principles of action for these managers that allow for the standardization of practices.

Moreover, in some contracts (of the Sponsored or Administrative Concessions-type), an independent verifier will be contracted to take on the responsibility of verifying compliance with the performance standards by the private partner and, eventually, of the milestones of the construction phase. It should be noted, however, that there is no established and uniform practice as regards the existence of the independent verifier, or even the process used to contract it (whether this is by the private or public authority).

The Risk Matrix

The PPP Law specifies (in article 4) that, in the contracting of the PPP, an objective allocation of risks between the parties should be observed, specifically defining (in article 5) risks related to acts of God, force majeure, unilateral decisions by the governing authority, and extraordinary events.

In the case of the Concessions Law, risk allocation between parties is not permitted, it being defined that the provision of the public service must be made at the risk and expense of the private party. For this reason, it has been the practice in the Common Concessions to transfer a large part of the risk to the private partner.

In Brazil, there is no standardized risk matrix. However, in general, the same matrix from previous projects tends to be used.

The PPP Contractual Framework

Standardization

In the Brazilian market, not only are there no standardized contracts there are still multiple institutional frameworks for PPPs in the different states. In fact, there is a great heterogeneity in the way the different governments act, made possible by the existence of specific jurisdictions for the PPPs in some states and by the great reliance of the governments on the EIP for the preparation and structuring of their PPPs.

Although some effort has already been put into the standardization of contracts, such as in the state of Minas Gerais which has published a "Manual for the Standardization of Key PPP Rules" ("Manual de Padronização de Regras Chave de PPP"), there are still no directives or uniform frameworks for the treatment of PPPs within the country.

Contract Duration

The definition of the contract duration, whether of concessions covered by the PPP Law or of public service concessions (regulated by the Concessions Law), is the responsibility of the grantor. The PPP Law only defines that the contract duration should be compatible with the amortization of the investments made, being never less than five nor more than thirty-five years (including extensions). In the case of Common Concessions, the legal framework does not stipulate any specific protocol for the determination of the partnership period.

Contract Scope

There is a difference between the treatment of Common Concessions and the part-

BOX 10. ATTEMPTING TO STANDARDIZE PPP RULES: A CASE STUDY ON THE STATE OF MINAS GERAIS

The State of Minas Gerais pioneered the implementation of a specific legal framework for PPPs, having published, in 2003, State Law no. 14,868/2003 (one year before the publication of the Federal PPP Law). With this law, the State of Minas Gerais defined the guidelines for its PPP program, established the requirements and possible objectives of this contracting modality, and defined the obligations of each of the parties involved and the means of remuneration of the private partner.

Within the scope of its PPP Law, the government of Minas Gerais defined the PPP as a contract between the Public Administration and a private entity. Through this partnership, under the contractual terms, the private entity participates in the implementation and development of a particular construction work, service, or public project, and carries out the operation and management of the activities associated with the project, being responsible for contributing financial, material, and human resources. In addition to ensuring the preservation of the public interest in the development and execution of the contracts drawn up, the public partner is responsible for the partial or full remuneration of the private partner (depending on the type of partnership), which should be linked to the performance of the private partner, according to the quality and service standards defined in the contract.

For the development of its PPP program, the government of Minas Gerais implemented a PPP Unit, integrated into the State Department of Economic Development of Minas Gerais (which has been subsequently passed to the State Department of Finance of Minas Gerais). The Unit became responsible for the operational and coordination activities of the partnerships, taking on, specifically, the following functions:

- To provide technical advice on the preparation of projects and contracts;
- To provide technical support to the PPP decision-making body, including analyses and recommendations regarding the design, development, and monitoring of the implementation of the state plan for PPPs;
- To provide technical advice regarding guarantees for the proposed projects;
- To disseminate its own methodology of PPP contracts, as well as to establish a reference centre for information on concepts, methodology, and the procurement of PPP projects; and
- To coordinate and assist other entities of the Public Administration responsible for the management and supervision of each PPP contract, according to its competence (http://www.ppp.mg.gov.br/).

Since the implementation of the PPP Unit, the State of Minas Gerais has already signed 10 PPP contracts, establishing itself, together with the State of São Paulo, as one of the Brazilian states with the highest number of implemented PPPs (Werneck and Saadi, 2018).

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BOX 10. ATTEMPTING TO STANDARDIZE PPP RULES: A CASE STUDY ON THE STATE OF MINAS GERAIS *(continued)*

After 10 years' experience in the development and structuring of PPPs, the government of Minas Gerais, through its PPP Unit, published a manual of good practices and general guidelines on the main issues faced in PPP projects. The "Manual for the Standardization of Key PPP Rules" is a compilation of methodologies and best practices adopted by the government of Minas Gerais since the creation of the Public-Private Partnership State Program. Prior to its publication, this Manual was submitted for public consultation, seeking to obtain contributions from all areas of society, including companies, specialists in the field, and the governments of other states.

The Manual addresses issues such as the contracting of consultants, project structuring, public consultation, public hearings, and the EIP, as well as drafting suggestions for the request for proposal ("edital") clauses and for the PPP contract.

nerships that Brazilian law considers PPPs. While the PPP Law states that the scope of the PPP contract may not consist solely of contracting people, supplying equipment, or implementing public works projects, the Concessions Law does not identify any restrictions as to the scope of the concession contract.

Investment

Not all contracts provide for additional investment obligations over the duration of the partnership. In the case of road concessions, however, contracts generally anticipate that, in addition to the initial investments, the concessionaire will continue to make investments when certain traffic thresholds are reached.

The inclusion of new investments in both concessions and PPPs is negotiated by the contractual parties, with there being no specific legal conditions or requirements, except for those applicable to road, rail, and airport sector PPPs. Federal Law no. 13.448/2017 provides that the concessionaires of road, rail, and airport sector PPPs may benefit from an early extension of the concession period when carrying out investments that were not provided for in the contractual instrument in question. In this sense, the grantor assumes and bears the inherent risk of investments additional to those originally planned in the PPP contract. However, the early extension is subject to the following requirements: (i) for road concessions, at least 80 percent of the project initially planned must already have been completed; and (ii) for rail concessions, the private partner must have provided an adequate service in accordance with the terms established under the law in force. In this context, in the event of the early extension of the partnership period, the amended contract must incorporate the schedule of the mandatory investments anticipated, as well as mechanisms that discourage defaults or delays in the fulfilment of the obligations by the concessionaire.

Regarding Common Concessions, the Concessions Law does not lay down requirements for potential investment situations

additional to those established during the public tender. In fact, the requirements for additional investment are defined on a contract-by-contract basis, with a wide range of conditions applying in these cases.

Financing Arrangements

The risk inherent in financing is usually assumed by the private entity, although the PPP Law and the Concessions Law provide for different possibilities. In Common Concessions, the law specifically stipulates that the financing risk is assumed in its entirety by the concessionaire, which is obliged to raise, apply, and manage the financial resources necessary for the pursuance of the concession. To that end, the Concessions Law authorizes concessionaires to use rights arising from the concession as guarantees, such as, for example, the cession of revenue derived from services ceded, or step-in rights.

In the case of partnerships covered by the PPP Law, the financing risk rests primarily with the concessionaire, although the possibility of this risk being shared with the grantor is provided for, in that it may make contributions to finance the acquisition or construction of the concession's assets. In this context, it should be noted that there are limits to the contracting of financing by the concessionaire, as only 70 percent of the resource needs can come from public institutions, with this limit rising to 80 percent when related to projects located in regions with a low Human Development Index (HDI). In addition, the combination of financing and capital granted by financial institutions controlled by the granting authority and other public institutions, or pension funds is also conditional. Concessionaires may only be financed by public institutions up to the limit of 80 percent of the resource needs of the project, or 90 percent, when referring to low HDI regions. In Brazil, the financing of PPPs has been mainly provided by BNDES.

Refinancing

Risk-sharing between the concessionaire and the grantor is not an issue that is clearly set out either in the Concessions Law or in the PPP Law. Consequently, when dealing with concession preservation issues, there is no legal support outlined, especially as regards the definition of the mechanisms to be adopted, with the management of risks being carried out at the lowest possible cost, at each partner's discretion.

Nevertheless, as regards the refinancing of PPPs, the PPP Law provides for the sharing of economic gains inherent in the reduction of the refinancing risk between the grantor and the concessionaire. However, there are no conditions and/or requirements specifically encouraging the concessionaires (the entities primarily responsible for the raising, application, and management of the financial resources) to search for more favorable financing options for the project.

Environmental Authorizations

The Brazilian general regulatory framework does not provide for the mandatory obtaining of an environmental license prior to the contracting process. In fact, the Concessions Law does not define to whom this risk should be allocated, emphasizing only that it is the responsibility of the grantor to promote quality, productivity, environmental preservation, and conservation.

As regards the PPP Law, it determines that the launch of the tender for the contracting of the PPP is conditional on obtaining "(...) prior environmental license or issuance of the guidelines for the environmental licensing of the enterprise, in the form of the regulation, whenever the object of the contract so requires". Given the foregoing, for Common Concessions projects, there is no legal requirement to obtain a license prior to the launch of the tender for the concession contract, and there are no guidelines regarding environmental licensing. This implies, once again, a high level of discretion in the process, which may give rise to the imposition of higher prices by the concessionaires given the difficulty and drawn-out nature of the environmental licensing process.

Assets Included within the Contract

According to PPP Law, at the time of contracting, the grantor must transfer to the concessionaire the public asset pool necessary to carry out the provision of services. The concessionaire has the duty to manage and maintain these assets during the entire period of the concession. In addition, the concessionaire must acquire all equipment and products necessary for the adequate pursuance of the services. The asset pool used during the concession shall, at the end of the concession period, revert to being public property.

Upon termination of the concession, all assets and rights transferred to the concessionaire by the grantor for the pursuance of the services shall be returned to the grantor so that it may, in turn, promote a new concession process in relation to the asset pool. The reversion of the assets and equipment at the end of the concession contract is conditional on a compensation paid of the amount of the unamortized value of the reverted assets.

Unlike the PPP Law, the Concessions Law neither establishes the obligation of the grantor to collate and transfer the assets to the concessionaire (this obligation being the responsibility of the latter), nor the obligation to maintain an updated inventory and register of the assets associated with Common Concessions. It should be noted, however, that, as with the PPP Law, after the expiration of the public service concession, the pool of revertible assets, rights, and privileges held pro tempore by the concessionaire must be transferred to the grantor, as provided for in the public call notice or as established in the contract. Considering the foregoing, Common Concessions exhibit greater discretion and ambiguity in attributing the responsibilities inherent in the collating, management, and maintenance of the asset and equipment pool necessary for the concession, with these specificities being more clearly defined under the PPP Law.

Special Purpose Vehicle (SPV)

The PPP Law provides that, prior to the performance of the contract, an SPV be incorporated and be assigned the obligation to implement and manage the concession. The public administration may not hold a majority of the capital with voting rights of the SPV, except in the event the concessionaire defaults in its duties and the grantor is obliged to assume control of the project.

In addition, the SPV must comply with internal governance standards, as well as

adopt accounting and financial statements standardized in accordance with regulations. At the end of the concession contract, all the revertible assets (those related to the concession) should be transferred to the public authority, with the SPV retaining only the non-revertible assets, if any.

Land Acquisition

In terms of land acquisition, in the Brazilian PPP market, there is no rule on the allocation of risk between the public authority and the concessionaire. It is not predefined which party should bear the land acquisition risk; this being established in each contract.

Only the public administration has the power to declare the public utility of land (such as by asserting the right of eminent domain) or to establish the right of way in a certain area. Nevertheless, the government can allocate to the concessionaire the obligation to negotiate with landowners, conduct expropriation procedures, and indemnify the owners, as part of its PPP obligations.

Construction Risk

When the concession includes public works, the construction risk is usually borne by the private partner, particularly in the case of Common Concessions, where, according to the law, the service should be provided at the concessionaire's risk. In the case of Sponsored or Administrative Concessions, the construction risk can be shared by the public and private partners, through the process of "contribution of resources" ("aporte de recursos"), which involves the public partner paying some of the investment costs incurred by the private partner.

Subcontractors

According to the law, the private partner may subcontract its activities. This is contingent upon it taking into consideration the limits and conditions that should be specified in the corresponding contract.

Ancillary Activities

There are no defined rules regarding the sharing of revenues derived from ancillary activities. However, the contracts usually include the sharing of these revenues with the public partner, through a reduction in regular public payments.

In general, these ancillary activities are subject to public partner approval, and the concessionaire is not allowed to sign contracts for the provision of these activities with a duration longer than that of the PPP contract. However, in some contracts, such as for the São Paulo Metro Line 6, the private partner may sign contracts to explore these ancillary activities for a period that goes beyond the PPP contract term, if agreed by the public partner. This could be a way of improving the extraordinary revenues of the concession by allowing the reduction of the project cost borne by the public partner (by reducing the public payments to the concessionaire through a gain-sharing mechanism).

Payment Mechanism

According to the existing legal framework in Brazil, PPPs may imply payments from the public partner alone (in the case of Administrative Concessions), collections from the users alone (in the case of Common Concessions), or a mix of public payments and revenues collected from the market (in the case of Sponsored Concessions). The law does not

clarify the different possible remuneration forms; nevertheless, the main types of remuneration identified from existing contracts are as follows:

a. Availability payments: these are payments made by the public partner. They are only dependent on the fulfilment of performance standards set out in the contract and are not related to the utilization rate of the infrastructure. In this case, the payment provided by the public administration shall be preceded by service delivery, although the public administration may pay the private partner according to the portion of the service that is made available. As stated in the law, this kind of payment is only allowed in Sponsored and Administrative Concessions. Examples of PPPs where this type of remuneration was applied are the Tamoios PPP (a road concession in the State of São Paulo) and the PPP covering street lighting in Belo Horizonte;
b. Public payments based on demand: in this case, public payments are based on the effective utilization rate of the infrastructure. This type of remuneration is not very common in Brazil, although it is found in PPPs in the sanitation sector, where the remuneration of the private partner consists of availability payments and variable payments calculated according to the cubic meters of sewage treated;
c. Payments for the acquisition of certain assets under the concession: in its original version, the PPP Law only allowed government payments to commence after the start of operations of the concession services, albeit proportionally. The amendment introduced in the PPP Law through Federal Law no. 12766/2012 allows for the sharing of the investment by the public partner (through the mechanism of "advance payments"), making way for the introduction of government payments before the start of service delivery. This type of remuneration was applied, for example, in the PPP for Metro Lines 5 and 17 of the State of São Paulo; and
d. User payments: in this case, the remuneration of the private partner is based on tariffs collected from infrastructure users. In Common Concessions, this is the only kind of remuneration available. In Sponsored Concessions, this type of remuneration is usually combined with public payments in order to guarantee the financial viability of the project. This remuneration model was applied to all federal road concessions, airport concessions, and federal freight rail concessions.

Indexation of Remuneration

Under PPP Law, the contracts should define not only the way in which the private partner is remunerated but also the methods for payment adjustment and indexation. If the contract allows automatic payment adjustments based on mathematical indices and formulae, there is no need for pre-approval before applying those adjustments. The Concessions Law also allows that tariffs paid by users are adjusted based on formulae that should be included in the contract.

Compensation that may be Paid by the Public Authority to the Private Partner

Compensation may be paid by the public partner if there is a need for financial rebalancing of the contract or in the event of early termination. Compensation in the case of financial rebalancing is calculated according to two different methodologies: the initial IRR used by the private partner in the bidding process; or a specific discount rate applied to calculate the present value of the impact of the events that originated the right to rebalance. In recent concessions, the government has been using the Marginal Cash Flow ("Fluxo de Caixa Marginal") methodology, which consists of using a specific and pre-determined discount rate in the financial rebalancing procedure, that is applicable for each event, in order to calculate the specific amount of negative impact induced by that event.

Foreign Exchange Risk

In Brazil, there is no rule for assigning foreign exchange risk, but, heretofore, this risk has usually been allocated to the private partner. This is a matter of uncertainty and risk for banks when they are financing PPPs. The IPP has recently started analyzing ways of mitigating this risk, in order to increase the confidence level of investors and finance providers.

Performance Indicators

Performance indicators are defined on a case-by-case basis.

Performance Evaluation

There is no consistency either in the way performance evaluation is managed or as regards the entity responsible for carrying this out. There are cases where the regulatory agencies assume this role, where the sectorial entities do this themselves, and where a working group is constituted (as is the case in the State of São Paulo). Moreover, whereas some contracts include the role of independent verifier, in others this function does not exist. The decision on who hires this entity is also not uniform. Each contract defines whether the position of independent verifier should be included, as well as the rules for the implementation of this function, when applicable.

Reporting

The way the private partner reports its performance achievements to the public partner is defined in the contractual clauses. There is no definitive rule on this issue.

Business Model

There is no provision regarding the presentation of a business model by the private partner. Recently there has been a trend towards *not* requesting the financial model of the private partner because there is a perception that the business plan presented at the beginning of the concession could lead to additional litigation and potential increased costs in the event of financial rebalancing. The reasoning behind this option against presenting a financial model is that there is a perception that the financial model freezes the IRR presented by private partner at the outset and constrains possible alterations to it; as a result, this could lead to changes in the risk matrix.

Changes to the PPP Contract

The Concessions Law states that, when there is a contract change requested by the public

partner, the financial equilibrium of the contract must be rebalanced.

Contract Financial Rebalancing

In general, there are two different ways in which contracts can be financially rebalanced in Brazil. The first method of financial rebalancing is based on the financial model presented by the concessionaire at the outset. In this case, the financial impacts of the event that originated the right for financial rebalancing will be compensated to the necessary amount to ensure that the current IRR (post-event) matches the IRR presented by the private partner at the beginning of the concession.

The second methodology for financial rebalancing (which is now commonly used) is to use Marginal Cash Flows ("Fluxo de Caixa Marginal"). In this case, the cash flows used to calculate the negative impact of the event that originated the right for financial rebalancing are calculated as at the moment the event occurred (and are not necessarily the same as those included in the financial model of the concessionaire). The rate used to calibrate the current IRR is a specific value calculated as an indexed amount or a fixed value, as stated in the contract.

Early Termination of the PPP Contract

The Concessions Law expressly establishes that a PPP contract may be terminated in the event of: (i) redemption (early termination due to the public party's interest in reassuming the provision of services); (ii) forfeiture (due to the concessionaire's breach of contract); (iii) rescission (judicial termination due to the administration's breach of contract); (iv) annulment; or (v) the bankruptcy, or other reason for dissolution, of the concessionaire.

The termination of a PPP contract implies: (i) the transfer of the public service to the public authority; (ii) the reversion of all the revertible assets to the public entity; and (iii) the application of the mechanism for compensation for the termination of the contract. In most cases, the compensation is calculated based on the non-amortized amount of revertible assets. The calculation of compensation therefore has two issues that have to be addressed: i) the definition of what the revertible assets are and the specific identification, at each moment, of those assets, particularly taking into consideration that the concessionaire may make other investments in non-revertible assets that need to be excluded; and ii) the establishment of the rules and criteria to calculate the non-amortized value of the assets.

Public Guarantees

With the publication of the PPP Law, a new need has also arisen: the mitigation of the counterparty risk to which private partners are exposed, considering the fact that their remuneration (at least in part) depends on payments from public entities. The need to mitigate this risk is, of course, due to the credit risk of the different public players in Brazil being at an unacceptable level for investors, particularly foreign investors.

Recognizing this need, the PPP Law (in article 8) allowed for the PPP contract to stipulate that the responsibilities of public administrations using PPPs could be guaranteed by:

- future revenues;
- the creation or use of special funds established in law;

- guarantees provided by insurance companies not controlled by a government authority;
- guarantees provided by international organizations or by financial institutions not controlled by the state;
- guarantees provided by a guarantee fund or by a state-owned enterprise set up for this purpose; or
- other mechanisms permitted by law.

Currently, the subject of guarantees is still a major issue for investors and for the financing banks, since the guarantees are not very effective, and their value and their level of enforceability are questionable. Among the most common problems associated with these guarantees are that their value does not guarantee all the obligations of the public partner during the duration of the contract (the liquidity of the guarantee) and that it is not clear to what extent the guaranteeing mechanisms are effectively independent of government actions (the effectiveness of the guarantee as a mitigant of credit risk). In Common Concessions, regulated by the Concessions Law, this question does not apply, since no regular payments are made by the public party to the private partner.

Private Partner Guarantees

The PPP Law states that contracts should include the provision by the private partner of performance guarantees compatible with the burdens and risks involved. These guarantees should respect the limits that are established in the Public Procurement Law, which are 10 percent of the total contract value for contracts that include public works and services, both of which have high technical complexity and execution risk, and 5 percent of the total contract value for the remaining contracts.

In Common Concessions, there should also exist a performance guarantee provided by the private partner. This is compulsory in the case of concessions that include public works.

Step-in Rights

PPP Law allows the inclusion in contracts of step-in rights conditions in favour of the financial institutions, with the objective of promoting the financial restructuring of SPVs and ensuring the continuity of service provision. The conditions for the exercise of step-in rights should be defined within the PPP contract.

The Concessions Law also allows for the inclusion of step-in rights, requiring, however, two conditions for the execution of these rights by the financing institutions: i) the enforceability of these rights should be dependent on prior public partner authorization; and ii) after exercising their rights, banks must guarantee the continuity of concession services.

The Profit-Sharing Mechanism

There is no specific rule on the profit-sharing mechanism. However, certain contracts allow the private partner to earn ancillary revenues and to establish a sharing mechanism for that revenue. In some sectors, such as metro lines, there is a recent trend towards the maximization of ancillary revenues. Furthermore, according to PPP Law, the PPP contract must anticipate the possibility of refinancing, and, in that case, the benefits should be shared between the parties.

Force Majeure Risk

PPP Law regulates that PPP contracts must contain provisions regarding risk allocation in the event of force majeure, but the law does not define to which party this risk should be allocated. However, this risk is usually borne by the public partner, particularly in cases where the concessionaire has taken all efforts to prevent the effects of this risk (namely by obtaining insurance whenever possible).

Dispute Resolution Mechanisms

Arbitration is not mandatory, but PPP contracts can include a private dispute resolution mechanism clause, such as arbitration. It is up to the procuring authority to decide if it wants to select arbitration when it designs the contract.

Insurance

Although the PPP Law and the Concessions Law do not include any insurance provisions, it is common practice that PPP contracts include this kind of obligation.

The Main Challenges and Recommendations for Improvement

Although the public service concession model, the current so-called Common Concessions model, has been in use since the 1990s (when the Concessions Law was published), the most comprehensive concept of PPPs, involving state payments in the form of availability payments, was only implemented a little over 10 years ago in Brazil.

In contrast to other countries, such as the United Kingdom which has used the model since the 1980s, the Brazilian experience in PPPs is undoubtedly more recent. However, Brazil, like most LAC countries, has used the PPP model in a very intensive manner to finance the implementation and improvement of its infrastructure. In the last decade, Brazil has been conspicuous among LAC countries, as it has been responsible for about 65 percent of the total investment carried out in the region in the form of PPPs, followed, albeit by a long distance, by Mexico, with 11 percent of the region's investment implemented in this way (OVE, 2017).

This growth in the number of PPPs has been accompanied by an effort to improve the institutional and legal framework for PPPs. However, despite this effort, there is still a way to go to ensure that PPPs can function as an effective instrument in the implementation of the country's investment program, and thus help to bridge the infrastructure gap and foster economic growth. In the context of limited budget space, PPPs can function as an effective catalyst for economic growth, not only through private investment, but also through the Value for Money concept.

Before taking cognizance of the obstacles that still remain and which will have to be addressed in order to guarantee the Value for Money of PPPs, it is important to state some of the specificities of the Brazilian market with regard to PPPs:

a. Brazil has a restricted PPP concept that excludes concessions where remuneration is exclusively based on the collection of user tariffs (with these being regulated by a specific Law);
b. Given its federal structure, there are a large number of public project promoters, at federal, state, and local level. Although

PPPs are regulated by federal laws, there are states that have their own legislation that sets specific standards, introducing increased heterogeneity;

c. Contrary to other markets, especially in Europe, in Brazil it is not possible (nor practicable given the perceived existence of credit risk) to implement PPPs that imply payments from the state without ensuring the existence of state guarantees. Thus, the PPP Law itself provides for the existence of these guarantees, which is one of the aspects that characterizes the Brazilian legal concept of PPPs, distinguishing it from the concept of Common Concessions;

d. The structuring and implementation of the projects is ensured by each of the contracting authorities, although PPP Units exist in some states with responsibilities for these aspects, as is the case in the State of São Paulo. However, the practices between different governments are significantly heterogeneous and demonstrate different levels of success;

e. The preparation of preliminary studies and the structuring of projects, especially in the case of local governments, have been carried out essentially through recourse to the EIP, implying that public agents receive several structuring proposals. They must then analyse them and decide on the final structure of the project (which may include components of different proposals);

f. The long-term financing of PPP projects is not assured at the time of the awarding of the contract. As a rule, at that stage, the private entity takes out a bridge loan, with corporate guarantees, which is refinanced only at the end of the construction, typically after the technical and financial completion. This is because BNDES, still the main financier of projects, generally imposes these rules. Such a situation implies that, when the contract is awarded, there is no guarantee that the private partner will be able to obtain long-term financing. This risk has recently resulted in the inability of some concessionaires to secure this financing (in some cases due to the involvement of their shareholders in the "Lava Jato" scandal). This has led to the initiation of early termination proceedings, with the state being involved in negotiations with some of the concessionaires for this reason;

g. Unlike in many countries (such as Portugal and the United Kingdom), project finance is not well developed in Brazil. This is by virtue, on the one hand, of the subsidization of the BNDES rates over a long period of time, which prevented the development of commercial bank financing and, on the other hand, because of some of the characteristics of the Brazilian market, in which the risks are perceived by banks to be high and difficult to mitigate. For example:

   - Construction contracts are not usually turnkey contracts, as would be desirable from the financier's point of view. This has often resulted in both cost overruns and time delays, with these risks being unacceptable for banks in a financing situation with only project guarantees (such as project finance). On the other

hand, it is also not easy to mitigate this risk through a completion guarantee, as this product is not widely available in the market;

- There is insufficient legal certainty, both in the contracts and in the judicial system. There is also insufficient transparency, as well as delays in resolving litigation or achieving financial rebalancing. The role of regulatory agencies in these processes contributes to this perception of the market, as they are considered too interventionist by some players and their degree of political autonomy is still questioned;
- There is weak enforcement of state guarantees. Banks are not normally willing to assume the counterparty risk of governments, so it is essential to have guarantees that work (e.g., guarantees indexed to receivables), but these are not always available;
- Brazil does not yet have a tradition of carrying out rigorous due diligence processes to evaluate project risks, with this type of information being essential for banks to properly understand and feel comfortable with the risks assumed;
- Currency risk is still difficult for banks to handle; and
- The fact that some of the concessionaire's obligations are dependent on direct action by governments is perceived as an increased risk for banks. Examples of these are the process of obtaining environmental licenses and the process of expropriations. These both frequently create problems, and the concessionaire generally depends on the state to fulfil its obligations;

h. The mortality rate of the projects is very high; and

i. The Union Court of Auditors has a very active role during the PPP implementation decision process, with the approval process occurring before the publication of the public call notice ("edital"). This is unlike what takes place in most countries where the approval of the court of auditors occurs only after the signing of the contract (as a second line of defense). The procedure of the states' court of auditors is, however, different, which is another disturbing factor in the perception of international investors of the overall PPP market in Brazil.

Bearing in mind the characteristics of the Brazilian market, the situation over the last few years, and the lessons learned, according to the perception of several stakeholders, the following section identifies the main challenges for the PPP sector (understood in the broadest sense).

Implement Coordinated and Standardized National PPP Procedures

Despite all the improvements that have been implemented, especially since 2016, in Brazil there is still a lack of the necessary technical capacity to generate good projects at the national level. Although it is recognized that it is difficult to concentrate the structuring of all PPPs (national and subnational) in a single entity given the country's size, it is

considered that it would still be desirable for some activities to be centralized, specifically the capacity to issue common guidelines and procedures at the national level for project structuring purposes, with these guidelines then serving to guide, for example, the work of external consultants.

"There is no nationwide framework for planning and integrating PPP investment projects in infrastructure at the municipal, state, and federal levels. This lack of coordination and standardization of national PPP procedures can be a constraint, especially for projects crossing administrative boundaries" (OVE, 2017).

At the federal level, the creation of the IPP has already resulted in a breakthrough in this sense, since the IPP Council has started issuing guidelines of good practices that must be followed in the process of contracting new partnerships. This covers both Administrative and Sponsored Concessions, as well as Common Concessions. By way of an example, in its resolution no. 1, the IPP Council required : (i) the promotion of transparency in contracting procedures, and the publication of documents in English, where necessary; (ii) the guaranteeing of the environmental viability of the project, through the issuance of a Prior License or the guidelines for achieving environmental licensing, prior to the bidding process; and iii) the inclusion in the public call notice, and in the draft contract, of a risk matrix, which shall include the identification, assessment, and allocation of risks to the party most qualified to manage them at the lowest costs.

Nevertheless, despite this endeavor by the federal government, given that the work of the IPP is essentially limited to federal projects, there is still a lack of centralization at the national level of a framework of good practices and guidelines on how to structure and implement PPP contracts in order to ensure Value for Money.

The United Kingdom is a good example of this type of practice. In the UK, there is a guide produced by HM Treasury on the main issues that arise in privately financed PPP projects, which sets out provisions to be included by public sector bodies when drafting contracts. These drafting provisions are to be included in PF2 contracts either on a required basis (where exact wording must be used), or on a recommended basis, in order to foment the attainment of commercially balanced contracts and deliver best Value for Money.

In order to improve the technical capacity of the Brazilian governments and ensure the consistency, transparency, and stability necessary for the success of PPPs, it is important to focus not only on building the capacity of the various agents involved, but also on a greater centralization of processes and knowledge. In particular, the following should be achieved:

- A centralized collection of comprehensive and detailed information on existing projects, so that it is possible not only for investors to understand the PPP market as a whole, but also to incorporate lessons learned into future procedures;
- The preparation of guidelines and principles to be followed by the different governments, regardless of their autonomy in the management and implementation of partnerships; and
- The harmonization of different practices between the states and federal level in

order to provide security and predictability to international investors wanting to understand how the infrastructure market in Brazil works as a whole. Although the work that has been developed by the IPP bodies is important in strengthening the confidence of international investors in the Brazilian PPP market, the effectiveness of this effort depends on the ability of the rules, process standards, procedures, guidelines, and control documentation being defined and implemented not only at the federal level but also at the state and municipal level, in order to provide transparency and security to investors and other stakeholders.

Increase Technical Capacity to Structure New PPP Projects

In Brazil, there is still a lack of a capacity to generate good projects. Broadly speaking, this has been one of the most critical aspects in the evolution of the PPP market in Brazil. Although the existence of many advances and improvements at this level is recognized, this issue continues to be identified by various stakeholders as one of the major challenges faced by the Brazilian infrastructure market, especially at the subnational level (Infrascope, 2017).

The issue of government capacity-building remains critical, although a number of notable efforts to improve the process of PPP structuring have been identified. As an example of the aspects that have contributed to this improvement, the following stand out:

a. Investment in the creation of several PPP Units (in several states). The existence of these technical units is a positive factor in guaranteeing the accumulation of knowledge and improving the technical capacity of governments. However, it is important to highlight that there are, as yet, no common principles and guidelines for the functioning of these units, so it would be advisable to centralize the process of coordinating the principles to be followed in project structuring;
b. The support of development banks and their direct involvement in the structuring of some projects. While this support has been crucial, it is not possible to cover all projects;
c. The development and concentration of relevant know-how in public banks, namely in BNDES and Caixa. These banks have a very important role in PPP structuring in the current scenario, supporting governments in the definition of the scope of works and in the contracting of external consultants directly responsible for structuring projects and drawing up PPP contracts; and
d. The creation of the Investment Partnerships Program (IPP) and its associated bodies, the IPP Council and the IPP Secretariat, which have contributed, through their opinions, guidelines, and resolutions, to the improvement of the project structuring process and to the implementation of best practices. This has encouraged foreign investment. Despite the positive role that these bodies have played, their contribution is only at the federal level, having no role to play at the state or municipal level.

At the project structuring level, the lack of technical capacity has been filled through the use of the EIP, which has been one of

the most commonly used options, especially at the local level, to ensure the structuring and implementation of PPPs. However, this mechanism has proved to be inefficient, not only resulting in a high mortality rate (low efficacy) but also, in many cases, leading to the initiation of bad contracts. In Brazil, the rate of contract renegotiation is very high, often resulting from contracts being poorly drafted (OVE, 2017).

As a result, the structuring of projects continues to be one of the great challenges for Brazil in the area of PPPs. Projects structured by the public administration tend to be very limited in the face of the complexity required, incorporating contractual gaps and with the public sector sometimes approaching the preparation of the PPP model in a similar way to the traditional contracting of works and services. The contracting of external consultants remains a difficult and inefficient process (considering the limitations of the Public Procurement Law) and would benefit from the development of principles and guidelines (which are not yet available). The EIP, although being the most used form, demonstrates a reduced success rate and often leads to unbalanced contracts. In addition to conflicts of interest, there is, essentially, a lack of trust that the projects presented will actually be implemented. In addition, there is little confidence in the capacity of the public partner to evaluate and consolidate project structuring, leading some private entities to neglect to put in the effort to present sound, fully-developed projects.

On a positive note, there are other models for project structuring, for instance, through respected institutions in the market, such as BNDES and Caixa, and partnerships with development banks, such as the IFC and the IADB. Currently, both BNDES and Caixa are playing an increasingly important role in assisting governments in the area of contract structuring. However, in practice, the implementation of standardized procedures continues to be inadequate. In addition to building the technical capacity of agents, greater uniformity in contracts and procedures is required to ensure Value for Money, to increase transparency, and to improve the perceptions of foreign investors and, consequently, the credibility of the contracting authorities.

Improve Transparency in Order to Boost International Confidence

Standardized disclosure practices can mitigate against the risk of incidents of corruption, such as occurred in Brazil with the "Lava Jato" scandal. The existence of a robust transparency policy is imperative to ensure the stability, predictability, and credibility that investors seek. Such a policy would result in international investors in particular having quick and easy access to relevant documentation for understanding the legal and institutional framework of PPPs, as well as documentation on public tenders and contracts.

In Brazil, although there has already been a significant breakthrough in this regard, particularly at the federal level with the creation of the IPP and the work developed by its constituent bodies, there is still progress to be made before a uniform degree of transparency is ensured at the level of the different governments. As is stated in OVE 2017: "improving disclosure

practices in PPP projects is key to increasing transparency, mitigating corruption risk, and raising public awareness about the benefits of PPP projects".

Increased transparency leads to a lower probability of political interference, better control over the parties' contractual compliance with obligations, and more effective monitoring of the degree of effective execution of the Value for Money measure of the partnerships, through an ex-post logic. Achieving this would also contribute to an increase in investor confidence.

PPP Contract Clauses: Improve Problematic Areas (in Terms of Contract Execution) and Increase the Level of Standardization, Where Possible

According to the experience of different stakeholders involved in PPPs, some PPP contracts are poorly drafted, which is one of the factors that explains the high number of contract renegotiations in Brazil. Public authorities do not have, as yet, the intended technical capacity, which represents a risk in terms of misleading contract drafting. A contract with vague or ambiguous clauses has a high probability of being a contract with future issues in terms of interpretation, leading to the need for renegotiation and/or potential litigation between the parties.

Furthermore, given the complexity involved at the design phase, PPP contracts are highly exposed to corruption risk, this risk being more relevant when contracts are incomplete. Most commonly, contracts fail to be fully completed when the "contracting costs of writing contingent clauses are high" (Iossa and Martimort, 2016).

It is therefore crucial to have a well-designed PPP contract, since, if key contractual clauses are not well drafted, this can lead not only to potential litigation, but also to undermining Value for Money. In such a circumstance, the benefits of using the PPP modality could be reduced, and the incidence of conflicts could be significantly increased (Guasch, Benitez, Portabales and Flor, 2014).

Recognizing the importance of correctly defining PPP contract clauses, some countries, like the UK, have chosen to use standardized PPP contracts, which are designed by central government and applied locally. This can be a way of increasing the consistency and transparency of PPP contracts, and is also a technique for reducing the probability of corruption occurring in the PPP design phase (Iossa and Martimort, 2016).

According to the different stakeholders interviewed, the most significant problems that have been identified when clauses are implemented during the period of the PPP contract were the following:

- **Early termination:** in the case of early termination, the private partner usually receives compensation based on the non-amortized value of assets. The problem here relates to the definition of the assets to be included in the compensation calculation. It is not sufficiently clear how the non-amortized portion of the investments should be determined, nor is it always obvious which assets are the revertible ones on which the compensation should be based. Moreover, the

valuation of assets in the balance sheet of the private partner may include cost overruns incurred by the concessionaire during the construction period. In theory, if the construction risk is borne by the private partner, when calculating the compensation, it should be possible to apportion the asset value into the value that should be compensated and the value that corresponds to cost overruns and, therefore, should not be considered in the calculation.

A possible solution to this could be to draft, during the construction phase, a certificate of eligible costs to be considered in a compensation calculation in the event of early termination. There should also be an updated registry of assets;

- **Environmental licenses:** this issue has been a huge problem in terms of project implementation, as it is a risk that is usually very difficult to assess, quantify, and mitigate against, leading to delays and cost overruns. Therefore, the allocation of this risk should be well-addressed in order to avoid passing on to the private partner a risk that it cannot handle and that could lead either to excessive cost or to the reduced bankability of the PPP;
- **Risk and the upside-sharing mechanism:** although the contract may include these mechanisms, in practice, since the bidding process only considers the criterion of pricing, it is not easy to incentivize private bidders to maximize these revenues which could help reduce the burden of PPPs for the public partner;
- **Business model:** financial models are excluded from the bidding documents to be presented by bidders when submitting their proposals. It is known that there are problems associated with these models being used to calculate compensation in the event of financial rebalancing. However, it is arguable that it is important to have a prior understanding of the financial standing of the private partner. Therefore, a method of maintaining the financial model within the contract should be explored, so as to ensure that its exclusion would not be an impediment in any compensation calculation;
- **Financing arrangements:** this is one of the main problems in Brazil in relation to PPP implementation. There have been problems with different concessionaires being unable to find long-term solutions for their financing arrangements. In order to solve this, it is very important to develop long-term financing solutions within Brazil (outside of just the BNDES) so as to increase the confidence of investors and finance providers. It would also be important to include in the contract an opt-out clause in the event that the private partner does not identify sources of long-term financing within a certain period (a solution of this type has been already implemented in the State of São Paulo);
- **Investment obligations:** contracts should include investment obligations that are linked to certain thresholds, or at least are open to being decided in the future, according to a criterion that should be defined in the contract from the beginning. It is important to include investment obligations in order to maintain the functionality and operability of concession assets. There are some concessions where these obligations are

not clearly stated (such as in the railway sector);

- **A contract rebalancing mechanism:** in most cases, the contract does not objectively define the way in which compensation should be calculated, with it being, occasionally, subject to the will of the regulatory agencies. This situation is not well-regarded by either investors or financiers, due to the lack of clarity and given that these agencies are seen as public entities with low political independence. Therefore, it is very important to develop a more automatic mechanism to calculate compensation in the event of financial rebalancing;
- **Payment mechanism:** it is important to incorporate a more standardized method of determining the payment mechanism in order to avoid paying for services that have not been provided, and to better align payments with actual performance;
- **Land acquisition:** the expropriation of land is usually a very complex process that may lead to delays and cost overruns. It is very difficult to estimate the impact of this risk and, therefore, its allocation should be carefully assessed; and
- **Public guarantees:** all PPPs that involve public payments have to include provisions for public guarantees. This is still a major problem for investors and banks, since the guarantees that are in place are not adequate, in terms of effectiveness and liquidity. Amongst the most common problems associated with these guarantees are that their value does not cover all the obligations of the public partner and that it is not clear to what extent the guarantees in place are mitigants of credit risk.

In order to mitigate these problems, it is important to have a centralized center of expertise on PPPs that could gather all the lessons learned based on the accumulated experience within the country (of more than 20 years) and include design guidelines on which to base future PPP contracts. It is very important to have such a center of expertise, which should act universally to define centralized guidelines to be applied at both national and subnational levels.

The examples mentioned above are only a few illustrations of the issues identified by stakeholders that need to be addressed and corrected in future PPP contracts. What is missing is an entity which would be empowered to gather both past experiences and lessons learned, and, based on that, to prescribe an efficient risk allocation to be followed in future PPP contracts. In order to do that, it is very important that the PPP framework should be adapted, in order to accommodate a reorganization based on a central unit and on central guidelines to be considered in the design of contracts. When there is sufficient past experience on what might be expected during the operational phase of a PPP, it is easier to design an efficient allocation of risks that would enhance the benefit of bundling the design and the service operation of a public project together using the PPP model (Iossa and Martimort, 2012).

Improve Risk Matrix Analysis

Brazil does not have standardized contracts, and also does not have a standard risk

matrix. However, in practice, notwithstanding the improvements that have recently been achieved[90], new projects tend to adopt the risk matrix used in previous projects.

Although there are some risks for which it is possible to define at the outset which party is most capable of managing them, irrespective of the type of project, there are others where risk allocation has to be decided on a case-by-case basis, depending on the characteristics of the project. Therefore, it is most important to establish the rules and principles of action that should govern how public agents should address the risk matrix issue.

In Brazil, the great challenge is to encourage the culture of discussing the risk matrix, evaluating it in a multidisciplinary way, conveying it clearly and unequivocally into contractual clauses[91] (ensuring that its application will be assured), and always using and referring to it whenever there is a need to amend the contract. This is so as to avoid changes to the initial risk allocation over the course of the contract, as has happened in some cases.

Furthermore, and given the existence of different public players in the structuring of PPP contracts, it is important to define clear rules as to how the matrix should be constructed and used. In addition, the standardization of some clauses with transversal application to different projects should be considered. Examples of issues to be considered for standardization include: the risk related to the expropriation process and the obtaining of environmental licenses; the risk of obtaining long-term financing; demand risk (considering different types of projects); and construction risk[92].

However, it should be borne in mind that, in practice, it is not possible to develop a risk matrix and then not discuss its applicability to the specific characteristics of the project in question. For this reason, the definition of an action framework based on good practices is deemed very important to prevent a topic of this importance being neglected or treated without due attention.

Therefore, with regard to the process of risk allocation, the Brazilian example presents some challenges that need to be addressed, namely that:

a. there are no clear and standardized rules as to the procedure for identifying, quantifying, and allocating the risks of a PPP, with the definition of the risk matrix being dependent on the will of those structuring each of the projects;
b. there is strong recourse to the EIP during the preparation of tenders, leaving the definition of the risk matrix in the hands of consultants, although public officials may have insufficient technical capacity to evaluate the proposals of the different consultants;

[90] Of note is, on the one hand, the measures implemented by the IPP at the federal level, and, on the other, the improvements introduced in contracts in the State of São Paulo.

[91] The risk allocation should be implicitly included in the contractual clauses and a detailed risk matrix should be included as an appendix to the PPP contract (to improve transparency and to facilitate future contract monitoring).

[92] Currently, even though this risk is theoretically borne by the private entity, in practice this may not be the case, due to possible cost overruns and the fact that these may be imputed to the granting authority in an early termination situation, through the compensation mechanism in force.

c. historically, especially in the case of Common Concessions (where the law specifically provides for this), there has been a tendency to transfer all risks to the private partner. This is not necessarily the most appropriate option, considering that, when a risk is difficult to predict and quantify and is allocated to a private partner that is unable to manage such a risk, the cost of the PPP will tend to be excessive; and
d. the risk matrix may not be correctly mirrored in the PPP contract clauses, which creates ambiguity in the execution of contracts which may result in conflicts and lead to the need for renegotiation. The Brazilian market experiences a large number of contract renegotiations.

It is very important to improve the risk allocation process since it is one way (or perhaps the only way) to ensure that PPPs can become a valuable and effective instrument for contracting public projects (at least under certain circumstances). Moreover, the risk allocation process should be used as an instrument for forecasting future contingencies so as to estimate the potential impact of PPPs on public accounts (using multiple scenarios and a stress-testing approach[93]).

Clear and Objective Definition of Performance Indicators, to Ensure the Value for Money of the Partnership throughout its Lifecycle

Since PPP contracts are based on outputs and results (performance indicators), and not on inputs, it is important that the contract defines a system of indicators and goals that, if not achieved, imply penalties and deductions in the remuneration of the private partner. This is an important point since performance indicators, and in particular the level of achievement of the defined goals, effectively determine the remuneration to be paid to the private partner. So, if the indicators are not able to verifiably capture the performance and quality of the services provided, the state may be paying for a service that is not what is expected, and such a situation may call into question the Value for Money of the partnership.

Any contractual relationship has coupled with it a certain agency cost, due to unavoidable information asymmetries, but above all due to the possible non-alignment of interests between the parties. Therefore, it is fundamental, from the earliest stages of drawing up the future contract, to correctly identify the quality requirements to be met by the private partner, the results to be achieved, and also the indicators that best measure this performance.

Thus, it is considered a challenge, in Brazil, to achieve the clear definition and quantification of results and objectives that the public authority intends to achieve. One mechanism to ensure that these results/objectives are met would be a system of Key Performance Indicators (KPIs), with an associated penalty regime, which would be capa-

[93] Through stress-testing, it is possible to better understand how plausible certain risks are, and by how much the additional contingencies may impact the public entity. In other words, stress-testing can be an effective way of properly evaluating potential contingencies if an adverse scenario occurs and, consequently, of helping to put in place relevant mitigation measures.

ble of fostering the desired alignment of interests between the parties.

If this objective definition of performance indicators is not ensured, or if the performance monitoring is incorrectly carried out, the benefit of using a PPP could ultimately dissipate. It is of utmost importance to have a clear definition of objectives to be achieved by the private partner and to have an effective monitoring system in place to verify the fulfilment of KPIs during the life of the PPP. The potential superiority of the PPP model (its value for money) can only be achieved during the operational phase.

Contract Management and Service Performance Validation

In Brazil, there are no clear rules on the governance model associated with contract management. Each contract is managed independently. There is no uniformity either in the way the contract is managed or as regards the entity responsible for its management. There are cases where the regulatory agencies assume this role, other cases where the sectorial power itself does so, and yet others where a working group is constituted (as is the case in the State of São Paulo). Furthermore, whereas some contracts include the use of an independent verifier, others do not, and the decision on who hires this entity is also not uniform. Thus, it is important to define a governance model, in terms of PPP contract management, for the validation of service performance, in order to safeguard the Value for Money of the partnership over the duration of the contract.

Furthermore, an independent verifier is considered crucial in all contracts, even in those where there is a regulatory agency. There should be consistency among the different PPP contracts as regards the inclusion of an independent verifier, as well as regarding how this entity is contracted.

When choosing the independent verifier, if the process is carried out by the public partner, there will be two notable limitations:

a. Firstly, the independent verifier can only be contracted for a maximum period of five years, and the entity will need to re-bid for the role at the end of this period (due to restrictions within the Public Procurement Law); and
b. Secondly, considering the restrictions of the Public Procurement Law, it is not possible to consider the reputation of the independent verifier, but only to assess objective criteria, such as experience in similar activities. It would therefore be essential to verify the independence of the entity to be contracted.

In the case where the independent verifier is contracted and paid for by the private partner, the contracting period limitation can be avoided; however, there is a risk that it will not be possible to guarantee the independence of the entity due to conflicts of interest.

Thus, while recognizing the importance of including an independent verifier in all contracts, a challenge is identified in guaranteeing the entity's independence, and thereby minimizing potential conflicts of interest. It is recommended that a solution be considered that involves the private party contracting the independent verifier, but with the entity being chosen by the public partner.

Ensure the Enforceability of State Guarantees

Another challenge identified is the need to find ways to ensure the liquidity and effectiveness of the guarantees provided by the public partner to cover its counterparty risk. In addition to ensuring that the value of the guarantee is sufficient to cover the liabilities of the public partner throughout the duration of the contract, it is still necessary to confirm that the mechanism chosen to provide the guarantee is enforceable.

Ensure the Bankability of PPPs

Ensuring the bankability of a PPP is a necessary and precedent condition to securing its success. Considering that the private partner may most likely be unable to finance the investment in the project without recourse to outside funding (as, even if such a situation were possible, it wouldn't maximize shareholder return), it is fundamental that public authorities, when structuring a project, always keep in mind the importance of verifying that the chosen solution does not jeopardize the bankability of the project.

In Brazil, the history of PPPs affirms that the financing of projects, particularly the medium- and long-term ones, has been dominated by BNDES. Due to subsidized financing rates made available by the bank (until the end of 2017, at which point the rate changed), BNDES was almost always the main financier of PPPs. Currently, however, following the change in the government's subsidy policy in respect of BNDES, there is a new framework, through which the state now intends to encourage and attract funding from commercial banks or the capital market, reducing the participation of BNDES as the main financier.

Thus, one of the challenges currently being faced is guaranteeing the bankability of the projects, in order to attract other financiers. The objective of any lender is to minimize the credit risk associated with its financing, by ensuring the highest possible predictability of the client's cash flows that will serve to repay the debt.

As a result, one of the most important issues for any lender is to identify, quantify, and mitigate the risks associated with its financing. In this context, to guarantee the bankability of projects, it is even more important that, in the structuring process of new contracts, an efficient allocation of project risks is carried out, in order to ensure that the private partner is only transferred the risks it is better able to manage. In addition to optimal risk allocation, it is, naturally, also important to ensure a stable institutional, political, and legal environment that provides confidence to finance providers.

6 FINAL REMARKS

PPPs continue to be an important instrument in the implementation of public infrastructure projects. However, PPPs are only one model of public procurement amongst several, and not all projects are well-suited to be structured as PPPs. The decision supporting whether to adopt the PPP methodology for a specific project should be based on a Value for Money analysis, with the PPP model only being justified where there is strong evidence that it provides higher Value for Money than the other procurement options.

When discussing what dictates the success (or failure) of a PPP, the first consideration is whether the project underlying the PPP is the right one and whether the PPP methodology is the right procurement model for the project, that is, the one that maximizes Value for Money. However, the success of a PPP goes beyond these considerations. In fact, even if it is a suitable project and the PPP model is the one that delivers the highest Value for Money, the PPP may not succeed. The reason for this is simple: the Value for Money of a PPP that is envisaged at the beginning (at the moment of decision-making) may be put at risk if, during the preparation phase of the PPP, the risk matrix and contractual terms are not properly defined. This may not only hinder the success of the competitive procurement process, but it might also create serious execution difficulties during the life of the contract, leading to renegotiations and/or PPP price increases, with obvious reductions in Value for Money.

The achievement of a previously predicted Value for Money result depends, initially, on the correct definition of the contractual terms of the PPP, which in turn should reflect a sound, balanced, and rigorous risk matrix. The risk matrix should reflect the best allocation of risk between the private and public partners, taking into consideration that risk always carries a cost and, therefore, each risk should be allocated to the party that can manage it in the most effective way, in order to maximize Value for Money. It is therefore important to ensure that the contractual terms of the PPP are correctly defined and aligned with both the risk allocation and the steps taken to evaluate the PPP's Value for Money. An appropriate definition of contractual terms is, therefore, a necessary condition for the success of a PPP. This is the reason why, throughout this document, the standardization of contract terms has been advised as a way of mitigat-

ing the risk of both PPP contracts and the risk matrix being poorly drawn up or misconstrued.

Looking at international practices (such as those in Portugal and the UK that were described in detail in this document), there are good examples of countries with full standardization (the UK, for instance), but also good examples of countries, such as Portugal, where, while there is no formal PPP standardization, the existence of a PPP Unit is a way of implementing the standardization of principles on the drafting of contracts.

The objective of this document was to emphasize the importance of ensuring harmonized guidelines as a necessary condition to ensure that PPPs are rigorously prepared, which implies that risks are efficiently allocated, and the PPP contract is well-drafted. Even when it seems that the PPP model has superior Value for Money for a specific project, this Value for Money will only materialize if the aforementioned conditions are met.

The Value for Money of a PPP is mainly derived from the value associated with appropriate risk-sharing, but it is also determined by the private partner, in some circumstances, having better tools to deal with certain risks and to perform specific services with better performance and innovation. In order to capture this additional value, it is important not only to efficiently allocate the risks (in order not to overprice the PPP) but also to correctly regulate the partnership, through the contractual terms, in order for interests to be appropriately aligned between the private and public partners.

Only when a PPP is well-prepared can it be implemented in a professional and transparent manner, minimizing tender costs, maximizing value for money, and providing a fair opportunity to all prospective private sector participants. Only in these circumstances will it be possible to provide a transparent mechanism for the provision of competitively innovative solutions that result in better services and better value for money.

For a successful PPP program, it is important that countries develop PPP-specific policies and institutional frameworks in order to deal with the constraints that arise from: (i) insufficient due diligence and preparation; (ii) an inappropriately-allocated risk matrix; (iii) insufficient fiscal oversight; (iv) an ambiguous or defective transaction process; (v) unclear project development, processes, and roles; (vi) a lack of transparency on criteria for project selection; and (vii) a lack of federal, state, and regional harmonization and coordination mechanisms.

In order to leverage the intensification of interest in using PPPs for delivering infrastructure in LAC but making sure to also take care not to put the public accounts at risk, it is important to overcome all of the constraints around PPP preparation and procurement through a harmonization and standardization process. The first step to achieving this goal is to develop a sound institutional framework for PPPs, with a clear ownership of responsibilities, which could be incorporated into a sustainable and successful government PPP program. This institutional framework should guide government agencies and market participants on how PPPs will be carried out, from PPP preparation and procurement through to the terms of a PPP agreement. There are benefits to using harmonized and standardized approaches and cooperation across the fed-

eral, state, and regional levels. In addition of saving time and money by developing and using common materials, the standardization of principles and procedures promotes transparency and security in the PPP market, and enables the monitoring of PPP performance and the control of public expenditure, increasing Value for Money.

The establishment of an adequate institutional framework is in fact a condition precedent to the implementation of a standardization process for PPP contracts and their risk matrices. An appropriate PPP institutional framework should clarify: (i) the steps of the PPP process; (ii) the clear allocation of responsibilities and institutional roles to the different actors involved in the implementation and management of PPPs throughout their lifecycle; and (iii) the creation of structures or centers of technical expertise (PPP Units) responsible for developing and accumulating the necessary skills and knowledge to ensure the success of the country's PPP program. Only after properly implementing the PPP institutional framework is a country able to successfully proceed to standardizing the PPP contract.

It is therefore important to retain the idea that the standardization process should be integrated into a well-defined institutional framework. In this way, concrete responsibilities would be allocated to the various agents, providing political and legal support for the implementation and practical application of this standardization. This would ensure that best practices are applied consistently across all PPP contracts in the country, at both the national and subnational levels.

Furthermore, it is also important to highlight that the elaboration and oversight of PPP contracts is a demanding task that requires adequate technical capacity. Therefore, in order to cope with the huge complexity within the PPP universe, it is recommended that the standardization process be centralized and managed by a team of dedicated public agents (within a technical skills center). This would ensure the internalization of knowledge and experience within the public sector, leveraging the benefits of the accumulated experience in the country and the lessons learned.

What should LAC countries do if this capacity is not sufficient or is even absent? Should these countries forego using PPPs?

As PPPs can constitute an important and effective tool for governments to implement their investment programs and help close the infrastructure gap that exists in LAC countries, it does not seem appropriate to advise governments to simply forego using PPPs. As was explained previously in this document, the PPP can be a very efficient model of procurement for a specific infrastructure project. When Value for Money is conclusively shown, it can offer many advantages compared with other procurement models. Therefore, the question should not be whether countries should forego using PPPs, but instead what they should do in order to build up appropriate capacity.

The governments of LAC countries have been attempting to mitigate this shortcoming of technical capacity through the use of both external consultants and unsolicited proposals. Could this be the solution to the problem? Unfortunately, not really!

It is not possible to delegate to the private sector the role of the public sector

and the public interest, given the potential conflicts of interest between the parties. Consequently, it is always necessary to ensure that public agents have a critical analytical capacity, since this is the only way to avoid asymmetry of information, resources, and technical capacity between public and private partners. A lack of such capacity may result in poor project preparation and an inadequate allocation of risks between public and private partners, which, as already mentioned, frequently leads to contract renegotiations and to fiscal contingencies.

It is important to develop, within the public sector, the know-how and technical capacity needed to support the structuring and launch process of PPPs, the decision-making process of governments, and to maintain control over the fiscal outcome of PPPs. It is also important to improve the ability to accumulate experience, assess lessons learned, and implement better solutions in a standardized way.

How is it possible to do this? There could certainly be many ways of building up capacity. Based on experience and lessons learned from European countries, it is strongly recommended to establish a center of expertise (such as a PPP Unit) which would act on an overarching basis within the country. This would help ensure the build-up of experience and know-how and is also a way of achieving desirable levels of standardization of processes and procedures. Technical expertise centers would become the main owners of the process and would centralize all information related to the institutional framework of PPPs. Even in the early stages, when technical capacity is not yet sufficient and external advisors remain of the utmost importance, PPP Units would maintain a crucial role in terms of quality assurance, by ensuring both consistency between different projects and that general principles are always applied. As stated by EPEC, "A central source of technical expertise, such as a PPP Unit, can support policymakers and procuring authorities in acquiring a clear understanding of capacity requirements from the beginning. Such central expertise may also be able to develop strategies to help build up the depth of the advisory market itself and capitalize on lessons learnt" (EPEC, 2015).

Moreover, PPP Units should be responsible for the centralization of comprehensive and detailed information on projects. This is so that it is possible not only for investors to get to know the PPP market (bringing greater transparency to the process), but also so that lessons learned are incorporated into future procedures (considering the benefits of economies of learning).

The case histories of Portugal and the UK presented in this document are good illustrations of countries that have successfully implemented PPP Units and that have standardized processes. In the UK, standardization is more formal, through the implementation of standardized contracts, which has been regarded as a key aspect of the success of its PPP market. It is clear that contract standardization is a key factor for ensuring transparency and stability, which, in turn, are important ingredients for attracting investors (particularly international ones), for promoting project bankability, and for increasing the efficiency of PPPs across their lifecycle (which allows for a more efficient implementation process as well as

more effective contract monitoring). The UK example has been widely used as a basis for the design of PPP programs in many countries, given its success. Although it is important to examine successful cases, the process of standardizing procedures should be carried out taking into consideration the specificities of each country's legal regime, as well as the particularities of both local conditions and the unique features of risk allocation within the country.

The Portuguese model is a good example of how the establishment of a PPP Unit can have a positive effect on the efficiency of PPP implementation and execution. Although there is no formal PPP standardization process in Portugal, the existence of a PPP Unit has greatly contributed to the standardization of the principles used in contract drafting. Until the establishment of the PPP Unit, there was a problem in the Portuguese PPP environment because of the lack of clear ownership of PPP issues by public entities. This lack of ownership was one of the main reasons why a number of PPPs that were implemented without a clear Value for Money analysis became problematic (resulting in renegotiations and contingencies). The establishment of a new institutional framework and the PPP Unit (which was done at the same time) led to a strong increase in public sector technical capacity and to improvement in, and standardization of, contract drafting.

What are the key messages in terms of risk matrix and PPP contract standardization for LAC countries? Although it is not appropriate for all infrastructure projects, the PPP model can play a very important role in overcoming the infrastructure gap by improving infrastructure implementation and thereby promoting economic growth. Under certain circumstances (and when its Value for Money is proven), the PPP can be a valuable instrument by providing more efficient and innovative public services, and, when correctly used, can generate public savings and the fiscal space that LAC countries need for their investments.

In order to maximize the potential benefit of using PPPs, it is very important to bear in mind that a PPP represents a contractual relationship between the public and private sectors. As a result, as happens with any relationship, PPPs are exposed to a certain degree of agency cost, due not only to the inevitable information asymmetries that exist, but also to the potential for inadequate alignment of interests between the parties. In order to minimize the impact of this potential conflict of interest, the PPP contract, which is the main tool for managing the relationship between the parties, should be carefully designed at the preparation phase.

Furthermore, it is important to mention that the PPP model is based on outputs rather than inputs, which means that the most important task to perform during the preparation phase of a PPP is the definition of the outputs that the private partner has to achieve and the determination of how much should be paid for them. The price to be paid for those outputs should be consistent with the project risk matrix, which, in turn, should be drafted taking into consideration the risk allocation (between the parties) that best maximizes the Value for Money of the PPP (meaning that each risk has a price and should be allocated to the party that is able to bear it in a more efficient way).

Therefore, when preparing a PPP contract, the public partner should correctly define: i) the amount of output that is to be achieved (the service to be delivered by the private partner); ii) the service standards that the private partner must meet; iii) the risk allocation between the parties (that maximizes the Value for Money of the PPP); and iv) the correct incentive mechanism to align the interests of both parties (specifically through the payments/deductions mechanism).

Given the importance of the correct definition of the PPP contract and risk matrix, as well as the complexity involved in these tasks, it is of utmost importance to standardize, to the greatest extent possible, the principles and guidelines that are to be adopted. Failing to provide any guidance on the PPP preparation process (particularly on contract and risk matrix drafting) is not advisable, since it can lead to an increased likelihood of: i) poor contractual specification (potentially generating future litigation and contract renegotiations, with frequent negative fiscal impacts during the contract lifecycle); ii) higher transaction costs; iii) a lengthier process for the preparation and launch of PPPs; iv) reduction in the Value for Money expected for the PPP; v) possible instances of corruption, given the less transparent process; and vi) inconsistent treatment of similar projects, which is a negative factor for both project bankability and the inclination of international investors to invest (since investors look for clear, stable, and predictable rules underlying the various public tenders).

In fact, standardization can be a way of improving the quality of the contractual documents, guaranteeing consistency between different projects, improving the transparency of the market, reducing the time and cost involved in the preparation and launch of PPPs, and minimizing the potential for future conflicts between the parties through greater clarity and objectivity in the definition of contractual clauses (EPEC, 2015).

When examining the approaches taken internationally, it is clear that there are different levels and types of standardization. There are cases where contracts are already standardized (the UK is one good example of this which is considered best practice), while there are other cases where, although there is no standardized contract, there is a set of principles that govern the design of contracts, granting consistency to the contracting process (as is the case in Australia, also regarded as best practice). There are still other cases (such as Portugal) where the existence of a PPP Unit has greatly contributed to the standardization of the principles used in contract drafting.

It is advisable, in any case, to define clear rules on a governments' ability to accept risks, ensuring that PPP contracts are drawn up in order to correctly reflect the risk allocation in an objective, predictable, rigorous, and clear manner. The standardization of principles and procedures should undoubtedly be regarded as a necessary step to improve the transparency, efficiency, and effectiveness of any PPP program implementation and, consequently, to improve the fiscal space created by the PPP tool.

Bearing in mind the different international approaches taken, the core messages that LAC countries should note when considering standardization are the following:

- There are clear advantages associated with the standardization of principles and procedures that should guide the design and implementation of PPP contracts and risk matrices. For countries with less mature PPP markets, or where there is still a way to go on improving the institutional framework and increasing technical capacity, it is most advisable to start with the standardization of principles (with ownership clearly defined) and only then evolve towards formal contract standardization (incorporating lessons learned);
- The standardization process requires not only the prior implementation of an appropriate and robust PPP institutional framework[94], but also conditions for developing technical capabilities and accumulating experience. It is advisable, therefore, that any standardization process be preceded by the establishment of a centralized PPP Unit (particularly in the case of LAC countries characterized by high heterogeneity on processes and procedures involved in structuring contracts);
- PPP Units can function as a way of not only ensuring the centralization and ownership of the standardization process, but also of accumulating the technical capabilities and experience needed to internalize PPP structuring skills. At the very least, this would minimize the risk of overreliance on external consultants' work without any critical analysis capacity existing or being developed within the public sector;
- The standardization process should be carried out with respect to a specific country's situation, characteristics, and jurisdiction. Although best practices should be considered, it is not advisable to simply select and adapt a PPP contract from another country; and
- While it is difficult to ensure the complete standardization of all contractual clauses, with tailor-made provisions to regulate project specificities, it is recommended that core principles be adopted to define all important aspects of the contract. The specific terms of some clauses should reflect common mechanisms between the various contracts (such as contract termination provisions, compensation events, etc.).

An important issue that has been mentioned in this paper, but which would deserve more in-depth analysis in the future, is the insufficient development of the project finance market for PPPs in Brazil, and in LAC countries in general. This is in contrast to the situation in other countries with a strong PPP tradition. In Brazil, in particular, notwithstanding the development and growth that has been observed in the PPP market, it is still a challenge to encourage the participation of commercial banks or capital markets in project financing. Further analysis could explain why it is still so difficult to achieve a financial close after the PPP contract has been awarded.

[94] The institutional framework is important not only to facilitate and accelerate the standardization process, but also to create the conditions for all stakeholders to comply with the approved PPP rules and standards.

APPENDIX

The appendix includes more detail on the UK and Portuguese case histories.

The UK PPP Contractual Framework

The main contractual clauses

Contract Duration

When deciding on the duration of the contract, the factors that are considered include:

- the service requirements of the authority and the authority's ability to forecast the quality and quantity of outputs over the long-term;
- the expected life of the assets underpinning the service and any possible residual value, and the need for and timing of major refurbishment or asset refreshment programs during the contract;
- the importance of maintaining performance incentives over time;
- the ability of the contractor to accurately forecast its base cost; and
- the possibility of an option to extend the term of the contract by entering into a further contract period with the initial contractor.

PF2 contracts, however, should not be entered into for periods of less than ten years.

Contract Scope

The object of the contract[95] is defined on a case-by-case basis. However, in order to improve flexibility and reduce project costs, soft services (such as cleaning, catering, and security), together with the ongoing replacement of furniture and loose equipment, should be retained by the contracting authority and excluded from the contract, except in exceptional circumstances.

Investment

Under PF2 projects, the responsibilities and risks related to the investment are retained by the contractor, which should ensure that assets are built to a high quality and maintained to a high standard throughout their life. It is the contractor that has to ensure that

[95] The object of a contract means all works that the contractor shall provide under the terms of the contract.

facilities are completed on time and within budget and that has to consider the costs over the entire length of the contract, rather than just during the design and construction phase.

However, depending on its characteristics and risks, an authority may consider making a capital contribution to a project, which should be kept to a modest amount. To result in better Value for Money, payments should be linked to the achievement of important milestones in the construction schedule (rather than scheduled dates) and should be directly attributable to the construction cost. The capital contributions should not undermine the project's overall balance of risk transfer—with sponsor equity and private sector debt absorbing all of the expected losses in the project—and the financial savings resulting from the timing of capital contributions must outweigh any additional risks in the context of the construction and operational risks posed to the authority.

Regarding the risk of additional capital expenditure being required in the construction phase or in the operational period of a project, this risk is normally retained by the authority. If a compensation event results from additional capital expenditure, the authority will deal with this through: (i) a lump sum reimbursement; (ii) staged payments; or (iii) the payment of a 'supplementary unitary charge' over a period as an annuity equivalent of the capital expenditure.

Financing Arrangements

The majority of the private finance projects in the UK have been based on a project-finance structure, with the debt (provided by banks or the bond market) being raised on a project-specific basis, relying primarily on the project contract and the contractor (and its various sub-contracts) for security, and on the specific project's cash flows for repayment. The approach that has been used in the UK, in order to assure the financing of PPP projects, follows the traditional one, with the procuring authority requiring, in its request for tender, that underwritten debt funding should be provided by each bidder as an element of its proposal. However, the authority also reserves the right to run a debt funding competition, which gives government the flexibility to use this mechanism if it considers the financing terms are uncompetitive or that the market has changed (Lester and Kean, 2009).

In fact, for large PPPs in the UK, it is usual to see the authority playing an active role in securing competitive financing terms by requiring a debt funding competition by the preferred bidder, which should carry out a competition amongst potential lenders in order to obtain the best financing terms possible ('The EPEC PPP Guide', https://www.eib.org/epec/g2g/intro1-guide.htm). A draft outline guidance on preferred bidder debt funding competitions has been developed by HM Treasury, in order to introduce best practice in running privately led but publicly overseen debt funding competitions after the selection of the preferred bidder for private finance-initiative projects. This guidance establishes that senior debt finance should be subject to competitive selection, additionally subject to oversight by the procuring authority in every instance, above an interim threshold of £50m.

However, if an authority elects not to do so,[96] and instead requires bidders to submit either underwritten bids to comply with the competitive dialogue procedure or firmly committed finance to comply with the negotiated procedure, then a subsequent funding competition should not be run after the selection of a preferred bidder (HM Treasury, 2006). The contractor should not make any amendment to financing agreements unless the proposed amendment has been submitted to the authority for review and no objection has been raised by the authority.

Refinancing

The decision to refinance the project rests with the contractor and any refinancing proposal should be subject to the consent of the contracting authority. Standard form PF2 project contracts include a refinancing gain-share mechanism in order to ensure that any gains made by the SPV from refinancing are shared with the public sector. The standard contract terms for PF2 projects limit the amount that can be received under the gain-share mechanism to around 30 percent.

PPP Assets

As already mentioned, during the contract term the contractor will be responsible for appropriately managing the maintenance of the relevant assets (such as land or buildings and equipment[97]). The contract should specify what condition the assets should be in on the expiry date, and it should also stipulate the arrangements for a survey of the assets' condition before the end of the contract to assess whether such standards have been met.

In projects where the assets are to be transferred or reverted to the authority upon termination, generally at no cost or at a fixed price, the contracts typically provide for sums to be retained by the authority in the final years[98] if handback surveys disclose that significant maintenance is expected to be necessary to ensure that the relevant assets meet the handover requirements at the end of the term of the contract.

Special Purchase Vehicles

The PF2 Guidance assumes that the party contracting with the public sector will be a special purpose vehicle (SPV, a company incorporated by the central government unit in conjunction with the authority at the start of the procurement, in which the winning bidder will take an equity stake), with sub-contractors executing the performance of the project on its behalf.

In PF2 projects, the UK Government, through an arm's-length HM Treasury unit,

[96] An authority, after consultation with its departmental private finance unit, may decide not to run a preferred bidder debt funding competition if it believes that the costs will outweigh the benefits.

[97] As well as books and records (including operating and maintenance manuals, health and safety manuals, and other know–how), spare parts, tools and other assets (together with any warranties in respect of assets being transferred), revenues and any other contractual rights, and intellectual property rights, but excluding any assets and rights in respect of which the authority is the full legal and beneficial owner.

[98] Where the assets have no alternative use and the authority elects to retake possession of them, the contract should provide that a certain proportion of each unitary charge paid by the authority during the last few years of the contract goes into a secured retention fund to ensure that it can call on sufficient funds to carry out any necessary maintenance identified by the survey. The period for and the size of payments into the retention fund must be set on a project-specific basis, by reference to the amount likely to be needed to rectify defects in the assets.

may take a minority stake (usually 10 per cent) in the project vehicle (and there is no obligation to provide, at financial close, further funding above the amount agreed). The separation of the equity investor from the public sector and the procuring authority aims to minimize the potential for conflicts of interest arising as a result of the public sector acting as both investor and procurer.

Environmental Authorization Licenses, Other Licenses, and Permits

The responsibility for obtaining the majority of the permits and authorizations necessary for the development of the project (such as planning authorizations, and environmental and operational permits) is usually established in the contract and is most often assigned to the contractor.

Land or Equipment Acquisition

The nature of the interest that the contractor should have in the asset during the life of the project should be considered and, in the context of the procurement of assets for the purpose of delivering the project, consideration should also be given as to whether or not the authority or the contractor would be best placed to manage such procurement. In equipment projects, the contractor will usually own or procure the equipment, while, in property projects, the authority will typically own the land and the buildings built on it.

The nature of the contracting authority's interest in the relevant asset will dictate the extent to which, and the manner in which, the authority can transfer the benefit of the relevant asset to the contractor (transfer, grant a license, or lease), so as to allow the contractor to carry out and perform the service. As part of the contracting authority's feasibility study for a proposed project, the authority should consider this ability to transfer, grant a license, or lease the assets required to the contractor (to allow the contractor to perform the service). The authority must ensure that legal due diligence is carried out to verify the legal interest and also that the condition of the asset is verified and should highlight any restrictive covenants, conditions of transfer, and/or claims over the relevant asset.

In projects where the location of the site is critical to the success of the project, the contracting authority usually procures the site. However, where there is no requirement for the project to be operated from a specific site, the land acquisition responsibility can be passed on to the bidders, which are encouraged to offer innovative solutions in this regard.

Public bodies (including local authorities) have powers to acquire land by way of a compulsory purchase order (CPO). A CPO can be issued only if the relevant public body can demonstrate that: (i) the taking of the land is necessary; and (ii) there is a compelling case that it is in the public interest. In the context of major projects, a CPO may be issued to allow the relevant authority to acquire the required land or property without the consent of the owner and a compensation should be paid to the non-consenting landowner (Sweny & Crawford, 2018).

Construction Risk

The design, construction, integration, installation, testing, maintenance, and ultimate performance of any asset procured or devel-

oped for the purposes of meeting the requirements of the output specification are all the contractor's responsibility.

In some projects, the effects of late handover or service commencement can be remedied through the payment mechanism. However, when there is a critical date beyond which the adverse consequences of non-provision of the handover or service are greatly amplified, the authority should have a contingency plan that can be implemented (at the expense of the contractor). The contracting authority should protect itself against these prolonged uncertainties arising from late service commencement by defining a longstop date, a cut-off date after which it may, as a last resort, terminate the contract if the contractor has not commenced service delivery by such a date (subject to the step-in rights of the senior lenders) so that it can use another contractor.

The planned handover date or the planned service commencement date and the longstop date should be extended to the extent of any delay caused by any compensation event, relief event, or force majeure event. In addition to the non-payment of the unitary charge, the authority may need other protections from the contractor such as liquidated damages (usually subject to a cap), performance bonds and/or parent company guarantees.

Subcontractors

The use of subcontractors is allowed, and the authority should recognize that it should grant the contractor the right to replace its subcontractors in order to improve performance and avoid termination. In this sense, the contracts generally include the possibility of a "wipe clean" of deductions and warning notices on the replacement of a subcontractor by the contractor.

Third Party Revenues

Third party revenues derived from peripheral activities of the project (such as, for example, a canteen or a car park) are allowed and should be assessed as part of the Value for Money evaluation of the proposed structure as a whole. Providing a benefit to the contractor, third party revenues may reduce the unitary charge paid by the contracting authority. A revenue-sharing arrangement for revenues above the amount assumed in the unitary charge reduction may be implemented.

Payment Mechanism

Under PFI/PF2, authorities usually pay contractors based on a single unitary charge, which must not be paid until the commencement of the service[99]. The payments are normally linked to the availability and/or performance of the service[100].

An alternative to availability-based payments is the level of the unitary charge being determined by usage (by volume or

[99] In certain projects, however, it may be appropriate for the authority to commence payment before a complete service is available (if the project is developed in multiple stages, for example, in order to ensure consistency with any initial ramp-up in services). Irregular payment profiles are not recommended as they can make the project more difficult to finance and more expensive for the public body.

[100] For accommodation PF2 projects, payment mechanisms normally involve both determinants of payment: availability of the facilities, and performance of the services. The accommodation sector is the only sector that is required to use the standardized output specification and payment mechanism.

demand)[101]. There are also some projects in which the contractor separately takes the risk on the amount of third-party revenue which can be derived from the core service[102] or peripheral activities, which may exist alongside a predominantly availability-based payment mechanism.

Payment mechanisms are monitored, with the performance being assessed against evaluation criteria, entitling the procuring or contract management authority to reduce payments for non-performance of operating obligations under the PPP contract. Other main features of the payment mechanism considered in the PF2 Guidance are:

- the unitary charge should never be paid in advance of the period to which it relates;
- when the payment mechanism is based on availability with an overlay of performance deductions, the payment of the unitary charge will be linked to both the availability and the quality of the service (meaning that the unitary charge for the service is not made up of separate independent elements related to availability and to performance);
- the payment mechanism should adjust for sub-standard performance or availability, and deductions should reflect proportionally the severity of the failure: no service and/or unavailability of facilities should lead to no payment; a minor failure should result in a minor deduction (except in the case of persistent failure, where ratchet mechanisms may increase the level of deduction), with it being possible to establish a cap on the amount of deductions (subject to a justification on Value for Money grounds); and
- the level of payment should be fully auditable with enough information provided by the contractor to allow the authority to validate the calculation of the monthly unitary charge.

Indexation of Remuneration

Payments are usually indexed in order to allow adjustments for inflation, certain operating costs and/or changes in law over the project term, depending on the interest of both the authority and the contractor in setting out provisions for varying the unitary charge in certain specified circumstances.

Compensations that could be Paid by the Public Authority to the Private Partner

The PF2 Guidance defines compensation events as events for which respective risks rest with the authority and in respect of which the contractor should be compensated, such as:

- Authority breach[103] of an obligation or any title warranty;
- Authority changes; and

[101] It should be mentioned, however, that in most of its projects, the Highways Agency currently uses an availability-based mechanism, since the contractor is neither able to control demand, nor is demand plainly linked to the level of service.

[102] Such as light rail projects, in which the authority has tended to pass the fare box revenue to the contractor, or waste projects, that may include the sale of electricity, or housing projects, which tend to involve the rental income as part of the revenue of the contractor.

[103] A breach that will not typically lead to an authority default (which can lead to termination of the contract), but which will, however, cause delay and put the contractor to material expense, including, for example, a failure to allow the contractor appropriate access to an authority-provided site.

- Discriminatory or specific changes in law[104].

The scope of the compensation event concept can be extended to cover other particular events, on a case-by-case basis. Such events are more appropriately dealt with using compensation methods than by resulting in an authority default since termination must, under any circumstance, be a last resort (although when an event renders the contractual relationship of both parties untenable, the authority may elect to exercise its voluntary termination rights).

Generally, if the compensation event in question involves:

- capital expenditure, in most of the cases it will be more practicable to deal with this by way of a lump sum reimbursement (or staged payments). The amount payable would exceed the amount of the relevant increase in capital expenditure by any incremental increase in financing costs consequence of a more rapid drawdown of senior and/or junior debt than originally anticipated and by the agreed costs incurred in arranging any such financing;
- capital expenditure, but the authority cannot afford to pay compensation in the form of a lump sum. It may pay a 'supplementary unitary charge' over a period as an annuity equivalent of the capital expenditure; or
- a change in operating costs, where the contracting authority could simply reimburse the contractor on the basis of costs incurred.

In any case, an alteration in the unitary charge is also considered an appropriate means of payment for compensation events. This approach may have complicated financial consequences and financial advisers may need to be consulted since it requires the use of a financial model to determine the change in the unitary charge that allows for the restoration of the main ratios and returns to their values, had the compensation event not occurred.

Foreign Exchange Risk

Not applicable in UK projects.

Performance Indicators

In order to ensure the achievement of the services output specification, each project has specific availability and/or performance requirements, based on which the respective performance indicators are defined. These indicators are usually calculated by the contractor and audited by the authority and have an impact on the level of remuneration earned by the private partner. The definition of performance indicators is carried out on a case-by-case basis, although there are many indicators that may be cross-cutting and used in different types of projects.

[104] As mentioned below:
- a discriminatory change in law exists when the terms of which apply expressly to: (i) the project and not to similar projects; (ii) the contractor and not to other persons; and/or (iii) PFI and/or PF2 Contractors and not to other persons; and
- a specific change in law is related to any change in law which specifically refers to the provision of services the same as or similar to the service contracted or to the holding of shares in companies with the main business of providing services the same as or similar to the service contracted.

Performance Evaluation

The performance evaluation and monitoring of the contract against the payment mechanism is carried out by the authority contract management team, which, among others, has the responsibility to apply deductions from the payments if the project presents poor performance or availability. Since the performance measurement is used in the payment mechanism, the contract should set out:

- the level of performance required;
- the means by which the authority is able to monitor the performance of the contractor against such required level; and
- the consequences for the contractor of a failure to meet the required level.

In the UK, it is not usually the case that independent experts validate the project's performance evaluation.

Reporting

PF2 contracts include comprehensive reporting obligations, reflecting the recognition of monitoring as a means of achieving the project's Value for Money. The private partner must provide the procuring or contract management authority with periodic operational and financial data, with the PF2 Guidance establishing a set of records and information that the contractor should deliver. These might include a report that is to be prepared by the contractor each year on service delivery, including any performance failures and deductions incurred in the previous year, as well as annual financial accounts, amongst other measures.

The contracting authority and the contractor shall also meet on an annual basis to review contract performance and explore efficiencies, reviewing:

- the project reports for the past year;
- the contractor's annual service report against the annual service plan;
- a summary of energy consumption over the past year (identifying the effectiveness of energy consumption reduction initiatives previously undertaken and identifying areas where energy consumption can be further reduced); and
- such other reports for the past year as the authority may request related to the 'contractor's records and provision of information' clause of the contract.

Financial Model

The procuring authority, in the tender documents, usually requires the bidders to prepare and present a financial model in their proposals. The financial model is agreed between the parties prior to the signing of the contract and can be updated from time to time (following, for example, a benchmarking or market-testing exercise, a qualifying change in law, or an authority change), for the purpose of, amongst other things, calculating the unitary charge.

Although there is no objection, in principle, to the parties referring to a financial model to calculate compensation payable for compensation events[105], the PF2 Guidance presents alternative means. The use of these alternatives avoids the potential conflict arising on how to model an event that was not originally modelled for and audited,

[105] See section above: *Compensations that could be Paid by the Public Authority to the Private Partner.*

as well as the manipulation of the financial model, since the preservation of the ratios and equity return can be achieved in a number of different ways.

Changes to the PPP Contract

The service requirements set out in the contract should consider the authority's long-term requirements (and not just its current requirements), anticipating any changes in service that can reasonably be foreseen. Consequently, an appropriate level of flexibility should be built into the initial bid solution to handle the anticipated changes, and a well-developed change mechanism should be included in the contract to cope with the residual unanticipated changes to the service during the contract period.

In order to reduce the cost and complexity of changes, while improving the contractual operational flexibility of the projects, PF2 project contracts usually include an adjustment and change mechanism that covers three main changes: (i) use or functionality of the asset; (ii) changes in the capacity of the asset or service; and (iii) change in the service specifications or performance standards[106]. The duration of the contract cannot be changed.

The PF2 Guidance provides the methodology for implementing changes to a PPP contract through the inclusion in the contract by the procuring authority of a well-developed change protocol that deals effectively and appropriately with the different types of changes. Authorities will normally be liable for the cost of changes associated with authority changes and should ensure they have budgeted these accordingly.

For contractor changes, the authority must be under no obligation to pay, except if a payment from the authority is explicitly agreed as part of the negotiations with the contractor. The costs of introducing a change in the service resulting from a qualifying change in law (a discriminatory change in law, a specific change in law, or a general change in law) should be shared in accordance with the section 'change in law' below and, to the extent not dealt with, should be borne by the contractor.

Regarding documentation, amendments to project and finance documents by the contractor require the contracting authority's consent, although certain minor changes may only require notification to the authority following their amendment.

Early Termination of the PPP Contract

According to the PF2 Guidance, the early termination of a PPP contract can be caused by:

- authority default;
- contractor default or persistent breach (subsequent to the period established for the contractor to remedy the breach);
- force majeure;
- corrupt gifts and fraud;
- uninsurability;
- breach of refinancing provisions; or
- the authority exercising a right to terminate the contract voluntarily.

[106] New Priority School Building Programme PF2 deals also include a partial termination arrangement in order to establish the compensation to be paid to investors under partial termination at a lower level than compensation paid in a full termination scenario.

Additionally, under Public Contracts Regulations 2015, public contracts are required to include provisions establishing termination of the contract where:

- it has been substantially modified in a manner not permitted;
- the private partner has been involved in specific fraudulent activities; or
- the award of the contract has been the subject of successful infraction proceedings determined by the Court of Justice of the European Union.

In some circumstances, such as when the termination leads to the automatic acquisition of the asset or land of the project, the authority may have to compensate the contractor on termination. Additionally, authority termination rights will normally be subject to the step-in rights of the project's senior funders.

Unless the authority remedies the situation, the contractor will normally be able to terminate the contract in the event of authority default (including for non-payment, breaches that frustrate the service provision, breach of assignment restrictions and expropriation, sequestration, or requisition of a material part of the assets of the project by the authority or another relevant authority). In these circumstances, the contractor and its financiers will normally be fully compensated (that is, they will be no worse off because of authority default than if the contract had proceeded as expected). If the authority exercises its right to voluntarily terminate the contract, the contractor should also be fully compensated, including the repayment of project senior debt and the contractor's sponsor's equity returns.

Compensation on Public Sector Termination of Contract

Upon public sector default or voluntary early termination, the authority is required to pay compensation to:

Debt Holders:

- the amount of debt outstanding; plus
- the cost of terminating hedging arrangements (such as interest rate swaps) in the case of bank-financed deals or, in the case of bond-financed deals, a premium to allow investors to obtain a similar return from investing in another bond.

Equity Investors: the level of compensation to be paid to equity investors (including equity provided in the form of shareholder loans) will be one of the following, depending on the calculation chosen by the investors when the deal was initially agreed:

- the return expected at the start of the contract compared with the actual return achieved to date (if the investors have already achieved the return, there will be no compensation); or
- the expected return for the remaining part of the contract; or
- the market value of the equity and shareholder loans, assessed as if the contract were to continue to run.

And/or

Other Considerations.

Any cash held by the SPV will be netted off from these amounts. Redundancy payments,

if any, will also need to be paid. Subject to the contractor's rights of remedying any remediable breach and/or of financially compensating the authority for the effects of the breach, and to the step-in rights of the project's senior funders, the authority is entitled to terminate the contract in case of contractor default or persistent breach.

According to the PF2 Guidance, a market value approach is the required approach to define the amount of compensation payable on contractor default termination for all PF2 projects. Following termination, if the contract is transferred to a new contractor via a retendering procedure (with the authority selling the unexpired term of the contract on its original terms), the price for which the contract is to be sold (determined through a competitive bidding process), net of the authority's costs, represents the compensation payable to the former contractor. Alternatively, if the authority elects (for operational reasons, for example) not to retender the project, or if there is no liquid market for the project, the authority will, instead, pay the contractor (from its own resources) an assessed market value corresponding to the amount it would have received through an appropriate retender process (again, net of costs) as if a liquid market had existed (with the PF2 Guidance providing the main points that should be considered when assessing such market value).

Continuing force majeure events that cannot be remedied within a reasonable timeframe may also lead to termination. Since these events are neither party's fault, the financial consequence must be shared, with the compensation being on a no-fault basis: senior debt should be repaid, and the contractor's sponsor's equity will only be repaid at 'par'.

On termination of the contract for corrupt gifts and fraud, or for breach of the refinancing provisions, the authority shall pay the contractor an amount equal to the revised senior debt termination amount[107].

If a risk which is to be insured against under the required insurances or statutory insurances becomes uninsurable, the con-

[107] The PF2 Guidance defines the revised senior debt termination amount as:
"(a) all amounts outstanding at the termination date, including interest and (other than in respect of additional permitted borrowing) default interest accrued as at that date, from the contractor to the senior lenders in respect of permitted borrowing; and
(b) all amounts including costs of early termination of interest rate hedging arrangements and other breakage costs, payable by the contractor to the senior lenders as a result of a prepayment in respect of permitted borrowing, or, in the case of early termination or interest rate hedging arrangements only, as a result of termination of this contract, subject to the contractor and the senior lenders mitigating all such costs to the extent reasonably possible,
Less, to the extent it is a positive amount, the aggregate of (without double counting in relation to the calculation of the revised senior debt termination amount or the amounts below):

(i) all credit balances on any bank accounts (but excluding the joint insurance account) held by or on behalf of the contractor on the termination date;
(ii) any amounts claimable on or after the termination date in respect of contingent funding liabilities;
(iii) all amounts, including costs of early termination of interest rate hedging arrangements and other breakage costs, payable by the senior lenders to the contractor as a result of prepayment of amounts outstanding in respect of permitted borrowing, or, in the case of early termination of interest rate hedging arrangements only, as a result of termination of this contract;
(iv) all other amounts received by the senior lenders on or after the termination date and before the date on which any compensation is payable by the authority to the contractor as a result of enforcing any other rights they may have; and
(v) all additional permitted borrowing distributions."

tractor will be in breach of contract where it has caused the relevant risk to be uninsurable. This will give rise to a termination right for contractor default and the authority should pay compensation equivalent to the amount payable in such a case. If insurance in respect of a certain risk becomes unavailable, for reasons outside the control of the contractor, and the parties are not able to agree a means whereby the risk can be managed or shared and the risk reverts to the authority, the occurrence of that risk entitles the authority to choose either to pay an amount equal to the insurance proceeds that would have been payable had the required insurances or statutory insurances been available (in which case termination will not occur) or terminate the contract and pay compensation equivalent to the amount payable on a force majeure termination to the contractor.

Public Guarantees

In the UK, private finance projects can benefit from the UK Guarantees Scheme, a scheme launched in 2012[108] by HM Treasury to support private investment in UK infrastructure projects, offering a government-backed guarantee to boost infrastructure projects' access to debt finance. The scheme guarantees the payment of principal and interest on infrastructure debt issued by the holding/project company of infrastructure projects to banks or investors. All guarantees are issued on a commercial basis and are managed by the Infrastructure and Projects Authority (the IPA).

Non-financial guarantees from the public sector may also be applicable in certain circumstances, which will usually be time-limited and will not extend beyond the information on which the contractor should rely on for its bid. Examples of where warranties from the public sector are likely to be appropriate are where employees are being transferred by the contracting authority to the contractor, or where a particular known risk exists in relation to a building.

Guarantees from the Private Partner

According to the PF2 Guidance, a contracting authority may usually obtain comfort that the contractor and its sub-contractors will be able to meet their contractual obligations to provide the contracted service and any corresponding financial liabilities, if a well-structured limited-recourse project is implemented. This is provided that the sub-contractors have a suitable track record and financial standing, that the level of equity is sufficient to prove the commitment of the shareholders to the project, and that the rest of the financing structure is sufficiently robust[109]. However, the authority has to be careful of placing undue reliance on such comfort, as the senior lenders will in many

[108] In October 2012, the Infrastructure (Financial Assistance) Act became law and the UK government was allowed to issue guarantees to projects meeting a broad definition of infrastructure (including courts, education, energy, health, housing, prisons, and transport), in order to avoid investment in UK infrastructure projects becoming delayed because of adverse credit conditions.

[109] Even though the final interest of the contracting authority is not the same as that of the senior lenders, the authority may take some comfort from the fact that the lenders will normally require a security package from the contractor and its consortium in return for providing the necessary debt finance, incentivizing them to perform their obligations under the project's contract to ensure that the security is never called.

cases be repaid prior to the termination date of the contract.

If the project is funded with the internal resources of the contractor, with no third-party senior debt being provided, the contractor may be required to provide the authority with a guarantee from its parent company, or the strongest credit company within its group (and/or be required to maintain specific financial covenants throughout the term of the contract). Additionally, in order to be able (subject to the prior step-in rights of the senior lenders) to take over the sub-contracts on the contractor's default, the contracting authority might look for collateral warranties (that is, a direct contractual undertaking, which might be guaranteed by the parent company or other companies of substance within the group) from each of the sub-contractors, granting direct claims and the ability to step-in to the relevant sub-contracts in certain circumstances.

Where there are no guarantees, the comfort that the contactor and its sub-contractors will be able to satisfy their contractual obligations could normally take the form of indemnities provisions and contractual claims. There are also some warranties and undertakings that the public authority usually requires from the contractor, such as warranties regarding corporate capacity and compliance with tax obligations.

Step-in Rights

Standard PPP contracts allow for lenders to take control of the PPP project if either the private partner defaults or if the PPP contract is under threat of termination due to failure. Lender step-in rights are established in a direct agreement to be entered into by and between the lender(s), the authority, and the contractor. Required drafting provisions for a direct agreement are set out in the PF2 Guidance.

Profit-sharing Mechanism

Private finance contracts include a gain-share mechanism, so that the public sector shares in any gains made from refinancing debt. However, due to the new Eurostat rules, the standard contract terms for PF2 projects limit the amount that can be received under the gain-share mechanism to around 30 percent (since a bigger proportion of gains increases the likelihood of the project debt being recorded as government debt).

The most recent PFI contracts include an insurance gain-share mechanism in order to allow the public sector to share part of the savings made by the SPV. The insurance gain-share mechanism also implies that, if the actual cost of insurance is significantly higher than the base cost, the public sector would pay part of the additional insurance cost.

Force Majeure Risk

The purpose of force majeure provisions is to give the affected party relief from the responsibility to comply with all or a material part of its obligations under the contract and to give the parties an opportunity to terminate the contract if the event lasts for a certain period. Force majeure events relate to events which, unlike relief events, are likely to have a catastrophic effect on either party's ability to fulfil its obligations under the contract (war, terrorism, or contamination, for example). In practice, such events are highly unlikely to occur, and as neither party is likely to be in a better position than the other to manage the

occurrence or the effects of force majeure, and the events may continue for a long period of time, such events are given a different treatment from relief events and the financial consequences are shared, regardless of the insurability of the events.

Change in Law

According to the PF2 Guidance, change in law is split into the following:

- discriminatory change in law, the terms of which apply expressly to: (i) the project and not to similar projects; (ii) the contractor and not to other persons; and/or (iii) PFI and/or PF2 Contractors and not to other persons;
- specific change in law, which means any change in law which specifically refers to the provision of services the same as or similar to the service contracted, or to the holding of shares in companies the main business of which is providing services the same as or similar to the service contracted; and
- general change in law, which means a change in law which is not a discriminatory change in law or a specific change in law.

Costs arising from discriminatory and specific changes in law which were not foreseeable at the time of the signing of the contract, and whether involving capital expenditure or not, should be borne by the contracting authority during both the construction and the operating phases of the contract.

Given this, where the change was foreseeable at the time the contract was signed, the risk will lie with the contractor, except that: (i) during the construction phase, whether or not it was foreseeable, the contractor will bear the risk of a general change in law; and (ii) the contractor will, at all times, bear the risk of a general change in law which does not involve capital expenditure, since the public sector takes the risk of additional capital expenditure arising from an unforeseeable general change in law.

When the contracting authority bears the risk of a change in law, the contractor should be obliged to keep any cost increases to a minimum.

Dispute Resolution Mechanisms

The dispute resolution procedure typically used consists of consultation (mediation) between the contracting authority and the contractor over a fixed period of time, in an attempt to come to a mutually satisfactory agreement. If the consultation fails, the parties are encouraged to seek alternative means of dispute resolution wherever possible, such as the presentation of the case by the parties to an expert to decide. Such a person is appointed from a panel (e.g., of construction or operation experts) and the appointment is regulated by the contract. However, if this fails, the dispute may be referred either to arbitration or to the courts for a final and binding decision.

Insurance

The authority has the responsibility to require the contractor to take out and maintain certain insurances as a means of managing particular risks. The financial structure of private finance projects usually stipulates that buildings and business interruption insurances are required.

The insurance requirements and associated contractual provisions should be clearly stated in the tender documents, and bidders should be requested to price these matters into their bids. The contract will then set out the insurance requirements for the duration of the contract and a base cost (subject to annual inflation indexation) will be agreed and incorporated into the unitary charge to be paid by the public sector.

The contract must also address the situation where a risk required to be insured against, and which was previously insurable, becomes uninsurable. In this context, uninsurability includes both the unavailability of insurance for a particular risk, or premiums being charged at a level which is not commercially viable. The consequences of uninsurability (which may range from contractor default to the contracting authority accepting liability for the occurrence of the event) will depend on the type of risk involved and whether either party was responsible for the uninsurability.

The Portuguese PPP Contractual Framework

Main contractual clauses

Contract Duration

National and European community rules for the determination of the duration of the contract converge on the following criterion: the period of validity of each contract should be fixed in terms of the period of time deemed necessary to amortize and remunerate the capital invested by the concessionaire, under normal conditions of profitability of the operation.

The Public Procurement Law also foresees a 30-year period for cases in which the parties do not stipulate any contract duration. It clarifies that this period already includes the duration of any contractual extension provided, without prejudice to a special law that sets a different alternative duration, or to the maximum duration[110].

Contract Scope

There are two traditional objects in PPP contracts, namely:

a. a contract whereby the private partner undertakes to pursue the obligations related to certain public works, namely, the design and/or execution, typically also including the right to proceed with the respective operation and/or maintenance, in both cases, against the right to the payment of a price or a remuneration; and
b. a contract whereby the private partner assumes the responsibility of managing a public service activity, being remunerated by the financial results of that management, or directly by the public contractor.

However, the contract scope is generally defined on a contract-by-contract basis, there being no established rule. In the case of the health sector, for example, while the first wave of PPP contracts included the construction and maintenance of the infrastructure and the operation of the clinical services, the most recently launched contract (called Hospital Lisboa Oriental) incorporates only the infrastructure element. This change is

[110] As per article 410 of the CCP.

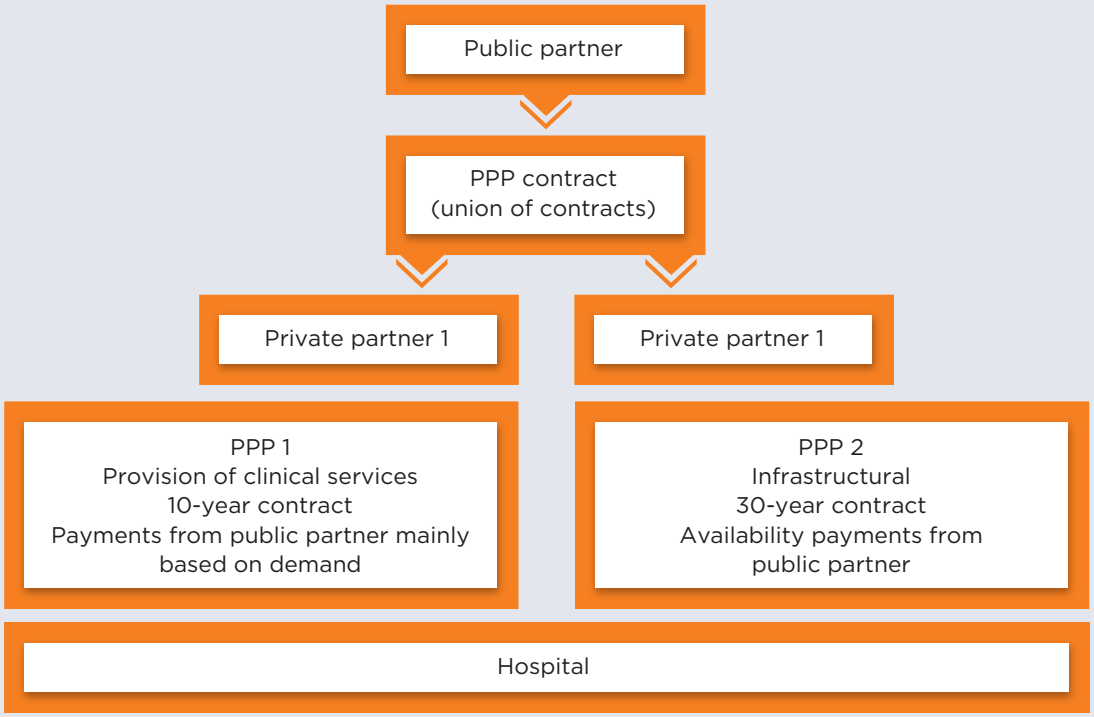
BOX 11. HEALTHCARE PPP CONTRACTS

There are currently four hospitals operating under the PPP regime in Portugal, all fully integrated into the country's national health network, with two private partners per hospital. In contrast to most countries with a PPP tradition, in Portugal, the PPP model was not only applied to the hospital building but also to the provision of clinical services. This is known as the "first wave" model.

In this first wave approach, for each hospital, there is a PPP contract, which corresponds to the union of two contracts incorporating two different activities as follows:

- The infrastructure PPP: the private partner is responsible for the building construction and the supply of heavy equipment, and also for infrastructure services during the 30 years of the contract; and
- The clinical services PPP: a different private partner is responsible for providing clinical services over a 10 year contract, with an extension option (10+10 years). The government may decide to extend the contract duration subject to the private partner's agreement.

In the case of the infrastructure PPPs, the private partner's remuneration is based on availability payments made by the public partner. In the case of the clinical services PPPs, the



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BOX 11. HEALTHCARE PPP CONTRACTS *(continued)*

private partner's remuneration consists of payments from the public authority based on the clinical output actually performed by the private partner, as well as an availability payment related to the hospital's emergency services.

Under this first wave PPP model, there is an interface risk between the infrastructure manager and the clinical services provider, which is regulated by a "utilization agreement" signed between the two private partners.

The next PPP (for Hospital Lisboa Oriental) will be different from the previous ones, as it has been structured as an infrastructure-only contract (with a contract duration of 30 years), with the national health service providing healthcare services directly. This will be the first of the "second wave" of PPP contracts.

Hospital Lisboa Oriental will be a general hospital integrating all medical specialties, with a projected capacity of 875 beds. This hospital, the capacity of which is in line with the strategic plan for the region of Lisboa and Vale do Tejo, will be replacing 6 older hospitals (currently in operation) with one hospital with a smaller-sized footprint, located in the city of Lisbon.

The new PPP (which is still in the tendering phase) only includes the construction, management, and maintenance of the new hospital building. The heavy equipment supply that will be provided by the contracting authority.

The remuneration of the private partner will be made up of availability payments made by the public partner, less any penalties for non-compliance with the quality and availability standards provided for in the bidding documents. In addition, the private partner will also have access to ancillary revenues related to the operation of the car parks.

the result of a political decision, although, as regards each PPP, the team that structures the contract (led by the UTAP) assesses which object is most appropriate for the PPP with the aim of maximizing Value for Money.

Investment

The private partner bears both the responsibility and the risk associated with the investment. In the calculation of this investment, consideration must be given to the traditional concepts associated with the investment that the private partner must undertake for the fulfilment of the object of the PPP contract. This includes whether it is related to a construction contract, the provision of a service, or otherwise, as well as to its adequacy for the sector and activity in question, that is, whether it is an activity that collects revenue, or whether it is a regulated activity, amongst other factors.

The private partner may also carry out activities not provided for in the contract, as long as these are complementary or ancillary to those constituting the principal object of the contract and occur with the prior authorization of the public partner[111]. In general

[111] As per article 412 of the CCP.

terms, the exercise of such complementary or ancillary activities may generate revenue to be shared among the partners of a PPP. Such a revenue-sharing mechanism between the partners may be achieved, wholly or in part, by reducing the value of tariffs applied or through other consideration, with this having a financial expression and benefitting either the users of the works or services, or the public partner itself.

Financing Arrangements

It is understood that it is a cornerstone of the PPP concept, given its inception and context, that the private partner is, characteristically, the entity responsible for obtaining the funds necessary for the development of all the activities integrating the object of the contract. Although in some cases the participation of the public partner in the financing may be permitted, for example through a guarantee or subsidy mechanism, this should never assume the nature of a main characteristic, as, in this circumstance, the balance of risks associated with the PPP would be jeopardized.

It is, typically, the private partner that best controls this risk and is more capable of managing it. The public partner, on the other hand, must seek to relinquish any principal responsibility as regards the financing (and it appears that it has sought to do this in the current PPPs).

In Portugal, prior to the signing of the contract, the normal practice is to require the private partner to present a formalized long-term financing solution[112], the terms of which must be attached to the PPP contract. Furthermore, changes to the financing arrangements throughout the duration of the PPP contract always require the prior authorization of the public partner.

To date, PPP funding in Portugal has typically been secured through project finance[113]-type structures. The financing package usually includes direct contracts between the banks and the contracting authority, contemplating step-in rights in favor of the lenders. Under these financing structures, the commitment of the shareholders is usually limited to first-demand guarantees on equity subscription, including, in some cases, stand-by equity guarantees to be enforced in case of cash shortfalls by the concessionaire (these guarantees are usually valid during the construction phase when the risk of default of the SPV is higher).

Refinancing

Normally, PPP contracts allow the private partner to negotiate the debt with its lenders and to refinance it. By taking this approach, higher levels of efficiency are expected, as well as debt costs that are more appropriate to the risk in question. This benefits the balance of the contract itself and the position of the respective partners in its execution. The positive financial impacts resulting from the negotiation or refinancing are shared between the private and public partners, on the terms allowed in law and, normally, are provided for in the PPP contract.

[112] The private partner must present to the public authority a signed long-term financing agreement by the PPP contract signing date.

[113] This is a type of financing agreement whereby the borrower is an SPV and where the financing is structured without recourse to the shareholders, with the repayment and collateral being based solely on the project's cash flows.

Environmental Authorizations/Licenses

Generally, it is the responsibility of the private partner to request, fund, obtain, and ensure the maintenance, under the legal and regulatory terms, of the licenses, authorizations, certifications, and accreditations necessary for the exercise of the activities included in the object of the PPP contract. These include those related to construction, the environment, the facilities they operate or maintain, and/or the activity they develop.

As a result of the national legislator's concern with the above-mentioned licensing issue, and particularly focused on avoiding unanticipated events at the time of the awarding or during the execution of the contract, DL 111/2012 expressly states that it must be a prerequisite for the launch and award of a PPP contract to "*obtain the required authorizations, licenses and administrative opinions, such as those of an environmental and urban nature, on which the development of the project depends, in order to allow all the execution risks to be or come to be appropriately transferred to the private partner*"[114]. Thus, the practice that has been followed, especially after the constitution of the UTAP, is to require the obtaining of the Environmental Impact Statement ("Declaração de Impacto Ambiental") before the launch of the tender, so that the risk that is passed to the private partner is transparent as well as being more easily measurable and controllable by them, thereby avoiding an excessive transfer of costs that might affect the balance of the contract.

Assets Included within the Contract

In the case of "brownfield"[115] projects, the private partner typically receives the assets assigned to the contract in their current state, obtaining acknowledgement of that state through the tender and contemplating, in the respective proposal, the investment that must be made on the assets in relation to their maintenance, acquisition, lease, hire, or replacement. In the case of "greenfield"[116] projects, there are usually no built assets at the beginning of the contract and the investment responsibility lies with the private partner that bears the construction risk. It is a typical obligation of the private partner to assume responsibility for the costs associated with the technical means and equipment necessary to ensure the proper execution of the PPP contract and that they are adequate for the purposes for which they are intended.

In the context of this type of contract, the broad nature of the assets allocated, and the rights incorporated under the PPP contract, necessitates a specific approach, which is reflected in the following characteristics of most of the contracts under consideration:

a. They cannot be encumbered, sold, or be the object of a contract that has a similar effect, without the prior authorization of the public partner;
b. They are included in a register that identifies them in detail and that must be updated throughout the validity of the contract; and

[114] As per article 6 of DL 111/2012.

[115] Land or property previously used for industrial or commercial purposes (possibly with known or suspected pollution including soil contamination due to hazardous waste).

[116] Land not previously developed or polluted.

c. They revert, as a general rule, upon termination of the PPP contract, to the public partner, free of onuses and encumbrances, in good state of operation and conservation, and fully operational, with the private partner ensuring that, until that moment, the obligations related to their conservation, maintenance, and replacement were complied with.

The last point is particularly relevant insofar as it operates as a guarantee mechanism that the private partner neither delivers the PPP on its termination in any state of disrepair, nor neglects the state of the assets (movable or real estate), equipment, or rights, throughout the period of validity of the contract. Naturally, the fulfilment of this obligation to deliver the assets in a *good state of repair* is subject to normal wear and tear as a result of their prudent use during the period of execution of the contract.

With this obligation imposed on the private partner, there is always the risk hanging over the public partner that, upon termination of the contract, not all of the conditions for the uninterrupted continuity of the activities included under the PPP contract will be met. Such a risk should be mirrored in the risk matrix, and the uncertainty inherent in this circumstance should reinforce the importance of routine monitoring of the execution of the contract, in general, and of this aspect related to the state of the assets and rights, in particular.

Special Purpose Vehicle

Generally, PPP contracts lay down specific rules regarding the company to be incorporated for the purpose of the award of the contract, with primarily three main objects:

a. To ensure the confinement of risk to within an entity;
b. To control the corporate object of that company; and
c. To monitor the changes in ownership, direct or indirect, of the company to which the public works or services in question are designated.

On the last point, PPP contracts are subject to the authorization of the public partner in relation to any amendments to the memorandum of association of the company incorporated for the purpose, as well as respecting the sale or encumbrance of shareholdings in the share capital[117].

In the concessions covered by DL 111/2012, there have been no examples of shareholdings taken by the public partner in the share capital of the incorporated company. Although not forbidden, this may be more common, under the Portuguese legal system, in municipal level PPPs.

Land Acquisition

The law does not define a specific method of allocating this risk. However, common practice, primarily in the case of road transport PPPs, has been to allocate the management, control, and costs of the expropriation processes to the private partner, as it is the party most capable of managing this risk efficiently. It is up to the public partner to issue the Declaration of Public Use ("Decla-

[117] As per article 324 of the CCP.

ração de Utilidade Pública") on land necessary for the project, after the private partner has submitted for approval the execution phase documentation of the project in which the land necessary to develop the PPP is identified.

Construction Risk

When construction is the object of the PPP contract, the responsibilities related to this are allocated to the private partner, which must ensure all the means (human, technical, and material) for the construction of the works, provide the guarantees of proper execution required by law and by the contract, and assume the consequences (financial or otherwise) arising from delays that are not attributable to the public partner.

More specifically, when, besides construction, the contractual object also includes the design of the project, the private partner assumes responsibility for the preparation of all the studies and analyses that are necessary under the PPP. It is responsible, at its own expense, for eliminating or correcting any errors, deficiencies, or omissions that occur under the project. It is also common in PPP contracts for the private partner to assume the risk associated with any constraints and restrictions related to the land, and to consider this when preparing the respective project.

In terms of the condition of the land, it is common for the following to be transferred to the private partner:

a. The obligation to request, fund, obtain, and maintain all the permits necessary for the removal of the existing constraints and restrictions on land use that have not yet been obtained and paid for by the public partner prior to the launch of the tender procedure; and
b. The responsibility to undertake, within the scope of the tender, a visit to the land in order to specifically carry out all the reconnaissance, valuations, inquiries, studies, and measurements that, in the opinion of the private partner, are necessary for the purpose of preparing the proposal.

Since the private partner is given the opportunity to visit the land that will be the object of the construction, the private partner is precluded from invoking lack of knowledge of the conditions of the site or of imputing any responsibility in that regard to the public partner, or to any other third party, for non-compliance with any aspect related to the execution of the works or the contract in question.

Finally, with regard to guarantees, in addition to the aforementioned performance guarantee, it is not uncommon to require the shareholders of the private partner to issue a commitment (a comfort letter or a stronger guarantee statement) whereby they assume effective responsibility for compliance by the entity they control with regard to all the legal and contractual obligations.

Subcontractors

The contracting of third parties for the execution of activities covered by the PPP contract is, typically, acceptable provided that it has been previously authorized by the public partner. Subcontracting, as a general rule, should not be allowed when there is strong evidence

that it may serve as a means of distorting competition rules[118].

In any case, subcontracting does not exempt the private partner from any of its obligations. The contract must make it clear that the private partner remains fully responsible for the proper and timely fulfilment of all of its own obligations arising under the PPP contract and it is always the frontline responsible entity, ahead of the public partner.

Ancillary Activities

As mentioned above, as a general rule, PPP contracts include the sharing of the benefits of ancillary activities with the public partner.

Payment Mechanisms

The Decree-Law regulating PPPs does not define the payment mechanisms to be included under the PPP contract, defining only that the contract must include an adequate remuneration that is appropriate to the amounts invested and the type and level of risks the private partner incurs.

However, in practice, the payment mechanisms included in PPP contracts in Portugal are mainly based on the following components:

- Availability payments: payments made directly by the public partner to the private partner based on its service performance. These payments should be adjusted for deductions in the event of non-performance in terms of the availability and/or quality of the service (measured by performance indicators). This is the payment method used for some motorways and also for the infrastructure services of the healthcare PPPs;
- Payments based on demand: payments made by the public partner based on actual infrastructure demand. This is the payment mechanism used for shadow toll[119] motorways;
- Tariffs collected from the users of the infrastructure. This type of remuneration is used for: i) toll motorways; ii) a railway system (the Fertagus project); and iii) the provision of clinical services for the healthcare PPPs;
- Payments based on demand but with a floor based on a demand guarantee from the granting authority. There is only one PPP with this payment mechanism, the Metro Sul do Tejo, a light railway system; and
- Advance payments: this scheme is not very common in Portugal. However, for the Metro Sul do Tejo PPP, the investment in long-term infrastructure was totally assured by contributions from the public entity.

These payment mechanisms may be used individually or in combination with each other. For example, there are motorway PPPs which use availability payments and simultaneous real/shadow toll payments.

Indexation of Remuneration

In some PPP contracts, the private partner's remuneration (whether based on public authority payments or based on user tariffs)

[118] As per articles 317 of the CCP.

[119] A shadow toll or per vehicle fee is a contractual payment made by a government to a private company that has built, operates and/or maintains a road. Payments are normally based on the number of vehicles using a section of road over a period.

is indexed to the annual rate of inflation, although this is not always the rule. The use of an indexing mechanism, and the degree of such indexation, varies from contract to contract, there being no pre-defined rule.

Compensations that may be Paid by the Public Authority to the Private Partner

Under the Portuguese legal regime[120], the financial rebalancing system adjusts for certain eventualities. It regulates situations in which, for reasons not attributable to the private partner, the contract may need to be repositioned, reverting it to the situation it would have been in if the triggering eventuality had not occurred.

The situations which most commonly give rise to a right to financial rebalancing are: (i) unilateral modification, by the public partner, of the conditions for the development of activities under the PPP contract; (ii) the occurrence of force majeure situations; and (iii) legislative and regulatory amendments of a specific nature[121]. Each of these cases gives rise to an increase in expenses or a loss of income for the private partner.

In addition, the private partner is entitled to financial rebalancing only if, in view of the risk-sharing between the parties, the triggering cause changes the assumptions underlying the financial equation of the project cash flows to which it has been obligated, provided that the public contractor knew, or should have been aware of, such altered assumptions. It is also clear, under the national legal system, that financial rebalancing takes effect from the date of the occurrence of the cause that changed the assumptions, and it must be, in relation to the event that originated it, single, complete, and final for the entire period of the contract[122].

The rebalancing takes many forms, with the parties being able to stipulate a mechanism in the contract or, in the absence this, the law allows it to take place through the extension of the period of execution or duration of the contract. The revision of the price or the assumption, by the public contractor, corresponds to the decrease in the expected revenues or the increase in the expected costs associated with the execution of the contract[123].

As regards the respective amount, the following limits have been identified, both being related to the event that gave rise to the rebalancing[124]:

a. The value of the financial rebalancing must correspond to that amount necessary to restore the financial position on which the contract was based, having as its basis the value of the financial equation of the project cash flows agreed by the parties, and the effect the triggering event had on that financial equation; and
b. The value determined cannot place either of the partners in a more favorable situation than was originally the case and cannot cover any losses that had already arisen before the rebalancing was agreed

[120] As per article 282 of the CCP.
[121] Non-specific legislative or regulatory changes (labour, tax, environmental, and public procurement laws, for example) do not grant the right to contract financial rebalancing.
[122] As per no. 4 of article 282 of the CCP.
[123] As per no. 3 of article 282 of the CCP.
[124] As per no. 5 and 6 of article 282 of the CCP.

or would in any event be inherent under the risks of the contract itself.

Foreign Exchange Risk

This risk not applicable to the Portuguese situation.

Performance Indicators

In general terms, national legislation[125] allows the public partner to apply sanctions in the event of non-compliance or inadequate compliance by the co-contractor. Such a possibility is commonly reflected in the contract terms, which establish maximum limits for the sanctions, indexed to the contractual price, as well as performance indicators, which allow the public authority (in its monitoring and inspection capacity) to verify compliance.

The indicators can be revised to match the performance of the private partner to the specific needs of the public partner, this being a risk normally retained by the public authority. Indeed, in healthcare PPP contracts, there is a provision that foresees a continuous improvement in the goals that the private partner should achieve under the performance indicators (this aims to incentivize the private partner to increase its efficiency and effectiveness).

In addition, due to the dynamic and long-lasting character of this type of contract, it is often the public partner that is allowed to introduce revisions to the technical and service specifications, such as when, for example: (i) the specifications originally contracted do not permit the private partner's timely compliance with the required levels and performance indicators; (ii) technological developments or service requirements and standards justify a revision of those specifications; or (iii) specific legislative or regulatory changes affect those specifications, requiring their revision.

The design of performance indicators in Portugal is carried out on a case-by-case basis, considering the specificities of the PPP, although a common approach is already applied to different contracts within the same sector. Improvements in this area have been made in the most recent PPP contracts, which are now structured by the PPP Unit.

Performance Evaluation

Performance evaluation, as well as the application of penalties, is carried out by the PPP contract manager ("gestor de contrato"), which is normally the public contracting authority. There is no tradition in Portugal of using independent entities to substantiate performance evaluation. However, particularly in the case of healthcare PPPs, the contract manager sometimes contracts external consultants to help on this issue (although these external consultants do not act as independent verifiers).

Reporting

PPP contracts include comprehensive reporting obligations, reflecting concerns over the need to monitor contracts to guarantee their Value for Money. This is another area where the UTAP has introduced improvements. In order to ensure the private partner's reporting obligations allow for a close and rigorous monitoring of the status of the PPP throughout its execution, a concrete set of rules has been introduced, not only related to the con-

[125] As per article 329 of the CCP.

tent but also to the form of reporting of the private partners. It reinforces the inspection powers of the public authority.

One of the innovations recently introduced was the obligation that the private partner keeps its business plan updated, based on the actual progress of the PPP. This is important, as it facilitates the calculation of the amount payable by the public partner in the event that financial compensation to the private partner is necessary.

Business Model

The submission of the business model of the private partner has been common practice in Portugal. However, previously, the initial business model remained unchanged and was used for the purpose of calculating financial compensation when necessary. This situation proved difficult to manage, leading to litigation between the parties, especially when the demand risk was assumed by the private partner. As a result, the use of the initial business model for the calculation of the compensation implied a transfer, at least in part, of this risk to the public partner.

This limitation led to the need to change the method of calculating the amount of the compensation[126]; even so, the business model continues to be requested at the time of the signing of the PPP contract with the winning bidder (although this model is not fixed for the purpose of calculating compensation in the future within the scope of the financial equilibrium process).

Changes to the PPP Contract

The complex and long-term nature of PPP projects means that their related contracts may have to be amended during the projects' lifecycle (via the renegotiation process between the parties), both in their content (objective modification) and in their parts (subjective modification). The acknowledgement of this dynamism of PPP contracts does not mean that any modification is permitted.

As determined and influenced by European Community legislation, and in some cases with stricter requirements, national legislation provides, in the CCP[127], that public contracts may be amended by agreement between the parties, by a judicial or arbitral decision, or by an administrative act of the public contractor when the grounds raised are matters of public interest.

As grounds for such modification, the following are admissible:

a. A fundamental and unpredictable change in the circumstances on which the parties had based the decision to contract the agreement, provided it is demonstrated that requiring the continuation of the project or contract seriously affects the principles of good faith, and provided that such a change is not covered by the risks inherent within the contract; and
b. A new situation, or a new weighting of existing circumstances, requiring the amendment on grounds of public interest.

[126] Compensation was initially calculated on the basis of the calculated loss amount (taking into consideration an updated business model) and was not based on the initial business model, as this latter model would not reflect, at a specific moment, the actual status of the PPP.

[127] As per articles 311 of the CCP.

Any modification on these grounds must observe certain limits, as stated above[128]. So, in detail, in addition to limits related to the percentage of the contractual price that these modifications may represent, and which may not exceed certain limits, the modification may not:

a. lead to a substantial change in the object of the contract;
b. represent a method of preventing, restricting, or distorting competition;
c. alter the order of the evaluated proposals or the admission of other proposals, where these modifications form part of the technical specifications; or
d. change the economic balance of the contract that places the private partner in a more favorable situation than was originally established in the contract.

Modifications that result from the durable nature of the contractual relationship are not subject to paragraphs b) and c) of the previous passage, provided that the course of time justifies this approach.

Under national law, the private partner is entitled to financial rebalancing whenever the modification of the contract has produced an abnormal and unforeseeable change of circumstances attributable to a decision of the public contractor, adopted outside the exercise of its powers inherent within the contractual relationship, or simply for reasons of public interest determined by the public partner. Other cases of abnormal and unforeseeable change of circumstances give rise to the right to contract modification or financial compensation but it would then be determined according to criteria of equity[129].

Finally, it should be noted that the objective modification of PPP contracts must, firstly, comply with disclosure obligations when above a certain amount provided by law, and, secondly, be preceded by a procedure in which a relevant role is assumed by the UTAP, as better explained below.

According to DL 111/2012[130], in the event that the public authority intends to issue a unilateral determination capable of justifying a financial rebalancing of the respective partnership contract, it must: (i) estimate the financial effects resulting from the determination; and (ii) verify the corresponding budgetary availability.

Furthermore, in the context of the execution of the corresponding contract and the conditions within it, any decision by the public partner that may give rise to the situations listed below, must be preceded by the prior agreement of the government members responsible for the finance area and the project in question. These must also be preceded by the favorable opinion of the UTAP. The relevant situations are as follows:

a. An increase in the charges anticipated on the part of the public sector, unless the respective amount does not exceed, in annual terms, gross Euros 1 million, or a cumulative amount of gross Euros 10 million, at discounted rates; or
b. A reduction in the charges on the part of the private partner.

[128] If these limits are not respected, the modification must be established by means of a new autonomous contract formulation procedure.
[129] As per article 314 of the CCP.
[130] As per articles 19 through 23 of DL 111/2012 for all paragraphs that follow in the text in respect of this point.

Furthermore, in the event of the sharing of the benefits of the financial rebalancing, or of their full attribution to the public partner, or (with consideration to the recent history of PPP contracts in Portugal and the role of the UTAP over the last 5 years) in the event of the renegotiation of the contract, a negotiating committee will be set up for the purpose. This will be composed of members appointed by the service or entity representing the public partner (line ministry representatives) and by the UTAP (finance ministry representatives).

It is the responsibility of the negotiating committee to take such action as may be necessary to complete the negotiation process. This includes representing the public partner in the negotiation sessions with the private partner, liaising with the service or entity that represents the public partner in the respective contract, presenting the drafts of the legal instruments necessary for the conclusion of the negotiating process, and preparing the draft report to be submitted for the approval of the competent line ministry and finance ministry.

Contract Financial Rebalancing

In the event of financial rebalancing, the calculation of the amount of compensation to be paid has been a difficult issue to solve, with it having led to several litigation suits. One of the problems associated with the financial rebalancing mechanism previously implemented in PPP contracts was that the value of the financial compensation was indexed to the IRR value initially presented by the private partner in the bidding phase. It is important to note that the compensation calculation mechanism is not prescribed in PPP Law, it being determined in each PPP contract.

Recognizing the risk of this issue, in terms of putting compliance with the original risk matrix in jeopardy, in the most recent PPPs, the UTAP has taken the initiative of changing this mechanism. This will ensure that the compensation is calculated to cover only the direct impact of the event that gave rise to the financial rebalancing request. Under this new mechanism, it is possible to avoid overcompensation, when the demand risk is borne by the private partner and that risk has already materialized. It is, however, important to mention that this methodology is not defined in PPP Law. Therefore, the standardization of this practice is only possible if the contracts are structured by the UTAP, which is the case for PPP contracts included within the scope of the PPP Law, but is not necessarily the case for regional and local PPP contracts (since these are not structured by UTAP members).

Early Termination of the PPP Contract

PPP contracts, as with public contracts in general, may result in early termination on the grounds of non-compliance attributable to the private partner (termination of the contract by the public partner). This is without prejudice to the application by the public contractor of the penalties provided for in the contract, or the application of the provisions related to the obligation of compensation for late payment and definitive non-compliance laid down in the legislation in general[131]. This was the case for the Túnel do Marão PPP, which was terminated by the public authority given the impossibility of the private partner discharging the debt under the financing agreements signed.

[131] As per article 325 of the CCP.

Another cause for the early termination of these contracts is revocation by agreement between the parties ("revogação por acordo entre as partes"), which may occur at any time, within the context of causes that have been validly established in the agreement between the parties. The PPP contract may also be terminated by resolution at the initiative of the private partner, for instance, when there is an abnormal and unforeseeable change of circumstances[132], when the definitive non-performance of the contract is attributable to the public contractor, or when the public contractor unlawfully exercises the powers attributed to it and, contrary to good faith, enforces the continuance of the contract[133].

The circumstance of resolution on the initiative of the public partner based on grounds of public interest[134] is also allowed, provided it is duly substantiated and payment is made to the co-contractor of a fair compensation. This compensation should correspond to the emergent damages and loss of profits, with these being net of the benefit resulting from any anticipated gains.

Due to the effects being different for each of the partners, the risk of early termination of the contract normally ends up being shared between the two partners. In addition to those typically set out in PPP contracts, the risk associated with early termination also provides for the following events:

a. Seizure ("sequestro")[135]: the occurrence of seizure may be due to interruption or serious deficiencies, in the case of a serious breach by the private partner, resulting in the public partner taking charge of the development of the activities under the contract in question.

   In the case of seizure, the private partner must bear the costs of carrying out the activities for as long as it is in charge, including any extraordinary expenses necessary to restore the normal execution or operation of the public works, or the normal operation of the public service, as the case may be. This provision has, by law, a maximum time limit of one year. If the private partner is unable or unwilling to resume contractual execution, the public authority may decide to terminate the contract, with the effect of reversion of the assets and any indemnities set forth above; and

b. Redemption ("resgate")[136]: the public authority may redeem the PPP contract, for reasons of public interest, provided that one third of the validity of the contract's duration has elapsed.

   In this case, the public partner automatically assumes the rights and obligations of the private partner, provided these were set up prior to the redemption notification, any other such rights or obligations being only binding to the public partner if it authorizes this.

   As regards the effects of the redemption, it is legally permissible for

[132] In this case, there is only a right to terminate when this does not cause serious prejudice to the attainment of the public interest or, if it implies such damage, when the continuance of the contract manifestly jeopardizes the economic and financial viability of the public partner, that is, it is excessively onerous.
[133] As per article 332 of the CCP.
[134] As per article 334 of the CCP.
[135] As per article 421 of the CCP.
[136] As per article 422 of the CCP.

the private partner to be entitled to compensation corresponding to emergent damages and loss of profits, with these being net of the benefit resulting from the anticipated gains. The redemption has the same effect as the above-mentioned termination as regards the reversion of assets allocated to the PPP contract in question.

Public Guarantees

In Portugal, it is not necessary for the public authority to provide guarantees for the fulfilment of its obligations. Since Portugal belongs to the European Union, the counterparty risk of the Portuguese State in the PPP context is acceptable, and it is not necessary to issue any public guarantees, as occurs in the case of LAC countries, for instance.

Private Partner Guarantees

As mentioned, the private partner is, as a rule, required to provide performance guarantees during the construction phase, as well as shareholders' guarantees, to ensure their commitment to the project.

In addition to the foregoing, in the case of risk allocation, the CCP[137] now provides a maximum value for the security deposit (5 percent of the contractual price) and a specific discharge regime for it. This has the effect that the part of the risk not covered by the security deposit, by legal imposition, is retained by the public partner, given that the value of the security deposit and/or its period of validity will most likely not be sufficient to ensure compliance by the private partner of the obligations arising under the PPP contract. It is therefore up to the private partner to avail itself of mechanisms, such as shareholder guarantees, with a view to, at least, minimizing this risk.

Step-in Rights

It is not unusual for this type of contract to have, in addition to other contractual documents, a tripartite agreement signed by the two partners and the financing entities. Through this, the financing entities may, with the authorization of the public contractor and under legally established terms[138], intervene in the contract, with the objective of ensuring the continuity of the provision of the anticipated services under the contract.

As can be seen, this is a step-in right granted to the banks, which the law permits in cases of serious breach of contractual obligations by the private partner. This can be affected either by transferring the shareholding control of the private partner to the financing entities, or to another entity, as indicated by the financing entities. Alternatively, this can be achieved by ceding the contractual position of the PPP contract to the financing entities, or to a different entity, as they determine. In the most recent PPP cases, the rules regarding the exercise of step-in rights by the banks were defined directly in the PPP contract clauses.

Profit-sharing Mechanism

PPP contracts in Portugal used to incorporate profit-sharing mechanisms, especially in the case of refinancing and ancillary revenues. However, in the most recent PPPs, the sharing mechanisms have been reweighted to consider Eurostat's rules regarding the

[137] As per article 89 of the CCP.
[138] As per article 322 of the CCP.

BOX 12. BUDGETARY AND ACCOUNTING TREATMENT OF THE PUBLIC COMMITMENTS OF PPPS IN PORTUGAL

PPPs are recorded in the public accounts (for statistical purposes) according to risks and rewards criteria and following Eurostat rules. In this context, there are currently 3 PPPs that are considered on-balance sheet, which means that the liabilities associated with these PPPs are included as Portuguese debt (according to the Maastricht criteria). For those recorded as off-balance sheet, the debt is not recognized in the public accounts and the government only records the regular payments for services provided under the PPP contracts over the long-term.

The Eurostat rules look at the "economic ownership" of the asset, involving an analysis of: i) the parties involved; ii) the structure of the project; iii) how the contract allocates risks and rewards between the parties (mainly the construction, availability, and demand risks); and iv) the issues related to government financing, guarantees, force majeure compensation, termination compensation, refinancing, and the payment mechanism. According to Eurostat rules, if the risks and rewards associated with the PPP assets lie with the public partner, then the assets should be recorded as public assets and counted as government debt (Eurostat and EPEC, 2016).

In terms of the budgeting process, in Portugal, PPP expenses are included in the annual budgets of the authorities that are responsible for their payments. There is also a multiannual budget that is drawn up by the UTAP (the Portuguese PPP Unit) but the payments are the responsibility of each contracting authority. The UTAP has been trying to increase trans-budgetary comparability, through the standardization of the technical and macroeconomic criteria behind the budget process.

There is no standard system to evaluate and account for contingent liabilities and, therefore, they are treated on a case-by-case basis. According to public accounting standards, contingent liabilities are not recorded in the National Accounts System, as long as they are considered contingent. Therefore, contingencies are only accounted for when they develop into real liabilities. The UTAP discloses (in its reports available on its website, www.utap.pt) the maximum amount of contingencies at any moment in time, based on private partners' claims that are either under arbitration or are facing court proceedings.

limitation of this sharing, to ensure the continued off-balance sheet classification of PPPs.

Force Majeure Risk

Force majeure events are normally distinguished, in the contractual and risk allocation terminology, between force majeure events related to insurable and uninsurable occurrences.

In the first case, this is the responsibility of the private partner, inasmuch as compliance is possible by virtue of the insurance that this entity has contracted and that will entitle it to receive an indemnity. In the second case, since the private partner does not control these occurrences, and it is not possible to cover them through the compulsory insurance contracted, this event has the effect of exonerating the private partner

from the punctual fulfilment of the obligations arising from the contract, but it must be noted, only to the extent that their fulfilment has been prevented by such force majeure occurrence.

Changes in Law

As a rule, the public partner bears the risk regarding changes to laws of a specific nature that have a direct and relevant impact on the activities of the PPP contract. Any other changes are, typically, a risk assumed by the private partner.

Dispute Resolution Mechanisms

Typically, by virtue of a specific clause to that effect in contracts, conflicts resulting from PPP contracts are settled by arbitration, under international arbitration standards. It should be noted that the UTAP is expected to monitor arbitration procedures related to partnerships and make available all the technical support requested by the representatives of the public partner[139].

Insurance

As a general rule in PPP contracts, the private partner assumes the obligation to draw up and maintain in force all insurance contracts obligated under law, in accordance with the applicable legislation and throughout the duration of the partnership. In addition, it must take out all insurance cover that is necessary to ensure an effective and comprehensive coverage of the risks inherent in the activities to be developed under the contract in question.

Such obligations naturally include the obligation to make timely payments of the respective premiums. Even when a particular contractual obligation has been subcontracted to a third party, the private partner has the responsibility to keep that obligation covered by insurance.

[139] As per article 27 of DL 111/2012.

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