

UNCITRAL

Legislative Guide

on Privately Financed

Infrastructure Projects

Prepared by the United Nations
Commission on International Trade Law



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Preface

The present *Legislative Guide* was prepared by the United Nations Commission on International Trade Law (UNCITRAL). In addition to representatives of member States of the Commission, representatives of many other States and of a number of international organizations, both intergovernmental and non-governmental, participated actively in the preparatory work.

The Commission considered possible work to be undertaken in the field of privately financed infrastructure projects in 1996, in the light of a note by the Secretariat on build-operate-transfer (BOT) projects.¹ The Commission decided to prepare a legislative guide and requested the Secretariat to prepare draft chapters of such a guide.² The Commission reviewed the drafts chapters from its thirtieth to its thirty-third sessions.³ The Commission adopted the *Legislative Guide* at its thirty-third session, held in New York from 12 June to 7 July 2000, subject to editorial modifications left to the Secretariat, and requested the Secretariat to ensure its widest possible dissemination.⁴

¹“Build-operate-transfer projects: note by the Secretariat” (A/CN.9/424) (*Yearbook of the United Nations Commission on International Trade Law 1996* (hereinafter referred to as the “*UNCITRAL Yearbook*”) (United Nations publication, Sales No. E.98.V.7, vol. XXVII), part two, chap. V).

²See *Official Records of the General Assembly, Fifty-first Session, Supplement No. 17 (A/51/17)*, paras. 225-230 (*UNCITRAL Yearbook 1996*, part one).

³See *ibid.*, *Fifty-second Session, Supplement No. 17 (A/52/17)*, paras. 231-247 (*UNCITRAL Yearbook 1997*, vol. XXVIII (United Nations publication, Sales No. E.99.V.6), part one); *ibid.*, *Fifty-third Session, Supplement No. 17 (A/53/17)*, paras. 12-206 (*UNCITRAL Yearbook 1998*, vol. XXIX (United Nations publication, Sales No. E.99.V.12), part one); and *ibid.*, *Fifty-fourth Session, Supplement No. 17 (A/54/17)*, paras. 12-307).

⁴See *Official Records of the General Assembly, Fifty-fifth Session, Supplement No. 17 (A/55/17)*, para. 372.

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Consolidated legislative recommendations

Foreword

The following pages contain a set of recommended legislative principles entitled “legislative recommendations”. The legislative recommendations are intended to assist in the establishment of a legislative framework favourable to privately financed infrastructure projects. The legislative recommendations are followed by notes that offer an analytical introduction with references to financial, regulatory, legal, policy and other issues raised in the subject area. The user is advised to read the legislative recommendations together with the notes, which provide background information to enhance understanding of the legislative recommendations.

The legislative recommendations deal with matters that it is important to address in legislation specifically concerned with privately financed infrastructure projects. They do not deal with other areas of law that, as discussed in the notes to the legislative recommendations, also have an impact on privately financed infrastructure projects. Moreover, the successful implementation of privately financed infrastructure projects typically requires various measures beyond the establishment of an appropriate legislative framework, such as adequate administrative structures and practices, organizational capability, technical expertise, appropriate human and financial resources and economic stability.

For host countries wishing to promote privately financed infrastructure projects it is recommended that the following principles be implemented by the law:

I. General legislative and institutional framework

Constitutional, legislative and institutional framework (see chap. I, “General legislative and institutional framework”, paras. 2-14)

Recommendation 1. The constitutional, legislative and institutional framework for the implementation of privately financed infrastructure projects should ensure transparency, fairness, and the long-term sustainability of projects. Undesirable restrictions on private sector participation in infrastructure development and operation should be eliminated.

Scope of authority to award concessions (see chap. I, “General legislative and institutional framework”, paras. 15-22)

Recommendation 2. The law should identify the public authorities of the host country (including, as appropriate, national, provincial and local authorities) that are empowered to award concessions and enter into agreements for the implementation of privately financed infrastructure projects.

Recommendation 3. Privately financed infrastructure projects may include concessions for the construction and operation of new infrastructure facilities and systems or the maintenance, modernization, expansion and operation of existing infrastructure facilities and systems.

Recommendation 4. The law should identify the sectors or types of infrastructure in respect of which concessions may be granted.

Recommendation 5. The law should specify the extent to which a concession might extend to the entire region under the jurisdiction of the respective contracting authority, to a geographical subdivision thereof or to a discrete project, and whether it might be awarded with or without exclusivity, as appropriate, in accordance with rules and principles of law, statutory provisions, regulations and policies applying to the sector concerned. Contracting authorities might be jointly empowered to award concessions beyond a single jurisdiction.

Administrative coordination (see chap. I, “General legislative and institutional framework”, paras. 23-29)

Recommendation 6. Institutional mechanisms should be established to coordinate the activities of the public authorities responsible for issuing approvals, licences, permits or authorizations required for the implementation of privately financed infrastructure projects in accordance with statutory or regulatory provisions on the construction and operation of infrastructure facilities of the type concerned.

Authority to regulate infrastructure services (see chap. I, “General legislative and institutional framework”, paras. 30-53)

Recommendation 7. The authority to regulate infrastructure services should not be entrusted to entities that directly or indirectly provide infrastructure services.

Recommendation 8. Regulatory competence should be entrusted to functionally independent bodies with a level of autonomy sufficient to ensure that their decisions are taken without political interference or inappropriate pressures from infrastructure operators and public service providers.

Recommendation 9. The rules governing regulatory procedures should be made public. Regulatory decisions should state the reasons on which they are based and should be accessible to interested parties through publication or other means.

Recommendation 10. The law should establish transparent procedures whereby the concessionaire may request a review of regulatory decisions by an independent and impartial body, which may include court review, and should set forth the grounds on which such a review may be based.

Recommendation 11. Where appropriate, special procedures should be established for handling disputes among public service providers concerning alleged violations of laws and regulations governing the relevant sector.

II. Project risks and government support

Project risks and risk allocation (see chap. II, “Project risks and government support”, paras. 8-29)

Recommendation 12. No unnecessary statutory or regulatory limitations should be placed upon the contracting authority’s ability to agree on an allocation of risks that is suited to the needs of the project.

Government support (see chap. II, “Project risks and government support”, paras. 30-60)

Recommendation 13. The law should clearly state which public authorities of the host country may provide financial or economic support to the implementation of privately financed infrastructure projects and which types of support they are authorized to provide.

III. Selection of the concessionaire

General considerations (see chap. III, “Selection of the concessionaire”, paras. 1-33)

Recommendation 14. The law should provide for the selection of the concessionaire through transparent and efficient competitive procedures adapted to the particular needs of privately financed infrastructure projects.

Pre-selection of bidders (see chap. III, “Selection of the concessionaire”, paras. 34-50)

Recommendation 15. The bidders should demonstrate that they meet the pre-selection criteria that the contracting authority considers appropriate for the particular project, including:

(a) Adequate professional and technical qualifications, human resources, equipment and other physical facilities as necessary to carry out all the phases of the project, namely, engineering, construction, operation and maintenance;

(b) Sufficient ability to manage the financial aspects of the project and capability to sustain the financing requirements for the engineering, construction and operational phases of the project;

(c) Appropriate managerial and organizational capability, reliability and experience, including previous experience in operating public infrastructure.

Recommendation 16. The bidders should be allowed to form consortia to submit proposals, provided that each member of a pre-selected consortium may participate, either directly or through subsidiary companies, in only one bidding consortium.

Recommendation 17. The contracting authority should draw up a short list of the pre-selected bidders that will subsequently be invited to submit proposals upon completion of the pre-selection phase.

Procedures for requesting proposals (see chap. III, “Selection of the concessionaire”, paras. 51-84)

Single-stage and two-stage procedures for requesting proposals

Recommendation 18. Upon completion of the pre-selection proceedings, the contracting authority should request the pre-selected bidders to submit final proposals.

Recommendation 19. Notwithstanding the above, the contracting authority may use a two-stage procedure to request proposals from pre-selected bidders when it is not feasible for it to formulate project specifications or performance indicators and contractual terms in a manner sufficiently detailed and precise to permit final proposals to be formulated. Where a two-stage procedure is used, the following provisions should apply:

(a) The contracting authority should first call upon the pre-selected bidders to submit proposals relating to output specifications and other characteristics of the project as well as to the proposed contractual terms;

(b) The contracting authority may convene a meeting of bidders to clarify questions concerning the initial request for proposals;

(c) Following examination of the proposals received, the contracting authority may review and, as appropriate, revise the initial project specifications and contractual terms prior to issuing a final request for proposals.

Content of the final request for proposals

Recommendation 20. The final request for proposals should include at least the following:

(a) General information as may be required by the bidders in order to prepare and submit their proposals;

(b) Project specifications and performance indicators, as appropriate, including the contracting authority's requirements regarding safety and security standards and environmental protection;

(c) The contractual terms proposed by the contracting authority;

(d) The criteria for evaluating the proposals, the relative weight to be accorded to each such criterion and the manner in which the criteria are to be applied in the evaluation of proposals.

Clarifications and modifications

Recommendation 21. The contracting authority may, whether on its own initiative or as a result of a request for clarification by a bidder, modify the final request for proposals by issuing addenda at a reasonable time prior to the deadline for submission of proposals.

Evaluation criteria

Recommendation 22. The criteria for the evaluation and comparison of the technical proposals should concern the effectiveness of the proposal submitted by the bidder in meeting the needs of the contracting authority, including the following:

- (a) Technical soundness;
- (b) Operational feasibility;
- (c) Quality of services and measures to ensure their continuity;
- (d) Social and economic development potential offered by the proposals.

Recommendation 23. The criteria for the evaluation and comparison of the financial and commercial proposals may include, as appropriate:

- (a) The present value of the proposed tolls, fees, unit prices and other charges over the concession period;
- (b) The present value of the proposed direct payments by the contracting authority, if any;
- (c) The costs for design and construction activities, annual operation and maintenance costs, present value of capital costs and operating and maintenance costs;
- (d) The extent of financial support, if any, expected from the Government;
- (e) Soundness of the proposed financial arrangements;
- (f) The extent of acceptance of the proposed contractual terms.

Submission, opening, comparison and evaluation of proposals

Recommendation 24. The contracting authority may establish thresholds with respect to quality, technical, financial and commercial aspects to be reflected in the proposals in accordance with the criteria set out in the request for proposals. Proposals that fail to achieve the thresholds should be regarded as non-responsive.

Recommendation 25. Whether or not it has followed a pre-selection process, the contracting authority may retain the right to require the bidders to

demonstrate their qualifications again in accordance with criteria and procedures set forth in the request for proposals or the pre-selection documents, as appropriate. Where a pre-selection process has been followed, the criteria should be the same as those used in the pre-selection proceedings.

Final negotiations and project award

Recommendation 26. The contracting authority should rank all responsive proposals on the basis of the evaluation criteria set forth in the request for proposals and invite for final negotiation of the project agreement the bidder that has attained the best rating. Final negotiations may not concern those terms of the contract which were stated as non-negotiable in the final request for proposals.

Recommendation 27. If it becomes apparent to the contracting authority that the negotiations with the bidder invited will not result in a project agreement, the contracting authority should inform that bidder that it is terminating the negotiations and then invite for negotiations the other bidders on the basis of their ranking until it arrives at a project agreement or rejects all remaining proposals.

Concession award without competitive procedures (see chap. III, “Selection of the concessionaire”, paras. 85-96)

Recommendation 28. The law should set forth the exceptional circumstances under which the contracting authority may be authorized to award a concession without using competitive procedures, such as:

(a) When there is an urgent need for ensuring continuity in the provision of the service and engaging in a competitive selection procedure would therefore be impractical;

(b) In case of projects of short duration and with an anticipated initial investment value not exceeding a specified low amount;

(c) Reasons of national defence or national security;

(d) Cases where there is only one source capable of providing the required service (for example, because it requires the use of patented technology or unique know-how);

(e) In case of unsolicited proposals of the type referred to in legislative recommendations 34 and 35;

(f) When an invitation to the pre-selection proceedings or a request for proposals has been issued but no applications or proposals were submitted or all proposals failed to meet the evaluation criteria set forth in the request for proposals, and if, in the judgement of the contracting authority, issuing a new request for proposals would be unlikely to result in a project award;

(g) Other cases where the higher authority authorizes such an exception for compelling reasons of public interest.

Recommendation 29. The law may require that the following procedures be observed for the award of a concession without competitive procedures:

(a) The contracting authority should publish a notice of its intention to award a concession for the implementation for the proposed project and should engage in negotiations with as many companies judged capable of carrying out the project as circumstances permit;

(b) Offers should be evaluated and ranked according to the evaluation criteria established by the contracting authority;

(c) Except for the situation referred to in recommendation 28 (c), the contracting authority should cause a notice of the concession award to be published, disclosing the specific circumstances and reasons for the award of the concession without competitive procedures.

Unsolicited proposals (see chap. III, “Selection of the concessionaire”, paras. 97-117)

Recommendation 30. By way of exception to the selection procedures described in legislative recommendations 14–27, the contracting authority may be authorized to handle unsolicited proposals pursuant to specific procedures established by the law for handling unsolicited proposals, provided that such proposals do not relate to a project for which selection procedures have been initiated or announced by the contracting authority.

Procedures for determining the admissibility of unsolicited proposals

Recommendation 31. Following receipt and preliminary examination of an unsolicited proposal, the contracting authority should inform the proponent, within a reasonably short period, whether or not there is a potential public interest in the project. If the project is found to be in the public interest, the contracting authority should invite the proponent to submit a formal proposal in sufficient detail to allow the contracting authority to make a proper evaluation of the concept or technology and determine whether the proposal meets the conditions set forth in the law and is likely to be successfully implemented at the scale of the proposed project.

Recommendation 32. The proponent should retain title to all documents submitted throughout the procedure and those documents should be returned to it in the event that the proposal is rejected.

Procedures for handling unsolicited proposals that do not involve proprietary concepts or technology

Recommendation 33. The contracting authority should initiate competitive selection procedures under recommendations 14–27 above if it is found that the envisaged output of the project can be achieved without the use of a process, design, methodology or engineering concept for which the author of the unsolicited proposal possesses exclusive rights or if the proposed concept or technology is not truly unique or new. The author of the unsolicited proposal should be invited to participate in such proceedings and may be given a premium for submitting the proposal.

Procedures for handling unsolicited proposals involving proprietary concepts or technology

Recommendation 34. If it appears that the envisaged output of the project cannot be achieved without using a process, design, methodology or engineering concept for which the author of the unsolicited proposal possesses exclusive rights, the contracting authority should seek to obtain elements of comparison for the unsolicited proposal. For that purpose, the contracting authority should publish a description of the essential output elements of the proposal with an invitation for other interested parties to submit alternative or comparable proposals within a certain reasonable period.

Recommendation 35. The contracting authority may engage in negotiations with the author of the unsolicited proposal if no alternative proposals are received, subject to approval by a higher authority. If alternative proposals are submitted, the contracting authority should invite all the proponents to negotiations in accordance with the provisions of legislative recommendation 29 (a)–(c).

Confidentiality (see chap. III, “Selection of the concessionaire”, para. 118)

Recommendation 36. Negotiations between the contracting authority and bidders should be confidential and one party to the negotiations should not reveal to any other person any technical, price or other commercial information relating to the negotiations without the consent of the other party.

Notice of project award (see chap. III, “Selection of the concessionaire”, para. 119)

Recommendation 37. The contracting authority should cause a notice of the award of the project to be published. The notice should identify the concessionaire and include a summary of the essential terms of the project agreement.

Record of selection and award proceedings (see chap. III, “Selection of the concessionaire”, paras. 120-126)

Recommendation 38. The contracting authority should keep an appropriate record of key information pertaining to the selection and award proceedings. The law should set forth the requirements for public access.

Review procedures (see chap. III, “Selection of the concessionaire”, paras. 127-131)

Recommendation 39. Bidders who claim to have suffered, or who may suffer, loss or injury owing to a breach of a duty imposed on the contracting authority by the law may seek review of the contracting authority's acts in accordance with the laws of the host country.

IV. Construction and operation of infrastructure: legislative framework and project agreement

General provisions on the project agreement (see chap. IV, “Construction and operation of infrastructure: legislative framework and project agreement”, paras. 1-11)

Recommendation 40. The law might identify the core terms to be provided in the project agreement, which may include those terms referred to in recommendations 41-68 below.

Recommendation 41. Unless otherwise provided, the project agreement should be governed by the law of the host country.

Organization of the concessionaire (see chap. IV, “Construction and operation of infrastructure: legislative framework and project agreement”, paras. 12-18)

Recommendation 42. The contracting authority should have the option to require that the selected bidders establish an independent legal entity with a seat in the country.

Recommendation 43. The project agreement should specify the minimum capital of the project company and the procedures for obtaining the approval by the contracting authority of the statutes and by-laws of the project company and fundamental changes therein.

The project site, assets and easements (see chap. IV, “Construction and operation of infrastructure: legislative framework and project agreement”, paras. 19-32)

Recommendation 44. The project agreement should specify, as appropriate, which assets will be public property and which assets will be the private property of the concessionaire. The project agreement should identify which assets the concessionaire is required to transfer to the contracting authority or to a new concessionaire upon expiry or termination of the project agreement; which assets the contracting authority, at its option, may purchase from the concessionaire; and which assets the concessionaire may freely remove or dispose of upon expiry or termination of the project agreement.

Recommendation 45. The contracting authority should assist the concessionaire in obtaining such rights related to the project site as necessary for the operation, construction and maintenance of the facility. The law might empower the concessionaire to enter upon, transit through, do work or fix installations upon property of third parties, as required for the construction, operation and maintenance of the facility.

Financial arrangements (see chap. IV, “Construction and operation of infrastructure: legislative framework and project agreement”, paras. 33-51)

Recommendation 46. The law should enable the concessionaire to collect tariffs or user fees for the use of the facility or the services it provides. The project agreement should provide for methods and formulas for the adjustment of those tariffs or user fees.

Recommendation 47. Where the tariffs or fees charged by the concessionaire are subject to external control by a regulatory body, the law should set forth the mechanisms for periodic and extraordinary revisions of the tariff adjustment formulas.

Recommendation 48. The contracting authority should have the power, where appropriate, to agree to make direct payments to the concessionaire as a substitute for, or in addition to, service charges to be paid by the users or to enter into commitments for the purchase of fixed quantities of goods or services.

Security interests (see chap. IV, “Construction and operation of infrastructure: legislative framework and project agreement”, paras. 52-61)

Recommendation 49. The concessionaire should be responsible for raising the funds required to construct and operate the infrastructure facility and, for that purpose, should have the right to secure any financing required for the project with a security interest in any of its property, with a pledge of shares of the project company, with a pledge of the proceeds and receivables arising out of the concession, or with other suitable security, without prejudice to any rule of law that might prohibit the creation of security interests in public property.

Assignment of the concession (see chap. IV, “Construction and operation of infrastructure: legislative framework and project agreement”, paras. 62 and 63)

Recommendation 50. The concession should not be assigned to third parties without the consent of the contracting authority. The project agreement should set forth the conditions under which the contracting authority might give its consent to an assignment of the concession, including the acceptance by the new concessionaire of all obligations under the project agreement and evidence of the new concessionaire's technical and financial capability as necessary for providing the service.

Transfer of controlling interest in the project company (see chap. IV, “Construction and operation of infrastructure: legislative framework and project agreement”, paras. 64-68)

Recommendation 51. The transfer of a controlling interest in a concessionaire company may require the consent of the contracting authority, unless otherwise provided.

Construction works (see chap. IV, “Construction and operation of infrastructure: legislative framework and project agreement”, paras. 69-79)

Recommendation 52. The project agreement should set forth the procedures for the review and approval of construction plans and specifications by the contracting authority, the contracting authority's right to monitor the construction of, or improvements to, the infrastructure facility, the conditions under which the contracting authority may order variations in respect of construction specifications and the procedures for testing and final inspection, approval and acceptance of the facility, its equipment and appurtenances.

Operation of infrastructure (see chap. IV, “Construction and operation of infrastructure: legislative framework and project agreement”, paras. 80-97)

Recommendation 53. The project agreement should set forth, as appropriate, the extent of the concessionaire's obligations to ensure:

- (a) The adaptation of the service so as to meet the actual demand for the service;
- (b) The continuity of the service;
- (c) The availability of the service under essentially the same conditions to all users;
- (d) The non-discriminatory access, as appropriate, of other service providers to any public infrastructure network operated by the concessionaire.

Recommendation 54. The project agreement should set forth:

- (a) The extent of the concessionaire's obligation to provide the contracting authority or a regulatory body, as appropriate, with reports and other information on its operations;
- (b) The procedures for monitoring the concessionaire's performance and for taking such reasonable actions as the contracting authority or a regulatory body may find appropriate, to ensure that the infrastructure facility is properly operated and the services are provided in accordance with the applicable legal and contractual requirements.

Recommendation 55. The concessionaire should have the right to issue and enforce rules governing the use of the facility, subject to the approval of the contracting authority or a regulatory body.

General contractual arrangements (see chap. IV, “Construction and operation of infrastructure: legislative framework and project agreement”, paras. 98-150)

Recommendation 56. The contracting authority may reserve the right to review and approve major contracts to be entered into by the concessionaire, in particular contracts with the concessionaire's own shareholders or related persons. The contracting authority's approval should not normally be withheld except where the contracts contain provisions inconsistent with the

project agreement or manifestly contrary to the public interest or to mandatory rules of a public law nature.

Recommendation 57. The concessionaire and its lenders, insurers and other contracting partners should be free to choose the applicable law to govern their contractual relations, except where such a choice would violate the host country's public policy.

Recommendation 58. The project agreement should set forth:

(a) The forms, duration and amounts of the guarantees of performance that the concessionaire may be required to provide in connection with the construction and the operation of the facility;

(b) The insurance policies that the concessionaire may be required to maintain;

(c) The compensation to which the concessionaire may be entitled following the occurrence of legislative changes or other changes in the economic or financial conditions that render the performance of the obligation substantially more onerous than originally foreseen. The project agreement should further provide mechanisms for revising the terms of the project agreement following the occurrence of any such changes;

(d) The extent to which either party may be exempt from liability for failure or delay in complying with any obligation under the project agreement owing to circumstances beyond their reasonable control;

(e) Remedies available to the contracting authority and the concessionaire in the event of default by the other party.

Recommendation 59. The project agreement should set forth the circumstances under which the contracting authority may temporarily take over the operation of the facility for the purpose of ensuring the effective and uninterrupted delivery of the service in the event of serious failure by the concessionaire to perform its obligations.

Recommendation 60. The contracting authority should be authorized to enter into agreements with the lenders providing for the appointment, with the consent of the contracting authority, of a new concessionaire to perform under the existing project agreement if the concessionaire seriously fails to deliver the service required or if other specified events occur that could justify the termination of the project agreement.

V. Duration, extension and termination of the project agreement

Duration and extension of the project agreement (see chap. V, "Duration, extension and termination of the project agreement", paras. 2-8)

Recommendation 61. The duration of the concession should be specified in the project agreement.

Recommendation 62. The term of the concession should not be extended, except for those circumstances specified in the law, such as:

(a) Completion delay or interruption of operation due to the occurrence of circumstances beyond either party's reasonable control;

(b) Project suspension brought about by acts of the contracting authority or other public authorities;

(c) To allow the concessionaire to recover additional costs arising from requirements of the contracting authority not originally foreseen in the project agreement that the concessionaire would not be able to recover during the normal term of the project agreement.

Termination of the project agreement (see chap. V, “Duration, extension and termination of the project agreement”, paras. 9-35)

Termination by the contracting authority

Recommendation 63. The contracting authority should have the right to terminate the project agreement:

(a) In the event that it can no longer be reasonably expected that the concessionaire will be able or willing to perform its obligations, owing to insolvency, serious breach or otherwise;

(b) For reasons of public interest, subject to payment of compensation to the concessionaire.

Termination by the concessionaire

Recommendation 64. The concessionaire should have the right to terminate the project agreement under exceptional circumstances specified in the law, such as:

(a) In the event of serious breach by the contracting authority or other public authority of their obligations under the project agreement;

(b) In the event that the concessionaire's performance is rendered substantially more onerous as a result of variation orders or other acts of the contracting authority, unforeseen changes in conditions or acts of other public authorities and that the parties have failed to agree on an appropriate revision of the project agreement.

Termination by either party

Recommendation 65. Either party should have the right to terminate the project agreement in the event that the performance of its obligations is rendered impossible by the occurrence of circumstances beyond either party's reasonable control. The parties should also have the right to terminate the project agreement by mutual consent.

Consequences of expiry or termination of the project agreement (see chap. V, “Duration, extension and termination of the project agreement”, paras. 36-62)

Transfer of assets to the contracting authority or to a new concessionaire

Recommendation 66. The project agreement should lay down the criteria for establishing, as appropriate, the compensation to which the concessionaire may be entitled in respect of assets transferred to the contracting authority or to a new concessionaire or purchased by the contracting authority upon expiry or termination of the project agreement.

Financial arrangements upon termination

Recommendation 67. The project agreement should stipulate how compensation due to either party in the event of termination of the project agreement is to be calculated, providing, where appropriate, for compensation for the fair value of works performed under the project agreement, and for losses, including lost profits.

Wind-up and transitional measures

Recommendation 68. The project agreement should set out, as appropriate, the rights and obligations of the parties with respect to:

- (a) The transfer of technology required for the operation of the facility;
- (b) The training of the contracting authority's personnel or of a successor concessionaire in the operation and maintenance of the facility;
- (c) The provision, by the concessionaire, of operation and maintenance services and the supply of spare parts, if required, for a reasonable period after the transfer of the facility to the contracting authority or to a successor concessionaire.

VI. Settlement of disputes

Disputes between the contracting authority and the concessionaire (see chap. VI, “Settlement of disputes”, paras. 3-41)

Recommendation 69. The contracting authority should be free to agree to dispute settlement mechanisms regarded by the parties as best suited to the needs of the project.

Disputes between project promoters and between the concessionaire and its lenders, contractors and suppliers (see chap. VI, “Settlement of disputes”, para. 42)

Recommendation 70. The concessionaire and the project promoters should be free to choose the appropriate mechanisms for settling commercial disputes among the project promoters, or disputes between the concessionaire and its lenders, contractors, suppliers and other business partners.

Disputes involving customers or users of the infrastructure facility (see chap. VI, “Settlement of disputes”, paras. 43-45)

Recommendation 71. The concessionaire may be required to make available simplified and efficient mechanisms for handling claims submitted by its customers or users of the infrastructure facility.

Introduction and background information on privately financed infrastructure projects*

A. Introduction

1. The roles of the public and the private sectors in the development of infrastructure have evolved considerably in history. Public services such as gas street lighting, power distribution, telegraphy and telephony, steam railways and electrical tramways were launched in the nineteenth century and in many countries they were provided by private companies that had obtained a licence or concession from the Government. Numerous privately funded road or canal projects were carried out at that time and there was a rapid development of international project financing, including international bond offerings to finance railways or other major infrastructure.

2. However, during most of the twentieth century the international trend was, in turn, towards public provision of infrastructure and other services. Infrastructure operators were often nationalized and competition was reduced by mergers and acquisitions. The degree of openness of the world economy also receded during this period. Infrastructure sectors remained privately operated only in a relatively small number of countries, often with little or no competition. In many countries the pre-eminence of the public sector in infrastructure service provision became enshrined in the constitution.

3. The current reverse trend towards private sector participation and competition in infrastructure sectors started in the early 1980s and has been driven by general as well as country-specific factors. Among the general factors are significant technological innovations; high indebtedness and stringent budget constraints limiting the public sector's ability to meet increasing infrastructure needs; the expansion of international and local capital markets, with a consequent improvement in access to private funding; and an increasing number of successful international experiences with private participation and competition in infrastructure. In many countries, new legislation was adopted, not only to govern such transactions, but also to modify the market structure and the rules of competition governing the sectors in which they were taking place.

*Section B of the present chapter is conceived as general background information on matters that are examined from a legislative perspective in the subsequent chapters of the *Guide*. For additional information, the reader is particularly advised to consult publications by other international organizations, such as the *Guidelines for Infrastructure Development through Build-Operate-Transfer (BOT) Projects*, prepared by the United Nations Industrial Development Organization (UNIDO publication, Sales No. UNIDO.95.6.E), the *World Development Report 1994: Infrastructure for Development* (New York, Oxford University Press, 1994) and the *World Development Report 1996: From Plan to Market* (New York, Oxford University Press, 1996), both published by the World Bank, or *Financing Private Infrastructure* (Washington, D.C., 1996), published by the International Finance Corporation.

4. The purpose of the present *Guide* is to assist in the establishment of a legal framework favourable to private investment in public infrastructure. The advice provided in the *Guide* aims at achieving a balance between the desire to facilitate and encourage private participation in infrastructure projects, on the one hand, and various public interest concerns of the host country, on the other. The *Guide* discusses a number of concerns of fundamental public interest, which, despite numerous differences of policy and legislative treatment, are recognized in most legal systems. Points of public concern include matters such as continuity in the provision of public services; adherence to environmental protection, health, safety and quality standards set by the host country; fairness of prices charged to the public; non-discriminatory treatment of customers or users, full disclosure of information pertaining to the operation of infrastructure facilities and the flexibility needed to meet changed conditions, including expansion of the service to meet additional demand. Fundamental concerns of the private sector, in turn, usually include issues such as stability of the legal and economic environment in the host country; transparency of laws and regulations and predictability and impartiality in their application; enforceability of property rights against violations by third parties; assurances that private property is respected by the host country and not interfered with other than for reasons of public interest and only if compensation is paid; and freedom of the parties to agree on commercial terms that ensure a reasonable return on invested capital commensurate with the risks taken by private investors. The *Guide* does not provide a single set of model solutions to address these concerns, but it helps the reader to evaluate different approaches available and to choose the one most suitable in the national or local context.

1. *Organization and scope of the Guide*

5. The *Guide* contains a set of recommended legislative principles entitled “legislative recommendations”. The legislative recommendations are intended to assist in the establishment of a legislative framework favourable to privately financed infrastructure projects. The legislative recommendations are followed by notes offering an analytical introduction with references to financial, regulatory, legal, policy and other issues raised in the subject area. The user is advised to read the legislative recommendations together with the notes, which provide background information to enhance understanding of the legislative recommendations.

6. The legislative recommendations deal with matters that it is important to address in legislation specifically concerned with privately financed infrastructure projects. They do not deal with other areas of law, which, as discussed in notes to the legislative recommendations, also have an impact on privately financed infrastructure projects. Moreover, the successful implementation of privately financed infrastructure projects typically requires various measures beyond the establishment of an appropriate legislative framework, such as adequate administrative structures and practices, organizational capability, technical expertise, appropriate human and financial resources and economic stability. Although some of these matters are mentioned in the notes, they are not addressed in the legislative recommendations.

7. The *Guide* is intended to be used as a reference by national authorities and legislative bodies when preparing new laws or reviewing the adequacy of existing laws and regulations. For that purpose, the *Guide* helps identify areas of law that are typically most relevant to private capital investment in public infrastructure projects and discusses the content of those laws which would be conducive to attracting private capital, national and foreign. The *Guide* is not intended to provide advice on drafting agreements for the execution of privately financed infrastructure projects. However, the *Guide* does discuss some contractual issues (for instance, in chaps. IV, “Construction and operation of infrastructure: legislative framework and project agreement” and V, “Duration, extension and termination of the project agreement”) to the extent that they relate to matters that might usefully be addressed in the legislation.

8. The *Guide* pays special attention to infrastructure projects that involve an obligation, on the part of the selected investors, to undertake physical construction, repair or expansion works in exchange for the right to charge a price, either to the public or to a public authority, for the use of the infrastructure facility or for the services it generates. Although such projects are sometimes grouped with other transactions for the “privatization” of governmental functions or property, the *Guide* is not concerned with “privatization” transactions that do not relate to the development and operation of public infrastructure. In addition, the *Guide* does not address projects for the exploitation of natural resources, such as mining, oil or gas exploitation projects under some “concession”, “licence” or “permission” issued by the public authorities of the host country.

2. Terminology used in the Guide

9. The following paragraphs explain the meaning and use of certain expressions that appear frequently in the *Guide*. For terms not mentioned below, such as technical terms used in financial and business management writings, the reader is advised to consult other sources of information on the subject, such as the *Guidelines for Infrastructure Development through Build-Operate-Transfer (BOT) Projects* prepared by the United Nations Industrial Development Organization (UNIDO).¹

(a) “Public infrastructure” and “public services”

10. As used in the *Guide*, the expression public infrastructure refers to physical facilities that provide services essential to the general public. Examples of public infrastructure in this sense may be found in various sectors and include various types of facility, equipment or system: power generation plants and power distribution networks (electricity sector); systems for local and long-distance telephone communications and data transmission networks (telecommunications sector); desalination plants, waste water treatment plants, water

¹UNIDO publication, Sales No. UNIDO.95.6.E, hereafter referred to as the *UNIDO BOT Guidelines*.

distribution facilities (water sector); facilities and equipment for waste collection and disposal (sanitation sector); and physical installations and systems used for public transportation, such as urban and inter-urban railways, underground trains, bus lines, roads, bridges, tunnels, ports, airlines and airports (transportation sector).

11. The line between publicly and privately owned infrastructure must be drawn by each country as a matter of public policy. In some countries, airports are owned by the Government; in others they are privately owned but subject to regulation or to the terms of an agreement with the competent public authority. Hospital and medical facilities, as well as prison and correctional facilities may be in public or private hands, depending on the country's preferences. Often, but not always, power and telecommunication facilities are in the public sector. No view is expressed in the *Guide* as to where the line should be drawn in a particular country.

12. The notions of public infrastructure and public services are well established in the legal tradition of some countries, being sometimes governed by a specific body of law, which is typically referred to as administrative law (see chap. VII, "Other relevant areas of law", paras. 24-27). However, in a number of other countries, apart from being subject to special regulations, public services are not regarded as being intrinsically distinct from other types of business. As used in the *Guide*, the expressions public services and public service providers should not be understood in a technical sense that may be attached to them under any particular legal system.

(b) "*Concession*", "*project agreement*" and related expressions

13. In many countries, public services constitute government monopolies or are otherwise subject to special regulation. Where that is the case, the provision of a public service by an entity other than a public authority typically requires an act of authorization by the appropriate governmental body. Different expressions are used to define such acts of authorization under national laws and in some legal systems various expressions may be used to denote different types of authorization. Commonly used expressions include terms such as "concession", "franchise", "licence" or "lease" ("*affermage*"). In some legal systems, in particular those belonging to the civil law tradition, certain forms of infrastructure projects are referred to by well-defined legal concepts such as public works concession or public service concession. As used in the *Guide*, the word "concession" is not to be understood in a technical sense that may be attached to it under any particular legal system or domestic law.

14. As used in the *Guide*, the term "project agreement" means an agreement between a public authority and the entity or entities selected to carry out the project that sets forth the terms and conditions for the construction or modernization, operation and maintenance of the infrastructure. Other expressions that may be used in some legal systems to refer to such an agreement, such as "concession agreement" or "concession contract", are not used in the *Guide*.

15. The *Guide* uses the word “concessionaire” to refer generally to an entity that carries out an infrastructure project under a concession issued by a public authority of the host country. The term “project company” is sometimes used in the *Guide* to refer specifically to an independent legal entity established for the purpose of carrying out a particular project.

(c) *References to national authorities*

16. As used in the *Guide*, the word “Government” encompasses the various public authorities of the host country entrusted with executive or policy-making functions, at the national, provincial or local level. The expression “public authorities” is used to refer, in particular, to entities of, or related to, the executive branch of the Government. The expressions “legislature” and “legislator” are used specifically with reference to the organs that exercise legislative functions in the host country.

17. The expression “contracting authority” is generally used in the *Guide* to refer to the public authority of the host country that has the overall responsibility for the project and on behalf of which the project is awarded. Such authority may be national, provincial or local (see below, paras. 69 and 70).

18. The expression “regulatory agency” is used in the *Guide* to refer to the public authority that is entrusted with the power to issue and enforce rules and regulations governing the operation of the infrastructure. The regulatory agency may be established by statute with the specific purpose of regulating a particular infrastructure sector.

(d) *“Build-operate-transfer” and related expressions*

19. The various types of project referred to in this *Guide* as privately financed infrastructure projects are sometimes divided into several categories, according to the type of private participation or the ownership of the relevant infrastructure, as indicated below:

(a) *Build-operate-transfer (BOT)*. An infrastructure project is said to be a BOT project when the contracting authority selects a concessionaire to finance and construct an infrastructure facility or system and gives the entity the right to operate it commercially for a certain period, at the end of which the facility is transferred to the contracting authority;

(b) *Build-transfer-operate (BTO)*. This expression is sometimes used to emphasize that the infrastructure facility becomes the property of the contracting authority immediately upon its completion, the concessionaire being awarded the right to operate the facility for a certain period;

(c) *Build-rent-operate-transfer (BROT) or “build-lease-operate-transfer” (BLOT)*. These are variations of BOT or BTO projects where, in addition to the obligations and other terms usual to BOT projects, the concessionaire rents the physical assets on which the facility is located for the duration of the agreement;

(d) *Build-own-operate-transfer (BOOT)*. These are projects in which a concessionaire is engaged for the financing, construction, operation and maintenance of a given infrastructure facility in exchange for the right to collect fees and other charges from its users. Under this arrangement the private entity owns the facility and its assets until it is transferred to the contracting authority;

(e) *Build-own-operate (BOO)*. This expression refers to projects where the concessionaire owns the facility permanently and is not under an obligation to transfer it back to the contracting authority.

20. Besides acronyms used to highlight the particular ownership regime, other acronyms may be used to emphasize one or more of the obligations of the concessionaire. In some projects, existing infrastructure facilities are turned over to private entities to be modernized or refurbished, operated and maintained, permanently or for a given period of time. Depending on whether the private sector will own such an infrastructure facility, those arrangements may be called either “refurbish-operate-transfer” (ROT) or “modernize-operate-transfer” (MOT), in the first case, or “refurbish-own-operate” (ROO) or “modernize-own-operate” (MOO), in the latter. The expression “design-build-finance-operate” (DBFO) is sometimes used to emphasize the concessionaire’s additional responsibility for designing the facility and financing its construction.

B. Background information on privately financed infrastructure projects

21. In most of the countries that have recently built new infrastructure through private investment, privately financed infrastructure projects are an important tool in meeting national infrastructure needs. Essential elements of national policies include the level of competition sought for each infrastructure sector, the way in which the sector is structured and the mechanisms used to ensure adequate functioning of infrastructure markets. National policies to promote private investment in infrastructure are often accompanied by measures destined to introduce competition between public service providers or to prevent abuse of monopolistic conditions where competition is not feasible.

22. In devising programmes to promote private sector investment in the development and operation of public infrastructure, a number of countries have found it useful to review the assumptions under which public sector monopolies were established, including the historical circumstances and political conditions that had led to their creation, with a view to

(a) identifying those activities which still maintain the characteristics of natural monopoly; and

(b) assessing the feasibility and desirability of introducing competition in certain infrastructure sectors.

1. Private investment and infrastructure policy

23. The measures that may be required to implement a governmental policy to promote competition in various infrastructure sectors will depend essentially on the prevailing market structure. The main elements that characterize a particular market structure include barriers to the entry of competitors of an economic, legal, technical or other nature, the degree of vertical or horizontal integration, the number of companies operating in the market as well as the availability of substitute products or services.

(a) Competition policy and monopolies

24. The term “monopoly” in the strict sense refers to a market with only one supplier. However, pure monopoly and perfect competition mark two ends of a spectrum. Most markets for commodities or services are characterized by a degree of competition that lies between those two extremes. Generally, monopolies can be classified as natural monopolies, legal monopolies and de facto monopolies; each of them may require different policy approaches;

(a) *Natural monopolies*. These are economic activities that allow a single provider to supply the whole market at a lower cost than two or more providers. This situation is typical for economic activities that entail large investment and high fixed costs, but decreasing costs of producing an additional unit of services (e.g. an additional cubic metre of water) to attend an increase of demand. Natural monopolies tend to exhibit large upfront fixed investment requirements that make it difficult for a new company, lacking comparable economies of scale, to enter the market and undercut the incumbent;

(b) *Legal monopolies*. Legal monopolies are established by law and may cover sectors or activities that are or are not natural monopolies. In the latter category, monopolies exist solely because competition is prohibited. The developments that had led many countries to the establishment of legal monopolies were often based on the consideration that national infrastructure needs, in terms of both quality and quantity, could not be adequately met by leaving infrastructure to the free market;

(c) *De facto monopolies*. These monopolies may not necessarily be the result of economic fundamentals or of legal provisions, but simply of the absence of competition, resulting, for example, from the integrated nature of the infrastructure company and its ability to control essential facilities to the exclusion of other suppliers.

25. Although monopolies are sometimes justified on legal, political or social grounds, they may produce negative economic effects. A service provider operating under monopolistic conditions is typically able to fix prices above those which would be charged in competitive conditions. The surplus profit that results from insufficient competition implies a transfer of wealth from consumers to producers. Monopolies have also been found to cause a net loss of welfare to the economy as a result of inflated prices generated by artificially low production; a reduced rate of innovation; and insufficient efforts to reduce

production costs. Furthermore, in particular in infrastructure sectors, there may be secondary effects on other markets. (For example, lack of competition and efficiency in telecommunications has negative repercussions through increases in cost for the economy at large.)

26. Despite their negative economic effects, monopolies and other regulatory barriers to competition have sometimes been maintained in the absence of natural monopoly conditions. One of the reasons cited for retaining monopolies is that they may be used to foster certain policy objectives, such as ensuring the provision of services in certain regions or to certain categories of consumer at low prices or even below cost. Examples of services for which the price may not cover costs include lifeline telephone, water or power service, discounted transport for certain categories of traveller (e.g. schoolchildren or senior citizens), as well as other services for low-income or rural users. A monopolistic service provider is able to finance the provision of such services through internal “cross-subsidies” from other profitable services provided in other regions or to other categories of consumer.

27. Another reason sometimes cited for retaining legal monopolies in the absence of natural monopoly conditions is to make the sector more attractive to private investors. Private operators may insist on being granted exclusivity rights to provide a certain service so as to reduce the commercial risk of their investment. However, that objective has to be balanced against the interests of consumers and the economy as a whole. For those countries where the granting of exclusivity rights is found to be needed as an incentive to private investment, it may be advisable to consider restricting competition, though on a temporary basis only (see chap. I, “General legislative and institutional framework”, paras. 20-22).

(b) Scope for competition in different sectors

28. Until recently, monopolistic conditions prevailed in most infrastructure sectors either because the sector was a natural monopoly or because regulatory barriers or other factors (e.g. vertically integrated structure of public service providers) prevented effective competition. However, rapid technological progress has broadened the potential scope for competition in infrastructure sectors, as discussed briefly below:

(a) *Telecommunication sector.* New wireless technology not only makes mobile telecommunication services possible, but it is also increasingly competing with fixed (wireline) services. Fibre optic networks, cable television networks, data transmission over power lines, global satellite systems, increasing computing power, improved data compression techniques, convergence between communications, broadcasting and data processing are further contributing to the breakdown of traditional monopolies and modes of service provision. As a result of these and other changes, telecommunication services have become competitive and countries are increasingly opening up the sector to free entry, while limiting access only to services that require the use of scarce public resources, such as radio frequency;

(b) *Energy sector.* In the energy sector, combined-cycle gas turbines and other technologies allowing for efficient power production on smaller scales and standardization in manufacturing of power generation equipment have led several countries to change the monopolistic and vertically integrated structure of domestic electricity markets. Increasing computing power and improved data-processing software make it easier to dispatch electricity across a grid and to organize power pools and other mechanisms to access the network and trade in electricity;

(c) *Transport sector.* Technology is in many cases also at the origin of changing patterns in the transport sector: the introduction of containers and other innovations, such as satellite communications, making it possible to track shipments across the globe, have had profound consequences on shipping, port management and rail and truck transport, while fostering the development of intermodal transport.

29. Technological changes such as these have prompted the legislatures in a number of countries to extend competition to infrastructure sectors by adopting legislation that abolishes monopolies and other barriers to entry, changes the way infrastructure sectors are organized and establishes a regulatory framework that fosters effective competition. The extent to which this can be done depends on the sector, the size of the market and other factors.

2. *Restructuring of infrastructure sectors*

30. In many countries, private participation in infrastructure development has followed the introduction of measures to restructure infrastructure sectors. Legislative action typically begins with the abolition of rules that prohibit private participation in infrastructure and the removal of all other legal impediments to competition that cannot be justified by reasons of public interest. It should be noted, however, that the extent to which a particular sector may be opened to competition is a decision that is taken in the light of the country's overall economic policy. Some countries, in particular developing countries, might have a legitimate interest in promoting the development of certain sectors of local industry and might thus choose not to open certain infrastructure sectors to competition.

31. For monopolistic situations resulting from legal prohibitions rather than economic and technological fundamentals, the main legislative action needed to introduce competition is the removal of the existing legal barriers. This may need to be reinforced by rules of competition (such as the prohibition of collusion, cartels, predatory pricing or other unfair trading practices) and regulatory oversight (see chap. I, "General legislative and institutional framework", paras. 30-53). For a number of activities, however, effective competition may not be obtained through the mere removal of legislative barriers without legislative measures to restructure the sector concerned. In some countries, monopolies have been temporarily maintained only for the time needed to facilitate a gradual, more orderly and socially acceptable transition from a monopolistic to a competitive market structure.

(a) *Unbundling of infrastructure sectors*

32. In the experience of some countries it has been found that vertically or horizontally integrated infrastructure companies may be able to prevent effective competition. Integrated companies may try to extend their monopolistic powers in one market or market segment to other markets or market segments in order to extract monopoly rents in those activities as well. Therefore, some countries have found it necessary to separate the monopoly element (such as the grid in many networks) from competitive elements in given infrastructure sectors. By and large, infrastructure services tend to be competitive, whereas the underlying physical infrastructure often has monopolistic characteristics.

33. The separation of competitive activities from monopolistic ones may in turn require the unbundling of vertically or horizontally integrated activities. Vertical unbundling occurs when upstream activities are separated from downstream ones, for example, by separating production, transmission, distribution and supply activities in the power sector. The objective is typically to separate key network components or essential facilities from the competitive segments of the business. Horizontal unbundling occurs when one or more parallel activities of a monopolist public service provider are divided among separate companies, which may either compete directly with each other in the market (as is increasingly the case with power production) or retain a monopoly over a smaller territory (as may be the case with power distribution). Horizontal unbundling refers both to a single activity or segment being broken up (as in the power sector examples) and to substitutes being organized separately in one or more markets (as in the case of separation of cellular services from fixed-line telephony, for example).

34. However, the costs and benefits of such changes need to be considered carefully. Costs may include those associated with the change itself (e.g. transaction and transition costs, including the loss incurred by companies that lose benefits or protected positions as a result of the new scheme) and those resulting from the operation of the new scheme, in particular higher coordination costs resulting, for example, from more complicated network planning, technical standardization or regulation. Benefits, on the other hand, may include new investments, better or new services, more choice and lower economic costs.

(b) *Recent experience in major infrastructure sectors*

(i) *Telecommunications*

35. Unbundling has not been too common in the telecommunication sector. In some countries, long-distance and international services were separated from local services; competition was introduced in the former, while the latter remained largely monopolistic. In some of those countries that trend is now being reversed, with local telephone companies being allowed to provide long-distance services and long-distance companies being allowed to provide local services, all in a competitive context. Mandatory open access rules are common in the telecommunication sector of those countries where the historical public service provider offers services in competition with other providers while controlling essential parts of the network.

(ii) *Electricity*

36. Electricity laws recently enacted in various countries call for the unbundling of the power sector by separating generation, transmission and distribution. In some cases, supply is further distinguished from distribution in order to leave only the monopolistic activity (i.e. the transport of electricity for public use over wires) under a monopoly. In those countries, the transmission and distribution companies do not buy or sell electricity but only transport it against a regulated fee. Trade in electricity occurs between producers or brokers on the one hand and users on the other. In some of the countries concerned, competition is limited to large users only or is being phased in gradually.

37. Where countries have opted for the introduction of competition in the power and gas sectors, new legislation has organized the new market structure, stipulating to what extent the market had to be unbundled (sometimes including the number of public service providers to be created out of the incumbent monopoly), or removed barriers to new entry. The same energy laws have also established specific competition rules, whether structural (e.g. prohibition of cross-ownership between companies in different segments of the market, such as production, transmission and distribution, or gas and electricity sale and distribution) or behavioural (e.g. third-party access rules, prohibition of alliances or other collusive arrangements). New institutions and regulatory mechanisms, such as power pools, dispatch mechanisms or energy regulatory agencies, have been established to make the new energy markets work. Finally, other aspects of energy law and policy have had to be amended in conjunction with these changes, including the rules governing the markets for oil, gas, coal and other energy sources.

(iii) *Water and sanitation*

38. The most common market structure reform introduced in the water and sanitation sector is horizontal unbundling. Some countries have created several water utilities where a single one existed before. This is particularly common in, but is not limited to, countries with separate networks that are not or only slightly interconnected. In practice, it has been found that horizontal unbundling facilitates comparison of the performance of service providers.

39. Some countries have invited private investors to provide bulk water to a utility or to build and operate water treatment or desalination plants, for example. In such vertical unbundling, the private services (and the discrete investments they require) are usually rendered under contract to a utility and do not fundamentally modify the monopolistic nature of the market structure: the plants usually do not compete with each other and are usually not allowed to bypass the utility to supply customers. A number of countries have introduced competition in bulk water supply and transportation; in some cases, there are active water markets. Elsewhere, competition is limited to expensive bottled or trucked water and private wells.

(iv) Transport

40. In the restructuring measures taken in various countries, a distinction is made between transport infrastructure and transport services. The former may often have natural monopoly characteristics, whereas services are generally competitive. Competition in transport services should be considered not only within a single mode but also across modes, since trains, trucks, buses, airlines and ships tend to compete for passengers and freight.

41. With respect to railways, some countries have opted for a separation between the ownership and operation of infrastructure (e.g. tracks, signalling systems and train stations) on the one hand and of rail transport services (e.g. passenger and freight) on the other. In such schemes, the law does not allow the track operator also to operate transport services, which are operated by other companies often in competition with each other. Other countries have let integrated companies operate infrastructure as well as services, but have enforced third-party access rights to the infrastructure, sometimes called “trackage rights”. In those cases, transport companies, whether another rail line or a transport service company, have right of access to the track on certain terms and the company controlling the track has the obligation to grant such access.

42. In many countries, ports were until recently managed as public sector monopolies. When opening the sector to private participation, legislators have considered different models. Under the landlord-port system, the port authority is responsible for the infrastructure as well as overall coordination of port activities; it does not, however, provide services to ships or merchandise. In service ports, the same entity is responsible for infrastructure and services. Competition between service providers (e.g. tugboats, stevedoring and warehousing) may be easier to establish and maintain under the landlord system.

43. Legislation governing airports may also require changes, whether to allow private investment or competition between or within airports. Links between airport operation and air traffic control may also need to be considered carefully. Within airports, many countries have introduced competition in handling services, catering and other services to planes, as well as in passenger services such as retail shops, restaurants, parking and the like. In some countries, the construction and operation of a new terminal at an existing airport has been entrusted to a new operator, thus creating competition between terminals. In others, new airports have been built on a BOT basis and existing ones transferred to private ownership.

(c) Transitional measures

44. The transition from monopoly to market needs to be carefully managed. Political, social or other factors have led some countries to pursue a gradual or phased approach to implementation. As technology and other outside forces are constantly changing, some countries have adopted sector reforms that could be accelerated or adjusted to take those changing circumstances into account.

45. Some countries have felt that competition should not be introduced at once. In such cases, legislation has provided for temporary exclusivity rights, limitation in the number of public service providers or other restrictions on competition. Those measures are designed to give the incumbent adequate time to prepare for competition and to adjust prices, while giving the public service provider adequate incentives for investment and service expansion. Other countries have included provisions calling for the periodic revision (at the time of price reviews, for example) of such restrictions with a view to ascertaining whether the conditions that justified them at the time when they were introduced still prevail.

46. Another transitional measure, at least in some countries with government-owned public service providers, has been the restructuring or privatization of the incumbent service provider. In most countries where government-owned providers of public services have been privatized, liberalization has by and large either accompanied or preceded privatization. Some countries have proceeded otherwise and have privatized companies with significant exclusivity rights, often to increase privatization proceeds. They have, however, found it difficult and sometimes very expensive to remove, restrict or shorten at a later stage the exclusive rights or monopolies protecting private or privatized public service providers.

3. Forms of private sector participation in infrastructure projects

47. Private sector participation in infrastructure projects may be devised in a variety of different forms, ranging from publicly owned and operated infrastructure to fully privatized projects. The appropriateness of a particular variant for a given type of infrastructure is a matter to be considered by the Government in view of the national needs for infrastructure development and an assessment of the most efficient ways in which particular types of infrastructure facility may be developed and operated. In a particular sector more than one option may be used.

(a) Public ownership and public operation

48. In cases where public ownership and control is desired, direct private financing as well as infrastructure operation under commercial principles may be achieved by establishing a separate legal entity controlled by the Government to own and operate the project. Such an entity may be managed as an independent private commercial enterprise that is subject to the same rules and business principles that apply to private companies. Some countries have a well established tradition in operating infrastructure facilities through these types of company. Opening the capital of such companies to private investment or making use of such a company's ability to issue bonds or other securities may create an opportunity for attracting private investment in infrastructure.

49. Another form of involving private participation in publicly owned and operated infrastructure may be the negotiation of "service contracts" whereby

the public operator contracts out specific operation and maintenance activities to the private sector. The Government may also entrust a broad range of operation and maintenance activities to a private entity acting on behalf of the contracting authority. Under such an arrangement, which is sometimes referred to as a “management contract”, the private operator’s compensation may be linked to its performance, often through a profit-sharing mechanism, although compensation on the basis of a fixed fee may also be used, in particular where the parties find it difficult to establish mutually acceptable mechanisms to assess the operator’s performance.

(b) Public ownership and private operation

50. Alternatively, the whole operation of public infrastructure facilities may be transferred to private entities. One possibility is to give the private entity, usually for a certain period, the right to use a given facility, to supply the relevant services and to collect the revenue generated by that activity. Such a facility may already be in existence or may have been specially built by the private entity concerned. This combination of public ownership and private operation has the essential features of arrangements that in some legal systems may be referred to as “public works concessions” or “public service concessions”.

51. Another form of private participation in infrastructure is where a private entity is selected by the contracting authority to operate a facility that has been built by or on behalf of the Government, or whose construction has been financed with public funds. Under such an arrangement, the operator assumes the obligation to operate and maintain the infrastructure and is granted the right to charge for the services it provides. In such a case, the operator assumes the obligation to pay to the contracting authority a portion of the revenue generated by the infrastructure that is used by the contracting authority to amortize the construction cost. Such arrangements are referred to in some legal systems as “lease” or “*affermage*”.

(c) Private ownership and operation

52. Under the third approach, the private entity not only operates the facility, but also owns the assets related to it. Here, too, there may be substantial differences in the treatment of such projects under domestic laws, for instance as to whether the contracting authority retains the right to reclaim title to the facility or to assume responsibility for its operation (see also chap. IV, “Construction and operation of infrastructure: legislative framework and project agreement”, paras. 23-29).

53. Where the facility is operated pursuant to a governmental licence, private ownership of physical assets (e.g. a telecommunication network) is often separable from the licence to provide the service to the public (e.g. long-distance telephone services), in that the licence can be withdrawn by the competent public authority under certain circumstances. Thus, private ownership of the facility may not necessarily entail an indefinite right to provide the service.

4. *Financing structures and sources of finance for infrastructure*

(a) *Notion of project finance*

54. Large-scale projects involving the construction of new infrastructure facilities are often carried out by new corporate entities specially established for that purpose by the project promoters. Such a new entity, often called a “project company”, becomes the vehicle for raising funds for the project. Because the project company lacks an established credit or an established balance sheet on which the lenders can rely, the preferred financing modality for the development of new infrastructure is called “project finance”. In a project finance transaction, credit will be made available to the extent that the lenders can be satisfied to look primarily to the project’s cash flow and earnings as the source of funds for the repayment of loans taken out by the project company. Other guarantees either are absent or cover only certain limited risks. To that end, the project’s assets and revenue, and the rights and obligations relating to the project, are independently estimated and are strictly separated from the assets of the project company’s shareholders.

55. Project finance is also said to be “non-recourse” financing owing to the absence of recourse to the project company’s shareholders. In practice, however, lenders are seldom ready to commit the large amounts needed for infrastructure projects solely on the basis of a project’s expected cash flow or assets. The lenders may reduce their exposure by incorporating into the project documents a number of back-up or secondary security arrangements and other means of credit support provided by the project company’s shareholders, the Government, purchasers or other interested third parties. This modality is commonly called “limited recourse” financing.

(b) *Financing sources for infrastructure projects*

56. Alternatives to traditional public financing are playing an increasing role in the development of infrastructure. In recent years, new infrastructure investment in various countries has included projects with exclusively or predominantly private funding sources. The two main types of fund are debt finance, usually in the form of loans obtained on commercial markets, and equity investment. However, financing sources are not limited to those. Public and private investment have often been combined in arrangements sometimes called “public-private partnerships”.

(i) *Equity capital*

57. The first type of capital for infrastructure projects is provided in the form of equity investment. Equity capital is obtained in the first place from the project promoters or other individual investors interested in taking stock in the concessionaire. However, such equity capital normally represents only a portion of the total cost of an infrastructure project. In order to obtain commercial loans or to have access to other sources of funds to meet the capital requirements of the project, the project promoters and other individual investors have

to offer priority payment to the lenders and other capital providers, thus accepting that their own investment will only be paid after payment of those other capital providers. Therefore, the project promoters typically assume the highest financial risk. At the same time, they will hold the largest share in the project's profit once the initial investment is paid. Substantial equity investment by the project promoters is typically welcomed by the lenders and the Government, as it helps reduce the burden of debt service on the concessionaire's cash flow and serves as an assurance of those companies' commitment to the project.

(ii) *Commercial loans*

58. Debt capital often represents the main source of funding for infrastructure projects. It is obtained on the financial market primarily by means of loans extended to the project company by national or foreign commercial banks, typically using funds that originate from short- to medium-term deposits remunerated by those banks at floating interest rates. Consequently, loans extended by commercial banks are often subject to floating interest rates and normally have a maturity term shorter than the project period. However, where feasible and economic, given financial market conditions, banks may prefer to raise and lend medium- to long-term funds at fixed rates, so as to avoid exposing themselves and the concessionaire over a long period to interest rate fluctuations, while also reducing the need for hedging operations. Commercial loans are usually provided by lenders on condition that their payment takes precedence over the payment of any other of the borrower's liabilities. Therefore, commercial loans are said to be "unsubordinated" or "senior" loans.

(iii) *"Subordinated" debt*

59. The third type of fund typically used in these projects are "subordinated" loans, sometimes also called "mezzanine" capital. Such loans rank higher than equity capital in order of payment, but are subordinate to senior loans. This subordination may be general (i.e. ranking generally lower than any senior debt) or specific, in which case the loan agreements specifically identify the type of debt to which it is subordinated. Subordinated loans are often provided at fixed rates, usually higher than those of senior debt. As an additional tool to attract such capital, or sometimes as an alternative to higher interest rates, providers of subordinated loans may be offered the prospect of direct participation in capital gains, by means of the issue of preferred or convertible shares or debentures, sometimes providing an option to subscribe for shares of the concessionaire at preferential prices.

(iv) *Institutional investors*

60. In addition to subordinated loans provided by the project promoters or by public financial institutions, subordinated debt may be obtained from financing companies, investment funds, insurance companies, collective investment schemes (e.g. mutual funds), pension funds and other so-called "institutional investors". These institutions normally have large sums available for long-term investment and may represent an important source of additional capital for

infrastructure projects. Their main reasons for accepting the risk of providing capital to infrastructure projects are the prospect of remuneration and interest in diversifying investment.

(v) *Capital market funding*

61. As more experience is gained with privately financed infrastructure projects, increased use is being made of capital market funding. Funds may be raised by the placement of preferred shares, bonds and other negotiable instruments on a recognized stock exchange. Typically, the public offer of negotiable instruments requires regulatory approval and compliance with requirements of the relevant jurisdiction, such as requirements concerning the information to be provided in the prospectus of issuance and, in some jurisdictions, the need for prior registration. Bonds and other negotiable instruments may have no other security than the general credit of the issuer or may be secured by a mortgage or other lien on specific property.

62. The possibility of gaining access to capital markets is usually greater for existing public utilities with an established commercial record than for companies specially established to build and operate a new infrastructure and lacking the required credit rating. Indeed, a number of stock exchanges require that the issuing company have some established record over a certain minimum period before being permitted to issue negotiable instruments.

(vi) *Financing by Islamic financial institutions*

63. One additional group of potential capital providers are Islamic financial institutions. Those institutions operate under rules and practices derived from the Islamic legal tradition. One of the most prominent features of banking activities under their rules is the absence of interest payments or strict limits to the right to charge interest and consequently the establishment of other forms of consideration for the borrowed money, such as profit-sharing or direct participation of the financial institutions in the results of the transactions of their clients. As a consequence of their operating methods, Islamic financial institutions may be more inclined than other commercial banks to consider direct or indirect equity participation in a project.

(vii) *Financing by international financial institutions*

64. International financial institutions may also play a significant role as providers of loans, guarantees or equity to privately financed infrastructure projects. A number of projects have been co-financed by the World Bank, the International Finance Corporation or by regional development banks.

65. International financial institutions may also play an instrumental role in the formation of “syndications” for the provision of loans to the project. Some of those institutions have special loan programmes under which they become the sole “lender of record” to a project, acting on its own behalf and on behalf

of participating banks and assuming responsibility for processing disbursements by participants and for subsequent collection and distribution of loan payments received from the borrower, either pursuant to specific agreements or based on other rights that are available under their status of preferred creditor. Some international financial institutions may also provide equity or mezzanine capital, by investing in capital market funds specialized in securities issued by infrastructure operators. Lastly, international financial institutions may provide guarantees against a variety of political risks, which may facilitate the project company's task of raising funds in the international financial market (see chap. II, "Project risks and government support", paras. 61-71).

(viii) Support by export credit and investment promotion agencies

66. Export credit and investment promotion agencies may provide support to the project in the form of loans, guarantees or a combination of both. The participation of export credit and investment promotion agencies may provide a number of advantages, such as lower interest rates than those applied by commercial banks and longer-term loans, sometimes at a fixed interest rate (see chap. II, "Project risks and government support", paras. 72-74).

(ix) Combined public and private finance

67. In addition to loans and guarantees extended by commercial banks and national or multilateral public financial institutions, in a number of cases public funds have been combined with private capital for financing new projects. Such public funds may originate from government income or sovereign borrowing. They may be combined with private funds as initial investment or as long-term payments, or may take the form of governmental grants or guarantees. Infrastructure projects may be co-sponsored by the Government through equity participation in the concessionaire, thus reducing the amount of equity and debt capital needed from private sources (see chap. II, "Project risks and government support", paras. 40 and 41).

5. Main parties involved in implementing infrastructure projects

68. The parties to a privately financed infrastructure project may vary greatly, depending on the infrastructure sector, the modality of private sector participation and the arrangements used for financing the project. The following paragraphs identify the main parties in the implementation of a typical privately financed infrastructure project involving the construction of a new infrastructure facility and carried out under the "project finance" modality.

(a) The contracting authority and other public authorities

69. The execution of a privately financed infrastructure project frequently involves a number of public authorities in the host country at the national, provincial or local level. The contracting authority is the main body responsible for the project within the Government. Furthermore, the execution of the

project may necessitate the active participation (e.g. for the issuance of licences or permits) of other public authorities in addition to the contracting authority, at the same or at a different level of Government. Those authorities play a crucial role in the execution of privately financed infrastructure projects.

70. The contracting authority or another public authority normally identifies the project pursuant to its own policies for infrastructure development in the sector concerned and determines the type of private sector participation that would allow the most efficient operation of the infrastructure facility. Thereafter, the contracting authority conducts the process that leads to the selection of the concessionaire. Furthermore, throughout the life of the project, the Government may need to provide various forms of support—legislative, administrative, regulatory and sometimes financial—so as to ensure that the facility is successfully built and adequately operated. Finally, in some projects the Government may become the ultimate owner of the facility.

(b) The project company and the project promoters

71. Privately financed infrastructure projects are usually carried out by a joint venture of companies including construction and engineering companies and suppliers of heavy equipment interested in becoming the main contractors or suppliers of the project. The companies that participate in such a joint venture are referred to in the *Guide* as the “promoters” of the project. Those companies will be intensively involved in the development of the project during its initial phase and their ability to cooperate with each other and to engage other reliable partners will be essential for timely and successful completion of the work. Furthermore, the participation of a company with experience in operating the type of facility being built is an important factor to ensure the long-term viability of the project. Where an independent legal entity is established by the project promoters, other equity investors not otherwise engaged in the project (usually institutional investors, investment banks, bilateral or multilateral lending institutions, sometimes also the Government or a government-owned corporation) may also participate. The participation of local investors, where the project company is required to be established under the laws of the host country (see chap. IV, “Construction and operation of infrastructure: legislative framework and project agreement”, paras. 12-18), is sometimes encouraged by the Government.

(c) Lenders

72. The risks to which the lenders are exposed in project finance, be it non-recourse or limited recourse, are considerably higher than in conventional transactions. This is even more the case where the security value of the physical assets involved (e.g. a road, bridge or tunnel) is difficult to realize, given the lack of a “market” where such assets could easily be sold, or act as obstacles to recovery or repossession. This circumstance affects not only the terms under which the loans are provided (e.g. the usually higher cost of project finance and extensive conditions to funding), but also, as a practical matter, the availability of funds.

73. Owing to the magnitude of the investment required for a privately financed infrastructure project, loans are often organized in the form of “syndicated” loans with one or more banks taking the lead role in negotiating the finance documents on behalf of the other participating financial institutions, mainly commercial banks. Commercial banks that specialize in lending for certain industries are typically not ready to assume risks with which they are not familiar (for a discussion of project risks and risk allocation, see chap. II, “Project risks and government support”, paras. 8-29). For example, long-term lenders may not be interested in providing short-term loans to finance infrastructure construction. Therefore, in large-scale projects, different lenders are often involved at different phases of the project. With a view to avoiding disputes that might arise from conflicting actions taken by individual lenders or disputes between lenders over payment of their loans, lenders extending funds to large projects sometimes do so under a common loan agreement. Where various credit facilities are provided under separate loan agreements, the lenders will typically negotiate a so-called “inter-creditor agreement”. An inter-creditor agreement usually contains provisions dealing with matters such as provisions for disbursement of payments, pro rata or in a certain order of priority; conditions for declaring events of default and accelerating the maturity of credits; and coordination of foreclosure on security provided by the project company.

(d) International financial institutions and export credit and investment promotion agencies

74. International financial institutions and export credit and investment promotion agencies will have concerns of generally the same order as other lenders to the project. In addition to this, they will be particularly interested in ensuring that the project execution and its operation are not in conflict with particular policy objectives of those institutions and agencies. Increasing emphasis is being given by international financial institutions to the environmental impact of infrastructure projects and their long-term sustainability. The methods and procedures applied to select the concessionaire will also be carefully considered by international financial institutions providing loans to the project. Many global and regional financial institutions and national development funding agencies have established guidelines or other requirements governing procurement with funds provided by them, which is typically reflected in their standard loan agreements (see also chap. III, “Selection of the concessionaire”, para. 18).

(e) Insurers

75. Typically, an infrastructure project will involve casualty insurance covering its plant and equipment, third-party liability insurance and worker’s compensation insurance. Other possible types of insurance include insurance for business interruption, interruption in cash flows and cost overrun (see chap. IV, “Construction and operation of infrastructure: legislative framework and project agreement”, paras. 119 and 120). Those types of insurance are usually available on the commercial insurance markets, although the availabil-

ity of commercial insurance may be limited for certain extraordinary events outside the control of the parties (e.g. war, riots, vandalism, earthquakes or hurricanes). The private insurance market is playing an increasing role in coverage against certain types of political risk, such as contract repudiation, failure by a public authority to perform its contractual obligations or unfair calls for independent guarantees. In some countries, insurance underwriters structure comprehensive insurance packages aimed at avoiding certain risks being left uncovered owing to gaps between individual insurance policies. In addition to private insurance, guarantees against political risks may be provided by international financial institutions, such as the World Bank, the Multilateral Investment Guarantee Agency and the International Finance Corporation, by regional development banks or by export credit and investment promotion agencies (see chap. II, "Project risks and government support", paras. 61-74).

(f) *Independent experts and advisers*

76. Independent experts and advisers play an important role at various stages of privately financed infrastructure projects. Experienced companies typically supplement their own technical expertise by retaining the services of outside experts and advisers, such as financial experts, international legal counsel or consulting engineers. Merchant and investment banks often act as advisers to project promoters in arranging the finance and in formulating the project to be implemented, an activity that, while essential to project finance, is quite distinct from the financing itself. Independent experts may advise the lenders to the project, for example, on the assessment of project risks in a specific host country. They may also assist public authorities in devising sector-specific strategies for infrastructure development and in formulating an adequate legal and regulatory framework. Furthermore, independent experts and advisers may assist the contracting authority in the preparation of feasibility and other preliminary studies, in the formulation of requests for proposals or standard contractual terms and specifications, in the evaluation and comparison of proposals or in the negotiation of the project agreement.

77. In addition to private entities, a number of intergovernmental organizations (e.g. UNIDO and the regional commissions of the Economic and Social Council) and international financial institutions (e.g. the World Bank and the regional development banks) have special programmes whereby they may either provide this type of technical assistance directly to the Government or assist the latter in identifying qualified advisers.

I. General legislative and institutional framework

A. General remarks

1. The establishment of an appropriate and effective legal framework is a prerequisite to creating an environment that fosters private investment in infrastructure. For countries where such a legal framework already exists, it is important to ensure that the law is sufficiently flexible and responsive to keep pace with the developments in various infrastructure sectors. This chapter deals with some general issues that domestic legislators are advised to consider when setting up or reviewing the legal framework for privately financed infrastructure projects in order to achieve the above objectives. Section B (paras. 2-14) sets out general considerations on the constitutional and legislative framework; section C (paras. 15-22) deals with the scope of authority to award infrastructure and public services concessions; section D (paras. 23-29) discusses possible measures to enhance administrative coordination; and section E (paras. 30-53) deals with institutional and procedural arrangements for the regulation of infrastructure sectors.

B. Constitutional, legislative and institutional framework

2. This section considers general guiding principles that may inspire the legal framework for privately financed infrastructure projects. It further points out the possible implications that the constitutional law of the host country may have for the implementation of these projects. Lastly, this section deals briefly with possible choices to be made regarding the level and type of instrument that might need to be enacted and their scope of application.

1. General guiding principles for a favourable constitutional and legislative framework

3. In considering the establishment of an enabling legal framework or in reviewing the adequacy of the existing framework, domestic legislators may wish to take into account some general principles that have inspired recent legislative actions in various countries, which are discussed briefly in the following paragraphs.

(a) Transparency

4. A transparent legal framework is characterized by clear and readily accessible rules and by efficient procedures for their application. Transparent laws

and administrative procedures create predictability, enabling potential investors to estimate the costs and risks of their investment and thus to offer their most advantageous terms. Transparent laws and administrative procedures may also foster openness through provisions requiring the publication of administrative decisions, including, when appropriate, an obligation to state the grounds on which they are based and to disclose other information of public relevance. They also help to guard against arbitrary or improper actions or decisions by the contracting authority or its officials and thus help to promote confidence in a country's infrastructure development programme. Transparency of laws and administrative procedures is of particular importance where foreign investment is sought, since foreign companies may be unfamiliar with the country's practices for the award of infrastructure projects.

(b) Fairness

5. The legal framework is both the means by which Governments regulate and ensure the provision of public services to their citizens and the means by which public service providers and their customers may protect their rights. A fair legal framework takes into account the various (and sometimes possibly conflicting) interests of the Government, the public service providers and their customers and seeks to achieve an equitable balance between them. The private sector's business considerations, the users' right to adequate services, both in terms of quality and price, the Government's responsibility for ensuring the continuous provision of essential services and its role in promoting national infrastructure development are but a few of the interests that deserve appropriate recognition in the law.

(c) Long-term sustainability

6. An important objective of domestic legislation on infrastructure development is to ensure the long-term provision of public services, with increasing attention being paid to environmental sustainability. Inadequate arrangements for the operation and maintenance of public infrastructure severely limit efficiency in all sectors of infrastructure and result directly in reduced service quality and increased costs for users. From a legislative perspective, it is important to ensure that the host country has the institutional capacity to undertake the various tasks entrusted to public authorities involved in infrastructure projects throughout their phases of implementation. Another measure to enhance the long-term sustainability of a national infrastructure policy is to achieve a correct balance between competitive and monopolistic provision of public services. Competition may reduce overall costs and provide more back-up facilities for essential services. In certain sectors, competition has also helped to increase the productivity of infrastructure investment, to enhance responsiveness to the needs of the customers and to obtain better quality for public services, thus improving the business environment in all sectors of the economy.

2. Constitutional law and privately financed infrastructure projects

7. The constitutional law of a number of countries refers generally to the duty of the State to ensure the provision of public services. Some of them list

the infrastructure and service sectors that come under the responsibility of the State, while in others the task of identifying those sectors is delegated to the legislator. Under some national constitutions, the provision of certain public services is reserved exclusively to the State or to specially created public entities. Other constitutions, however, authorize the State to award concessions to private entities for the development and operation of infrastructure and the provision of public services. In some countries, there are limitations to the participation of foreigners in certain sectors or requirements that the State should participate in the capital of the companies providing public services.

8. For countries wishing to promote private investment in infrastructure it is important to review existing constitutional rules so as to identify possible restrictions to the implementation of privately financed infrastructure projects. In some countries, privately financed infrastructure projects have been delayed by uncertainties regarding the extent of the State's authority to award them. Sometimes, concerns that those projects might contravene constitutional rules on State monopolies or on the provision of public services have led to judicial disputes, with a consequent negative impact on the implementation of the projects.

9. It is further important to take into account constitutional rules relating to the ownership of land or infrastructure facilities. The constitutional law of some countries contains limitations to private ownership of land and certain means of production. In other countries, private property is recognized, but the constitution declares all or certain types of infrastructure to be State property. Prohibitions and restrictions of this nature can be an obstacle to the execution of projects that entail private operation, or private operation and ownership, of the relevant infrastructure (see further chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 23-29).

3. General and sector-specific legislation

10. Legislation frequently plays a central role in promoting private investment in public infrastructure projects. The law typically embodies a political commitment, provides specific legal rights and may represent an important guarantee of stability of the legal and regulatory regime. In most countries, the implementation of privately financed infrastructure projects was in fact preceded by legislative measures setting forth the general rules under which those projects were awarded and executed.

11. As a matter of constitutional law or legislative practice, some countries may need to adopt specific legislation in respect of individual projects. In other countries with a well-established tradition of awarding concessions to the private sector for the provision of public services, the Government is authorized by general legislation to award to the private sector any activity carried out by the public sector having an economic value that makes such activity capable of being exploited by private entities. General legislation of this type creates a framework for providing a uniform treatment to issues that are common to privately financed projects in different infrastructure sectors.

12. However, by its very nature, general legislation is normally not suitable to address all the particular requirements of different sectors. Even in countries that have adopted general legislation addressing cross-sectoral issues, it has been found that supplementary sector-specific legislation allows the legislator to formulate rules that take into account the market structure in each sector (see above, “Introduction and background information on privately financed infrastructure projects”, paras. 21-46). It should be noted that in many countries sector-specific legislation was adopted at a time when a significant portion or even the entirety of the national infrastructure consisted of State monopolies. For countries interested in promoting private sector investment in infrastructure it is advisable to review existing sector-specific legislation so as to ascertain its suitability for privately financed infrastructure projects.

13. Sector-specific legislation may further play an important role in establishing a framework for the regulation of individual infrastructure sectors (see below, paras. 30-53). Legislative guidance is particularly useful in countries at the initial stages of setting up or developing national regulatory capacities. Such legislation represents a useful assurance that the regulators do not have unlimited discretion in the exercise of their functions, but are bound by the parameters provided by the law. However, it is generally advisable to avoid rigid or excessively detailed legislative provisions dealing with contractual aspects of the implementation of privately financed infrastructure projects, which in most cases would not be adequate to their long-term nature (see further chap. IV, “Construction and operation of infrastructure: legislative framework and project agreement”, and chap. V, “Duration, extension and termination of the project agreement”).

14. Many countries have used legislation to establish the general principles for the organization of infrastructure sectors and the basic policy, institutional and regulatory framework. However, the law may not be the best instrument to set detailed technical and financial requirements. Many countries have preferred to enact regulations setting forth more detailed rules to implement the general provisions of domestic laws on privately financed infrastructure projects. Regulations are found to be easier to adapt to a change in environment, whether the change results from the transition to market-based rules or from external developments, such as new technologies or changing economic or market conditions. Whatever the instrument used, clarity and predictability are of the essence.

C. Scope of authority to award concessions

15. The implementation of privately financed infrastructure projects may require the enactment of special legislation or regulations authorizing the State to entrust the provision of public services to private entities. The enactment of express legislative authorization may be an important measure to foster the confidence of potential investors, national or foreign, in a national policy to promote private sector investment in infrastructure. Central elements to the authority to award concessions for infrastructure projects are discussed in the following paragraphs.

1. Authorized agencies and relevant fields of activity

16. In some legal systems the Government's responsibility for the provision of public services may not be delegated without prior legislative authorization. For those countries which wish to attract private investment in infrastructure, it is particularly important to state clearly in the law the authority to entrust entities other than public authorities of the host country with the right to provide certain public services. Such a general provision may be particularly important in those countries where public services are governmental monopolies or where it is envisaged to engage private entities to provide certain services that used to be available to the public free of charge (see further chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 37 and 38).

17. Where general legislation is adopted, it is also advisable to identify clearly the public authorities or levels of government competent to award infrastructure projects and to act as contracting authorities. In order to avoid unnecessary delay, it is particularly advisable to have rules in place that make it possible to ascertain the persons or offices that have the authority to enter into commitments on behalf of the contracting authority (and, as appropriate, of other public authorities) at different stages of negotiation and to sign the project agreement. It is useful to consider the extent of powers that may be needed by authorities other than the central Government to carry out projects falling within their purview. For projects involving offices or agencies at different levels of government (for example, national, provincial or local), where it is not possible to identify in advance all the relevant offices and agencies involved, other measures may be needed to ensure appropriate coordination among them (see below, paras. 23-29).

18. For purposes of clarity, it is advisable to identify in such general legislation those sectors in which concessions may be awarded. Alternatively, where this is not deemed feasible or desirable, the law might identify those activities which may not be the object of a concession (for example, activities related to national defence or security).

2. Purpose and scope of concessions

19. It may be useful for the law to define the nature and purpose of privately financed infrastructure projects for which concessions may be awarded in the host country. One possible approach may be to define the various categories of projects according to the extent of the rights and obligations assumed by the concessionaire (for example, "build-operate-transfer", "build-own-operate", "built-transfer-operate" and "build-transfer"). However, given the wide variety of schemes that may come into play in connection with private investment in infrastructure, it may be difficult to provide exhaustive definitions of all of them. As an alternative, the law could generally provide that concessions may be awarded for the purpose of entrusting an entity, private or public, with the obligation to carry out infrastructure works and deliver certain public services, in exchange for the right to charge a price for the use of the facility or premises

or for the service or goods it generates, or for other payment or remuneration agreed to by the parties. The law could further clarify that concessions may be awarded for the construction and operation of a new infrastructure facility or system or for maintenance, repair, refurbishment, modernization, expansion and operation of existing infrastructure facilities and systems, or only for the management and delivery of a public service.

20. Another important issue concerns the nature of the rights vested in the concessionaire, in particular whether the right to provide the service is exclusive or whether the concessionaire will face competition from other infrastructure facilities or service providers. Exclusivity may concern the right to provide a service in a particular geographical region (for example, a communal water distribution company) or embrace the whole territory of the country (for example, a national railway company); it may relate to the right to supply one particular type of goods or services to one particular customer (for example, a power generator being the exclusive regional supplier to a power transmitter and distributor) or to a limited group of customers (for example, a national long-distance telephone carrier providing connections to local telephone companies).

21. The decision whether or not to grant exclusivity rights to a certain project or category of projects should be taken in the light of the host country's policy for the sector concerned. As discussed earlier, the scope for competition varies considerably in different infrastructure sectors. While certain sectors, or segments thereof, have the characteristics of natural monopolies, in which case open competition is usually not an economically viable alternative, other infrastructure sectors have been successfully opened to free competition (see "Introduction and background information on privately financed infrastructure projects", paras. 28 and 29).

22. It is desirable therefore to deal with the issue of exclusivity in a flexible manner. Rather than excluding or prescribing exclusive concessions, it may be preferable for the law to authorize the grant of exclusive concessions when it is deemed to be in the public interest, such as in cases where the exclusivity is justified for the purpose of ensuring the technical or economical viability of the project. The contracting authority may be required to state the reasons for envisaging an exclusive concession prior to starting the procedure to select the concessionaire. Such general legislation may be supplemented by sector-specific laws regulating the issue of exclusivity in a manner suitable for each particular sector.

D. Administrative coordination

23. Depending on the administrative structure of the host country, privately financed infrastructure projects may require the involvement of several public authorities, at various levels of government. For instance, the competence to lay down regulations and rules for the activity concerned may rest in whole or in part with a public authority at a level different from the one that is responsible for providing the relevant service. It may also be that both the regulatory

and the operational functions are combined in one entity, but that the authority to award government contracts is centralized in a different public authority. For projects involving foreign investment, it may also happen that certain specific competences fall within the mandate of an agency responsible for approving foreign investment proposals.

24. Recent international experience has demonstrated the usefulness of entrusting a central unit within the host country's administration with the overall responsibility for formulating policy and providing practical guidance on privately financed infrastructure projects. Such a central unit may also be responsible for coordinating the input of the main public authorities that interface with the project company. It is recognized, however, that such an arrangement may not be possible in some countries, owing to their particular administrative organization. Where it is not feasible to establish such a central unit, other measures may be considered to ensure an adequate level of coordination among the various public authorities involved, as discussed in the following paragraphs.

1. Coordination of preparatory measures

25. One important measure to ensure the successful implementation of privately financed infrastructure projects is the requirement that the relevant public authority conduct a preliminary assessment of the project's feasibility, including economic and financial aspects such as expected economic advantages of the project, estimated cost and potential revenue anticipated from the operation of the infrastructure facility and the environmental impact of the project. The studies prepared by the contracting authority should, in particular, identify clearly the expected output of the project, provide sufficient justification for the investment, propose a modality for private sector participation and describe a particular solution to the output requirement.

26. Following the identification of the future project, it is for the Government to establish its relative priority and to assign human and other resources for its implementation. At that point, it is desirable that the contracting authority review existing statutory or regulatory requirements relating to the operation of infrastructure facilities of the type proposed with a view to identifying the main public authorities whose input will be required for the implementation of the project. It is also important at this stage to consider the measures that may be required in order for the contracting authority and the other public authorities involved to perform the obligations they may reasonably anticipate in connection with the project. For instance, the Government may need to make advance budgeting arrangements to enable the contracting authority or other public authorities to meet financial commitments that extend over several budgetary cycles, such as long-term commitments to purchase the project's output (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 50 and 51). Furthermore, a series of administrative measures may be needed to implement certain forms of support provided to the project, such as tax exemptions and customs facilitation (see chap. II, "Project risks and government support", paras. 51-54), which may require considerable time.

2. Arrangements for facilitating the issuance of licences and permits

27. Legislation may play a useful role in facilitating the issuance of licences and permits that may be needed in the course of a project (such as licences under foreign exchange regulations; licences for the incorporation of the concessionaire; authorizations for the employment of foreigners; registration and stamp duties for the use or ownership of land; import licences for equipment and supplies; construction licences; licences for the installation of cables or pipelines; licences for bringing the facility into operation; and spectrum allocation for mobile communication). The required licences or permits may fall within the competence of various organs at different levels of the administration and the time required for their issuance may be significant, in particular when the approving organs or offices were not originally involved in conceiving the project or negotiating its terms. Delay in bringing an infrastructure project into operation as a result of missing licences or permits for reasons not attributable to the concessionaire is likely to result in an increase in the cost of the project and in the price paid by the users.

28. Thus, it is advisable to conduct an early assessment of licences and permits needed for a particular project in order to avoid delay in the implementation phase. A possible measure to enhance the coordination in the issuance of licences and permits might be to entrust one organ with the authority to receive the applications for licences and permits, to transmit them to the appropriate agencies and to monitor the issuance of all licences and permits listed in the request for proposals and other licences that might be introduced by subsequent regulations. The law may also authorize the relevant agencies to issue provisional licences and permits and provide a time period beyond which those licences and permits are deemed to be granted unless they are rejected in writing.

29. However, it should be noted that the distribution of administrative authority among various levels of government (for example, local, regional and central) often reflects fundamental principles of a country's political organization. Therefore, there are instances where the central Government would not be in a position to assume responsibility for the issuance of all licences and permits or to entrust one single body with such a coordinating function. In those cases, it is important to introduce measures to counter the possibility of delay that might result from such distribution of administrative authority, such as, for instance, agreements between the contracting authority and the other public authorities concerned to facilitate the procedures for a given project or other measures intended to ensure an adequate level of coordination among the various public authorities involved and to make the process of obtaining licences more transparent and efficient. Furthermore, the Government might consider providing some assurance that it will assist the concessionaire as much as possible in obtaining licences required by domestic law, for instance by providing information and assistance to bidders regarding the required licences, as well as the relevant procedures and conditions. From a practical point of view, in addition to coordination among various levels of government and various public authorities, there is a need to ensure consistency in the application of criteria for the issuance of licences and for the transparency of the administrative process.

E. Authority to regulate infrastructure services

30. The provision of certain public services is generally subject to a special regulatory regime that may consist of substantive rules, procedures, instruments and institutions. That framework represents an important instrument to implement the governmental policy for the sector concerned (see “Introduction and background information on privately financed infrastructure projects”, paras. 21-46). Depending on the institutional structure of the country concerned and on the allocation of powers between different levels of government, provincial or local legislation may govern some infrastructure sectors, in full or concurrently with national legislation.

31. Regulation of infrastructure services involves a wide range of general and sector-specific issues, which may vary considerably according to the social, political, legal and economic reality of each host country. While occasionally discussing some of the main regulatory issues that are encountered in a similar context in different sectors (see, for instance, chapter IV, “Construction and operation of infrastructure: legislative framework and project agreement”, paras. 39-46 and 82-95), the *Guide* is not intended to exhaust the legal or policy issues arising out of the regulation of various infrastructure sectors. The term “regulatory agencies” refers to the institutional mechanisms required to implement and monitor the rules governing the activities of infrastructure operators. Because the rules applicable to infrastructure operation often allow for a degree of discretion, a body is required to interpret and apply them, monitor compliance, impose sanctions and settle disputes arising out of the implementation of the rules. The specific regulatory tasks and the amount of discretion they involve will be determined by the rules in question, which can vary widely.

32. The *Guide* assumes that the host country has in place the proper institutional and bureaucratic structures and human resources necessary for the implementation of privately financed infrastructure projects. Nevertheless, as a contribution to domestic legislatures considering the need for, and desirability of, establishing regulatory agencies for monitoring the provision of public services, this section discusses some of the main institutional and procedural issues that may arise in that connection. The discussion contained in this section is illustrative of different options that have been used in domestic legislative measures to set up a regulatory framework for privately financed infrastructure projects, but the *Guide* does not thereby advocate the establishment of any particular model or administrative structure. Practical information and technical advice may be obtained from international financial institutions that carry out programmes to assist their member countries in setting up an adequate regulatory framework (such as the World Bank and the regional development banks).

1. Sectoral competence and mandate of regulatory agencies

33. Regulatory responsibilities may be organized on a sectoral or cross-sectoral basis. Countries that have opted for a sectoral approach have in many cases decided to place closely linked sectors or segments thereof under the same regulatory structure (for example, a common regulatory agency for power and

gas or for airports and airlines). Other countries have organized regulation on a cross-sectoral basis, in some cases with one regulatory entity for all infrastructure sectors and in others with one entity for utilities (water, power, gas, telecommunications) and one for transport. In some countries the competence of regulatory agencies might also extend to several sectors within a given region.

34. Regulatory agencies whose competence is limited to a particular sector usually foster the development of technical, sector-specific expertise. Sector-specific regulation may facilitate the development of rules and practices that are tailored to the needs of the sector concerned. However, the decision between sector-specific and cross-sectoral regulation depends in part on the country's regulatory capacity. Countries with limited expertise and experience in infrastructure regulation may find it preferable to reduce the number of independent structures and try to achieve economies of scale.

35. The law setting up a regulatory mechanism often stipulates a number of general objectives that should guide the actions of regulatory agencies, such as the promotion of competition, the protection of users' interests, the satisfaction of demand, the efficiency of the sector or the public service providers, their financial viability, the safeguarding of the public interest or of public service obligations and the protection of investors' rights. Having one or two overriding objectives helps clarify the mandate of regulatory agencies and establish priorities among sometimes conflicting objectives. A clear mandate may also increase a regulatory agency's autonomy and credibility.

2. *Institutional mechanisms*

36. The range of institutional mechanisms for the regulation of infrastructure sectors varies greatly. While there are countries that entrust regulatory functions to organs of the Government (for example, the concerned ministries or departments), other countries have preferred to establish autonomous regulatory agencies, separate from the Government. Some countries have decided to subject certain infrastructure sectors to autonomous and independent regulation while leaving others under ministerial regulation. Sometimes, powers may also be shared between an autonomous regulatory agency and the Government, as is often the case with respect to licensing. From a legislative perspective, it is important to devise institutional arrangements for the regulatory functions that ensure to the regulatory agency an adequate level of efficiency, taking into account the political, legal and administrative tradition of the country.

37. The efficiency of the regulatory regime is in most cases a function of the objectiveness with which regulatory decisions are taken. This, in turn, requires that regulatory agencies should be able to take decisions without interference or inappropriate pressures from infrastructure operators and public service providers. To that effect, legislative provisions in several countries require the independence of the regulatory decision-making process. In order to achieve the desired level of independence it is advisable to separate the regulatory functions from operational ones by removing any regulatory functions that may still be vested with the public service providers and entrust them to a

legally and functionally independent entity. Regulatory independence is supplemented by provisions to prevent conflicts of interest, such as prohibitions for staff of the regulatory agency to hold mandates, accept gifts, enter into contracts or have any other relationship (directly or through family members or other intermediaries) with regulated companies, their parents or affiliates.

38. This leads to a related issue, namely, the need to minimize the risk of decisions being made or influenced by a body that is also the owner of enterprises operating in the regulated sector or a body acting on political rather than technical grounds. In some countries it was felt necessary to provide the regulatory agency with a certain degree of autonomy vis-à-vis the political organs of government. Independence and autonomy should not be considered solely on the basis of the institutional position of the regulatory function, but also on the basis of its functional autonomy (i.e. the availability of sufficient financial and human resources to discharge their responsibilities adequately).

3. Powers of regulatory agencies

39. Regulatory agencies may have decision-making powers, advisory powers or purely consultative powers or a combination of these different levels of powers depending on the subject matter. In some countries, regulatory agencies were initially given limited powers, which were expanded later as the agencies established a track record of independence and professionalism. The legislation often specifies which powers are vested with the Government and which with a regulatory agency. Clarity in this respect is important to avoid unnecessary conflicts and confusion. Investors, as well as consumers and other interested parties, should know to whom to turn with various requests, applications or complaints.

40. Selection of public service providers, for example, is in many countries a process involving the Government as well as the regulatory agency. If the decision to award a project involves broad judgement of a political rather than technical nature, which may often be the case in the context of infrastructure privatization, final responsibility often rests with the Government. If, however, the award criteria are more technical, as may be the case with a liberal licensing regime for power generation or telecommunication services, many countries entrust the decision to an independent regulatory agency. In other cases, the Government may have to ask the regulatory agency's opinion prior to awarding a concession. On the other hand, some countries exclude direct involvement of regulatory agencies in the award process on the basis that it could affect the way they later regulate the provision of the service concerned.

41. The jurisdiction of regulatory agencies normally extends to all enterprises operating in the sectors they regulate, with no distinction between private and public enterprises. The use of some regulatory powers or instruments may be limited by law to the dominant public service providers in the sector. A regulatory agency may, for example, have price policing powers only vis-à-vis the incumbent or dominant public service provider, while new entrants may be allowed to set prices freely.

42. The matters on which regulatory agencies have to arbitrate range from normative responsibilities (for example, rules on the award of concessions and conditions for certification of equipment) to the actual award of concessions; the approval of contracts or decisions proposed by the regulated entities (for example, a schedule or contract on network access); the definition and monitoring of an obligation to provide certain services; the oversight over public service providers (in particular compliance with licence conditions, norms and performance targets); price setting or adjustments; vetting of subsidies, exemptions or other advantages that could distort competition in the sector; sanctions; and dispute settlement.

4. Composition, staff and budget of regulatory agencies

43. When setting up a regulatory agency, a few countries have opted for an agency comprised of a single officer, whereas most others have preferred a regulatory commission. A commission may provide greater safeguards against undue influence or lobbying and may limit the risk of rash regulatory decisions. A one-person regulatory agency, on the other hand, may be able to reach decisions faster and may be held more accountable. To improve the management of the decision-making process in a regulatory commission, the number of members is often kept small (typically three or five members). Even numbers are often avoided to prevent a deadlock, though the chairman could have a casting vote.

44. To increase the regulatory agency's autonomy, different institutions may be involved in the nomination process. In some countries regulatory agencies are appointed by the head of State based on a list submitted by parliament; in others the executive branch of the Government appoints the regulatory agency but subject to confirmation by parliament or upon nominations submitted by parliament, user associations or other bodies. Minimum professional qualifications are often required of the officials of the regulatory agencies, as well as the absence of conflicts of interest that might disqualify them from the function. Terms of office of members of regulatory boards may be staggered in order to prevent total turnover and appointment of all members by the same administration; staggering also promotes continuity in regulatory decision-making. Terms of office are often for a fixed term, may be non-renewable and may be terminated before the expiry of the term for limited reasons only (such as criminal conviction, mental incapacitation, gross negligence or dereliction of duty). Regulatory agencies are often faced with experienced lawyers, accountants and other experts working for the regulated industry and need to be able to acquire the same level of expertise, skills and professionalism, either in-house or by hiring outside advisers as needed.

45. Stable funding sources are critical in order for the regulatory agency to function adequately. In many countries, the budget of the regulatory agency is funded by fees and other levies on the regulated industry. Fees may be set as a percentage of the turnover of the public service providers or be levied for the award of licences, concessions or other authorizations. In some countries, the agency's budget is complemented as needed by budget transfers provided in

the annual finance law. However, this may create an element of uncertainty that may reduce the agency's autonomy.

5. Regulatory process and procedures

46. The regulatory framework typically includes procedural rules governing the way the institutions in charge of the various regulatory functions have to exercise their powers. The credibility of the regulatory process requires transparency and objectivity, irrespective of whether regulatory authority is exercised by a government department or minister or by an autonomous regulatory agency. Rules and procedures should be objective and clear so as to ensure fairness, impartiality and timely action by the regulatory agency. For purposes of transparency, the law should require that they be made public. Regulatory decisions should state the reasons on which they are based and should be made accessible to interested parties, through publication or other appropriate means.

47. Transparency may be further enhanced, as required by some laws, by the publication by the regulatory agency of an annual report on the sector, including, for example, the decisions taken during the exercise, the disputes that have arisen and the way they were settled. Such an annual report may also include the accounts of the regulatory agency and an audit thereof by an independent auditor. Legislation in many countries further requires that this annual report be submitted to a committee of parliament.

48. Regulatory decisions may have an impact on the interests of diverse groups, including the concerned public service provider, its current or potential competitors and business or non-business users. In many countries, the regulatory process includes consultation procedures for major decisions or recommendations. In some countries, that consultation takes the form of public hearings, in others of consultation papers on which comments from interested groups are solicited. Some countries have also established consultative bodies comprised of users and other concerned parties and require that their opinion be sought before major decisions and recommendations are made. To enhance transparency, comments, recommendations or opinions resulting from the consultation process may have to be published or made publicly available.

6. Recourse against decisions of the regulatory agency

49. Another important element of the host country's regulatory regime are the mechanisms whereby public service providers may request a review of regulatory decisions. As with the whole regulatory process, a high degree of transparency and credibility is essential. To be credible, the review should be entrusted to an entity that is independent from the regulatory agency taking the original decision, from the political authorities of the host country and from the public service providers.

50. Review of decisions of regulatory agencies is often in the jurisdiction of courts, but in some legal systems recourse against decisions by regulatory

agencies is in the exclusive jurisdiction of special tribunals dealing solely with administrative matters, which in some countries are separate from the judicial system. If there are concerns over the review process (for example, as regards possible delays or the capacity of courts to make evaluations of the complex economic issues involved in regulatory decisions) review functions may be entrusted to another body, at least in the first instance, before a final recourse to courts or administrative tribunals. In some countries, requests for review are considered by a high-level cross-sectoral independent oversight body. There are also countries where requests for review are heard by a panel composed of persons holding specified judicial and academic functions. As to the grounds on which a request for review may be based, in many cases there are limits, in particular as to the right of the appellate body to substitute its own discretionary assessment of facts for the assessment of the body whose decision is being reviewed.

7. Settlement of disputes between public service providers

51. Disputes may arise between competing concessionaires (for example, two operators of cellular telephony systems) or between concessionaires providing services in different segments of the same infrastructure sector. Such disputes may involve allegations of unfair trade practices (for example, price dumping), uncompetitive practices inconsistent with the country's infrastructure policy (see "Introduction and background information on privately financed infrastructure projects", paras. 23-29) or violation of specific duties of public service providers (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 82-93). In many countries, legislative provisions have been found necessary in order to establish an appropriate framework for the settlement of these disputes.

52. Firstly, the various parties may not have contractual arrangements with one another that could provide for an appropriate dispute settlement mechanism. Even where it would be possible to establish a contractual mechanism, the host country may have an interest that disputes involving certain issues (for example, conditions of access to a given infrastructure network) be settled by a specific body in order to ensure consistency in the application of the relevant rules. Furthermore, certain disputes between public service providers may involve issues that, under the laws of the host country, are not considered able to be settled through arbitration.

53. Domestic laws often establish administrative procedures for handling disputes between public service providers. Typically, public service providers may file complaints with the regulatory agency or with another governmental agency responsible for the application of the rules alleged to have been violated (for example, a governmental body in charge of enforcing competition laws and regulations), which in some countries has the authority to issue a binding decision on the matter. Such mechanisms, even where mandatory, do not necessarily preclude resort by the aggrieved persons to courts, although in some legal systems the courts may only have the power to control the legality of the decision (for example, observance of due process) but not its merits.

II. Project risks and government support

A. General remarks

1. Privately financed infrastructure projects create opportunities for reducing the commitment of public funds and other resources for infrastructure development and operation. They also make it possible to transfer to the private sector a number of risks that would otherwise be borne by the Government. The precise allocation of risks among the various parties involved is typically defined after consideration of a number of factors, including the public interest in the development of the infrastructure in question and the level of risk faced by the project company, other investors and lenders (and the extent of their ability and readiness to absorb those risks at an acceptable cost). Adequate risk allocation is essential to reducing project costs and to ensuring the successful implementation of the project. Conversely, an inappropriate allocation of project risks may compromise the project's financial viability or hinder its efficient management, thus increasing the cost at which the service is provided.

2. In the past, debt financing for infrastructure projects was obtained on the basis of credit support from project sponsors, multilateral and national export credit agencies, Governments and other third parties. In recent years, these traditional sources have not been able to meet the growing needs for infrastructure capital and financing has been increasingly obtained on a project finance basis.

3. Project finance, as a method of financing, seeks to establish the creditworthiness of the project company on a "stand alone" basis, even before construction has begun or any revenues have been generated, and to borrow on the basis of that credit. Commentators have observed that project finance may hold the key to unlocking the vast pools of capital theoretically available in the capital markets for investment in infrastructure. However, project finance has distinctive and demanding characteristics from a financial point of view. Principal among these is that, in a project finance structure, financing parties must rely mainly upon the project company's assets and cash flows for repayment. If the project fails they will have no recourse, or only limited recourse, to the financial resources of a sponsor company or other third party for repayment (see also "Introduction and background information on privately financed infrastructure projects", paras. 54 and 55).

4. The financial methodology of project financing requires a precise projection of the capital costs, revenues and projected costs, expenses, taxes and liabilities of the project. In order to predict these numbers precisely and with certainty and to create a financial model for the project, it is typically necessary to project the "base case" amounts of revenues, costs and expenses of the project company over a long period—often 20 years or more—in order to

determine the amounts of debt and equity the project can support. Central to this analysis is the identification and quantification of risks. For this reason, the identification, assessment, allocation and mitigation of risks is at the heart of project financing from a financial point of view.

5. Among the most important, yet difficult, risks to assess and to mitigate are “political risks” (risks associated with adverse actions of the host Government, its agencies and its courts, in particular in granting licences and permits, adopting regulations applicable to the project company and its markets, taxation and the performance and enforcement of contractual obligations) and “currency risks” (risks related to the value, transferability and convertibility of the local currency). In order to guard against such risks, in particular, project finance structures have often incorporated insurance or guarantees of international financial institutions and export credit agencies as well as guarantees of the host Government.

6. Section B of the present chapter (paras. 8-29) gives an overview of the main risks encountered in privately financed infrastructure projects and contains a brief discussion of common contractual solutions for risk allocation, which emphasizes the need to provide the parties with the necessary flexibility for negotiating a balanced allocation of project risks. Section C (paras. 30-60) sets out policy considerations that the Government may wish to take into account when designing the level of direct governmental support that may be provided to infrastructure projects, such as the degree of public interest in the execution of any given project and the need to avoid the assumption by the Government of open-ended or excessive contingent liabilities. Section C considers some additional support measures that have been used in governmental programmes to promote private investment in infrastructure development, without advocating the use of any of them in particular. Lastly, sections D (paras. 61-71) and E (paras. 72-74) outline guarantees and support measures that may be provided by export credit agencies and investment promotion agencies.

7. Other chapters of this *Guide* deal with related aspects of the host Government’s legal regime that are of relevance to the credit and risk analysis of a project. Depending upon the sector and type of project the emphasis will, of course, vary. The reader is referred in particular to chapters IV, “Construction and operation of infrastructure: legislative framework and project agreement”; V, “Duration, extension and termination of the project agreement”; VI, “Settlement of disputes”; and VII, “Other relevant areas of law”.

B. Project risks and risk allocation

8. As used in this chapter, the notion of “project risks” refers to those circumstances which, in the assessment of the parties, may have a negative effect on the benefit they expect to achieve with the project. While there may be events that would represent a serious risk for most parties (for example, the physical destruction of the facility by a natural disaster), each party’s risk exposure will vary according to its role in the project.

9. The expression “risk allocation” refers to the determination of which party or parties should bear the consequences of the occurrence of events identified as project risks. For example, if the project company is obliged to deliver the infrastructure facility to the contracting authority with certain equipment in functioning condition, the project company is bearing the risk that the equipment may fail to function at the agreed performance levels. The occurrence of that project risk, in turn, may have a series of consequences for the project company, including its liability for failure to perform a contractual obligation under the project agreement or the applicable law (for example, payment of damages to the contracting authority for delay in bringing the facility into operation); certain losses (for example, loss of revenue as a result of delay in beginning operating the facility); or additional cost (for example, cost of repair of faulty equipment or of securing replacement equipment).

10. The party bearing a given risk may take preventive measures with a view to limiting the likelihood of the risk, as well as specific measures to protect itself, in whole or in part, against the consequences of the risk. Such measures are often referred to as “risk mitigation”. In the previous example, the project company will carefully review the reliability of the equipment suppliers and the technology proposed. The project company may require its equipment suppliers to provide independent guarantees concerning the performance of their equipment. The supplier may also be liable to pay penalties or liquidated damages to the project company for the consequences of failure of its equipment. In some cases, a more or less complex chain of contractual arrangements may be made to mitigate the consequences of a project risk. For instance, the project company may combine the guarantees provided by the equipment supplier with commercial insurance covering some consequences of the interruption of its business as a result of equipment failure.

1. Overview of main categories of project risk

11. For purposes of illustration, the following paragraphs provide an overview of the main categories of project risks and give examples of certain contractual arrangements used for risk allocation and mitigation. For further discussion on this subject, the reader is advised to consult other sources of information, such as the *UNIDO BOT Guidelines*.¹

(a) Project disruption caused by events outside the control of the parties

12. The parties face the risk that the project may be disrupted by unforeseen or extraordinary events outside their control, which may be of a physical nature, such as natural disasters—floods, storms or earthquakes—or the result of human action, such as war, riots or terrorist attacks. Such unforeseen or extraordinary events may cause a temporary interruption of the project execution or the operation of the facility, resulting in construction delay, loss of revenue and other losses. Severe events may cause physical damage to the facility or even destruc-

¹See “Introduction and background information on privately financed infrastructure projects”, footnote 1.

tion beyond repair (for a discussion of the legal consequences of the occurrence of such events, see chap. IV, “Construction and operation of infrastructure: legislative framework and project agreement”, paras. 131-139).

(b) *Project disruption caused by adverse acts of Government*
(“political risk“)

13. The project company and the lenders face the risk that the project execution may be negatively affected by acts of the contracting authority, another agency of the Government or the host country’s legislature. Such risks are often referred to as “political risks” and may be divided into three broad categories: “traditional” political risks (for example, nationalization of the project company’s assets or imposition of new taxes that jeopardize the project company’s prospects of debt repayment and investment recovery); “regulatory” risks (for example, introduction of more stringent standards for service delivery or opening of a sector to competition) and “quasi-commercial” risks (for example, breaches by the contracting authority or project interruptions due to changes in the contracting authority’s priorities and plans) (for a discussion of the legal consequences of the occurrence of such events, see chap. IV, “Construction and operation of infrastructure: legislative framework and project agreement”, paras. 122-125). In addition to political risks originating from the host country, some political risks may result from acts of a foreign Government, such as blockades, embargoes or boycotts imposed by the Governments of the investors’ home countries.

(c) *Construction and operation risks*

14. The main risks that the parties may face during the construction phase are the risks that the facility cannot be completed at all or cannot be delivered according to the agreed schedule (completion risk); that the construction cost exceeds the original estimates (construction cost overrun risk); or that the facility fails to meet performance criteria at completion (performance risk). Similarly, during the operational phase the parties may face the risk that the completed facility cannot be effectively operated or maintained to produce the expected capacity, output or efficiency (performance risk); or that the operating costs exceed the original estimates (operation cost overrun). It should be noted that construction and operation risks do not affect only the private sector. The contracting authority and the users in the host country may be severely affected by an interruption in the provision of needed services. The Government, as representative of the public interest, will be generally concerned about safety risks or environmental damage caused by improper operation of the facility.

15. Some of these risks may be brought about by the project company or its contractors or suppliers. For instance, construction cost overrun and delay in completion may be the result of inefficient construction practices, waste, insufficient budgeting or lack of coordination among contractors. Failure of the facility to meet performance criteria may also be the result of defective design, inadequacy of the technology used or faulty equipment delivered by the project company’s suppliers. During the operational phase, performance failures may

be the consequence, for example, of faulty maintenance of the facility or negligent operation of mechanical equipment. Operation cost overruns may also derive from inadequate management.

16. However, some of these risks may also result from specific actions taken by the contracting authority, by other public authorities or even the host country's legislature. Performance failures or cost overruns may be the consequence of the inadequacy of the technical specifications provided by the contracting authority during the selection of the concessionaire. Delays and cost overruns may also be brought about by actions of the contracting authority subsequent to the award of the project (delays in obtaining approvals and permits, additional costs caused by changes in requirements due to inadequate planning, interruptions caused by inspecting agencies or delays in delivering the land on which the facility is to be built). General legislative or regulatory measures, such as more stringent safety or labour standards, may also result in higher construction or operating costs. Shortfalls in production may be caused by the non-delivery of the necessary supplies (for example, power or gas) on the part of public authorities.

(d) Commercial risks

17. "Commercial risks" relate to the possibility that the project cannot generate the expected revenue because of changes in market prices or demand for the goods or services it generates. Both of these forms of commercial risk may seriously impair the project company's capacity to service its debt and may compromise the financial viability of the project.

18. Commercial risks vary greatly according to the sector and type of project. The risk may be regarded as minimal or moderate where the project company has a monopoly over the service concerned or when it supplies a single client through a standing off-take agreement. However, commercial risks may be considerable in projects that depend on market-based revenues, in particular where the existence of alternative facilities or supply sources makes it difficult to establish a reliable forecast of usage or demand. This may be a serious concern, for instance, in tollroad projects, since tollroads face competition from toll-free roads. Depending on the ease with which drivers may have access to toll-free roads, the toll revenues may be difficult to forecast, especially in urban areas where there may be many alternative routes and roads may be built or improved continuously. Furthermore, traffic usage has been found to be even more difficult to forecast in the case of new tollroads, especially those which are not an addition to an existing toll facility system, because there is no existing traffic to use as an actuarial basis.

(e) Exchange rate and other financial risks

19. Exchange rate risk relates to the possibility that changes in foreign exchange rates alter the exchange value of cash flows from the project. Prices and user fees charged to local users or customers will most likely be paid for in local currency, while the loan facilities and sometimes also equipment or

fuel costs may be denominated in foreign currency. This risk may be considerable, since exchange rates are particularly unstable in many developing countries or countries whose economies are in transition. In addition to exchange rate fluctuations, the project company may face the risk that foreign exchange control or lowering reserves of foreign exchange may limit the availability in the local market of foreign currency needed by the project company to service its debt or repay the original investment.

20. Another risk faced by the project company concerns the possibility that interest rates may rise, forcing the project to bear additional financing costs. This risk may be significant in infrastructure projects given the usually large sums borrowed and the long duration of projects, with some loans extending over a period of several years. Loans are often given at a fixed rate of interest (for example, fixed-rate bonds) to reduce the interest rate risk. In addition, the finance package may include hedging facilities against interest rate risks, for example, by way of interest rate swaps or interest rate caps.

2. Contractual arrangements for risk allocation and mitigation

21. It follows from the above that the parties need to take into account a wide range of factors to allocate project risks effectively. For this reason, it is generally not advisable to have in place statutory provisions that limit unnecessarily the negotiators' ability to achieve a balanced allocation of project risks, as appropriate to the needs of individual projects. Nevertheless, it may be useful for the Government to provide some general guidance to officials acting on behalf of domestic contracting authorities, for instance, by formulating advisory principles on risk allocation.

22. Practical guidance provided to contracting authorities in a number of countries often refers to general principles for the allocation of project risks. One such principle is that specific risks should normally be allocated to the party best able to assess, control and manage the risk. Additional guiding principles envisage the allocation of project risks to the party with the best access to hedging instruments (that is, investment schemes to offset losses in one transaction by realizing a simultaneous gain on another) or the greatest ability to diversify the risks or to mitigate them at the lowest cost. In practice, however, risk allocation is often a factor of both policy considerations (for example, the public interest in the project or the overall exposure of the contracting authority under various projects) and the negotiating strength of the parties. Furthermore, in allocating project risks it is important to consider the financial strength of the parties to which a specific risk is allocated and their ability to bear the consequences of the risk, should it occur.

23. It is usually for the project company and its contractors to assume ordinary risks related to the development and operation of the infrastructure. For instance, completion, cost overrun and other risks typical of the construction phase are usually allocated to the construction contractor or contractors through a turnkey construction contract, whereby the contractor assumes full

responsibility for the design and construction of the facility at a fixed price, within a specified completion date and according to particular performance specifications (see chap. IV, “Construction and operation of infrastructure: legislative framework and project agreement”, para. 70). The construction contractor is typically liable to pay liquidated damages or penalties for any late completion. In addition, the contractor is also usually required to provide a guarantee of performance, such as a bank guarantee or a surety bond. Separate equipment suppliers are also usually required to provide guarantees in respect of the performance of their equipment. Guarantees of performance provided by contractors and equipment suppliers are often complemented by similar guarantees provided by the concessionaire to the benefit of the contracting authority. Similarly, the project company typically mitigates its exposure to operation risks by entering into an operation and maintenance contract in which the operating company undertakes to achieve the required output and assumes the liability for the consequences of operational failures. In most cases, arrangements of this type will be an essential requirement for a successful project. The lenders, for their part, will seek protection against the consequences of those risks, by requiring the assignment of the proceeds of any bonds issued to guarantee the contractor’s performance, for instance. Loan agreements typically require that the proceeds from contract bonds be deposited in an account pledged to the lenders (that is, an “escrow account”), as a safeguard against misappropriation by the project company or against seizure by third parties (for example, other creditors). Nevertheless, the funds paid under the bonds are regularly released to the project company as needed to cover repair costs or operating and other expenses.

24. The contracting authority, on the other hand, will be expected to assume those risks which relate to events attributable to its own actions, such as inadequacy of technical specifications provided during the selection process or delay caused by failure to provide agreed supplies on time. The contracting authority may also be expected to bear the consequences of disruptions caused by acts of Government, for instance by agreeing to compensate the project company for loss of revenue due to price control measures (see chap. IV, “Construction and operation of infrastructure: legislative framework and project agreement”, para. 124). While some political risks may be mitigated by procuring insurance, such insurance, if at all available for projects in the country concerned, may not be obtainable at an acceptable cost. Thus, prospective investors and lenders may turn to the Government, for instance, to obtain assurances against expropriation or nationalization and guarantees that proper compensation will be payable in the event of such action (see para. 50). Depending on their assessment of the level of risk faced in the host country, prospective investors and lenders may not be ready to pursue a project in the absence of those assurances or guarantees.

25. Most of the project risks referred to in the preceding paragraphs can, to a greater or lesser extent, be regarded as falling within the control of one party or the other. However, a wide variety of project risks result from events outside the control of the parties or are attributable to the acts of third parties and other principles of risk allocation may thus need to be considered.

26. For example, the project company could expect that the interest rate risk, together with the inflation risk, would be passed on to the end-users or customers of the facility through price increases, although this may not always be possible because of market-related circumstances or price control measures. The price structure negotiated between the project company and the contracting authority will determine the extent to which the project company will avoid those risks or whether it will be expected to absorb some of them (see chap. IV, “Construction and operation of infrastructure: legislative framework and project agreement”, paras. 36-46).

27. Another category of risk that may be allocated under varying schemes concerns extraneous events such as war, civil disturbance, natural disasters or other events wholly outside the control of the parties. In traditional infrastructure projects carried out by the public sector, the public entity concerned usually bears the risk, for example, of destruction of the facility by natural disasters or similar events, to the extent that those risks may not be insurable. In privately financed infrastructure projects the Government may prefer this type of risk to be borne by the project company. However, depending on their assessment of the particular risks faced in the host country, the private sector may not be ready to bear those risks. Therefore, in practice there is not a single solution to cover this entire category of risk and special arrangements are often made to deal with each of them. For example, the parties may agree that the occurrence of some of those events may exempt the affected party from the consequences of failure to perform under the project agreement and there will be contractual arrangements providing solutions for some of their adverse consequences, such as contract extensions to compensate for delay resulting from events or even some form of direct payment under special circumstances (see chap. IV, “Construction and operation of infrastructure: legislative framework and project agreement”, paras. 131-139). Those arrangements will be supplemented by commercial insurance purchased by the project company, where available at an acceptable cost (see chap. IV, “Construction and operation of infrastructure: legislative framework and project agreement”, paras. 119 and 120).

28. Special arrangements may also need to be negotiated for the allocation of commercial risks. Projects such as mobile telecommunication projects usually have a relatively high direct cost recovery potential and in most cases the project company is expected to carry out the project without sharing those risks with the contracting authority and without recourse to support from the Government. In other infrastructure projects, such as power-generation projects, the project company may revert to contractual arrangements with the contracting authority or other public authority in order to reduce its exposure to commercial risks, for example, by negotiating long-term off-take agreements that guarantee a market for the product at an agreed price. Payments may take the form of actual consumption or availability charges or combine elements of both; the applicable rates are usually subject to escalation or indexation clauses in order to protect the real value of revenues from the increased costs of operating an ageing facility (see also chap. IV, “Construction and operation of infrastructure: legislative framework and project agreement”, paras. 50 and 51). Lastly,

there are relatively capital-intensive projects with more slowly developing cost recovery potential, such as water supply and some tollroad projects, which the private sector may be reluctant to carry out without some form of risk-sharing with the contracting authority, for example, through fixed revenue assurances or agreed capacity payments regardless of actual usage (see also chap. IV, “Construction and operation of infrastructure: legislative framework and project agreement”, paras. 48 and 49).

29. The risk allocation eventually agreed to by the contracting authority and the project company will be reflected in their mutual rights and obligations, as set forth in the project agreement. The possible legislative implications of certain provisions commonly found in project agreements are discussed in other chapters of the *Guide* (see chaps. IV, “Construction and operation of infrastructure: legislative framework and project agreement”, and V, “Duration, extension and termination of the project agreement”). Various other agreements will also be negotiated by the parties to mitigate or reallocate the risks they assume (for example, loan agreements; construction, equipment supply, operation and maintenance contracts; direct agreement between the contracting authority and the lenders; and off-take and long-term supply agreements, where applicable).

C. Government support

30. The discussion in the preceding section shows that the parties may use various contractual arrangements to allocate and mitigate project risks. Nevertheless, those arrangements may not always be sufficient to ensure the level of comfort required by private investors to participate in privately financed infrastructure projects. It may also be found that certain additional government support is needed to enhance the attractiveness of private investment in infrastructure projects in the host country.

31. Government support may take various forms. Generally, any measure taken by the Government to enhance the investment climate for infrastructure projects may be regarded as governmental support. From that perspective, the existence of legislation enabling the Government to award privately financed infrastructure projects or the establishment of clear lines of authority for the negotiation and follow-up of infrastructure projects (see chap. I, “General legislative and institutional framework”, paras. 23-29) may represent important measures to support the execution of infrastructure projects. As used in the *Guide*, however, the expression “government support” has a narrower connotation and refers in particular to special measures, in most cases of a financial or economic nature, that may be taken by the Government to enhance the conditions for the execution of a given project or to assist the project company in meeting some of the project risks, above and beyond the ordinary scope of the contractual arrangements agreed to between the contracting authority and the project company to allocate project risks. Government support measures, where available, are typically an integral part of governmental programmes to attract private investment for infrastructure projects.

1. Policy considerations relating to government support

32. In practice, a decision to support the implementation of a project is based on an assessment by the Government of the economic or social value of the project and whether that justifies additional governmental support. The Government may estimate that the private sector alone may not be able to finance certain projects at an acceptable cost. The Government may also consider that particular projects may not materialize without certain support measures that mitigate some of the project risks. Indeed, the readiness of private investors and lenders to carry out large projects in a given country is not only based on their assessment of specific project risks, but is also influenced by their comfort with the investment climate in the host country, in particular in the infrastructure sector. Factors to which private investors may attach special importance include the host country's economic system and the degree of development of market structures and the degree to which the country has already succeeded with privately financed infrastructure projects over a period of years.

33. For the above reasons, a number of countries have adopted a flexible approach for dealing with the issue of governmental support. In some countries, this has been done by legislative provisions that tailor the level and type of support to the specific needs of individual infrastructure sectors. In other countries, this has been achieved by providing the host Government with sufficient legislative authority to extend certain types of assurance or guarantee while preserving its discretion not to make them available in all cases. However, the host Government will be interested in ensuring that the level and type of support provided to the project does not result in the assumption of open-ended liabilities. Indeed, over-commitment of public authorities through guarantees given to a specific project may prevent them from extending guarantees in other projects of perhaps even greater public interest.

34. The efficiency of governmental support programmes for private investment in infrastructure may be enhanced by the introduction of appropriate techniques for budgeting for governmental support measures or for assessing the total cost of other forms of governmental support. For example, loan guarantees provided by public authorities usually have a cost lower than the cost of loan guarantees provided by commercial lenders. The difference (less the value of fees and interests payable by the project company) represents a cost for the Government and a subsidy for the project company. However, loan guarantees are often not recorded as expenses until such time as a claim is made. Thus, the actual amount of the subsidy granted by the Government is not recorded, which may create the incorrect impression that loan guarantees entail a lesser liability than direct subsidy payments. Similarly, the financial and economic cost of tax exemptions granted by the Government may not be apparent, which makes them less transparent than other forms of direct governmental support. For these reasons, countries that are contemplating establishing support programmes for privately financed infrastructure projects may need to devise special methods for estimating the budgetary cost of support measures such as tax exemptions, loans and loan guarantees provided by public authorities that take into account the expected present value of future costs or loss of revenue.

2. *Forms of government support*

35. The availability of direct governmental support, be it in the form of financial guarantees, public loans or revenue assurances, may be an important element in the financial structuring of the project. The following paragraphs briefly describe forms of governmental support that are sometimes authorized under domestic laws and discuss possible legislative implications they may have for the host country, without advocating the use of any of them in particular.

36. Generally, besides the administrative and budgetary measures that may be needed to ensure the fulfilment of governmental commitments throughout the duration of the project, it is advisable for the legislature to consider the possible need for an explicit legislative authorization to provide certain forms of support. Where government support is found advisable, it is important for the legislature to bear in mind the host country's obligations under international agreements on regional economic integration or trade liberalization, which may limit the ability of public authorities of the contracting States to provide support, financial or otherwise, to companies operating in their territories. Furthermore, where a Government is contemplating support for the execution of an infrastructure project, that circumstance should be made clear to all prospective bidders at an appropriate time during the selection proceedings (see chap. III, "Selection of the concessionaire", para. 67).

(a) Public loans and loan guarantees

37. In some cases, the law authorizes the Government to extend interest-free or low-interest loans to the project company to lower the project's financing cost. Depending on the accounting rules to be followed, some interest-free loans provided by public agencies can be recorded as revenue in the project company's accounts, with loan payments being treated as deductible costs for tax and accounting purposes. Moreover, subordinate loans provided by the Government may enhance the financial terms of the project by supplementing senior loans provided by commercial banks without competing with senior loans for repayment. Governmental loans may be generally available to all project companies in a given sector or they may be limited to providing temporary assistance to the project company in the event that certain project risks materialize. The total amount of any such loan may be further limited to a fixed sum or to a percentage of the total project cost.

38. In addition to public loans, some national laws authorize the contracting authority or other agency of the host Government to provide loan guarantees for the repayment of loans taken by the project company. Loan guarantees are intended to protect the lenders (and, in some cases, investors providing funds to the project as well) against default by the project company. Loan guarantees do not entail an immediate disbursement of public funds and they may appear more attractive to the Government than direct loans. However, loan guarantees may represent a substantial contingent liability and the Government's exposure may be significant, especially in the event of total failure by the project company. Indeed, the Government would in most cases

find little comfort in a possible subrogation in the rights of the lenders against an insolvent project company.

39. Thus, in addition to introducing general measures to enhance the efficiency of governmental support programmes (see para. 34), it may be advisable to consider concrete provisions to limit the Government's exposure under loan guarantees. Rules governing the provision of loan guarantees may provide a maximum ceiling, which could be expressed as a fixed sum or, if more flexibility is needed, a certain percentage of the total investment in any given project. Another measure to circumscribe the contingent liabilities of the guaranteeing agency may be to define the circumstances under which such guarantees may be extended, taking into account the types of project risk the Government may be ready to share. For instance, if the Government considers sharing only the risks of temporary disruption caused by events outside the control of the parties, the guarantees could be limited to the event that the project company is rendered temporarily unable to service its loans owing to the occurrence of specially designated unforeseeable events outside the project company's control. If the Government wishes to extend a greater degree of protection to the lenders, the guarantees may cover the project company's permanent failure to repay its loans for the same reasons. In such a case, however, it is advisable not to remove the incentives for the lenders to arrange for the continuation of the project, for instance by identifying another suitable concessionaire or by stepping in through an agent appointed to remedy the project company's default (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 147-150). The call on the governmental guarantees could thus be conditional upon the prior exhaustion of other remedies available to the lenders under the project agreement, the loan agreements or their direct agreements with the contracting authority, if any. In any event, full loan guarantees by the Government amounting to a total protection of the lenders against the risk of default by the project company are not a common feature of infrastructure projects carried out under the project finance modality.

(b) Equity participation

40. Another form of additional support by the Government may consist of direct or indirect equity participation in the project company. Equity participation by the Government may help achieve a more favourable ratio between equity and debt by supplementing the equity provided by the project sponsors, in particular where other sources of equity capital, such as investment funds, cannot be tapped by the project company. Equity investment by the Government may also be useful to satisfy legal requirements of the host country concerning the composition of locally established companies. The company laws of some jurisdictions, or special legislation on infrastructure projects, require a certain amount of participation of local investors in locally established companies. However, it may not always be possible to secure the required level of local participation on acceptable terms. Local investors may lack the interest or financial resources to invest in large infrastructure projects; they may also be averse to or lack experience in dealing with specific project risks.

41. Governmental participation may involve certain risks that the Government may wish to consider. In particular, there is a risk that such participation may be understood as an implied guarantee by the Government, so that the parties, or even third parties, may expect the Government to back the project fully or eventually even take it over at its own cost if the project company fails. Where such an implied guarantee is not intended, appropriate provisions should be made to clarify the limits of governmental involvement in the project.

(c) Subsidies

42. Tariff subsidies are used in some countries to supplement the project company's revenue when the actual income of the project falls below a certain minimum level. The provision of the services in some areas where the project company is required to operate may not be a profitable undertaking, because of low demand or high operational costs or because the project company is required to provide the service to a certain segment of the population at low cost. Thus, the law in some countries authorizes the Government to undertake to extend subsidies to the project company in order to make it possible to provide the services at a lower price.

43. Subsidies usually take the form of direct payments to the project company, either lump-sum payments or payments calculated specifically to supplement the project company's revenue. In the latter case, the Government should ensure that it has in place adequate mechanisms for verifying the accuracy of subsidy payments made to the project company, by means, for example, of audit and financial disclosure provisions in the project agreement. An alternative to direct subsidies may be to allow the project company to cross-subsidize less profitable activities with revenue earned in more profitable ones. This may be done by combining in the same concession both profitable and less profitable activities or areas of operation, or by granting to the project company the commercial exploitation of a separate and more profitable ancillary activity (see paras. 48-60).

44. However, it is important for the legislature to consider practical implications and possible legal obstacles to the provision of subsidies to the project company. For example, subsidies are found to distort free competition and the competition laws of many countries prohibit the provision of subsidies or other forms of direct financial aid that are not expressly authorized by legislation. Subsidies may also be inconsistent with the host country's international obligations under international agreements on regional economic integration or trade liberalization.

(d) Sovereign guarantees

45. In connection with privately financed infrastructure projects, the term "sovereign guarantees" is sometimes used to refer to any of two types of guarantee provided by the host Government. The first type includes guarantees issued by the host Government to cover the breach of obligations assumed by the contracting authority under the project agreement. A second category in-

cludes guarantees that the project company will not be prevented by the Government from exercising certain rights that are granted to it under the project agreement or that derive from the laws of the country, for example, the right to repatriate profits at the end of the project. Whatever form such guarantees may take, it is important for the Government and the legislature to consider the Government's ability to assess and manage efficiently its own exposure to project risks and to determine the acceptable level of direct or contingent liabilities it can assume.

(i) *Guarantees of performance by the contracting authority*

46. Performance guarantees may be used where the contracting authority is a separate or autonomous legal entity that does not engage the responsibility of the Government itself. Such guarantees may be issued in the name of the Government or of a public financial institution of the host country. They may also take the form of a guarantee issued by international financial institutions that are backed by a counter-guarantee by the Government (see paras. 61-71). Guarantees given by the Government may be useful instruments to protect the project company from the consequences of default by the contracting authority or other public authority assuming specific obligations under the project agreement. The most common situations in which such guarantees are used include the following:

(a) *Off-take guarantees.* Under these arrangements, the Government guarantees payment of goods and services supplied by the project company to public entities. Payment guarantees are often used in connection with payment obligations under off-take agreements in the power-generation sector (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", para. 50). Such guarantees may be of particular importance where the main or sole customer of the project company is a government monopoly. Additional comfort is provided to the project company and lenders when the guarantee is subscribed by an international financial institution;

(b) *Supply guarantees.* Supply guarantees may also be provided to protect the project company from the consequences of default by public sector entities providing goods and supplies required for the operation of the facility—fuel, electricity or water, for example—or to secure payment of indemnities for which the contracting authority may become liable under the supply agreement;

(c) *General guarantees.* These are guarantees intended to protect the project company against any form of default by the contracting authority, rather than default on specifically designated obligations. Although general performance guarantees may not be very frequent, there are cases in which the project company and the lenders may regard them as a condition necessary for executing the project. This may be the case, for example, where the obligations undertaken by the contracting authority are not commensurate with its creditworthiness, as may happen in connection with large concessions granted by municipalities or other autonomous entities. Guarantees by the Government may be useful to ensure specific performance, for example, when the host Government undertakes to substitute for the contracting entity in the perform-

ance of certain acts (for example, delivery of an appropriate site for disposal of by-products).

47. Generally, it is important not to overestimate the adequacy of sovereign guarantees alone to protect the project company against the consequences of default by the contracting authority. Except when their purpose is to ensure specific performance, sovereign guarantees usually have a compensatory function. Thus, they may not substitute for appropriate contractual remedies in the event of default by the contracting authority (see chap. IV, “Construction and operation of infrastructure: legislative framework and project agreement”, paras. 140-150). Different types of contractual remedies, or combinations thereof, may be used to deal with various events of default, for example, liquidated damages in the event of default and price increases or contract extensions in the event of additional delay in project execution caused by acts of the contracting authority. Furthermore, in order to limit the Government’s exposure and to reduce the risk of calls on the guarantee, it is advisable to consider measures to encourage the contracting authority to live up to its obligations under the project agreement or to make efforts to control the causes of default. Such measures may include express subrogation rights of the guarantor against the contracting authority or internal control mechanisms to ensure the accountability of the contracting authority or its agents in the event, for instance, of wanton or reckless breach of its obligations under the project agreement resulting in a call on the sovereign guarantee.

(ii) Guarantees against adverse acts of Government

48. Unlike performance guarantees, which protect the project company against the consequences of default by the contracting authority, the guarantees considered here relate to acts of other authorities of the host country that are detrimental to the rights of the project company or otherwise substantially affect the implementation of the project agreement. Such guarantees are often referred to as “political risk guarantees”.

49. One type of guarantee contemplated in national laws consists of foreign exchange guarantees, which usually fulfil three functions: to guarantee the convertibility of the local earnings into foreign currency, to guarantee the availability of the required foreign currency and to guarantee the transferability abroad of the converted sums. Foreign exchange guarantees are common in privately financed infrastructure projects involving a substantial amount of debt denominated in currencies other than the local currency, in particular in those countries which do not have freely convertible currencies. Some laws also provide that such a guarantee may be backed by a bank guarantee issued in favour of the project company. A foreign exchange guarantee is not normally intended to protect the project company and the lenders against the risks of exchange rate fluctuation or market-induced devaluation, which are considered to be ordinary commercial risks. However, in practice, Governments have sometimes agreed to assist the project company in cases where the project company is unable to repay its debts in foreign currency owing to extreme devaluation of the local currency.

50. Another important type of guarantee may be to assure the company and its shareholders that they will not be expropriated without adequate compensation. Such a guarantee would typically extend both to confiscation of property owned by the project company in the host country and to the nationalization of the project company itself, that is, confiscation of shares of the project company's capital. This type of guarantee is usually provided for in laws dealing with direct foreign investment and in bilateral investment protection treaties (see chap. VII, "Other relevant areas of law", paras. 4-6).

(e) Tax and customs benefits

51. Another method for the host Government to support the execution of privately financed projects could be to grant some form of tax and customs exemption, reduction or benefit. Domestic legislation on foreign direct investment often provides special tax regimes to encourage foreign investment and in some countries it has been found useful expressly to extend such a taxation regime to foreign companies participating in privately financed infrastructure projects (see also chap. VII, "Other relevant areas of law", paras. 34-39).

52. Typical tax exemptions or benefits include exemption from income or profit tax or from property tax on the facility, or exemptions from income tax on interest due on loans and other financial obligations assumed by the project company. Some laws provide that all transactions related to a privately financed infrastructure project will be exempted from stamp duties or similar charges. In some cases, the law establishes some preferential tax treatment or provides that the project company will benefit from the same favourable tax treatment generally given to foreign investments. Sometimes the tax benefit takes the form of a more favourable income tax rate, combined with a decreasing level of exemption during the initial years of the project. Such exemptions and benefits are sometimes extended to the contractors engaged by the project company, in particular foreign contractors.

53. Further taxation measures sometimes used to promote privately financed infrastructure projects are exemptions from withholding tax to foreign lenders providing loans to the project. Under many legal systems, any interest, commission or fee in connection with a loan or indebtedness that is borne directly or indirectly by locally established companies or is deductible against income earned locally is deemed to be local income for taxation purposes. Therefore, both local and foreign lenders to infrastructure projects may be liable to the payment of income tax in the host country, which the project company may be required to withhold from payments to foreign lenders, as non-residents of the host country. Income tax due by the lenders in the host country is typically taken into account in the negotiations between the project company and the lenders and may result in a higher financial cost for the project. In some countries, the competent organs are authorized to grant exemptions from withholding tax in connection with payments to non-residents that are found to be made for a purpose that promotes or enhances the economic or technological development of the host country or are otherwise deemed to be related to a purpose of public relevance.

54. Besides tax benefits or exemptions, national laws sometimes facilitate the import of equipment for the use of the project company by means of exemption from customs duties. Such exemption typically applies to the payment of import duties on equipment, machinery, accessories, raw materials and materials imported into the country for purposes of conducting preliminary studies, designing, constructing and operating infrastructure projects. In the event that the project company wishes to transfer or sell the imported equipment on the domestic market, the approval of the contracting authority usually needs to be obtained and the relevant import duties, turnover tax or other taxes need to be paid in accordance with the laws of the country. Sometimes the law authorizes the Government either to grant an exemption from customs duty or to guarantee that the level of duty will not be raised to the detriment of the project.

(f) Protection from competition

55. An additional form of governmental support may consist of assurances that no competing infrastructure project will be developed for a certain period or that no agency of the Government will compete with the project company, directly or through another concessionaire. Assurances of this sort serve as a guarantee that the exclusivity rights that may be granted to the concessionaire (see chap. I, “General legislative and institutional framework”, paras. 20-22) will not be nullified during the life of the project. Protection from competition may be regarded by the project company and the lenders as an essential condition for participating in the development of infrastructure in the host country. Some national laws contain provisions whereby the Government undertakes not to facilitate or support the execution of a parallel project that might generate competition to the project company. In some cases, the law contains an undertaking by the Government that it will not alter the terms of such exclusivity to the detriment of the project company without the project company’s consent.

56. Provisions of this type may be intended to foster the confidence of the project sponsors and the lenders that the basic assumptions under which the project was awarded will be respected. However, they may be inconsistent with the host country’s international obligations under agreements on regional economic integration and trade liberalization. Furthermore, they may limit the ability of the Government to deal with an increase in the demand for the service concerned as the public interest may require or to ensure the availability of the services to various categories of user. It is therefore important to consider carefully the interests of the various parties involved. For instance, the required price level to allow profitable exploitation of a tollroad may exceed the paying capacity of low-income segments of the public. Thus, the contracting authority may have an interest in maintaining open to the public a toll-free road as an alternative to a new tollroad. At the same time, however, if the contracting authority decides to improve or upgrade the alternative road, the traffic flow may be diverted from the tollroad built by the project company, thus affecting its flow of income. Similarly, the Government may wish to introduce free competition for the provision of long-distance telephone services in order to expand the availability and reduce the cost of telecommunication services (for a brief overview of issues relating to competition, see “Intro-

duction and background information on privately financed infrastructure projects”, paras. 24-29). The consequence of such a measure, however, may be a significant erosion of the income anticipated by the project company.

57. Generally, it may be useful to authorize the Government, where appropriate, to give assurances that the project company’s exclusive rights will not be unduly affected by subsequent changes in governmental policies without appropriate compensation. However, it may not be advisable to adopt statutory provisions that rule out the possibility of subsequent changes in the Government’s policy for the sector concerned, including a decision to promote competition or to build parallel infrastructure. The possible consequences of such future changes for the project company should be dealt with by the parties in contractual provisions dealing with changes in circumstances (see chap. IV, “Construction and operation of infrastructure: legislative framework and project agreement”, paras. 121-130). It is particularly advisable to provide the contracting authority with the necessary power to negotiate with the project company the compensation that may be due for loss or damage that may result from a competing infrastructure project subsequently launched by the contracting authority or from any equivalent measure of the Government that adversely affects the project company’s exclusive rights.

(g) Ancillary revenue sources

58. One additional form of support to the execution of privately financed infrastructure projects may be to allow the project company to diversify its investment through additional concessions for the provision of ancillary services or the exploitation of other activities. In some cases, alternative sources of revenue may also be used as a subsidy to the project company for the purpose of pursuing a policy of low or controlled prices for the main service. Provided that the ancillary activities are sufficiently profitable, they may enhance the financial feasibility of a project: the right to collect tolls on an existing bridge, for example, may be an incentive for the execution of a new toll-bridge project. However, the relative importance of ancillary revenue sources should not be overemphasized.

59. In order to allow the project company to pursue ancillary activities, it may be necessary for the Government to receive legislative authorization to grant the project company the right to use property belonging to the contracting authority for the purposes of such activities (for example, land adjacent to a highway for construction of service areas) or the right to charge fees for the use of a facility built by the contracting authority. Where it is felt necessary to control the development and possibly the expansion of such ancillary activities, the approval of the contracting authority might be required in order for the project company to undertake significant expansion of facilities used for ancillary activities.

60. Under some legal systems, certain types of ancillary source of revenue offered by the Government may be regarded as a concession separate from the main concession and it is therefore advisable to review possible limitations to

the project company's freedom to enter into contracts for the operation of ancillary facilities (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 100 and 101).

D. Guarantees provided by international financial institutions

61. Besides guarantees given directly by the host Government, there may be guarantees issued by international financial institutions, such as the World Bank, the Multilateral Investment Guarantee Agency and the regional development banks. Such guarantees usually protect the project company against certain political risks, but under some circumstances they may also cover breach of the project agreement, for instance, where the project company defaults on its loans as a result of the breach of an obligation by the contracting authority.

1. Guarantees provided by multilateral lending institutions

62. In addition to lending to Governments and public authorities, multilateral lending institutions, such as the World Bank and the regional development banks, have developed programmes to extend loans to the private sector. Sometimes they can also provide guarantees to commercial lenders for public and private sector projects. In most cases, guarantees provided by those institutions require a counter-guarantee from the host Government.

63. Guarantees by multilateral lending institutions are designed to mitigate the risks of default on sovereign contractual obligations or long-maturity loans that private lenders are not prepared to bear and are not equipped to evaluate. For instance, guarantees provided by the World Bank may typically cover specified risks (the partial risk guarantee) or all credit risks during a specified part of the financing term (the partial credit guarantee), as summarized below. Most regional development banks provide guarantees under terms similar to those of the World Bank.

(a) Partial risk guarantees

64. A partial risk guarantee covers specified risks arising from non-performance of sovereign contractual obligations or certain political force majeure events. Such guarantees ensure payment in the case of debt service default resulting from the non-performance of contractual obligations undertaken by Governments or their agencies. They may cover various types of non-performance, such as failure to maintain the agreed regulatory framework, including price formulas; failure to deliver inputs, such as fuel supplied to a private power company; failure to pay for outputs, such as power purchased by a government utility from a power company or bulk water purchased by a local public distribution company; failure to compensate for project delays or interruptions caused by government actions or political events; procedural delays; and adverse changes in exchange control laws or regulations.

65. When multilateral lending institutions participate in financing a project, they sometimes provide support in the form of a waiver of recourse that they would otherwise have to the project company in the event that default is caused by events such as political risks. For example, a multilateral lending institution taking a completion guarantee from the project company may accept that it cannot enforce that guarantee if the reason for failure to complete was a political risk reason.

(b) Partial credit guarantees

66. Partial credit guarantees are provided to private sector borrowers with a government counter-guarantee. They are designed to cover the portion of financing that falls due beyond the normal tenure of loans provided by private lenders. These guarantees are generally used for projects involving private sector participation that need long-term funds to be financially viable. A partial credit guarantee typically extends maturities of loans and covers all events of non-payment for a designated part of the debt service.

2. *Guarantees provided by the Multilateral Investment Guarantee Agency*

67. The Multilateral Investment Guarantee Agency (MIGA) offers long-term political risk insurance coverage to new investments originating in any member country and destined for any developing member country other than the country from which the investment originates. New investment contributions associated with the expansion, modernization or financial restructuring of existing projects are also eligible, as are acquisitions that involve the privatization of State enterprises. Eligible forms of foreign investment include equity, shareholder loans and loan guarantees issued by equity holders, provided the loans and loan guarantees have terms of at least three years. Loans to unrelated borrowers can also be insured, as long as a shareholder investment in the project is concurrently insured. Other eligible forms of investment are technical assistance, management contracts and franchising and licensing agreements, provided they have terms of at least three years and the remuneration of the investor is tied to the operating results of the project. MIGA insures against the following risks: foreign currency transfer restrictions, expropriation, breach of contract, war and civil disturbance.

(a) Transfer restrictions

68. The purpose of guarantees of foreign currency transfer extended by MIGA is similar to that of sovereign foreign exchange guarantees that may be provided by the host Government (see para. 49). This guarantee protects against losses arising from an investor's inability to convert local currency (capital, interest, principal, profits, royalties and other remittances) into foreign exchange for transfer outside the host country. The coverage insures against

excessive delays in acquiring foreign exchange caused by action or failure to act by the host Government, by adverse changes in exchange control laws or regulations and by deterioration in conditions governing the conversion and transfer of local currency. Currency devaluation is not covered. On receipt of the blocked local currency from an investor, MIGA pays compensation in the currency of its contract of guarantee.

(b) Expropriation

69. This guarantee protects against loss of the insured investment as a result of acts by the host Government that may reduce or eliminate ownership of, control over or rights to the insured investment. In addition to outright nationalization and confiscation, “creeping” expropriation—a series of acts that, over time, have an expropriatory effect—is also covered. Coverage is provided on a limited basis for partial expropriation (for example, confiscation of funds or tangible assets). Bona fide, non-discriminatory measures taken by the host Government in the exercise of legitimate regulatory authority are not covered. For total expropriation of equity investments, MIGA pays the net book value of the insured investment. For expropriation of funds, MIGA pays the insured portion of the blocked funds. For loans and loan guarantees, the Agency insures the outstanding principal and any accrued and unpaid interest. Compensation is paid upon assignment of the investor’s interest in the expropriated investment (for example, equity shares or interest in a loan agreement) to MIGA.

(c) Breach of contract

70. This guarantee protects against losses arising from the host Government’s breach or repudiation of a contract with the investor. In the event of an alleged breach or repudiation, the investor must be able to invoke a dispute resolution mechanism (for example, arbitration) under the underlying contract and obtain an award for damages. If, after a specified period of time, the investor has not received payment or if the dispute resolution mechanism fails to function because of actions taken by the host Government, MIGA will pay compensation.

(d) War and civil disturbance

71. This guarantee protects against loss from damage to, or the destruction or disappearance of, tangible assets caused by politically motivated acts of war or civil disturbance in the host country, including revolution, insurrection, coup d’état, sabotage and terrorism. For equity investments, MIGA will pay the investor’s share of the least of the book value of the assets, their replacement cost or the cost of repair of damaged assets. For loans and loan guarantees, MIGA will pay the insured portion of the principal and interest payments in default as a direct result of damage to the assets of the project caused by war and civil disturbance. War and civil disturbance coverage also extends to events that, for a period of one year, result in an interruption of project operations essential to overall financial viability. This type of business interruption is effective when the investment is considered a total loss; at that point, MIGA will pay the book value of the total insured equity investment.

E. Guarantees provided by export credit agencies and investment promotion agencies

72. Insurance against certain political, commercial and financial risks, as well as direct lending, may be obtained from export credit agencies and investment promotion agencies. Export credit agencies and investment promotion agencies have typically been established in a number of countries to assist in the export of goods or services originating from that country. Export credit agencies act on behalf of the Governments of the countries supplying goods and services for the project. Most export credit agencies are members of the International Union of Credit and Investment Insurers (Berne Union), whose main objectives include promoting international cooperation and fostering a favourable investment climate; developing and maintaining sound principles of export credit insurance; and establishing and sustaining discipline in the terms of credit for international trade.

73. While the support available differs from country to country, export credit agencies typically offer two lines of coverage:

(a) *Export credit insurance.* In the context of the financing of privately financed infrastructure projects, the essential purpose of export credit insurance is to guarantee payment to the seller whenever a foreign buyer of exported goods or services is allowed to defer payment. Export credit insurance may take the form of “supplier credit” or “buyer credit” insurance arrangements. Under the supplier credit arrangements the exporter and the importer agree on commercial terms that call for deferred payment evidenced by negotiable instruments (for example, bills of exchange or promissory notes) issued by the buyer. Subject to proof of creditworthiness, the exporter obtains insurance from an export credit agency in its home country. Under the buyer credit modality, the buyer’s payment obligation is financed by the exporter’s bank, which in turn obtains insurance coverage from an export credit agency. Export credits are generally classified as short-term (repayment terms of usually under two years), medium-term (usually two to five years) and long-term (over five years). Official support by export credit agencies may take the form of “pure cover”, by which is meant insurance or guarantees given to exporters or lending institutions without financing support. Official support may also be given in the form of “financing support”, which is defined as including direct credits to the overseas buyer, refinancing and all forms of interest rate support;

(b) *Investment insurance.* Export credit agencies may offer insurance coverage either directly to a borrower or to the exporter for certain political and commercial risks. Typical political and commercial risks include war, insurrection or revolution; expropriation, nationalization or requisition of assets; non-conversion of currency; and lack of availability of foreign exchange. Investment insurance provided by export credit agencies typically protects the investors in a project company established abroad against the insured risks, but not the project company itself. Investment insurance cover tends to be extended to a wide range of political risks. Export credit agencies prepared to cover such risks will typically require sufficient information on the legal system of the host country.

74. The conditions under which export credit agencies of member countries of the Organisation for Economic Cooperation and Development (OECD) offer support to both supplier and buyer credit transactions have to be in accordance with the OECD Arrangement on Guidelines for Officially Supported Export Credits (also referred to as the “OECD consensus“). The main purpose of the arrangement is to provide a suitable institutional framework to prevent unfair competition by means of official support for export credits. In order to avoid market-distorting subsidies, the Arrangement regulates the conditions of terms of insurances, guarantees or direct lending supported by Governments.

III. Selection of the concessionaire

A. General remarks

1. The present chapter deals with methods and procedures recommended for use in the award of privately financed infrastructure projects. In line with the advice of international organizations, such as UNIDO¹ and the World Bank,² the *Guide* expresses a preference for the use of competitive selection procedures, while recognizing that sometimes concessions may be awarded without competitive procedures according to the legal tradition of the country concerned (see also paras. 85-88).

2. The selection procedures recommended in this chapter present some of the features of the principal method for the procurement of services under the UNCITRAL Model Law on Procurement of Goods, Construction and Services (the “UNCITRAL Model Procurement Law”).³ A number of adaptations have been introduced to take into account the particular needs of privately financed infrastructure projects, such as a clearly defined pre-selection phase. Where appropriate, this chapter refers the reader to provisions of the UNCITRAL Model Procurement Law, which may, *mutatis mutandis*, supplement the selection procedure described herein.

1. Selection procedures covered by the Guide

3. Private investment in infrastructure may take various forms, each requiring special methods for selecting the concessionaire. For the purpose of discussing possible selection methods for the infrastructure projects dealt with in the *Guide*, a distinction may be made between three main forms of private investment in infrastructure:

(a) *Purchase of public utility enterprises.* Private capital may be invested in public infrastructure through the purchase of physical assets or the shares of public utility enterprises. Such transactions are often carried out in accordance with rules governing the award of contracts for the disposition of state property. In many countries, the sale of shares of public utility enterprises requires prior legislative authorization. Disposition methods often include offering of shares on stock markets or competitive proceedings such as auctions or invitations to bid whereby the property is awarded to the qualified party offering the highest price;

¹UNIDO BOT Guidelines, p. 96.

²International Bank for Reconstruction and Development, *Procurement under IBRD and IDA Loans*, Washington, D.C., 1996, para. 3.13 (a).

³The UNCITRAL Model Law on Procurement of Goods, Construction and Services and its accompanying Guide to Enactment were adopted by the United Nations Commission on International Trade Law at its twenty-seventh session, held in New York from 31 May to 17 June 1994.

(b) *Provision of public services without development of infrastructure.* In other types of project, the service providers own and operate all the equipment necessary and sometimes compete with other suppliers for the provision of the relevant service. Some national laws establish special procedures whereby the State may authorize a private entity to supply public services by means of exclusive or non-exclusive “licences”. Licences may be publicly offered to interested parties who satisfy the qualification requirements set forth by the law or established by the licensing authority. Sometimes licensing procedures involve public auctions to interested qualified parties;

(c) *Construction and operation of public infrastructure.* In projects for the construction and operation of public infrastructure, a private entity is engaged to provide both works and services to the public. The procedures governing the award of those contracts are in some aspects similar to those which govern public procurement of construction and services. National laws provide a variety of methods for public procurement, ranging from structured competitive methods, such as tendering proceedings, to less structured negotiations with prospective suppliers.

4. This chapter deals primarily with selection procedures suitable for use in relation to infrastructure projects that involve an obligation, on the part of the selected private entity, to undertake physical construction, repair or expansion works in the infrastructure concerned with a view to subsequent private operation (that is, those referred to in para. 3 (c)). It does not deal specifically with other methods of selecting providers of public services through licensing or similar procedures, or of merely disposing of State property through capital increases or offerings of shares.

2. *General objectives of selection procedures*

5. For the award of contracts for infrastructure projects, the contracting authority may either apply methods and procedures already provided in the laws of the host country or establish procedures specifically designed for that purpose. In either situation, it is important to ensure that such procedures are generally conducive to attaining the fundamental objectives of rules governing the award of public contracts. Those objectives are discussed briefly below.

(a) *Economy and efficiency*

6. In connection with infrastructure projects, “economy” refers to the selection of a concessionaire that is capable of performing works and delivering services of the desired quality at the most advantageous price or that offers the best commercial proposal. In most cases, economy is best achieved by means of procedures that promote competition among bidders. Competition provides them with incentives to offer their most advantageous terms and it can encourage them to adopt efficient or innovative technologies or production methods in order to do so.

7. It should be noted, however, that competition does not necessarily require the participation of a large number of bidders in a given selection process. For large projects, in particular, there may be reasons for the contracting authority to wish to limit the number of bidders to a manageable number (see para. 20). Provided that appropriate procedures are in place, the contracting authority can take advantage of effective competition even where the competitive base is limited.

8. Economy can often be promoted through participation by foreign companies in selection proceedings. Not only can foreign participation expand the competitive base, it can also lead to the acquisition by the contracting authority and its country of technologies that are not available locally. Foreign participation in selection proceedings may be necessary where there exists no domestic expertise of the type required by the contracting authority. A country wishing to achieve the benefits of foreign participation should ensure that its relevant laws and procedures are conducive to such participation.

9. “Efficiency” refers to selection of a concessionaire within a reasonable amount of time, with minimal administrative burdens and at reasonable cost both to the contracting authority and to participating bidders. In addition to the losses that can accrue directly to the contracting authority from inefficient selection procedures (owing, for example, to delayed selection or high administrative costs), excessively costly and burdensome procedures can lead to increases in the overall project costs or even discourage competent companies from participating in the selection proceedings altogether.

*(b) Promotion of the integrity of and confidence
in the selection process*

10. Another important objective of rules governing the selection of the concessionaire is to promote the integrity of and confidence in the process. Thus, an adequate selection system will usually contain provisions designed to ensure fair treatment of bidders, to reduce or discourage unintentional or intentional abuses of the selection process by persons administering it or by companies participating in it and to ensure that selection decisions are taken on a proper basis.

11. Promoting the integrity of the selection process will help to promote public confidence in the process and in the public sector in general. Bidders will often refrain from spending the time and sometimes substantial sums of money to participate in selection proceedings unless they are confident that they will be treated fairly and that their proposals or offers have a reasonable chance of being accepted. Those which do participate in selection proceedings in which they do not have that confidence would probably increase the project cost to cover the higher risks and costs of participation. Ensuring that selection proceedings are run on a proper basis could reduce or eliminate that tendency and result in more favourable terms to the contracting authority.

12. To guard against corruption by government officials, including employees of the contracting authorities, the host country should have in place an effec-

tive system of sanctions. These could include sanctions of a criminal nature that would apply to unlawful acts of officials conducting the selection process and of participating bidders. Conflicts of interest should also be avoided, for instance by requiring that officials of the contracting authority, their spouses, relatives and associates abstain from owning a debt or equity interest in a company participating in a selection process or accepting to serve as a director or employee of such a company. Furthermore, the law governing the selection proceedings should obligate the contracting authority to reject offers or proposals submitted by a party who gives or agrees to give, directly or indirectly, to any current or former officer or employee of the contracting authority or other public authority a gratuity in any form, an offer of employment or any other thing or service of value, as an inducement with respect to an act or decision of or procedure followed by the contracting authority in connection with the selection proceedings. These provisions may be supplemented by other measures, such as the requirement that all companies invited to participate in the selection process undertake neither to seek to influence unduly the decisions of the public officials involved in the selection process nor otherwise to distort the competition by means of collusive or other illicit practices (that is, the so-called “integrity agreement”). Also, in the procurement practices adopted by some countries, bidders are required to guarantee that no official of the procuring entity has been or shall be admitted by the bidder to any direct or indirect benefit arising from the contract or the award thereof. Breach of such a provision typically constitutes a breach of an essential term of the contract.

13. The confidence of investors may be further fostered by adequate provisions to protect the confidentiality of proprietary information submitted by them during the selection proceedings. This should include sufficient assurances that the contracting authority will treat proposals in such a manner as to avoid the disclosure of their contents to competing bidders; that any discussions or negotiations will be confidential; and that trade or other information that bidders might include in their proposals will not be made known to their competitors.

(c) Transparency of laws and procedures

14. Transparency of laws and procedures governing the selection of the concessionaire will help to achieve a number of the policy objectives already mentioned. Transparent laws are those in which the rules and procedures to be followed by the contracting authority and by bidders are fully disclosed, are not unduly complex and are presented in a systematic and understandable way. Transparent procedures are those which enable the bidders to ascertain what procedures have been followed by the contracting authority and the basis of decisions taken by it.

15. One of the most important ways to promote transparency and accountability is to include provisions requiring that the contracting authority maintain a record of the selection proceedings (see paras. 120-126). A record summariz-

ing key information concerning those proceedings facilitates the exercise of the right of aggrieved bidders to seek review. That in turn will help to ensure that the rules governing the selection proceedings are, to the extent possible, self-policing and self-enforcing. Furthermore, adequate record requirements in the law will facilitate the work of public authorities exercising an audit or control function and promote the accountability of contracting authorities to the public at large as regards the award of infrastructure projects.

16. An important corollary of the objectives of economy, efficiency, integrity and transparency is the availability of administrative and judicial procedures for the review of decisions made by the authorities involved in the selection proceedings (see paras. 127-131).

3. Special features of selection procedures for privately financed infrastructure projects

17. Generally, economy in the award of public contracts is best achieved through methods that promote competition among a range of bidders within structured, formal procedures. Competitive selection procedures, such as tendering, are usually prescribed by national laws as the rule for normal circumstances in procurement of goods or construction.

18. The formal procedures and the objectivity and predictability that characterize the competitive selection procedures generally provide optimal conditions for competition, transparency and efficiency. Thus, the use of competitive selection procedures in privately financed infrastructure projects has been recommended by UNIDO, which has formulated detailed practical guidance on how to structure those procedures.¹ The rules for procurement under loans provided by the World Bank also advocate the use of competitive selection procedures and provide that a concessionaire selected pursuant to bidding procedures acceptable to the World Bank is generally free to adopt its own procedures for the award of contracts required to implement the project. However, where the concessionaire was not itself selected pursuant to those competitive procedures, the award of subcontracts has to be done pursuant to competitive procedures acceptable to the World Bank.²

19. It should be noted, however, that no international legislative model has thus far been specifically devised for competitive selection procedures in privately financed infrastructure projects. On the other hand, domestic laws on competitive procedures for the procurement of goods, construction or services may not be entirely suitable for privately financed infrastructure projects. International experience in the award of privately financed infrastructure projects has in fact revealed some limitations of traditional forms of competitive selection procedures, such as the tendering method. In view of the particular issues raised by privately financed infrastructure projects, which are briefly discussed below, it is advisable for the Government to consider adapting such procedures for the selection of the concessionaire.

(a) *Range of bidders to be invited*

20. The award of privately financed infrastructure projects typically involves complex, time-consuming and expensive proceedings, and the sheer scale of most infrastructure projects reduces the likelihood of obtaining proposals from a large number of suitably qualified bidders. In fact, competent bidders may be reluctant to participate in procurement proceedings for high-value projects if the competitive field is too large and where they run the risk of having to compete with unrealistic proposals or proposals submitted by unqualified bidders. Open tendering without a pre-selection phase is therefore usually not advisable for the award of infrastructure projects.

(b) *Definition of project requirements*

21. In traditional public procurement of construction works the procuring authority usually assumes the position of a *maître d'ouvrage* or employer, while the selected contractor carries out the function of the performer of the works. The procurement procedures emphasize the inputs to be provided by the contractor, that is, the contracting authority establishes clearly what is to be built, how and by what means. It is therefore common for invitations to tender for construction works to be accompanied by extensive and very detailed technical specifications of the type of works and services being procured. In those cases, the contracting authority will be responsible for ensuring that the specifications are adequate to the type of infrastructure to be built and that such infrastructure will be capable of being operated efficiently.

22. However, for many privately financed infrastructure projects, the contracting authority may envisage a different allocation of responsibilities between the public and the private sector. In those cases, after having established a particular infrastructure need, the contracting authority may prefer to leave to the private sector the responsibility for proposing the best solution for meeting such a need, subject to certain requirements that may be established by the contracting authority (for example, regulatory performance or safety requirements, sufficient evidence that the technical solutions proposed have been previously tested and have met internationally acceptable safety and other standards). The selection procedure used by the contracting authority may thus give more emphasis to the output expected from the project (that is, the services or goods to be provided) than to technical details of the works to be performed or means to be used to provide those services.

(c) *Evaluation criteria*

23. For projects to be financed, owned and operated by public authorities, goods, construction works or services are typically purchased with funds available under approved budgetary allocations. With the funding sources usually secured, the main objective of the procuring entity is to obtain the best value for the funds it spends. Therefore, in those types of procurement the decisive factor in establishing the winner among the responsive and technically accept-

able proposals (that is, those which have passed the threshold with respect to quality and technical aspects) is often the global price offered for the construction works, which is calculated on the basis of the cost of the works and other costs incurred by the contractor, plus a certain margin of profit.

24. Privately financed infrastructure projects, in turn, are typically expected to be financially self-sustainable, with the development and operational costs being recovered from the project's own revenue. Therefore, a number of other factors will need to be considered in addition to the construction and operation cost and the price to be paid by the users. For instance, the contracting authority will need to consider carefully the financial and commercial feasibility of the project, the soundness of the financial arrangements proposed by the bidders and the reliability of the technical solutions used. Such interest exists even where no governmental guarantees or payments are involved, because unfinished projects or projects with large cost overruns or higher than expected maintenance costs often have a negative impact on the overall availability of needed services and on the public opinion in the host country. Also, the contracting authority will aim at formulating qualification and evaluation criteria that give adequate weight to the need to ensure the continuous provision of and, as appropriate, universal access to the public service concerned. Furthermore, given the usually long duration of infrastructure concessions, the contracting authority will need to satisfy itself as to the soundness and acceptability of the arrangements proposed for the operational phase and will weigh carefully the service elements of the proposals (see para. 74).

(d) Negotiations with bidders

25. Laws and regulations governing tendering proceedings often prohibit negotiations between the contracting authority and the contractors concerning a proposal submitted by them. The rationale for such a strict prohibition, which is also contained in article 35 of the UNCITRAL Model Procurement Law, is that negotiations might result in an "auction", in which a proposal offered by one contractor is used to apply pressure on another contractor to offer a lower price or an otherwise more favourable proposal. As a result of that strict prohibition, contractors selected to provide goods or services pursuant to traditional procurement procedures are typically required to sign standard contract documents provided to them during the procurement proceedings.

26. The situation is different in the award of privately financed infrastructure projects. The complexity and long duration of such projects makes it unlikely that the contracting authority and the selected bidder could agree on the terms of a draft project agreement without negotiation and adjustments to adapt those terms to the particular needs of the project. This is particularly true for projects involving the development of new infrastructure where the final negotiation of the financial and security arrangements takes place only after the selection of the concessionaire. It is important, however, to ensure that these negotiations are carried out in a transparent manner and do not lead to changes to the basis on which the competition was carried out (see paras. 83 and 84).

4. *Preparations for the selection proceedings*

27. The award of privately financed infrastructure projects is in most cases a complex exercise requiring careful planning and coordination among the offices involved. By ensuring that adequate administrative and personnel support is available to conduct the type of selection proceeding that it has chosen, the Government plays an essential role in promoting confidence in the selection process.

(a) Appointment of the award committee

28. One important preparatory measure is the appointment of the committee that will be responsible for evaluating the proposals and making an award recommendation to the contracting authority. The appointment of qualified and impartial members to the selection committee is not only a requirement for an efficient evaluation of the proposals, but may further foster the confidence of bidders in the selection process.

29. Another important preparatory measure is the appointment of the independent advisers who will assist the contracting authority in the selection procedures. The contracting authority may need, at this early stage, to retain the services of independent experts or advisers to assist in establishing appropriate qualification and evaluation criteria, defining performance indicators (and, if necessary, project specifications) and preparing the documentation to be issued to bidders. Consultant services and advisers may also be retained to assist the contracting authority in the evaluation of proposals, drafting and negotiation of the project agreement. Consultants and advisers can be particularly helpful by bringing a range of technical expertise that may not always be available in the host country's civil service, such as technical or engineering advice (for example, on technical assessment of the project or installations and technical requirements of contract); environmental advice (for example, environmental assessment and operation requirements); or financial advice (for example, on financial projections, review of financing sources, assessing the adequate ratio between debt and equity and drafting of financial information documents).

(b) Feasibility and other studies

30. As indicated earlier (see chap. I, "General legislative and institutional framework", para. 25), one of the initial steps that should be taken by the Government in relation to a proposed infrastructure project is to conduct a preliminary assessment of its feasibility, including economic and financial aspects such as expected economic advantages of the project, estimated cost and potential revenue anticipated from the operation of the infrastructure facility. The option to develop infrastructure as a privately financed project requires a positive conclusion on the feasibility and financial viability of the project. An assessment of the project's environmental impact should also ordinarily be carried out by the contracting authority as part of its feasibility studies. In some countries, it has been found useful to provide for some public participation in the preliminary assessment of the project's environmental impact and the various options available to minimize it.

31. Prior to starting the proceedings leading to the selection of a prospective concessionaire, it is advisable for the contracting authority to review and, as required, expand those initial studies. In some countries contracting authorities are advised to formulate model projects for reference purposes (typically including a combination of estimated capital investment, operation and maintenance costs) prior to inviting proposals from the private sector. The purpose of such model projects is to demonstrate the viability of the commercial operation of the infrastructure and the affordability of the project in terms of total investment cost and cost to the public. They will also provide the contracting authority with a useful tool for comparison and evaluation of proposals. The confidence of bidders will be promoted by evidence that the technical, economical and financial assumptions of the project, as well as the proposed role of the private sector, have been carefully considered by the contracting authority.

(c) Preparation of documentation

32. Selection proceedings for the award of privately financed infrastructure projects typically require the preparation of extensive documentation, including a project outline, pre-selection documents, the request for proposals, instructions for preparing proposals and a draft of the project agreement. The quality and clarity of the documents issued by the contracting authority plays a significant role in ensuring an efficient and transparent selection procedure.

33. Standard documentation prepared in sufficiently precise terms may be an important element to facilitate the negotiations between bidders and prospective lenders and investors. It may also be useful for ensuring consistency in the treatment of issues common to most projects in a given sector. However, in using standard contract terms it is advisable to bear in mind the possibility that a specific project may raise issues that had not been anticipated when the standard document was prepared or that the project may necessitate particular solutions that might be at variance with the standard terms. Careful consideration should be given to the need to achieve an appropriate balance between the level of uniformity desired for project agreements of a particular type and the flexibility that might be needed for finding project-specific solutions.

B. Pre-selection of bidders

34. Given the complexity of privately financed infrastructure projects the contracting authority may wish to limit the number of bidders from whom proposals will subsequently be requested only to those who satisfy certain qualification criteria. In traditional government procurement, the pre-selection proceedings may consist of the verification of certain formal requirements, such as adequate proof of technical capability or prior experience in the type of procurement, so that all bidders who meet the pre-selection criteria are automatically admitted to the tendering phase. The pre-selection proceedings for privately financed infrastructure projects may, in turn, involve elements of evaluation and selection. This may be the case, for example, where the contracting authority establishes a ranking of pre-selected bidders (see para. 48).

1. *Invitation to the pre-selection proceedings*

35. In order to promote transparency and competition, it is advisable that the invitation to the pre-selection proceedings be made public in a manner that reaches an audience wide enough to provide an effective level of competition. The laws of many countries identify publications, usually the official gazette or other official publication, in which the invitation to the pre-selection proceedings is to be published. With a view to fostering participation of foreign companies and maximizing competition, the contracting authority may wish to have the invitations to the pre-selection proceedings made public also in a language customarily used in international trade, in a newspaper of wide international circulation or in a relevant trade publication or technical or professional journal of wide international circulation. One possible medium for such publication is *Development Business*, published by the Department of Public Information of the United Nations Secretariat.

36. Pre-selection documents should contain sufficient information for bidders to be able to ascertain whether the works and services entailed by the project are of a type that they can provide and, if so, how they can participate in the selection proceedings. The invitation to the pre-selection proceedings should, in addition to identifying the infrastructure to be built or renovated, contain information on other essential elements of the project, such as the services to be delivered by the concessionaire, the financial arrangements envisaged by the contracting authority (for example, whether the project will be entirely financed by user fees or tolls or whether public funds may be provided as direct payments, loans or guarantees) and, where already known, a summary of the main required terms of the project agreement to be entered into as a result of the selection proceedings.

37. In addition, the invitation to the pre-selection proceedings should include general information similar to the information typically provided in pre-selection documents under general rules on public procurement.⁴

2. *Pre-selection criteria*

38. Generally, bidders should be required to demonstrate that they possess the professional and technical qualifications, financial and human resources, equipment and other physical facilities, managerial capability, reliability and experience necessary to carry out the project. Additional criteria that might be particularly relevant for privately financed infrastructure projects may include the ability to manage the financial aspects of the project and previous experience in operating public infrastructure or in providing services under regulatory oversight (for example, quality indicators of their past performance, size

⁴For example, instructions for preparing and submitting pre-selection applications; any documentary evidence or other information that must be submitted by bidders to demonstrate their qualifications; and the manner, place and deadline for the submission of applications (see UNCITRAL Model Procurement Law, art. 7, para. 3).

and type of previous projects carried out by the bidders); the level of experience of the key personnel to be engaged in the project; sufficient organizational ability (including minimum levels of construction, operation and maintenance equipment); ability to sustain the financing requirements for the engineering, construction and operational phases of the project (demonstrated, for instance, by evidence of the bidders' ability to provide an adequate amount of equity to the project and sufficient evidence from reputable banks attesting the bidder's good financial standing). Qualification requirements should cover all phases of an infrastructure project, including financing management, engineering, construction, operation and maintenance, where appropriate. In addition, the bidders should be required to demonstrate that they meet such other qualification criteria as would typically apply under the general procurement laws of the host country.⁵

39. One important aspect to be considered by the contracting authority relates to the relationship between the award of one particular project and the governmental policy pursued for the sector concerned (see "Introduction and background information on privately financed infrastructure projects", paras. 21-46). Where competition is sought, the Government may be interested in ensuring that the relevant market or sector is not dominated by one enterprise (for example, that the same company does not operate more than a certain limited number of local telephone companies within a given territory). To implement such a policy and to avoid market domination by bidders who may have already been awarded a concession within a given sector of the economy, the contracting authority may wish to include in the pre-selection documents for new concessions provisions that limit the participation of or prevent another award to such bidders. For purposes of transparency, it is desirable for the law to provide that, where the contracting authority reserves the right to reject a proposal on those or similar grounds, adequate notice of that circumstance must be included in the invitation to the pre-selection proceedings.

40. Qualification requirements should apply equally to all bidders. A contracting authority should not impose any criterion, requirement or procedure with respect to the qualifications of bidders that has not been set forth in the pre-selection documents. When considering the professional and technical qualifications of bidding consortia, the contracting authority should consider the individual specialization of the consortium members and assess whether the combined qualifications of the consortium members are adequate to meet the needs of all phases of the project.

⁵For example, that they have legal capacity to enter into the project agreement; that they are not insolvent, in receivership, bankrupt or being wound up, their affairs are not being administered by a court or a judicial officer, their business activities have not been suspended and they are not the subject of legal proceedings for any of the foregoing; that they have fulfilled their obligations to pay taxes and social security contributions in the State; that they have not, and their directors or officers have not, been convicted of any criminal offence related to their professional conduct or the making of false statements or misrepresentations as to their qualifications to enter into a procurement contract within a certain period of years preceding the commencement of the selection proceedings or have not been otherwise disqualified pursuant to administrative suspension or disbarment proceedings (see UNCITRAL Model Procurement Law, art. 6, para. 1 (b)).

3. *Issues relating to the participation of bidding consortia*

41. Given the large scale of most infrastructure projects, the interested companies typically participate in the selection proceedings through consortia especially formed for that purpose. Therefore, information required from members of bidding consortia should relate to the consortium as a whole as well as to its individual participants. For the purpose of facilitating the liaison with the contracting authority, it may be useful to require in the pre-selection documents that each consortium designate one of its members as a focal point for all communications with the contracting authority. It is generally advisable for the contracting authority to require that the members of bidding consortia submit a sworn statement undertaking that, if awarded the contract, they shall bind themselves jointly and severally for the obligations assumed in the name of the consortium under the project agreement. Alternatively, the contracting authority may reserve itself the right to require at a later stage that the members of the selected consortium establish an independent legal entity to carry out the project (see also chap. IV, “Construction and operation of infrastructure: legislative framework and project agreement”, paras. 12-18).

42. It is also advisable for the contracting authority to review carefully the composition of consortia and their parent companies. It may happen that one company, directly or through subsidiary companies, joins more than one consortium to submit proposals for the same project. Such a situation should not be allowed, since it raises the risk of leakage of information or collusion between competing consortia, thus undermining the credibility of the selection proceedings. It is therefore advisable to provide in the invitation to the pre-selection proceedings that each of the members of a qualified consortium may participate, either directly or through subsidiary companies, in only one bid for the project. A violation of this rule should cause the disqualification of the consortium and of the individual member companies.

4. *Pre-selection and domestic preferences*

43. The laws of some countries provide for some sort of preferential treatment for domestic entities or afford special treatment to bidders that undertake to use national goods or employ local labour. Such preferential or special treatment is sometimes provided as a material qualification requirement (for example, a minimum percentage of national participation in the consortium) or as a condition for participating in the selection procedure (for example, to appoint a local partner as a leader of the bidding consortium).

44. Domestic preferences may give rise to a variety of issues. Firstly, their use is not permitted under the guidelines of some international financial institutions and might be inconsistent with international obligations entered into by many States pursuant to agreements on regional economic integration or trade facilitation. Furthermore, from the perspective of the host country it is important to weigh the expected advantages against the disadvantage of depriving the contracting authority of the possibility of obtaining better options to meet the national infrastructure needs. It is also important not to allow total insulation

from foreign competition so as not to perpetuate lower levels of economy, efficiency and competitiveness of the concerned sectors of national industry. This is the reason why many countries that wish to provide some incentive to national suppliers, while at the same time taking advantage of international competition, do not contemplate a blanket exclusion of foreign participation or restrictive qualification requirements. Domestic preferences may take the form of special evaluation criteria establishing margins of preference for national bidders or bidders who offer to procure supplies, services and products in the local market. The margin of preference technique, which is provided in article 34, paragraph 4 (d), of the UNCITRAL Model Procurement Law, is more transparent than subjective qualification or evaluation criteria. Furthermore, it allows the contracting authority to favour local bidders that are capable of approaching internationally competitive standards, and it does so without simply excluding foreign competition. Where domestic preferences are envisaged, they should be announced in advance, preferably in the invitation to the pre-selection proceedings.

5. Contribution towards costs of participation in the selection proceedings

45. The price charged for the pre-selection documents should only reflect the cost of printing such documents and providing them to the bidders. It should not be used as an additional tool to limit the number of bidders. Such a practice is both ineffective and adds to the already considerable cost of participation in the pre-selection proceedings. The high costs of preparing proposals for infrastructure projects and the relatively high risks that a selection procedure may not lead to a contract award may function as a deterrent for some companies to join in a consortium to submit a proposal, in particular when they are not familiar with the selection procedures applied in the host country.

46. Therefore, some countries authorize the contracting authority to consider arrangements for compensating pre-selected bidders if the project cannot proceed for reasons outside their control or for contributing to the costs incurred by them after the pre-selection phase, when justified in a particular case by the complexity involved and the prospect of significantly improving the quality of the competition. When such contribution or compensation is envisaged, appropriate notice should be given to potential bidders at an early stage, preferably in the invitation to the pre-selection proceedings.

6. Pre-selection proceedings

47. The contracting authority should respond to any request by a bidding consortium for clarification of the pre-selection documents that is received by the contracting authority within a reasonable time prior to the deadline for the submission of applications so as to enable the bidders to make a timely submission of their application. The response to any request that might reasonably be expected to be of interest to other bidders should, without identifying the source of the request, be communicated to all bidders to which the contracting authority provided the pre-selection documents.

48. In some countries, practical guidance on selection procedures encourages domestic contracting authorities to limit the prospective proposals to the lowest possible number sufficient to ensure meaningful competition (for example, three or four). For that purpose, those countries apply a quantitative rating system for technical, managerial and financial criteria, taking into account the nature of the project. Quantitative pre-selection criteria are found to be more easily applicable and transparent than qualitative criteria involving the use of merit points. However, in devising a quantitative rating system, it is important to avoid unnecessary limitation of the contracting authority's discretion in assessing the qualifications of bidders. The contracting authority may also need to take into account the fact that the procurement guidelines of some multilateral financial institutions prohibit the use of pre-selection proceedings for the purpose of limiting the number of bidders to a predetermined number. In any event, where such a rating system is to be used, that circumstance should be clearly stated in the pre-selection documents.

49. Upon completion of the pre-selection phase, the contracting authority usually draws up a short list of the pre-selected bidders that will subsequently be invited to submit proposals. One practical problem sometimes faced by contracting authorities concerns proposals for changes in the composition of bidding consortia during the selection proceedings. From the perspective of the contracting authority, it is generally advisable to exercise caution in respect of proposed substitutions of individual members of bidding consortia after the closing of the pre-selection phase. Changes in the composition of consortia may substantially alter the basis on which the pre-selected bidding consortia were short-listed by the contracting authority and may give rise to questions about the integrity of the selection proceedings. As a general rule, only pre-selected bidders should be allowed to participate in the selection phase, unless the contracting authority can satisfy itself that a new consortium member meets the pre-selection criteria to substantially the same extent as the retiring member of the consortium.

50. While the criteria used for pre-selecting bidders should not be weighted again at the evaluation phase, the contracting authority may wish to reserve itself the right to require, at any stage of the selection process, that the bidders again demonstrate their qualifications in accordance with the same criteria used to pre-select them.

C. Procedures for requesting proposals

51. This section discusses the procedures for requesting proposals from the pre-selected bidders. The procedures described herein are in a number of respects similar to the procedures for the solicitation of proposals under the preferred method for the procurement of services provided in the UNCITRAL Model Procurement Law, with some adaptations needed to fit the needs of contracting authorities awarding infrastructure projects.

1. *Phases of the procedure*

52. Following the pre-selection of bidders, it is advisable for the contracting authority to review its original feasibility study and the definition of the output and performance requirements and to consider whether a revision of those requirements is needed in the light of the information obtained during the pre-selection proceedings. At this stage, the contracting authority should already have determined whether a single or a two-stage procedure will be used to request proposals.

(a) Single-stage procedure

53. The decision between having a single or a two-stage procedure for requesting proposals will depend on the nature of the contract, on how precisely the technical requirements can be defined and whether output results (or performance indicators) are used for selection of the concessionaire. If it is deemed both feasible and desirable for the contracting authority to formulate performance indicators or project specifications to the necessary degree of precision or finality, the selection process may be structured as a single-stage procedure. In that case, after having concluded the pre-selection of bidders, the contracting authority would proceed directly to issuing a final request for proposals (see paras. 59-72).

(b) Two-stage procedure

54. There are cases, however, in which it may not be feasible for the contracting authority to formulate its requirement in sufficiently detailed and precise project specifications or performance indicators to permit proposals to be formulated, evaluated and compared uniformly on the basis of those specifications and indicators. This may be the case, for instance, when the contracting authority has not determined the type of technical and material input that would be suitable for the project in question (for example, the type of construction material to be used in a bridge). In such cases, it might be considered undesirable, from the standpoint of obtaining the best value, for the contracting authority to proceed on the basis of specifications or indicators it has drawn up in the absence of discussions with bidders as to the exact capabilities and possible variations of what is being offered. For that purpose, the contracting authority may wish to divide the selection proceedings into two stages and allow a certain degree of flexibility for discussions with bidders.

55. Where the selection procedure is divided into two stages, the initial request for proposals typically calls upon the bidders to submit proposals relating to output specifications and other characteristics of the project as well as to the proposed contractual terms. The invitation for bids would allow bidders to offer their own solutions for meeting the particular infrastructure need in accordance with defined standards of service. The proposals submitted at this stage would typically consist of solutions on the basis of a conceptual design or performance indicators without indication of financial elements, such as the expected price or level of remuneration.

56. To the extent the terms of the contractual arrangements are already known by the contracting authority, they should be included in the request for proposals, possibly in the form of a draft of the project agreement. Knowledge of certain contractual terms, such as the risk allocation envisaged by the contracting authority, is important in order for the bidders to formulate their proposals and discuss the “bankability” of the project with potential lenders. The initial response to those contractual terms, in particular the risk allocation envisaged by the contracting authority, may help the contracting authority assess the feasibility of the project as originally conceived. However, it is important to distinguish between the procedure to request proposals and the negotiation of the final contract, after the project has been awarded. The purpose of this initial stage is to enable the contracting authority to formulate its requirement subsequently in a manner that enables a final competition to be carried out on the basis of a single set of parameters. The invitation of initial proposals at this stage should not lead to a negotiation of the terms of the contract prior to its final award.

57. The contracting authority may then convene a meeting of bidders to clarify questions concerning the request for proposals and accompanying documentation. The contracting authority may, at the first stage, engage in discussions with any bidder concerning any aspect of its proposal. The contracting authority should treat proposals in such a manner as to avoid the disclosure of their contents to competing bidders. Any discussions need to be confidential and one party to the discussions should not reveal to any other person any technical, financial or other information relating to the discussions without the consent of the other party.

58. Following those discussions, the contracting authority should review and, as appropriate, revise the initial project specifications. In formulating those revised specifications, the contracting authority should be allowed to delete or modify any aspect of the technical or quality characteristics of the project originally set forth in the request for proposals and any criterion originally set forth in those documents for evaluating and comparing proposals. Any such deletion, modification or addition should be communicated to bidders in the invitation to submit final proposals. Bidders not wishing to submit a final proposal should be allowed to withdraw from the selection proceedings without forfeiting any security that they may have been required to provide.

2. Content of the final request for proposals

59. At the final stage, the contracting authority should invite the bidders to submit final proposals with respect to the revised project specifications, performance indicators and contractual terms. The request for proposals should generally include all information necessary to provide a basis to enable the bidders to submit proposals that meet the needs of the contracting authority and that the contracting authority can compare in an objective and fair manner.

(a) *General information to bidders*

60. General information to bidders should cover, as appropriate, those items which are ordinarily included in solicitation documents or requests for proposals for the procurement of goods, construction and services.⁶ Particularly important is the disclosure of the criteria to be used by the contracting authority in determining the successful proposal and the relative weight of such criteria (see paras. 73-77).

(i) *Information on feasibility studies*

61. It is advisable to include in the general information provided to bidders instructions for the preparation of feasibility studies they may be required to submit with their final proposals. Such feasibility studies typically cover, for instance, the following aspects:

(a) *Commercial viability.* In particular in projects financed on a non-recourse or limited recourse basis, it is essential to establish the need for the project outputs and to evaluate and project such needs over the proposed operational life of the project, including expected demand (for example, traffic forecasts for roads) and pricing (for example, tolls);

(b) *Engineering design and operational feasibility.* Bidders should be requested to demonstrate the suitability of the technology they propose, including equipment and processes, to national, local and environmental conditions, the likelihood of achieving the planned performance level and the adequacy of the construction methods and schedules. This study should also define the proposed organization, methods and procedures for operating and maintaining the completed facility;

(c) *Financial viability.* Bidders should be requested to indicate the proposed sources of financing for the construction and operation phases, including debt capital and equity investment. While the loan and other financing agreements in most cases are not executed until after the signing of the project agreement, the bidders should be required to submit sufficient evidence of the lenders' intention to provide the specified financing. In some countries, bidders are also required to indicate the expected financial internal rate of return in relation to the effective cost of capital corresponding to the financing arrangements proposed. Such information is intended to allow the contracting authority to consider the reasonableness and affordability of the proposed prices or fees to be charged by the concessionaire and the potential for subsequent increases therein;

(d) *Environmental impact.* This study should identify possible negative or adverse effects on the environment as a consequence of the project and

⁶For example, instructions for preparing and submitting proposals, including the manner, place and deadline for the submission of proposals and the period of time during which proposals shall be in effect and any requirements concerning tender securities; the means by which bidders may seek clarifications of the request for proposals, and a statement as to whether the contracting authority intends, at this stage, to convene a meeting of bidders; the place, date and time for the opening of proposals and the procedures to be followed for opening and examining proposals; and the manner in which the proposals will be evaluated (see UNCITRAL Model Procurement Law, arts. 27 and 38).

indicate corrective measures that need to be taken to ensure compliance with the applicable environmental standards. Such a study should take into account, as appropriate, the relevant environmental standards of international financial institutions and of national, provincial and local authorities.

(ii) *Information on bid securities*

62. It is advisable for the request for proposals to indicate any requirements of the contracting authority with respect to the issuer and the nature, form, amount and other principal terms of any bid security that the bidders may be required to provide so as to cover those losses which may result from withdrawal of proposals or failure by the selected bidder to conclude a project agreement. In order to ensure fair treatment of all bidders, requirements that refer directly or indirectly to the conduct by the bidder submitting the proposal should not relate to conduct other than withdrawal or modification of the proposal after the deadline for submission of proposals or before the deadline if so stipulated in the request for proposals; failure to achieve financial closing; failure to sign the project agreement if required by the contracting authority to do so; and failure to provide required security for the fulfilment of the project agreement after the proposal has been accepted or to comply with any other condition prior to signing the project agreement specified in the request for proposals. Safeguards should be included to ensure that a bid security requirement is only imposed fairly and for the purpose intended.⁷

(iii) *Qualification of bidders*

63. Where no pre-selection of bidders was carried out prior to the issuance of the request for proposals or when the contracting authority retains the right to require the bidders to demonstrate again their qualifications, the request for proposals should set out the information that needs to be provided by the bidders to substantiate their qualifications (see paras. 38-40).

(b) *Project specifications and performance indicators*

64. The level of detail provided in the specifications, as well as the appropriate balance between the input and output elements, will be influenced by considerations of issues such as the type and ownership of the infrastructure and the allocation of responsibilities between the public and the private sectors (see paras. 21 and 22). It is generally advisable for the contracting authority to bear in mind the long-term needs of the project and to formulate its specifications in a manner that allows it to obtain sufficient information to select the

⁷Article 32 of the UNCITRAL Model Procurement Law provides certain important safeguards, including, *inter alia*, the requirement that the contracting authority should make no claim to the amount of the tender security and should promptly return, or procure the return of, the tender security document, after whichever of the following that occurs earliest: (a) the expiry of the tender security; (b) the entry into force of the project agreement and the provision of a security for the performance of the contract, if such a security is required by the request for proposals; (c) the termination of the selection process without the entry into force of a project agreement; or (d) the withdrawal of the proposal prior to the deadline for the submission of proposals, unless the request for proposals stipulates that no such withdrawal is permitted.

bidder that offers the highest quality of services the best economic terms. The contracting authority may find it useful to formulate the project specifications in a way that defines adequately the output and performance required without being overly prescriptive in how that is to be achieved. Project specifications and performance indicators typically cover items such as the following:

(a) *Description of project and expected output.* If the services require specific buildings, such as a transport terminal or an airport, the contracting authority may wish to provide no more than outline planning concepts for the division of the site into usage zones on an illustrative basis, instead of plans indicating the location and size of individual buildings, as would normally be the case in traditional procurement of construction services. However, where in the judgement of the contracting authority it is essential for the bidders to provide detailed technical specifications, the request for proposals should include, at least, the following information: description of the works and services to be performed, including technical specifications, plans, drawings and designs; time schedule for the execution of works and provision of services; and the technical requirements for the operation and maintenance of the facility;

(b) *Minimum applicable design and performance standards, including appropriate environmental standards.* Performance standards are typically formulated in terms of the desired quantity and quality of the outputs of the facility. Proposals that deviate from the relevant performance standards should be regarded as non-responsive;

(c) *Quality of services.* For projects involving the provision of public services, the performance indicators should include a description of the services to be provided and the relevant standards of quality to be used by the contracting authority in the evaluation of the proposals. Where appropriate, reference should be made to any general obligations of public service providers as regards expansion and continuity of the service so as to meet the demand of the community or territory served, ensuring non-discriminatory availability of services to the users and granting non-discriminatory access of other service providers to any public infrastructure network operated by the concessionaire, under the terms and conditions established in the project agreement (see chap. IV, “Construction and operation of infrastructure: legislative framework and project agreement”, paras. 82-93).

65. Bidders should be instructed to provide the information necessary in order for the contracting authority to evaluate the technical soundness of proposals, their operational feasibility and responsiveness to standards of quality and technical requirements, including the following information:

- (a) Preliminary engineering design, including proposed schedule of works;
- (b) Project cost, including operating and maintenance cost requirements and proposed financing plan (for example, proposed equity contribution or debt);
- (c) The proposed organization, methods and procedures for the operation and maintenance of the project under bidding;
- (d) Description of quality of services.

66. Each of the above-mentioned performance indicators may require the submission of additional information by the bidders, according to the project being awarded. For the award of a concession for distribution of electricity in a specific region, for example, indicators may include minimum technical standards such as: (a) specified voltage (and frequency) fluctuation at the consumer level; (b) duration of outages (expressed in hours per year); (c) frequency of outages (expressed in a number per year); (d) losses; (e) number of days to connect a new customer; and (f) commercial standards for customer relationship (for example, number of days to pay bills, to reconnect installations or to respond to customers' complaints).

(c) Contractual terms

67. It is advisable for the bidding documents to provide some indication of how the contracting authority expects to allocate the project risks (see also chaps. II, "Project risks and government support", and IV, "Construction and operation of infrastructure: legislative framework and project agreement"). This is important in order to set the terms of debate for negotiations on certain details of the project agreement (see paras. 83 and 84). If risk allocation is left entirely open, the bidders may respond by seeking to minimize the risks they accept, which may frustrate the purpose of seeking private investment for developing the project. Furthermore, the request of proposals should contain information on essential elements of the contractual arrangements envisaged by the contracting authority, such as:

(a) The duration of the concession or invitations to bidders to submit proposals for the duration of the concession;

(b) Formulas and indices to be used in adjustments to prices;

(c) Government support and investment incentives, if any;

(d) Bonding requirements;

(e) Requirements of regulatory agencies, if any;

(f) Monetary rules and regulations governing foreign exchange remittances;

(g) Revenue-sharing arrangements, if any;

(h) Indication, as appropriate, of the categories of assets that the concessionaire would be required to transfer to the contracting authority or make available to a successor concessionaire at the end of the project period;

(i) Where a new concessionaire is being selected to operate an existing infrastructure, a description of the assets and property that will be made available to the concessionaire;

(j) The possible alternative, supplementary or ancillary revenue sources (for example, concessions for exploitation of existing infrastructure), if any, that may be offered to the successful bidder.

68. Bidders should be instructed to provide the information necessary in order for the contracting authority to evaluate the financial and commercial elements

of the proposals and their responsiveness to the proposed contractual terms. The financial proposals should normally include the following information:

(a) For projects in which the concessionaire's income is expected to consist primarily of tolls, fees or charges paid by the customers or users of the infrastructure facility, the financial proposal should indicate the proposed price structure. For projects in which the concessionaire's income is expected to consist primarily of payments made by the contracting authority or another public authority to amortize the concessionaire's investment, the financial proposal should indicate the proposed amortization payments and repayment period;

(b) The present value of the proposed prices or direct payments based on the discounting rate and foreign exchange rate prescribed in the bidding documents;

(c) If it is estimated that the project would require financial support by the Government, the level of such support, including, as appropriate, any subsidy or guarantee expected from the Government or the contracting authority;

(d) The extent of risks assumed by the bidders during the construction and operation phase, including unforeseen events, insurance, equity investment and other guarantees against those risks.

69. In order to limit and establish clearly the scope of the negotiations that will take place following the evaluation of proposals (see paras. 83 and 84), the final request for proposals should indicate which are the terms of the project agreement that are deemed not negotiable.

70. It is useful for the contracting authority to require that the final proposals submitted by the bidders contain evidence showing the comfort of the bidder's main lenders with the proposed commercial terms and allocation of risks, as outlined in the request for proposals. Such a requirement might play a useful role in resisting pressures to reopen commercial terms at the stage of final negotiations. In some countries, bidders are required to initial and return to the contracting authority the draft project agreement together with their final proposals as a confirmation of their acceptance of all terms in respect of which they did not propose specific amendments.

3. Clarifications and modifications

71. The right of the contracting authority to modify the request for proposals is important in order to enable it to obtain what is required to meet its needs. It is therefore advisable to authorize the contracting authority, whether on its own initiative or as a result of a request for clarification by a bidder, to modify the request for proposals by issuing an addendum at any time prior to the deadline for submission of proposals. However, when amendments are made that would reasonably require bidders to spend additional time preparing their proposals, such additional time should be granted by extending the deadline for submission of proposals accordingly.

72. Generally, clarifications, together with the questions that gave rise to the clarifications, and modifications must be communicated promptly by the contracting authority to all bidders to whom the contracting authority provided the request for proposals. If the contracting authority convenes a meeting of bidders, it should prepare minutes of the meeting containing the requests submitted at the meeting for clarification of the request for proposals and its responses to those requests and should send copies of the minutes to the bidders.

4. *Evaluation criteria*

73. The award committee should rate the technical and financial elements of each proposal in accordance with the prediscovered rating systems for the technical evaluation criteria and should specify in writing the reasons for its rating. Generally, it is important for the contracting authority to achieve an appropriate balance between evaluation criteria relating to the physical investment (for example, the construction works) and evaluation criteria relating to the operation and maintenance of the infrastructure and the quality of services to be provided by the concessionaire. Adequate emphasis should be given to the long-term needs of the contracting authority, in particular the need to ensure the continuous delivery of the service at the required level of quality and safety.

(a) *Evaluation of technical aspects of the proposals*

74. Technical evaluation criteria are designed to facilitate the assessment of the technical, operational, environmental and financing viability of the proposal vis-à-vis the prescribed specifications, indicators and requirements prescribed in the bidding documents. To the extent practicable, the technical criteria applied by the contracting authority should be objective and quantifiable, so as to enable proposals to be evaluated objectively and compared on a common basis. This reduces the scope for discretionary or arbitrary decisions. Regulations governing the selection process might spell out how such factors are to be formulated and applied. Technical proposals for privately financed infrastructure projects are usually evaluated in accordance with the following criteria:

(a) *Technical soundness.* Where the contracting authority has established minimum engineering design and performance specifications or standards, the basic design of the project should conform to those specifications or standards. Bidders should be required to demonstrate the soundness of the proposed construction methods and schedules;

(b) *Operational feasibility.* The proposed organization, methods and procedures for operating and maintaining the completed facility must be well defined, should conform to the prescribed performance standards and should be shown to be workable;

(c) *Quality of services.* Evaluation criteria used by the contracting authority should include an analysis of the manner in which the bidders undertake to maintain and expand the service, including the guarantees offered for ensuring its continuity;

(d) *Environmental standards.* The proposed design and the technology of the project to be used should be in accordance with the environmental standards set forth in the request for proposals. Any negative or adverse effects on the environment as a consequence of the project as proposed by the bidders should be properly identified, including the corresponding corrective or mitigating measures;

(e) *Enhancements.* These may include other terms the author of the project may offer to make the proposals more attractive, such as revenue-sharing with the contracting authority, fewer governmental guarantees or reduction in the level of government support;

(f) *Potential for social and economic development.* Under this criterion, the contracting authority may take into account the potential for social and economic development offered by the bidders, including benefits to underprivileged groups of persons and businesses, domestic investment or other business activity, the encouragement of employment, the reservation of certain production for domestic suppliers, the transfer of technology and the development of managerial, scientific and operational skills;

(g) *Qualification of bidders.* When no pre-selection was made by the contracting authority prior to the issuance of the request for proposals, the contracting authority should not accept a proposal if the bidders that submitted the proposals are not qualified.

(b) *Evaluation of financial and commercial aspects of the proposals*

75. In addition to criteria for the technical evaluation of proposals, the contracting authority needs to define criteria for assessing and comparing the financial proposals. Criteria typically used for the evaluation and comparison of the financial and commercial proposals include, as appropriate, the following:

(a) *The present value of the proposed tolls, fees, unit prices and other charges over the concession period.* For projects in which the concessionaire's income is expected to consist primarily of tolls, fees or charges paid by the customers or users of the infrastructure facility, the assessment and comparison of the financial elements of the final proposals is typically based on the present value of the proposed tolls, fees, rentals and other charges over the concession period according to the prescribed minimum design and performance standards;

(b) *The present value of the proposed direct payments by the contracting authority, if any.* For projects in which the concessionaire's income is expected to consist primarily of payments made by the contracting authority to amortize the concessionaire's investment, the assessment and comparison of the financial elements of the final proposals is typically based on the present value of the proposed schedule of amortization payments for the facility to be constructed according to the prescribed minimum design and performance standards, plans and specifications;

(c) *The costs for design and construction activities, annual operation and maintenance costs, present value of capital costs and operating and main-*

tenance costs. It is advisable for the contracting authority to include these items among the evaluation criteria so as to permit an assessment of the financial feasibility of the proposals;

(d) *The extent of financial support, if any, expected from the Government.* Government support measures expected or required by the bidders should be included among the evaluation criteria as they may entail significant immediate or contingent financial liability for the Government (see chap. II, “Project risks and government support”, paras. 30-60);

(e) *Soundness of the proposed financial arrangements.* The contracting authority should assess whether the proposed financing plan, including the proposed ratio between equity investment and debt, is adequate to meet the construction, operating and maintenance costs of the project;

(f) *The extent of acceptance of the proposed contractual terms.* Proposals for changes or modifications in the contractual terms circulated with the request for proposals (such as in those dealing with risk allocation or compensation payments) may have substantial financial implications for the contracting authority and should be carefully examined.

76. A comparison of the proposed tolls, fees, unit prices or other charges is an important factor for ensuring objectiveness and transparency in the choice between equally responsive proposals. However, it is important for the contracting authority to consider carefully the relative weight of this criterion in the evaluation process. The notion of “price” usually does not have the same value for the award of privately financed infrastructure projects as it has in the procurement of goods and services. Indeed, the remuneration of the concessionaire is often the combined result of charges paid by the users, ancillary revenue sources and direct subsidies or payments made by the public entity awarding the contract.

77. It flows from the above that, while the unit price for the expected output retains its role as an important element of comparison of proposals, it may not always be regarded as the most important factor. Of particular importance is the overall assessment of the financial feasibility of the proposals since it allows the contracting authority to consider the bidders’ ability to carry out the project and the likelihood of subsequent increases in the proposed prices. This is important with a view to avoiding project awards to bidders that offer attractive but unrealistically low prices in the expectation of being able to raise such prices once a concession is obtained.

5. *Submission, opening, comparison and evaluation of proposals*

78. Proposals should be required to be submitted in writing, signed and placed in sealed envelopes. A proposal received by the contracting authority after the deadline for the submission of proposals should not be opened and should be returned to the bidder that submitted it. For the purpose of ensuring transparency, national laws often prescribe formal procedures for the opening of pro-

posals, usually at a time previously specified in the request for proposals, and require that the bidders that have submitted proposals, or their representatives, be permitted by the contracting authority to be present at the opening of the proposals. Such a requirement helps to minimize the risk that the proposals might be altered or otherwise tampered with and represents an important guarantee of the integrity of the proceedings.

79. In view of the complexity of privately financed infrastructure projects and the variety of evaluation criteria usually applied in the award of the project, it may be advisable for the contracting authority to apply a two-step evaluation process whereby non-financial criteria would be taken into consideration separately from, and perhaps before, financial criteria so as to avoid situations where undue weight would be given to certain elements of the financial criteria (such as the unit price) to the detriment of the non-financial criteria.

80. To that end, in some countries bidders are required to formulate and submit their technical and financial proposals in two separate envelopes. The two-envelope system is sometimes used because it permits the contracting authority to evaluate the technical quality of proposals without being influenced by their financial components. However, the method has been criticized as being contrary to the objective of economy in the award of public contracts. In particular, there is said to be a danger that, by selecting proposals initially on the basis of technical merit alone and without reference to price, a contracting authority might be tempted to select, upon the opening of the first envelope, proposals offering technically superior works and to reject proposals offering less sophisticated solutions that nevertheless meet the contracting authority's needs at an overall lower cost. International financial institutions, such as the World Bank, do not accept the two-envelope system for projects financed by them because of concerns that the system gives margin to a higher degree of discretion in the evaluation of proposals and makes it more difficult to compare them in an objective manner.

81. As an alternative to the use of a two-envelope system, the contracting authorities may require both technical and financial proposals to be contained in one single proposal, but structure their evaluation in two stages, as in the evaluation procedure provided in article 42 of the UNCITRAL Model Procurement Law. At an initial stage, the contracting authority typically establishes a threshold with respect to quality and technical aspects to be reflected in the technical proposals in accordance with the criteria as set out in the request for proposals, and rates each technical proposal in accordance with such criteria and the relative weight and manner of application of those criteria as set forth in the request for proposals. The contracting authority then compares the financial and commercial proposals that have attained a rating at or above the threshold. When the technical and financial proposals are to be evaluated consecutively, the contracting authority should initially ascertain whether the technical proposals are *prima facie* responsive to the request for proposals (that is, whether they cover all items required to be addressed in the technical proposals). Incomplete proposals, as well as proposals that deviate from the request for proposals, should be rejected at this stage. While the contracting

authority may ask bidders for clarifications of their proposals, no change in a matter of substance in the proposal, including changes aimed at making a non-responsive proposal responsive, should be sought, offered or permitted at this stage.

82. In addition to deciding whether to use a two-envelope system or a two-stage evaluation procedure, it is important for the contracting authority to disclose the relative weight to be accorded to each evaluation criterion and the manner in which criteria are to be applied in the evaluation of proposals. Two possible approaches might be used to reach an appropriate balance between financial and technical aspects of the proposals. One possible approach is to consider as most advantageous the proposal that obtains the highest combined rating in respect of both price and non-price evaluation criteria. Alternatively, the price proposed for the output (for example, the water or electricity price or the level of tolls) might be the deciding factor in establishing the winning proposal among the responsive proposals. In any event, in order to promote the transparency of the selection process and to avoid improper use of non-price evaluation criteria, it is advisable to require the awarding committee to provide written reasons for selecting a proposal other than the one offering the lowest unit price for the output.

6. Final negotiations and project award

83. The contracting authority should rank all responsive proposals on the basis of the evaluation criteria set forth in the request for proposals and invite the best-rated bidder for final negotiation of certain elements of the project agreement. If two or more proposals obtain the highest rating, or if there is only an insignificant difference in the rating of two or more proposals, the contracting authority should invite for negotiations all the bidders that have obtained essentially the same rating. The final negotiations should be limited to fixing the final details of the transaction documentation and satisfying the reasonable requirements of the selected bidder's lenders. One particular problem faced by contracting authorities is the danger that the negotiations with the selected bidder might lead to pressures to amend, to the detriment of the Government or the consumers, the price or risk allocation originally contained in the proposal. Changes in essential elements of the proposal should not be permitted, as they may distort the assumptions on the basis of which the proposals were submitted and rated. Therefore, the negotiations at this stage may not concern those terms of the contract which were deemed not negotiable in the final request for proposals (see para. 69). The risk of reopening commercial terms at this late stage could be further minimized by insisting that the selected bidder's lenders indicate their comfort with the risk allocation embodied in their bid at a stage where there is competition among bidders (see para. 70). The contracting authority's financial advisers might contribute to this process by advising whether bidders' proposals are realistic and what levels of financial commitment are appropriate at each stage. The process of reaching financial close can itself be quite lengthy.

84. The contracting authority should inform the remaining responsive bidders that they may be considered for negotiation if the negotiations with the bidder with better ratings do not result in a project agreement. If it becomes apparent to the contracting authority that the negotiations with the invited bidder will not result in a project agreement, the contracting authority should inform that bidder that it is terminating the negotiations and then invite for negotiations the next bidder on the basis of its ranking until it arrives at a project agreement or rejects all remaining proposals. To avoid the possibility of abuse and unnecessary delay, the contracting authority should not reopen negotiations with any bidder with whom they have already been terminated.

D. Concession award without competitive procedures

85. In the legal tradition of certain countries, privately financed infrastructure projects involve the delegation by the contracting authority of the right and duty to provide a public service. As such, they are subject to a special legal regime that differs in many respects from the regime that applies generally to the award of public contracts for the purchase of goods, construction or services.

86. Given the very particular nature of the services required (including their complexity, amount of investment involved and completion time), the procedures used in those countries place the accent on the contracting authority's freedom to choose the operator who best suits its need, in terms of professional qualifications, financial strength, ability to ensure the continuity of the service, equal treatment of the users and quality of the proposal. In contrast to the competitive selection procedures usually followed for the award of other public contracts, which sometimes may appear to be excessively rigid, preference is given to a procedure that is characterized by a high degree of flexibility and discretion on the part of the contracting authority. However, freedom of negotiation does not mean arbitrary choice and the laws of those countries provide procedures to ensure transparency and fairness in the conduct of the selection process.

87. In some countries where tendering is under normal circumstances the rule for public procurement of goods, construction and services, guidelines issued to contracting authorities advise the use of negotiations whenever possible for the award of privately financed infrastructure projects. The rationale for encouraging negotiations in those countries is that in negotiating with bidders the Government is not bound by predetermined requirements or rigid specifications and has more flexibility for taking advantage of innovative or alternative proposals that may be submitted by the bidders in the selection proceedings, as well as for changing and adjusting its own requirements in the event that more attractive options for meeting the infrastructure needs are formulated during the negotiations.

88. Negotiations outside structured competitive procedures generally afford a high degree of flexibility that some countries have found beneficial to the

selection of the concessionaire. Coupled with appropriate measures to ensure transparency, integrity and fairness, such negotiations carried out in those countries have led to satisfactory results. However, such negotiations may have a number of disadvantages that make them less suitable to be used as a principal selection method in a number of countries. Because of the high level of flexibility and discretion afforded to the contracting authority, negotiations outside structured competitive procedures require highly skilled personnel with sufficient experience in negotiating complex projects. They also require a well structured negotiating team, clear lines of authority and a high level of coordination and cooperation among all the offices involved. The use of negotiations for the award of privately financed infrastructure projects may therefore not represent a viable alternative for countries that do not have the tradition of using such methods for the award of large government contracts. Another disadvantage of those negotiations is that they may not ensure the level of transparency and objectivity that can be achieved by more structured competitive procedures. In some countries there might be concerns that the higher level of discretion in those negotiations might carry with it a higher risk of abusive or corrupt practices. In view of the above, the host country may wish to prescribe the use of competitive selection procedures as a rule for the award of privately financed infrastructure projects and to reserve concession awards without competitive procedures only for exceptional cases.

1. Authorizing circumstances

89. For purposes of transparency as well as for ensuring discipline in the award of projects, it might be generally desirable for the law to identify the exceptional circumstances under which the contracting authority may be authorized to select the concessionaire without using competitive selection procedures. They may include, for example, the following:

(a) When there is an urgent need for ensuring immediate provision of the service and engaging in a competitive selection procedure would therefore be impractical, provided that the circumstances giving rise to the urgency were neither foreseeable by the contracting authority nor the result of dilatory conduct on its part. Such an exceptional authorization may be needed, for instance, in cases of interruption in the provision of a given service or where an incumbent concessionaire fails to provide the service at acceptable standards or if the project agreement is rescinded by the contracting authority, when engaging in a competitive selection procedure would be impractical in view of the urgent need to ensure the continuity of the service;

(b) In the case of projects of short duration and with an anticipated initial investment value not exceeding a specified low amount;

(c) Reasons of national defence or security;

(d) Cases where there is only one source capable of providing the required service (for example, because it can be provided only by the use of patented technology or unique know-how) including certain cases of unsolicited proposals (see paras. 115-117);

(e) When an invitation to the pre-selection proceedings or a request for proposals has been issued, but no applications or proposals were submitted or all proposals were rejected and, in the judgement of the contracting authority, issuing a new request for proposals would be unlikely to result in a project award. However, in order to reduce the risk of abuse in changing the selection method, the contracting authority should only be authorized to award a concession without using competitive selection procedures when such a possibility was expressly provided for in the original request for proposals.

2. Measures to enhance transparency in the award of concessions without competitive procedures

90. Procedures to be followed in procurement through negotiation outside structured competitive procedures are typically characterized by a higher degree of flexibility than the procedures applied to other methods of procurement. Few rules and procedures are established to govern the process by which the parties negotiate and conclude their contract. In some countries, procurement laws allow contracting authorities virtually unrestricted freedom to conduct negotiations as they see fit. The laws of other countries establish a procedural framework for negotiation designed to maintain fairness and objectivity and to bolster competition by encouraging participation of bidders. Provisions on procedures for selection through negotiation address a variety of issues discussed below, in particular, requirements for approval of the contracting authority's decision to select the concessionaire through negotiation, selection of negotiating partners, criteria for comparison and evaluation of offers, and recording of the selection proceedings.

(a) Approval

91. A threshold requirement found in many countries is that a contracting authority must obtain the approval of a higher authority prior to engaging in selection through negotiations outside structured competitive procedures. Such provisions generally require the application for approval to be in writing and to set forth the grounds necessitating the use of negotiation. Approval requirements are intended, in particular, to ensure that the concession award without competitive procedures is used only in appropriate circumstances.

(b) Selection of negotiating partners

92. In order to make the award proceedings as competitive as possible, it is advisable to require the contracting authority to engage in negotiations with as many companies judged susceptible of meeting the need as circumstances permit. Beyond such a general provision, there is no specific provision in the laws of some countries on the minimum number of contractors or suppliers with whom the contracting authority is to negotiate. The laws of some other countries, however, require the contracting authority, where practicable, to negotiate with, or to solicit proposals from, a minimum number of bidders (three, for example). The contracting authority is permitted to negotiate with a smaller number in certain circumstances, in particular, when fewer than the minimum number of potential bidders were available.

93. For the purpose of enhancing transparency, it is also advisable to require a notice of the negotiation proceedings to be given to bidders in a specified manner. For example, the contracting authority may be required to publish the notice in a particular publication normally used for that purpose. Such notice requirements are intended to bring the procurement proceedings to the attention of a wider range of bidders than might otherwise be the case, thereby promoting competition. Given the magnitude of most infrastructure projects, the notice should normally contain certain minimum information (a description of the project, for example, or qualification requirements) and should be issued in sufficient time to allow bidders to prepare offers. Generally the formal eligibility requirements applicable to bidders in competitive selection proceedings should also apply in negotiation proceedings.

94. In some countries, notice requirements are waived when the contracting authority resorts to negotiation following unsuccessful bidding proceedings (see para. 89 (e)), if all qualified bidders are permitted to participate in the negotiations or if no bids at all were received.

(c) Criteria for comparison and evaluation of offers

95. Another useful measure to enhance the transparency and effectiveness of negotiations outside structured competitive procedures consists of establishing general criteria that proposals are requested to meet (for example, general performance objectives or output specifications), as well as criteria for evaluating offers made during the negotiations and for selecting the winning concessionaire (for example, the technical merit of an offer, prices, operating and maintenance costs and the profitability and development potential of the project agreement). Where more than one proposal is received, some elements of competition may be usefully introduced in the negotiations. The contracting authority should identify the proposals that appear to meet those criteria and engage in discussions with the author of each such proposal in order to refine and improve upon the proposal to the point where it is satisfactory to the contracting authority. The price of each proposal does not enter into those discussions. When the proposals have been finalized, it may be advisable for the contracting authority to seek a best and final offer on the basis of the clarified proposals. It is recommendable that bidders should include with their final offer evidence that the risk allocation that the offer embodies would be acceptable to their proposed lenders. From the best and final offers received, the preferred bidder can then be chosen. The project would then be awarded to the party offering the “most economical” or “most advantageous” proposal in accordance with the criteria for selecting the winning concessionaire set forth in the invitation to negotiate.

(d) Notice of concession award

96. The contracting authority should be required to establish a record of the selection proceedings (see paras. 120-126) and should publish a notice of the concession award, which, except in cases involving national defence or national security interests, should disclose, in particular, the specific circum-

stances and reasons for the award of the concession without competitive procedures (see para. 122). In some countries, transparency is further enhanced by requiring that the project agreement be opened to public inspection.

E. Unsolicited proposals

97. Public authorities are sometimes approached directly by private companies who submit proposals for the development of projects in respect of which no selection procedures have been opened. These proposals are usually referred to as “unsolicited proposals”. Unsolicited proposals may result from the identification by the private sector of an infrastructure need that may be met by a privately financed project. They may also involve innovative proposals for infrastructure management and offer the potential for transfer of new technology to the host country.

1. Policy considerations

98. One possible reason sometimes cited for waiving the requirement of competitive selection procedures is to provide an incentive for the private sector to submit proposals involving the use of new concepts or technologies to meet the contracting authority’s needs. By the very nature of competitive selection procedures, no bidder has an assurance of being awarded the project, unless it wins the competition. The cost of formulating proposals for large infrastructure projects may be a deterrent for companies concerned about their ability to match proposals submitted by competing bidders. In contrast, the private sector may see an incentive for the submission of unsolicited proposals in rules that allow a contracting authority to negotiate such proposals directly with their authors. The contracting authority, too, may have an interest in the possibility of engaging in direct negotiations in order to stimulate the private sector to formulate innovative proposals for infrastructure development.

99. At the same time, however, the award of projects pursuant to unsolicited proposals and without competition from other bidders may expose the Government to serious criticism, in particular in cases involving exclusive concessions. In addition, prospective lenders, including multilateral and bilateral financial institutions, may have difficulty in lending or providing guarantees for projects that have not been the subject of competitive selection proceedings. They may fear the possibility of challenge and cancellation by future Governments (for example, because the project award may be deemed subsequently to have been the result of favouritism or because the procedure did not provide objective parameters for comparing prices, technical elements and the overall effectiveness of the project) or legal or political challenge by other interested parties, such as customers dissatisfied with increased prices or competing companies alleging unjust exclusion from a competitive selection procedure.

100. In view of the above considerations, it is important for the host country to consider the need for, and the desirability of, devising special procedures for

handling unsolicited proposals that differ from the procedures usually followed for the award of privately financed infrastructure projects. For that purpose, it may be useful to analyse two situations most commonly mentioned in connection with unsolicited proposals, namely, unsolicited proposals claiming to involve the use of new concepts or technologies to address the contracting authority's infrastructure needs and unsolicited proposals claiming to address an infrastructure need not already identified by the contracting authority.

(a) Unsolicited proposals claiming to involve the use of new concepts or technologies to address the contracting authority's infrastructure needs

101. Generally, for infrastructure projects that require the use of some kind of industrial process or method, the contracting authority would have an interest in stimulating the submission of proposals incorporating the most advanced processes, designs, methodologies or engineering concepts with demonstrated ability to enhance the project's outputs (by significantly reducing construction costs, for example, accelerating project execution, improving safety, enhancing project performance, extending economic life, reducing costs of facility maintenance and operations or reducing negative environmental impact or disruptions during either the construction or the operational phase of the project).

102. The contracting authority's legitimate interests might also be achieved through appropriately modified competitive selection procedures instead of a special set of rules for handling unsolicited proposals. For instance, if the contracting authority is using selection procedures that emphasize the expected output of the project, without being prescriptive about the manner in which that output is to be achieved (see paras. 64-66), the bidders would have sufficient flexibility to offer their own proprietary processes or methods. In such a situation, the fact that each of the bidders has its own proprietary processes or methods would not pose an obstacle to competition, provided that all the proposed methods are technically capable of generating the output expected by the contracting authority.

103. Adding the necessary flexibility to the competitive selection procedures may in these cases be a more satisfactory solution than devising special non-competitive procedures for dealing with proposals claiming to involve new concepts or technologies. With the possible exception of proprietary concepts or technologies whose uniqueness may be ascertained on the basis of the existing intellectual property rights, a contracting authority may face considerable difficulties in defining what constitutes a new concept or technology. Such a determination may require the services of costly independent experts, possibly from outside the host country, to avoid allegations of bias. A determination that a project involves a novel concept or technology might also be met by claims from other interested companies also claiming to have appropriate new technologies.

104. However, a somewhat different situation may arise if the uniqueness of the proposal or its innovative aspects are such that it would not be possible to implement the project without using a process, design, methodology or engi-

neering concept for which the proponent or its partners possess exclusive rights, either worldwide or regionally. The existence of intellectual property rights in relation to a method or technology may indeed reduce or eliminate the scope for meaningful competition. This is why the procurement laws of most countries authorize procuring entities to engage in single-source procurement if the goods, construction or services are available only from a particular supplier or contractor or if the particular supplier or contractor has exclusive rights over the goods, construction or services and no reasonable alternative or substitute exists (see the UNCITRAL Model Procurement Law, art. 22).

105. In such a case, it would be appropriate to authorize the contracting authority to negotiate the execution of the project directly with the proponent of the unsolicited proposal. The difficulty, of course, would be how to establish, with the necessary degree of objectivity and transparency, that there exists no reasonable alternative or substitute to the method or technology contemplated in the unsolicited proposal. For that purpose, it is advisable for the contracting authority to establish procedures for obtaining elements of comparison for the unsolicited proposal.

(b) Unsolicited proposals claiming to address an infrastructure need not already identified by the contracting authority

106. The merit of unsolicited proposals of this type consists of the identification of a potential for infrastructure development that has not been considered by the authorities of the host country. However, in and of itself this circumstance should not normally provide sufficient justification for a directly negotiated project award in which the contracting authority has no objective assurance that it has obtained the most advantageous solution for meeting its needs.

2. Procedures for handling unsolicited proposals

107. In the light of the above considerations, it is advisable for the contracting authority to establish transparent procedures for determining whether an unsolicited proposal meets the required conditions and whether it is in the contracting authority's interest to pursue it.

(a) Restrictions to the receivability of unsolicited proposals

108. In the interest of ensuring proper accountability for public expenditures, some domestic laws provide that no unsolicited proposal may be considered if the execution of the project would require significant financial commitments from the contracting authority or other public authority such as guarantees, subsidies or equity participation. The reason for such a limitation is that the procedures for handling unsolicited proposals are typically less elaborate than ordinary selection procedures and may not ensure the same level of transpar-

ency and competition that would otherwise be achieved. However, there may be reasons for allowing some flexibility in the application of this condition. In some countries, the presence of government support other than direct government guarantees, subsidy or equity participation (for example, the sale or lease of public property to authors of project proposals) does not necessarily disqualify a proposal from being treated and accepted as an unsolicited proposal.

109. Another condition for consideration of an unsolicited proposal is that it should relate to a project for which no selection procedures have been initiated or announced by the contracting authority. The rationale for handling an unsolicited proposal without using a competitive selection procedure is to provide an incentive for the private sector to identify new or unanticipated infrastructure needs or to formulate innovative proposals for meeting those needs. This justification may no longer be valid if the project has already been identified by the authorities of the host country and the private sector is merely proposing a technical solution different from the one envisaged by the contracting authority. In such a case, the contracting authority could still take advantage of innovative solutions by applying a two-stage selection procedure (see paras. 54-58). However, it would not be consistent with the principle of fairness in the award of public contracts to entertain unsolicited proposals outside selection proceedings already started or announced.

(b) Procedures for determining the admissibility of unsolicited proposals

110. A company or group of companies that approaches the Government with a suggestion for private infrastructure development should be requested to submit an initial proposal containing sufficient information to allow the contracting authority to make a prima facie assessment of whether the conditions for handling unsolicited proposals are met, in particular whether the proposed project is in the public interest. The initial proposal should include, for instance, the following information: a statement of the author's previous project experience and financial standing; a description of the project (type of project, location, regional impact, proposed investment, operational costs, financial assessment and resources needed from the Government or third parties); details about the site (ownership and whether land or other property will have to be expropriated); and a description of the service and the works.

111. Following a preliminary examination, the contracting authority should inform the company, within a reasonably short period, whether or not there is a potential public interest in the project. If the contracting authority reacts positively to the project, the company should be invited to submit a formal proposal, which, in addition to the items covered in the initial proposal, should contain a technical and economic feasibility study (including characteristics, costs and benefits) and an environmental impact study. Furthermore, the author of the proposal should be required to submit satisfactory information regarding the concept or technology contemplated in the proposal. The information disclosed should be in sufficient detail to allow the contracting authority to evaluate the concept or technology properly and to determine whether it meets the required conditions and is likely to be successfully implemented on the scale

of the proposed project. The company submitting the unsolicited proposal should retain title to all documents submitted throughout the procedure and those documents should be returned to it in the event the proposal is rejected.

112. Once all the required information is provided by the author of the proposal, the contracting authority should decide, within a reasonably short period, whether it intends to pursue the project and, if so, what procedure will be used. Choice of the appropriate procedure should be made on the basis of the contracting authority's preliminary determination as to whether or not the implementation of the project would be possible without the use of a process, design, methodology or engineering concept for which the proposing company or its partners possess exclusive rights.

(c) *Procedures for handling unsolicited proposals that do not involve proprietary concepts or technology*

113. If the contracting authority, upon examination of an unsolicited proposal, decides that there is public interest in pursuing the project, but the implementation of the project is possible without the use of a process, design, methodology or engineering concept for which the proponent or its partners possess exclusive rights, the contracting authority should be required to award the project by using the procedures that would normally be required for the award of privately financed infrastructure projects, such as, for instance, the competitive selection procedures described in this *Guide* (see paras. 34-84). However, the selection procedures may include certain special features so as to provide an incentive to the submission of unsolicited proposals. These incentives may consist of the following measures:

(a) The contracting authority could undertake not to initiate selection proceedings regarding a project in respect of which an unsolicited proposal was received without inviting the company that submitted the original proposal;

(b) The original bidder might be given some form of premium for submitting the proposal. In some countries that use a merit-point system for the evaluation of financial and technical proposals the premium takes the form of a margin of preference over the final rating (that is, a certain percentage over and above the final combined rating obtained by that company in respect of both financial and non-financial evaluation criteria). One possible difficulty of such a system is the risk of setting the margin of preference so high as to discourage competing meritorious bids, thus resulting in the receipt of a project of lesser value in exchange for the preference given to the innovative bidder. Alternative forms of incentives may include the reimbursement, in whole or in part, of the costs incurred by the original author in the preparation of the unsolicited proposal. For purposes of transparency, any such incentives should be announced in the request for proposals.

114. Notwithstanding the incentives that may be provided, the author of the unsolicited proposal should generally be required to meet essentially the same qualification criteria as would be required of the bidders participating in a competitive selection proceedings (see paras. 38-40).

(d) *Procedures for handling unsolicited proposals involving proprietary concepts or technology*

115. If it appears that the innovative aspects of the proposal are such that it would not be possible to implement the project without using a process, design, methodology or engineering concept for which the author or its partners possess exclusive rights, either worldwide or regionally, it may be useful for the contracting authority to confirm that preliminary assessment by applying a procedure for obtaining elements of comparison for the unsolicited proposal. One such procedure may consist of the publication of a description of the essential output elements of the proposal (for example, the capacity of the infrastructure facility, quality of the product or the service or price per unit) with an invitation to other interested parties to submit alternative or comparable proposals within a certain period. Such a description should not include input elements of the unsolicited proposal (the design of the facility, for example, or the technology and equipment to be used), in order to avoid disclosing to potential competitors proprietary information of the person who had submitted the unsolicited proposal. The period for submitting proposals should be commensurate with the complexity of the project and should afford the prospective competitors sufficient time to formulate their proposals. This may be a crucial factor for obtaining alternative proposals, for example, if the bidders would have to carry out detailed subsurface geological investigations that might have been carried out over many months by the original bidder, who would want the geological findings to remain secret.

116. The invitation for comparative or competitive proposals should be published with a minimum frequency (for example, once every week for three weeks) in at least one newspaper of general circulation. It should indicate the time and place where bidding documents may be obtained and should specify the time during which proposals may be received. It is important for the contracting authority to protect the intellectual property rights of the original author and to ensure the confidentiality of proprietary information received with the unsolicited proposal. Any such information should not form part of the bidding documents. Both the original bidder and any other company that wishes to submit an alternative proposal should be required to submit a bid security (see para. 62). Two possible avenues may then be pursued, according to the reactions received to the invitation:

(a) If no alternative proposals are received, the contracting authority may reasonably conclude that there is no reasonable alternative or substitute to the method or technology contemplated in the unsolicited proposal. This finding of the contracting authority should be appropriately recorded and the contracting authority could be authorized to engage in direct negotiations with the original proponent. It may be advisable to require that the decision of the contracting authority be reviewed and approved by the same authority whose approval would normally be required in order for the contracting authority to select a concessionaire through direct negotiation (see para. 89). Some countries whose laws mandate the use of competitive procedures have used these procedures in order to establish the necessary transparency required to avoid future challenges to the award of a concession following an unsolicited proposal. In those

countries, the mere publication of an invitation to bid would permit an award to the bidder who originally submitted the unsolicited proposal, even if its bid were the only one received. This is so because compliance with competitive procedures typically requires that the possibility of competition should have been present and not necessarily that competition actually occurred. Publicity creates such a possibility and adds a desirable degree of transparency;

(b) If alternative proposals are submitted, the contracting authority should invite all the bidders to negotiations with a view to identifying the most advantageous proposal for carrying out the project (see paras. 90-96). In the event that the contracting authority receives a sufficiently large number of alternative proposals, which appear *prima facie* to meet its infrastructure needs, there may be scope for engaging in full-fledged competitive selection procedures (see paras. 34-84), subject to any incentives that may be given to the author of the original proposal (see para. 113 (b)).

117. The contracting authority should be required to establish a record of the selection proceedings (paras. 120-126) and to publish a notice of the award of the project (see para. 119).

F. Confidentiality

118. In order to prevent abuse of the selection procedures and to promote confidence in the process, it is important that confidentiality be observed by all parties, especially where negotiations are involved. Such confidentiality is important in particular to protect any trade or other information that bidders might include in their proposals and that they would not wish to be made known to their competitors. Confidentiality should be kept regardless of the selection method used by the contracting authority.

G. Notice of project award

119. Project agreements frequently include provisions that are of direct interest for parties other than the contracting authority and the concessionaire and who might have a legitimate interest in being informed about certain essential elements of the project. This is the case in particular for projects involving the provision of a service directly to the general public. For purposes of transparency, it may be advisable to establish procedures for publicizing those terms of the project agreement which may be of public interest. Such a requirement should apply regardless of the method used by the contracting authority to select the concessionaire (for example, whether through competitive selection procedures, direct negotiations or as a result of an unsolicited proposal). One possible procedure may be to require the contracting authority to publish a notice of the award of the project, indicating the essential elements of the proposed agreements, such as: (a) the name of the concessionaire; (b) a description of the works and services to be performed by the concessionaire; (c) the duration of the concession; (d) the price structure; (e) a summary of the

essential rights and obligations of the concessionaire and the guarantees to be provided by it; (f) a summary of the monitoring rights of the contracting authority and remedies for breach of the project agreement; (g) a summary of the essential obligations of the Government, including any payment, subsidy or compensation offered by it; and (h) any other essential term of the project agreement, as provided in the request for proposals.

H. Record of selection and award proceedings

120. In order to ensure transparency and accountability and to facilitate the exercise of the right of aggrieved bidders to seek review of decisions made by the contracting authority, the contracting authority should be required to keep an appropriate record of key information pertaining to the selection proceedings.

121. The record to be kept by the contracting authority should contain, as appropriate, such general information concerning the selection proceedings as is usually required to be recorded for public procurement (such as the information listed in article 11 of the UNCITRAL Model Procurement Law), as well as information of particular relevance for privately financed infrastructure projects. Such information may include the following:

(a) A description of the project for which the contracting authority requested proposals;

(b) The names and addresses of the companies participating in bidding consortia and the name and address of the members of the bidders with whom the project agreement has been entered into; and a description of the publicity requirements, including copies of the publicity used or of the invitations sent;

(c) If changes to the composition of the pre-selected bidders are subsequently permitted, a statement of the reasons for authorizing such changes and a finding as to the qualifications of any substitute or additional consortia concerned;

(d) Information relative to the qualifications, or lack thereof, of bidders and a summary of the evaluation and comparison of proposals, including the application of any margin of preference;

(e) A summary of the conclusions of the preliminary feasibility studies commissioned by the contracting authority and a summary of the conclusions of the feasibility studies submitted by the qualified bidders;

(f) A summary of any requests for clarification of the pre-selection documents or the request for proposals, the responses thereto, as well as a summary of any modification of those documents;

(g) A summary of the principal terms of the proposals and of the project agreement;

(h) If the contracting authority has found most advantageous a proposal other than the proposal offering the lowest unit price for the expected output, a justification of the reasons for that finding by the awarding committee;

(i) If all proposals were rejected, a statement to that effect and the grounds for rejection;

(j) If the negotiations with the consortium that submitted the most advantageous proposal and any subsequent negotiations with remaining responsive consortia did not result in a project agreement, a statement to that effect and of the grounds therefor.

122. For concession awards without competitive procedures (see para. 89), it may be useful to include in the record of those proceedings, in addition to requirements referred to in paragraph 121 that may be applicable, the following additional information:

(a) A statement of the grounds and circumstances on which the contracting authority relied to justify the direct negotiation;

(b) The type of publicity used or the name and address of the company or companies directly invited to the negotiations;

(c) The name and address of the company or companies that requested to participate and those which were excluded from participating, if any, and the grounds for their exclusion;

(d) If the negotiations did not result in a project agreement, a statement to that effect and of the grounds therefor;

(e) The justification given for the selection of the final concessionaire.

123. For selection proceedings engaged in as a result of unsolicited proposals (see paras. 107-117), it may be useful to include in the record of those proceedings, in addition to requirements referred to in paragraph 121 that may be applicable, the following additional information:

(a) The name and address of the company or companies submitting the unsolicited proposal and a brief description of it;

(b) A certification by the contracting authority that the unsolicited proposal was found to be of public interest and to involve new concepts or technologies, as appropriate;

(c) The type of publicity used or the name and address of the company or companies directly invited to the negotiations;

(d) The name and address of the company or companies that requested to participate and those which were excluded from participating, if any, and the grounds for their exclusion;

(e) If the negotiations did not result in a project agreement, a statement to that effect and of the grounds therefor;

(f) The justification given for the selection of the final concessionaire.

124. It is advisable for the rules on record requirements to specify the extent and the recipients of the disclosure. Setting the parameters of disclosure involves balancing factors such as the general desirability, from the standpoint

of the accountability of contracting authorities, of broad disclosure; the need to provide bidders with information necessary to enable them to assess their performance in the proceedings and to detect instances in which there are legitimate grounds for seeking review; and the need to protect the bidders' confidential trade information. In view of these considerations, it may be advisable to provide two levels of disclosure, as envisaged in article 11 of the UNCITRAL Model Procurement Law. The information to be provided to any member of the general public may be limited to basic information geared to the accountability of the contracting authority to the general public. However, it is advisable to provide for the disclosure for the benefit of bidders of more detailed information concerning the conduct of the selection, since that information is necessary to enable the bidders to monitor their relative performance in the selection proceedings and to monitor the conduct of the contracting authority in implementing the requirements of the applicable laws and regulations.

125. Moreover, appropriate measures should be taken to avoid the disclosure of confidential trade information of suppliers and contractors. This is true in particular with respect to what is disclosed concerning the evaluation and comparison of proposals, as excessive disclosure of such information may be prejudicial to the legitimate commercial interests of bidders. As a general rule, the contracting authority should not disclose more detailed information relating to the examination, evaluation and comparison of proposals and proposal prices, except when ordered to do so by a competent court.

126. Provisions on limited disclosure of information relating to the selection process would not preclude the applicability to certain parts of the record of other statutes in the enacting State that confer on the public at large a general right to obtain access to government records. Disclosure of the information in the record to legislative or parliamentary oversight bodies may be mandated pursuant to the law applicable in the host country.

I. Review procedures

127. The existence of fair and efficient review procedures is one of the basic requirements for attracting serious and competent bidders and for reducing the cost and the length of award proceedings. An important safeguard of proper adherence to the rules governing the selection procedure is that bidders have the right to seek review of actions by the contracting authority in violation of those rules or of the rights of bidders. Various remedies and procedures are available in different legal systems and systems of administration, which are closely linked to the question of review of governmental actions. Whatever the exact form of review procedures, it is important to ensure that an adequate opportunity and effective procedures for review are provided. It is particularly useful to establish a workable "pre-contract" recourse system (that is, procedures for reviewing the contracting authority's acts as early in the selection proceedings as feasible). Such a system increases the possibility of taking corrective actions by the contracting authority before loss is caused and helps

to reduce cases where monetary compensation is the only option left to redress the consequences of an improper action by the contracting authority. Elements for the establishment of an adequate review system are contained in chapter VI of the UNCITRAL Model Procurement Law.

128. Appropriate review procedures should establish in the first place that bidders have a right to seek review of decisions affecting their rights. In the first instance, that review may be sought from the contracting authority itself, in particular where the project is yet to be awarded. This may facilitate economy and efficiency, since in many cases, in particular prior to the awarding of the project, the contracting authority may be quite willing to correct procedural errors, of which it may even not have been aware. It may also be useful to provide for a review by higher administrative organs of the Government, where such a procedure would be consistent with constitutional, judicial and administrative structures. Finally, most domestic procurement regimes affirm the right to judicial review, which should generally also be available in connection with the award of infrastructure projects.

129. In order to strike a workable balance between, on the one hand, the need to preserve the rights of bidders and the integrity of the selection process and, on the other, the need to limit disruption of the selection process, domestic laws often include a number of restrictions on review procedures. These include restricting the right to review to bidders; establishing time limits for filing of applications for review and for disposition of cases, including time limits for any suspension of the selection proceedings that may apply at the level of administrative review; and excluding from the review procedures a number of decisions that are left to the discretion of the contracting authority and that do not directly involve questions of the fairness of treatment accorded to bidders. In most legal systems, administrative review procedures are available to bidders to challenge decisions by contracting authorities, although judicial review procedures may not be universally available.

130. There exist in most States mechanisms and procedures for review of acts of administrative organs and other public entities. In some States, review mechanisms and procedures have been established specifically for disputes arising in the context of procurement by those organs and entities. In other States, those disputes are dealt with by means of the general mechanisms and procedures for review of administrative acts. Certain important aspects of proceedings for review, such as the forum where review may be sought and the remedies that may be granted, are related to fundamental conceptual and structural aspects of the legal system and the system of State administration in every country. Many legal systems provide for review of acts of administrative organs and other public entities before an administrative body that exercises hierarchical authority or control over the organ or entity. In legal systems that provide for such hierarchical administrative review, the question of which body or bodies are to exercise that function in respect of acts of particular organs or entities depends largely on the structure of the State administration. In the context of general procurement laws, for example, some States provide for review by a body that exercises overall supervision and control over pro-

curement in the State (such as a central procurement board); in other States the review function is performed by the body that exercises financial control and oversight over operations of the Government and of the public administration. In some States, the review function in relation to particular types of cases involving administrative organs or other public entities is performed by specialized independent administrative bodies whose competence is sometimes referred to as “quasi-judicial”. Those bodies are not, however, considered in those States to be courts within the judicial system.

131. Many national legal systems provide for judicial review of acts of administrative organs and public entities. In several of those legal systems judicial review is provided in addition to administrative review, while in other systems only judicial review is provided. Some legal systems provide only administrative review, and not judicial review. In some legal systems where both administrative and judicial review are provided, judicial review may be sought only after opportunities for administrative review have been exhausted; in other systems the two means of review are available as options. The main issue raised concerning judicial review is the effect that a judgement that annuls a public bidding would have on the awarded contract, especially when public works have already been initiated. Procurement laws tend to attempt to strike a balance between the conflicting interests of the public sector, that is, the need to uphold the integrity of the procurement procedure and not to delay the rendering of a public service, and the interest of the bidders to preserve their rights. Except where a project agreement was the result of unlawful acts, a good solution is that a judgement should not render the project agreement void, but award damages to the injured party. It is usually agreed that such damages should not include loss of profits, but be limited to the cost incurred by the bidder in preparing the bid.

IV. Construction and operation of infrastructure: legislative framework and project agreement

A. General provisions of the project agreement

1. The “project agreement” between the contracting authority and the concessionaire is the central contractual document in an infrastructure project. The project agreement defines the scope and purpose of the project as well as the rights and obligations of the parties; it provides details on the execution of the project and sets forth the conditions for the operation of the infrastructure or the delivery of the relevant services. Project agreements may be contained in a single document or may consist of more than one separate agreement between the contracting authority and the concessionaire. This section discusses the relation between the project agreement and the host country’s legislation on privately financed infrastructure projects. It also discusses procedures and formalities for the conclusion and entry into force of the project agreement.

1. Legislative approaches

2. Domestic legislation often contains provisions dealing with the content of the project agreement. In some countries, the law merely refers to the need for an agreement between the concessionaire and the contracting authority, while the laws of other countries contain extensive mandatory provisions concerning the content of clauses to be included in the agreement. An intermediate approach is taken by those laws which list a number of issues that need to be addressed in the project agreement without regulating in detail the content of its clauses.

3. General legislative provisions on certain essential elements of the project agreement may serve the purpose of establishing a general framework for the allocation of rights and obligations between the parties. They may be intended to ensure consistency in the treatment of certain contractual issues and to provide guidance to the public authorities involved in the negotiation of project agreements at different levels of government (national, provincial or local). Such guidance may be found particularly useful by contracting authorities lacking experience in the negotiation of project agreements. Lastly, legislation may sometimes be required so as to provide the contracting authority with the power to agree on certain types of provisions.

4. However, general legislative provisions dealing in detail with the rights and obligations of the parties might deprive the contracting authority and the concessionaire of the necessary flexibility to negotiate an agreement that takes

into account the needs and particularities of a specific project. Therefore, it is advisable to limit the scope of general legislative provisions concerning the project agreement to those strictly necessary, such as, for instance, provisions on matters for which prior legislative authorization might be needed or those which might affect the interests of third parties or provisions relating to essential policy matters on which variation by agreement is not admitted.

2. *The law governing the project agreement*

5. Statutory provisions on the law applicable to the project agreement are not frequently found in domestic legislation on privately financed infrastructure projects. Where they do appear, they usually provide for the application of the laws of the host country by a general reference to domestic law or by mentioning special statutory or regulatory texts that apply to the project agreement. In some legal systems there may be an implied submission to the laws of the host country, even in the absence of a statutory provision to that effect.

6. The law governing the project agreement includes the rules contained in laws and regulations of the host country related directly to privately financed infrastructure projects, where specific legislation on the matter exists. In some countries the project agreement may be subject to administrative law, while in others the project agreement may be governed by private law (see chap. VII, “Other relevant areas of law”, paras. 24-27). The governing law also includes legal rules of other fields of law that apply to the various issues that arise during the execution of an infrastructure project (see generally chap. VII, “Other relevant areas of law”, sect. B). Some of those rules may be of an administrative or other public law nature and their application in the host country may be mandatory, such as those dealing with environmental protection measures and health and labour conditions. Some domestic laws expressly identify the matters that are subject to rules of mandatory application. However, a number of issues arising out of the project agreement or the operation of the facility may not be the subject of mandatory rules of a public law nature. This is typically the case of most contractual issues arising under the project agreement (for example, formation, validity and breach of contract, including liability and compensation for breach of contract and wrongful termination).

7. Host countries wishing to adopt legislation on privately financed infrastructure projects where no such legislation exists may need to address the various issues raised by such projects in more than one statutory instrument. Other countries may wish to introduce legislation dealing only with certain issues that have not already been addressed in a satisfactory manner in existing laws and regulations. For instance, specific legislation on privately financed infrastructure projects could establish the particular features of the procedures to select the concessionaire and refer, as appropriate, to existing legislation on the award of government contracts for details on the administration of the process. By the same token, when adopting legislation on privately financed infrastructure projects, host countries may need to repeal the application of certain laws and regulations that, in the view of the legislature, constitute obstacles to their implementation.

8. For purposes of clarity, it may be useful to provide information to potential investors concerning those statutory and regulatory texts which are directly applicable to the execution of privately financed infrastructure projects and, as appropriate, those whose application has been repealed by the legislature. However, as it would not be possible to list exhaustively in the law all the statutes or regulations of direct or subsidiary relevance for privately financed infrastructure projects, such a list might best be provided in a non-legislative document, such as a promotional brochure or general information provided to bidders with the request for proposals (see chap. III, “Selection of the concessionaire”, para. 60).

3. Conclusion of the project agreement

9. For projects as complex as infrastructure projects, it is not unusual for several months to elapse in the final negotiations (see chap. III, “Selection of the concessionaire”, paras. 83 and 84) before the parties are ready to sign the project agreement. Additional time may also be needed in order to accomplish certain formalities that are often prescribed by law, such as approval of the project agreement by a higher authority. The entry into force of the project agreement or of certain categories of project agreement is in some countries subject to an act of parliament or even the adoption of special legislation. Given the cost entailed by delay in the implementation of the project agreement, it is advisable to find ways of expediting the final negotiations in order to avoid unnecessary delay in the conclusion of the project agreement.

10. A number of factors have been found to cause delay in negotiations, such as inexperience of the parties, poor coordination between different public authorities, uncertainty as to the extent of governmental support and difficulties in establishing security arrangements acceptable to the lenders. The Government may make a significant contribution by providing adequate guidance to negotiators acting on behalf of the contracting authority in the country. The clearer the understanding of the parties as to the provisions to be made in the project agreement, the greater the chances that the negotiation of the project agreement will be conducted successfully. Conversely, where important issues remain open after the selection process and little guidance is provided to the negotiators as to the substance of the project agreement, there may be considerable risk of costly and protracted negotiations as well as of justified complaints that the selection process was not sufficiently transparent and competitive.

11. The procedures for conclusion and entry into force of the project agreement should also be reviewed with a view to expediting matters and avoiding the adverse consequences of delays in the project’s timetable. In some countries the power to bind the contracting authority or the Government, as appropriate, is delegated in the relevant legislation to designated officials, so that the entry into force of the project agreement occurs upon signature or upon the completion of certain formalities, such as publication in the official gazette. In countries where such a procedure would not be feasible or where final approvals by another entity may still be required, it would be desirable to consider

streamlining the approval procedures. Where such procedures are perceived as arbitrary or cumbersome, the Government may be requested to provide sufficient guarantees to the concessionaire and the lenders against such risk (see chap. II, “Project risks and government support”, paras. 45-50). In some countries where approval requirements exist, contracting authorities have sometimes been authorized to compensate the selected bidder for costs incurred during the selection process and in preparations for the project, should final approval be withheld for reasons not attributable to the selected bidder.

B. Organization of the concessionaire

12. Certain requirements concerning the organization of the concessionaire are often found in domestic legislation and are elaborated upon by detailed provisions in project agreements. They typically deal with issues such as the establishment of the concessionaire as a legal entity, its capital, scope of activities, statutes and by-laws. In most cases, the selected bidders establish a project company as an independent legal entity with its own juridical personality, which then becomes the concessionaire under the project agreement. A project company established as an independent legal entity is the vehicle typically used for raising financing under the project finance modality (see “Introduction and background information on privately financed infrastructure projects”, para. 54). Its establishment facilitates coordination in the execution of the project and provides a mechanism for protecting the interests of the project, which may not necessarily coincide with the individual interests of all of the project promoters. This aspect may be of particular importance where significant portions of the services or supplies required by the project are to be provided by members of the project consortium.

13. The project company is usually required to be established within a reasonably short period after the award of the project. Since a substantial part of the liabilities and obligations of the concessionaire, including long-term ones (project agreement, loan and security agreements and construction contracts), are usually agreed upon at an early stage, the project may benefit from being independently represented at the time those instruments are negotiated. However, firm and final commitments by the lenders and other capital providers cannot reasonably be expected to be available prior to the final award of the concession.

14. Entities providing public services are often required to be established as legal entities under the laws of the host country. This requirement reflects the legislature’s interest to ensure, *inter alia*, that public service providers comply with domestic accounting and publicity provisions (such as publication of financial statements or requirements to make public certain corporate acts). However, this emphasizes the need for the host country to have adequate company laws in place (see chap. VII, “Other relevant areas of law”, paras. 30-33). The ease with which the project company can be established, with due regard to reasonable requirements deemed to be of public interest, may help to avoid unnecessary delay in the implementation of the project.

15. Another important issue concerns the equity investment required for the establishment of the project company. The contracting authority has a legitimate interest in seeking an equity level that ensures a sound financial basis for the project company and guarantees its capability to meet its obligations. However, as the total investment needed as well as the ideal proportion of debt and equity capital vary from project to project, it may be undesirable to provide a legislative requirement of a fixed sum as minimum capital for all companies carrying out infrastructure projects in the country. The contracting authority might instead be given more flexibility to arrive at a desirable amount of equity investment commensurate with the project's financial needs. For instance, the expected equity investment might be expressed as a desirable ratio between debt and equity in the request for proposals and might be included among the evaluation criteria for financial and commercial proposals, so as to stimulate competition among the bidders (see chap. III, "Selection of the concessionaire", paras. 75 and 77).

16. In any event, it is advisable to review legislative provisions or regulatory requirements relating to the organization of the concessionaire so as to ensure their consistency with international obligations assumed by the host country. Provisions that restrict or require specific types of legal entity or joint venture through which a service supplier may supply a service and limitations on the participation of foreign capital in terms of a maximum percentage limit on foreign share-holding or the total value of individual or aggregate foreign investment may be inconsistent with specific obligations undertaken by the signatory States of certain international agreements on economic integration or the liberalization of trade in services.

17. Domestic laws sometimes contain provisions concerning the scope of activities of the project company, requiring, for instance, that they be limited to the development and operation of a particular project. Such restrictions may serve the purpose of ensuring the transparency of the project's accounts and preserving the integrity of its assets, by segregating the assets, proceeds and liabilities of this project from those of other projects or other activities not related to the project. Also, such a requirement may facilitate the assessment of the performance of each project since deficits or profits could not be covered with, or set off against, debts or proceeds from other projects or activities.

18. The contracting authority might also wish to be assured that the statutes and by-laws of the project company will adequately reflect the obligations assumed by the company in the project agreement. For this reason, project agreements sometimes provide that the entry into force of changes in the statutes and by-laws of the project company is effective upon approval by the contracting authority. Where the contracting authority or another public authority participates in the project company, provisions are sometimes made to the effect that certain decisions necessitate the positive vote of the contracting authority in the meeting of the shareholders or board. In any event, it is important to weigh the public interests represented through the contracting authority against the need to afford the project company the flexibility necessary

for the conduct of its business. Where it is deemed necessary to require the contracting authority's approval to proposed amendments to the statutes and by-laws of the project company, it is advisable to limit such a requirement to cases concerning provisions deemed to be of fundamental importance (for example, amount of capital, classes of shares and their privileges or liquidation procedures), which should be identified in the project agreement.

C. The project site, assets and easements

19. Provisions relating to the site of the project are an essential part of most project agreements. They typically deal with issues such as title to land and project assets, acquisition of land, and easements required by the concessionaire to carry out works or to operate the infrastructure. To the extent that the project agreement contemplates transfer of public property to the concessionaire or the creation of a right of use regarding public property, prior legislative authority may be required. Legislation may also be needed to facilitate the acquisition of the required property or easements when the project site is not located on public property.

1. Ownership of project assets

20. As indicated earlier, private sector participation in infrastructure projects may be devised in a variety of different forms, ranging from publicly owned and operated infrastructure to fully privatized projects (see "Introduction and background information on privately financed infrastructure projects", paras. 47-53). Irrespective of the host country's general or sectoral policy, it is important that the ownership regime of the various assets involved be clearly defined and based on sufficient legislative authority. However, there may be no compelling need for detailed legislative provisions on this matter. In various countries it was found sufficient to provide legislative guidance as to matters that need to be addressed in the project agreement.

21. In some legal systems, physical infrastructure required for the provision of public services is generally regarded as public property, even where it was originally acquired or created with private funds. This would typically include any property especially acquired for the construction of the facility in addition to any property that might have been made available to the concessionaire by the contracting authority. However, during the life of the project the concessionaire may make extensive improvements or additions to the facility. It may not always be easily ascertainable under the applicable law whether or not such improvements or additions become an integral part of the public assets held in possession by the concessionaire or whether some of them may be separable from the public property held by the concessionaire and become the concessionaire's private property. It is therefore advisable for the project agreement to specify, as appropriate, which assets will be public property and which will become the private property of the concessionaire.

22. The need for clarity in respect of ownership of project assets is not limited to legal systems where physical infrastructure required for the provision of public services is regarded as public property. Generally, where the contracting authority provides the land or facility required to execute the project, it is advisable for the project agreement to specify, as appropriate, which assets will remain public property and which will become the private property of the concessionaire. The concessionaire may either receive title to such land or facilities or be granted only a leasehold interest or the right to use the land or facilities and build upon it, in particular where the land remains public property. In either case, the nature of the concessionaire's rights should be clearly established, as this will directly affect the concessionaire's ability to create security interests in project assets for the purpose of raising financing for the project (see paras. 54 and 55).

23. In addition to the ownership of assets during the duration of the concession period, it is important to consider the ownership regime upon expiry or termination of the project agreement. In some countries the law places particular emphasis on the contracting authority's interest in the physical assets related to the project and generally require the handover to the contracting authority of all of them, whereas in other countries privately financed infrastructure projects are regarded primarily as a means of procuring services over a specified period, rather than of constructing assets. Thus, the laws of the latter countries limit the concessionaire's handover obligations to public assets and property originally made available to the concessionaire or certain other assets deemed to be necessary to ensure provision of the service. Sometimes, such property is transferred directly from the concessionaire to another concessionaire who succeeds it in the provision of the service.

24. Differences in legislative approaches often reflect the varying role of the public and private sectors under different legal and economic systems, but may also be the result of practical considerations on the part of the contracting authority. One practical reason for the contracting authority to allow the concessionaire to retain certain assets at the end of the project period may be the desire to lower the cost at which the service will be provided. If the project assets are likely to have a residual value for the concessionaire and that value can be taken into account during the selection process, the contracting authority may expect the tariffs charged for the service to be lower. Indeed, if the concessionaire does not expect to have to cover the entire cost of the assets in the life of the project, but can cover part of it by selling them, or using them for other purposes, after the project agreement expires, there is a possibility that the service may be provided at a lower cost than if the concessionaire had to cover all its costs in the life of the project. Moreover, certain assets may require such extensive refurbishing or technological upgrading at the end of the project period that it might not be cost-effective for the contracting authority to claim them. There may also be residual liabilities or consequential costs, for instance, because of liability for environmental damage or demolition costs.

25. For these reasons, the laws of some countries do not contemplate an unqualified transfer of all assets to the contracting authority, but allow a distinction between three main categories of assets:

(a) Assets that must be transferred to the contracting authority. This category typically includes public property that was used by the concessionaire to provide the service concerned. Assets may include both facilities made available to the concessionaire by the contracting authority and new facilities built by the concessionaire pursuant to the project agreement. Some laws also require the transfer of assets, goods and property subsequently acquired by the concessionaire for the purpose of operating the facility, in particular where they become part of, or are permanently affixed to, the infrastructure facility to be handed over to the contracting authority;

(b) Assets that may be purchased by the contracting authority, at its option. This category usually includes assets originally owned by the concessionaire, or subsequently acquired by it, which, without being indispensable or strictly necessary for the provision of the service, may enhance the convenience or efficiency of operating the facility or the quality of the service;

(c) Assets that remain the private property of the concessionaire. These are assets owned by the concessionaire that do not fall under (b) above. Typically the contracting authority is not entitled to such assets, which may be freely removed or disposed of by the concessionaire.

26. In the light of the above, it is useful to require in the law that the project agreement specify, as appropriate, which assets will be public property and which will be the private property of the concessionaire. The project agreement should identify which assets the concessionaire is required to transfer to the contracting authority or to a new concessionaire upon expiry or termination of the project agreement; which assets the contracting authority, at its option, may purchase from the concessionaire; and which assets the concessionaire may freely remove or dispose of upon expiry or termination of the project agreement. These provisions should be complemented by contractual criteria for establishing, as appropriate, the compensation to which the concessionaire may be entitled in respect of assets transferred to the contracting authority or to a new concessionaire or purchased by the contracting authority upon expiry or termination of the project agreement (see chap. V, “Duration, extension and termination of the project agreement”, paras. 37-40).

2. Acquisition of land required for execution of the project

27. Where a new infrastructure facility is to be built on public land (that is, land owned by the contracting authority or another public authority) or an existing infrastructure facility is to be modernized or rehabilitated, it will normally be for the owner of such land or facility to make it available to the concessionaire. The situation is more complex when the land is not already owned by the contracting authority and needs to be purchased from its owners. In most cases, the concessionaire would not be in the best position to assume responsibility for purchasing the land needed for the project, in view of the

potential delay and expense involved in negotiations with a possibly large number of individual owners, nor, as may be necessary in some jurisdictions, to undertake complex searches of title deeds and review of chains of previous property transfers so as to establish the regularity of the title of individual owners. It is therefore typical for the contracting authority to assume responsibility for providing the land required for the implementation of the project, so as to avoid unnecessary delay or increase in project cost as a result of the acquisition of land. The contracting authority may purchase the required land from its owners or, if necessary, acquire it compulsorily.

28. The procedure whereby private property is compulsorily acquired by the Government against the payment of appropriate compensation to the owners, which is referred to in domestic legal systems by various technical expressions, such as “expropriation”, is referred to in the present *Guide* as “compulsory acquisition”. In countries where the law contemplates more than one type of procedure for compulsory acquisition, it may be desirable to authorize the competent public authorities to carry out all acquisitions required for privately financed infrastructure projects pursuant to the most efficient of those procedures, such as the special procedures that in some countries apply for reasons of compelling public need (see chap. VII, “Other relevant areas of law”, paras. 22 and 23).

29. The power to acquire property compulsorily is usually vested in the Government, but the laws of a number of countries also authorize infrastructure operators or public service providers (such as railway companies, electricity authorities or telephone companies) to perform certain actions for the compulsory acquisition of private property required for providing or expanding their services to the public. In those countries in particular where the award of compensation to the owners of the property compulsorily acquired is adjudicated in court proceedings, it has been found useful to delegate to the concessionaire the authority to carry out certain acts relating to the compulsory acquisition, while the Government remains responsible for accomplishing those acts which, under the relevant legislation, are preconditions to the initiation of the acquisition proceedings. Upon acquisition, the land often becomes public property, although in some cases the law may authorize the contracting authority and the concessionaire to agree on a different arrangement, taking into account their respective shares in the cost of acquiring the property.

3. *Easements*

30. Special arrangements may be required, in cases where the concessionaire needs to transit on or through the property of third parties to access the project site or to perform or maintain any works required for the provision of the service (for example, to place traffic signs on adjacent lands; to install poles or electric transmission lines above third parties’ property; to install and maintain transforming and switching equipment; to trim trees that interfere with telephone lines placed on abutting property; or to lay oil, gas or water pipes).

31. The right to use another person's property for a specific purpose or to do work on it is often referred to by the word "easement". Easements usually require the consent of the owner of the property to which they pertain, unless such rights are provided by the law. Usually it is not an expeditious or cost-effective solution to leave it to the concessionaire to acquire easements directly from the owners of the properties concerned. Instead it is more frequent for those easements to be compulsorily acquired by the contracting authority simultaneously with the project site.

32. A somewhat different alternative might be for the law itself to empower public service providers to enter, pass through or do work or affix installations upon the property of third parties, as required for the construction, operation and maintenance of public infrastructure. Such an approach, which may obviate the need to acquire easements in respect of individual properties, may be used in sector-specific legislation where it is deemed possible to determine, in advance, certain minimum easements that may be needed by the concessionaire. For instance, a law specific to the power generation sector may lay down the conditions under which the concessionaire obtains a right of cabling for the purpose of placing and operating basic and distribution networks on property belonging to third parties. Such a right may be needed for a number of measures, such as establishing or placing underground and overhead cables, as well as establishing supporting structures and transforming and switching equipment; maintaining, repairing and removing any of those installations; establishing a safety zone along underground or overhead cables; or removing obstacles along the wires or encroaching on the safety zone. Under some legal systems, the owners may be entitled to compensation should the extent of the rights granted to the concessionaire be such that the use of the properties by their owners is substantially hindered.

D. Financial arrangements

33. Financial arrangements typically include provisions concerning the concessionaire's obligations to raise funds for the project, outline the mechanisms for disbursing and accounting for funds, establish methods for calculating and adjusting the tariffs charged by the concessionaire and deal with the types of security interests that may be established in favour of the concessionaire's creditors. It is important to ensure that the laws of the host country facilitate or at least do not pose obstacles to the financial management of the project.

1. Financial obligations of the concessionaire

34. In privately financed infrastructure projects the concessionaire is typically responsible for raising the funds required to construct and operate the infrastructure facility. The concessionaire's obligations in this regard are typically set forth in detailed provisions in the project agreement. In most cases, the contracting authority or other public authorities would be interested in limiting their financial obligations to those specifically expressed in the project agreement or those forms of direct support that the Government has agreed to extend to the project.

35. The amount of private capital contributed directly by the project company's shareholders typically represents only a portion of the total proposed investment. A far greater portion derives from loans extended to the concessionaire by commercial banks and international financial institutions and from the proceeds of the placement of bonds and other negotiable instruments on the capital market (see "Introduction and background information on privately financed infrastructure projects", paras. 54-67). It is therefore important to ensure that the law does not unnecessarily restrict the concessionaire's ability to enter into the financial arrangements it sees fit for the purpose of financing the infrastructure.

2. Tariff setting and tariff control

36. Tariffs or usage fees charged by the concessionaire may be the main (sometimes even the sole) source of revenue to recover the investment made in the project in the absence of subsidies or payments by the contracting authority (see paras. 47-51) or the Government (see chap. II, "Project risks and government support," paras. 30-60). The concessionaire will therefore seek to be able to set and maintain tariffs and fees at a level that ensures sufficient cash flow for the project. However, in some legal systems there may be limits to the concessionaire's freedom to establish tariffs and fees. The cost at which public services are provided is typically an element of the Governments's infrastructure policy and a matter of immediate concern for large sections of the public. Thus, the regulatory framework in many countries includes special rules to control tariffs and fees for the provision of public services. Furthermore, statutory provisions or general rules of law in some legal systems establish parameters for pricing goods or services, for instance by requiring that tariffs meet certain standards of "reasonableness", "fairness" or "equity".

(a) The concessionaire's authority to collect tariffs

37. In a number of countries prior legislative authorization may be necessary in order for a concessionaire to collect tariffs for the provision of public services or to demand a fee for the use of public infrastructure facilities. The absence of such a general provision in legislation has in some countries given rise to judicial disputes challenging the concessionaire's authority to charge a tariff for the service.

38. Where it is deemed necessary to include in general legislation provisions concerning the level of tariffs and user fees, they should seek to achieve a balance between the interests of investors and current and future users. It is advisable that statutory criteria for determining tariffs and fees take into account, in addition to social factors the Government regards as relevant, the concessionaire's interest in achieving a level of cash flow that ensures the economic viability and commercial profitability of the project. Furthermore, it is advisable to provide the parties with the necessary authority to negotiate appropriate arrangements, including compensation provisions, in order to address situations where the application of tariff control rules directly or indirectly related to the provision of public services may result in fixing tariffs or fees below the level required for the profitable operation of the project (see para. 124).

(b) *Tariff control methods*

39. Domestic laws often subject tariffs or user fees to some control mechanism. Many countries have chosen to set only the broad tariff principles in legislation while leaving their actual implementation to the regulatory agency concerned and to the terms and conditions of licences or concessions. This approach is advisable because formulas are sector-specific and may require adaptation during the life of a project. Where tariff control measures are used, the law typically requires that the tariff formula be advertised with the request for proposals and be incorporated into the project agreement. Tariff control systems typically consist of formulas for the adjustment of tariffs and monitoring provisions to ensure compliance with the parameters for tariff adjustment. The most common tariff control methods used in domestic laws are based on rate-of-return and price-cap principles. There are also hybrid regimes that have elements of both. It should be noted that a well-functioning tariff control mechanism requires detailed commercial and economic analysis and that the brief discussion that follows offers only an overview of selected issues and possible solutions.

(i) *Rate-of-return method*

40. Under the rate-of-return method, the tariff adjustment mechanism is devised so as to allow the concessionaire an agreed rate of return on its investment. The tariffs for any given period are established on the basis of the concessionaire's overall revenue requirement to operate the facility, which involves determining its expenses, the investments undertaken to provide the services and the allowed rate of return. Reviews of the tariffs are undertaken periodically, sometimes whenever the contracting authority or other interested parties consider that the actual revenue is higher or lower than the revenue requirement of the facility. For that purpose, the contracting authority verifies the expenses of the facility, determines to what extent investments undertaken by the concessionaire are eligible for inclusion in the rate base and calculates the revenues that need to be generated to cover the allowable expenses and the return on investment agreed upon. The rate-of-return method is typically used in connection with the supply of public services for which a constant demand can be forecast, such as power, gas or water supply. For facilities or services exposed to greater elasticity of demand, such as tollroads, it might not be possible to keep the concessionaire's rate of return constant by regular tariff adjustments.

41. The rate-of-return method has been found to provide a high degree of security for infrastructure operators, since the concessionaire is assured that the tariffs charged will be sufficient to cover its operating expenses and allow the agreed rate of return. Because tariffs are adjusted regularly, thus keeping the concessionaire's rate of return essentially constant, investment in companies providing public services is exposed to little market risk. The result is typically lower costs of capital. The possible disadvantage of the rate-of-return method is that it provides little incentive for infrastructure operators to minimize their costs because of the assurance that those costs will be recovered through tariff adjustments. However, some level of incentive may exist if the tariffs are not adjusted instantaneously or if the adjustment does not apply retroactively. It should be noted that the implementation of the rate-of-return method requires

a substantial amount of information, as well as extensive negotiations (for example, on eligible expenditures and cost allocation).

(ii) Price-cap method

42. Under the price-cap method, a tariff formula is set for a given period (such as four or five years) taking into account future inflation and future efficiency gains expected from the facility. Tariffs are allowed to fluctuate within the limits set by the formula. In some countries, the formula is a weighted average of various indices, in others it is a consumer price index minus a productivity factor. Where substantial new investments are required, the formula may include an additional component to cover these extra costs. The formula can apply to all services of the company or to selected groups of services only, and different formulas may be used for different groups. The periodic readjustment of the formula is, however, based on the rate-of-return type of calculations, requiring the same type of detailed information as indicated above, though on a less frequent basis.

43. The implementation of the price-cap method may be less complex than the rate-of-return method. The price-cap method has been found to provide greater incentives for public service providers, since the concessionaire retains the benefits of lower than expected costs until the next adjustment period. At the same time, however, public service providers are typically exposed to more risk under the price-cap method than under the rate-of-return method. In particular, the concessionaire faces the risk of loss when the costs turn out to be higher than expected, since the concessionaire cannot raise the tariffs until the next tariff adjustment. The greater risk exposure increases the costs of capital. If the project company's returns are not allowed to rise, there may be difficulties in attracting new investment. Also, the company may be tempted to lower the quality of the service in order to reduce costs.

(iii) Hybrid methods

44. Many tariff adjustment methods currently being used combine elements of both the rate-of-return and the price-cap methods with a view to both reducing the risk borne by the service providers and providing sufficient incentives for efficiency in the operation of the infrastructure. One such hybrid method employs sliding scales for adjusting the tariffs that ensure upward adjustment when the rate of return falls below a certain threshold and downward adjustment when the rate of return exceeds a certain maximum, with no adjustment for rates of return falling between those levels. Other possible approaches to balancing the rate-of-return and price-cap methods include a review by the contracting authority of the investments made by the concessionaire to ensure that they meet the criteria of usefulness in order to be taken into account when calculating the concessionaire's revenue requirement. Another tariff adjustment technique that may be used to set tariffs, or more generally to monitor tariff levels, is benchmark or yardstick pricing. By comparing the various cost components of one public service provider with those of another and with international norms, the contracting authority may be able to judge whether tariff adjustments requested by the public service provider are reasonable.

(c) *Policy considerations on tariff control*

45. Each of the main tariff adjustment methods discussed above has its own advantages and disadvantages and varying impact on private sector investment decisions (see paras. 41 and 43). This should be taken into account by the legislature when considering the appropriateness of tariff control methods to domestic circumstances. Different methods may also be used for different infrastructure sectors. Some laws indeed authorize the contracting authority to apply either a price-cap or rate-of-return method in the selection of concessionaires, according to the scope and nature of investments and services. In choosing a tariff control method, it is important to take into account the impact of the various policy options on private sector investment decisions. Whatever mechanism is chosen, the capacity of the contracting authority or the regulatory agency to monitor adequately the performance of the concessionaire and to implement the adjustment method satisfactorily should be carefully considered (see also chap. I, “General legislative and institutional framework”, paras. 30-53).

46. It is important to bear in mind that tariff adjustment formulas cannot be set once and for all, as technology, exchange rates, wage levels, productivity and other factors are bound to change significantly, sometimes even unpredictably, over the concession period. Furthermore, tariff adjustment formulas are typically drawn up assuming a certain level of output or demand and may lead to unsatisfactory results if the volume of output or demand changes considerably. Therefore, many countries have established mechanisms for revision of tariff formulas, including periodic revisions (every four or five years, say) of the formula or ad hoc revisions whenever it is demonstrated that the formula has failed to ensure adequate compensation to the concessionaire (see also paras. 59-68). The tariff regime will also require adequate stability and predictability to enable public service providers and users to plan accordingly and to allow financing based on a predictable revenue. Investors and lenders may be particularly concerned about regulatory changes affecting the tariff adjustment method. Thus, they typically require the tariff adjustment formula to be incorporated into the project agreement.

3. *Financial obligations of the contracting authority*

47. Where the concessionaire offers services directly to the general public, the contracting authority or other public authority may undertake to make direct payments to the concessionaire as a substitute for, or in addition to, service charges to be paid by the users. Where the concessionaire produces a commodity for further transmission or distribution by another service provider, the contracting authority may undertake to purchase that commodity wholesale at an agreed price and on agreed conditions. The main examples of such arrangements are discussed briefly below.

(a) *Direct payments*

48. Direct payments by the contracting authority have been used in some countries as a substitute for, or as a supplement to, payments by the end users,

in particular in tollroad projects, through a mechanism known as “shadow tolling”. Shadow tolls are arrangements whereby the concessionaire assumes the obligation to develop, build, finance and operate a road or another transportation facility for a set number of years in exchange for periodic payments in place of, or in addition to, real or explicit tolls paid by users. Shadow toll schemes may be used to address risks that are specific to transportation projects, in particular the risk of lower-than-expected traffic levels (see chap. II, “Project risks and government support”, para. 18). Furthermore, shadow toll schemes may be politically more acceptable than direct tolls, for example, where it is feared that the introduction of toll payments on public roads may give rise to protests by road users. However, where such arrangements involve some form of subsidy to the project company, their conformity with certain obligations of the host country under international agreements on regional economic integration or trade liberalization should be carefully considered.

49. Shadow tolls may involve a substantial expenditure for the contracting authority and require close and extensive monitoring by it. In countries that have used shadow tolls for the development of new road projects, payments by the contracting authority to the concessionaire are based primarily on actual traffic levels, as measured in vehicle-miles. It is considered advisable to provide that payments are not made until traffic begins, so that the concessionaire has an incentive to open the road as quickly as possible. At the same time, it has been found useful to calculate payments on the basis of actual traffic for the duration of the concession. This system gives the concessionaire a reason to ensure that usage of the road will be disrupted as little as possible by repair works. Alternatively, the project agreement could contain a penalty or liquidated damages clause for lack of lane availability resulting from repair works. The concessionaire is typically required to perform continuous traffic counts to calculate annual vehicle-miles, which are verified periodically by the contracting authority. A somewhat modified system may combine both shadow tolls and direct tolls paid by the users. In such a system, shadow tolls are only paid by the contracting authority in the event that the traffic level over a certain period falls below the agreed minimum level necessary for the concessionaire to operate the road profitably.

(b) *Purchase commitments*

50. In the case of independent power plants or other facilities that generate goods or services capable of being delivered on a long-term basis to an identified purchaser, the contracting authority or other public authority often assume an obligation to purchase such goods and services, at an agreed rate, as they are offered by the concessionaire. Contracts of this type are usually referred to as “off-take agreements”. Off-take agreements often include two types of payments: payments for the availability of the production capacity and payments for units of actual consumption. In a power generation project, for example, the power purchase agreement may contemplate the following charges:

(a) *Capacity charges*. These are charges payable regardless of actual output in a billing period and are calculated to be sufficient to pay all of the

concessionaire's fixed costs incurred to finance and maintain the project, including debt service and other ongoing financing expenses, fixed operation and maintenance expenses and a certain rate of return. The payment of capacity charges is often subject to the observance of certain performance or availability standards;

(b) *Consumption charges.* These charges are not intended to cover all of the concessionaire's fixed costs, but rather to pay the variable or marginal costs that the concessionaire has to bear to generate and deliver a given unit of the relevant service or good (such as a kilowatt-hour of electricity). Consumption charges are usually calculated to cover the concessionaire's variable operating costs, such as that of fuel consumed when the facility is operating, water treatment expenses and costs of consumables. Variable payments are often tied to the concessionaire's own variable operating costs or to an index that reasonably reflects changes in operating costs.

51. From the perspective of the concessionaire, a combined scheme of capacity and consumption charges is particularly useful to ensure cost recovery where the transmission or distribution function for the goods or services generated by the concessionaire is subject to a monopoly. However, the capacity charges provided in the off-take agreement should be commensurate with the other sources of generating capacity available to, or actually used by, the contracting authority. In order to ensure the availability of funds for payments by the contracting authority under the off-take agreement, it is advisable to consider whether advance budgeting arrangements are required. Payments under an off-take agreement may be backed by a guarantee issued by the host Government or by a national or international guarantee agency (see chap. II, "Project risks and government support", paras. 46 and 47).

E. Security interests

52. Generally, security interests in personal property provide the secured creditor with essentially two kinds of rights: a property right allowing the secured creditor, in principle, to repossess the property or have a third party repossess and sell it, and a priority right to receive payment with the proceeds from the sale of the property in the event of default by the debtor. Security arrangements in project finance generally play a defensive or preventive role by ensuring that, in the event a third party acquires the debtor's operations (for example, by foreclosure, in bankruptcy or directly from the debtor) all of the proceeds resulting from the sale of those assets will go first to repayment of outstanding loans. Nevertheless, lenders would generally aim at obtaining security interests that allow them to foreclose and take possession of a project they can take over and operate either to restore its economical viability with a view to reselling at an appropriate time or to retaining the project indefinitely and collecting an ongoing revenue.

53. Security arrangements are crucial for financing infrastructure projects, in particular where the financing is structured under the "project finance" modality. The financing documents for privately financed infrastructure projects typi-

cally include both security over physical assets related to the project and security over intangible assets held by the concessionaire. A few of the main requirements for the successful closure of the security arrangements are discussed below. It should be noted, however, that, in some legal systems, any security given to lenders that makes it possible for them to take over the project is only allowed under exceptional circumstances and under certain specific conditions, namely, that the creation of such security requires the agreement of the contracting authority; that the security should be granted for the specific purpose of facilitating the financing or operation of the project; and that the security interests should not affect the obligations undertaken by the concessionaire. Those conditions often derive from general principles of law or from statutory provisions and cannot be waived by the contracting authority through contractual arrangements.

1. Security interests in physical assets

54. The negotiation of security arrangements required in order to obtain financing for the project may face legal obstacles where project assets are public property. If the concessionaire lacks title to the property it will in many legal systems have no (or only limited) power to encumber such property. Where limitations of this type exist, the law may still facilitate the negotiation of security arrangements for instance by indicating the types of asset in respect of which such security interests may be created or the type of security interest that is permissible. In some legal systems, a concessionaire that is granted a leasehold interest or right to use certain property may create a security interest over the leasehold interest or right to use.

55. Furthermore, security interests may also be created where the concession encompasses different types of public property, such as when title to adjacent land (and not only the right to use it) is granted to a railway company in addition to the right to use the public infrastructure. Where it is possible to create any form of security interests in respect of assets owned by, or required to be handed over to, the contracting authority or assets in relation to which the contracting authority has a contractual option of purchase (see para. 28), the law may require the approval of the contracting authority in order for the concessionaire to create such security interests.

2. Security interests in intangible assets

56. The main intangible asset in an infrastructure project is the concession itself, that is the concessionaire's right to operate the infrastructure or to provide the relevant service. In most legal systems, the concession provides its holder with the authority to control the entire project and entitles the concessionaire to earn the revenue generated by the project. Thus, the value of the concession well exceeds the combined value of all of the physical assets involved in a project. Because the concession holder would usually have the right to possess and dispose of all project assets (with the possible exception of those which are owned by other parties, such as public property in the possession of the conces-

sionaire), the concession would typically encompass both present and future assets of a tangible or intangible nature. The lenders may therefore regard the concession as an essential component of the security arrangements negotiated with the concessionaire. A pledge of the concession itself may have various practical advantages for the concessionaire and the lenders, in particular in legal systems that would not otherwise allow the creation of security over all of a company's assets or which do not generally recognize non-possessory security interests (see chap. VII, "Other relevant areas of law", paras. 10-16). These advantages may include avoiding the need to create separate security interests for each project asset, allowing the concessionaire to continue to deal with those assets in the ordinary course of business and making it possible to pledge certain assets without transferring actual possession of the assets to the creditors. Furthermore, a pledge of the concession may entitle the lenders, in case of breach by the concessionaire, to avert termination of the project by taking over the concession and making arrangements for continuation of the project under another concessionaire. A pledge of the concession may, therefore, represent a useful complement to or, under certain circumstances, a substitute for a direct agreement between the lenders and the contracting authority concerning the lenders' step-in rights (see paras. 147-150).

57. However, in some legal systems there may be obstacles to a pledge of the concession in the absence of express legislative authorization. Under various legal systems, security interests may only be created in respect of assets that can be freely transferable by the grantor of the security. Since the right to operate the infrastructure is in most cases not transferable without the consent of the contracting authority (see paras. 62 and 63), in some legal systems it may not be possible for the concessionaire to create security interests over the concession itself. Recent legislation in some civil law jurisdictions has removed that obstacle by creating a special category of security interest, sometimes referred to by expressions such as "*hipoteca de concesión de obra pública*" or "*prenda de concesión de obra pública*" ("public works concession mortgage" or "pledge of public works concession"), which generally provides the lenders with an enforceable security interest covering all of the rights granted to the concessionaire under the project agreement. However, in order to protect the public interest, the law requires the consent of the contracting authority for any measure by the lenders to enforce such a right, under conditions to be provided in an agreement between the contracting authority and the lenders. A somewhat more limited solution has been achieved in some common law jurisdictions in which a distinction has been made between the non-transferable right to carry out a certain activity under a governmental licence (that is, the "public rights" arising under the licence) and the right to claim proceeds received by the licensee (the latter's "private rights" under the licence).

3. *Security interests in trade receivables*

58. Another form of security typically given in connection with most privately financed infrastructure projects is an assignment to lenders of proceeds from contracts with customers of the concessionaire. Those proceeds may consist of the proceeds of a single contract (such as a power purchase commitment by a

power distribution entity) or of a large number of individual transactions (such as monthly payment of gas or water bills). Those proceeds typically include the tariffs charged to the public for the use of the infrastructure (for example, tolls on a tollroad) or the price paid by the customers for the goods or services provided by the concessionaire (electricity charges, for example). They may also include the revenue of ancillary concessions. Security of this type is a typical element of the financing arrangements negotiated with the lenders and the loan agreements often require that the proceeds of infrastructure projects be deposited in an escrow account managed by a trustee appointed by the lenders. Such a mechanism may also play an essential role in the issuance of bonds and other negotiable instruments by the concessionaire.

59. Security over trade receivables plays a central role in financing arrangements that involve the placement of bonds and other negotiable instruments. Those instruments may be issued by the concessionaire itself, in which case the investors purchasing the security will become its creditors, or they may be issued by a third party to whom the project receivables have been assigned through a mechanism known as “securitization”. Securitization involves the creation of financial securities backed by the project’s revenue stream, which is pledged to pay the principal and interest of that security. Securitization transactions usually involve the establishment of a legal entity separate from the concessionaire and especially dedicated to the business of securitizing assets or receivables. This legal entity is often referred to as a “special-purpose vehicle”. The concessionaire assigns project receivables to the special-purpose vehicle, which, in turn, issues to investors interest-bearing instruments that are backed by the project receivables. The securitized bondholders thereby acquire the right to the proceeds of the concessionaire’s transactions with its customers. The concessionaire collects the tariffs from the customers and transfers the funds to the special-purpose vehicle, which then transfers it to the securitized bondholders. In some countries, recent legislation has expressly recognized the concessionaire’s authority to assign project receivables to a special-purpose vehicle, which holds and manages the receivables for the benefit of the project’s creditors. With a view to protecting the bondholders against the risk of insolvency of the concessionaire, it may be advisable to adopt the necessary legislative measures to enable the legal separation between the concessionaire and the special-purpose vehicle.

60. In most cases it would not be practical for the concessionaire to specify individually the receivables being assigned to the creditors. Assignment of receivables in project finance therefore typically takes the form of a bulk assignment of future receivables. Statutory provisions recognizing the concessionaire’s authority to pledge the proceeds of infrastructure projects have been included in recent domestic legislation in various legal systems. However, there may be considerable uncertainty in various legal systems with regard to the validity of the wholesale assignment of receivables and of future receivables. It is therefore important to ensure that domestic laws on security interests do not hinder the ability of the parties effectively to assign trade receivables in order to obtain financing for the project (see chap. VII, “Other relevant areas of law”, paras. 10-16).

4. Security interests in the project company

61. Where the concession may not be assigned or transferred without the consent of the contracting authority (see paras. 62 and 63), the law sometimes prohibits the establishment of security over the shares of the project company. It should be noted, however, that security over the shares of the project company is commonly required by lenders in project finance transactions and that general prohibitions on the establishment of such security may limit the project company's ability to raise funding for the project. As with other forms of security, it may therefore be useful for the law to authorize the concessionaire's shareholders to create such security, subject to the contracting authority's prior approval, where an approval would be required for the transfer of equity participation in the project company (see paras. 64-68).

F. Assignment of the concession

62. Concessions are granted in view of the particular qualifications and reliability of the concessionaire and in most legal systems they are not freely transferable. Indeed, domestic laws often prohibit the assignment of the concession without the consent of the contracting authority. The purpose of these restrictions is typically to ensure the contracting authority's control over the qualifications of infrastructure operators or public service providers.

63. Some countries have found it useful to mention in the legislation the conditions under which approval for the transfer of a concession prior to its expiry may be granted, such as, for example, acceptance by the new concessionaire of all obligations under the project agreement and evidence of the new concessionaire's technical and financial capability to provide the service. General legislative provisions of this type may be supplemented by specific provisions in the project agreement setting forth the scope of those restrictions, as well as the conditions under which the consent of the contracting authority may be granted. However, it should be noted that restrictions typically apply to the voluntary transfer of its rights by the concessionaire; they do not preclude the compulsory transfer of the concession to an entity appointed by the lenders, with the consent of the contracting authority, for the purpose of averting termination due to serious breach by the concessionaire (see also paras. 147-150).

G. Transfer of controlling interest in the project company

64. The contracting authority may be concerned that the original members of the bidding consortium maintain their commitment to the project throughout its duration and that effective control over the project company will not be transferred to entities unknown to the contracting authority. Concessionaires are selected to carry out infrastructure projects at least partly on the basis of their experience and capabilities for that sort of project (see chap. III, "Selection of the concessionaire", paras. 38-40). Contracting authorities are therefore concerned that, if the concessionaire's shareholders are entirely free to transfer

their investment in a given project, there will be no assurance as to who will actually be delivering the relevant services.

65. Contracting authorities may draw reassurance from the experience that the selected bidding consortium demonstrated in the pre-selection phase and from the performance guarantees provided by the parent organizations of the original consortium and its subcontractors. In practice, however, the reassurance that may result from the apparent expertise of the shareholders in the concessionaire should not be overemphasized. Where a separate legal entity is established to carry out the project, which is often the case (see para. 12), the backing of the concessionaire's shareholders, should the project run into difficulties, may be limited to their maximum liability. Thus, restrictions on the transferability of investment, in and of themselves, may not represent sufficient protection against the risk of performance failure by the concessionaire. In particular, these restrictions are not a substitute for appropriate contractual remedies under the project agreement, such as monitoring of the level of service provided (see paras. 147-150) or termination without full compensation in case of unsatisfactory performance (see chap. V, "Duration, extension and termination of the project agreement", paras. 44 and 45).

66. In addition to the above, restrictions on the transferability of shares in companies providing public services may also present some disadvantages for the contracting authority. As noted earlier (see "Introduction and background information on privately financed infrastructure projects", paras. 54-67), there are numerous types of funding available from different investors for different risk and reward profiles. The initial investors, such as construction companies and equipment suppliers, will seek to be rewarded for the higher risks they take on, while subsequent investors may require a lesser return commensurate with the reduced risks they bear. Most of the initial investors have finite resources and need to recycle capital in order to be able to participate in new projects. Therefore, those investors might not be willing to tie up capital in long-term projects. At the end of the construction period, the initial investors might prefer to sell their interest on to a secondary equity provider whose required rate of return is less. Once usage is more certain, another refinancing could take place. However, if the investors' ability to invest and re-invest capital for project development is restricted by constraints on the transferability of shares in infrastructure projects, there is a risk of a higher cost of funding. In some circumstances it may not be possible to fund a project at all, as some investors whose involvement may be crucial for the implementation of the project may not be willing to participate. From a long-term perspective, the development of a market place for investment in public infrastructure may be hindered if investors are unnecessarily constrained in the freedom to transfer their interest in privately financed infrastructure projects.

67. For the above reasons, it may be advisable to limit the restrictions on the transfer of a controlling interest in the project company to a certain period of time (for example, a certain number of years after the entry into force of the project agreement) or to situations where such restrictions are justified by reasons of public interest. One such situation may be where the concessionaire

is in possession of public property or where the concessionaire receives loans, subsidies, equity or other forms of direct governmental support. In these cases, the contracting authority's accountability for the proper use of public funds requires assurances that the funds and assets are entrusted to a solid company, to which the original investors remain committed during a reasonable period. Another situation that may justify imposing limitations on the transfer of shares of concessionaire companies may be where the contracting authority has an interest in preventing transfer of shares to particular investors. For example, the contracting authority may wish to control acquisition of controlling shares of public service providers to avoid the formation of oligopolies or monopolies in liberalized sectors. Or it may not be thought appropriate for a company that had defrauded one part of Government to be employed by another through a newly acquired subsidiary.

68. In these exceptional cases it may be advisable to require that the initial investors seek the prior consent of the contracting authority before transferring their equity participation. It should be made clear in the project agreement that any such consent should not be unreasonably withheld or unduly delayed. For transparency purposes, it may also be advisable to establish the grounds for withholding approval and to require the contracting authority to specify in each instance the reasons for any refusal. The appropriate duration of such limitations—whether for a particular phase of the project or for the entire concession term—may need to be considered on a case-by-case basis. In some projects, it may be possible to relax such restrictions after the facility has been completed. It is also advisable to clarify in the project agreement whether these limitations, if any, should apply to the transfer of any participation in the concessionaire, or whether the concerns of the contracting authority will focus on one particular investor (such as a construction company or the facility designer) while the construction phase lasts or for a significant time beyond.

H. Construction works

69. Contracting authorities purchasing construction works typically act as the employer under a construction contract and retain extensive monitoring and inspection rights, including the right to review the construction project and request modifications to it, to follow closely the construction work and schedule, to inspect and formally accept the completed work and to give final authorization for the operation of the facility.

70. On the other hand, in many privately financed infrastructure projects, the contracting authority may prefer to transfer such responsibility to the concessionaire. Instead of assuming direct responsibility for managing the details of the project, the contracting authorities may prefer to transfer that responsibility to the concessionaire by requiring the latter to assume full responsibility for the timely completion of the construction. The concessionaire, too, will be interested in ensuring that the project is completed on time and that the cost estimate is not exceeded, and will typically negotiate fixed-price, fixed-time turnkey contracts that include guarantees of performance by the construction

contractors. Therefore, in privately financed infrastructure projects it is the concessionaire that for most purposes performs the role that the employer would normally play under a construction contract.

71. For these reasons, legislative provisions on the construction of privately financed infrastructure facilities are in some countries limited to a general definition of the concessionaire's obligation to perform the public works in accordance with the provisions of the project agreement and give the contracting authority the general right to monitor the progress of the work with a view to ensuring that it conforms to the provisions of the agreement. In those countries, more detailed provisions are then left to the project agreement.

1. Review and approval of construction plans

72. Where it is felt necessary to deal with construction works and related matters in legislation, it is advisable to devise procedures that help to keep completion time and construction costs within estimates and lower the potential for disputes between the concessionaire and the public authorities involved. For instance, where statutory provisions require that the contracting authority review and approve the construction project, the project agreement should establish a deadline for the review of the construction project and provide that the approval shall be deemed to be granted if no objections are made by the contracting authority within the relevant period. It may also be useful to set out in the project agreement the grounds on which the contracting authority may raise objections to or request modifications in the project, such as safety, defence, security, environmental concerns or non-conformity with the specifications.

2. Variation in the project terms

73. During the course of construction of an infrastructure facility, it is common for situations to arise that make it necessary or advisable to alter certain aspects of the construction. The contracting authority may therefore wish to retain the right to order changes in respect of such aspects as the scope of construction, the technical characteristics of equipment or materials to be used in the work or the construction services required under the specifications. Such changes are referred to in this *Guide* as "variations". As used in the *Guide*, the word "variation" does not include tariff adjustments or revisions made as a result of cost changes or currency fluctuations (see paras. 39-44). Likewise, renegotiation of the project agreement in cases of substantial change in conditions (see paras. 126-130) is not regarded in the *Guide* as a variation.

74. Given the complexity of most infrastructure projects, it is not possible to exclude the need for variations in the construction specifications or other requirements of the project. However, such variations often cause delay in the execution of the project or in the delivery of the public service; they may also render the performance under the project agreement more onerous for the concessionaire. Furthermore, the cost of implementing extensive variation orders may exceed the concessionaire's own financial means, thus requiring

substantial additional funding that may not be obtainable at an acceptable cost. It is therefore advisable for the contracting authority to consider measures to control the possible need for variations. The quality of the feasibility studies required by the contracting authority and of the specifications provided during the selection process (see chap. III, “Selection of the concessionaire”, paras. 61 and 64–66) play an important role in avoiding subsequent changes in the project.

75. The project agreement should set forth the specific circumstances under which the contracting authority may order variations in respect of construction specifications and the compensation that may be due to the concessionaire, as appropriate, to cover the additional cost and delay entailed by implementing the variations. The project agreement should also clarify the extent to which the concessionaire is obliged to implement those variations and whether the concessionaire may object to variations and, if so, on which grounds. According to the contractual practice of some legal systems, the concessionaire may be released of its obligations when the amount of additional costs entailed by the modification exceeds a set maximum limit.

76. Various contractual approaches for dealing with variations have been used in large construction contracts to deal with the extent of the contractor’s obligation to implement changes and the required adjustments in the contract price or contract duration. Such solutions may also be used, *mutatis mutandis*, to deal with variations sought by the contracting authority under the project agreement.¹ It should be noted, however, that in infrastructure concessions the project company’s payment consists of user fees or prices for the output of the facility, rather than a global price for the construction work. Thus, compensation methods used in connection with infrastructure concessions sometimes include a combination of various methods, ranging from lump-sum payments to tariff increases, or extensions of the concession period. For instance, there may be changes that result in an increase in the cost that the concessionaire may be able to absorb and finance itself and amortize by means of an adjustment in the tariff or payment mechanism, as appropriate. If the concessionaire cannot refinance or fund the changes itself, the parties may wish to consider lump-sum payments as an alternative to an expensive and complicated re-financing structure.

3. *Monitoring powers of the contracting authority*

77. In some legal systems, public authorities purchasing construction works customarily retain the power to order the suspension or interruption of the works for reasons of public interest. However, with a view to providing some reassurance to potential investors, it may be useful to limit the possibility of such interference and to provide that no such interruption should be of a duration or extent greater than is necessary, taking into consideration circumstances that gave rise to the requirement to suspend or interrupt the work. It

¹ For a discussion of approaches and possible solutions used in construction contracts for complex industrial works, see the *UNCITRAL Legal Guide on Drawing Up Contracts for the Construction of Industrial Works* (United Nation publication, Sales No. E.87.V.10), chap. XXIII, “Variation clauses”.

may also be useful to agree on a maximum period of suspension and to provide for appropriate compensation to the concessionaire. Furthermore, guarantees may be provided to ensure payment of compensation or to indemnify the concessionaire for loss resulting from suspension of the project (see also chap. II, “Project risks and government support”, paras. 48-50).

78. In some legal systems, facilities built for use in connection with the provision of certain public services become public property once construction is finished (see para. 24). In such cases, the law often requires that the completed facility be formally accepted by the contracting authority or another public authority. Such formal acceptance is typically given only after inspection of the completed facility and satisfactory conclusion of the necessary tests to ascertain that the facility is operational and meets the specifications and technical and safety requirements. Even where formal acceptance by the contracting authority is not required (for example, where the facility remains the property of the concessionaire), provisions concerning final inspection and approval of the construction work by the contracting authority are often required in order to ensure compliance with health, safety, building or labour regulations. The project agreement should set out in detail the nature of the completion tests or the inspection of the completed facility; the timetable for the tests (for instance, it may be appropriate to undertake partial tests over a period, rather than a single test at the end); the consequences of failure to pass a test; and the responsibility for organizing the resources for the test and covering the corresponding costs. In some countries, it has been found useful to authorize the facility to operate on a provisional basis, pending final approval by the contracting authority, and to provide an opportunity for the concessionaire to rectify defects that might be found at that juncture.

4. Guarantee period

79. The construction contracts negotiated by the concessionaire will typically provide for a quality guarantee under which the contractors assume liability for defects in the works and for inaccuracies or insufficiencies in technical documents supplied with the works, except for reasonable exclusions (such as normal wear and tear or faulty maintenance or operation by the concessionaire). Additional liability may also derive from statutory provisions or general principles of law under the applicable law, such as a special extended liability period for structural defects in works, which is provided in some legal systems. The project agreement should provide that final approval or acceptance of the facility by the contracting authority will not release the construction contractors from any liability for defects in the works and for inaccuracies or insufficiencies in technical documents that may be provided under the construction contracts and the applicable law.

I. Operation of infrastructure

80. Conditions for the operation and maintenance of the facility, as well as for quality and safety standards, are often enumerated in the law and spelled out in detail in the project agreement. In addition, especially in the areas of elec-

tricity, water and sanitation and public transportation, the contracting authority or an independent regulatory agency may exercise an oversight function over the operation of the facility. An exhaustive discussion of legal issues relating to the conditions of operation of infrastructure facilities would exceed the scope of this *Guide*. The following paragraphs therefore contain only a brief presentation of some of the main issues.

81. Regulatory provisions on infrastructure operation and legal requirements for the provision of public services are intended to achieve various objectives of public relevance. Given the usually long duration of infrastructure projects, there is a possibility that such provisions and requirements may need to be changed during the life of the project agreement. It is important, however, to bear in mind the private sector's need for a stable and predictable regulatory framework. Changes in regulations or the frequent introduction of new and stricter rules may have a disruptive impact on the implementation of the project and compromise its financial viability. Therefore, while contractual arrangements may be agreed to by the parties to counter the adverse effects of subsequent regulatory changes (see paras. 122-125), regulatory agencies would be well advised to avoid excessive regulation or unreasonably frequent changes in existing rules.

1. Performance standards

82. Public service providers generally have to meet a set of technical and service standards. Such standards are in most cases too detailed to figure in legislation and may be included in implementing decrees, regulations or other instruments. Service standards are often spelled out in great detail in the project agreement. They include quality standards, such as requirements with respect to water purity and pressure; ceilings on the length of time to perform repairs; ceilings on the number of defects or complaints; timely performance of transport services; continuity in supply; and health, safety and environmental standards. Legislation may, however, impose the basic principles that will guide the establishment of detailed standards or require compliance with international standards.

83. The contracting authority typically retains the power to monitor the adherence of the project company to the regulatory performance standards. The concessionaire will be interested in avoiding as much as possible any interruption in the operation of the facility and in protecting itself against the consequences of any such interruption. It will seek assurances that the exercise by the contracting authority of its monitoring or regulatory powers does not cause undue disturbance or interruption in the operation of the facility and that it does not result in undue additional costs to the concessionaire.

2. Extension of services

84. In some legal systems, an entity operating under a governmental concession to provide certain essential services such as electricity or potable water to a community or territory and its inhabitants is held to assume an obligation to

provide a service system that is reasonably adequate to meet the demand of the community or territory. That obligation often relates not only to the historic demand at the time the concession was awarded, but implies an obligation to keep pace with the growth of the community or territory served and gradually to extend the system as may be required by the reasonable demand of the community or territory. In some legal systems, the obligation has the nature of a public duty that may be invoked by any resident of the relevant community or territory. In other legal systems, it has the nature of a statutory or contractual obligation that may be enforced by the contracting authority or by a regulatory agency, as the case may be.

85. In some legal systems, this obligation is not absolute and unqualified. The concessionaire's duty to extend its service facilities may indeed depend upon various factors, such as the need and cost of the extension and the revenue that may be expected as a result of the extension; the concessionaire's financial situation; the public interest in effecting such an extension; and the scope of the obligations assumed by the concessionaire in that regard under the project agreement. In some legal systems, the concessionaire may be under an obligation to extend its service facilities even if the particular extension is not immediately profitable or even if, as a result of the extensions being carried out, the concessionaire's territory might eventually include unprofitable areas. That obligation is nevertheless subject to some limits, since the concessionaire is not required to carry out extensions that place an unreasonable burden on it or its customers. Depending on the particular circumstances, the cost of carrying out extensions of service facilities may be absorbed by the concessionaire, passed on to the customers or end users in the form of tariff increases or extraordinary charges or absorbed in whole or in part by the contracting authority or other public authority by means of subsidies or grants. Given the variety of factors that may need to be taken into account in order to assess the reasonableness of any particular extension, the project agreement should define the circumstances under which the concessionaire may be required to carry out extensions in its service facilities and the appropriate methods for financing the cost of any such extension.

3. Continuity of service

86. Another obligation of public service providers is to ensure the continuous provision of the service under most circumstances, except for narrowly defined exempting events (see also paras. 132-134). In some legal systems, that obligation has the nature of a statutory duty that applies even if it is not expressly stated in the project agreement. The corollary of that rule, in legal systems where it exists, is that various circumstances that under general principles of contract law might authorize a contract party to suspend or discontinue the performance of its obligations, such as economic hardship or breach by the other party, cannot be invoked by the concessionaire as grounds for suspending or discontinuing, in whole or in part, the provision of a public service. In some legal systems, the contracting authority may even have special enforcement powers to compel the concessionaire to resume providing service in the event of unlawful discontinuance.

87. That obligation, too, is subject to a general rule of reasonableness. Various legal systems recognize the concessionaire's right to fair compensation for having to deliver the service under situations of hardship (see paras. 126-130). Moreover, in some legal systems, it is held that a public service provider may not be required to operate where its overall operation results in a loss. Where the public service as a whole, and not only one or more of its branches or territories, ceases being profitable, the concessionaire may have the right to direct compensation by the contracting authority or, alternatively, the right to terminate the project agreement. However, termination typically requires the consent of the contracting authority or a judicial decision. In legal systems that allow such a solution, it is advisable to clarify in the project agreement which extraordinary circumstances would justify the suspension of the service or even release the concessionaire from its obligations under the project agreement (see paras. 132-139; also chap. V, "Duration, extension and termination of the project agreement", para. 34).

4. *Equal treatment of customers or users*

88. Entities that provide certain services to the general public are, in some jurisdictions, under a specific obligation to ensure the availability of the service under essentially the same conditions to all users and customers falling within the same category. However, differentiation based on a reasonable and objective classification of customers and users is accepted in those legal systems as long as like contemporaneous service is rendered to consumers and users engaged in like operations under like circumstances. It may thus not be inconsistent with the principle of equal treatment to charge different prices or to offer different access conditions to different categories of users (for example, domestic consumers, on the one hand, and business or industrial consumers, on the other), provided that the differentiation is based on objective criteria and corresponds to actual differences in the situation of the consumers or the conditions under which the service is provided to them. Nevertheless, where a difference in charges or other conditions of service is based on actual differences in service (such as higher charges for services provided at hours of peak consumption), it typically has to be commensurate with the amount of difference.

89. In addition to differentiation established by the concessionaire itself, different treatment of certain users or customers may be the result of legislative action. In many countries, the law requires that specific services must be provided at particularly favourable terms to certain categories of users and customers, such as discounted transport for schoolchildren or senior citizens, or reduced water or electricity rates for lower-income or rural users. Public service providers may recoup these service burdens or costs in several ways, including through government subsidies, through funds or other official mechanisms created to share the financial burden of these obligations among all public service providers or through internal cross-subsidies from more profitable services (see chap. II, "Project risks and government support", paras. 42-44).

5. Interconnection and access to infrastructure networks

90. Companies operating infrastructure networks in sectors such as railway transport, telecommunications or power or gas supply are sometimes required to allow other companies to have access to the network. That requirement may be stated in the project agreement or in sector-specific laws or regulations. Interconnection and access requirements have been introduced in certain infrastructure sectors as a complement to reforms in the structure of a given sector; in others, they have been adopted to foster competition in sectors that remained fully or partially integrated (for a brief discussion of market structure issues, see “Introduction and background information”, paras. 21-46).

91. Network operators are often required to provide access on terms that are fair and non-discriminatory from a financial as well as a technical point of view. Non-discrimination implies that the new entrant or service provider should be able to use the infrastructure of the network operator on conditions that are not less favourable than those granted by the network operator to its own services or to those of competing providers. It should be noted, however, that many pipeline access regimes, for example, do not require completely equal terms for the carrier and rival users. The access obligation may be qualified in some way. It may, for instance, be limited to spare capacity only or be subject to reasonable, rather than equal, terms and conditions.

92. While access pricing is usually cost-based, regulatory agencies often retain the right to monitor access tariffs to ensure that they are high enough to give adequate incentive to invest in the required infrastructure and low enough to allow new entrants to compete on fair terms. Where the network operator provides services in competition with other providers, there may be requirements that its activities be separated from an accounting point of view in order to determine the actual cost of the use by third parties of the network or parts of it.

93. Technical access conditions may be equally important and network operators may be required to adapt their network to satisfy the access requirements of new entrants. Access may be to the network as a whole or to monopolistic parts or segments of the network (sometimes also referred to as bottleneck or essential facilities). Many Governments allow service providers to build their own infrastructure or to use alternative infrastructure where available. In such cases, the service provider may only need access to a small part of the network and cannot, under many regulations, be forced to pay more than the cost corresponding to the use of the specific facility it needs, such as the local telecommunications loop, transmission capacity for the supply of electricity or the use of a track section of railway.

6. Disclosure requirements

94. Many domestic laws impose on public service providers an obligation to provide to the regulatory agency accurate and timely information on their

operations and to grant it specific enforcement rights. The latter may encompass inquiries and audits, including detailed performance and compliance audits, sanctions for non-cooperative companies and injunctions or penalty procedures to enforce disclosure.

95. Public service providers are normally required to maintain and disclose to the regulatory agency their financial accounts and statements and to maintain detailed cost accounting allowing the regulatory agency to track various aspects of the company's activities separately. Financial transactions between the concessionaire company and affiliated companies may also require scrutiny, as concessionaire companies may try to transfer profits to non-regulated businesses or foreign affiliates. Infrastructure operators may also have detailed technical and performance reporting requirements. As a general rule, however, it is important to define reasonable limits to the extent and type of information that infrastructure operators are required to submit. Furthermore, appropriate measures should be taken to protect the confidentiality of any proprietary information that the concessionaire and its affiliated companies may submit to the regulatory agency.

7. Enforcement powers of the concessionaire

96. In countries with a well-established tradition of awarding concessions for the provision of public services, the concessionaire may have the power to establish rules designed to facilitate the provision of the service (such as instructions to users or safety rules), take reasonable measures to ensure compliance with those rules and suspend the provision of service for emergency or safety reasons. For that purpose, general legislative authority, or even case-by-case authorization from the legislature, may be required in most legal systems. The extent of powers given to the concessionaire is usually defined in the project agreement, however, and may not need to be provided in detail in legislation. It may be advisable to provide that the rules issued by the concessionaire become effective upon approval by the regulatory agency or the contracting authority, as appropriate. However, the right to approve operating rules proposed by the concessionaire should not be arbitrary and the concessionaire should have the right to appeal a decision to refuse approval of the proposed rules (see also chap. I, "General legislative and institutional framework", paras. 49 and 50).

97. Of particular importance for the concessionaire is the question whether the provision of the service may be discontinued because of default or non-compliance by its users. Despite the concessionaire's general obligation to ensure the continuous provision of the service (see paras. 86 and 87), many legal systems recognize that entities providing public services may establish and enforce rules that provide for shutting off of the service for a consumer or user who has defaulted in payment for it or who has seriously infringed the conditions for using it. The power to do so is often regarded as crucial in order to prevent abuse and ensure the economic viability of the service. However, given the essential nature of certain public services, that power may require legisla-

tive authority in some legal systems. Furthermore, there may be a number of expressed or implied limitations upon or conditions for the exercise of that power, such as special notice requirements and specific consumer remedies. Additional limitations and conditions may derive from the application of general consumer protection rules (see chap. VII, “Other relevant areas of law”, paras. 45 and 46).

J. General contractual arrangements

98. This section discusses selected contractual arrangements that typically appear in project agreements in various sectors and are often reflected in standard contract clauses used by domestic contracting authorities. Although essentially contractual in nature, the arrangements discussed in this section may have some important implications for the legislation of the host country, according to its particular legal system.

1. Subcontracting

99. Given the complexity of infrastructure projects, the concessionaire typically retains the services of one or more construction contractors to perform some or the bulk of the construction work under the project agreement. The concessionaire may also wish to retain the services of contractors with experience in the operation and maintenance of infrastructure during the operational phase of the project. The laws of some countries generally acknowledge the concessionaire’s right to enter into contracts as needed for the execution of the construction work. A legislative provision recognizing the concessionaire’s authority to subcontract may be particularly useful in countries where there are limitations to the ability of government contractors to subcontract.

(a) Choice of subcontractors

100. The concessionaire’s freedom to hire subcontractors is in some countries restricted by rules that prescribe the use of tendering and similar procedures for the award of subcontracts by public service providers. Such statutory rules have often been adopted when infrastructure facilities were primarily or exclusively operated by the Government, with little or only marginal private sector investment. The purpose of such statutory rules is to ensure economy, efficiency, integrity and transparency in the use of public funds. However, in the case of privately financed infrastructure projects, such provisions may discourage the participation of potential investors, since the project sponsors typically include engineering and construction companies that participate in the project in the expectation that they will be given the main contracts for the execution of the construction and other work.

101. The concessionaire’s freedom to select its subcontractors is not unlimited, however. In some countries, the concessionaire has to identify in its proposal which contractors will be retained, including information on their

technical capability and financial standing. Other countries either require that such information be provided at the time the project agreement is concluded or subject such contracts to prior review and approval by the contracting authority. The purpose of such provisions is to avoid possible conflicts of interest between the project company and its shareholders, a point that would normally also be of interest to the lenders, who may wish to ensure that the project company's contractors are not overpaid. In any event, if it is deemed necessary for the contracting authority to have the right to review and approve the project company's subcontracts, the project agreement should clearly define the purpose of such review and approval procedures and the circumstances under which the contracting authority's approval may be withheld. As a general rule, approval should not normally be withheld unless the subcontracts are found to contain provisions manifestly contrary to the public interest (for example, provisions for excessive payments to subcontractors or unreasonable limitations of liability) or contrary to mandatory rules having the nature of public law that apply to the execution of privately financed infrastructure projects in the host country.

(b) *Governing law*

102. It is common for the concessionaire and its contractors to choose a law that is familiar to them and that in their view adequately governs the issues addressed in their contracts. Depending upon the type of contract, different issues concerning the governing law clause will arise. For example, equipment supply and other contracts may be entered into with foreign companies and the parties may wish to choose a law known to them as providing, for example, an adequate warranty regime for equipment failure or non-conformity of equipment. In turn, the concessionaire may agree to the application of the laws of the host country in connection with contracts entered into with local customers.

103. Domestic laws specific to privately financed infrastructure projects seldom contain provisions concerning the law governing the contracts entered into by the concessionaire. In fact, most countries have found no compelling reason for making specific provisions concerning the law governing the contracts between the concessionaire and its contractors and have preferred to leave the question to a choice-of-law clause in their contracts or to the applicable rules of private international law. It should be noted, however, that the freedom to choose the applicable law for contracts and other legal relationships is in some legal systems subject to conditions and restrictions pursuant to rules of private international law or certain rules of public law of the host country. For instance, States parties to some regional economic integration agreements are obliged to enact harmonized provisions of private international law dealing, *inter alia*, with contracts between public service providers and their contractors. While rules of private international law often allow considerable freedom to choose the law governing commercial contracts, that freedom is in some countries restricted for contracts and legal relationships that are not qualified as commercial, such as, for instance, certain contracts entered into by public authorities of the host country (for example, guarantees and assurances by the Government, power purchase or fuel supply commitments by a public authority) or contracts with consumers.

104. In some cases, provisions have been included in domestic legislation for the purpose of clarifying, as appropriate, that the contracts entered into between the concessionaire and its contractors are governed by private law and that the contractors are not agents of the contracting authority. A provision of that type may in some countries have a number of practical consequences, such as no subsidiary liability of the contracting authority for the acts of the sub-contractors or no obligation on the part of the responsible public entity to pay worker's compensation for work-related illness, injury or death to the sub-contractors' employees.

2. Liability with respect to users and third parties

105. Defective construction or operation of an infrastructure facility may result in the death of or personal injury to employees of the concessionaire, users of the facility or other third parties or in damage to their property. The issues concerning damages to be paid to third parties in such cases are complex and may be governed not by rules of the law applicable to the project agreement governing contractual liability, but rather by applicable legal rules governing extra-contractual liability, which are often mandatory. Also, in some legal systems, there are special mandatory rules governing the extra-contractual liability of public authorities to which the contracting authority may be subject. Moreover, the project agreement cannot limit the liability of the concessionaire or the contracting authority to compensate third parties who are not parties to the project agreement. It is therefore advisable for the contracting authority and the concessionaire to provide for the internal allocation of risks between them as regards damages to be paid to third parties due to death, personal injury or damage to their property, to the extent that this allocation is not governed by mandatory rules. It is also advisable for the parties to provide for insurance against such risks (see paras. 119 and 120).

106. If a third party suffers personal injury or damage to its property as a result of the construction or operation of the facility and brings a claim against the contracting authority, the law may provide that the concessionaire alone should bear any responsibility in that regard and that the contracting authority should not bear any liability as regards such third-party claims, except where the damage was caused by the serious breach or recklessness of the contracting authority. It may be useful to provide, in particular, that the mere approval of the design or specification of the facility by the contracting authority or its acceptance of the construction works or final authorization for the operation of the facility or its use by the public does not entail the assumption by the contracting authority of any liability for damage sustained by users of the facility or other third parties arising out of the construction or operation of the facility or the inadequacy of the approved design or specifications. Moreover, since provisions on the allocation of liability may not be enforceable against third parties under the applicable law, it may be advisable for the project agreement to provide that the contracting authority should be protected and indemnified in respect of compensation claims brought by third parties who sustain injury or damage to their property resulting from the construction or operation of the infrastructure facility.

107. The project agreement should also provide that the parties should inform each other of any claim or proceedings or anticipated claims or proceedings against them in respect of which the contracting authority is entitled to be indemnified and give reasonable assistance to one another in the defence of such claims or proceedings to the extent permitted by the law of the country where such proceedings are instituted.

3. *Performance guarantees and insurance*

108. The obligations of the concessionaire are usually complemented by the provision of some form of guarantee of performance in the event of breach and insurance coverage against a number of risks. The law in some countries generally requires that adequate guarantees of performance be provided by the concessionaire and refer the matter to the project agreement for further details. In other countries, the law contains more detailed provisions, for instance requiring the offer of a certain type of guarantee up to a stated percentage of the basic investment.

(a) Types, functions and nature of performance guarantees

109. Performance guarantees are generally of two types. Under one type, the monetary performance guarantee, the guarantor undertakes only to pay the contracting authority funds up to a stated limit to satisfy the liabilities of the concessionaire in the event of the latter's failure to perform. Monetary performance guarantees may take the form of a contract bond, a stand-by letter of credit or an on-demand guarantee. Under the other type of guarantee, the performance bond, the guarantor chooses one of two options: (a) to rectify defective or finish incomplete construction itself; or (b) to obtain another contractor to rectify defective or finish incomplete construction and compensate the contracting authority for losses caused by the failure to perform. The value of such an undertaking is limited to a stated amount or a certain percentage of the contract value. Under a performance bond, the guarantor also frequently reserves the option to discharge its obligations solely by the payment of money to the contracting authority. Performance bonds are generally furnished by specialized guarantee institutions, such as bonding and insurance companies. A special type of performance bond is the maintenance bond, which protects the contracting authority against future failures that could arise during the start-up or maintenance period and serve as guarantee that any repair or maintenance work during the post-completion warranty period will be duly carried out by the concessionaire.

110. As regards their nature, performance guarantees may be generally divided into independent guarantees and accessory guarantees. A guarantee is said to be "independent" if the guarantor's obligation is independent from the concessionaire's obligations under the project agreement. Under an independent guarantee (often called a first-demand guarantee) or a stand-by letter of credit, the guarantor or issuer is obligated to make payment on demand by the beneficiary and the latter is entitled to recover under the instrument if it presents the document or documents stipulated in the terms of the guarantee or stand-

by letter of credit. Such a document might be simply a statement by the beneficiary that the contractor has failed to perform. The guarantor or issuer is not entitled to withhold payment on the ground that there has in fact been no failure to perform under the main contract; however, under the law applicable to the instrument, payment may in very exceptional and narrowly defined circumstances be refused or restrained (for example, when the claim by the beneficiary is manifestly fraudulent). In contrast, a guarantee is accessory when the obligation of the guarantor involves more than the mere examination of a documentary demand for payment in that the guarantor may have to evaluate evidence of liability of the contractor for failure to perform under the works contract. The nature of the link may vary under different guarantees and may include the need to prove the contractor's liability in arbitral proceedings. By their nature, performance bonds have an accessory character to the underlying contract.

(b) Advantages and disadvantages of various types of performance guarantee

111. From the perspective of the contracting authority, monetary performance guarantees may be particularly useful in covering additional costs that may be incurred by the contracting authority as a result of delay or breach by the concessionaire. Monetary performance guarantees may also serve as an instrument to put pressure on the concessionaire to complete construction in time and to perform its other obligations in accordance with the requirements of the project agreement. However, the amount of those guarantees is typically only a fraction of the economic value of the obligation guaranteed and is usually not sufficient to cover the cost of engaging a third party to perform instead of the concessionaire or its contractors.

112. From the perspective of the contracting authority, a first-demand guarantee has the advantage of assuring prompt recovery of funds under the guarantee, without evidence of failure to perform by the contractor or of the extent of the beneficiary's loss. Furthermore, guarantors furnishing monetary performance guarantees, in particular banks, prefer first-demand guarantees, as the conditions are clear as to when their liability to pay accrues, and the guarantors will thus not be involved in disputes between the contracting authority and the concessionaire as to whether or not there has been a failure to perform under the project agreement. Another advantage for a bank issuing a first-demand guarantee is the possibility of quick and efficient recovery of the sums paid under a first-demand guarantee by direct access to the concessionaire's assets.

113. A disadvantage to the contracting authority of a first-demand guarantee or a stand-by letter of credit is that those instruments may increase the overall project costs, since the concessionaire is usually obliged to obtain and set aside large counter-guarantees in favour of the institutions issuing the first-demand guarantee or the stand-by letter of credit. Also, a concessionaire that furnishes such a guarantee may wish to take out insurance against the risk of recovery by the contracting authority under the guarantee or the stand-by letter of credit when there has been in fact no failure to perform by the concessionaire and the

cost of that insurance is included in the project cost. The concessionaire also may include in the project cost the potential costs of any action that it may need to institute against the contracting authority to obtain the repayment of the sum improperly claimed.

114. A disadvantage to the concessionaire of a first-demand guarantee or a stand-by letter of credit is that, if there is recovery by the contracting authority when there has been no failure to perform by the concessionaire, the latter may suffer immediate loss if the guarantor or the issuer of the letter of credit reimburses itself from the assets of the concessionaire after payment to the contracting authority. The concessionaire may also experience difficulties and delays in recovering from the contracting authority the sum improperly claimed.

115. The terms of an accessory guarantee usually require the beneficiary to prove the failure of the contractor to perform and the extent of the loss suffered by the beneficiary. Furthermore, the defences available to the debtor if it is sued for a failure to perform are also available to the guarantor. Accordingly, there is a risk that the contracting authority may face a protracted dispute when it makes a claim under the bond. In practice, this risk may be reduced, for instance, if the submission of claims under the terms of the bond is subject to a procedure such as that provided in article 7 (j)(i) of the Uniform Rules on Contract Bonds, drawn up by the International Chamber of Commerce.² Article 7 (j)(i) of the Uniform Rules provides that notwithstanding any dispute or difference between the principal and the beneficiary in relation to the performance of the contract or any contractual obligation, a default for the purposes of payment of a claim under a contract bond shall be deemed to be established upon issue of a certificate of default by a third party (who may without limitation be an independent architect or engineer or referee) if the bond so provides and the service of such a certificate or a certified copy thereof upon the guarantor. Where such a procedure is adopted, the contracting authority may be entitled to obtain payment under the contract bond even though its entitlement to that payment is disputed by the concessionaire.

116. As a reflection of the lesser risk borne by the guarantor, the monetary limit of liability of the guarantor may be considerably higher than under a first-demand guarantee, thus covering a larger percentage of work under the project agreement. A performance bond may also be advantageous if the contracting authority cannot conveniently arrange for the rectification of faults or completion of construction itself and requires the assistance of a third party to arrange for rectification or completion. Where, however, the construction involves the use of a technology known only to the concessionaire, rectification or completion by a third person may not be feasible and a performance bond may not have the last-mentioned advantage over a monetary performance guarantee. For the concessionaire, accessory guarantees have the advantage of preserving the concessionaire's borrowing power, since accessory guarantees, unlike first-demand guarantees and stand-by letters of credit, do not affect the concessionaire's line of credit with the lenders.

²The text of the Uniform Rules on Contract Bonds is reproduced in document A/CN.9/459/Add.1.

117. It follows from the above considerations that different types of guarantees may be useful in connection with the various obligations assumed by the concessionaire. While it is useful to require the concessionaire to provide adequate guarantees of performance, it is advisable to leave it to the parties to determine the extent to which guarantees are needed and which guarantees should be provided in respect of the various obligations assumed by the concessionaire, rather than requiring in the law only one form of guarantee to the exclusion of others. It should be noted that the project company itself will require a series of performance guarantees to be provided by its contractors (see para. 6) and that additional guarantees to the benefit of the contracting authority usually increase the overall cost and complexity of a project. In some countries, practical guidance provided to domestic contracting authorities advises them to consider carefully whether and under what circumstances such guarantees are required, which specific risks or loss they should cover and which type of guarantee is best suited in each case. The ability of the project company to raise finance for the project may be jeopardized by bond requirements set at an excessive level.

(c) Duration of guarantees

118. One particular problem of privately financed infrastructure projects concerns the duration of the guarantee. The contracting authority may have an interest in obtaining guarantees of performance that remain valid during the entire life of the project, covering both the construction and the operational phase. However, given the long duration of infrastructure projects and the difficulty in evaluating the various risks that may arise, it may be problematic for the guarantor to issue a performance bond for the whole duration of the project or to procure reinsurance for its obligations under the performance bond. In practice, this problem is compounded by stipulations that the non-renewal of a performance bond constitutes a reason for a call on the bond, so that merely allowing the project company to provide bonds for shorter periods may not be a satisfactory solution. One possible solution, used in some countries, is to require separate bonds for the construction and the operation phase, thus allowing for better assessment of risks and reinsurance prospects. Such a system may be enhanced by defining in precise terms the risk to be covered during the operation period, thus allowing for a better assessment of risks and a reduction of the total amount of the bond. Another possibility to be considered by the contracting authority may be to require the provision of performance guarantees during specific crucial periods, rather than for the entire duration of the project. For instance, a bond might be required during the construction phase and last for an appropriate period beyond completion, so as to cover possible latent defects. Such a bond might then be replaced by a performance bond for a certain number of years of operation, as appropriate in order for the project company to demonstrate its capability to operate the facility in accordance with the required standards. If the project company's performance proves to be satisfactory, the bond requirement might be waived for the remainder of the operation phase, up to a certain period before the end of the concession term, when the project company might be required to place another bond to guarantee its obligations in connection with the handing over

of assets and other measures for the orderly wind-up of the project, as appropriate (see chap. V, “Duration, extension and termination of the project agreement”, paras. 50-62).

(d) *Insurance arrangements*

119. Insurance arrangements made in connection with privately financed infrastructure projects typically vary according to the phase to which they apply, with certain types of insurance only being purchased during a particular project phase. Some forms of insurance, such as business interruption insurance, may be purchased by the concessionaire in its own interest, while other forms of insurance may be a requirement under the laws of the host country. Forms of insurance often required by law include insurance coverage against damage to the facility, third-party liability insurance, workers’ compensation insurance and pollution and environmental damage insurance.

120. Mandatory insurance policies under the laws of the host country often need to be obtained from a local insurance company or from another institution admitted to operate in the country, which in some cases may pose a number of practical difficulties. In some countries, the type of coverage usually offered may be more limited than the standard coverage available on the international market, in which case the concessionaire may remain exposed to a number of perils that may exceed its self-insurance capacity. That risk is particularly serious in connection with environmental damage insurance. Further difficulties may arise in some countries as a result of limitations on the ability of local insurers to reinsure the risks on the international insurance and reinsurance markets. As a consequence, the project company may often need to procure additional insurance outside the country, thus adding to the overall cost of financing the project.

4. *Changes in conditions*

121. Privately financed infrastructure projects normally last for a long period of time, during which many circumstances relevant to the project may change. The impact of many changes may be automatically covered in the project agreement, either through financial arrangements such as a tariff structure that includes an indexation clause (see paras. 39-46), or by the assumption by either party, expressly or by exclusion, of certain risks (for example, if the price of fuel or electricity supply is not taken into account in the indexation mechanisms, then the risk of higher than expected prices is absorbed by the concessionaire). However, there are changes that might not lend themselves easily to inclusion in an automatic adjustment mechanism or that the parties may prefer to exclude from such a mechanism. From a legislative perspective, two particular categories deserve special attention: legislative or regulatory changes and unexpected changes in economic conditions.

(a) *Legislative and regulatory changes*

122. Given the long duration of privately financed infrastructure projects, the concessionaire may face additional costs in meeting its obligations under the

project agreement because of future, unforeseen changes in legislation applying to its activities. In extreme cases, legislation could even make it financially or physically impossible for the concessionaire to carry on with the project. For the purpose of considering the appropriate solution for dealing with legislative changes, it may be useful to distinguish between legislative changes having a particular incidence on privately financed infrastructure projects or on one specific project, on the one hand, and general legislative changes affecting other economic activities also, and not only infrastructure operation, on the other.

123. All business organizations, in the private and public sectors alike, are subject to changes in law and generally have to deal with the consequences that such changes may have for business, including the impact of changes on the price of or demand for their products. Possible examples might include changes in the structure of capital allowances that apply to entire classes of assets, whether owned by the public or private sector and whether related to infrastructure projects or not; regulations that affect the health and safety of construction workers on all construction projects, not just infrastructure projects; and changes in the regulations on the disposal of hazardous substances. General changes in law may be regarded as an ordinary business risk rather than a risk specific to the concessionaire's activities and it may be difficult for the Government to undertake to protect infrastructure operators from the economic and financial consequences of changes in legislation that affect other business organizations equally. Thus, there may not be a *prima facie* reason why the concessionaire should not bear the consequences of general legislative risks, including the risk of costs arising from changes in law applying to the whole business sector.

124. Nevertheless, it is important to take into account possible limitations in the concessionaire's capacity to respond to or absorb cost increases that result from general legislative changes. Infrastructure operators are often subject to service standards and tariff control mechanisms that make it difficult for them to respond to changes in the law in the same manner as other private companies (by increasing tariffs or by reducing services, for example). Where tariff control mechanisms are provided in the project agreement, the concessionaire will seek to obtain assurances from the contracting authority and the regulatory agency, as appropriate, that it will be allowed to recover the additional costs entailed by changes in legislation by means of tariff increases. Where such an assurance cannot be given, it is advisable to empower the contracting authority to negotiate with the concessionaire the compensation to which the concessionaire may be entitled in the event that tariff control measures do not allow for full recovery of the additional costs generated by general legislative changes.

125. A different situation arises when the concessionaire faces increased costs as a result of specific legislative changes that target the particular project, a class of similar projects or privately financed infrastructure projects in general. Such changes cannot be regarded as an ordinary business risk and may significantly alter the economic and financial assumptions based on which the project agreement was negotiated. Thus, the contracting authority often agrees

to bear the additional cost resulting from specific legislation that targets the particular project, a class of similar projects or privately financed infrastructure projects in general. For example, in highways projects, legislation aimed at a specified road project or road operating company, or at that class of privately operated road projects, might result in a tariff adjustment under the relevant provisions in the project agreement.

(b) Changes in economic conditions

126. Some legal systems have rules that allow a revision of the terms of the project agreement following changes in the economic or financial conditions that, without preventing the performance of a party's contractual obligations, render the performance of those obligations substantially more onerous than originally foreseen at the time they were entered into. In some legal systems, the possibility of a revision of the terms of the agreement is generally implied in all Government contracts or is expressly provided for in the relevant legislation.

127. The financial and economic considerations for the concessionaire's investment are negotiated in the light of assumptions based on the circumstances prevailing at the time of the negotiations and the reasonable expectations of the parties as to how those circumstances will evolve during the life of the project. To a certain extent, projections of economic and financial parameters and sometimes even a certain margin of risk will normally be included in the formulation of the financial proposals by the bidders (see chap. III, "Selection of the concessionaire", para. 68). However, certain events may occur that the parties could not reasonably have anticipated when the project agreement was negotiated and that, had they been taken into account, would have resulted in a different risk allocation or consideration for the concessionaire's investment. Given the long duration of infrastructure projects, it is important to devise mechanisms to deal with the financial and economic impact of such events. Revision rules have been applied in a number of countries and have been found useful to help parties find equitable solutions for ensuring the continued economic and financial viability of infrastructure projects, thus averting a disruptive failure of performance by the concessionaire. However, revision rules may also have some disadvantages, in particular from the perspective of the Government.

128. As with general legislative changes, changes in economic conditions are risks to which most business organizations are exposed without having recourse to a general guarantee of the Government that would protect them against the economic and financial effects of those changes. An unqualified obligation of the contracting authority to compensate the concessionaire for changes of economic conditions may result in a reversion to the public sector of a substantial portion of the commercial risks originally allocated to the concessionaire and represent an open-ended financial liability. Furthermore, it should be noted that the proposed tariff level and the essential elements of risk allocation are important, if not decisive, factors in the selection of the conces-

sionaire. An excessively generous recourse to renegotiation of the project may lead to unrealistically low proposals being submitted during the selection procedure in the expectation of tariff increases once the project has been awarded. Thus, the contracting authority may have an interest in establishing reasonable limits for statutory or contractual provisions authorizing revisions of the project agreement following changes in economic conditions.

129. It may be desirable to provide in the project agreement that a change in circumstances that justifies a revision of the project agreement must have been beyond the control of the concessionaire and of such a nature that the concessionaire could not reasonably be expected to have taken it into account at the time the project agreement was negotiated or to have avoided or overcome its consequences. For example, a tollroad operator holding an exclusive concession might not be expected to take into account and assume the risk of traffic shortfalls brought about by the subsequent opening of an alternative toll-free road by an entity other than the contracting authority. However, the concessionaire would normally be expected to take into account the possibility of reasonable labour cost increases over the life of the project. Thus, under normal circumstances, the fact that wages turned out to be higher than expected would not be sufficient reason for revising the project agreement.

130. It may also be desirable to provide in the project agreement that a request for revision of the project agreement requires that the alleged changes of economic and financial conditions amount to a certain minimum value in proportion to the total project cost or the concessionaire's revenue. Such a rule might be useful in order to avoid cumbersome adjustment negotiations for small changes until the changes have accumulated to comprise a significant figure. In some countries, there are rules that establish a ceiling for the cumulative amount of periodic revisions of the project agreement. The purpose of such rules is to avoid the misuse of the change mechanism as a means for achieving an overall financial balance that bears no relation to the one contemplated in the original project agreement. From the perspective of the concessionaire and the lenders, however, such limitations may represent exposure to considerable risk in the event, for instance, of dramatic cost increases resulting from an extraordinarily radical change of circumstances. Therefore, both the desirability of introducing a ceiling and the appropriate amount of such ceiling need to be carefully considered.

5. Exempting impediments

131. During the life of an infrastructure project, events may occur that impede the performance by a party of its contractual obligations. The events causing such an impediment are typically outside either party's control and may be of a physical nature, such as a natural disaster, or may be the result of human action, such as war, riots or terrorist attacks. Many legal systems generally recognize that a party that fails to perform a contractual obligation because of the occurrence of certain types of event may be exempted from the consequences of any such failure to perform.

(a) *Definition of exempting impediments*

132. Exempting impediments typically include occurrences beyond the control of a party that cause the party to be unable to perform its obligation and that the party has been unable to overcome by the exercise of due diligence. Common examples include the following: natural disasters (such as cyclones, floods, droughts, earthquakes, storms, fires or lightning); war (whether declared or not) or other military activity, including riots and civil disturbance; failure or sabotage of facilities, acts of terrorism, criminal damage or the threat of such acts; radioactive or chemical contamination or ionizing radiation; effects of the natural elements, including geological conditions that cannot be foreseen and resisted; and employees' strikes of exceptional importance.

133. Some laws make only a general reference to exempting impediments, whereas other laws contain extensive lists of circumstances that excuse the parties from performance under the project agreement. The latter technique may serve the purpose of ensuring a consistent treatment of the matter for all projects developed under the relevant legislation, thus avoiding situations where one concessionaire obtains a more favourable allocation of risks than that provided in other project agreements. However, it is important to consider the possible disadvantages of setting forth in statutory or regulatory provisions a list of events that are to be considered exempting impediments for all cases. There is a risk that the list might be incomplete, leaving out important impediments. Furthermore, certain natural disasters, such as storms, cyclones and floods, may be normal conditions at a particular time of the year at the project site. As such, those natural disasters may represent risks that any public service provider acting in the region would be expected to assume.

134. Another aspect that may need to be carefully considered is whether and to what extent certain acts of public authorities other than the contracting authority may constitute exempting impediments. The concessionaire may be required to secure a licence or other official approval for the performance of certain of its obligations. The project agreement might thus provide that, if the licence or approval is refused, or if it is granted but later withdrawn because of the concessionaire's own failure to meet the relevant criteria for the issuance of the licence or approval, the concessionaire cannot rely on the refusal as an exempting impediment. However, if the licence or approval is refused or withdrawn for extraneous or improper motives, it would be equitable to provide that the concessionaire may rely on the refusal as an exempting impediment. A further possibility of impediment might be an interruption of the project brought about by a public authority or organ of government other than the contracting authority, for instance, because of changes in governmental plans and policies that require the interruption or major revision of the project that substantially affect the original design. In such situations, it may be important to consider the institutional relationship between the contracting authority and the public authority that brings about the impediment as well as their degree of independence from one another. An event classified as an exempting impediment may in some cases amount to an outright breach of the project agreement by the contracting authority, depending on whether the contracting authority could reasonably control or influence the acts of the other public authority.

(b) Consequences for the parties

135. During the construction phase, the occurrence of exempting impediments usually justifies an extension of the time allowed for the completion of the facility. In that connection, it is important to consider the implications of any such extension for the overall duration of the project, in particular where the construction phase is taken into account for calculating the total concession period. Delays in the completion of the facility reduce the operational period and may adversely affect the global revenue estimates of the concessionaire and the lenders. It may therefore be advisable to consider under what circumstances it may be justified to extend the concession period so as to take into account possible extensions that occur during the construction phase. Lastly, it is advisable to provide that, if the event in question is of a permanent nature, the parties may have the option to terminate the project agreement (see also chap. V, “Duration, extension and termination of the project agreement”, para. 34).

136. Another important question is whether the concessionaire will be entitled to compensation for loss of revenue or property damage that results from the occurrence of exempting impediments. The answer to that question is given by the risk allocation provided in the project agreement. Except for cases in which the Government provides some form of direct support, privately financed infrastructure projects are typically undertaken at the concessionaire’s own risk, including the risk of losses that may result from natural disasters and other exempting impediments, against which the concessionaire is usually required to procure adequate insurance coverage. Thus, some laws expressly exclude any form of compensation to the concessionaire in the event of loss or damage that results from the occurrence of exempting impediments. It does not necessarily follow, however, that an event qualified as an exempting impediment may not, at the same time, justify a revision of the terms of the project agreement so as to restore its economic and financial balance (see also paras. 126-130).

137. However, a different type of risk allocation is sometimes contemplated for projects involving the construction of facilities that are permanently owned by the contracting authority or facilities that are required to be transferred to the contracting authority at the end of the project period. In some countries, the contracting authority is authorized to make arrangements for assisting the concessionaire to repair or rebuild infrastructure facilities damaged by natural disasters or similar occurrences defined in the project agreement, provided that the possibility of such assistance was contemplated in the request for proposals. Sometimes the contracting authority is authorized to agree to pay compensation to the concessionaire in case of an interruption of the work for more than a certain number of days up to a maximum time limit, if the interruption is caused by an event for which the concessionaire is not responsible.

138. Should the concessionaire become unable to perform because of any such impediment and should the parties fail to achieve an acceptable revision of the contract, some national laws authorize the concessionaire to terminate the project agreement, without prejudice to the compensation that might be due

under the circumstances (see chap. V, “Duration, extension and termination of the project agreement”, para. 34).

139. Statutory and contractual provisions on exempting impediments also need to be considered in the light of other rules governing the provision of the service concerned. The law in some legal systems requires public service providers to make every effort to continue providing the service despite the occurrence of circumstances defined as contractual impediments (see paras. 86 and 87). In those cases, it is advisable to consider the extent to which such an obligation may reasonably be imposed on the concessionaire and what compensation may be due for the additional costs and hardship faced by it.

6. *Breach and remedies*

140. Generally, there is a wide range of remedies that the parties may agree on to deal with the consequences of breach, culminating with termination of the project agreement. The following paragraphs set out general considerations on breach and remedies by either party (see paras. 141 and 142). They consider the legislative implication of certain types of remedy intended to rectify the causes of breach and preserve the continuity of the project, in particular the intervention of the contracting authority (see paras. 143-146) or the substitution of the concessionaire (see paras. 147-150). The ultimate remedy of terminating the project agreement and the consequences that may result from termination are discussed elsewhere in the *Guide* (see chap. V, “Duration, extension and termination of the project agreement”, sects. D and E).

(a) *General considerations*

141. The remedies for breach by the concessionaire typically include those which are customary in construction or long-term service contracts such as forfeiture of guarantees, contractual penalties and liquidated damages.³ In most cases, such remedies are typically contractual in nature and do not give rise to significant legislative considerations. Nevertheless, it is important to establish adequate procedures for ascertaining failures and giving opportunity for rectifying such failures. In some countries, the imposition of contractual penalties requires findings of official inspections and other procedural steps, including review by senior officials of the contracting authority prior to the imposition of more serious sanctions. Those procedures may be complemented by provisions distinguishing between defects that can be rectified and those which cannot and by setting down the corresponding procedures and remedies. It is usually advisable to require that the concessionaire be given notice requiring it to remedy the breach within a sufficient period. It may also be advisable to contemplate the payment of penalties or liquidated damages by the concessionaire in the event of non-performance of essential obligations and to clarify that no penalties apply in case of breach of secondary or ancillary obligations and for which other remedies may be obtained under national law. Further-

³For a discussion of remedies used in construction contracts for complex industrial works, see the *UNCITRAL Legal Guide on Drawing Up Contracts for the Construction of Industrial Works*, chap. XVIII, “Delay, defects and other failures to perform”.

more, a performance monitoring system that provides for penalties or liquidated damages may be complemented by a scheme of bonuses payable to the concessionaire for improving over agreed terms.

142. While the contracting authority may protect itself against the consequences of breach by the concessionaire through a variety of judicially enforceable contractual arrangements, the remedies available to the concessionaire in case of breach by the contracting authority may be subject to a number of limitations under the applicable law. Important limitations may derive from rules of law that recognize the immunity of public authorities from judicial suit and enforcement measures. Depending on the legal nature of the contracting authority or of other public authorities that assume obligations vis-à-vis the concessionaire, the latter may be deprived of the possibility of enforcing measures of execution to secure the fulfilment of obligations entered into by those public entities (see also chap. VI, “Settlement of disputes”, paras. 33-35). This situation makes it the more important to provide mechanisms to protect the concessionaire against the consequences of breach by the contracting authority, for example by means of governmental guarantees covering specific events of breach or guarantees provided by third parties, such as multilateral lending institutions (see also chap. II, “Project risks and government support”, paras. 61-71).

(b) Step-in rights for the contracting authority

143. Some national laws expressly authorize the contracting authority to take over temporarily the operation of the facility, normally in case of failure to perform by the concessionaire, in particular where the contracting authority has a statutory duty to ensure the effective delivery at all times of the service concerned. In some legal systems, such a prerogative is considered to be inherent in most government contracts and may be presumed to exist even without being expressly mentioned in legislation or in the project agreement.

144. It should be noted that the contracting authority’s right to intervene, its “step-in right”, is an extreme measure. Private investors may fear that the contracting authority may use it, or threaten to use it, in order to impose its own desires about the way in which the service is provided, or even to get control of the project assets. It is therefore advisable to define as clearly as possible the circumstances in which step-in rights can be exercised. It is important to limit the contracting authority’s right to intervene to cases of serious failure of services and not merely in case of dissatisfaction with the concessionaire’s performance. It may be useful to clarify in the law that the contracting authority’s intervention in the project is temporary and is intended to remedy a specific, urgent problem that the concessionaire has failed to remedy. The concessionaire should resume responsibility for service delivery once the emergency situation has been remedied.

145. The contracting authority’s ability to step in may be limited in that it may be difficult immediately to identify and engage a subcontractor to carry out the actions that the contracting authority is stepping in to do. Furthermore,

frequent interventions carry a risk of the reversion to the contracting authority of risks that have been transferred in the project agreement to the concessionaire. The concessionaire should not rely on the contracting authority to step in to deal with a particular risk instead of handling it itself, as required by the project agreement.

146. It is advisable to clarify in the project agreement which party bears the cost of an intervention by the contracting authority. In most cases, the concessionaire should bear the costs incurred by the contracting authority when the intervention is caused by a performance failure attributable to the concessionaire's own fault. In some cases, to prevent disputes about liability and about the appropriate level of costs, the agreement may authorize the contracting authority to take steps to remedy the problem itself and then charge the actual cost of having done so (including its own administrative costs) to the concessionaire. However, when such intervention takes place following the occurrence of an exempting impediment (see paras. 131-139), the parties might agree on a different solution, depending on how that particular risk has been allocated in the project agreement.

(c) Step-in rights for the lenders

147. During the life of the project situations may arise where, because of breach by the concessionaire or the occurrence of an extraordinary event outside the concessionaire's control, it may nevertheless be in the interest of the parties to avert termination of the project by allowing the project to continue under the responsibility of a different concessionaire. The lenders, whose main security is the revenue generated by the project, are particularly concerned about the risk of interruption or termination of the project prior to repayment of the loans. In the event of breach impediment affecting the concessionaire, the lenders will be interested in ensuring that the work will not be left incomplete and that the concession will be operated profitably. The contracting authority, too, may be interested in allowing the project to be carried out by a new concessionaire, as an alternative for having to take it over and continue it under its own responsibility.

148. Clauses allowing the lenders to select, with the consent of the contracting authority, a new concessionaire to perform under the existing project agreement have been included in a number of recent agreements for large infrastructure projects. Such clauses are typically supplemented by a direct agreement between the contracting authority and the lenders who are providing finance to the concessionaire. The main purpose of such a direct agreement is to allow the lenders to avert termination by the contracting authority when the concessionaire is in breach by substituting a concessionaire that will continue to perform under the project agreement in place of the concessionaire in breach. Unlike the contracting authority's right to intervene, which relates to a specific, temporary and urgent failure of the service, lenders' step-in rights are for cases where the concessionaire's failure to provide the service is recurrent or can reasonably be regarded as irremediable. In the experience of countries that have recently made use of such direct agreements, it has been found

that the ability to head off termination and provide an alternative concessionaire gives the lenders additional security against breach by the concessionaire. At the same time, it provides the contracting authority an opportunity to avoid the disruption entailed by terminating the project agreement, thus maintaining continuity of service.

149. However, in some countries, the implementation of such clauses may face difficulties in the absence of legislative authorization. The concessionaire's inability to carry out its obligations is usually a ground for the contracting authority to take over the operation of the facility or terminate the agreement (see chap. V, "Duration, extension and termination of the project agreement", paras. 15-23). For the purpose of selecting a new concessionaire to succeed the concessionaire in breach, the contracting authority often needs to follow the same procedures that applied to the selection of the original concessionaire and it might not be possible for the contracting authority to agree in consultation with the lenders on engaging a new concessionaire that has not been selected pursuant to those procedures. On the other hand, even where the contracting authority is authorized to negotiate with a new concessionaire under emergency conditions, a new project agreement might need to be entered into with the new concessionaire and there may be limitations to its ability to assume the obligations of its predecessor.

150. Therefore, it may be useful to acknowledge in the law the contracting authority's right to enter into agreements with the lenders providing for the appointment, with the consent of the contracting authority, of a new concessionaire to perform under the existing project agreement, when the concessionaire seriously fails to deliver the service required under the project agreement or following the occurrence of other specified events that could justify the termination of the project agreement. The agreement between the contracting authority and the lenders should, *inter alia*, specify the following: the circumstances in which the lenders are permitted to substitute a new concessionaire; the procedures for the substitution of the concessionaire; the grounds for refusal by the contracting authority of a proposed substitute; and the obligations of the lenders to maintain the service at the same standards and on the same terms as required by the project agreement.

V. Duration, extension and termination of the project agreement

A. General remarks

1. Most privately financed infrastructure projects are undertaken for a certain period, at the end of which the concessionaire transfers to the contracting authority the responsibility for the operation of the infrastructure facility. Section B deals with elements to be taken into account when establishing the concession period. Section C deals with the question of whether and under what circumstances the project agreement may be extended. Section D considers circumstances that may authorize the termination of the project agreement prior to the expiry of its term. Lastly, section E deals with the consequences of the expiry or termination of the project agreement, including the transfer of project assets and the compensation to which either party may be entitled upon termination, and the wind-up of the project.

B. Duration of the project agreement

2. The laws of some countries contain provisions that limit the duration of infrastructure concessions to a certain number of years. Some laws establish a general limit for most infrastructure projects and special limits for projects in particular infrastructure sectors. In some countries there are maximum duration periods only for certain infrastructure sectors.

3. The desirable duration of a project agreement may depend on a number of factors, such as the operational life of the facility; the period during which the service is likely to be required; the expected useful life of the assets associated with the project; how changeable the technology required for the project is; and the time needed for the concessionaire to repay its debts and amortize the initial investment. The notion of economic “amortization”, in this context, refers to the gradual charging of the investment made against project revenue on the assumption that the facility would have no residual value at the end of the project term. Given the difficulty of establishing a single statutory limit for the duration of infrastructure projects, it is advisable to provide the contracting authority with some flexibility to negotiate, in each case, a term that is appropriate to the project in question.

4. In some legal systems, this result is achieved by provisions that require that all concessions should be subject to a maximum duration period, without specifying any number of years. Sometimes the law only indicates which elements are to be taken into account for determining the duration of the con-

cession, which may include the nature and amount of investment required to be made by the concessionaire and the normal amortization period for the particular facilities and installations concerned. Some project or sector-specific laws provide for a combined system requiring that the project agreement provide for the expiry of the concession at the end of a certain period or once the debts of the concessionaire have been fully repaid and a certain revenue, production or usage level has been achieved, whichever is the earliest.

5. However, where it is found necessary to adopt statutory limits, the maximum period should be sufficiently long to allow the concessionaire to repay its debts fully and to achieve a reasonable profit. Furthermore, it may be useful to authorize the contracting authority, in exceptional cases, to agree to longer concession periods, taking into account the amount of the investment and the required recovering period, and subject to special approval procedures.

C. Extension of the project agreement

6. In the contracting practice of some countries, the contracting authority and the concessionaire may agree on one or more extensions of the concession period. More often, however, domestic laws only authorize an extension of the project agreement under exceptional circumstances. In this case, upon expiry of the project agreement the contracting authority is normally required to select a new concessionaire, normally using the same procedures applied to select the concessionaire whose concession has expired (for a discussion of selection procedures, see chap. III, “Selection of the concessionaire”).

7. A number of countries have found it useful to require that exclusive concessions be rebid from time to time rather than freely extended by the parties. Periodic rebidding may give the concessionaire strong performance incentives. The period between the initial award and the first (and subsequent) rebidding should take into account the level of investment and other risks faced by the concessionaire. For example, for solid waste collection concessions not requiring heavy fixed investments, the periodicity may be relatively short (three to five years, for example), whereas longer periods may be desirable for power or water distribution concessions. In most countries, rebidding coincides with the end of the project term, but in others a concession may be granted for a long period (say 99 years), with periodic rebidding (for instance, every 10 or 15 years). In the latter mechanism, which has been adopted in a few countries, the first rebidding occurs before the concessionaire has fully recouped its investments. As an incentive to the incumbent operator, some laws provide that the concessionaire may be given preference over other bidders in the award of subsequent concessions for the same activity. However, the concessionaire may have rights to compensation if it does not win the next bidding round, in which case all or part of the bidding proceeds may revert to the incumbent concessionaire. Requiring that the winning bidder should pay off the incumbent concessionaire for any property rights and for the investment not yet recovered reduces the longer-term risk faced by investors and lenders and provides them a valuable exit option (see paras. 39 and 40).

8. Notwithstanding the above, it is advisable not to exclude entirely the option to negotiate an extension of the concession period under certain specified circumstances. The duration of an infrastructure project is one of the main factors taken into account in the negotiation of financial arrangements and has a direct impact on the price of the services provided by the concessionaire. The parties may find that an extension of the project agreement (as a substitute for or combined with other compensation mechanisms) may be a useful option to deal with unexpected impediments or other changes of circumstances arising during the life of the project. Such circumstances may include any of the following: extension to compensate for project suspension or loss of profit due to the occurrence of impeding events (see chap. IV, “Construction and operation of infrastructure: legislative framework and project agreement”, paras. 131-139); extension to compensate for project suspension brought about by the contracting authority or other public authorities (see chap. IV, “Construction and operation of infrastructure: legislative framework and project agreement”, paras. 140 and 141); or extension to allow the concessionaire to recover the cost of additional work required to be done on the facility and which the concessionaire would not be able to recover during the normal term of the project agreement without unreasonable tariff increases (see chap. IV, “Construction and operation of infrastructure: legislative framework and project agreement”, paras. 73-76). For purposes of transparency and accountability, in some countries the extension of the concession period is subject to a global cumulative limit or requires the approval of a specially designated public authority.

D. Termination

9. The grounds for termination of the project agreement before the expiry of its term and the consequences of any such termination are often dealt with in domestic legislation. Usually the law authorizes the parties to terminate the project agreement following the occurrence of certain types of events. The main interest of all parties involved in a privately financed infrastructure project is to ensure the satisfactory completion of the facility and the continuous and orderly provision of the relevant public service. Given the serious consequences of termination, as provision of the service may be interrupted or even discontinued, termination should under most circumstances be regarded as a measure of last resort. The conditions for the exercise of this right by either party should be carefully considered. While they may not need to be identical, it is generally desirable to achieve a broadly equitable balance of rights and conditions regarding termination for both parties.

10. In addition to identifying the circumstances or types of events that may give rise to a termination right, it is advisable for the parties to consider appropriate procedures to establish whether there are valid grounds for terminating the project agreement. Of particular importance is the question whether the project agreement may be unilaterally terminated or whether termination requires a decision by a judicial or other dispute settlement body.

11. The concessionaire is usually not allowed to terminate the project agreement without cause and in some legal systems termination by the concessionaire even in the event of breach by the contracting authority requires a final judicial decision. However, in some countries, pursuant to rules applicable to contracts with government entities, such a right may be exercised by public authorities, subject to payment of compensation to the concessionaire. In other countries, however, an exception is made in the case of public service concessions, whose contractual nature is found to be incompatible with unilateral termination rights. Lastly, some legal systems do not recognize unilateral termination rights for public authorities. However, project promoters and lenders would be concerned about the risk of premature or unjustified termination by the contracting authority, even where a decision to terminate might be subject to review through the dispute settlement mechanism. It should also be noted that giving the contracting authority the unilateral right to terminate the project agreement would not be an adequate substitute for well-designed contractual mechanisms of performance monitoring or for appropriate guarantees of performance (see chap. IV, “Construction and operation of infrastructure: legislative framework and project agreement”, paras. 80-97 and 108-120).

12. Provisions concerning termination should therefore be brought into line with the remedies for breach provided in the project agreement. In particular, it is useful to distinguish the conditions for termination from those for step-in by the contracting authority (see chap. IV, “Construction and operation of infrastructure: legislative framework and project agreement”, paras. 143-146). It is also important to consider the contracting authority’s termination rights against the background of the financing agreements negotiated by the concessionaire with its lenders. In most cases, events that may lead to the termination of the project agreement would also constitute events of default under the loan agreements, with the consequence that the entire outstanding debt of the concessionaire may fall due immediately. It would thus be useful to attempt to avoid the risk of termination by allowing the lenders to propose another concessionaire when termination of the project agreement with the original concessionaire appears imminent (see chap. IV, “Construction and operation of infrastructure: legislative framework and project agreement”, paras. 108-120).

13. In the light of the above, it is generally advisable to provide that the termination of the project agreement in most cases require a final finding by the dispute settlement body provided in the agreement. Such a requirement would reduce concerns about premature or unjustified recourse to termination. At the same time, it would not preclude the taking of appropriate measures to ensure the continuity of the service, pending the final decision of the dispute settlement body, as long as contractual remedies for breach, such as step-in rights for the contracting authority and the lenders, are provided in the project agreement. In countries where such a requirement would not be consistent with general principles of administrative law applicable to government contracts, it might be important to ensure, at least, that the contracting authority’s right to terminate the project agreement should be without prejudice to the concessionaire’s right to seek subsequent judicial review of the contracting authority’s decision to terminate.

1. Termination by the contracting authority

14. The contracting authority's termination rights usually relate to three categories of circumstances: serious breach by the concessionaire; insolvency or bankruptcy of the concessionaire; and termination for reasons of public interest.

(a) *Serious breach by the concessionaire*

15. The contracting authority has the duty to ensure that public services are provided in accordance with applicable laws, regulations and contractual provisions. Thus, a number of domestic laws expressly recognize the contracting authority's right to terminate the project agreement in the event of breach by the concessionaire. Because of the disruptive effects of termination and in the interest of preserving the continuity of the service, it is not advisable to regard termination as a sanction for each and any instance of unsatisfactory performance by the concessionaire. On the contrary, it is generally advisable to resort to the extreme remedy of termination only in cases of "particularly serious" or "repeated" failures to perform, especially when it can no longer be reasonably expected that the concessionaire will be able or willing to perform under the project agreement. Many legal systems use specific technical expressions to refer to situations where the degree of breach by one contracting party is of such a nature that the other party may terminate their contractual relation before the expiry of its term (for example, "fundamental breach", "material breach" or similar expressions). Such situations are referred to in the *Guide* as "serious breach".

16. Circumscribing the possibility of termination to cases of serious breach may give assurance to lenders and project promoters that they will be protected against unreasonable or premature decisions by the contracting authority. The law may generally provide for the contracting authority's right to terminate the project agreement upon serious breach by the concessionaire and leave it for the project agreement to define further the notion of serious breach and, as appropriate, provide illustrative examples of it. From a practical point of view, it is not advisable to attempt, by statute or in the project agreement, to provide a list of the events that justify termination.

17. As a general rule, it is desirable that the concessionaire be granted an additional period of time to fulfil its obligations and to avert the consequences of its breach prior to the contracting authority's resorting to remedies. For example, the concessionaire should be given notice specifying the nature of the relevant circumstances and requiring it to rectify them within a certain period. The possibility might also be given for the lenders and sureties, as the case may be, to avert the consequences of the concessionaire's breach, for instance by temporarily engaging a third party to cure the consequences of breach by the concessionaire, in accordance with the terms of the performance bonds provided to the contracting authority or the terms of a direct agreement between the lenders and the contracting authority (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 108-120 and 147-150). The project agreement may also provide that, if the circumstances are not rectified before the expiry of the relevant period, the

contracting authority may then terminate the project agreement, subject to first notifying the lenders and giving them an opportunity within a certain period to exercise any right of substitution that the lenders might have in accordance with a direct agreement between them and the contracting authority. However, reasonable deadlines need to be set, since the contracting authority cannot be expected to bear indefinitely the continuing cost of a situation of breach of the project agreement by the concessionaire. Furthermore, the procedures should be without prejudice to the contracting authority's right to step in to avert the risk of disruption of service by the concessionaire (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 145 and 146).

(i) Serious breach before the beginning of construction

18. The concessionaire typically needs to accomplish a series of steps prior to undertaking construction works. Some of these requirements may even constitute conditions precedent to the entry into force of the project agreement. Examples of events that often justify the withdrawal of the concession award at an early stage include the following:

(a) Failure to secure the required financial means, to sign the project agreement or to establish the project company within the established deadline;

(b) Failure to obtain licences or permits required for pursuing the activity that is the object of the concession;

(c) Failure to undertake the construction of the facility, to commence development of the project or to submit the plans and designs required within a set period of time from the award of the concession.

19. Termination should in principle be reserved for situations where the contracting authority may no longer reasonably expect that the selected concessionaire will take the necessary measures to commence execution of the project. In that connection, it is important for the contracting authority to take into account any circumstances that may excuse the concessionaire's delay in fulfilling its obligations. Furthermore, the concessionaire should not suffer the consequences of inaction or error on the part of the contracting authority or other public authorities. For instance, the termination of the project agreement would not normally be justified if the concessionaire's failure to obtain government licences and permits within the agreed schedule was not attributable to the concessionaire's own fault.

(ii) Serious breach during the construction phase

20. Examples of events that may justify the termination of the project agreement during the construction phase include the following:

(a) Failure to observe building regulations, specifications or minimum design and performance standards and non-excusable failure to complete work within the agreed schedule;

- (b) Failure to provide or renew the required guarantees in the agreed terms;
- (c) Violation of essential statutory or contractual obligations.

21. Termination should be commensurate with the degree of breach by the concessionaire and the consequences of breach for the contracting authority. For instance, the contracting authority may have a legitimate interest in specifying a date when the construction must be completed and may therefore be justified in regarding a delay in completion as an event of breach and hence a ground for termination. However, delay alone, in particular if it is not excessive in relation to the specifications of the project agreement, might not be sufficient reason for termination when the contracting authority is otherwise satisfied with the concessionaire's ability to complete the construction in accordance with the required quality standards and its commitment to doing so.

(iii) Serious breach during the operational phase

22. Examples of particular instances of breach that typically justify the termination of the concession during the operational phase include any of the following:

- (a) Serious failure to provide services in accordance with the statutory and contractual standards of quality, including disregard of price control measures;
- (b) Non-excusable suspension or interruption of the provision of the service without prior consent from the contracting authority;
- (c) Serious failure by the concessionaire to maintain the facility, its equipment and appurtenances in accordance with the agreed standards of quality or non-excusable delay in carrying out maintenance works in accordance with the agreed plans, schedules and timetables;
- (d) Failure to comply with sanctions imposed by the contracting authority or the regulatory agency, as appropriate, for infringements of the concessionaire's duties.

23. For the purpose of enhancing transparency and integrity in governmental matters, the laws of some countries also provide for the termination of project agreements if the concessionaire is guilty of tax fraud or other types of fraudulent acts, or if its agents or employees are involved in bribery of public officials and other corrupt practices (see also chap. VII, "Other relevant areas of law", paras. 50-52). The latter considerations underscore the importance of designing effective mechanisms to combat corruption and bribery and to afford the concessionaire the opportunity to file complaints against demands for illegal payments or unlawful threats by officials of the host country.

(b) Insolvency of the concessionaire

24. Infrastructure services typically need to be provided continuously and for that reason most domestic laws stipulate that the agreement may be terminated if the concessionaire is declared insolvent or bankrupt. In order to ensure the

continuity of the service, the assets and property required to be handed over to the contracting authority may be excluded from the insolvency proceedings and the law may require prior governmental approval for any act of disposition by a liquidator or insolvency administrator of any categories of assets owned by the concessionaire.

25. In a legal system that allows the establishment of security interests over the concession itself (see chap. IV, “Construction and operation of infrastructure: legislative framework and project agreement”, para. 57), the law provides that the contracting authority may, in consultation with the holders of such security creditors, appoint a temporary administrator so as to ensure the continued provision of the relevant service, until the secured creditors admitted to the insolvency proceedings decide, upon the recommendation of the insolvency administrator, whether the activity should be pursued or whether the right to exploit the concession should be put to a bidding process.

(c) Termination for reasons of public interest

26. In the contracting practice of some countries, public authorities procuring construction works traditionally retain the right to terminate the construction contract for reasons of public interest (that is, without having to provide any justification other than that the termination is in the Government’s interest). In some common law jurisdictions, that right, which is sometimes referred to as “termination for convenience”, can only be exercised if expressly provided for in a statute or in the relevant contract. Several legal systems belonging to the civil law tradition also recognize a similar power of public authorities to terminate contracts for reasons of public interest or “general interest”. In some countries, such a right may be implied in the Government’s contracting power, even in the absence of an explicit statutory or contractual provision to that effect. The Government’s right to terminate for reasons of public interest, in those legal systems which recognize it, is regarded as essential in order to preserve the Government’s unfettered ability to exercise its functions affecting the public good.

27. Nevertheless, the conditions for the exercise of this right, and the consequences of doing so, should be carefully considered. The authority to determine what constitutes public interest may lie within the Government’s discretion, so that the contracting authority’s decision to terminate the project agreement could only be challenged under specific circumstances (for instance, improper motive, “*détournement de pouvoir*”). However, a general and unqualified right to terminate the project agreement for reasons of public interest may represent an imponderable risk that neither the concessionaire nor the lenders may be ready to accept without sufficient guarantees that they will receive prompt compensation for the loss sustained. The possibility of termination for reasons of public interest, where contemplated, should therefore be made known to prospective investors on the earliest possible occasion and should be expressly mentioned in the draft project agreement circulated with the request for proposals (see chap. III, “Selection of the concessionaire”, para.

67). The compensation due for termination for reasons of public interest may, in practice, cover items that are taken into account when calculating the compensation that is due for termination for serious breach by the contracting authority (see para. 42). Furthermore, it is generally advisable to limit the exercise of the right to terminate the project agreement to situations where such termination is needed for a compelling reason of public interest, which should be restrictively interpreted (for example, where major subsequent changes in governmental plans and policies require the integration of a project into a larger network or where changes in the contracting authority's plans require major project revisions that substantially affect the original design or the project's commercial feasibility under private operation). In particular, it is not advisable to regard the right of termination for reasons of public interest as a substitute for other contractual remedies in case of dissatisfaction with the concessionaire's performance (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 140-150).

2. *Termination by the concessionaire*

28. While the contracting authority in some legal systems may retain an unqualified right to terminate the project agreement, the grounds for termination by the concessionaire are usually limited to serious breach by the contracting authority or other exceptional situations and do not normally include a general right to terminate the project agreement at will. Moreover, some legal systems do not recognize the concessionaire's right to terminate the project agreement unilaterally, but only the right to request a third party, such as the competent court, to declare the termination of the project agreement.

(a) *Serious breach by the contracting authority*

29. Generally, the concessionaire's right to terminate the project agreement is limited to situations where the contracting authority is found to be in breach of a substantial part of its obligations (such as failure to make agreed payments to the concessionaire or failure to issue licences required for the operation of the facility for reasons other than the concessionaire's own fault). In those legal systems where the contracting authority has the right to request modifications in the project, the concessionaire may have the right to terminate the project agreement if the contracting authority alters or modifies the original project in such a fashion as to cause a substantial increase in the amount of investment required and the parties fail to agree on the appropriate amount of compensation (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 73-76).

30. In addition to serious breach by the contracting authority itself, it may be equitable to authorize termination by the concessionaire should the latter be rendered unable to provide the service as a result of acts of public authorities other than the contracting authority, such as failure to provide certain measures of support required for the execution of the project agreement (see chap. II, "Project risks and government support", paras. 35-60).

31. Although termination by the concessionaire may not always require a final finding by a judicial or other dispute settlement body, there may be limits to the remedies available to the concessionaire in the event of breach by the contracting authority. Pursuant to a rule of law followed in many legal systems, a party to a contract may withhold performance of its obligations in the event of breach by the other party of a substantial part of its obligations. However, in some legal systems that rule does not apply to government contracts and the law provides instead that government contractors are not excused from performing solely on the ground of breach by the contracting authority unless and until the contract is rescinded by a judicial or arbitral decision.

32. Limitations on the concessionaire's right to withhold performance are typically intended to ensure the continuity of public services (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 86 and 87). Nevertheless, it should be noted that while the contracting authority may mitigate the consequences of breach by the concessionaire by using its right to step in, the concessionaire does not usually have a comparable remedy. In the event of serious breach by the contracting authority, the concessionaire may sustain considerable or even irreparable damage, depending on the time required to obtain a final decision releasing the concessionaire from its obligations under the project agreement. These circumstances underscore the importance of government guarantees in respect of obligations assumed by contracting authorities (see chap. II, "Project risks and government support", paras. 45-50) and the need for allowing the parties the choice of expeditious and effective dispute settlement mechanisms (see chap. VI, "Settlement of disputes", paras. 3-42).

(b) Changes in conditions

33. Domestic laws often allow the concessionaire to terminate the project agreement if the concessionaire's performance has been rendered substantially more onerous by the occurrence of an unforeseen change in conditions and the parties have failed to agree on an appropriate revision to adapt the project agreement to the changed conditions (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 126-130).

3. Termination by either party

(a) Impediment of performance

34. Some laws provide that the parties may terminate the project agreement if the performance of their obligations is rendered permanently impossible as a result of a circumstance defined in the project agreement as an exempting impediment (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 132-139). In that connection, it is advisable to provide in the project agreement that if the exempting impediment persists for a certain period or if the cumulative duration of two

or more exempting impediments exceeds a certain time, the agreement may be terminated by either party. If the execution of the project is rendered impossible on legal grounds, because of changes in legislation or as a result of judicial decisions affecting the validity of the project agreement, for instance, such a termination right might not require any period of time to elapse and might be exercised immediately upon the change of legislation or other legal obstacle becoming effective.

(b) *Mutual consent*

35. Some domestic laws authorize the parties to terminate the project agreement by mutual consent, usually subject to the approval of a higher authority. Legislative power to this effect may be needed by the contracting authority in legal systems where the termination by mutual consent might amount to a discontinuation of the public service for which the contracting authority is responsible.

E. Consequences of expiry or termination of the project agreement

36. The concessionaire's right to operate the facility and to provide the relevant service typically finishes upon expiry of the project term or termination of the project agreement. Unless the infrastructure is to be permanently owned by the concessionaire, the expiry or termination of the project agreement often requires the transfer of assets to the contracting authority or to another concessionaire who undertakes to operate the facility. There may be important financial consequences that will need to be regulated in detail in the project agreement, in particular in the event of termination by either party. The parties will also need to agree on various wind-up measures to ensure the orderly transfer of the responsibility for operating the facility and providing the service.

1. Transfer of project-related assets

37. In most cases, the assets and property originally made available to the concessionaire and other goods related to the project are to revert to the contracting authority upon expiry or termination of the project agreement (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 23-29). In a typical "build-operate-transfer" project, the concessionaire would also be obliged to transfer to the contracting authority the physical infrastructure and other project-related assets upon expiry or termination of the project agreement. The assets required to be transferred to the contracting authority often include intangible assets, such as outstanding receivables and other rights existing at the time of transfer. Depending on the project, the assets to be transferred may include specific technology or know-how (see paras. 51-55). It should be noted that in some projects the assets are transferred directly from the concessionaire to another concessionaire who succeeds it in the provision of the service.

(a) *Transfer of assets to the contracting authority*

38. Different arrangements may be needed, depending on the type of asset to be transferred (see chap. IV, “Construction and operation of infrastructure: legislative framework and project agreement”, para. 28):

(a) *Assets that must be transferred to the contracting authority.* In the legal tradition of some countries, at the end of the project term, the concessionaire is required to transfer such assets free of any liens and encumbrances and at no cost to the contracting authority, except for compensation for improvements made to, or modernization of, the property for the purpose of ensuring the continuity of the service the cost of which has not yet been recovered by the concessionaire. In practice, such a rule presupposes the negotiation of a concession period sufficiently long and a level of revenue high enough for the concessionaire to amortize fully its investment and to repay its debts in full. Other laws allow for more flexibility by authorizing the contracting authority to compensate the concessionaire for the residual value, if any, of assets built by the concessionaire;

(b) *Assets that may be purchased by the contracting authority, at its option.* If the contracting authority decides to exercise its option to purchase those assets, the concessionaire is normally entitled to compensation corresponding to their fair market value at the time. However, if those assets were expected to be fully amortized (that is, if the concessionaire’s financing arrangements do not envisage any expectation of residual value of the assets), then the price paid might be only nominal. In the contracting practice of some countries, it is usual for contracting authorities to be granted some security interest in such assets as a guarantee for their effective transfer;

(c) *Assets that remain the private property of the concessionaire.* Typically these assets may be freely removed or disposed of by the concessionaire.

(b) *Transfer of assets to a new concessionaire*

39. As indicated earlier, the contracting authority may wish to rebid the concession at the end of the project agreement, rather than to operate the facility itself (see para. 3). For that purpose, it may be useful for the law to require the concessionaire to make the assets available to a new concessionaire. In order to ensure an orderly transition and continuity of the service, the concessionaire should be required to cooperate with the new concessionaire in the handover. The transfer of assets between the concessionaires may require that some compensation be paid to the incumbent concessionaire, depending on whether or not the assets have been amortized.

40. One important element to consider in this connection is the structure of the financial proposal formulated by the concessionaire during the selection process (see also chap. IV, “Construction and operation of infrastructure: legislative framework and project agreement”, para. 27). In public infrastructure projects, one of the basic assumptions of the bidders’ financial proposal is that all assets required to be built or acquired for the project will be fully amortized (that is, their cost will be recovered in full) in the life of the project. Thus, the financial

proposals will not normally include an expectation of residual value for the assets at the end of the project period. In such cases, there may not be a *prima facie* reason for requiring a successor concessionaire to pay any compensation to the original concessionaire, which may be required to make all assets available to its successor at no cost or only for a nominal consideration. Indeed, if the concessionaire has achieved its expected return, a transfer payment from a successor concessionaire would be an additional cost that would ultimately have to be remunerated by the prices charged by the successor under the second agreement. However, if the tariff level contemplated in the concessionaire's original proposal was based on the assumption of some residual value of the assets at the end of the project period or if the financial proposal assumed significant revenue from third parties, the concessionaire might be entitled to compensation for assets handed over to a successor concessionaire.

(c) Condition of assets at the time of transfer

41. Where assets are handed over to the contracting authority or transferred directly to a new concessionaire upon the expiry of the concession period, the concessionaire is typically obligated to transfer them, free of liens or encumbrances, and in such condition as would be necessary for normal functioning of the infrastructure facility, taking into account the needs of the service. The contracting authority's right to receive those assets in such operating condition is complemented in some laws by the obligation imposed upon the concessionaire to keep and transfer the project in such proper condition as prudent maintenance requires and to provide some sort of guarantee to that effect (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", para. 118). Where the contracting authority requires the assets to be returned in a prescribed condition, the required conditions should be reasonable. While it may be reasonable for the contracting authority to require that the assets have some defined period of residual life, it would not be reasonable to expect them to be as new. Furthermore, these requirements may not be applicable in the event of termination of the project agreement, in particular termination prior to successful completion of the construction phase.

42. It is advisable to devise procedures for ascertaining the condition of the assets that should be transferred to the contracting authority. It may be useful, for example, to establish a committee comprised of representatives of both the contracting authority and the concessionaire to establish whether the facilities are in the prescribed condition and conform to the relevant requirements set forth in the project agreement. The project agreement may also provide for the appointment and terms of reference of such a committee, which may be given authority to request reasonable measures by the concessionaire to repair or eliminate any defects and deficiencies found in the facilities. It may be advisable to provide for a special inspection to take place one year prior to the termination of the concession, following which the contracting authority may require additional maintenance measures by the concessionaire so as to ensure that the goods are in proper condition at the time of the transfer. The contract-

ing authority may wish to require that the concessionaire provide special guarantees for the satisfactory handover of the facilities (see chap. IV, “Construction and operation of infrastructure: legislative framework and project agreement”, para. 118). The contracting authority might draw on such guarantees to pay the repair cost of damaged assets or property.

2. *Financial arrangements upon termination*

43. Termination of the project agreement may occur before the concessionaire has been able to recover its investment, repay its debts and yield the expected profit, which may cause significant loss to the concessionaire. Loss may also be sustained by the contracting authority, which may need to make additional investment or incur considerable expense in order, for instance, to ensure the completion of the facility or the continued provision of the relevant services. In view of these circumstances, project agreements typically contain extensive provisions dealing with the financial rights and obligations of the parties upon termination. The usual standards of compensation typically vary according to the various grounds for termination. Nevertheless, the following factors are usually taken into account in compensation arrangements:

(a) *Outstanding debt, equity investment and anticipated profit.* Project termination is typically included among the events of default in the concessionaire’s loan agreements. Since loan agreements usually include a so-called “acceleration clause”, whereby the entire debt may become due upon the occurrence of an event of default, the immediate loss sustained by the concessionaire upon termination of the project agreement may include the amount of debt then outstanding. Whether and to what extent such a loss might be compensated for by the contracting authority usually depends on the grounds for terminating the project agreement. Partial compensation may be limited to an amount corresponding to the value of works satisfactorily performed by the concessionaire, whereas full compensation would cover the entire outstanding debt. Another category of loss that is sometimes taken into account in compensation arrangements refers to loss of equity investment by the project promoters, to the extent that such an investment has not yet been recovered at the time of termination. Lastly, termination also deprives the concessionaire of future profits that the facility may generate. Although lost profits are not usually regarded as actual damage, in exceptional circumstances, such as wrongful termination by the contracting authority, the current value of expected future profit may be included in the compensation due to the concessionaire;

(b) *Degree of completion, residual value and amortization of assets.* Contractual compensation schemes for various termination grounds typically include compensation commensurate with the degree of completion of the works at the time of termination. The value of the works is usually determined on the basis of the investment required for construction (in particular if the termination takes place during the construction phase), the replacement cost or the “residual” value of the facility. The residual value means the market value of the infrastructure at the time of termination. Market value may be difficult

to determine or even non-existent for certain types of physical infrastructure (such as bridges or roads) or for facilities whose operational life is close to expiry. Sometimes the residual value may be estimated taking into account the expected usefulness of the facility for the contracting authority. However, difficulties may be found in establishing the value of unfinished works, in particular if the amount of the investment still required by the contracting authority to render the facility operational would exceed the amount actually invested by the concessionaire. In any event, full payment of residual value seldom takes place, in particular where the project's revenue constitutes the sole remuneration for the concessionaire's investment. Thus, instead of full compensation for the facility's value, the concessionaire often receives compensation only for the residual value of assets that have not yet been fully amortized at the time of termination.

(a) *Termination due to breach by the concessionaire*

44. The concessionaire is not usually entitled to damages in the event of termination due to its own breach. In some cases the concessionaire may be under an obligation to pay damages to the contracting authority, although, in practice, a defaulting concessionaire whose debts are declared due by its creditors would seldom have sufficient financial means left for actual payment of such damages.

45. It should be noted that termination due to breach, even where it is regarded as a sanction for serious performance failures, should not result in the unjust enrichment of either party. Thus, termination does not necessarily entail a right for the contracting authority to take over assets without making any payment to the concessionaire. An equitable solution for dealing with this issue may be to distinguish between the different types of asset, according to the arrangements envisaged for them in the project agreement (see para. 38):

(a) *Assets that must be transferred to the contracting authority.* Where the project agreement requires the automatic transfer of project assets to the contracting authority at the end of the project agreement, termination on breach does not usually entail the payment of compensation to the concessionaire for those assets, except for the residual value of work satisfactorily performed, to the extent that it has not yet been amortized by the concessionaire;

(b) *Assets that may be purchased by the contracting authority, at its option.* Financial compensation may be adequate in cases where the contracting authority has an option to buy the assets at market value on expiry of the project agreement or the right to require that such an option be given to the winner of a new project award. However, it may be legitimate to envisage a financial compensation that is less than the full value of the assets so as to stimulate performance by the concessionaire. By the same token, such compensation may not need to cover the full cost of repaying the concessionaire's outstanding debt. It is advisable to set forth the details of the formula for financial compensation in the project agreement (that is, whether it covers the break-up value of the asset or the lesser of the outstanding debt and the alternative use value);

(c) *Assets that remain the private property of the concessionaire.* Assets in the concessionaire's private property that do not fall under (a) or (b) above may usually be removed and disposed of by the concessionaire, so that the need for compensation arrangements seldom arises. However, a different situation may arise in the case of fully privatized projects, where all assets, including those essential for the provision of the services, are owned by the concessionaire. In such cases, in order to ensure the continuity of the services, the contracting authority may find it necessary to take over the assets, even though not contemplated in the project agreement. In such cases, it would be equitable to compensate the concessionaire for the fair market value of the assets. The project agreement may, however, provide that the compensation should be reduced by the costs incurred by the contracting authority in operating the facility or engaging another operator.

(b) *Termination due to breach by the contracting authority*

46. The concessionaire is usually entitled to full compensation for loss sustained as a result of termination on grounds attributable to the contracting authority. The compensation due to the concessionaire usually includes compensation for the value of the works and installations, to the extent they have not already been amortized, as well as for the loss caused to the concessionaire, including lost profits, which are usually calculated on the basis of the concessionaire's revenue during previous financial years, when termination occurs during the operational phase, or are based on a projection of the expected benefit during the duration originally envisaged. The concessionaire may be entitled to full compensation of debt and equity, including debt service and lost profits.

(c) *Termination on other grounds*

47. When considering compensation arrangements for termination due to circumstances unrelated to breach by either party, it may be useful to distinguish exempting impediments from termination declared by the contracting authority for reasons such as public interest or other similar reasons.

(i) *Termination due to exempting impediments*

48. By definition, exempting impediments are events beyond the parties' control and, as a general rule, termination under such circumstances might not give rise to claims for damages by either party. However, there may be circumstances where it might be equitable to provide for some compensation to the concessionaire, such as fair compensation for works already completed, in particular where, because of the specialized nature of the assets, they cannot be removed by the concessionaire or meaningfully used by it, but may be effectively used by the contracting authority for the purpose of providing the relevant service (a bridge, for instance). However, since termination in such cases cannot be attributed to the contracting authority, the compensation due to the concessionaire may not necessarily need to be "full" compensation (that is, repayment of debt, equity and lost profits).

(ii) *Termination for reasons of public interest*

49. Where the project agreement recognizes the contracting authority's right to terminate for reasons of public interest, the compensation payable to the concessionaire usually covers compensation for the same items included in compensation payable upon termination for breach by the contracting authority (see para. 46), although not necessarily to the full extent. In order to establish the equitable amount of compensation due to the concessionaire, it may be useful to distinguish between termination for reasons of public interest during the construction phase and termination for convenience during the operational phase:

(a) *Termination during the construction phase.* If the project agreement is terminated during the construction phase, the compensation arrangements may be similar to those which are followed in connection with large construction contracts that allow for termination for convenience. In those cases, the contractor is usually entitled to the portion of the price that is attributable to the construction satisfactorily performed, as well as for expenses and losses incurred by the contractor arising from the termination. However, since the contracting authority does not normally pay a price for the construction work carried out by the concessionaire, the main criterion for calculating compensation would typically be the total investment effectively made by the concessionaire up to the time of termination, including all sums actually disbursed under the loan facilities extended by the lenders to the concessionaire for the purpose of carrying out construction under the project agreement, and expenses related to the cancellation of loan agreements. One additional question is whether and to what extent the concessionaire may be entitled to recover lost profit for the portion of the contract that has been terminated for convenience. On the one hand, the concessionaire might have foregone other business opportunities in anticipation of completing the project and operating the facility through the anticipated duration of the concession. On the other hand, an obligation of the contracting authority to compensate the concessionaire for its lost profit might make it financially prohibitive for the contracting authority to exercise its right of termination for convenience. One approach may be for the project agreement to establish a scale of payments to be made by the contracting authority as compensation for lost profits and the amount of the payments depending upon the stage of the construction that has been completed when the project agreement is terminated for convenience;

(b) *Termination during the operational phase.* As regards the construction work satisfactorily completed by the concessionaire, the compensation arrangements may be the same as for termination during the construction phase. However, equitable compensation for termination during the operational phase might require fair compensation for lost profits. The higher standard of compensation in this case may be justified by the fact that, unlike termination during the construction phase, when the contracting authority might need to undertake to complete the work at its own expense, upon termination during the operational phase the contracting authority might be able to receive a completed facility capable of being operated profitably. Compensation for lost profits is often calculated on the basis of the concessionaire's revenue during

a certain number of previous financial years, but in some cases other elements, such as the anticipated profit on the basis of the agreed tariffs, may need to be taken into account. This is so because in some infrastructure projects such as toll roads and similar projects, which are characterized by high financial costs and relatively low income at the early stages of operation, termination may occur before the project has a history of profitability.

3. *Wind-up and transitional measures*

50. Where the facility is transferred to the contracting authority at the end of the concession period, the parties may need to make a series of arrangements in order to ensure that the contracting authority will be able to operate the facility at the prescribed standards of efficiency and safety. The project agreement may provide for the concessionaire's obligation to transfer certain technology or know-how required to operate the infrastructure facility. The project agreement may also provide for the continuation, for a certain transitional period, of certain obligations of the concessionaire in respect of the operation and maintenance of the facility. It may further include an obligation, on the part of the concessionaire, to supply or facilitate the supply of spare parts that may be needed by the contracting authority to carry out repairs in the facility. It should be noted, however, that the concessionaire might not be in a position to undertake itself some of the transitional measures referred to below, since in most cases the concessionaire would have been established for the sole purpose of carrying out the project and would need to procure the relevant technology or spare parts from third parties.

(a) *Transfer of technology*

51. In some cases, the facility transferred to the contracting authority will embody various technological processes necessary for the generation of certain goods, such as electricity or potable water, or the provision of the relevant services, such as telephone services. The contracting authority will often wish to acquire a knowledge of those processes and their application. The contracting authority will also wish to acquire the technical information and skills necessary for the operation and maintenance of the facility. Even where the contracting authority has the basic capability to undertake certain elements of the operation and maintenance (for example, building or civil engineering), the contracting authority may need to acquire a knowledge of special technical processes necessary to effect the operation in a manner appropriate to the facility in question. The communication to the contracting authority of that knowledge, information and skills is often referred to as the "transfer of technology". Obligations concerning the transfer of technology cannot be unilaterally imposed on the concessionaire and, in practice, these matters are the subject of extensive negotiations between the parties concerned. While the host country has a legitimate interest in gaining access to the technology needed to operate the facility, due account should be taken of the commercial interests and business strategies of the private investors.

52. Differing contractual arrangements can be adopted for the transfer of technology and the performance of the other obligations necessary to construct and operate the facility. The transfer of technology itself may occur in different ways, for example, through the licensing of industrial property, through the creation of a joint venture between the parties or the supply of confidential know-how. The *Guide* does not attempt to deal comprehensively with contract negotiation and drafting relating to the licensing of industrial property or the supply of know-how, as this subject has already been dealt with in detail in publications issued by other United Nations bodies.¹ The following paragraphs merely note certain major issues concerning the communication of skills necessary for the operation and maintenance of the facility through the training of the contracting authority's personnel or through documentation.

53. The most important method of conveying to the contracting authority the technical information and skills necessary for the proper operation and maintenance of the works is the training of the contracting authority's personnel. In order to enable the contracting authority to decide on its training requirements, in the request for proposals or during the contract negotiations the contracting authority might request the concessionaire to supply the contracting authority with an organizational chart showing the personnel requirements for the operation and maintenance of the works, including the basic technical and other qualifications the personnel must possess. Such a statement of requirements should be sufficiently detailed to enable the contracting authority to determine the extent of training required in relation to the personnel available to it. The concessionaire will often have the capability to provide the training. In some cases, however, the training may be given more effectively by a consulting engineer or through an institution specializing in training.

54. Technical information and skills necessary for the proper operation and maintenance of the facility may also be conveyed through the supply of technical documentation. The documentation to be supplied may consist of plans, drawings, formulas, manuals of operation and maintenance and safety instructions. It may be advisable to list in the project agreement the documents to be supplied. The concessionaire may be required to supply documents that are comprehensive and clearly drafted and are in a specified language. It may be advisable to obligate the concessionaire, at the request of the contracting authority, to give demonstrations of procedures described in the documentation if the procedures cannot be understood without demonstrations.

¹The negotiation and drafting of contracts for the licensing of industrial property and the supply of know-how is dealt with in detail in World Intellectual Property Organization, *Licensing Guide for Developing Countries* (WIPO publication No. 620 (E), 1977). The main issues to be considered in negotiating and drafting such contracts are set forth in the *Guidelines for Evaluation of Transfer of Technology Agreements*, Development and Transfer of Technology Series, No. 12 (ID/233, 1979), and in the *Guide for Use in Drawing Up Contracts Relating to the International Transfer of Know-How in the Engineering Industry* (United Nations publication, Sales No. E.70.II.E.15). Another relevant publication is the *Handbook on the Acquisition of Technology by Developing Countries* (United Nations publication, Sales No. E.78.II.D.15). For a discussion of transfer of technology in the context of contracts for the construction of industrial works, see the *UNCITRAL Legal Guide on Drawing Up International Contracts for the Construction of Industrial Works* (United Nations publication, Sales No. E.87.V.10), chap. VI, "Transfer of technology".

55. The points in time when the documentation is to be supplied may be specified. The project agreement may provide that the supply of all documentation is to be completed by the time fixed in the contract for completion of the construction. The parties may also wish to provide that transfer of the facility is not to be considered completed unless all documentation relating to the operation of the works and required under the contract to be delivered prior to the completion has been supplied. It may be advisable to provide that some documentation, such as operating manuals, is to be supplied during the course of construction, as such documentation may enable the contracting authority's personnel or engineer to obtain an understanding of the working of machinery or equipment while it is being erected.

(b) Assistance in connection with operation and maintenance of the facility after its transfer

56. The degree of assistance from the concessionaire needed by the contracting authority will depend on the technology and skilled personnel available to the contracting authority. If the contracting authority lacks personnel sufficiently skilled for the technical operation of the facility, it may wish to obtain the concessionaire's assistance in operating the facility, at least for an initial period. The contracting authority may, in some cases, wish the concessionaire to provide the personnel to occupy many of the technical posts in the facility, while in other cases the contracting authority may wish the concessionaire only to provide technical experts to collaborate in an advisory capacity with the contracting authority's personnel in the performance of a few highly specialized operations.

57. In order to assist the contracting authority in operating and maintaining the facility, the project agreement may obligate the concessionaire to submit, prior to the transfer of the facility, an operation and maintenance programme designed to keep the facility operating over its remaining lifetime at the level of efficiency required under the project agreement. An operation and maintenance programme would include matters such as an organizational chart showing the key personnel required for the technical operation of the facility and the functions to be discharged by each person; periodic inspection of the facility; lubrication, cleaning and adjustment; and replacement of defective or worn-out parts. Maintenance may also include operations of an organizational character, such as establishing a maintenance schedule or maintenance records. The concessionaire may also be required by the contracting authority to supply operation and maintenance manuals setting out appropriate operation and maintenance procedures. Those manuals should be in a format and language readily understood by the contracting authority's personnel.

58. An effective means of training the contracting authority's personnel in operation and maintenance procedures may be to provide in the project agreement that the personnel of the contracting authority are to be associated with the personnel of the concessionaire in carrying out the operation and maintenance for a certain time prior to or beyond the transfer of the facility. The positions to be occupied by the personnel employed by the contracting author-

ity can then be identified and their qualifications and experience specified. In order to avoid friction and inefficiency, it is desirable that any authority to be exercised by the personnel of each party over the personnel of the other during the relevant period be clearly described.

(c) *Supplies of spare parts*

59. In projects that provide for the transfer of the facility to the contracting authority, the contracting authority will have to obtain spare parts to replace those which are worn out or damaged and to maintain, repair and operate the facility. Spare parts may not be available locally and the contracting authority may have to depend on the concessionaire to supply them. The planning of the parties with respect to the supply of spare parts and services after the transfer of the facility would be greatly facilitated if the parties were to anticipate and provide in the project agreement for the needs of the contracting authority in that regard. However, given the long duration of most infrastructure projects, it may be difficult for the parties to anticipate and provide in the project agreement for the needs of the contracting authority after the transfer of the facility.

60. A possible approach may be for the parties to enter into a separate contract regulating these matters.² Such a contract may be entered into closer in time to the transfer of the facility, when the contracting authority may have a clearer view of its requirements. If spare parts are manufactured not by the concessionaire but for the concessionaire by suppliers, the contracting authority may prefer to enter into contracts with those suppliers rather than to obtain them from the concessionaire or, alternatively, the contracting authority may wish to have the concessionaire procure them as the contracting authority's agent.

61. It is desirable for the contracting authority's personnel to develop the technical capacity to install the spare parts. For this purpose, the project agreement may obligate the concessionaire to supply the necessary instruction manuals, tools and equipment. The instruction manuals should be in a format and language readily understood by the contracting authority's personnel. The contract may also require the concessionaire to furnish "as built" drawings indicating how the various pieces of equipment interconnect and how access can be obtained to them to enable the spare parts to be installed and to enable maintenance and repairs to be carried out. In certain cases, it may be appropriate for the concessionaire to be required to train the contracting authority's personnel in the installation of spare parts.

(d) *Repairs*

62. It is in the contracting authority's interest to enter into contractual arrangements that will ensure that the facility will be repaired expeditiously in the

²The Economic Commission for Europe has prepared a *Guide on Drawing Up International Contracts for Services Relating to Maintenance, Repair and Operation of Industrial and Other Works* (ECE/TRADE/154), *mutatis mutandis*, which may, assist parties in drafting a separate contract or contracts dealing with maintenance and repair of the facility after its transfer to the contracting authority.

event of a breakdown. In many cases, the concessionaire may be better qualified than a third person to effect repairs. In addition, if the project agreement prevents the contracting authority from disclosing to third persons the technology supplied by the concessionaire, this may limit the selection of third persons to effect repairs to those who provide assurances regarding non-disclosure of the concessionaire's technology that are acceptable to the concessionaire. On the other hand, if major items of equipment have been manufactured for the concessionaire by suppliers, the contracting authority may find it preferable to enter into independent contracts for repair with them. In defining the nature and duration of repair obligations imposed on the concessionaire, if any, it is advisable to do so clearly and to distinguish them from obligations assumed by the concessionaire under quality guarantees to remedy defects in the facility.

VI. Settlement of disputes

A. General remarks

1. An important factor for the implementation of privately financed infrastructure projects is the legal framework in the host country for the settlement of disputes. Investors, contractors and lenders will be encouraged to participate in projects in countries where they have the confidence that any disputes arising out of contracts forming part of the project will be resolved fairly and efficiently. By the same token, efficient procedures for avoiding disputes or settling them expeditiously will facilitate the exercise of the contracting authority's monitoring functions and reduce the contracting authority's overall administrative cost. In order to create a more hospitable climate for investors, the legal framework of the host country should give effect to certain basic principles, such as the following: foreign firms should be guaranteed access to the courts under substantially the same conditions as domestic ones; parties to private contracts should have the right to choose foreign law as the law applicable to their contracts; foreign judgements should be enforceable; and there should be neither unnecessary restrictions to access to non-judicial dispute settlement mechanisms nor legal impediments for the creation of facilities for settling disputes amicably outside the judicial system.

2. Privately financed infrastructure projects typically require the establishment of a network of interrelated contracts and other legal relationships involving various parties. Legislative provisions dealing with the settlement of disputes arising in the context of these projects must take account of the diversity of relations, which may call for different dispute settlement methods depending on the type of dispute and the parties involved. The main disputes may be divided into three broad categories:

(a) *Disputes arising under agreements between the concessionaire and the contracting authority and other governmental agencies.* In most civil law countries, the project agreement is governed by administrative law (see chap. VII, "Other relevant areas of law", paras. 24-27), while in other countries the agreement is in principle governed by contract law as supplemented by special provisions developed for government contracts for the provision of public services. This regime may have implications for the dispute settlement mechanism that the parties to the project agreement may be able to agree upon. Similar considerations may also apply to certain contracts entered into between the concessionaire and governmental agencies or government-owned companies supplying goods or services to the project or purchasing goods or services generated by the infrastructure facility;

(b) *Disputes arising under contracts and agreements entered into by the project promoters or the concessionaire with related parties for the implemen-*

tation of the project. These contracts usually include at least the following: (i) contracts between parties holding equity in the project company (e.g. shareholders' agreements, agreements regarding the provision of additional financing or arrangements regarding voting rights); (ii) loan and related agreements, which involve, apart from the project company, parties such as commercial banks, governmental lending institutions, international lending institutions and export credit insurers; (iii) contracts between the project company and contractors, which themselves may be consortia of contractors, equipment suppliers and providers of services; (iv) contracts between the project company and the parties who operate and maintain the project facility; and (v) contracts between the concessionaire and private companies for the supply of goods and services needed for the operation and maintenance of the facility;

(c) *Disputes between the concessionaire and other parties.* These other parties include the users or customers of the facility, who may be, for example, a government-owned utility company that purchases electricity or water from the project company so as to resell it to the ultimate users; commercial companies, such as airlines or shipping lines contracting for the use of the airport or port; or individual persons paying for the use of a toll road. The parties to these disputes may not necessarily be bound by any prior legal relationship of a contractual or similar nature.

B. Disputes between the contracting authority and the concessionaire

3. Disputes that arise under the project agreement often involve problems that do not frequently arise in connection with other types of contracts. This is due to the complexity of infrastructure projects and the fact that they are to be performed over a long period of time, with a number of enterprises participating in the construction and in the operational phases. Also, these projects usually involve governmental agencies and a high level of public interest. These circumstances place emphasis on the need to have mechanisms in place that avoid as much as possible the escalation of disagreements between the parties and preserve their business relationship; that prevent the disruption of the construction works or the provision of the services; and that are tailored to the particular characteristics of the disputes that may arise.

4. Some of the main considerations particular to the various phases of implementation of privately financed infrastructure projects are discussed in this section. The settlement of the concessionaire's grievances in connection with decisions by regulatory agencies has been considered in the context of the authority to regulate infrastructure services (see chap. I, "General legislative and institutional framework", paras. 51-53). The settlement of disputes arising during the process of selecting a concessionaire (that is, pre-contractual disputes) has also been dealt with earlier in the *Guide* (see chap. III, "Selection of the concessionaire", paras. 127-131).

1. General considerations on methods for prevention and settlement of disputes

5. The issues that most frequently give rise to disputes during the life of the project agreement are those related to possible breaches of the agreement during the construction phase, the operation of the infrastructure facility or in connection with the expiry or termination of the project agreement. These disputes may be very complex and they often involve highly technical matters that need to be resolved speedily in order not to disrupt the construction or the operation of the infrastructure facility. For these reasons it is advisable for the parties to devise mechanisms that allow for the choice of competent experts to assist in the settlement of disputes. Furthermore, the long duration of privately financed infrastructure projects makes it important to devise mechanisms to prevent, as much as possible, disputes from arising so as to preserve the business relationship between the parties.

6. With a view to achieving the objectives mentioned above, project agreements often provide for composite dispute-settlement clauses designed to prevent, to the extent possible, disputes from arising, to foster reaching agreed solutions and to put in place efficient dispute settlement methods when disputes nevertheless arise. Such clauses typically provide for a sequential series of steps starting with an early warning of issues that may develop into a dispute unless the parties take action to prevent them. When a dispute does occur it is provided that the parties should exchange information and discuss the dispute with a view to identifying a solution. If the parties are unable to resolve the dispute themselves, then either party may require participation of an independent and impartial third party to assist them to find an acceptable solution. In most cases, adversarial dispute settlement mechanisms are only used when the disputes cannot be settled through the use of such conciliatory methods.

7. However, there may be limits to the parties' freedom to agree to certain dispute prevention or dispute settlement methods: one such limit may arise from the subject matter of the dispute; another limit may in some legal systems arise from the governmental character of the contracting authority. In some legal systems, the traditional position has been that the Government and its agencies may not agree on certain dispute settlement methods, in particular, arbitration. This position has often been restricted to mean that it does not apply to public enterprises of industrial or commercial character, which, in their relations with third parties, act pursuant to private law or commercial law.

8. Limitations to the freedom to agree on dispute settlement methods, including arbitration, may also relate to the legal nature of the project agreement. Under some civil law systems where project agreements are regarded as administrative contracts, disputes arising thereunder may need to be settled through the judiciary or through administrative courts of the host country. Under other legal systems, similar prohibitions may be expressly included in legislation or judicial precedents directly applicable to project agreements, or may be the result of established contract practices, usually based on legislative rules or regulations.

9. For countries that wish to allow the use of non-judicial methods, including arbitration, for the settlement of disputes arising in connection with privately financed infrastructure projects, it is important to remove possible legal obstacles and to provide a clear authorization for domestic contracting authorities to agree on dispute settlement methods. The absence of such legislative authority may give rise to questions as to the validity of the dispute-settlement clause and cause delay in the settlement of disputes. If, for example, an arbitral tribunal finds that the arbitration agreement has been validly concluded despite any subsequent defence that the contracting authority had no authorization to conclude it, the question may reappear at the recognition and enforcement stage before a court in the host country or before a court of a third country where the award is to be recognized or enforced.

2. *Commonly used methods for preventing and settling disputes*

10. The following paragraphs set out the essential features of methods used for preventing and settling disputes and consider their suitability for the various phases of large infrastructure projects, namely, the construction phase, the operational phase and the post-termination phase. Although the project agreement usually provides for composite dispute prevention and dispute settlement mechanisms, care should be taken to avoid excessively complex procedures or to impose too many layers of different procedures. The brief presentation of selected methods for dispute prevention and dispute settlement methods contained in the following paragraphs is intended to inform legislators about the particular features and usefulness of these various methods. It should not be understood as a recommendation for the use of any particular combination of methods.

(a) Early warning

11. Early warning provisions may be an important tool to avoid disputes. Under these provisions, if one of the parties to a contract feels that events that have occurred, or claims that the party intends to make, have the potential to cause disputes, these events or claims should be brought to the attention of the other party as soon as possible. Delays in making these claims are not only a source of conflict, because they are likely to surprise the other party and therefore create resentment and hostility, but they also render the claims more difficult to prove. For that reason, early warning provisions typically require the claiming party to submit a quantified claim, along with the necessary proof, within an established time period. To make the provision effective, a sanction is frequently included for non-compliance with the provision, such as the loss of the right to pursue the claim or an increased burden of proof. In infrastructure projects, early warning frequently refers to events that might adversely affect the quality of the works or the public services, increase their cost, cause delays or endanger the continuity of the service. Early warning provisions are therefore useful throughout the duration of an infrastructure project.

(b) *Partnering*

12. Another tool that is used as a means of dispute avoidance is partnering. The object of partnering is to create, through mutually developed formal strategies and from the outset of a project, an environment of trust, teamwork and cooperation among all key parties involved in the project. Partnering has been found to be useful to avoid disputes and to commit the parties to work efficiently to achieve the goals of the project. The partnering relationships are defined in workshops attended by the key parties to the project and usually organized by the contracting authority. At the initial workshop, a mutual understanding of the concept of partnering is established, goals for the project for all the parties are defined and a procedure to resolve critical issues quickly is developed. At the conclusion of this workshop, a “partnering charter” is drafted and signed by the participants, signifying their commitment to work jointly towards the success of the project. The charter usually includes an issue resolution procedure designed to determine claims and resolve other problems, beginning at the lowest possible level of management and at the earliest possible opportunity. If a solution is not reached within a given time-frame, the issue is raised to the next level of management. Outsiders to the project are only called in if no agreement by the people responsible for the project is achieved.

(c) *Facilitated negotiation*

13. The purpose of this procedure is to aid the parties in the negotiation process. The parties appoint a facilitator at the commencement of the project. His function is to assist the parties in resolving any disputes, without providing subjective opinions on the issues, but rather coaxing them into analysing thoroughly the merits of their cases. This procedure is specially useful when there are numerous parties involved who would find it difficult to negotiate and coordinate all the differing opinions without such facilitation.

(d) *Conciliation and mediation*

14. The term “conciliation” is used in the *Guide* as a broad notion referring to proceedings in which a person or a panel assists the parties in an independent and impartial manner in their attempt to reach an amicable settlement of their dispute. Conciliation differs from negotiations between the parties in dispute (in which the parties would typically engage after the dispute has arisen) in that conciliation involves independent and impartial assistance to settle the dispute, whereas in settlement negotiations between the parties no third-person assistance is involved. The difference between conciliation and arbitration is that conciliation ends either in the settlement of the dispute agreed by the parties or it ends unsuccessfully; in arbitration, however, the arbitral tribunal imposes a binding decision on the parties, unless they have settled the dispute before the award is made. In practice, such conciliation proceedings are referred to by various expressions, including “mediation”. Nevertheless, in the legal tradition of some countries, a distinction is drawn

between conciliation and mediation to emphasize the fact that, in conciliation, a third party is trying to bring together the disputing parties to help them reconcile their differences, while mediation goes further by allowing the mediator to suggest terms for the resolution of the dispute. However, the terms “conciliation” and “mediation” are used as synonyms more frequently than not.

15. Conciliation is increasingly being increasingly practised in various parts of the world, including in regions where it was not commonly used in the past. This trend is reflected, *inter alia*, in the establishment of a number of private and public bodies offering conciliation services to interested parties. The conciliation procedure is usually private, confidential, informal and easily pursued. It may also be quick and inexpensive. The conciliator may assume multiple roles and is in general more active than a facilitator. He or she may frequently challenge the parties’ position to stress weaknesses that usually facilitate agreement and, if authorized, may suggest possible settlement scenarios. The procedure is generally non-binding and the conciliator’s responsibility is to facilitate settlement by directing the parties’ attention to the issues and possible solutions, rather than passing judgement. This procedure is particularly useful when there are many parties involved and it would therefore be difficult to achieve an agreement by direct negotiations.

16. If the parties provide for conciliation in the project agreement, they will have to settle a number of procedural questions in order to increase the chance of a settlement. Settling such procedural questions is greatly facilitated by the incorporation into the contract, by reference, of a set of conciliation rules such as the UNCITRAL Conciliation Rules.¹ Other sets of conciliation rules have been prepared by various international and national organizations.

(e) *Non-binding expert appraisal*

17. This is a procedure where a neutral third party is charged with providing an appraisal on the merits of the dispute and suggested outcome. It serves as a “reality check” showing the contesting parties what the possible outcome of the more expensive and usually slower binding procedures such as arbitration or court proceedings would be. This procedure is useful where the parties have difficulty in communicating because their positions have become entrenched or where they do not see clearly the weaknesses of their positions or the strengths of the other party’s positions. A non-binding expert appraisal is usually followed by negotiations, either direct or facilitated.

¹ For the official text of the *UNCITRAL Conciliation Rules*, see *Official Records of the General Assembly, Thirty-fifth Session, Supplement No. 17 (A/35/17)*, para. 106 (*Yearbook of the United Nations Commission on International Trade Law*, vol. XI, 1980, part one, chap. II, sect. A (United Nations publication, Sales No. E.81.V.8)). The UNCITRAL Conciliation Rules have also been reproduced in booklet form (United Nations publication, Sales No. E.81.V.6). Accompanying the Rules is a model conciliation clause, which reads: “Where, in the event of a dispute arising out of or relating to this contract, the parties wish to seek an amicable settlement of that dispute by conciliation, the conciliation shall take place in accordance with the UNCITRAL Conciliation Rules as at present in force”. The use of the UNCITRAL Conciliation Rules was recommended by the General Assembly in its resolution 35/52 of 4 December 1980.

(f) *Mini-trial*

18. This procedure assumes the form of a mock trial in which site-level personnel of each party make submissions to a “tribunal” composed of a senior executive of each party and a third neutral person. After the submissions, which are typically to be made within predetermined time periods, the executives enter into a facilitated negotiation procedure with the assistance of a neutral person, to try to reach an agreement taking advantage of the issues that have been elucidated during the “trial”. Counsel for the parties are frequently present and are useful in identifying the relevant issues. The purpose of the mini-trial is to inform senior executives of the issues involved in the dispute and to serve as a reality check of what the outcome of a real trial might be.

(g) *Senior executive appraisal*

19. This procedure is similar to the mini-trial but it is less adversarial and uses a more consensus-oriented approach. The procedure begins with the presentation of short position papers by each party, followed by short responses. At an “appraisal conference” headed by a facilitator, a senior executive from each of the parties makes brief oral presentations elucidating the issues submitted in the position papers or other points raised by the parties or the facilitator. This conference is followed by a negotiation meeting, chaired by the facilitator, with a view to reaching an agreement. Both the mini-trial and the senior executive appraisal tend to be less of a strong reality check than the non-binding expert appraisal and therefore less likely to motivate difficult decisions in the absence of commercial pressure to do so.

(h) *Review of technical disputes by independent experts*

20. During the construction phase, the parties may wish to consider providing for certain types of dispute to be referred to an independent expert appointed by both parties. This method may be of particular use in connection with disagreements relating to technical aspects of the construction of the infrastructure facility (for example, whether the works comply with contractual specifications or technical standards).

21. The parties may, for instance, appoint a design inspector or a supervisor engineer, respectively, to review disagreements relating to the inspection and approval of the design, and the progress of construction works (see chap. IV, “Construction and operation of infrastructure: legislative framework and project agreement”, paras. 69-79). The independent experts should have expertise in the designing and construction of similar projects. The powers of the independent expert (such as whether the independent expert makes recommendations or issues binding decisions), as well as the circumstances under which the independent expert’s advice or decision may be sought by the parties, should be set forth in the project agreement. In some large infrastructure projects, for instance, the advice of the independent expert may be sought by the concessionaire whenever there is a disagreement between the concessionaire and the contracting authority as to whether certain aspects of the design

or construction works conform with the applicable specifications or contractual obligations. Referral of a matter to a design inspector or to a supervising engineer, as appropriate, may be particularly relevant in connection with provisions in the project agreement that require prior consent of the contracting authority for certain actions by the concessionaire, such as final authorization for operation of the infrastructure facility (see chap. IV, “Construction and operation of infrastructure: legislative framework and project agreement”, para. 78).

22. Independent experts have often been used for the settlement of technical disputes under construction contracts, and the various mechanisms and procedures developed in the practice of the construction industry may be used, *mutatis mutandis*, in connection with privately financed infrastructure projects. However, it should be noted that the scope of disputes between the contracting authority and the concessionaire is not necessarily the same as would be the case for disputes that typically arise under a construction contract. This is so because the respective positions of the contracting authority and the concessionaire under the project agreement are not fully comparable with those of the owner and the performer of works under a construction contract. For instance, disputes concerning the amount of payment due to the contractor for the quantities of works actually performed, which are frequent in construction contracts, are not typical for the relations between contracting authority and concessionaire, since the latter does not usually receive payments from the contracting authority for the construction works performed.

(i) *Dispute review boards*

23. Project agreements for large infrastructure projects often establish permanent boards composed of experts appointed by both parties, possibly with the assistance of an appointing authority, for the purpose of assisting in the settlement of disputes that may arise during the construction and the operational phases (referred to in the *Guide* as “dispute review boards”). Proceedings before a dispute review board can be informal and expeditious, and tailored to suit the characteristics of the dispute that it is called upon to settle. The appointment of a dispute review board may prevent misunderstandings or differences between the parties from developing into formal disputes that would require settlement in arbitral or judicial proceedings. In fact, its effectiveness as a tool for avoiding disputes is one of the special strengths of this procedure, but a dispute review board may also serve as a mechanism to resolve disputes, in particular when the board is given the power to render binding decisions.

24. Under the dispute review board procedure, the parties typically select, at the outset of the project, three experts renowned for their knowledge in the field of the project to constitute the board. These experts may be replaced if the project comprises different stages that may require different expertise (that is, different expertise will be required during the construction of the facility and during the later administration of the public service), and in some large infrastructure projects more than one board has been established. For example, one dispute review board may deal exclusively with disputes regarding matters

of a technical nature (e.g. engineering design, fitness of certain technology, compliance with environmental standards) whereas another board may deal with disputes of a contractual or financial nature (regarding, for instance, the amount of compensation due for delay in issuing licences or disagreements on the application of price adjustment formulas). Each board member should be experienced in the particular type of project, including experience in the interpretation and administration of project agreements, and should undertake to remain impartial and independent of the parties. These persons may be furnished with periodic reports on the progress of construction or on the operation of the infrastructure facility, as appropriate, and may be informed immediately of differences arising between the parties. They may meet with the parties, either at regular intervals or when the need arises, to consider differences that have arisen and to suggest possible ways of resolving those differences.

25. In their capacity as agents to avert disputes, the members of the board may make periodic visits to the project site, meet with the parties and keep informed of the progress of the work. These meetings help identify any potential conflicts early, before they start festering and turn into full-fledged disputes. When potential conflicts are detected, the board proposes solutions, which, given the expertise and prestige of its members, are likely to be accepted by the parties. Referral of a dispute triggers an evaluation by the board, which is done in an informal manner, typically by discussion with the parties during a regular site visit. The board controls the discussion, but each party is given a full opportunity to state its views, and the dispute review board is free to ask questions and to request documents and other evidence. The advantages of conducting hearings at the job site, soon after the events have occurred and before adversarial positions have hardened, are obvious. The board then meets privately and seeks to formulate a recommendation or a decision. If the parties do not accept these proposals and disputes do arise, the board, if authorized to do so by the parties, is in a unique position to solve them expeditiously because of its familiarity with the problems and contractual documents.

26. Given their usually long duration, many circumstances relevant to the execution of privately financed infrastructure projects may change before the end of the concession term. While the impact of some changes may be automatically covered in the project agreement (see chap. IV, "Construction and operation of infrastructure: legislative framework and project agreement", paras. 126-130) there are changes that might not lend themselves easily to inclusion in an automatic adjustment mechanism or that the parties may prefer to exclude from such a mechanism. It is therefore important for the parties to establish mechanisms for dealing with disputes that may arise in connection with changing circumstances. This is of particular significance for the operational phase of the project. Where the parties have agreed on rules that allow a revision of the terms of the project agreement following certain circumstances, the question may arise as to whether those circumstances have occurred and, if so, how the contractual terms should be changed or supplemented. With a view to facilitating a resolution of possible disputes and avoiding a stalemate in case the parties are unable to agree on a contract revision, it is advisable for the parties to clarify whether and to what extent

certain contractual terms may be changed or supplemented by the dispute review board. It may be noted, in this context, that the parties might not always be able to rely on an arbitral tribunal or a domestic court for that purpose. Indeed, under some legal systems, courts and arbitrators are not competent to change or supplement contractual terms. Under other legal systems, courts and arbitrators may do so only if they are expressly so authorized by the parties. Under yet other legal systems, arbitrators may do so but courts may not.

27. The law governing arbitral or judicial proceedings may determine the extent to which the parties may authorize arbitrators or a court to review a decision of the dispute review board. Excluding such review has the advantage that the decision of the dispute review board would be immediately final and binding. However, permitting such a review gives the parties greater assurance that the decision will be correct. Early clauses on dispute review boards did not provide that their recommendations would become binding if not challenged in arbitral or judicial proceedings. In practice, however, the combination of the persuasive force of unanimous recommendations by independent experts agreed by the parties has led both contracting authorities and project companies to accept the recommendations voluntarily rather than litigate or arbitrate. Recent contract provisions on dispute review boards usually provide that a decision of the board, while not immediately binding on the parties, becomes binding unless one or both parties refer the dispute to arbitration or initiate judicial proceedings within a specified period of time. Apart from avoiding potentially protracted litigation or arbitration, the parties often take into account the potential difficulty of overcoming what might be regarded by the court or arbitral tribunal as a powerful recommendation, inasmuch as it had been made by independent experts familiar with the project from the outset and was based on contemporaneous observation of the project prior to, and at the time of, the dispute having first arisen.

28. Although this occurs very rarely, the parties may agree to make the board's decision final and binding. It should be noted, however, that despite the parties' agreement to be bound by the board's decision, under many legal systems, the decision by the dispute review board, while binding as a contract, may not be enforceable in a summary proceeding, such as a proceeding for the enforcement of an arbitral award, since it does not have the status of an arbitral award. If the parties contemplate providing for proceedings before a dispute review board, it will be necessary for them to settle various aspects of those proceedings in the project agreement. It would be desirable for the project agreement to delimit as precisely as possible the authority conferred upon the dispute review board. With regard to the nature of their functions, the project agreement might authorize the dispute review board to make findings of fact and to order interim measures. It may specify the functions to be performed by the dispute review board and the type of issues with which they may deal. If the parties are permitted to initiate arbitral or judicial proceedings within a specified period of time after the decision is rendered, the parties might specify that findings of fact made by a dispute review board are to be regarded as conclusive in arbitral or judicial proceedings. The project agreement might also obligate the parties to implement a decision by the dispute review board con-

cerning interim measures or a decision on the substance of specified issues; if the parties fail to do so, they will be considered as having failed to perform a contractual obligation. Regarding the duration of the board's functions, the project agreement may provide that the board will continue to function for a certain period beyond the expiry or termination of the project agreement, in order to deal with disputes that may arise at that stage (for example, disputes as to the condition of and compensation due for assets handed over to the contracting authority).

(j) *Non-binding arbitration*

29. This procedure is sometimes used when less adversarial methods such as facilitated negotiation, conciliation or dispute review board procedures have been unsuccessful. Non-binding arbitration is conducted in the same manner as binding arbitration, and the same rules may be used except that the procedure ends with a recommendation. The procedure contemplates that the parties will proceed directly to litigation if the dispute is still unresolved under non-binding arbitration. Those who choose this procedure do so (a) if they have reservations about the binding nature of arbitration; or (b) as an incentive to avoid both arbitration and litigation, arbitration because it would seem redundant to go through the same procedure twice and litigation because of its length and cost.

(k) *Arbitration*

30. In recent years, arbitration has been used increasingly for settling disputes arising under privately financed infrastructure projects. Arbitration is typically used both for the settlement of disputes that arise during the construction or operation of the infrastructure facility and for the settlement of disputes related to the expiry or termination of the project agreement. Arbitration, often in a country other than the host country, is preferred, and in many cases required, by private investors and lenders, in particular foreign ones, since arbitral proceedings may be structured by the parties so as to be less formal than judicial proceedings and better suited to the needs of the parties and to the specific features of the disputes likely to arise under the project agreement. The parties can choose as arbitrators persons who have expert knowledge of the particular type of project. They may choose the place where the arbitral proceedings are to be conducted. They may also choose the language or languages to be used in the arbitral proceedings. Arbitral proceedings may be less disruptive of business relations between the parties than judicial proceedings. The proceedings and arbitral awards can be kept confidential, while judicial proceedings and decisions usually cannot. Furthermore, the enforcement of arbitral awards in countries other than the country in which the award was rendered is facilitated by the wide acceptance of the Convention on the Recognition and Enforcement of Foreign Arbitral Awards of 1958.²

²See United Nations, *Treaty Series*, vol. 330, No. 4739, reproduced in the *Register of Conventions and Other Instruments concerning International Trade Law*, vol. II (United Nations publication, Sales No. E.73.V.3).

31. With regard, in particular, to infrastructure projects involving foreign investors, it may be noted that a framework for the settlement of disputes between the contracting authority and foreign companies participating in a project consortium may be provided through adherence to the Convention on the Settlement of Investment Disputes between States and Nationals of Other States.³ The Convention, which has thus far been adhered to by 131 States, established the International Centre for the Settlement of Investment Disputes (ICSID). ICSID is an autonomous international organization with close links to the World Bank. ICSID provides facilities for the conciliation and arbitration of disputes between member countries and investors who qualify as nationals of other member countries. Recourse to ICSID conciliation and arbitration is voluntary. However, once the parties to a contract or dispute have consented to arbitration under the ICSID Convention, neither can withdraw its consent unilaterally. All ICSID members, whether or not parties to the dispute, are required by the Convention to recognize and enforce ICSID arbitral awards. The consent of the parties to ICSID arbitration may be given with regard to an existing dispute or with respect to a defined class of future disputes. The consent of the parties need not, however, be expressed in relation to a specific project; a host country might in its legislation on the promotion of investment offer to submit disputes arising out of certain classes of investment to the jurisdiction of ICSID and the investor might give its consent by accepting the offer in writing.

32. Bilateral investment agreements may also provide a framework for the settlement of disputes between the contracting authority and foreign companies. In these treaties, the host State typically extends to investors that qualify as nationals of the other signatory State a number of assurances and guarantees (see chap. VII, “Other relevant areas of law”, paras. 4-6) and expresses its consent to arbitration, for instance, by referral to ICSID or to an arbitral tribunal applying the UNCITRAL Arbitration Rules.⁴

(i) *Sovereign immunity*

33. The legislator may wish to review its laws on sovereign immunity and, to the extent considered advisable, clarify in which areas contracting authorities may or may not plead sovereign immunity. When arbitration is allowed and agreed upon between the parties to the project agreement, the implementation of an agreement to arbitrate may be frustrated or hindered if the contracting

³United Nations *Treaty Series*, vol. 575, No. 8359.

⁴The official text of the UNCITRAL Arbitration Rules is reproduced in *Official Records of the General Assembly, Thirty-first Session, Supplement No. 17 (A/31/17)*, chap.V, sect. C. (*Yearbook of the United Nations Commission on International Trade Law*, vol. VII, 1976, part one, chap. II, sect. A (United Nations publication, Sales No. E.77.V.1)). The UNCITRAL Arbitration Rules have also been reproduced in booklet form (United Nations publication, Sales No. E.77.V.6). Accompanying the Rules is a model arbitration clause, which reads: “Any dispute, controversy or claim arising out of or relating to this contract, or the breach, termination or invalidity thereof, shall be settled by arbitration in accordance with the UNCITRAL Arbitration Rules as at present in force.” The use of the UNCITRAL Arbitration Rules was recommended by the General Assembly in its resolution 31/98 of 15 December 1976.

authority is able to plead sovereign immunity, either as a bar to the commencement of arbitral proceedings or as a defence against recognition and enforcement of the award. Sometimes the law on this matter is not clear, which may raise concerns with the interested parties (for instance, the concessionaire, project promoters and lenders) that an agreement to arbitrate might not be effective. In order to address such possible concerns, it is advisable to review the law on this topic and to indicate the extent to which the contracting authority may raise a plea of sovereign immunity.

34. In addition, a contracting authority against which an award has been issued may raise a plea of immunity from execution against public property. There is a diversity of approaches to the question of sovereign immunity from execution. For example, under some national laws immunity does not cover governmental entities when engaged in commercial activities. In other national laws a link is required between the property to be attached and the claim in that, for example, immunity cannot be pleaded in respect of funds allocated for economic or commercial activity governed by private law upon which the claim is based or that immunity cannot be pleaded with respect to assets set aside by the State to pursue its commercial activities. In some countries, it is considered that it is for the Government to prove that the assets to be attached are in non-commercial use.

35. In some contracts involving entities that might plea sovereign immunity, clauses have been included to the effect that the Government waives its right to plead sovereign immunity. Such a consent or waiver might be contained in the project agreement or an international agreement; it may be limited to recognizing that certain property is used or intended to be used for commercial purposes. Such written clauses may be necessary inasmuch as it is not clear whether the conclusion of an arbitration agreement and participation in arbitral proceedings by the governmental entity constitutes an implied waiver of sovereign immunity from execution.

(ii) *Effectiveness of the arbitration agreement and enforceability of the award*

36. The effectiveness of an agreement to arbitrate depends on the legislative regime where the arbitration takes place. If the legislative regime for arbitration in the host country is seen as unsatisfactory, for instance, because it is found to pose unreasonable restrictions on party autonomy, a party might wish to agree on a place of arbitration outside the host country. It is therefore important for the host country to ensure that the domestic legislative regime for arbitration resolves the principal procedural issues in a manner appropriate for international arbitration cases. Such a regime is contained in the UNCITRAL Model Law on International Commercial Arbitration.⁵

⁵For the report of the United Nations Commission on International Trade Law on the work of its eighteenth session, see *Official Records of the General Assembly, Fortieth Session, Supplement No. 17 (A/40/17)*, para. 332 and annex I. The General Assembly, in its resolution 40/72 of 11 December 1985, recommended that all States give due consideration to the Model Law on International Commercial Arbitration, in view of the desirability of uniformity of the law of arbitral procedures and the specific needs of international commercial arbitration practice.

37. If the arbitration takes place outside the host country or if an award rendered in the host country would need to be enforced abroad, the effectiveness of the arbitration agreement would also depend on legislation governing the recognition and enforcement of arbitral awards. The Convention on the Recognition and Enforcement of Foreign Arbitral Awards (see para. 30), *inter alia*, deals with the recognition of an arbitration agreement and the grounds on which the court may refuse to recognize or enforce an award. The Convention is generally regarded as providing an acceptable and balanced regime for the recognition and enforcement of arbitral awards. The fact that the host country is a party to the Convention is likely to be seen as a crucial element in assessing the legal certainty of binding commitments and of the reliability of arbitration as a method for solving disputes by arbitration with parties from the country. It would also facilitate the enforcement abroad of an arbitral award rendered in the host country.

(1) *Judicial proceedings*

38. As indicated earlier, there are legal systems where the settlement of disputes arising out of agreements related to the provision of public services is a matter of the exclusive competence of the domestic judiciary or administrative courts. In some countries, governmental agencies lack the power to agree to arbitration, except under specific circumstances (see paras. 7-9), while in other legal systems the parties have the freedom to choose between judicial and arbitral proceedings.

39. Where it is possible for the parties to choose between judicial and arbitral proceedings, the contracting authority may see reasons for leaving any dispute to be resolved by the courts of the host country. Those courts are familiar with the law of the country, which often includes legislation specifically concerned with the project agreement. Furthermore, the contracting authority or other governmental agencies involved in the dispute may prefer local courts because of the familiarity with the court procedures and the language of the proceedings. It may also be considered that, to the extent project agreements involve issues of public policy and the protection of public interest, State courts are in a better position to give them proper effect.

40. However, such a view by the contracting authority may not be shared by prospective investors, financiers and other private parties. These parties may consider that arbitration is preferable to judicial proceedings because arbitration, being to a larger degree subject to the agreement of the parties than judicial proceedings, is in a position to resolve a dispute more efficiently. Private investors, in particular foreign ones, may also be reluctant to submit to the jurisdiction of domestic courts functioning under rules unfamiliar to them. In some countries it has been found that allowing the parties to choose the dispute settlement mechanism helped to attract foreign investment for the development of its infrastructure.

41. In considering whether any dispute should be resolved in judicial proceedings or whether an arbitration agreement should be entered into, where such

choice is permitted under the applicable law, factors typically taken into account by the parties include, for example, their confidence that the courts competent to decide a dispute will be unbiased and that the dispute will be resolved without inordinate delay. The efficiency of the national judicial system and the availability of forms of judicial relief that are adequate to disputes that might arise under the project agreement are additional factors to be taken into account. Furthermore, in view of the highly technical and complex issues involved in infrastructure projects, the parties will also consider the implications of using arbitrators selected for their particular knowledge and experience as compared with domestic courts, which may lack specific knowledge or experience in handling the technical questions in the area where the dispute arose. Another consideration may be the confidentiality of arbitration proceedings, relative informality of arbitral procedures and the possibly greater flexibility arbitrators may have in awarding appropriate remedies, all of which may be beneficial for preserving and developing the long-term relationship implicit in project agreements.

C. Disputes between project promoters and between the concessionaire and its lenders, contractors and suppliers

42. Domestic laws generally recognize that in commercial transactions, in particular international ones, the parties are free to agree on the forum that will settle in a binding decision any dispute that may arise between them. In international transactions, arbitration has become the preferred method, whether or not it is preceded by, or combined with, conciliation. Contracts between the concessionaire and lenders, contractors and suppliers in connection with infrastructure projects, are generally considered as commercial agreements. Accordingly, the parties to those contracts are usually free to choose their preferred dispute settlement method, which in most cases includes arbitration. Lenders, however, although in most cases favouring arbitration for the settlement of disputes arising out of the project agreement (and increasingly also for disputes between different lenders), often prefer judicial proceedings for the settlement of disputes between them and the concessionaire arising out of loan agreements. Where arbitration is the preferred method, the parties will typically wish to be able to select the place of arbitration and to determine whether or not any arbitration case should be administered by an arbitral institution. Host countries wishing to establish a hospitable legal climate for privately financed infrastructure projects would be well advised to review their laws with respect to such commercial contracts so as to eliminate any uncertainty regarding the freedom of the parties to agree to dispute settlement mechanisms of their choice.

D. Disputes involving customers or users of the infrastructure facility

43. Depending on the type of project, the concessionaire may provide goods or services to various different persons and entities, such as, for example,

government-owned utility companies that purchase electricity or water from the concessionaire so as to resell it to the ultimate users; commercial companies, such as airlines or shipping lines contracting for the use of the airport or port; or individuals paying for the use of a toll road. The considerations and policies regarding the settlement of disputes arising out of those legal relationships may vary according to who the parties are, the conditions under which the services are provided and the applicable regulatory regime.

44. In some countries, public service providers are required by law to establish special simplified and efficient mechanisms for handling claims brought by their customers. Such special regulation is typically limited to certain industrial sectors and applies to purchases of goods or services by customers. Statutory requirements for the establishment of such dispute settlement mechanisms may apply generally to claims brought by any of the concessionaire's customers or may be limited to customers who are individual persons acting in their non-commercial capacity. The concessionaire's obligation may be limited to the establishment of a mechanism for receiving and dealing with complaints by individual consumers. Such mechanisms may include a special facility or department set up within the project company for receiving and handling claims expeditiously, for instance by making available to the customers standard claim forms or toll-free telephone numbers for voicing grievances. If the matter is not satisfactorily resolved, the customer may have the right to file a complaint with a regulatory agency, if any, which in some countries may have the authority to issue a binding decision on the matter. Such mechanisms are often optional for the consumer and typically do not preclude resort by the aggrieved persons to courts.

45. If the customers are utility companies (such as a power distribution company) or commercial enterprises (for instance, a large factory purchasing power directly from an independent producer) who freely choose the services provided by the concessionaire and negotiate the terms of their contracts, the parties would typically settle any disputes by methods usual in trade contracts, including arbitration. Accordingly, there may not be a need for addressing the settlement of these disputes in legislation relating to privately financed infrastructure projects. However, where the concessionaire's customers are government-owned entities, their ability to agree on dispute settlement methods may be limited by rules of administrative law governing the settlement of disputes involving governmental entities. For countries that wish to allow the use of non-judicial methods, including arbitration, for the settlement of disputes between the concessionaire and its government-owned customers, it is important to remove possible legal obstacles and to provide a clear authorization for those entities to agree on dispute settlement methods (see paras. 7-9).

VII. Other relevant areas of law

A. General remarks

1. The stage of development of the relevant laws of the host country, the stability of its legal system and the adequacy of remedies available to private parties are essential elements of the overall legal framework for privately financed infrastructure projects. By reviewing and, as appropriate, improving its laws in those areas of immediate relevance for privately financed infrastructure projects, the host country will make an important contribution to securing a hospitable climate for private sector investment in infrastructure. Greater legal certainty and a favourable legal framework will translate into a better assessment of country risks by lenders and project sponsors. This will have a positive influence on the cost of mobilizing private capital and reduce the need for governmental support or guarantees (see chap. II, “Project risks and government support”, paras. 30-60).

2. Section B points out a few selected aspects of the laws of the host country that, without necessarily dealing directly with privately financed infrastructure projects, may have an impact on their implementation (see paras. 3-52). Section C indicates the possible relevance of a few international agreements for the implementation of privately financed infrastructure projects in the host country (see paras. 53-57).

B. Other relevant areas of law

3. In addition to issues pertaining to legislation directed specifically towards privately financed infrastructure projects, a favourable legal framework also requires supportive provisions in other areas of legislation. Private investment in infrastructure will be encouraged by the existence of legislation that promotes and protects private investment in economic activities. The following paragraphs pinpoint only a few selected aspects of other fields of law that may have an impact on the implementation of infrastructure projects. The existence of adequate legal provisions in those other fields may facilitate a number of transactions necessary to carry out infrastructure projects and help to reduce the perceived legal risk of investment in the host country.

1. Promotion and protection of investment

4. One matter of particular concern for the project promoters and lenders is the degree of protection afforded to investment in the host country. Foreign investors in the host country will require assurances that they will be protected

from nationalization or dispossession without judicial review and appropriate compensation in accordance with the rules in force in the host country and in accordance with international law. Project promoters will also be concerned about their ability, *inter alia*, to bring to the country without unreasonable restriction the qualified personnel required to work with the project, to import needed goods and equipment, to gain access to foreign exchange as needed and to transfer abroad or repatriate their profits or sums needed to repay loans that the company has entered into for the purpose of the infrastructure project. In addition to specific guarantees that may be provided by the Government (see chap. II, “Project risks and government support”, paras. 45-50), legislation on promotion and protection of investment may play an important role in connection with privately financed infrastructure projects. For countries that already have adequate investment protection legislation, it may be useful to consider expressly extending the protection provided in such legislation to private investment in infrastructure projects.

5. An increasing number of countries have entered into bilateral investment agreements that aim at facilitating and protecting the flow of investment between the contracting parties. Investment protection agreements usually contain provisions concerning the admission and treatment of foreign investment; transfer of capital between the contracting parties (payment of dividends abroad or repatriation of investment, for example); availability of foreign exchange for transfer or repatriation of proceeds of investment; protection from expropriation and nationalization; and settlement of investment disputes. The existence of such an agreement between the host country and the originating country or countries of the project sponsors may play an important role in their decision to invest in the host country. Depending on its terms, such an agreement may reduce the need for assurances or guarantees by the Government geared to individual infrastructure projects. Multilateral treaties may also be a source of investment protection provisions.

6. Moreover, in a number of countries rules aimed at facilitating and protecting the flow of investment (which also include areas such as immigration legislation, import control and foreign exchange rules) are contained in legislation that might not necessarily be based on a bilateral or multilateral treaty.

2. *Property law*

7. It is desirable for the property laws of the host country to reflect acceptable international standards, contain adequate provisions on the ownership and use of land and buildings, as well as movable and intangible property, and ensure the concessionaire’s ability to purchase, sell, transfer and license the use of property, as appropriate. Constitutional provisions protecting property rights have been found to be important factors in fostering private investment in many countries.

8. Where the concessionaire owns the land on which the facility is built, it is important that the ownership of the land can be clearly and unequivocally

established through adequate registration and publicity procedures. The concessionaire and lenders will need clear proof that ownership of the land will not be subject to dispute. They will therefore be reluctant to commit funds to the project if the laws of the host country do not provide adequate means for ascertaining ownership of the land.

9. It is also necessary to provide effective mechanisms for the enforcement of the property and possessory rights granted to the concessionaire against violation by third parties. Enforcement should also extend to easements and rights of way that may be needed by the concessionaire for providing and maintaining the relevant service (such as placing of poles and cables on private property to ensure the distribution of electricity) (see chap. IV, “Construction and operation of infrastructure: legislative framework and project agreement”, paras. 30-35).

3. *Security interests*

10. As indicated earlier (see chap. IV, “Construction and operation of infrastructure: legislative framework and project agreement”, paras. 52-61), security arrangements in privately financed infrastructure projects may be complex and consist of a variety of forms of security, including fixed security over physical assets of the concessionaire (for example, mortgages or charges), pledges of shares of the concessionaire and assignment of intangible assets (receivables) of the project. While the loan agreements are usually subject to the governing law chosen by the parties, the laws of the host country will in most cases determine the type of security that can be enforced against assets located in the host country and the remedies available.

11. Differences in the type of security or limitations in the remedies available under the laws of the host country may be a cause of concern to potential lenders. It is therefore important to ensure that domestic laws provide adequate legal protection to secured creditors and do not hinder the ability of the parties to establish appropriate security arrangements. Because of the significant differences between legal systems regarding the law of security interests, the *Guide* does not discuss in detail the technicalities of the requisite legislation and the following paragraphs provide only a general outline of the main elements of a modern regime for secured transactions.

12. In some legal systems, security interests can be created in virtually all kinds of assets, including intellectual property, whereas in other systems security interests can only be created in a limited category of assets, such as land and buildings. In some countries, security interests can be created over assets that do not yet exist (future assets) and security may be taken over all of a company’s assets, while allowing the company to continue to deal with those assets in the ordinary course of business. Some legal systems provide for a non-possessory security interest, so that security can be taken over assets without taking actual possession of the assets; in other systems, as regards

those assets which are not subject to a title registration system, security may only be taken by physical possession or constructive possession. Under some systems, enforcement of the security interest can be undertaken without court involvement, whereas in other systems it may only be enforced through court procedures. Some countries provide enforcement remedies that not only include sale of the asset, but also enable the secured lender to operate the asset either by taking possession or appointing a receiver; in other countries, judicial sale may be the primary enforcement mechanism. Under some systems, certain types of security will rank ahead of preferential creditors, whereas in others the preferential creditors rank ahead of all types of security. In some countries, creation of a security interest is cost-efficient, with minimal fees and duties payable, whereas in other countries it can be costly. In some countries, the value of the amount of security taken may be unlimited, while in others the value of security cannot be excessive in comparison with the debt owed. Some legal systems impose obligations on the secured lender on enforcement of the security, such as the obligation to take steps ensuring that assets will be sold at fair market value.

13. Basic legal protection may include provisions ensuring that fixed security (such as a mortgage) is a registrable interest and that, once such security is registered in the register of title or other public register, any purchaser of the property to which the security attaches should take the property subject to such security. This may be difficult, since in many countries no specialized registers of title exist. Furthermore, security should be enforceable against third parties, which may require that they have the nature of a property right and not a mere obligation, and should entitle the person receiving security to a sale, in enforcement proceedings, of the assets taken as security.

14. Another important aspect concerns the flexibility given to the parties to define the assets that are given as security. In some legal systems, broad freedom is given to the parties in the definition of assets that may be given as security. In some legal systems, it is possible to create security that covers all the assets of an enterprise, making it possible to sell the enterprise as a going concern, which may enable an enterprise in financial difficulties to be rescued while increasing the recovery of the secured creditor. Other legal systems, however, allow only the creation of security that attaches to specific assets and do not recognize security covering the entirety of the debtor's assets. There may also be limitations on the debtor's ability to trade in goods given as security. The existence of limitations and restrictions of this type makes it difficult or even impossible for the debtor to create security over generically described assets or over assets traded in the ordinary course of its business.

15. Given the long-term nature of privately financed infrastructure projects, the parties may wish to be able to define the assets that are given as security specifically or generally. They may also wish such security to cover present or future assets and assets that might change during the life of the security. It may be desirable to review existing provisions on security interests with a view to including provisions enabling the parties to agree on suitable security arrangements.

16. Thus far, no comprehensive uniform regime or model for the development of domestic security laws has been developed by international intergovernmental bodies. Governments might be advised, however, to take account of various efforts being undertaken in different organizations.¹ A model for the development of modern legislation on security interests is offered in the Model Law on Secured Transactions, which was prepared by the European Bank for Reconstruction and Development (EBRD) to assist legislative reform efforts in central and eastern European countries. Besides general provisions on who can create and who can receive a security right and general rules concerning the secured debts and the charged property, the EBRD Model Law on Secured Transactions covers other matters, such as the creation of security rights, the interests of third parties, enforcement of security and registration proceedings.

4. Intellectual property law

17. Privately financed infrastructure projects frequently involve the use of new or advanced technologies protected under patents or similar intellectual property rights. They may also involve the formulation and submission of original or innovative solutions, which may constitute the proponent's proprietary information under copyright protection. Therefore, private investors, national and foreign, bringing new or advanced technology into the host country or developing original solutions will need to be assured that their intellectual property rights will be protected and that they will be able to enforce those rights against infringements, which may require the enactment of criminal law provisions designed to combat infringements of intellectual property rights.

18. A legal framework for the protection of intellectual property may be provided by adherence to international agreements regarding the protection and registration of intellectual property rights. It would be desirable to strengthen the protection of intellectual property rights in line with such instruments as the Paris Convention for the Protection of Industrial Property of 1883.² The Con-

¹UNCITRAL is currently preparing a convention on assignment of receivables in international trade. The draft convention is intended to create certainty and transparency, to contribute to the modernization of law relating to assignments of receivables and to promote the availability of capital and credit at more affordable rates. The rules contained in the draft convention facilitate those objectives, *inter alia*, by recognizing the validity and supporting the use of assignments of receivables, especially for future claims and bulk assignments, which have become the backbone of new sources of credit in international capital markets. It is expected that the draft convention will be finalized in 2001. Another international initiative is the draft convention on international interests in mobile equipment currently being prepared by the International Institute for the Unification of Private Law (UNIDROIT) and other organizations. The essential purpose of the draft UNIDROIT convention is to provide for the constitution and effects of a new international interest in mobile equipment, defined so as to embrace not only classic security interests but also what is increasingly recognized as their functional equivalent, namely the lessor's interest under a leasing agreement. The draft UNIDROIT convention and the preliminary draft protocols thereto (which include a preliminary draft protocol on matters specific to aircraft equipment, a preliminary draft protocol on matters specific to railway rolling stock and a preliminary draft protocol on matters specific to space property) cover categories of high-value mobile equipment that by their nature are likely to be moving across or beyond national frontiers on a regular basis in the ordinary course of business and that are capable of unique identification.

²As revised in Brussels on 14 December 1900, in Washington, D.C., on 2 June 1911, in The Hague on 6 November 1925, at London on 2 June 1934, in Lisbon on 31 October 1958 and in Stockholm on 14 July 1967 and as amended on 2 October 1979.

vention applies to industrial property in the widest sense, including inventions, marks, industrial designs, utility models, trade names, geographical indications and the repression of unfair competition. The Convention provides that, as regards the protection of industrial property, each contracting State must grant national treatment. It also provides for the right of priority in the case of patents, marks and industrial designs and establishes a few common rules that all the contracting States must follow in relation to patents, marks, industrial designs, trade names, indications of source, unfair competition and national administrations. A framework for further international patent protection is provided under the Patent Cooperation Treaty of 1970, which makes it possible to seek patent protection for an invention simultaneously in each of a large number of countries by filing an international patent application. In some countries, international standards are supplemented by legislation aimed at affording legal protection to new technological developments, such as legislation that protects intellectual property rights in computer software and computer hardware design.

19. Other important instruments providing international protection of industrial property rights are the Madrid Agreement Concerning the International Registration of Marks of 1891,³ the Protocol Relating to the Madrid Agreement of 1989 and the Common Regulations under the Madrid Agreement and the Protocol Relating thereto of 1998. The Madrid Agreement provides for the international registration of marks (both trademarks and service marks) at the International Bureau of the World Intellectual Property Organization. International registration of marks under the Madrid Agreement has effect in several countries, potentially in all the contracting States (except the country of origin). Furthermore, the Trademark Law Treaty of 1994 simplifies and harmonizes procedures for the application for registration of trademarks, changes after registration and renewal.

20. In the area of industrial designs, the Hague Agreement Concerning the International Deposit of Industrial Designs of 1925⁴ provides for the international deposit of industrial designs at the International Bureau of WIPO. The international deposit has, in each of the contracting States designated by the applicant, the same effect as if all the formalities required by the domestic law for the grant of protection had been complied with by the applicant and as if all administrative acts required to that end had been accomplished by the office of that country.

21. The most comprehensive multilateral agreement on intellectual property to date is the Agreement on Trade-Related Aspects of Intellectual Property Rights (the “TRIPS Agreement”) which was negotiated under the auspices of the World Trade Organization (WTO) and came into effect on 1 January 1995.

³As revised in Brussels on 14 December 1900, in Washington, D.C., on 2 June 1911, in The Hague on 6 November 1925, in London on 2 June 1934, in Nice on 15 June 1957 and in Stockholm on 14 July 1967.

⁴With the Additional Act of Monaco of 1961, the Complementary Act of Stockholm of 1967 as amended on 28 September 1979 and the Regulations Under the Hague Agreement Concerning the International Deposit of Industrial Designs of 1998.

The areas of intellectual property that it covers are copyright and related rights (that is, the rights of performers, producers of sound recordings and broadcasting organizations); trademarks, including service marks; geographical indications, including appellations of origin; industrial designs; patents, including the protection of new varieties of plants; the layout-designs of integrated circuits; and undisclosed information, including trade secrets and test data. In respect of each of the main areas of intellectual property covered by it, the TRIPS Agreement sets out the minimum standards of protection to be provided by each contracting party by requiring, first, compliance with the substantive obligations, *inter alia*, of the Paris Convention in its most recent version. The main substantive provisions of the Paris Convention are incorporated by reference and thus become obligations under the TRIPS Agreement. The TRIPS Agreement also adds a substantial number of additional obligations on matters where the pre-existing conventions on intellectual property are silent or were seen as being inadequate. In addition, the Agreement lays down certain general principles applicable to all procedures for the enforcement of intellectual property rights. Furthermore, the TRIPS Agreement contains provisions on civil and administrative procedures and remedies, provisional measures, special requirements related to border measures and criminal procedures, which specify, in a certain amount of detail, the procedures and remedies that must be available so that intellectual property rights can effectively be enforced by their holders.

5. *Rules and procedures on compulsory acquisition of private property*

22. Where the Government assumes responsibility for providing the land required for the implementation of the project, that land may be either purchased from its owners or, if necessary, compulsorily acquired against the payment of adequate compensation by procedures sometimes referred to as “compulsory acquisition” or “expropriation” (see chap. IV, “Construction and operation of infrastructure: legislative framework and project agreement”, paras. 27-29). Many countries have legislation governing compulsory acquisition of private property and that legislation would probably apply to the compulsory acquisition of property required for privately financed infrastructure projects.

23. Compulsory acquisition may be carried out in judicial or administrative proceedings or may be effected by an ad hoc legislative act. In most cases, the proceedings involve both administrative and judicial phases, which may be lengthy and complex. The Government may thus wish to review existing provisions on compulsory acquisition for reasons of public interest with a view to assessing their adequacy to the needs of large infrastructure projects and to determining whether such provisions allow quick and cost-effective procedures, while affording adequate protection to the rights of the owners. To the extent permitted by law, it is important to enable the Government to take possession of the property without unnecessary delay, so as to avoid increased project costs.

6. *Rules on government contracts and administrative law*

24. In many legal systems belonging to or influenced by the tradition of civil law, the provision of public services may be governed by a body of law known as “administrative law”, which regulates a wide range of governmental functions. Such systems operate under the principle that the Government can exercise its powers and functions either by means of an administrative act or an administrative contract. It is also generally understood that, alternatively, the Government may enter into a private contract, subject to the law governing private commercial contracts. The differences between the two types of contract may be significant.

25. Under the concept of the administrative contract, the freedom and autonomy enjoyed by the parties to a private contract are subordinate to the public interest. In some legal systems, the Government has the right to modify the scope and terms of administrative contracts or even terminate them for reasons of public interest, usually subject to compensation for loss sustained by the private contracting party (see chap. V, “Duration, extension and termination of the project agreement”, paras. 26, 27 and 49). Additional rights might include extensive monitoring and inspection rights, as well as the right to impose sanctions on the private operator for failure to perform. This is often balanced by the requirement that other changes may be made to the contract as may be necessary to restore the original financial equilibrium between the parties and to preserve the contract’s general value for the private contracting party (see chap. IV, “Construction and operation of infrastructure: legislative framework and project agreement”, paras. 126-130). In some legal systems, disputes arising out of government contracts are subject to the exclusive jurisdiction of special tribunals dealing solely with administrative matters, which in some countries are separate from the judicial system (see chap. VI, “Settlement of disputes”, paras. 38-41).

26. The existence of a special legal regime applicable to infrastructure operators and public service providers is not limited to the legal systems referred to above. Although in legal systems influenced by the tradition of common law no such categorical distinction is made between administrative contracts and private contracts, similar consequences may be achieved by different means. While under such systems of law it is frequently held that the rule of law is best maintained by subjecting the Government to ordinary private law, it is generally recognized that the administration cannot by contract fetter the exercise of its sovereign functions. It cannot hamper its future executive authority in the performance of those governmental functions which affect the public interest. Under the doctrine of sovereign acts, which is upheld in some common law jurisdictions, the Government as contractor is excused from the performance of its contracts if the Government as sovereign enacts laws, regulations or orders in the public interest that prevent that performance. Thus, the law may permit a public authority to interfere with vested contractual rights. Usually such action is limited so that the changes cannot be of such magnitude that the other party could not fairly adapt to them. In those circumstances, the private party is ordinarily entitled to some sort of compensation or equitable

adjustment. In anticipation of such possibilities, in some countries a standard “changes” clause is included in a governmental contract that enables the Government to alter the terms on a unilateral basis or that provides for changes as a result of an intervening sovereign act.

27. Special prerogatives for governmental agencies are justified in those legal systems by reasons of public interest. It is however recognized that special governmental prerogatives, in particular the power to alter the terms of contracts unilaterally, may, if improperly used, adversely affect the vested rights of government contractors. For this reason, countries with a well established tradition of private participation in infrastructure projects have developed a series of control mechanisms and remedies to protect government contractors against arbitrary or improper acts by public authorities, such as access to impartial dispute settlement bodies and full compensation schemes for governmental wrongdoing. Where protection of this nature is not afforded, rules of law providing public authorities with special prerogatives may be regarded by potential investors as an imponderable risk, which may discourage them from investing in particular jurisdictions. For this reason, some countries have reviewed their legislation on government contracts so as to provide the degree of protection needed to foster private investment and remove those provisions which gave rise to concern about the long-term contractual stability required for infrastructure projects.

7. *Private contract law*

28. The laws governing private contracts play an important role in connection with contracts entered into by the concessionaire with subcontractors, suppliers and other private parties. The domestic law on private contracts should provide adequate solutions to the needs of the contracting parties, including flexibility in devising the contracts needed for the construction and operation of the infrastructure facility. Apart from some essential elements of adequate contract law, such as general recognition of party autonomy, judicial enforceability of contract obligations and adequate remedies for breach of contract, the laws of the host country may create a favourable environment for privately financed infrastructure projects by facilitating contractual arrangements likely to be used in those projects. An adequate set of rules of private international law is also important, given the likelihood that contracts entered into by the concessionaire will include some international elements.

29. Where new infrastructure is to be built, the concessionaire may need to import large quantities of supplies and equipment. Greater legal certainty for such transactions will be ensured if the laws of the host country contain provisions specially adapted to international sales contracts. A particularly suitable legal framework may be provided by adherence to the United Nations Convention on Contracts for the International Sale of Goods (Vienna, 1980)⁵ or other

⁵*Official Records of the United Nations Conference on Contracts for the International Sale of Goods, Vienna, 10 March-11 April 1980* (United Nations publication, Sales No. E.82.V.5), part I.

international instruments dealing with specific contracts, such as the Unidroit Convention on International Financial Leasing (Ottawa, 1988),⁶ drawn up by the International Institute for the Unification of Private Law (Unidroit).

8. *Company law*

30. In most projects involving the development of a new infrastructure, the project promoters will establish the project company as a separate legal entity in the host country (see chap. IV, “Construction and operation of infrastructure: legislative framework and project agreement”, paras. 12-18). It is recognized that the project company may take various forms in different countries, which may not necessarily entail a corporation. As in most cases it is a corporate form that is selected, it is particularly important for the host country to have adequate company laws with modern provisions on essential matters such as establishment procedures, corporate governance, issuance of shares and their sale or transfer, accounting and financial statements and protection of minority shareholders. Furthermore, the recognition of the investors’ ability to establish separate entities to serve as special-purpose vehicles for raising financing and disbursing funds may facilitate the closing of project finance transactions (see chap. IV, “Construction and operation of infrastructure: legislative framework and project agreement”, para. 59).

31. Although various corporate forms may be used, a common characteristic is that the concessionaire’s owners (or shareholders) will require that their liability be limited to the value of their shares in the company’s capital. If it is intended that the project company will offer shares to the public, limited liability will be necessary, as the prospective investors will usually only purchase those shares for their investment value and will not be closely involved in the operation of the project company. It is therefore important that the laws of the host country provide adequately for the limitation of liability of shareholders. Furthermore, adequate provisions governing the issuance of bonds, debentures or other securities by commercial companies will enable the concessionaire to obtain funds from investors on the security market, thus facilitating the financing of certain infrastructure projects.

32. Legislation should establish the responsibilities of directors and administrators of the project company, including the basis for criminal responsibility. It can also set out provisions for the protection of third parties affected by any breach of corporate responsibility. Modern company laws often contain specific provisions regulating the conduct of managers so as to prevent conflicts of interest. Provisions of this type require that managers act in good faith in the best interest of the company and do not use their position to foster their own or any other person’s financial interests to the detriment of the company.

⁶*Acts and Proceedings of the Diplomatic Conference for the adoption of the draft Unidroit Conventions on International Factoring and International Financial Leasing, Ottawa, 9-28 May 1988, vol. I.*

Provisions intended to curb conflicts of interest in corporate management may be particularly relevant in connection with infrastructure projects, where the concessionaire may wish to engage its own shareholders, at some stage of the project, to perform work or provide services in connection with it (see chap. IV, “Construction and operation of infrastructure: legislative framework and project agreement”, paras. 100 and 101).

33. It is important for the law to regulate adequately the decision-making process both for meetings of the shareholders and meetings of management organs of the company (the board of directors or supervisory board, for example). Protection of shareholders’ rights and, in particular, protection for minority shareholders from abuse by controlling or majority shareholders are important elements of modern company laws. Mechanisms for the settlement of disputes among shareholders are also critical. It is useful to recognize the right of the shareholders to regulate a number of additional matters concerning the management of the concessionaire through agreements among themselves or through management contracts with the directors of the concessionaire.

9. Tax law

34. In addition to possible tax incentives that may be generally available in the host country or that may be specially granted to privately financed infrastructure projects (see chap. II, “Project risks and government support”, paras. 51-54), the general taxation regime of the host country plays a significant role in the investment decisions of private companies. Beyond an assessment of the impact of taxation in the project cost and the expected margin of profit, private investors consider questions such as the overall transparency of the domestic taxation system, the degree of discretion exercised by taxation authorities, the clarity of guidelines and instructions issued to taxpayers and the objectivity of criteria used to calculate tax liabilities. This may be a complex matter, in particular in those countries where the authority to establish or increase taxes or to enforce tax legislation has been decentralized.

35. Privately financed infrastructure projects are typically highly leveraged and require a predictable cash flow. For that reason, it is crucial for all potential tax implications to be readily assessable throughout the life of the project. Unanticipated changes in the taxes that reduce that cash flow can have serious consequences for the project. In some countries, the Government is authorized to enter into agreements with the investors for the purpose of guaranteeing that the cash flow of the project will not be adversely affected by unexpected increases in taxation. Such arrangements are sometimes referred to as “tax stabilization agreements”. However, the Government may be restrained, by constitutional law or for political reasons, from providing this type of guarantee, in which case the parties may agree on compensation or contractual revision mechanisms for dealing with cost increases due to tax changes (see also chap. IV, “Construction and operation of infrastructure: legislative framework and project agreement”, paras. 122-125).

36. Most national tax regimes fall into one of three general categories. One approach is worldwide taxation with credits, in which all income earned anywhere is taxed in the home country and double taxation is avoided through the use of a foreign tax credit system; home country taxes are reduced by the amount of foreign taxes already paid. If this approach is used by an investor's home country, the investor's tax liability can be no less than it would be at home. Under a different taxation approach, the foreign income that has already been subject to foreign tax is exempt from taxation by the home country of the investor. Under a territorial approach, foreign income is exempt from home country taxation altogether. Investors in home countries that use the latter two systems of taxation would benefit from tax holidays and lower tax rates in the host country, but such tax relief would offer no incentive to an investor located in a tax haven.

37. The parties involved in the project may have different concerns over potential tax liability. Investors are usually concerned about the taxation of profits earned in the host country, taxation on payments made to contractors, suppliers, investors and lenders, and tax treatment of any capital gains (or losses) when the concessionaire is wound up. Investors may find that payments used to reduce taxes under their home country regime (such as payments for interest on borrowed funds, investigation costs, bidding costs and foreign exchange losses) may not be available in the host country, or vice versa. Since foreign tax credits are only allowed for foreign income taxes, investors need to ensure that any income tax paid in the host country satisfies the definition of income tax of their own country's taxing authority. Similarly, the project company in the host country may be treated for tax purposes as a different type of entity in the home country. In projects where the assets become public property, this may preclude deductions for depreciation under the laws of the home country.

38. One particular problem of privately financed infrastructure projects involving foreign investment is the possibility that foreign companies participating in a project consortium may be exposed to double taxation, that is, taxation of profits, royalties and interests in their own home countries as well as in the host country. The timing of tax payments and requirements to pay withholding taxes can also pose problems. A number of countries have entered into bilateral agreements to eliminate or at least reduce the negative effects of double taxation and the existence of such agreements between the host country and the home countries of the project sponsors often plays a role in their tax considerations.

39. Ultimately, it is the cumulative effect of all taxes combined that needs to be taken into consideration. For example, there may be taxes imposed by more than one level of taxing authority; in addition to taxation by the national Government, the concessionaire may also face municipal or provincial taxes. There may also be certain levies other than income taxes, which often are due and payable before the concessionaire has earned any revenues. These include sales taxes, sometimes referred to as "turnover taxes", value-added taxes, property taxes, stamp duties and import duties. Sometimes special provisions can be made to offer relief from these payments as well.

10. *Accounting rules and practices*

40. In several countries, companies are required by law to follow internationally acceptable standard accounting practices and retain the services of professional accountants or accounting auditors. Among the reasons for this is that the adoption of standard accounting practices is a measure taken to achieve uniformity in the valuation of businesses. In connection with the selection of the concessionaire, the use of standard accounting practices may also facilitate the task of evaluating the financial standing of bidders in order to determine whether they meet the pre-selection criteria required by the contracting authority (see chap. III, “Selection of the concessionaire”, paras. 38-40). Standard accounting practices are also essential for carrying out audits of the profits of companies, which may be required for the application of tariff structures and the monitoring of the concessionaire’s performance by the regulatory body (see chap. IV, “Construction and operation of infrastructure: legislative framework and project agreement”, paras. 39-46).

41. Special accounting rules for infrastructure operators have also been introduced in some countries to take into account the particular revenue profile of infrastructure projects. Projects involving the construction of infrastructure facilities, in particular roads and other transportation facilities, are typically characterized by a relatively short investment period, with high financial cost and no revenue stream, followed by a longer period with increasing revenue and decreasing financial cost and, under normal circumstances, stable operating costs. Accordingly, if traditional accounting rules were applied, the particular financial structure of such projects would need to be recorded in the project company’s accounts as a period of continuous negative results followed by a long period of net profit. This would not only have negative consequences, for instance, for the project company’s credit rating during the construction phase, but might also result in a disproportionate tax debt during the operational phase of the project. In order to avoid such a distortion, some countries have adopted special accounting rules for companies undertaking infrastructure projects that take into account the fact that the financial results of privately financed infrastructure projects may only become positive on a medium-term basis. Those special rules typically authorize infrastructure developers to defer part of the financial cost accrued during the deficit phase to the subsequent financial years, in accordance with financial schedules provided in the project agreement. However, the special accounting rules are typically without prejudice to other rules of law that may prohibit the distribution of dividends during financial years closed with negative results.

11. *Environmental protection*

42. Environmental protection encompasses a wide variety of issues, ranging from handling of wastes and hazardous substances to relocation of persons displaced by large land-use projects. It is widely recognized that environmental protection is a critical prerequisite to sustainable development. Environmental protection legislation is likely to have a direct impact on the implementation

of infrastructure projects at various levels, and environmental matters are among the most frequent causes of disputes. Environmental protection laws may include various requirements, such as the consent by various environmental authorities, evidence of no outstanding environmental liability, assurances that environmental standards will be maintained, commitments to remedy environmental damage and notification requirements. These laws often require prior authorization for the exercise of a number of business activities, which may be particularly stringent for some types of infrastructure (for instance, waste water treatment, waste collection, the coal-fired power sector, power transmission, roads and railways).

43. It is therefore advisable to include in legislation measures that make obligations arising from environmental laws transparent. It is important to ensure the highest possible degree of clarity in provisions concerning the tests that may be applied by the environmental authorities, the documentary and other requirements to be met by the applicants, the conditions under which licences are to be issued and the circumstances that justify the denial or withdrawal of a licence. Particularly important are provisions that guarantee the applicant's access to expeditious appeals procedures and judicial recourse, as appropriate. It may also be advisable to ascertain to the extent possible, prior to the final award of the project, whether the conditions for obtaining the required environmental licences are met. In some countries, special public authorities or advocacy groups may have the right to institute legal proceedings to seek to prevent environmental damage, which may include the right to seek the withdrawal of a licence deemed to be inconsistent with applicable environmental standards. In some of those countries, it has been found useful to involve representatives of the public in the proceedings that lead to the issuance of environmental licences. The legislation may also establish the range of penalties that may be imposed and specify the parties that may be held responsible for the damage.

44. Adhering to treaties relating to the protection of the environment may help to strengthen the international regime of environmental protection. A large number of international instruments have been developed in the past decades to establish common international standards. These include the following: Agenda 21⁷ and the Rio Declaration on Environment and Development,⁸ adopted by the United Nations Conference on Environment and Development in 1992; the World Charter for Nature (General Assembly resolution 37/7, annex); the Basel Convention on the Control of Transboundary Movement of Hazardous Wastes and Their Disposal of 1989; the Convention on Environmental Impact Assessment in a Transboundary Context of 1991;⁹ and the Convention on the Protection and Use of Transboundary Watercourses and International Lakes of 1992.¹⁰

⁷Report of the United Nations Conference on Environment and Development, Rio de Janeiro, 3-14 June 1992 (United Nations publication, Sales No. E.93.I.8 and corrigenda), vol. I: *Resolutions adopted by the Conference*, resolution 1, annex II.

⁸*Ibid.*, annex I.

⁹United Nations, *Treaty Series*, vol. 1989, No. I-34028 (not yet published).

¹⁰*Ibid.*, vol. 1936, No. I-33207 (not yet published).

12. *Consumer protection laws*

45. A number of countries have special rules of law on consumer protection. Consumer protection laws vary greatly from country to country, both in the way they are organized and in their substance. Nevertheless, consumer protection laws often include provisions such as favourable time limits for asserting claims and enforcing contractual rights; special rules for the interpretation of contracts whose terms are not usually negotiated with the consumer (sometimes referred to as “adhesion contracts”); extended warranties in favour of consumers; special termination rights; access to simplified dispute settlement instances (see also chap. VI, “Settlement of disputes”, paras. 43-45); or other protective measures.

46. From the concessionaire’s perspective, it is important to consider whether the host country’s laws on consumer protection may limit or hinder the concessionaire’s ability to enforce, for instance, its right to obtain payment for the services provided, to adjust prices or to discontinue services to customers who breach essential terms of their contracts or violate essential conditions for the provision of the services.

13. *Insolvency law*

47. The insolvency of an infrastructure operator or public service provider raises a number of issues that have led some countries to establish special rules to deal with such situations, including rules that enable the contracting authority to take the measures required to ensure the continuity of the project (see chap. V, “Duration, extension and termination of the project agreement”, paras. 24 and 25). The continuity in the provision of the service may be achieved by means of a legal framework that allows for the rescue of enterprises facing financial difficulties, such as reorganization and similar proceedings. In the event that bankruptcy proceedings become inevitable, the secured lenders will be specially concerned about provisions concerning secured claims, in particular as to whether secured creditors may foreclose on the security despite the opening of bankruptcy proceedings, whether secured creditors are given priority for payments made with the proceeds of the security and how claims of secured creditors are ranked. As noted earlier, a substantial portion of the concessionaire’s debt takes the form of “senior” loans, with the lenders requiring precedence of payment over payment of the subordinated debt of the concessionaire (see “Introduction and background information on privately financed infrastructure projects”, para. 58). The extent to which the lenders will be able to enforce such subordination arrangements will depend on the rules and provisions of the laws of the country that govern the ranking of creditors in insolvency proceedings. The legal recognition of party autonomy on the establishment of contractual subordination of different classes of loans may facilitate the financing of infrastructure projects.

48. Among the issues that the legislation should address are the following: the question of the ranking of creditors; the relationship between the insolvency administrator and creditors; legal mechanisms for reorganization of the insolvent debtor; special rules designed to ensure the continuity of the public serv-

ice in case of insolvency of the concessionaire; and provisions on avoidance of transactions entered into by the debtor shortly before the opening of the insolvency proceedings.

49. In large infrastructure projects, the insolvency of the project company is likely to involve creditors from more than one country or affect assets located in more than one country. It may therefore be desirable for the host country to have provisions in place that facilitate judicial cooperation, court access for foreign insolvency administrators and recognition of foreign insolvency proceedings. A suitable model that may be used by countries wishing to adopt legislation for that purpose is provided in the UNCITRAL Model Law on Cross-Border Insolvency.

14. Anti-corruption measures

50. The investment and business environment in the host country may also be enhanced by measures to fight corruption in the administration of government contracts. It is particularly important for the host country to take effective and concrete action to combat bribery and related illicit practices, in particular to pursue effective enforcement of existing laws prohibiting bribery.

51. The enactment of laws that incorporate international agreements and standards on integrity in the conduct of public business may represent a significant step in that direction. Important standards are contained in two resolutions of the United Nations General Assembly: resolution 51/59 of 12 December 1996, by which the Assembly adopted the International Code of Conduct for Public Officials, and resolution 51/191 of 16 December 1996, by which it adopted the United Nations Declaration against Corruption and Bribery in International Commercial Transactions. Other important instruments include the Convention on Combating Bribery of Foreign Public Officials in International Business Transactions of 1997, which was negotiated under the auspices of the Organisation for Economic Cooperation and Development.

52. Furthermore, it is important that the rules covering the functioning of contracting authorities and the monitoring of public contracts ensure the required degree of transparency and integrity. Where such rules do not exist, appropriate legislation and regulations should be developed and adopted. Simplicity and consistency, coupled with the elimination of unnecessary procedures that prolong the administrative procedures or make them cumbersome, are additional elements to be taken into consideration in this context.

C. International agreements

53. In addition to the internal legislation of the host country, privately financed infrastructure projects may be affected by international agreements entered into by the host country. The implications of certain international agreements is discussed briefly below, in addition to other international agreements mentioned throughout the *Guide*.

1. Membership in international financial institutions

54. Membership in multilateral financial institutions such as the World Bank, the International Development Association, the International Finance Corporation, the Multilateral Investment Guarantee Agency and the regional development banks may have a direct impact on privately financed infrastructure projects in various ways. Firstly, the host country's membership in those institutions is typically a requirement in order for projects in the host country to receive financing and guarantees provided by those institutions. Secondly, the rules on financing and guarantee instruments provided by those institutions typically contain a variety of terms and conditions of direct relevance for the terms of the project agreement and the loan agreements negotiated by the concessionaire (for example, a clause of negative pledge of public assets and provision of counter-guarantees in favour of the multilateral financial institution). Lastly, multilateral financial institutions usually follow a number of policy objectives whose implementation they seek to ensure in connection with projects supported by them (such as adherence to internationally acceptable environmental standards, long-term sustainability of the project beyond the initial concession period and transparency and integrity in the selection of the concessionaire and the disbursement of their loans).

2. General agreements on trade facilitation and promotion

55. A number of multilateral agreements have been negotiated to promote free trade at the global level. The most notable of those agreements have been negotiated under the auspices of the General Agreement on Tariffs and Trade and later WTO. Those agreements may contain general provisions on trade promotion and facilitation of trade in goods (such as a most-favoured-nation clause or prohibition of the use of quantitative restrictions and other discriminatory trade barriers) and on the promotion of fair trade practices (such as prohibition of dumping and limitations on the use of subsidies). Some specific agreements are aimed at the removal of barriers for the provision of services by foreigners in the contracting States or promoting transparency and eliminating discrimination of suppliers in public procurement. Those agreements may be relevant for national legislation on privately financed infrastructure projects that contemplates restrictions on the participation of foreign companies in infrastructure projects or establishes preferences for national entities or for the procurement of supplies on the local market.

3. International agreements on specific industries

56. In the context of the negotiations on basic telecommunications concluded as part of the General Agreement on Trade in Services (GATS), a number of States members of WTO representing most of the world market for telecommunication services have made specific commitments to facilitate trade in telecommunication services. It should be noted that all WTO member States (even those which have not made specific telecommunication commitments) are bound by the general GATS rules on services, including

specific requirements dealing with most-favoured-nation treatment, transparency, regulation, monopolies and business practices. The WTO telecommunication agreement adds sector- and country-specific commitments to the overall GATS agreement. Typical commitments cover the opening of various segments of the market, including voice telephony, data transmission and enhanced services, to competition and foreign investment. Legislators of current or prospective WTO member States should thus ensure that the country's telecommunication laws are consistent with the GATS agreement and their specific telecommunication commitments.

57. Another important sector-specific agreement at the international level is the Energy Charter Treaty, concluded in Lisbon on 17 December 1994 and in force since 16 April 1998, which has been enacted to promote long-term cooperation in the energy field. The Treaty provides for various commercial measures, such as the development of open and competitive markets for energy materials and products and the facilitation of transit and access to and transfer of energy technology. Furthermore, the Treaty aims at avoiding market distortions and barriers to economic activity in the energy sector and promotes the opening of capital markets to encourage the flow of capital in order to finance trade in materials and products. The Treaty also contains regulations about investment promotion and protection: equitable conditions for investors, monetary transfers related to investments, compensation for losses due to war, civil disturbance or other similar events and compensation for expropriation.

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