

The Next Day

PPP Contract Termination Rules and their Consequences for Project Viability

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Vicepresidency for Countries

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Discussion Papers

PPP Americas 2021

The Next Day: PPP Contract Termination Rules and their Consequences for Project Viability

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Discussion Papers

The PPP Americas 2021 Discussion Papers are a series of documents produced in preparation for the X Edition of PPP Americas, the most important forum on Public-Private Partnerships in Latin America and the Caribbean (LAC), organized every two (2) years by the Inter-American Development Bank (IDB).

As part of the PPP Americas 2021 edition, eight (8) groups of experts, professionals, consultants and academics were directly involved in the planning, identification, structuring and management of PPP projects in different countries. The groups, coordinated by IDB specialists, focused on the main issues in the area, to exchange experiences, discuss success stories and lessons learned in the various projects in the region.

In an open call in March 2020, more than two hundred (200) specialists, professionals and academics from the region applied to participate in the initiative. Over ninety (90) people were selected and collaborated, of more than eleven (11) different nationalities and with extensive experience in the main PPP markets in LAC.

Each topic explored in the groups led to a Discussion Document, compiling the reflections shared by the specialists in their joint discussions between June 2020 and April 2021. In addition, in January 2021, each group of specialists shared their insights with the other groups, to encourage the development of a richer and deeper conversation, and to take advantage of synergies between the different areas.

This initiative aims to help consolidate an environment for the exchange of experiences and best practices in PPPs for the region. Its main purpose is to serve as an input for the discussions that will take place at PPP Americas 2021—where solutions will be proposed in all directions.

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The Next Day:

PPP Contract Termination Rules and their Consequences for Project Viability

In preparation for the next discussion forum on Public-Private Partnerships (PPP), PPP Americas 2021, which will be held in Sao Paolo, Brazil, the organizing committee, led by the Inter-American Development Bank (IDB), has developed eight Discussion Papers focused on various topics of key relevance to the development and management of PPPs.

There is concern in Latin America and the Caribbean (LAC) as the wave of PPP projects signed in the 1990s are approaching their expiration dates, and the capacity to manage the termination of these contracts and its consequences are not exhaustively regulated, especially with regard to Early Termination (ET) events. According to a World Bank analysis, only 61% of PPPs in Latin America and the Caribbean regulate the consequences of contract termination.¹ Furthermore, in the last three decades a high number of PPP contract renegotiations (between 50% and 80% of contracts) have taken place. One of the risks associated with contract renegotiations is early termination; between 1984 and 2016, 9% of PPP contracts in the region were terminated early.²

This Discussion Paper analyzes various aspects related to PPP contract termination, including cases in which contracts are terminated satisfactorily at the end of their term and cases of early termination. In particular, the document focuses on the rules and procedures that regulate the different cases, which actors participate in this process, the identification and regulation of reversible assets, and the methods used to calculate restitution or compensation to the PPP contractor. This analysis is further developed based on the impact that a PPP contract termination can have on government interests (for example, fiscal effects), users (for example, quality and continuity of services), and investors (for example, project bankability).

Rules and Procedures

The rules on managing a PPP contract termination in LAC countries stem from similar scenarios. However, depending on the legal systems in the countries and whether or not PPP laws have been passed, the level of detail in contract termination rules may vary; in some cases, the use of catch-all clauses is a common feature. The level of sophistication in contract termination procedures differs from country to country depending on their institutional level, experience in managing and executing PPP contracts, and their rules for calculating restitution or compensation for the private partner.

Who Participates in the Process

¹ Procuring Infrastructure Public-Private Partnerships Report, Assessing Government Capability to Prepare, Procure, and Manage PPPs, 2018. PPIAF. World Bank.

² Procuring Infrastructure Public-Private Partnerships Report – World Bank, 2018

Sound institutions and regulatory frameworks established for the governance, the development and management of PPP contracts are crucial to the successful development of PPP projects in the region. The PPP termination process poses many institutional challenges, including the following: designing clear institutional frameworks to enable a termination process to be managed; developing an interinstitutional dialogue process to allow information and experience to be shared between those who develop PPPs and those who manage those contracts; the low technical capacity of the public sector, which can lead to poorly managed tendering processes and frequent renegotiations; and a lack of standardization at the subnational level and between countries regarding who participates in the management and settlement of a contract termination process and in what capacity. There are institutional mechanisms that can improve the administrative process and give peace of mind to investors and project financiers, such as the lender's step-in rights, arbitration, mediation, dispute resolution, and control entities. As corruption in PPP contracts can have a negative economic impact on society, it is important to consider procedural options that combine personal and material penalties, and also guarantee the continuity of the public service.

Reversion of Assets

At the end of a PPP contract, or in the case of early termination, the private partner generally has a contractual obligation to return the project assets to the contracting public authority. This reversion process is usually complex as the property rights of tangible and intangible assets are not defined, and it is unclear in what condition the assets must be when they are transferred. Therefore, PPP contracts must include clear rules on reversion in order to reduce the likelihood of a contractor returning assets in poor conditions. A practical example of this in LAC is the work of the National Infrastructure Agency (ANI) of Colombia to produce a Reversion Manual, which sets out the procedure and documents required to carry out reversion processes.

Calculating Restitution and Compensation for the PPP Contractor for Early Contract Termination

In the event that a PPP contract is terminated early, regardless of the cause, the contracting authority will receive an asset that it has not helped to fund and that has a monetary value. For this reason, to prevent unjust enrichment, restitution or compensation must be paid to the contractor. There are three basic calculation methodologies, each of which has advantages and disadvantages, both in its application and in the balance of interests of the public and private sector. Clear and detailed clauses in a PPP contract regarding the calculation of the value and payment term for restitution or compensation in all early termination scenarios will significantly increase the bankability and attractiveness of investment in a PPP project.

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Acronyms

AGU	Advocacia-Geral da União (Attorney General's Office)
ANI	National Infrastructure Agency
CGU	Controladoria-Geral da União (Office of the Comptroller General)
ET	Early Termination
IACAC	Inter-American Convention Against Corruption
IDB	Inter-American Development Bank
LAC	Latin America and the Caribbean
MPF	Ministério Público Federal do Brasil (Federal Public Ministry of Brazil)
PPP	Public-Private Partnerships
TAM	Medical Transfer Assistance
TCU	Tribunal de Contas da União do Brasil (Federal Court of Accounts of Brazil)
UNCAC	United Nations Convention against Corruption
UNECE	United Nations Economic Commission for Europe

Introduction

For the purposes of this paper, the definition of a PPP contract termination includes when the works and service provided to users are carried out satisfactorily and the contract reaches the end of its term, or when the contract is terminated before its original expiry date. An early termination event generally occurs as a result of a serious breach of PPP contract provisions, whether by the public contracting authority, the project contractor company, or due to a prolonged force majeure event that prevents the parties from performing the contract. A termination brings the contractual relationship between the public and private parties to an end. The assets are divided between the two parties, and an agreement is reached about all outstanding obligations, and the restitution or compensation payable at the termination of the contract is calculated.³

This paper is the result of group discussion sessions, during which leading specialists and professionals in the industry addressed the main challenges related to the treatment of contract termination rules, including the following:

- Balancing the bankability requirement and the predictability of long-term fiscal impacts.
- Addressing the output specifications in contracts for the assets that are to be returned in contexts of technological instability.
- Determining criteria to calculate the value of restitution or compensation in different contractual scenarios.

In the following chapters, PPP contract termination will be analyzed in relation to four topics that help to outline the main components governing the process. In Chapter 1, a comparative analysis will be provided of various cases of early termination, their causes, and contract law, and the ET procedure will be explored. Chapter 2 focuses on institutional challenges and mechanisms to improve the management of PPP contract termination. Chapter 3 studies the reversibility of assets based on the experience of Colombia's National Infrastructure Agency (ANI). Finally, Chapter 4 analyzes the different methodologies available to calculate contractual restitution and compensation in cases of early termination.

³ Managing PPP Contracts After Financial Close – Global Infrastructure Hub, 2018

Chapter 1 – Rules and Procedures: A Comparative Analysis

The early termination of a PPP contract is an event that prematurely stops the implementation of a project at a specific time in its life cycle, this includes the period from the commercial closure until the contract termination and reversion of the assets. Whether due to causes attributable to the contracting authority, the contractor, or upon mutual agreement or due to force majeure, termination actions are generally regulated by rules and procedures established in PPP contracts or, in some cases, by laws regulating the processes to be followed in the event that either of the parties fails to meet their obligations, or if the partnership is dissolved voluntarily due to a force majeure event. Therefore, the ways in which ET is handled and managed may vary between countries according to the type of legal system (Anglo-common-law system, or civil law system), the existence and applicability of a PPP law, and the maturity of their markets.

The rules governing ET of a PPP contract in Latin America and the Caribbean, as well as in other countries with extensive experience in projects of this kind, are based on very similar hypothesis. The differences between the countries do not lie so much in the nature of the circumstances that can lead to a contract termination, but in the level of detail and definition of each hypothesis, the procedures adopted to make the contract termination viable, and the discipline for calculating the restitution/compensation owed to the PPP contractor.

Compared with traditional public contracting methods, PPP schemes have advantages in terms of increasing service efficiency, optimizing the use of physical space for infrastructure, boosting project profitability, developing investment markets, and strengthening competition. However, poorly drafted clauses can diminish these benefits and significantly increase the frequency of conflict.

An ET event is a flaw in the original contract that prevents unexpected risk events from being foreseen or preparations for such events from being made; this could diminish the strengths and advantages of PPPs. Therefore, correctly drafted clauses and the implementation of clear processes can reduce associated risks, such as:

- Loss of continuity in long-term contracts that are no longer viable, until they are formally terminated.
- Handling of the context of the actual situation, in order to reach a form of termination with more favorable compensation principles.
- Contract termination under circumstances in which the breach of contract or obstacle could be overcome.
- Opportunistic behavior by the PPP contractor, seeking termination of the contract when the compensation would be more advantageous than continuing the contract.

- Opportunistic behavior by the contracting authority, seeking the termination of the contract after the completion of the initial investments, if the compensation is more favorable than the concession foreseen in the PPP contract.
- A failure by the PPP contractor or financiers, who could take action to prevent contract termination, if the incentives to continue the PPP contract or the concession were greater than the expectations of compensation.

1.1 Comparative Analysis of Regulatory Frameworks

As part of the research for this Discussion Paper, twelve projects in six countries were comprehensively analyzed⁴ to understand and evaluate the different ways in which ET provisions are addressed from a legal and contractual perspective. An event-based analysis will be provided of the causes, contract law, and the procedures involved in each case.

ET due to Factors Attributable to the PPP Contractor

Causes: Common standards may be observed in terms of the hypothesis that can give rise to early termination due to a breach by the PPP contractor. In general, they are explicitly incorporated into contracts, providing details of the causes that could give rise to such an event (for example, the Lima Metro project in Peru).

In some contracts, it is stipulated that termination may occur when less serious breaches continue (for example, the PF2 Standardization project, United Kingdom); in others, exhaustive descriptions are included, such as in the Victorian Comprehensive Cancer Centre Project, which includes contract breaches due to unresolved causes or due to unapproved cure plans.

Contract Law: The six countries studied have legal or contract provisions that grant the contracting authority the right to terminate in the case of a serious breach of contract by the PPP contractor. The contracting authority is also allowed to declare a contract terminated, on its own initiative, if it identifies a significant breach by the contractor. This makes the PPP contract inviable. In none of the cases studied is this decision dependent upon a prior assessment by an independent, administrative, or legal body.

⁴ Australia (State of Victoria): Victorian Comprehensive Cancer Centre Project; United Kingdom: Standardization of PF2 Contracts, London Overground Concession Agreement; Brazil: ANAC (National Agency of Civil Aviation) – Sexta Ronda, ANTT (National Agency of Land Transport) – BR 101 / SC, State of Sao Paulo – Piracicaba-Panorama Highway Concession (PiPa), State of Piauí – Piauí Connected PPP, State of Bahia – PPP in the health field, Municipality of Sao Paulo – Housing PPP; Colombia: National Infrastructure Agency – Caribbean Airport; Peru: Line 2 – Metro Lima Y Callao; Chile: Ministry of Public Works – La Araucanía Regional Airport

Procedure: The procedures vary according to the country and legal jurisdiction. However, some common features can be observed in procedure, including the following:

- Obligation to inform the PPP contractor in writing about the identified breach of contract, giving the contractor ample opportunity to resolve it or, on the contrary, prepare its defense.
 - Offer the financiers the chance to take over the PPP contract or adopt measures to rectify the irregularity.
 - Discipline to define contract termination as a measure of last resort. The contract provision must be: (1) of such a magnitude that it makes continuing the concession or properly providing the service unfeasible, (2) or highly reprehensible.
 - Provision of a mandatory cure period, which ranges from 20 calendar (Colombia) or working days (Australia), to 30 calendar days (Brazil) or 60 calendar days (Peru).
 - Inclusion of a period of transition in the case of formal termination of the contract.
- **Box 1 – Contracting Procedure in the Event of Serious Non-compliance by the PPP Contractor: Victorian Comprehensive Cancer Centre Project, Australia**

In Australia, in the event of a major default, the contractor must submit a plan to remedy the irregularity, with a resolution period and a work plan, indicating the costs and actions required to remedy the situation. If it is not possible to remedy the default, a cure plan must be submitted, indicating the reasons why it was not capable of cure, the measures to mitigate the consequences and compensate the damages caused, and the measures adopted to address the causes of the default. If the cure or prevention plan is accepted, it becomes binding on both parties. On the contrary, the rejection or failure to comply with the plan is an event that can cause the early termination of the contract.

ET due to a Breach by the Contracting Authority

Causes: In cases of ET due to a breach by the government, there are no concerns about this being reciprocal, as the contracting authority's obligations are generally limited to payment obligations and release of areas; the contractor, in contrast, has various performance obligations. An exhaustive list of causes that would prompt the PPP contractor to terminate the contract is provided as standard, which include the following situations:

- Expropriation, seizure or requisition of the contractor's assets.
- Failure to meet payment obligations beyond a specified amount or specified late payment period.

- Breaches of contract that make it unfeasible for the contractor to continue providing the service.

The events that can cause contract termination are usually defined by a minimum level of financial materiality or significance. Most breaches of contract can be represented by a monetary value and, therefore, can be remedied without terminating the contract, by making the untimely payment of unmet financial obligations plus the applicable late payment fees, or based on an economic and financial rebalance of the contract.

Contract Law: While all the other countries surveyed, except Australia, stipulate in their contracts that a serious breach by the contracting authority can lead to termination of a contract, the contractor does not receive the same treatment in terms of the power granted to it. In the United Kingdom, Peru, and Colombia, the PPP contractor has the right to declare the contract terminated in the event of a serious breach by the contracting authority, when it makes the PPP contract unviable or prevents the contractor from providing the services.

In Brazil, there is an explicit legal provision that requires an application to be filed when the PPP contractor wishes to terminate the contract on its own initiative; the contractor must then continue to provide the services until a legal authority declares the termination in a final judgment. In Peru, while the PPP contractor is guaranteed the right to declare a contract terminated, if the contracting authority suggests resolving the situation in an arbitration court, the dissolution of the contract will only come into effect following the arbitration decision.

Procedure: The procedure generally includes the obligation to inform the contracting authority about the identified breach of contract, within a maximum period starting from the date on which they had knowledge of it. To define contract termination as a measure of last resort, it is necessary to:

- Establish that the breach of contract must be of a magnitude that makes it unfeasible to continue the PPP contract or properly provide the service. To demonstrate this, a quantitative assessment of the contract must be considering using a value-for-money analysis.
- Ensure that, whenever possible, the contract's economic and financial balance is sufficient to eliminate the right of contract termination.
- Grant a cure period so that the contracting authority can meet the obligation or adopt measures to reorganize the contract; this period ranges from 30 calendar days (United Kingdom) to 60 calendar days (Peru).

In the event of formal termination of the PPP contract, the rules normally include a demobilization and transition period. In Brazil, as it is a legal requirement that termination can only occur following a legal decision that makes the termination final in a judgment, there is no cure period or demobilization and contract dissolution period.

ET for Public Interest Reasons

- Causes:** As a general rule, this hypothesis is an exceptional prerogative of the contracting authority, based on the assumption that it is not possible to adjust the contract entered into with the PPP contractor. As the causes are not defined in detail in the contracts, the contracting authority is given the authority to define the concept of public interest based on tangible facts.
- Contract Law:** The Latin American countries analyzed (Brazil, Colombia, Chile, and Peru) allow the contracting authority to unilaterally declare a contract terminated when it is shown that the public interest will be better served. None of the countries make the decision dependent on assessment by an independent, administrative or legal body.
There are exceptions in certain circumstances to exercising this prerogative. In Chile, for example, ET is possible when approximately 80% of the contract deadline has been met and at least 75% of the income provided by the contractor has been implemented.
- Procedure:** In general, there is an obligation to inform the PPP contractor in writing of the contracting authority's decision and, at the same time, the inability to object to the termination, since evaluating the public interest falls within the public authority's exclusive competence. ET based on this reason must be compensated with indemnification that is at least equal to the balance of financing debt, paid directly to the financiers, and repayment of the contractor's investment. In Brazil, early termination for public interest reasons, called expropriation, is subject to a specific authorization law.

ET due to Nullity of Contract

- Causes:** Nullity of a PPP contract is caused only by corruption or an irregularity that prevents past actions from being corrected or exploited.
- Contract Law:** The six countries reviewed have legal or contractual provisions that grant the contracting authority the right to terminate the contract if an unacceptable defect that compromises the service provision is identified. In Brazil, Colombia, Chile, and Peru, the contracting authority is allowed to declare the PPP contract null and void on its own initiative and provided that due legal process is observed.

Legislation in the countries studied foresees the possibility for the judiciary and, other external control bodies, if applicable, to declare the contract null. In Brazil, the legislative branch, following a request from the Court of Auditors, can exercise this competence. Termination for public interest is called “*encampação*” (takeover) in Brazil and is subject to a specific authorization law and prior payment of the compensation.

Procedure: The contracting authority is required to inform the PPP contractor in writing about the defects that it identifies. The process includes guaranteeing the contractor the right to make a statement first and the chance to suggest a remedy for the defect when its nature allows for this. Payment of compensation must be calculated based on the responsibility for the defect that causes the nullity.

ET due to a Fortuitous Event or Force Majeure

Causes: In most LAC countries, the possible causes of termination of a PPP contract due to a fortuitous event or force majeure are specified in the legislation in force. In Colombia, contracts foresee the occurrence of an event for which neither party is liable, which lasts for more than 90 days, if the parties agree that the contractual obligations affected by the event are of such significance that they have caused the contract term to be suspended.

Contract Law: In Latin America, the four countries researched have legal or contractual provisions that grant the contracting authority the right to terminate the contract if unforeseeable or force majeure events occur; these concepts are generally set out in civil law. In Brazil, the legal concept is included in the Civil Code, which establishes that the fortuitous event or case of force majeure are verified by the necessary event, the effects of which could not have been prevented.

The United Kingdom has an unusual provision that allows the value-for-money analysis that was performed when the PPP contract was signed to be revised; this can result in the amendment or even dissolution of the contract, when it is not possible to change it.

Procedure: It includes the obligation to inform the PPP contractor in writing about the causes that affected the performance of the contract. It must be demonstrated, using economic scenarios, that the contract could not be executed as it was economically and financially non-viable. The process includes guaranteeing the contractor the right to make a statement first, and the chance to suggest an amendment to the contract, subject to acceptance by the contracting authority, and the payment of compensation to the contractor.

Chapter 2 – Who Participates in the Process? Institutional Challenges and Mechanisms to Strengthen the Management of PPP contract Termination

The previous chapter explored the ways in which rules and procedures are essential to the definition, management, and the process of ET events and, in general, to the success of PPPs. However, they do not occur in isolation. There are entities responsible for carrying out the tasks related to contract termination, and other roles throughout the project's life cycle; these bodies are part of the general PPP governance framework. Good governance must promote projects with properly assigned risks; they should be divided or shared between the contracting parties that are most capable of managing them. When translating policy into successful implementation the quality of the institutions and their effectiveness must also be protected. For both natural or early contract termination, a well-defined, transparent structure with institutions that have clear roles and duties is key to properly managing the termination and to providing fair restitution or compensation to the parties involved.

PPP frameworks face many challenges, including the development and strengthening of institutions that are capable of effectively implementing PPP projects. There are different ways to structure institutional support. In LAC, there are two main governance models: a centralized model, in which the PPP units play a major role throughout the project cycle, and a decentralized model, under which the PPP projects are developed and structured by a wider range of governmental entities.⁵ Terminating a contract between a public and private entity has legal consequences that extend beyond the governance structure of the PPPs. Other stakeholders, such as national legal entities and international arbitration bodies, are key actors to take into account when attempting to understand the ramifications of an early termination event.

It is also important to contextualize the key UN principles that guide good governance in PPPs,⁶ and are relevant for understanding the objectives and motivations that should drive the institutions. The six principles of good governance are as follows:

⁵ Prats, Joan. "The Governance of Public-Private Partnerships: A Comparative Analysis." 2019. Interamerican Development Bank.

⁶ Guidebook on Promoting Good Governance in Public-Private Partnerships. 2009. United Nations Economic Commission for Europe.

1. Participation: the degree of involvement of all stakeholders;
2. Decency: the degree to which the formation and stewardship of the rules is undertaken without harming or causing grievance to people;
3. Transparency: the degree of clarity and openness with which decisions are made;
4. Accountability: the extent to which political actors are responsible to society for what they say and do;
5. Fairness: the degree to which rules apply equally to everyone in society; and
6. Efficiency: the extent to which limited human and financial resources are applied without waste, delay, or corruption or without prejudicing future generations.

This discussion paper analyzes who participates in the termination process from two perspectives. Firstly, it analyzes the institutional challenges that make it difficult to properly define, establish and manage early termination of a PPP contract, using experiences based on the Brazilian context, which are applicable to the very similar realities in other LAC countries. Secondly, it suggests institutional mechanisms that can help to improve the process and provide certainty and protection to projects in the event of early termination in the least burdensome way possible. To further this analysis, this section also explores early termination due to integrity-related events, such as corruption cases, what impacts they can have on the ET process, and how the different stakeholders are affected by such events.

2.1 Institutional Challenges

Institutional Framework

The level of success that countries can achieve in developing PPP projects and programs is closely linked to the strength of their institutions and the frameworks established to govern, develop, and manage contracts. It is essential for institutions to commit to playing a role in the process, not only by developing the institutional framework but also by assigning responsibilities to the different actors involved in the process. The complexity of structuring sound institutional frameworks that are capable of managing a termination process stems from three main factors:

- Numerous laws and regulations: it is difficult to identify all the specific laws and regulations that govern a termination event.
- Unclear responsibilities: not all participants in the process are aware of all the tasks for which each of them is responsible.
- Blurred lines: the limits of action of the various actors are unclear.

The institutional framework under which PPPs operate is a key element in properly aligning the incentives of each of the parties involved in all phases in the project cycle. With regard to PPP governance, there are different levels of institutional development in the various countries. According to the 2019 Infrascope report, which evaluates the environment for PPPs in Latin America and the Caribbean, the institutions that prepare, award, and oversee PPPs have a low

average maturity level across the region (average score of 56/100).⁷ At the subnational level the situation is even more complex, as the institutions are weaker because they often have lower capacity and less experience than in central governments. This makes it difficult to organize and define clear roles for the institutions involved in PPPs. In Brazil, for example, there is significant concern about how projects are developed and managed in the water and sewage sector given that there are many municipalities with non-homogenous characteristics.

The same institutional complexity that affects the development of PPP projects also arises during early contract termination. A problem that starts when structuring and implementing a project continues during its execution, and then worsens in an ET event. The instability and uncertainty that such situations generate are a result of the flawed design of institutional models. A sound institutional framework is therefore essential, and it should not only cover the legal process and model but also clearly define the institutional responsibilities and technical strength of the participants.

Interinstitutional Dialogue and Technical Capacity of the Public Sector

Specialized PPP units are generally key institutions created to meet governments' needs for the capacity to effectively run a PPP program. These units perform a unique role in preparing, structuring, and monitoring projects, and they have specific knowledge that is valuable to the successful implementation of projects. PPP units provide consultancy, operational, and technical support throughout the different stages of the project. Their role is important before, during, and after bidding. The first challenge is for these units to have an adequate transparency and integrity framework, including at least operational rules and mechanisms to guarantee access to information, as well as rules and mechanisms to ensure the integrity of decision makers and the decisions that they take. This includes, but is not limited to, digital systems to ensure real-time access to public information, systems to prevent conflicts of interest among the parties, information about end beneficiaries, and decision-making procedures that ensure the principle of equal consideration of decision options.

A common institutional challenge is the lack of information and experience sharing between the teams that develop PPPs and the teams that manage the contracts. These teams are generally located in different governmental institutions; for example, the PPP units that develop projects in the Finance Ministry, and the project teams that manage those projects from sectoral ministries. From the beginning of the projects, it is common for there to be limited dialogue and information-sharing between the PPP units, whether at the central or subnational government level, and other institutions that should be involved in the effective promotion and execution of these contracts.

This institutional problem is usually related to the maturity and soundness of the PPP process in each country, and to the government's commitment to support these institutions from the start. However, given the strategic role of PPP units, it is essential for them to be recognized as key actors in the entire project life cycle, and for there to be common understanding of roles and responsibilities. Therefore, it is crucial to develop protocols that encourage dialogue between the

⁷ Evaluating the environment for public-private partnerships in Latin America and the Caribbean. 2019 Infrascopes. The Economist Intelligence Unit.

parties to ensure that, in the event of a contract termination, the institutional framework, protocol, and responsibilities are clear and do not prevent the resolution of that process.

The quality of PPPs is often limited by governmental entities' low technical capacity and weak management incentives, which can result in poorly managed bidding processes or improperly drafted contracts and frequent renegotiations. The public sector's low capacity means that governments lack the resources and skills to structure and manage PPPs properly based on current international standards. Improved technical capacity in the public sector, together with greater transparency and less political interference, which affects the economic and financial sustainability of infrastructure services provision, would reduce uncertainty, and lay the foundations for increased investment and more efficient service provision.

Heterogenous Approaches

There is a lack of standardization between countries, and sometimes between subnational governments, on who participates in the management and resolution of contract termination process and in what capacity. Entities are assigned roles that do not necessarily correspond to their capacity or fall outside the scope of their mandates, or that in the worst case may conflict with their functions. This is the case when, for example, regulatory organizations are granted the contracting authority for a PPP contract, or when a project implementation unit performs a supervisory role at the same time. At the municipal level, it is very common not to have PPP units, and the projects are structured by the same actors that perform the role of contracting authority.

Overlapping powers is another issue, where the powers of control or regulatory bodies overlap with the institutions that have the authority to take decisions about a PPP contract. In both natural and early contract termination cases, this is particularly significant because it creates problems regarding legal jurisdiction; indeed, agreements reached with a control body can be annulled by another body, especially if they have a different duty of care. In Brazil, for example, to tackle corruption in PPP contracts, the institutional architecture is made up of four key institutions (MPF, Federal Public Ministry of Brazil; AGU, Attorney General's Office; CGU, Office of the Comptroller General; and Federal Court of Accounts). Each institution has different constitutional mandates that cannot be modified by common law.

Guaranteeing the Continuity of Service

PPPs are a tool for financing and managing public infrastructure; the assets that they cover are assigned or intended for public use or related to the provision of a service. As such, successful PPP projects guarantee the provision of public infrastructure that benefits the whole community. However, one of the main negative consequences in the event of early termination of a contract is that it interrupts this public service, resulting in negative social and economic effects for society.

Stopping the provision of services, from a highway to a power plant, can have damaging effects on citizens' daily lives and threaten the service provision function for which infrastructure PPPs are built. The service suspension can also have adverse long-term effects, such as a decline in the quality of

the service itself, or the loss of customers or consumers that may be obliged to rely on alternative services. Therefore, continuity of service must be addressed at project level by defining and managing the potential occurrence of an ET event. At the institutional level, attention should be paid to ensuring quick handling of the processes while considering the effect on users, whether by seeking remedies that do not interrupt the service provision or offering a temporary alternative.

A Return to Investor Protection

PPP contracts are financed with debt and equity under the project finance modality, where the funds provided by financiers are repaid by the cash flows generated by the project. PPPs involve a number of players in addition to the project sponsors and a myriad of legal instruments designed to finance, execute, and repay the work overtime through the flow of funds generated by the project. Early termination of a PPP contract does not only invalidate the main contract between the State and the contractor but also of all the contractual relationships associated with it. Thus, it prevents both the continuity of the project and the realization of the expectations of people unrelated to the illegal act who invested in the project (financiers and contractors), while also affecting their workers and all the potential beneficiaries, who expect these investments to provide better roads, transportation, and services. For this reason, financial entities and investors must analyze the risks of PPPs closely, including the possibility of ET of the contract. The uncertainty of not knowing or not having a clear ET process can increase financing costs or, in the worst case, put off investors.

As a general rule, all ET cases must include restitution or compensation paid to the PPP contractor depending on the cause of the ET, in order to prevent the unjust enrichment of the contracting authority. Investors and financiers must be certain that their investment will be assessed fairly and protected against any arbitrary government action, such as unilateral interventions. It is very unlikely that investors will invest if they perceive a lack of clear rules and fair restitution and compensation procedures in cases of early termination.

2.2 Institutional Mechanisms

A Sound Administrative Process

It is important for there to be an administrative process that has been set out in advance in a law or the contract; it should cover contract termination and indicate the necessary measures to take in the event of such a termination. Each of the entities that take part in the process must be clearly known, and their role must be clear to all stakeholders. It is crucial for there to be clarity in the procedure to be followed, the timeline, and the legal process for contract termination; this will ensure that the entities involved can implement and undergo a process that contractually guarantees fair management of an early termination event, as well as the continuity of service delivery for the community.

Minimizing asymmetries between institutions is another important aspect. A project's contract must be managed by a unit with the legal competence to process a case of early termination. If there is a responsible entity that manages the contract termination process, it must have the

power to take the final termination decision. This prerogative is very difficult to define when lots of entities are involved.

There is a draft law in the Sao Paulo government that stipulates that any decision of the regulating agency that results in financial obligations for the State must be subject to a prior decision of the State government. Commitments to pay restitution or compensation cannot be made unless the Ministry of Finance and Planning can approve what the contracting authority is doing.

Lender's Step-in Rights

Step-in rights are rights granted to lenders to intervene and take control of the infrastructure project when the PPP contractor is in breach of its contract. Negotiating their step-in rights is one way that lenders seek to protect themselves against a PPP contract termination following a breach by a private partner. In some jurisdictions, there may be mandatory laws that prevent the granting or exercise of the lender's step-in rights, which could be an obstacle to attracting finance from the private sector.

Step-in rights provide lenders certainty in terms of bankability, and **they** provide a framework in which **the** parties can meet to negotiate solutions in the event of a breach or termination.

Arbitration

An arbitration clause increases the security of the institutional framework as chambers of arbitration have their own rules which provide a better alternative institution mechanism for settling issues involving legal uncertainty. Although arbitration does have administrative costs, as the chamber of arbitration is identified, it is clear in advance how early termination will be handled, which gives investors clarity.

Mediation

Mediation is a common solution in a contracting procedure which takes place within the judiciary, which provides greater legal certainty both as regards the fulfillment of obligations laid down for contract terminations and for the public agents involved. The agency that decides to terminate a PPP contract can initiate mediation. It can lend transparency to processes, as well as legitimacy, and improve dialogue between the contracting authority and the PPP contractor during a technical assistance situation.

Dispute Settlement

They are important institutional mechanisms for early contract termination. Dispute settlement boards have a proven track record of resolving disputes without costly and time-consuming arbitration or litigation, and can be imposed as a consequence of a contract provision or by agreement of parties at a later stage in the project. Making use of dispute settlement boards for ET can prove to be a highly successful and profitable contractual process to prevent and resolve disputes during the course of the project.

Control Entities

These bodies are given the task and mandate of control and monitoring. In some countries these bodies have preventive powers, while in others they take ex-post action. There are also cases in which they have legal functions, and not only auditing and control tasks. Finally, in some cases they are responsible for issues related to civil servants' integrity; for example, taking sworn statements about assets and analyzing possible cases of unjust enrichment. In the public sector, control entities can comprehensively monitor (monitoring, evaluation, control, re-estimation) the development of projects. If early termination occurs, these entities can provide arguments for the termination and help to establish fair restitution or compensation for the parties.

2.3 Corruption in PPPs and their Effects on ET

There is extensive literature that analyzes the risks of integrity and corruption in PPPs.⁸ Recent experience has shown the negative consequences that corruption cases can have on the development of infrastructure and, in particular, on PPPs.⁹ Corruption and, therefore, monitoring integrity-related events, in PPPs is important at all stages of the project (Ioassa et al, 2011).

All international anti-corruption instruments are based on the principle that corruption cannot be profitable and that, as a consequence, governments must confiscate the product of the corruption or apply equivalent financial penalties (Aymerich-Cano, 2015).

The United Nations Economic Commission for Europe (UNECE) has developed a new standard on zero-tolerance to corruption in PPPs to support countries' efforts to strengthen transparency, accountability, and effective governance of investment in public infrastructure and service delivery. As part of this approach, declaring a contract null and void is one of the tools envisaged as a penalty for corruption.

Nullity and invalidity of the contract is the most likely consequence of corrupt activities, as it is the response envisaged in administrative law, given the lack of specific provisions in PPP laws themselves,¹⁰ to an irregular situation.

Declaring a contract null and void has economic costs for society and economic development as it brings a significant number of works to a standstill. In some projects in the region, such as the Odebrecht scandal, it has even led to the interruption of the respective payment chains, the bankruptcy of suppliers and the dismissal of thousands of workers, in addition to worsening society's distrust of the authorities and public officials.⁷ The zero-tolerance approach does not take into account whether the company has attempted to prevent bribery or whether it has

⁸ Ioassa, E. and Martimort, D. Corruption in Public-Private Partnerships (2011); Knorr and Schomaker, The Potential For Corruption In Public Private Partnerships – Theoretical Aspects and Some Policy Implications; and Bildfell, C. P3 Infrastructure Projects: A Recipe for Corruption or an Antidote? (2018)

⁹ De Michele, Roberto, Prats, Joan, and Losada Revol, Isaías. Effects of Corruption on Public-Private Partnership Contracts: Consequences of a Zero-tolerance Approach. 2018, Inter-American Development Bank.

monitored and punished employees who engage in bribery, cooperated with authorities, or whether it has fulfilled its side of the contract.¹⁰

It seems appropriate to analyze other, more balanced options that combine personal and material sanctions (removal of personnel, fines, replacement of suppliers, etc.) on those responsible for corrupt activities while ensuring the continuity of the infrastructure project and contracts, including those of law-abiding third parties provided that the project has a positive socio-economic impact.¹¹ PPPs involve a number of players in addition to the project sponsors and a myriad of legal instruments designed to finance, execute, and repay overtime work hours with the flow of funds generated by the project. The nullity of PPP contracts not only invalidates the main contract between the State and the contractor, but also all the contractual relations associated with it. Thus, it prevents both the continuity of the project and the realization of the expectations of people unrelated to the illegal act who invested in the project (financiers and contractors), while also affecting their workers and potential beneficiaries, who expect these investments to provide better public services.

- **Box 2 – Participants in Cases of ET Due to Corruption**

- **SPV (Special Purpose Vehicle):** PPPs are based on a structured financing project in which a special purpose vehicle owned by a consortium of companies, which may include the participation of the public sector, signs and executes the contract. This “project company” will be in charge of the financing, development, construction, maintenance, and operation of the works throughout the duration of the contract, outsourcing goods and services. The characteristic feature of PPPs is that they are an investment that is recouped over a long period from the flow of funds generated by the project itself (tolls, fees) or contributions from the State known as availability payments.
- **State agencies/organizations that execute the project:** they must aim to strengthen institutional frameworks and units specializing in PPPs, as mechanisms to guarantee technical and human resources that minimize opportunities for corruption.
- **Comptroller/Anti-corruption:** these bodies perform an oversight and monitoring role and mandate. International anti-corruption regulations contain express specifications about the organization of control entities. The Inter-American Convention against Corruption (IACAC) and the United Nations Convention against Corruption (UNCAC) stress the preventive nature of the control and, inter alia: (i) lay down the obligation to develop modern mechanisms for detecting, punishing, and eradicating corrupt acts; (ii) periodically evaluate the instruments used in the country with a view to determining their adequacy to fight corruption; (iii) ensure the existence of bodies that prevent corruption and grant them the necessary independence, the necessary resources and specialized staff, as well as provide training for that staff; (iv) promote cooperation between public bodies and civil servants.
- **Specialized PPP units:** permanent government structure with the necessary knowledge to identify or management opportunities for links between the public and private sector. PPP units provide consultancy, operational, and technical support throughout the project’s various stages. Their role is important before, during, and after bidding. They do not have a specific role for tackling corruption in

¹⁰ Davis, Kevin E. Civil Remedies for Corruption in Government Contracting: Zero Tolerance versus Proportional Liability. 2009. NYU School of Law.

¹¹ Advisory Group of Experts on Anticorruption, Transparency, and Integrity. Report of the Expert Advisory Group on Anti-corruption, Transparency and Integrity in Latin America and the Caribbean. Washington. 2018. Interamerican Development Bank.

PPPs, but they do help to prevent this crime. They do not perform an oversight and monitoring role like comptroller offices.

- **Suppliers:** if a contract is terminated due to corruption, payment chains are interrupted, which can lead to bankruptcy.
- **Workers:** contract annulments cause massive job losses.
- **Society:** terminating contracts in the event of corrupt acts increases society's distrust of public authorities and civil servants.
- **Project financiers:** financiers are highly vulnerable to nullity of contract as a response to an act of corruption, given that nullity eliminates the source of repayment, which may even occur after the entire investment has already been made. In PPPs there is also no potential recourse to the balance sheet of the company, but rather to that of the project company. The risk that the work will be declared abandoned due to corruption activities also discourages private investment.
- **Governments:** they have been forced to take measures to prevent impunity and punish those responsible for acts of corruption; at the same time, they must ensure the continuity of infrastructure projects to prevent downturns in the local economy as a consequence of a potential interruption to the works, which would in turn lead to unemployment and a potential reduction in the flow of investments.

Chapter 3 – Reversion of Assets: The experience of the National Infrastructure Agency (ANI) in Colombia

Under most PPP contracts, at the end of their term, the private partner is required to transfer or return the public asset in question (whether it is an airport, a road, a school or other type of infrastructure project) in satisfactory conditions that meet the performance and service quality standards of the contracting authority. The precise meaning of satisfactory conditions must be defined in the PPP contract, taking into account the early return of assets due to ET, with clearly measurable technical standards. The requirements applicable to the reversion or transfer of the asset can be described using technical standards, which must be measurable so that they can be independently verified. To meet these requirements, the private party must maintain the asset's quality or carry out repairs before returning it.

Early terminations can be very complicated for the public sector, and pose many challenges as many of the movable and immovable assets do not have defined property rights and create problems when transferring ownership, causing delays in the process. When contracts are interrupted prematurely, the State has three main options: take over the management of the asset itself; tender a traditional public works contract; or tender a new PPP contract, which may include additional capital expenditure works, as well as ongoing operations. This transition is important as it will affect the continuity of the public service provision, which is often not given sufficient strategic consideration.

One challenge identified in PPP contracts is that private partners tend to carry out as little maintenance as possible to reduce costs, encouraged by the prospect of maximizing earnings. Such challenges highlight the need for clear and measurable technical standards, as well as additional contract protections designed to protect the government's interests (such as maintenance reserve accounts and other performance guarantees). To prevent assets from losing value and reducing the quality of services, governments must find mechanisms to protect and facilitate the transfer of assets. PPP contracts must have a clear and well-defined asset return standard to minimize the chance of the contractor returning assets in poor condition.

This chapter analyzes the experience of ANI in Colombia in asset reversion in PPP contracts; it focuses on the key challenges that cannot be ignored when structuring sound contracts. The ANI is a decentralized state agency which is financially and technically independent from the Colombian government but is attached to the Ministry of Transport. It is responsible for planning, coordinating, structuring, implementing, managing, and evaluating concession projects and any other PPP that includes aspects related to design, construction, financing, operation, and maintenance. The ANI and other governmental entities, such as the National Highway Institute (INVIAS) and the Colombian Civil Aviation Authority (Aerocivil), which can perform the role of

contracting authorities, have played a central role in developing a mature PPP program in the country's transport sector.

3.1 Regulatory Framework

In accordance with the Colombian regulatory framework, contracts for the exploitation or concession of State assets include an agreement that, at the end of the exploitation and concession period, the elements and assets directly concerned become the contracting authority's property, without it having to pay any form of compensation. This exceptional power is enshrined in Articles 14 and 19 of Law 80 of 1993 and Article 31 of Law 1508 of 2012.

Under these laws, the reversion of assets associated with PPP projects has been managed since the 1990s. However, there have been some disputes with contractors that have resulted in litigation. Drawing on these experiences, the ANI has developed a Reversion Manual that sets out the procedure and the necessary documents to carry out all the reversion processes. The purpose of the manual is to, inter alia, present a clear and specific guide, so that the parties understand the concepts and procedures, establish the necessary time frames for the project reversion process, and gather together all the reversion processes and procedural standards to provide a basic decision-making guide.¹²

3.2 Contract Developments in Colombia's Road Program

Every road concession program in Colombia has a generation number depending on the structuring of the model adopted. In the first generation in the 1990s, two important laws were drafted: Law 80 of 1993 and Law 105. They were very basic laws containing 6 articles that covered the provision of public transport services through concession contracts. The design of the first generation of road concessions focused on road operation and maintenance concessions, and a minimum revenue guarantee was used as the payment structure. The fourth generation (4G) of projects is one of the most important milestones reached in Colombia's road program to date. They use a much more advanced contracting model, which is based on Law 1508 on PPPs; accordingly, the private party is responsible for financing, and it is paid once the functional units are delivered in accordance with certain predefined service levels. The fourth generation includes around 27 projects that were awarded with a very detailed definition of risks—and the government took on a lower proportion of the risks—and service availability payments.

In the same way, drawing on the experiences of the previous four generations, with the support of the ANI, the Colombian government has now developed the new 5G generation of road concessions, which already includes a very detailed list defining asset reversion in the contracts. In the templates for already existing contracts, which include terms and conditions for operation and maintenance, the following assets and items are listed as being reversible:

¹² Manual de Reversiones. 2019. National Infrastructure Agency. Government of Colombia.

1. Land in the project corridor area.
2. Civil works (roadways, separators, intersections, structures, drainage works, artwork, and signs).
3. Toll stations and their equipment.
4. Weighing stations and their equipment.
5. Operation control center and its equipment.
6. Operating bases (one or however many there are).
7. Service areas.
8. All vehicles assigned to the operation of the project.
9. Equipment installed for the operation of the project.
10. Computer equipment and software.
11. Telecommunications equipment.
12. Fiber optic network.
13. Equipment given to the Highway Police.
14. Rescue equipment.
15. Medical transfer assistance (TAM) equipment.
16. Any other work or property that is part of the Concession.¹³

3.3. Key Points to Consider

Based on an analysis of six projects managed by the ANI which have posed challenges in the asset reversion process, the most common difficulties are set out below.

Reversion of Land in the Project Corridor Area.

One of the main points to consider in a reversion process is the transfer of the land in the project corridor area to the State. This has caused significant conflict between the contractor and the contracting authority; for example, in the Vía al Puerto and Ruta del Sol II projects. The way in which reversion has been managed has evolved over time. In the first project generations, the State was responsible for handing over the land to the private party, which proved to be inefficient. This led to contract amendments in the following generations to assign this responsibility to the contractor. In the 4G contracts, it was stated in that the contractor must acquire the land for the projects in the first five years of construction and, at the same time, hand over ownership to the State.

Despite the improved management of this process in the 4G, it was still shown to be difficult for the contractor to meet this deadline. In the 5G projects, the rules for legally returning the land are more flexible and are aimed at achieving a balance, giving the contractor five years and the chance to extend that deadline subject to a penalty based on proportional availability discounts.

¹³ PPP contracts in Colombia can include social works linked to the contract. These types of works are part of the concession and must be returned when the contracts end.

Assigning Environmental Licenses

The assignment of environmental permits was problematic in almost all projects that were terminated abruptly. As laid down in the Infrastructure Law (Article 13, paragraph 3) early termination will entail the subrogation of the rights and obligations of the environmental license, permit or authorization holder to the responsible public entity.

Given the urgency of early contract termination, this process becomes complicated. In the Ruta del Sol II project, the legal form, that is transfer or subrogation, according to which the ownership of the environmental licenses would be given to the ANI was not established. In the project called Adicional 13 (Addendum 13) to the highway network of the Valle del Cauca, difficulties were also faced when transferring environmental licenses, as well as costs associated with ongoing activities.

Handover of Assets such as Vehicles and Equipment

In accordance with ANI's manual, vehicles that are used for the roads (for road surveillance, highway police, etc.), except construction vehicles (heavy machinery), are to be returned to the State as it covers the project costs, and the assets must be returned in good condition. A common problem is that the vehicles and equipment acquired for the project are under leasing contracts, and at the time of an early contract termination they have not been paid in full. Furthermore, even if the assets are owned by the project, transfer procedures are usually slow and burdensome. This was true in the Vía al Puerto project, when delays occurred in the handing over vehicles in the name of INVIAS; and also in the Cúcuta Metropolitan Area and North Santander project, where the project contractor leased the service vehicles when they were supposed to be returned at the end of the contract.

Termination of Business Contracts and Employment Relationships with Workers

In ET cases, there are contractual implications that go beyond the direct relationship between the contracting authority and the contractor. The contracts that the contractor signed with service companies, business enterprises, and workers are affected. If the termination process is not amicable, and the contractor does not take responsibility for it, the State becomes responsible for terminating these contracts. In the Ruta del Sol II project, the Brazilian firm Odebrecht was the leader of the consortium responsible for developing the project, and numerous problems arose related to these contracts. The documents certifying the termination of business contracts could not be found, which made it difficult for the business enterprises to cease commercial operations. Furthermore, it was not possible to establish that the employment relationship with the workers of the contracted company and of its construction company (CONSOL) had been terminated. As a result, the State received around 1,500 complaints regarding the termination of this contract.

Mining Rights

Similarly to environmental licenses, the Infrastructure Law regulates the subrogation of mining rights obtained for the project. In the Ruta del Sol II project, the company contracted to develop

the project (Ruta del Sol S.A.S.) applied for several mining exploitation rights for the works. They had not been cancelled and the responsibility for them was transferred to the State.

Social Compensation Commitments

In order to develop road projects community areas located in the project corridor area are involved. During this intervention process, PPP concession holders/ contractors make commitments to the community to re-establish their current conditions in other locations. These commitments usually remain unfulfilled in the event of ET, which was the case in the Ruta del Sol II project. For this reason, these types of commitments will be included in 5G project contracts as assets that must be returned.

Chapter 4 – Calculating Restitution and Compensation for ET in PPP Contracts: A Comprehensive Analysis of Existing Methodologies

4.1 Introduction

If a PPP contract is terminated prematurely, for whatever reason, the contracting authority receives an asset with a certain value that it has not helped to fund. Accordingly, to prevent unjust enrichment the contractor must receive restitution or compensation of some kind, considering that, in cases where the administration causes the ET, the private party stops receiving revenue for reasons unrelated to its performance.

ET can occur at any time in the contract's life cycle due to numerous reasons, which can be grouped into three categories.

1. Causes attributable to the contracting authority: A breach by the administration, public interest, voluntary or unilateral
2. Causes attributable to the private partner: A breach by the PPP contractor (this may be due to bankruptcy, inability to secure financing, repeated penalties, etc.)
3. Force majeure: Any unforeseeable event that makes it impossible to perform the PPP contract.

4.2 How It Is Regulated

Regulations on restitution and compensation for ET vary between countries and regions as regards the scope of the rules and implementation process. In Europe, not all countries have their own PPP legislation. There are a series of European Union directives¹⁴ that regulate this sector and serve as a guide for countries that wish to incorporate them into their own legislation. The most recent package of directives (adopted in 2014) has three main objectives: (1) simplify PPP contracts; (2) provide flexibility for each country/contract to incorporate critical issues that affect project bankability; and (3) provide legal certainty. However, with regard to these directives, it is not specified how to calculate the restitution and compensation for ET, nor is ET envisaged in cases that are the contractor's fault. It is implied that restitution should be paid in cases in which

¹⁴ Directive 2014/24/EU on public procurement; Directive 2014/25/EU on procurement by entities operating water, energy, transport, and postal services sectors; Directive 2014/23/EU on the award of concession contracts.

the administration decides that it is necessary and in the event of force majeure; despite this, it is not clearly specified that the PPP contractor would have to receive that compensation.

Eurostat has also published a guide to the statistical treatment of PPPs,¹⁵ which addresses the impact of PPPs on government balance sheets, including restitution and compensation for ET. It should be noted that the effects of these calculations, including any existing payment guarantees, may mean that the project is included on the government balance sheet and recorded as national debt.

Unlike Europe, in Latin America and the Caribbean, most countries have their own PPP legislation. The majority regulate cases in which restitution or compensation due to ET is required, and there are even cases in which it is specified how it should be quantified (Mexico, El Salvador, Costa Rica, Panama, Dominican Republic, Colombia, Venezuela, Brazil, Chile, and Paraguay). Elsewhere, it is stipulated that payment due to early termination must be made, but there are no rules on how to calculate it (Bahamas, Guatemala, Honduras, Nicaragua, Ecuador, Peru, Argentina, and Uruguay). In a few cases, no mention is made of how to handle restitution or compensation due to early termination (Barbados and Trinidad and Tobago).

- **Graph 1 – Legislation on ET Restitution or Compensation in LAC**



¹⁵ A guide to the statistical treatment of PPPs. 2016. European Development Bank and Eurostat.

4.3 Main Methods for Calculating Restitution and Compensation

There are three main methods used to calculate restitution/compensation in Latin America and the Caribbean, Europe, and other countries. These methods can be combined in a PPP contract depending on the time and circumstances of the ET. Each method will be explained below.

Book Value

This method has been used for many years and is traditionally used in PPP contracts. It uses the investment costs as the basis for calculating the restitution and compensation, minus the depreciation of the assets. Depending on that value, subsidies are reduced if they were granted by the government. If ET takes place during construction, the payment is equal to the actual progress of the project at that time.

Financing Based

The financing-based method focuses on project financing. The total unpaid debt at the time of ET is taken as the basis for calculating the restitution and compensation. In some cases, and depending on the cause of ET, a deduction may be applied to this value for damages. When the cause of the ET is not attributable to the PPP contractor, the equity is also included to quantify compensation.

Market Value

This is one of the most recent methods of restitution and compensation, taking the amount that a new PPP contractor would be willing to pay if the contract were to be tendered again. The highest bid (less the contracting authority's tendering costs) is the amount payable in restitution or compensation. This calculation is based on the market value in a tender with different bidders, and the private partner/PPP contractor would be compensated with the payment indicated by the market.

Other Methods

The following methods are specific cases that serve as examples of different approaches. However, they are not in line with usual international practices.

- Redemption windows (*ventanas de rescate*): the government reserves the right to unilaterally terminate the PPP contract at specific times in the contract called "windows". The PPP contractor defines the amount of this restitution or compensation in their bid and it is a bid variable.
- Chilean model: the restitution or compensation for ET is equal to the difference between the theoretical value of the revenue defined in the bid minus the actual revenue received until the time of the ET. When applying this method, the amount of income received for ET (which will be used to pay restitution to the contractor) is updated on the date of ET.
- Maximum redemption amount: restitution for ET is equal to the equity value of the investments (expropriation, construction works, and immovable assets) net of amortization until the ET. This method is similar to the book value method, with the exception that the maximum amount of restitution is limited to the amount defined in the PPP contract.

4.4 Advantages and Disadvantages of Valuation Methods

Each of the methodologies has advantages and disadvantages, as no perfect system exists nor does a method that is better than another. As many PPP contracts lack transparency and clarity, clear rules are important so that each government can choose the method that best suits their circumstances. The table below presents an analysis of the advantages and disadvantages of the different methodologies, and some key points to take into account when evaluating which is the most suitable method.

• **Table 1 - Advantages and Disadvantages of Valuation Methods**

Book Value		
Advantages	Disadvantages	Key Points to Take into Account
<ol style="list-style-type: none"> 1. It is a clear and simple calculation based on straight-line depreciation. 2. It allows an accurate estimate of its value throughout the contract, improving its bankability. 	<ol style="list-style-type: none"> 1. It can cause accounting interpretation issues depending on the recording method (financial asset, intangible asset). 2. The asset's book value may not correspond to its actual value, resulting in a higher or lower payment than is actually payable. 3. The book value does not include lost profits in the compensation for causes non-attributable to the contractor. 4. It does not guarantee repayment of debt. 	<ul style="list-style-type: none"> • Lost profits are usually added to ET for reasons not related to the contractor's performance. • The investment must include all the necessary costs to commission the infrastructure, including intermediate costs. • Following a review of the infrastructure's condition, the amount that would be necessary to deliver it in perfect condition is subtracted from the restitution/compensation.
Financing based		
Advantages	Disadvantages	Key Points to Take into Account
<ol style="list-style-type: none"> 1. It guarantees repayment of debt under any scenario and at any time, increasing the PPP contract's bankability. 2. It is a simple calculation that is easy to apply, and it helps to predict its future development to improve bankability. 	<ol style="list-style-type: none"> 1. The higher project leverage, the larger the restitution amount, which can serve as an incentive to increase risk. 2. As regards national accounts, it can be understood how this method guarantees debt and therefore consolidates it (according to Eurostat, this is understood to occur only in cases attributable to the contractor). 	<ul style="list-style-type: none"> ▪ It requires details about how to estimate lost profits in the event of ET by the government. ▪ All the costs related to the early debt repayment need to be included. ▪ In cases of ET for a reason attributable to the PPP contractor, and to prevent the unjust enrichment of the government, it would be necessary to envisage the equity repayment in the compensation.
Market Value		
Advantages	Disadvantages	Key Points to Take into Account
<ol style="list-style-type: none"> 1. No contingencies for the government. The project is not included in the national accounts (unless the government has an express payment obligation if there is no buyer on the market). 2. Method is more in line with the project's economic reality. 	<ol style="list-style-type: none"> 1. The restitution amount is difficult to estimate a priori, creating uncertainty for sponsors and financiers. 2. The repayment of the financing is not guaranteed, which can result in a negative impact on bankability. 3. It can create complications with the project's execution schedule. 	<ul style="list-style-type: none"> ▪ If this method is applied in an ET case for causes not attributable to the PPP contractor, the costs of the new tendering procedure should not be borne by it. The contracting authority should value some form of mitigation and include it in the compensation in relation to the repayment of current debt, in addition to the costs for prepayment and other costs directly linked to the ET.

4.5 Certainty in Calculating Early Termination

The valuation methodologies and rules, as well as their clarity and certainty, are equally important as they can have an impact depending on the different stakeholders that participate in a PPP contract. For public authorities, the payment of restitution or compensation for ET, whether due to causes attributable to the contracting authority or to the PPP contractor, can represent a very significant expenditure amount. That amount can have a substantial impact on public budgets; therefore, that payment must be recorded as a contingent liability. It is important to regularly monitor the payment, to prevent any surprises that could affect the soundness of the State's fiscal budget.

As regards the PPP contractor, the certainty and clarity provided by rules about ET have a direct impact on the ability to recoup its investment. The private partner is investing with its capital and must be certain about what would happen in the event of a termination in any scenario. If there are clear rules when tendering the contract, this will have a positive effect on the PPP contractor when it comes to submitting bids and, as a result, the cost to the government will be lower.

As far as financial institutions are concerned, restitution or compensation for ET is a key factor in the bankability of PPP projects. Financial institutions generally perform economic and financial analyses that include termination payments. Certainty in the process helps to improve financing, terms, and prices, which results in more bankable projects and better financing conditions.

4.6 Other Considerations and Possible Improvements

The existing valuation methodologies may be vague in many aspects. Certain issues are not addressed and leave gaps in the majority of PPP legislation and contracts. A list of points and possible improvements that policy makers and decision makers must take into account when calculating restitution and compensation for ET is provided below.

Considerations

1. A lack of clarity regarding damages in cases of ET for reasons attributable to the contracting authority: there are no clear guidelines about how damages are calculated, despite that fact that they affect not only the PPP contractor but also all the contractors that have made commitments to carry out the project. In such cases, the recognition of some form of lost profit could be considered for the PPP contractor and any contractors playing a specific role in the contract.
2. Little or no clarification is provided about the effect of enforcing guarantees and insurance policy settlements: when the early contract termination occurs, policies and insurance can be used to cover specific events in some way. If this payment is received, where it is discounted from and who receives the amounts should be analyzed.
3. Cash balance in project accounts: most PPP contracts require revenue flows to be kept in special accounts (such as the debt service reserve account, major maintenance reserve account, and the operations and maintenance account) for the purpose of mitigating the risk of failing to meet contractual obligations during the project's life cycle. These amounts must be taken into account when calculating restitution and compensation, as well as who will receive these amounts.

4. Outstanding balances and third-party claims/compensation: they must also be taken into account when calculating restitution and compensation commitments with suppliers and creditors, or any other contractor associated with the PPP contractor at that time.
5. Lack of a clearly defined payment process: once the restitution or compensation amount has been determined, it is important to define the process and payment terms, determine whether there will be one or several payments, whether there are maximum payment terms, or if it is possible to delay the payment of restitution/compensation, considering all the possible consequences on the operation and maintenance of the infrastructure.

Possible Improvements

1. Definition of compensation amounts (in the case of a government decision): this helps to limit the contingency for the government, providing clarity on the amounts required each year. This helps to limit uncertainty among private investors and financial institutions and provide flexibility to allow adjustments to the amount based on the specific project situation.
2. Definition of a maximum payment in the specifications: this limits possible contingencies for the government. This can provide the parties with certainty as they will know the maximum/minimum amount that they can receive/pay. Although this is a possible improvement, it should be noted that it could have a negative implication if the PPP contractor and the financial institutions consider the amount to be insufficient.
3. Improving project bankability: better financial conditions can be achieved by giving priority and clarity to payments to financial institutions; granting step-in rights to banks; defining total penalty amounts so that financiers have clear visibility as to what the restitution or compensation amounts are at any time; or clarifying the costs of interruption of financing.
4. Allocations to reserve accounts: include balances or allocations to reserve accounts to reduce the risk of the reversion of infrastructure being unsatisfactory at the time of early termination and to allow it to continue operating.
5. Payment procedure and schedule: to provide clarity about the procedure to calculate restitution and compensation and establish a payment schedule in the specifications.

Main Conclusions

The termination of PPP contracts has significant implications for government authorities, private partners, and users, who depend on the quality and continuity of a public service. An in-depth analysis has been provided in this Discussion Paper of key elements that help to define and manage contract termination, for the purpose of clarifying the topic and developing key messages to help decision makers, both in the public and private sectors, to better address this issue with a view to improving the development of PPP projects and programs.

The main conclusions drawn from each point of analysis are presented in bullet points below.

Rules and Procedures

- The laws that regulate termination processes vary from one country to another depending on their legal system, whether or not a PPP law is in force, the effectiveness of regulations, and the maturity of PPP markets.
- In the LAC region, termination rules originate from similar scenarios. The differences between countries lie in the level of detail covered in each one, the sophistication of processes, and the rules for calculating restitution and compensation for the private partner in the event of early contract termination.
- Rules and processes that are clearly and transparently developed have positive effects for all parties involved. For example, they can help to reduce losses in long-term contracts that are no longer viable; they can help to reduce the opportunistic behavior of private partners and contracting authorities which may seek a way out of the contract that benefits their position; and to attract financial institutions that want to financially quantify their investment exposure.
- The comparative analysis of six countries revealed that the causes of ET in different circumstances (due to factors attributable to the PPP contractor or to the contracting authority, for public interest reasons, contract annulment, of force majeure) are generally similar; they also have similar scenarios that provide reasons for such an event. Different levels of detail are provided, with some contracts commonly using catch-all general clauses.
- Most of the countries studied have contract law that allows the contracting authority to terminate a contract, in one way or another, irrespective of the reason. In cases of ET due to a breach by the contracting authority, the PPP contractor does not always have the right to terminate the contract. In Brazil, an application must be filed first.
- Although procedures vary according to the country, jurisdiction, and reason for termination, there are best practices that are applied in all cases, such as the requirement to inform the responsible party of the breach of contract identified and provide an opportunity to resolve the situation.

Who Participates in the Process

- Good governance of PPP contracts results in projects with properly assigned risks; they are divided or shared between the contracting parties that are most capable of managing them.
- A transparent governance framework with institutions that have clear roles and responsibilities is key to properly managing the termination and fair restitution/compensation of the parties involved. This is essential because terminating a contract has legal consequences that can extend beyond the governance structure of the PPPs.
- The level of success that countries can achieve in developing PPPs is closely linked to the strength of their institutions and the frameworks established to govern, develop, and manage contracts.
- A common institutional challenge is the lack of information and experience shared between the teams developing the PPPs and the teams managing the contracts.
- Another major challenge is the lack of standardization between countries, and, sometimes, between subnational governments, as regards who participates in the management and resolution of contract termination processes and in what capacity.
- Service interruption is one of the main negative consequences of the early termination of PPP contracts. At the institutional level, attention should be paid to ensuring swift handling of the processes while considering the effect on users, whether by seeking remedies that do not interrupt the service provision or offering a temporary alternative.
- There are institutional mechanisms that can help to strengthen the administrative process. It is important to have a pre-structured administrative process set out in law or the contract that addresses contract termination and indicates the necessary steps to take if such a situation arises. These institutional mechanisms include arbitration, mediation, dispute settlement boards, and control entities, which can bring peace of mind to the process and ensure that contracts are properly managed.
- Corruption in PPPs can have negative costs for society and an economic downturn as it involves significant numbers of works being brought to a standstill. International anti-corruption mechanisms are based on the zero-tolerance principle, according to which an appeal for nullity is envisaged as a tool and contract annulment as a penalty for a corrupt act. However, it would be appropriate to analyze more balanced options that combine personal and material penalties for those responsible for the corrupt act, and, at the same time, guarantee project continuity.

Reversion of Assets

- In most PPP contracts the private partner is required to return the public asset in question to the contracting authority in a satisfactory condition, whether at the end of the contract term or in the event of early termination. A definition of “satisfactory condition” must be provided in the PPP contract, with clearly measurable technical standards.

- In early termination cases, the asset reversion process is usually complex for the public sector, creating substantial difficulties as the property rights of many tangible and intangible assets are not defined, and this may cause issues when attempting to transfer them.
- One of the main challenges identified in PPP contracts is that private partners tend to carry out as little maintenance as possible to reduce costs, with the aim of maximizing earnings. PPP contracts must have a clear and well-defined asset return standard to reduce the likelihood of a contractor returning assets in poor conditions.
- One of the main points to consider in a reversion process is the legal transfer of the land used for the project to the State. The experience in Colombia with the road concession program shows that this has caused many conflicts between the project contractor and the contracting authority. Under the new 5G concession model, the reversion of the land in the project corridor area is flexible and aimed at achieving a balance; the contractor is granted five years to complete the transfer, with the option of extending this period under a penalty procedure with proportional availability discounts.
- Transferring environmental licenses to the public authority is a common problem, especially in projects that were terminated abruptly. Given the haste with which contracts are terminated early, this process can become complicated and cumbersome.
- Another common issue is the condition and handover of assets, such as vehicles and equipment, to the contracting authority. Apart from the condition of the assets, another frequent problem is that the vehicles and equipment may be acquired for the project by means of leasing contracts, which can lead to complications when an early contract termination occurs.
- Other complex issues concerning reversion include terminating business contracts and employment relationships with workers, transferring mining rights, and meeting social compensation commitments.
- Based on the experience gained in the road concession program in Colombia, the ANI has developed a Reversion Manual that sets out the procedure and the necessary documents to carry out all the reversion processes. The purpose of the manual is to, inter alia, present a clear and specific guide, so that the parties understand the concepts and procedures; establish the necessary time frames for the project reversion process; and gather together all the reversion processes and standards.

Calculating Restitution and Compensation for ET

- There is no perfect calculation method. Each of the three basic methodologies (book value, financing based, and market value) have advantages and disadvantages. One focuses on the past, one on the future, and the third on the financing structure.
- The key factor in the bankability of a PPP is clarity and as much detail as possible in the contract, and in the general law on the quantification and payment terms of restitution and compensation for all cases of early termination.

- In some cases, renegotiating a new contract between the government and the sponsors and financial institutions may be a cheaper and more efficient alternative to payment for restitution/compensation.
- Lost profit must always be considered as the possibility that ET may occur for reasons not attributable to the PPP contractor.
- The conflict of interests between the government and the entities (bankability versus consolidation) must be reconciled.
- All causes of early termination must be evaluated on the basis of the law and the contract, and it is important for nullity of contract to be included in the law.
- In order to give visibility to calculations and procedures, it is possible to create “redemption windows” in the contract that the public and private sector have previously accepted.

Annexes

Examples of Asset Reversion in Projects in Colombia

VÍA AL PUERTO PRIVATE INITIATIVE - 4G





National
Infrastructure
Agency

Physical scope: length 111 km
Reversion date: 28 March 2019

STRENGTHS

1. The concessionaire complied with all formalities and procedures established in the ANI for the delivery of the infrastructure within the time frames stipulated in the contract.

DIFFICULTIES

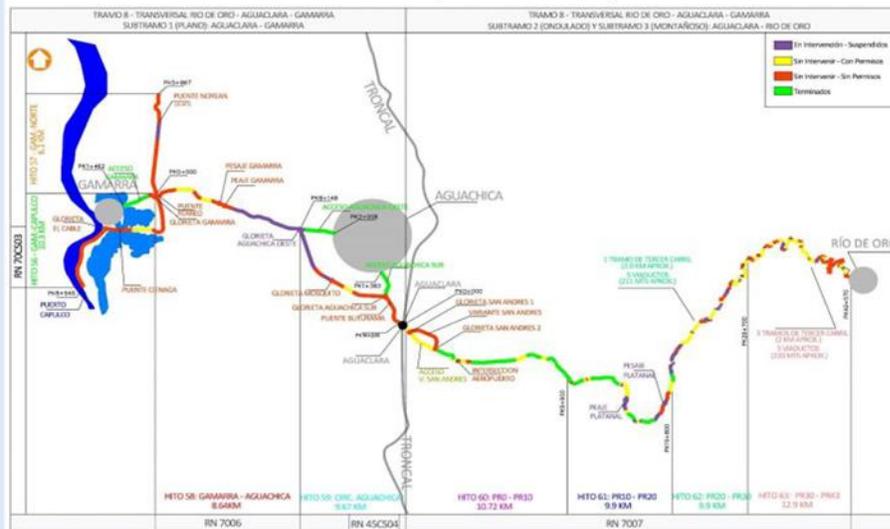
1. Transfer and/or subrogation of environmental licenses as the concession holder claimed that it was a case of subrogation, while the ANI and INVIAS claimed that it was a transfer, but the latter experienced many problems in receiving them.
2. Delays in handing over vehicles in the name of INVIAS.
3. The problems were raised by INVIAS.



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Ruta del Sol II

Illustration 2-12 Thematic map of the Transversal implementation status



Reversion date:
20 October 2017
Physical scope:
length 510 km



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Ruta del Sol II

DIFFICULTIES

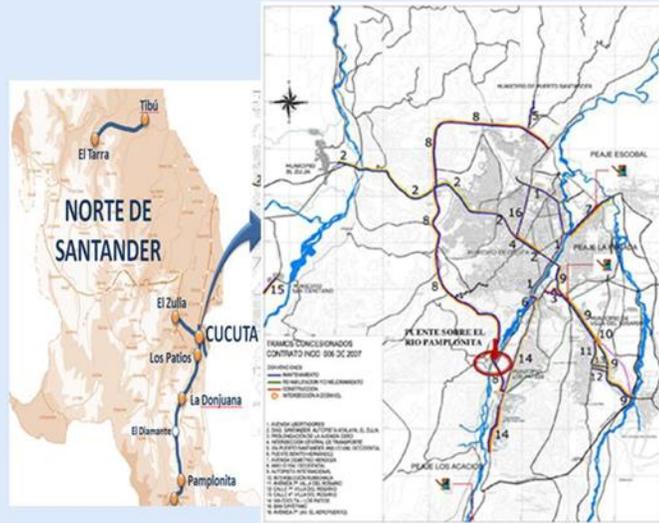
1. Ownership of most of the assets due to be reverted, including vehicles, immovable assets, and equipment, was not transferred to the National Agency.
2. The legal form, that is transfer or subrogation, according to which the ownership of the environmental licenses would be given to the ANI was not established.
3. Documents certifying the termination of business contracts, entered into by the concessionaire with private parties for commercial exploitation, could not be found.
4. The mining rights in the name of the Ruta del Sol S.A.S concessionaire had not been cancelled.
5. Social compensation commitments made by the concessionaire were not fulfilled.
6. The total amount of the concessionaire's liabilities could not be established at the time of reversion.
7. The termination of the employment relationship with the workers of the concessionaire and of its construction company, CONSOL, could not be established either.
8. It was not possible at the time to establish whether the concessionaire had managed and acquired the land in advance.
9. When attempting to verify the eligibility of the concessionaire's legal representative for the purpose of signing the reversion certificate, the legal representation certificate was not up to date.
10. It was not possible to check the documents and condition of the vehicles and equipment to be reverted to the National Agency.



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METROPOLITAN AREA OF CÚCUTA AND NORTH SANTANDER - 1G

Physical scope:
length 208.13 km
Reversion date:
30 July 2019



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METROPOLITAN AREA OF CÚCUTA AND NORTH SANTANDER - 1G

DIFFICULTIES

1. Return of vehicles allocated for the operation of the concession at the time of reversion, according to clauses in the contract (appendices), which outlined the possibility of subleasing those vehicles (tow trucks, ambulances, workshop cars, etc.) for the provision of those services, but they were required to be returned at the end of the contract.
2. The entities to which the infrastructure is reverted require improved technical specifications for the roads, without taking into account the basic contract scope.
3. Entities like INVIAS demand to carry out the reversion process with different procedures than those set out in the ANI reversion manual (they also request INVIAS forms to be completed).
4. A proposal is made to simplify reversion formalities, choosing to sign tripartite records in which the infrastructure is received from the concessionaire and, in the same record, it is delivered to the respective entity; the signature of separate records makes the process slow and cumbersome.



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META ROAD NETWORK - 4G



STRENGTHS

Reversion was planned in sections; some were incorporated into new projects that were set up, and others passed onto INVIAS with sufficient time to prepare and revise the inventories. The environmental dossiers had been closed in full.

Physical scope: length 188.3 km

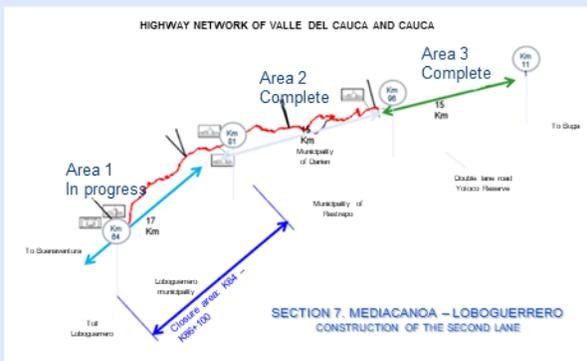
Reversion date: 9 June 2015 and 8 September 2015.



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ADDENDUM 13 TO CONTRACT No.005 of 1999



STRENGTHS

Areas 2 and 3 of section 7 covered by this addendum, following a declaration of nullity, were incorporated into the Vía al Puerto project on 24 February 2017

DIFFICULTIES

1. Environmental dossiers have not been closed.
2. Difficulties in transferring environmental licenses, as well as costs associated with pending activities.
3. Some equipment became obsolete.
4. In addendum 13, it was observed that the sudden contract termination created problems because the road was not in good enough condition to be made available to users.

Physical scope: length 147 km
Reversion date: 24 February 2017.



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Examples of Calculating Restitution/Compensation for Early Termination

Examples of regulation in contracts

L6 Metro Project, Sao Paulo, Brazil

Causes attributable to the concessionaire:

Contract	
Financing Based	
+	As a priority, the payment must take into account the value of the outstanding amount of payments for credits arranged by the concessionaire.
-	Compensation and payments to third parties as a result of ET
-	Fines, compensation, and any other payment that the concessionaire owes the contracting authority

Administration/Public interest reasons

Contract	
Book Value	
+	Investment value linked to reversible assets not depreciated or amortized
+	Compensation and payments to third parties as a result of ET
-	Fines, compensation, and any other payment that the concessionaire owes the contracting authority



Different valuation methods depending on the cause of ET



Examples of contract regulation

Uruguay Central Railway Project (i)

Causes attributable to the concessionaire

Contract	
Book Value	
+	Non-amortized investment from the Final Recognized Price* applying straight-line depreciation
-	Necessary repair costs
-	Prepayments by the contracting authority
+	Costs of interests incurred until commissioning
+	Cost of debt structuring and availability fee
-	Damages (70 times the maximum per day price in operation and 180 in construction)

Causes attributable to the administration

Contract	
Book Value	
+	Non-amortized investment from the Final Recognized Price applying straight-line depreciation
-	Necessary repair costs
-	Fines, expenses, and penalties executed from the performance bond
+	Necessary additional investments not paid, if applicable
+	Damages (70 times the maximum per day price in operation and 180 in construction)

Force majeure (operation/construction)

Contract	
Book Value	
+	Investment actually carried out, minus the amount paid in advance for the availability payment.



Same compensation for damages in both cases, for the administration or the concessionaire depending on the cause of the ET



*Investment amount recognized by the administration at the end of the construction phase

Examples of completed ET

Financing Based

Ruta del Sol II - Colombia	
Description	Highway construction
CAPEX	USD 1,200 M
Cause of ET	Breach by concessionaire (Odebrecht corruption)
Attributable to the	Administration
Method	Financing Based (total debt + 70% equity)
Amount	USD 64 M (equity) + USD 370 M (debt)
When	Up to 1 year after settlement
How	Several payments (to trade creditors and shareholders)



Examples of completed ET

Net book value

Madrid radial highways and other highways under PPPs (9 in total) – Spain	
Description	Construction of new highways
CAPEX	USD 7,250 M
Cause of ET	Construction and expropriation cost overruns, lower traffic and, as a consequence, no refinancing (mini-perm).
Attributable to the	concessionaire
Method	Net asset value
Amount	USD 4,000 M (concessionaires' estimate) vs USD 2,000 M (Administration's estimate).
When	6 months from the concessionaire's settlement (still pending).
How	Single payment



Examples of mechanisms regulated in contracts

RED project Aragon

Termination by Government declaration

Contract
<p>Redemption</p> <p>The Government reserves the right to unilaterally terminate the concession contract in years 10, 15, 20 and 25 of the contract. If it is terminated, the concessionaire must be informed one year in advance. The compensation amount at any time will be the amount the concessionaire included in the bid (no limits or criteria are defined to establish this amount). The amount defined by the concessionaire is a bid variable.</p> <p>In other cases ET compensation is calculated in accordance with the provisions of current legislation (Law on Public Service Contracts), i.e. Book Value + Lost Profits (for causes attributable to the Government)</p>

