INFRASTRUCTURE CONCESSION CONTRACTS: AN INTRODUCTION

What is infrastructure concession contract? What are the advantages and disadvantages of concession contracts? This paper addresses these two questions. Also, it outlines the basics of infrastructure concession contracts.

1. Introduction

Ownership of public assets is a sensitive issue for all governments. However, budgetary shortfalls as well as the repeated failure of governments all over the world to maintain these assets have forced them to change their attitude towards private ownership of such assets. As a result, policymakers have devised various ways in which the private sector can be brought in to maintain and operate public assets. Thus, concession contracts, through which ownership rights continue to reside with public authorities save operation rights and associated returns being transferred to private players, have been gaining popularity around the world.

Under concession contract, private partner gets exclusive rights from the government to operate, maintain and sometimes even carry out investment in a public utility for a given period of time. In return, the private party pays either a fixed sum, a percentage of revenue from the utility or a combination of the two to the government for exclusive rights over a facility. Revenue to the private party comes from the user fee charged to users of the facility. There are different types of concession contracts, including: ex-leasing, franchise, build-operate-transfer (BOT) etc. Private finance initiatives (PFIs) may also be considered similar to concessions.

The major advantage of a concession is that it allows certain public assets, for which private ownership is economically inefficient and politically not possible, to be maintained and operated efficiently by private players. Bidding for concession contracts introduces competition into the industry, albeit in an artificial sense. Such competition often induces private players to minimise cost, as one of the criteria used for awarding a concession is price cap regulation, in which they need to state the minimum price they would charge for services provided. Finally, in concession, competition between firms occurs before investment commitment that generally creates enough space for optimal pricing.

On the negative side, concessions require complex design and monitoring systems: thus, they are difficult to implement. Moreover, it is not possible for a concession contract to cover all uncertainties involved; this implies that fixing one price over the period of contract often turns out to be unviable and creates space for renegotiation and its abuse. Furthermore, there are no incentives for the private party to maintain the facility well or undertake necessary investment towards the end of the contract period.

2. How Do Concessions Work?

"Concession contracts are typically defined by the following four features:

1. The contract governs the relationship between the concession-granting authority and the private concessionaire. The concession-granting authority is the government, an inter-ministerial commission, or less common – and the least appropriate – the regulatory agency.

2. The concession is awarded for a limited but potentially renewable period, during which concessionaire enjoys the exclusive right to use the assets, exploit existing facilities, and develop new ones. The contract determines conditions under which concessionaire uses these facilities and the prices at which it provides the service. The facility continues to be publicly owned.

3. The concessionaire is responsible for all investments and for developing all new facilities – many of which are specified in the contract – under the supervision of state or regulator. The concessionaire retains control and use rights over the new assets until they are handed over at the expiration of the contract. The contract might contain a clause specifying compensation for investments not fully amortised by the end..."
of the concession period, and clauses specifying causes and remedies for early termination of contract and stating penalties and fines for non-compliance with agreed-upon terms.

4. The concessionaire is remunerated based on contractually established tariffs (with appropriate guidelines for review and adjustment) collected directly from users. These prices are typically regulated through rate-of-return or price-cap mechanisms, usually driven by the principle of “efficient financial equilibrium” – allowing the firm to earn a fair rate of return on its investments. If revenues do not cover costs, compensation mechanisms are established (see Kerf and others, 1998).

Given a wide range of settings in which they are used, concessions are often far more complicated than these basic features suggest. Concession contracts also usually contain other obligations and rights that require regular regulatory oversight in monitoring compliance, reconciliation of interpretations, adjustment of tariffs in the event of contingency, periodic (usually quinquennial) tariff reviews, and renegotiation of triggers and terms. The government’s role thus involves setting rules for competition at the bidding stage and enforcing terms of agreement and compliance with regulations.¹

3. Awarding Concession

Generally, the awarding process has to be competitive to ensure efficiency. The common trend is to follow a competitive bidding process. However, in some exceptional situations the government has to go for direct award of the concession or through bilateral negotiations. Thus, there are two ways of awarding concession – direct award and competitive bidding.

_Bilateral negotiation_ is considered to be less efficient compared to competitive bidding as the concessionaire selected through this process may not be the best available in terms of ability to manage the given public asset. He may not be the one likely to pay the highest concession fee or charge the most efficient rent from the consumer. Therefore, ’bilateral negotiations’ to award concessions should be avoided, except when there is only one candidate for a concession.

_Competitive bidding_ is the most commonly followed practice throughout the world, and is used to find the most efficient firm in the market. The process starts with some pre-qualification of potential buyers based on financial and technical criteria that reduce the number of bidders, but at the same time lower the risk of non-compliance by a defective bidder. However, when compared to bilateral negotiations, competitive bidding is associated with a higher probability of renegotiation. This is because bidders under a competitive bidding process often tend to quote tariffs that are less than the long run marginal cost of providing the service. As a result, they often try to renegotiate tariff levels during the contract period.

4. Selection of Concessionaire

Once the concession is awarded through competitive bidding, next stage is the selecting concessionaire, which is based on an open competitive bidding. After specifying important parameters (technical and non-technical), the short listed bidders are asked to bid on various factors depending on the nature of the project. For instance, under highway projects, bidders are allowed to bid on the amount of grants sought by

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¹ Adopted from J. Luis Guasch, “Granting and renegotiating Infrastructure Concessions Doing it Right” WBI Development Studies, pg 27.

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**Flowchart 1: A Typical Framework of a Concession Contract**

Awarding Process

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Selection of Concessionary

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Constructing/Building the Asset

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Start of Actual Functioning of the Asset (Status of the asset is A)

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Final Evaluation at the End of the Concession period

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Returning the Asset Back to the Government or Renewing the Concession or Re-bidding (Status of the asset is B)
and them. And one who states the lowest amount wins the bid. If the crucial variable is the concession fee, then the one who states the highest concession fee is the winner. And if the project is on a revenue sharing basis, then the bidder, who offers the highest revenue, share will be the winner. In some projects a bidder who asks for the lowest amount of subsidy for the concession period gets the tender if certain other conditions are satisfied.

Other criteria used are minimum duration of the concession, largest investment value, minimum total revenue, largest number of retained workers, and the best overall proposal etc. Sometimes multiple criteria are also used to select the concessionaire. In such cases, combinations of two or more criteria are used in selecting the concessionaire.

5. Concession Period
Concession period is determined by factors, which are project specific such as capacity of the asset to generate revenue, user tariffs, total investment, depreciation and operation and maintenance cost of the asset etc. For example, in port related projects, determining factors for the length of concession would be the capacity of the port terminal to handle cargo and average demand for port services. In case demand is uncertain in nature, a long concession period is preferred to mitigate the risk.

Concession period usually reflects the number of years required to recover the investment. For long duration concessions, fixing a particular time period for full amortisation is usually not feasible as infrastructure services require continuous investments that cannot be predicted well in advance; investments almost always must be made toward the end of the contract and cannot be amortised before its expiration (J L Guasch, 2004).

6. User Fee/Tariff
Determining user tariffs should be governed by precise rules as tariff levels influence revenue streams of projects significantly. User tariffs are also important in determining the length of the concession. In case other things remain equal, the higher the user tariffs the lower would be the concession period and vice versa. On many occasions user tariffs are also determined at the time of selecting the concessionaire. One who quotes the minimum user charge gets the tender.

7. Operation and Maintenance (O&M)
O&M of the project is one of the most important factors in determining quality of services to be delivered. While the concessionaire is responsible for O&M throughout the project life, government does monitor these activities to ensure quality of service. O&M is also important because the asset at the end of the project needs to be given back to government in the same condition as it was at the time of starting of the operation or even in an improved form.

8. Reversal of Assets
Returning the asset back to the government in good condition is a crucial stipulation of the concession agreement. Once quality of the asset is ensured, government can either take over the asset or go for re-bidding. In India, however, most projects based on concession agreements are either at a preliminary stage or halfway through their concession periods. There is hardly any information available on projects, for which the first concession period is over. As a result, there is not much awareness about how exactly reversal of assets is carried out in infrastructure projects. However, some questions are still to be explored: what happens to the asset once the government takes it over? How does the government decide which assets will go for re-bidding and which ones will be run by the government itself? How does the government ensure quality of service when it takes over the assets?

9. Conclusion
Variables that are negotiated at the time of the bidding process have wide implications for the reversal of assets that occur at the end of the concession contract. Therefore, it is important that the concession contracts are designed efficiently and effectively to ensure better quality of services not only at the beginning or during the concession contract, but also towards the end and henceforth. An important question in this context would be how optimally the concession contract is being designed and managed, keeping in mind the complex relationships among different variables. Optimisation of the concession contract implies the use of specific techniques to determine the most cost-effective and efficient solution for the design of concession contracts.