REQUEST FOR EXPRESSIONS OF INTEREST
CONSULTING SERVICES

Selection #: RG-E1642-P001
Selection Method: Full competitive
Country: Regional
Sector: IFD/CMF
Funding – TC #: RG-E1642
Project #: RG-E1642
Project name: Public Financial Assessment of Early Termination Risk in PPP contracts.
Description of Services: Development of a financial risk management framework to identify and assess public financial exposure to early termination risk of PPP contracts.

The Inter-American Development Bank (IDB) is executing the above-mentioned research project. For this project, the IDB intends to contract consulting services described in this Request for Expressions of Interest. Expressions of interest must be delivered using the IDB Portal for Bank Executed Operations (http://beo-procurement.iadb.org/home) by: *[March 2nd. 2020]*, 5:00 P.M. (Washington D.C. Time).

The consulting services ("the Services") include the development of a financial risk management framework to identify and assess public financial exposure to early termination risk of PPP contracts. The framework aims to: (i) reviewing, comparing and discussing strengths, weaknesses and potential adjustment for emerging markets to financial methodologies available to calculate early termination compensations under different termination scenarios; (ii) mapping current legal and regulatory status of early termination compensation in Latin American Countries; (iii) developing a financial tool to measure the yearly maximum financial exposure of the public sector during the life of a given PPP contract; and (iv) providing practical recommendations on how to manage the exposure to early termination during project preparation, construction phase and operational period, and how to pay the compensation in case of early termination. The estimated timeframe for completion this project is 7 months.

Eligible consulting firms will be selected in accordance with the procedures set out in the Inter-American Development Bank: *Policy for the Selection and Contracting of Consulting firms for Bank-executed Operational Work* - GN-2765-1. All eligible consulting firms, as defined in the Policy may express an interest. All eligible consulting firms, as defined in the Policy may express an interest. If the Consulting Firm is presented in a Consortium, it will designate one of them as a representative, and the latter will be responsible for the communications, the registration in the portal and for submitting the corresponding documents.

The IDB now invites eligible consulting firms to indicate their interest in providing the services described below in the draft summary of the intended Terms of Reference for the assignment. Interested consulting firms must provide information establishing that they are qualified to perform the Services (brochures, description of similar assignments, experience in similar conditions, availability of appropriate skills among staff, etc.). Eligible consulting firms may associate in a form of a Joint Venture or a sub-consultancy agreement to enhance their qualifications. Such association or Joint Venture shall appoint one of the firms as the representative.

Interested eligible consulting firms may obtain further information during office hours, 09:00 AM to 05:00 PM, (Washington D.C. Time) by sending an email to Juan Martinez Alvarez (jmar@iadb.org)

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Draft Summary of Terms of Reference

Public Financial Assessment of Early Termination Risk in PPP contracts

1. Background and Justification

Many Emerging Markets and Developing Economies have substantial infrastructure deficiencies they cannot address due to limited public budgets. In such cases the private sector can contribute to bring investments under public private partnerships (PPPs) arrangements. PPPs are long-term contracts between a private sponsor and a government entity, for the development and management of a public infrastructure, in which the private sponsor is providing the finance to construct, operate and maintain the new infrastructure (APMG, 2016). A big legacy and a significant concern of PPP contracts in Latin America and the Caribbean (LAC) along the last three decades is a very large number of contract renegotiations (OECD, 2014). After more than 25 years and more than 7,000 PPPs awarded in LAC countries, the incidence of contractual renegotiation remains very high, in the range of 50 to 80 percent of contracts (World Bank, 2017).

One of the major risks linked to contractual renegotiations is the risk of early termination. In LAC, contract renegotiation from 1984 to 2016 translated into 9% of the PPP contracts terminating early (World Bank, 2018). Early termination refers to the termination of a PPP contract prior to the scheduled end of its contract duration. An early termination event can typically be triggered by a serious breach of the provisions of a PPP contract by either the public contracting authority or the project company. The effect of termination is that the contractual relationship between the public and private parties comes to an end. Assets are divided between the two parties, and there is a settling of all outstanding obligations and a calculation of the compensation payable on termination (GIH, 2018).

Compensation is typically calculated depending on what party initiates the termination and differ under the following scenarios: (i) contracting authority default or voluntary termination; (ii) private partner default termination, and (iii) prolonged force majeure where no solution has been agreed to continue with the PPP Contract (World Bank, 2017). If early termination is caused by government default or voluntary buyback, the private sector should be compensated for lost profit in the remaining concession period, outstanding debts and additional costs due to the termination; if early termination is caused by private sector default, part of the initial investment should be compensated, and the government has no obligation to reimburse the equity that was invested; if early termination is caused by reasons of non-default, financial damages should be undertaken by both the government and the private sector, and the latter should be partially compensated for lost profit, outstanding debts and additional costs (Song, 2018).

Available literature regarding early termination risk concentrates on the main reasons leading to terminations as well as the legal implications of contractual terminations. Some publications lay out common compensation methodologies based on the party that initiates the termination, but these financial methodologies vary among countries. In cases of terminations initiated by the public sector, main methodological approaches are book value compensation and financing based compensations. The financing-based compensations are divided by source of financing between lenders and equity investors (main methodologies include “original return”, “market value”, and “future returns”). In cases of private sector default, most common methodologies are book value, market value and debt approach. In cases of *force majeure*, different approaches are taken but typically covers sums owed to the senior lenders, the equity contributions paid in by investors as well as payments owed to the subcontractors. However, most papers regarding compensation methodologies is primarily based on market practices from developed PPP markets that do not necessarily translate to emerging markets and do not include directions to the public sector on how to approach early terminations from a financial risk management perspective. Also, existing literature does not compare methodologies to evaluate which one is most suitable depending on lessons learnt from previous experience and relevant variables such as legal framework or access to information.

From the public sector perspective early termination is one of the most important financial risks when signing new PPP contracts and should be treated as a fiscal contingent liability (IMF, 2017). Most LAC countries do not have holistic financial risk management frameworks to estimate contingent liabilities arising from PPP contracts, including those from potential compensations from early terminations. Measuring the ex-ante financial exposure to early termination is critical to be able to fully assess fiscal exposure and potential impact of PPP contracts into public budgets. In this regard, the choice of compensation methodology for early termination raises numerous important issues, but the most basic issue highlighted previously, which governments typically neglect, is the financial liability it may impose on public budgets if the event of early termination materializes.

2. Scope of Services

The scope of service includes the development of a financial risk management framework to assess public financial exposure to early termination risk of PPP contracts. The framework aims to: (i) listing, reviewing, comparing and discussing strengths, weaknesses and potential adjustment for emerging markets to financial methodologies available to calculate early termination compensations under different termination scenarios; (ii) mapping current legal and regulatory status of early termination compensations in LAC countries; (iii) developing a financial tool to measure the yearly financial exposure of the public sector during the life of a given PPP contract; and (iv) providing practical recommendations on how to manage the exposure to early termination during project preparation, construction phase and operational period.

The projects aims to support answering the following questions for policy makers in LAC: What are the available methodologies to calculate compensations?; How could the government decide what methodology is most appropriate for country/sector/project context?; What is the key criteria to decide?; Can standard compensation methodologies be improved? Should they be adapted for emerging markets? If yes, how? What would be the key adjustments to consider?; How much would the public sector have to pay the private sector in cases of early termination applying different compensation methodologies?; What are the financial trade-offs governments make when selecting among different methodologies to calculate early termination?; How should governments integrate the assessment of the early termination exposure into the evaluation of fiscal contingent liabilities linked to PPP contracts? In case of compensation, when and how do the payments should be structured?

3. Key Activities

The selected consulting firm will have to carry out the following activities:

a. **Analytical framework (monograph):** The first part of the study will conduct a review of best practices and international standards to provide a taxonomy of: (i) regulatory and contractual provisions impacting the definition and calculation of early termination compensations, and (ii) financial methodologies for asset valuation and early termination compensation in different termination scenarios. The study will also include a brief academic literature review to describe recent research proposing new methodologies to develop compensation mechanisms for early termination[1]. The second part will encompass: (i) a comparative analysis of methodologies for asset valuation and early termination compensation, (ii) a discussion of what methodologies are better suited depending on key factors such as economic sector, project context, incentives, and access to information; (iv) recommendations on how to implement and/or adapt these methodologies to LAC countries in order to integrate them in the process of managing contingent liabilities; and (v) discussion on when and how compensation payments could be structured; (iii) high level mapping of current legal and regulatory status of early termination compensations in LAC countries included in the Infrascope Report[2].

b. **Case studies**. The services include the development of detailed case studies applying the proposed analytical framework to the context of specific projects. The study will incorporate in depth analysis of compensation methodologies in four countries. Also, the case studies will include examples of: (i) hypothetical projects facing early termination compensations to illustrate compensation methodologies and termination scenarios and/or (ii) real case studies explaining how the public sector determined the compensation during the termination process. The consulting firm will provide expert advice to the IBD project team in identifying four relevant LAC projects to be analyzed in depth; a preliminary assessment indicates Paraguay, Uruguay, Mexico and Colombia may be relevant markets for consideration.

c. **Practice Note.** Based on the activities above, the consulting firm will produce the final version of the analytical framework. The framework will also contain guidelines recommending the sequence of key analytical steps to design a compensation regulation for early termination of PPP contracts. The framework will also include principles, summary of best practices in establishing successful regulation and contractual clauses, analytical tools for decision making, and applied examples to guide governments of LAC countries when facing early termination scenarios. On the basis of the analysis under previous subsections (a) and (b) and bilateral exchanges with the relevant public sector institutions and private stakeholders, the consulting firm will produce a Practice Note as part of the monography, setting out good practice, enabling factors and recommendations to public sector decision-makers.

d. **Financial tool.** Development of tool to assess public financial exposure to early termination based on key PPP contractual terms (amortization schedule, compensation methodology, length of contract, etc.) and on different compensation methodologies under different termination scenarios: (i) private partner default termination, (ii) contracting authority default termination, (iii) voluntary termination by the contracting authority; and (iv) prolonged *force majeure* where no solution is feasible to

[1] For example, recent developments include methodologies that move from legal and accounting principles to quantitative methods for pricing the optimal early termination compensation such as real option theory (Lui, 2017), and bargaining -game model (Song, 2017).

[2] Infrascope, 2019.

continue with the PPP contract. A note documenting the development of the tool (financial models, compensation methodologies, assumptions and data sources) will also be included as part of this deliverable**.** The tool will have to be delivered as an excel file.

e. **Dissemination activities.** The consulting firm will also develop additional materials to meet IDB's dissemination strategy. Dissemination and training materials will include products associated to the previous deliverables: (i) summary of main findings, conclusions and case studies included in the analytical framework (i.e. power points and brochures); and (ii) user guide to explain how to operate the financial tool. The goal of this activity is to have a set of materials to disseminate content on IDB workshops, events and training sessions with policy makers. The consulting firm will be requested to participate in at least one IDB thematic workshop to present main deliverables. The consulting firm will produce a report with all the feedback provided during the workshop.