

Renegotiation of PPP Transactions in Response to Bankruptcy: The Melbourne Train/Tram Case Study

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M. Moseley

Lead Lawyer

Public Private Partnerships Group

The World Bank

moseley@worldbank.org

Senior Director

Legal Frameworks

Global Infrastructure Hub

mark.moseley@gihub.org

Outline of Presentation

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- **Issues and Concerns with Renegotiation**
- **Case Study - the 2004 Melbourne Train/Tram Franchise Renegotiations**

The Prevalence of Renegotiation

Introduction

- by definition, a renegotiation of a PPP transaction involves a change to the original contractual terms and conditions, as distinct from an adjustment (in payments or tariffs) that takes place pursuant to a mechanism defined in the contract
- a very significant number of PPP infrastructure transactions have been renegotiated after the contracts have been signed
- these renegotiations frequently occur within a short period of time following financial close
- the problem is particularly acute in certain sectors, notably water and sanitation
- the majority of renegotiations are initiated by the private sector operators, but there are also instances of government-requested renegotiations

The Prevalence of Renegotiation

2010 Data on Frequency and Timing

	Renegotiated Concession Contracts	Average Time to Renegotiation
All Sectors	61%	1.8 years
Electricity	25 %	2.1 years
Transport	73%	2.9 years
Water	87%	1.3 years
Mega and Natural Resources Projects	53%	2.0 years

Source: Guasch (2010) updated

The Prevalence of Renegotiation

Initiation of Renegotiation Requests

	Both Government and Operator	Government	Operator
All sectors	13%	26%	61%
Water and Sanitation	10%	24%	66%
Transport	16%	27%	57%

Source: Guasch (2004), *Granting and Renegotiating Infrastructure Concessions Doing It Right -- Analysis of Renegotiated Concessions in Latin America and the Caribbean, Mid-1980s to 2000*.

Issues and Concerns with Renegotiation

Drivers of Renegotiation

- renegotiations can arise from many causes
- in regulated markets, where prices cannot be adjusted, changes in economic circumstances will frequently lead to a request for renegotiation, either by the operator or the government
- occasionally, economic conditions will change unexpectedly due to macroeconomic conditions beyond the control of the parties (e.g. global financial crises, currency fluctuations, etc.)
- more commonly, demands for renegotiation arise due to poorly drafted contracts, or poorly prepared bids
- another major cause of renegotiation is opportunistic behavior on the part of governments or operators:
 - governments may decide to adjust tariffs, or unilaterally act to capture 'windfall profits'
 - operators may believe that the circumstances give them considerable leverage over the host government

Issues and Concerns with Renegotiation

Problematic Aspects

- the high incidence of renegotiation calls into question the credibility of the process for awarding PPP transactions
 - in his 2004 study, J. L. Guasch observed that there were fewer renegotiations when the initial contracts were awarded through a process of bilateral discussions, as opposed to competitive bidding – but this “should not be interpreted as an endorsement of [the bilateral] process”.
- it distorts the bidding process, by rewarding operators who are not necessarily efficient but who are skilled (re)negotiators
- renegotiations take place without the competitive pressure of the bidding process
- the results of renegotiations often favour operators, at the expense of either or both the government and end-users

Issues and Concerns with Renegotiation

Outcome of Renegotiations

	Percentage of renegotiated concession contracts with that outcome
Delays on Investment Obligation Targets	69%
Acceleration of Investment Obligations	18%
Tariff Increases	62%
Tariff Decreases	19%
Increase in the number of cost components with automatic pass-through to tariff increases	59%
Extension of Concession Period	38%
Reduction of Investment Obligations	62%
Adjustment of annual fee paid by operator to government	
Favorable to operator	31%
Unfavorable to operator	17%
Changes in the Asset-Capital Base	
Favorable to Operator	46%
Unfavorable to Operator	22%

Source: Guasch (2004), *Granting and Renegotiating Infrastructure Concessions Doing It Right -- Analysis of Renegotiated Concessions in Latin America and the Caribbean, Mid-1980s to 2000*.

Case Study - Melbourne Train/Tram

Introduction

- the Melbourne Train/Tram franchise renegotiation process is generally regarded as a good example of a well-managed and mutually beneficial renegotiation exercise
- a significant amount of information on the process is publicly available, due to the PPP transparency initiatives of the Government of Victoria, and the existence of a comprehensive public report on the renegotiation, prepared by the Auditor General of Victoria (www.audit.vic.gov.au/publications/2005/20050914-Melbourne's-Train-and-Tram-System.pdf)
- there is also a World Bank paper that discusses the transaction, in the context of other privatizations and PPP transactions in the regional rail sector: *Results of Railway Privatization in Australia and New Zealand*, found at: <https://openknowledge.worldbank.org/handle/10986/17403>

Case Study - Melbourne Train/Tram

Background

- in 1992, the Conservative Party came to power in the State of Victoria, and it began to take various measures to improve the cost efficiency of the publicly-owned tram and train services in and around Melbourne, which were being heavily subsidized by the Government
- as a result, staff levels were cut from 18,000 to 8400, and the level of Government subsidy was significantly reduced*
- to continue the reform process, the Government decided, in 1999, to enter into a PPP transaction, splitting the system into four franchises (two for rail services and two for tram services), thereby creating a system whereby the private operators could be compared to one another
- the franchises were to be for periods of 12 to 15 years

* Source: G. Currie, *A Review of Melbourne's Rail Franchising Reforms*, Journeys, November 2009

Case Study - Melbourne Train/Tram Background (cont.)

- a competitive tendering procurement process was followed, with the main bidding parameter being the amount of subsidy that would be paid by the Government to the winning bidder (the operator) in the form of fixed annual payments
- in addition, each operator would be able to earn a variable payment, based on farebox revenue, split between all of the operators according to a ridership formula (with user fares tied to inflation)
- each operator was required to commit to an extensive investment program, including new and refurbished rolling stock

Case Study - Melbourne Train/Tram Background (cont.)

- three firms won the four franchises on offer:
 - National Express Group (a UK-based firm) won one of the rail and one of the tram franchises (plus a separate country rail franchise)
 - Connex Melbourne (a subsidiary of the French firm Veolia) won the other rail franchise
 - MetroLink Victoria (an Australian consortium) won the other tram franchise, which it operated as Yarra Trams
- the Government was very pleased with the outcome of the tendering process, announcing that the new arrangements would:
 - achieve cost savings of some A\$ 1.8 billion, including a substantial reduction in Government operating subsidies to almost zero by the end of the franchise period
 - cut the cost of operations (relative to the public sector system) by a further 24%
 - increase ridership by 40-84% over the length of the franchise period*

* Source G. Currie, *A Review of Melbourne's Rail Franchising Reforms*

Case Study - Melbourne Train/Tram

Background (cont.)

- unfortunately, by 2002, each of the franchisees were in severe financial difficulties, primarily due to
 - unrealistic revenue and cost estimates
 - flaws in the innovative contractual arrangements such as, for example, the infrastructure maintenance provisions
 - the complexity of the farebox revenue sharing scheme, which led to numerous disputes
 - delays in the introduction of the new electronic ticketing system
- in December 2002, National Express withdrew from its contracts, forfeiting performance bonds with a value of A\$135 million and writing off approximately A\$300 million in losses*
- the new Government (from the opposition Labour Party) decided to restructure the system into a single train franchise and a single tram franchise, and award these two new franchises to the remaining franchisees, pursuant to a bilateral negotiation process, i.e. a renegotiation

* Source G. Currie, *A Review of Melbourne's Rail Franchising Reforms*

Case Study - Melbourne Train/Tram

Overview of the Renegotiation Process

- the renegotiations involved a new approach to the allocation of risks, with the Government of Victoria accepting many risks previously assigned to the operators – including risks associated with the condition of the infrastructure
- the new franchise agreements were for a much shorter period of time, lasting only until November 2008
- the principal tools which the Government used during the negotiation process were two financial models (one for the train system and one for the tram system) in the form of “public sector benchmarks”, whereby the Government was able to assess whether the offers submitted by the franchisees provided ‘value for money’, and whether the offers were realistic and financially sustainable

Case Study - Melbourne Train/Tram

Overview of the Renegotiation Process (cont.)

- in addition to the use of the two public sector benchmarks, the Government also employed a number of other techniques during the renegotiation process, including:
 - undertaking an analysis of the comparative profits earned by franchisees engaged in similar activities in other countries;
 - insisting upon provisions whereby profits in excess of 125% of forecast amounts would be shared with the Government
 - insisting upon provisions whereby the Government would have the right to conduct “open book” evaluations of the franchisees’ records before receiving their offers
 - attempting to replicate competitive tension by conducting the renegotiation process in a way that would have allowed for an competitive tender should the negotiations have failed (by, for example, establishing a comprehensive data room)
 - having Government staff develop a “dummy offer”, which could be compared with the actual offers received

Case Study - Melbourne Train/Tram

Results of the Renegotiation

- some commentators have suggested that the Melbourne experience is an example of the original bidders behaving opportunistically, in that the renegotiation did allow for an increase in both the Government subsidy and the fares charged to end-users
- however, there were also significant service quality improvements during the term of the renegotiated franchises, plus continued growth in the number of passengers



Photos from G. Currie, *A Review of Melbourne's Rail Franchising Reforms*

Case Study - Melbourne Train/Tram

Results of the Renegotiation (cont.)

- in July 2008, a benchmarking study of urban rail systems in Australia* compared the Connex system with the publicly-owned CityRail system in Sydney, with the following conclusions:
 - Connex had annual rolling stock costs that were 40% less than CityRail;
 - Connex had crewing costs which ranged from 17-29% less than CityRail
 - Connex's operating costs per train station were 43% better than CityRail
 - Connex's overhead costs per employee were less than 50% of CityRail
 - Connex's employees per service kilometer were less than 50% of those of CityRail

* Source: *Cost Review of CityRail's Regular Passenger Services*, LEK Consulting Report for the Independent Pricing and Regulatory Tribunal, Sydney, New South Wales, available at <http://www.ipart.nsw.gov.au>

Case Study - Melbourne Train/Tram

Lessons Learned

- in retrospect, it is clear that the subsidies requested by the bidders in 1999 were unrealistically low, and reflected an ‘optimism bias’ in favour of unrealistic demand growth
- the Government could have refused to renegotiate (in which case the two remaining franchisees would likely have gone into administration) or it could have simply increased the level of subsidy – instead, it chose to enter into bilateral renegotiation discussions
- a subsequent 2007 Report prepared for the Government by Deloitte (www.abp.unimelb.edu.au/files/miabp/ext-repvalue-assesment.pdf) concluded that the “performance of the incumbent operators has been sound when assessed against the 2004 tender evaluation criteria and KPIs in each franchise Business Plan”

Case Study - Melbourne Train/Tram

Current Status

- in 2009, the Government decided to have a full competitive tender for new eight-year contracts
- both of the incumbent franchisees participated in that tender process but lost to other bidders:
 - Metro Trains Melbourne, a Hong Kong/Australia consortium, has the rail franchise
 - KDR Melbourne, a French/Australia consortium, has the tram franchise
- each of the operators has an option to extend its franchise by another seven years, beyond 2017



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