



## MONITORING SYSTEM OF PPP PROJECTS IN KOSOVA

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## THE SCOPE OF PPP PROJECT MONITORING

Monitoring of PPP project implementation starts from the signing of the contract between the Public Authority (PA) and the private partner, and continues throughout the span of the project life time, up until the expiry of the contract. Hence, it is defined by two important elements that stand at the core of a PPP project: the contract and the management team. Therefore, the foundations for effective contract monitoring are laid earlier in the process as a successful monitoring involves first and foremost the quality of contract drafting, and secondly the competence of the management team.

Since the PPP contract may foresee limited obligations for the PA, it is quite common to assume that the main responsibilities of the PA are discharged upon procurement as the contract will be self-regulating. Such an assumption brings about weak contract monitoring regimes that often result in a reduction in the overall benefits of the PPP project. A competent and committed monitoring team, combined with clear and unambiguous, time bound, key performance indicators and reporting responsibilities set out in the contract are the most important factors for the success of the project in the implementation phase.

An effective monitoring of the PPP contract implementation must ensure that the construction of the infrastructure at the basis of the project is completed within the time set at the contract, as per the quality standards, and within the time and budget foreseen therein; the services are delivered continuously and to a high standard, in accordance with the contract, and payments or penalties are made accordingly; contractual responsibilities and risk allocations are maintained in practice, and the PA's responsibilities and risks managed efficiently; changes in the external environment—both risks and opportunities—are spotted and acted on effectively; and the efficiency expectations of the contract are achieved and the hand-back provision in the contract are met.

An important tool for effective monitoring by the management team is considered the management plan, or "*contract management manual*", as widely recognized by the PPP related leading international knowledge providers<sup>1</sup>. This document must ideally be produced by the management team right from its appointment, as a matter of its first tasks. This document, drafted in a reader friendly style, contains in concrete terms what is expected to be done by monitoring team throughout the duration of the contract, and sets out its own duties in terms of follow-up and monitoring. The manual provides the Public Authority with a means of planning and setting out its own organisational arrangements.

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<sup>1</sup> EPEC's Managing PPPs during their contract life - Guide for sound management 2014, or The APMG Public-Private Partnership (PPP) Certification Guide, etc.

The monitoring process is divided in two stages, corresponding to the respective stages of PPP contract life span: construction stage and operation stage. Mirroring the responsibilities of the parties in the contract, as different as they can be given the differences of the outputs and benefits involved in each of these stages of the project, the monitoring process involves different aspects and tasks, as well as common features of the responsibilities that are dealt with in details in the following chapters of this report.

## MONITORING AT CONSTRUCTION STAGE

During the Construction Phase, both parties involved into a PPP project are focused on elements such as schedule, cost, and quality. Depending on the type of PPP, one party might have more of a vested interest in schedule than in the cost and vice versa. Yet both parties will have obligations that ultimately involve significant cost, which might not be planned for. The PA must understand the overall construction delivery, although it is not primarily involved in it. It must satisfy itself that all of the relevant permits, procedures, and required documentation is in place by the private party in order for the correct reporting to happen. The PA needs to play its part in the construction phase, otherwise, issues of delay, miscommunication, and potential claims can arise. Efficient contract monitoring management can reduce complex issues through decision-making, coordinating and communicating. The main attributes of PPP project success or failure can be defined in three components: the completion of the project within budget, on schedule, and to the required specifications. The responsibility for budget overrun in PPP projects must be, and it usually lays upon the private contractor. However, many specification-related problems may be stemmed from the use of unclear or ill-defined specifications or scopes of work from the outset at the contract. Problems to PPP projects might also derive from incorporation of sophisticated technologies deployed in such projects and the lack of sufficient experience to deliver pursuant to such sophisticated technologies. Facing with such problems makes the planning and good practice contract monitoring exceptionally important for project success, specifically when dealing with cost, schedule, and final specifications (design).

The construction phase of a PPP can be summarized in the following main activities: the establishment of the private partner on site and obtaining of the necessary permits and clearances to enable itself to carry out the construction works; the finalizing of the design for the construction works by the private partner; the construction works; and the commissioning of the completed infrastructure and hand over to the operational team.

With regard to the establishment of the private partner on site, the PA must have made sure earlier in the process, definitely before the signing of the contract, that all the necessary permits and clearances to enable initiation of construction works are in place and the full hand over of the site to the private partner and its construction sub-contractor occurs as soon as possible upon the signing of the contract, and definitely within the deadline forecasted therein. The responsibility of obtaining the necessary consents relating to the design, construction, engineering, technical, and installation specifications put forward by the private partner (such as any building consent and any record of decision regarding Environmental Investigation Approvals [EIAs] required) should be borne by the private party.

The PA should have satisfied itself during its evaluation of the private partner's bid and the negotiations on the PPP contract (and in any event prior to the signature date) that the private partner's design proposals included in its bid will achieve the required output

specifications as set forth in the Request for Proposal. The private partner must be solely responsible for the design. The PA has only a right to review the design and advise the private partner of any areas of non-compliance with the contract. However, the PA should not be involved in the approval of the design that would amount to acceptance by it of any errors or inadequacies in the design. In this way, the PA reassures itself that the design and construction is in accordance with the output specification (and the construction prescriptions if any), but the private partner remains responsible for the achievement of the output specification and for any failure of the design, and the associated risks are not transferred to the PA.

Construction, in general, can take many forms of delivering the final product and it is quite usual that the construction contractor splits the work into phases or smaller packages and tenders them to individual sub-contractors. However, the main contractor will retain responsibility for the quality of all work and for coordination of sub-contractor activities. The most work intensive period during the construction stage is in the middle of the phase, where all of the work packages are delivered and almost all sub-contractors are involved. As a result, it is particularly important to pay attention to sequencing, lead times for the material delivery, and any time-sensitive compliance matters which can disrupt the program, particularly at this moment in development of the project.

Before the asset is handed over to the operations team, certain steps need to be carried out by a certifier. This certifier is usually an independent engineering company, commissioned in accordance with the contract. The certifying of the infrastructure upon construction includes the testing and issuing of the completion certificate. If the performance tests for the readiness of the infrastructure fail, the private partner must remedy such defects in order to obtain the completion certificate. The completion certificate is contractual evidence that the construction Phase is complete. As an exception, it may be appropriate in certain PPP project to have service commencement despite incomplete construction. In this case, the PA must ensure however that the private partner always remains incentivized (through the payment mechanism in the contract) to complete the outstanding works. The PA may either stipulate that full-service commencement will only be achieved when all constructions are complete.

## Performance and Risk Monitoring

Performance monitoring may be defined as an assurance role played by the PA's management team of the project, where assurance is obtained that the private partner has:

1. adequate systems, policies, procedures, and resources in place to perform the specific performance-related obligations set out in the PPP contract (the output specification);
2. a functional quality assurance system in place to do self-monitoring; and

3. achieved the required outputs to meet the specification.

Performance monitoring does not mean managing the task for on behalf of the private partner, nor does it mean leaving the performance management entirely to the private partner. It must be understood that the incentive for the private partner is to achieve financial efficiency over the period of the PPP contract and not the whole life-cycle of the asset created. Therefore, the private partner may seek to reduce construction costs and incur increased operational or maintenance costs over a concession period that is substantially less than the life of the assets. The PA on the other hand must be interested in a higher capital investment that brings upon a lower life-cycle cost.

The monitoring team undertakes a number of monitoring tasks during the construction phase such as:

1. Monitoring against the schedule;
2. Monitoring against the scope (and any agreed variations);
3. Monitoring performance and compliance with applicable laws and regulations;
4. Quality control and materials monitoring;
5. Daily relationship monitoring with the private partner; and
6. Stakeholder reporting and management.

Risk management during the construction phase is one of the most important functions of the contract monitoring team. The team needs to monitor and, where appropriate, manage the project risks contractually allocated between the parties, inherent risks borne by the PA, project risks not contractually allocated, and also the management of risks and threats associated with changes to the PPP contract. In accordance with the terms of the contract the team must closely monitor the reaching of output specifications, the private partner's performance management reporting requirements, and the penalty regime that applies in cases of non-performance. The contract must also provide for audits that can be exercised to the private partner during the life span of the project.

During the Construction Phase, the performance must be monitored mainly to ensure that the facilities provided reflect the PPP contract, that work progresses properly through commissioning according to the schedule, and other contract obligations are being met. Some examples of the monitoring team's roles and responsibilities during this phase are:

1. Providing management arrangements that create a clear and easily understood interface with the contractor;
2. Reporting to public sector stakeholders on the progress of the project, assessing design data submissions by the contractor, including the review of any potential impact on services delivery;



3. Monitoring progress on site to ensure that the facilities meet the contractual requirements, and attending monthly progress meetings to ensure the PA's views are recorded and actioned,

4. Monitoring the quality of the facilities during building operations and bringing matters of concern to the attention of the private party, managing variations, discussing and assessing the validity of any claims for relief events or works compensation events;

5. Maintaining the risk register to address issues of uncertainty to project delivery, planning, communicating, and coordinating arrangements alongside the private party,

6. Maintaining communication links with all relevant stakeholder groups, and preparing for the operations phase of the project.

The efficient discharge of such responsibilities might require additional support by external advisers such as architects, construction engineers, legal specialists, etc.

A very important step in the monitoring of the construction stage is related to the appointment of, and delivery by the certifying specialist (usually engineering qualified entity) at the end of the commissioning and construction stage. Depending upon the provisions of the relevant PPP contract, the certifier is either an independent engineer (engineering company) which is mostly the case, or an engineer employed/contracted by the public authority and formally reporting to it. This specialist/expert company will be responsible for certifying that the construction phase and the commissioning have been satisfactorily completed in compliance with the PPP contract through issuing a certificate that starts the operations phase and the right of the private partner to collect or receive revenue from users (in a concession) or the PA (in a PPP public contract). The decisions of the certifier must be beyond the influence of either party. This is normally achieved by appointing a company with the appropriate expertise (dependent on the type of project) and a reputation for fairness and impartiality. The PPP contract should protect the independent certifier in that it should clearly stipulate that the fact that the independent certifier is paid by the private partner in no way derogates from its fiduciary duty to act impartially. The primary function of the independent certifier is to inspect and monitor the work, attend any performance testing during commissioning, advise the private party of any items that in the independent certifier's opinion require rectification, and finally, when satisfied, to issue the certificate permitting operation.

### Cost implication oversight

Throughout the construction stage, the private partner must make payments that match the progress made by the construction contractor in completing the construction works. Such payments are typically made against milestones that are agreed as part of the PPP

contract. Thus, at each milestone, it is necessary for evidence to be provided that the work has advanced to the required stage and is of adequate quality to meet the output specification. The monitoring of costs at each milestone is also a factor in the provision of security by the construction contractors as well as in the calculation of termination payments in cases of early termination of the PPP contract. The risk of cost overruns is typically passed on to the construction contractor/private partner in cases where the overruns arise from factors outside of the construction contractor's control. Cost overruns must be funded by the private party or the construction contractor. The PA should avoid being drawn into any disputes that may arise between these two parties about such overruns. Cost monitoring should therefore be only for informational purposes for the PA.

### Schedule monitoring

The most efficient way to ensure that the works are done in compliance with the schedule provided for by the contract is by requiring the private partner to liaise with the monitoring team on a regular basis, and report on progress against the construction schedule. The reporting should include information on the progress of the works, notice of any anticipated delays, the program for managing any delays, and other issues of importance during construction. Poor schedule management translates into political and reputational risks for the PA. Ensuring the schedule accurately reflects progress, and is updated to reflect delays or changes, is critical because tasks are mutually interdependent and delays can increase costs. Project planning can establish the overall schedule and should specify when particular tasks must be completed. A good PPP contract provides for clear milestones that are easily observed and verified. The PA must be timely informed by the private partner of any potential changes that might impact the milestones or the critical path for delivery of the project. In such cases, or even when the expected change in the schedule is spotted by the monitoring team in absence of proper information by the private partner, a decision-making process on the potential change of the schedule requires the involvement of the highest authority on the part of the PA.

### Quality monitoring

A Quality Management System (QMS) needs to integrate the various internal processes within the specific project, and provide a process approach for project execution. The QMS enables not only the private partner, but the monitoring team as well to identify, measure, control, and improve the various core business processes that will ultimately lead to improved performance and mitigation of construction risk. A private partner has several obligations when dealing with quality management that represent in essence the monitoring benchmarks for the monitoring team during the construction phase:

1. the development of the QMS processes, procedures and other documents, as well as preparation for their implementation;
2. the implementation of QMS processes, including sequence and interaction of these processes, criteria and methods to ensure effective operation and control of the processes, availability of information necessary to support the effective operation and monitoring of these processes, and methods of measurement, monitoring, and analysis needed in order to implement those actions that will achieve;
3. the reporting on how well a quality requirement is being met or how well a quality process is performing, including the development of methods to measure, report, and improve on both the performance and effectiveness of processes;

Monitoring management quality is difficult and largely falls into the 'soft' indicator category. Nevertheless, an experienced monitoring team should regularly monitor the quality of the private partner's management and operating personnel, looking for weaknesses or trends that may provide an early indication of trouble ahead.

## Change management

It is impossible to predict the range of possible risks and to allocate these with precision over 20 years or more in a complex and changing environment. The key to achieving long-term value from a PPP lies also in how the balance of risk and rewards is established in the PPP contract so as to be able to survive significant changes over a long period of time, and to manage such changes in a structured manner that preserves the public benefit or Value for Money in the PPP. There are many examples of PPP contracts that have been amended or renegotiated.

The flexibility to amend contracts is very important, but so is the need to maintain public sector oversight over the change process to ensure the public benefit or Value for Money. Also, it is important to ensure that the risk allocation between the parties remains consistent (given the changes to the PPP contract) with that approved as part of the original PPP contract. If a PA needs a very high degree of flexibility for change in the project, this suggests the project was not suitable to be a PPP in the first place.

The PPP contract sets out the events in which the changes are allowed but it may not, however, specify all the logistical or administrative steps that need to be taken in order to agree or implement permitted changes, which involve foremost the approval by the Public Private Partnership Committee (PPPC).

The likelihood of scope changes, originating either from the private partner or the PA, is greatest in the Construction Phase, as the best means of achieving the output specifications in the context of actual conditions becomes apparent. Regardless of the

source of the change, there must be a formal process of scoping and reaching agreement on such changes. The most common means of doing so is a variation notice issued by one party to another, setting out the costs and risk implications and also the formal changes to the specification. The cost implications must be clearly identified, and approvals should be sought from the appropriate decision-makers, depending on the quantum of the change.

- Where the PA seeks to change the contract specification, it must issue a formal variation notice. The private partner must be permitted to identify the costs and risks of implementing the variation, notifying the PA of such costs through a variation proposal. The costs should be compared to the original or base case capital costs. It is extremely useful for the PPP contract to have a method by which the various overhead costs and mark-ups of the private partner are identified for variations, so that the decision to implement the variation depends on the base costs that the private partner receives from its contractors rather than the mark-ups that the private party seeks to cover for its costs and risks. The variation is then formally signed off between the parties and implemented. The costs for the variation must be financed by the PA. Since this change may also involve consistent operating and maintenance costs that were not included in the PPP contract and the financial model, there must be a mechanism by which these can be reimbursed by the PA.
- As to the private partner-initiated changes, the majority of those should relate to the means by which the output specification is achieved and should be at the cost and risk of the private partner. Nevertheless, the PA has a significant interest in reviewing and approving these changes so that the output specification continues to reflect the needs of the PA. This is because the PA remains the owner of the asset created, and it has an interest that the asset performs over a period much longer than the term of the PPP contract. In this case, the private partner issues the variation notice and confirms the detail of the change to the specification and that there is no cost to the PA. The PA then issues some form of no objection to the variation, which is then formalized and signed off on by the parties and then implemented. The PA must be sensitive to the concept of value engineering by the private party. Value engineering is where costs are reduced by the use of some innovative implementation method and is common in construction and system development. Cost reductions may well be shared between the parties in the variation agreement, but care must be taken to examine the risk that comes with such value engineering. An example in a rail system could be reducing the amount of derailment containment to a level that is consistent with good industry practice, but below that set out in the original output specification. An actual derailment in an area where the containment was omitted as part of a value engineering that the PA shared in, would lead to some interesting liability issues in civil and even criminal proceedings.

- The general risk of implementing the PPP contract lies with the private partner, except for force majeure events. Of particular importance are also political events affecting the execution of the contract. In such cases, the PPP contract must specify the manner in which such events are notified between the parties. It also needs to clearly indicate the extent that such an event will result in a variation to the PPP contract, a variation that must also be formalized between the parties. Where a party objects to or disagrees with the outcome of such a process, the variation would be decided in accordance with the dispute resolution procedure set out in the PPP contract.

Managing the changing environment and emerging risks through amending and adapting contracts is key to de-stressing projects. However, renegotiations of significant aspects of the PPP are in principle forbidden on the basis of considerations such as: 1. competitive bidding may be distorted and the most likely winner is not the most efficient company, but the one most skilled in renegotiation; with renegotiations carried out bilaterally, the positive effects of competitive pressure are lost; 2. renegotiations often reduce the overall economic benefits of PPP arrangements and might have a negative impact; and 3. it may interfere in lender rights to intervene in or prevent changes to the contracts in order to protect their rights.

### Private partner underperformance and non-compliance

The monitoring team must closely monitor the progress of the works and the quality thereof. Poor quality will result in delayed completion as the private party struggles to commission the work and obtain the certification needed to begin the operations phase. In most PPP projects the performance monitoring and reporting is done by the private partner, making the function for the PA largely one of assurance that the reporting is accurate and auditing performance measures when it is not. It is almost certain that the private party will not meet the required standards and not comply with the specification in the PPP contract during the lifespan of the project. This concept is defined as “non-performance” even though some of the services may have been partly provided or have partly met the specification. When dealing with under-performance and non-compliance in the construction phase, the issue is not the standard of services provided but rather the time taken to complete the asset and the quality of the asset on completion. In general terms, the private partner is incentivized to bring the asset into revenue-earning operation, but the PA may suffer some losses in case of delay and may create a right to claim some form of liquidated damages. Non-compliance by the private partner decreases the public benefit or Value for Money in the PPP by decreasing the quantity or quality of services offered to the public. The relationship between the public and private partners will be negatively affected to the detriment of the project’s sustainability. It also creates a bad precedent for PPPs as the public perception of private delivery of these services will be poor, and will lead to strong opposition to PPPs and questioning of the Value for Money

offered. The financial sustainability of the private partner will come under pressure and defaults under the financing agreements may be triggered, thereby leading to lender step-in.

It is inappropriate for the PA to condone or accept material non-performance by the private partner. The most common manner in which this occurs is if the monitoring team misses or fails to initiate proceedings for application of a penalty for non-performance. This is not necessarily fatal for future non-performance, as an isolated failure or delay by any party in exercising any right or remedy may not operate as a waiver of such right or remedy. Any waiver of a breach of the terms of the PPP contract is not necessarily a waiver of any subsequent breach or default. However, repeated acceptance of noncompliance may result in the PA losing the right to insist on compliance at a later date. Where non-performance is not material and instead constitutes a technical noncompliance with the contract that will not compromise the project outcomes or Value for Money, it may be appropriate for the PA to waive compliance with that requirement, as it may be counterproductive to initiate the contractual penalty or default processes for a non-material, non-performance issue. However, before doing so, the monitoring team should seek advice and approvals. Legal advice as to whether the non-performance can be waived without comprising other obligations under the contract, as well as legal advice regarding how to document the waiver to ensure that it only applies to the specific non-material obligation. Technical advice (for example, from the PA's engineering advisers) to confirm that the non-performance is not material and will not compromise the project outcomes or Value for Money (VfM). Approval by the relevant PA authority is only possible after the proper advice has been provided and the decision-making process is considered well informed.

The liquidated damages/penalties are the preferred remedy for late service commencement in PPPs. Liquidated damages are a payment, representing a genuine pre-estimate of the actual losses or damages suffered if the private partner fails to achieve service commencement on time. The events giving rise to liquidated damages, and the amounts, should be set out in the contract. It must be emphasised that the term "penalty", different from "liquidated damages", refers to amounts which bear no relationship to the harm suffered. An example would be the cost to the PA of renting alternative accommodation or paying higher service fees in the absence of the services to be rendered by the private partner under the PPP contract. In many PPPs, both the PA and the lenders are entitled to liquidated damages. The liquidated damages payable to the lender are often significantly larger than those payable to the PA, and they provide a strong incentive for the private partner to complete construction on time.

The contract should provide for performance bonds, such as construction bonds, or other forms of security called in by the PA. A construction bond will usually take the form of an on-demand bank guarantee which can be called by the recipient when, for example, the service commencement date is not met. It increases the cost of the project, but provides security in the case of a default. This default risk is highest in the early stages of the

construction phase because the PA may not be able to find another party to take over the project and therefore may incur significant cost in reinstating it. The calling of a performance bond requires that contractual triggers are met.

The delay in construction works translates in PA suffering the loss of the services to the users. Both parties suffer reputational damage as a result of delays. The loss of revenue is always severe as the private partner has a shorter period to earn revenue and, especially in PFI contracts, this loss is never regained. Simultaneously, shareholder returns are reduced. This may even extend to reduced refinancing gain opportunities. The operational impacts of delayed service commencement relate largely to the delay in the provision of the services. Where these involve social infrastructure like hospitals and schools, patients may receive inadequate treatment at alternative facilities, and learners may miss the start of a school year.

Many PPP contracts contain a “long stop date” by which services must commence regardless of what events or claims occur during the construction phase. If, notwithstanding all of the remedies, the services have not commenced by the long stop date, the PA must commence the process to terminate the PPP contract.

## Issue management

Issue management usually comes into effect when significant risks arise or materialize. Conflict and issues typically occur within a contract when a problem occurs. A key aspect of a partnering relationship is the resolution of problems quickly, efficiently, and without dispute. This can be achieved through a number of defined mechanisms, such as:

- 1.Documented discussion and formal note of agreement;
- 2.Harnessing the contractual change mechanism so that the issue does not affect the overall affordability of the project;
3. Agreed arrangements for change to the private party’s method statements; and
- 4.Regular scheduled meetings with attendance by key stakeholders from both parties.

If not provided for by the contract, the issue management procedures are normally left to monitoring teams to arrange in order to avoid disputes and the development of a blame culture. However, the basic tenets of a collaborative problem resolution methodology are to develop a systematic approach, incorporate an agreement to seek win-win solutions rather than parties to blame, create a culture of open discussions and equality of rights, and to acknowledge that adversarial attitudes waste time and money.

## Financial restructuring

Financial restructuring might be an option if the PPP project experiences significant troubles. A method of dealing with a project in financial difficulty is for the PPP contract to be auctioned by the PA, whereby a new bidder will pay the actual worth of the project and then continue to provide the service. This is consistent with the risk allocation to the private partner and is the preferred method of dealing with such projects. However, there is a risk that there will be no buyers willing or able to take over the project. Other tools employed for financial restructuring may include amendment to the finance documents or conversion of debt to equity. These are managed within the private partner, and PA involvement is limited to approvals of the changes made in the restructuring, especially where there may be change of control provisions in the PPP contract. Finance document amendments may include extended maturity dates, revised interest rates, and amended financial covenants, among others. It is of significant importance that amendment of financial covenant might require a pre legal assessment in terms of consideration as to the implications provided for in the Law on State Aid.

## Claims management

Well-structured PPP contracts allow for specific consequences for specific failures by one party to meet its obligations to the other party. These failures normally give rise to a compensation event or to a breach of the PPP contract, not to a general claim for damages. Therefore, it is possible for a party to implement a form of claim on the grounds that the other party has caused such harm or loss that it would be impossible to obtain relief without instituting a claim for damages. The role of the monitoring team is thus critical in ensuring the compliance of the PA's, and correctly documenting all events in meeting such obligations. The contract management team should have the resources and processes to permit good claims management. Claims management allows claims and potential claims to be identified and evaluated. By assessing their merit early on, claims or potential claims can be avoided or resolved quickly. Alternatively, the decision can be made to pursue other routes to resolution. Claims that are not legitimate (i.e. totally out of the scope of PPP contract) should be rejected by the contract management team at an early stage to avoid any waste of time and resources by PA higher authorities. Upon receipt of any claim or notice of breach, relief, or compensation event, the contract management team should follow the steps:

1. Determine the source of potential claim. For example, design error/omission, scope gap, documentation conflict, hidden/differing site conditions, abnormal weather, and so on;
2. Determine whether or not the claim has any basis in the PPP contract or in law. Consult legal resources on the matter;



3. Determine potential success of claims based on established legal precedent and contract documentation;
4. Determine worst case and best case magnitude from each party's perspective;
5. Develop the strategy of response which may range from a settlement agreement to following the dispute resolution process.

In general, PA's officials are not empowered to reach settlement agreements on claims, as these often have significant financial implications. As such, the dispute resolution process (DRP) is the default in all claims. Both parties need to follow the prescribed DRP to ensure that all time lines are met and all procedures complied with. The worst possible outcome is a default judgment under the DRP without the merits of the matter being decided upon.

### Extension of time in the construction phase

The private partner will have a limited set of events for which it can claim to: either extend the completion date by which the asset must be created, commissioned, and operated; or extend the expiry of the PPP contract (effectively an extension to the period in which it can earn revenue from operating the asset). These events are clearly set out in the PPP contract, and relate to matters outside the control of the private partner. Allowing an extension of time in these circumstances enables the project to continue with the private partner remaining incentivized to complete the project, which is a better Value for Money outcome than initiating a default process as a result of an event beyond the private partner's control.

The role of the monitoring team is to ensure that the basis for granting such an extension meets the criteria in the PPP contract in basis of fact, and in terms of compliance with the procedure set out therein. There are relief events (which entitle the private partner to an extension of time without compensation) and compensation events (which entitle the private partner to an extension of time and/or payment of an amount of compensation), but the process followed in both events should be the same.

Relief events are those events listed in the PPP contract that may arise at any stage during the term of the PPP contract, the consequences of which are best managed by the private partner even though they may not be within its control. The best example of a relief event is unforeseeable adverse weather conditions. The private partner bears the financial risk of relief events but neither liquidated damages nor rights of termination should arise because the private partner is granted an extension to the completion date. The private partner should give the PA notice of the occurrence of any of the relief events specified in the PPP contract. This should be done as soon as reasonably practicable after becoming aware of the occurrence of the event and within a defined period. The monitoring team must request further details and particulars if it is not satisfied that it has sufficient information to justify the extension of time. The ultimate decision is beyond

monitoring team's authority but the monitoring team should interrogate the private partner about the information provided. If the parties do not agree, then the matter must be determined in accordance with the DRP. The private partner must minimize the adverse effects of any relief event by taking action to minimize the delays caused by the event.

Compensation events differ from relief events because the private partner is entitled to an amount of compensation and possibly a time extension to the term of the PPP contract. Examples of compensation events are a failure on the part of the PA to timely provide land, or a right of way, or a delay caused by another government agency. In addition to the requirements for relief events the private partner must: a) specify the event that has occurred and explain why it qualifies as a compensation event; b) identify an impact that the event has had or is likely to have upon the performance of the private party's obligations; c) provide details of the additional time required to remedy that impact; and d) provide details of the additional liabilities, costs and expenses, and the loss of revenue that the private partner has incurred or is likely to incur. This must be summarized into a capital cost, for which the private partner must be compensated, and an operating cost that must be covered by an increase in revenue (user fees or periodic PA payments depending upon the type of PPP) or an extension in the term of the PPP contract. The monitoring team must interrogate and audit these costs closely as they may be overstated. The mitigation costs of the private partner must also be examined to see whether they were effective. Any unresolved disagreements on the matter must be dealt with through the DRP.

### Dealing with force majeure events

Force majeure events are a limited set of events which may arise during the term of the PPP contract through no fault of either party. These are best managed by the private partner. They are more severe than relief events, will typically last longer and may result in termination of the PPP contract. They are, by definition, unusual and rare events, and the contract management team should deal with these as exceptions. The focus should be on avoiding termination by the private partner, mitigating the effects and, if required, obtaining support from the lenders to defer payment until such time as the project is stable again.

The monitoring team must be notified of all claims within a limited period of time after the event. Claims submitted long after the event become impossible to evaluate, and the private partner will struggle to show how it dealt with the event and mitigated its consequences. The notice on force majeure must contain complete information, otherwise the notice should be rejected. The monitoring team should request further information on the claim until it is satisfied that it has enough information to evaluate it, and the claim should be grounded on the base case financial model and the original project schedule in order for the effect of the event to be evaluated against the original base case in terms of time and money.

Both parties should make considerable efforts to reach agreement on the schedule and cost implications of the event. In some cases, an independent evaluator can assist in this. The fall-back position should be the DRP.

## Dispute resolution procedures

Dispute circumstances are specific in any PPP construction projects and could influence the success and failure of projects. PPP construction project issues, concerns, and disputes occur as a result of numerous factors such as technical, climatic, and logistical events, while resolution of PPP construction project disputes is influenced by people's ideas, manners, activities, and cultural implications. Sometimes issues arising during the construction phase, cannot be solved through issue management processes and will inevitably end up in dispute. Therefore, a proper mechanism to secure resolution is needed. The private partner often prefers a resolution method other than a usual litigation procedure, arguing that courts can be slow, expensive, and sometimes even misjudged or misguided, whereas the public partner tends to rely on conventional court procedure. However, it must be emphasised in this context that in countries like Kosovo, with limited PPP historic records, the courts are other than adequately specialized to deal with the complexities of PPP agreements.

Another procedure that can be used as an alternative to resolution in cases of stress and material breach in the PPP contracts is the step-in procedure. A step-in occurs when another party, being it the public partner or the lender, temporarily assumes some or all of the obligations of the private party. In cases where there is no private partner breach, the private partner is relieved from the obligations that the step-in party has taken on by stepping-in. In addition, if the step-in does not involve the private partner's breach but affects its duties and obligations to perform, then the public partner must continue to make any required payments to the private partner when due — irrespective of whether the services under the agreement have been delivered or not. If the step-in by the public partner arises due to the private partner's breach, then the private partner should remedy any such breach at its own expense and should meet the public partner's costs of stepping-in. If the breach by the private partner persists after the public partner has stepped-out, then the lenders have the right to step-in.

The lenders' step-in occurs primarily when termination of the PPP agreement could occur. They step-in to ensure the continuity of the project if the private partner defaults under the PPP agreement or the financing agreements. This allows the lenders to remedy defaults following a threatened termination of the PPP agreement and the financing agreements. The main principles on which lender's step in applies are:

- The lenders must voluntarily step-in to resolve the issue in question;
- The PA must not suffer due to the step-in process, and the PPP contract must carry on according to the original set up, including any penalty deductions;

- The private partner must inform the lenders of all private partner's defaults, non-payment of the penalties, and any other issues that may affect the project;
- The lenders may only exercise their step-in rights upon payment of all such liabilities to the PA;
- Agreed remedial work within the time frame attached to it must be supplied by the lenders in order to assist in rectifying the issues that the private partner needs to achieve.

## Knowledge management

The importance of knowledge management is not only to ensure the continuity of knowledge throughout the life of the project, but also to assist the contract management team in meeting legislative and contractual requirements. The development of knowledge management system includes receiving, collecting, and recording the meaningful information; storing and sharing the information; information security; and maintaining and disposing of information. A process for such activities must be put in place and applied by the monitoring team. This will enable all parties involved to be proactive and record documentation accordingly, regardless of the time of their involvement during the lifespan of the project. Modern knowledge management electronic systems in the form of sophisticated software are available, though sometimes expensive<sup>2</sup>. If the process of obtaining, storing, sharing, and disposing of the data been successfully implemented, then the information and data is submitted and transferred between stakeholders in the appropriate form and at the appropriate time.

The life span of PPP projects is often extensive and it is almost impossible that the same personnel will see the project through to the conclusion. Therefore, it is likely that the monitoring team members are going to change several times throughout the life cycle of the project, and the new staff will need some time to familiarize themselves with the details and the history of the project in order to successfully manage the PPP. Planning for succession includes all the processes for transferring knowledge from staff exiting the project to new staff. Training for all new personnel with regard to the contract administration is imperative to ensure that all the policies and procedures are clear and will continue to be implemented in the same manner by the new personnel.

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<sup>2</sup> <https://www.oracle.com/applications/primavera/products/project-management.html>

## MONITORING AT OPERATIONS STAGE

Although the operations phase contains different aspects in comparison with the construction phase, the mechanism for applying good practice contract management therein does not differ significantly from that of the construction phase. However, during the operations phase key actions for the contract monitoring team change. Such different key actions cover areas such as managing payment regimes, including insurance and utilities, acting on the results of customer surveys, looking for continuous improvement in the service, and performance monitoring. Failure to implement an adequate contract monitoring system in operations phase could result in: payment for services that are either not received or not being performed satisfactorily; the project not performed as expected thus jeopardising project benefits; change to the balance of risk agreed at the contract; and finally, a possible break down in the relationship with the contractor. Here are some of the key mechanisms that need to be put in place to monitor the private party's performance, legal, and financial changes that might happen over the operations phase:

### Transition from construction to operation stage

Between the end of the infrastructure construction, and the beginning of its operation there is a substantial transition period where most of the professionals who designed, installed, and verified the initial condition of the infrastructure cease to be involved. A new team of people begins to run the asset, taking on the phase with far greater costs and environmental impact. This shift in personnel presents one of the greatest risks to the parties' ability to bridge the gap from construction to efficient operations. Assets naturally trend toward "performance decay", a phenomenon responsible for as much as 30 percent in efficiency loss in the first four years of operation in buildings such as offices, schools, and hospitals. Hardly any of the people supposed to manage the operations stage of the project are present during the earliest and most critical phases of planning and design. Everyone involved up until the completion of construction essentially leaves, turning over the facility to an entirely new group of professionals. Therefore, the monitoring team should ensure that its project plan includes the work to prepare for the transition between construction and operations stages of the project. The plan should include dependencies, time scales, and resources. The plan should link to the communications measures to ensure that the timing is appropriate and that stakeholders have been prepared for the changes. It is essential that the contractor is not delayed by any action, or lack of action, on the part of the PA.

## Monitoring of project delivery and service outputs performance

Monitoring procedures can include self-reporting procedures, independent audits, regular meetings and reports, and the use of intelligent systems that automate data collection and reporting processes. The monitoring system implemented must be sound and constantly used in order to deliver Value for Money (VfM). The monitoring performance system is primarily focused on the service performance (the level of achievement of the service levels or output specified in the contract), but it also tracks and monitors breaches of the contract. If the level of service performance is under the required standard, penalties and/or deductions or abatements might be implemented. Direct penalties are used in some user-pays projects. In availability based contracts, the financial penalization due to poor service performance (failure to meet the service levels or output required) is commonly effectuated by means of payment reductions or adjustments, in addition to the accrual of performance points. Performance points are mainly used to track and record breaches: once non-compliance or performance points reach a specified level, they can result in increased oversight, work by the PA at the private partner's expense, suspension of work, or termination of the contract under the persistent breach consideration. However, many other methods for determining penalties, deductions and abatements, and for tracking breaches are possible. The contract monitoring team should ensure that they understand the particular method used in their contract.

## Managing private partner underperformance and non-compliance

As in the construction phase, during the operations phase, the immediate mechanism to deal with non-compliance and contract breaches is typically a mechanism that has financial consequences for the private partner. However, the system and instruments for managing under-performance (by providing incentives for performance as required by the contract) have a higher complexity in this phase than during construction, as a wide and complex set of service requirements must now be monitored. A contract breach is a failure to observe a provision of the contract. A distinction may be made between breaches of the service performance requirements (that is, not meeting the service targets or standards) and the breach of other contractual provisions. The distinction is useful, as the financial consequence imposed by the contract for a service performance failure or under-performance situation may take the form of payment deductions (or abatements) in PA-pays contracts. However, in user-pays contracts, the financial consequence due to the lack of performance (as well as other non-compliances or contract breaches) will most often result in a direct penalty or a liquidated damage amount through the penalty system. The worse the performance, the larger the financial penalization, and the longer the non-performance persists the larger the penalization. In addition, by contract a non-performance in core performance areas usually triggers larger penalties. An example of the principle, as applied in an availability based (public contract or PA-pays) PPP contract

for a hospital, would be that non-performance leading to the non-availability of an operating theatre would attract a much larger financial consequence than the failure to meet the food quality standards required for wards. The concept is relatively simple and can also be applied to user-pays PPP contracts. In addition to the financial penalizations, another mechanism has to be in place to control and monitor non-performance and non-compliance or track the breaches, which is usually done under a “performance points regime”. This mechanism will serve to trigger other remedy actions against non-performance as it becomes more serious. The non-performance may be recurrent and result in a specific financial consequence (by means of increasing audits at the cost of the private partner, or by increasing the penalties or deductions through a ratchet mechanism), or may become so persistent that it is not sustainable to continue with the PPP contract. To effectively control this issue of the occurrence of severe and persistent breach, the contract may allow the PA to levy performance points on the private partner for any single breach. When a certain threshold of such points is reached, the public partner is typically entitled to impose further or incremental financial penalizations, exercise its right to step in, or even terminate the PPP contract.

### Performance monitoring methodology

The performance monitoring methodology in a PPP contract typically contains a performance management model, comprised of three key elements:

- The level of performance required to achieve the output specifications. The levels should be set such that the standards are reasonable and objectively measurable;
- The means of monitoring the private party performance: The monitoring methodology included in the PPP contract should occur at three levels, such as a systematic self-monitoring by the private partner through a Quality Management System (QMS), a review of the private party’s QMS by the monitoring team or an independent third party, and end-user feedback on the quality and effectiveness of service delivery. The PPP contract must also specify the way in which performance is reported for monitoring purposes; and
- The consequences for the private partner of a failure to meet the required level: The consequences of poor performance on the part of the private partner must be handled in accordance with the PPP contract, which should contain provisions for a number of responses to performance failure, ranging from formal warnings, penalties, and/or payment deductions to eventual termination for private partner default.

Important to emphasise that to the extent that the private partner is prevented from achieving the required performance levels by specific events outside of its control (as described and defined in the contract), the penalty regime and payment mechanism should provide adequate and appropriate relief to the private partner. Performance

monitoring systems should be established to enable the PPP contract monitoring team to:

1. check that all performance conditions and clauses in the PPP contract are acted upon;
2. develop effective mechanisms for obtaining feedback from end users and other key stakeholders;
3. review third party monitoring reports;
4. inspect deliverables to ensure inferior goods or services are not accepted; and
5. maintain comprehensive documentation on performance monitoring.

The PPP contract must specify the date by which the performance levels are to be achieved. Effective monitoring should provide the basis for reviewing actual private partner performance against the output specifications and other obligations contained in the contract. Reviews can be carried out by the monitoring team and/or independent third parties. The action taken by the management team to correct private partner performance must be in line with the provisions in the PPP contract and commensurate with the severity of the transgression. The application of formal warnings, penalties, and payment deductions or abatements, step-in and other responses should be undertaken in a manner that is likely to achieve the best result from the institutional point of view. An overly rigid approach may jeopardize continued service delivery to end users, while too much lenience could encourage the private partner to commit further breaches.

### Quality control and quality assurance procedures

PPP contract specifies the required performance level through output specifications and not required inputs. Required performance levels need to be worked out carefully by both parties during the competitive stages of procurement. The negotiated performance levels result in a key element of the risk transfer mechanism in the contract. The monitoring requirements usually are set out in the Request for Proposal (RFP) and a full methodology is part of the bid. The methodology will normally include a substantial element of self-monitoring by the private partner, subject to periodic review by the public partner. Additional monitoring may take place depending on the nature of the project. The periodic reports to be provided by the private partner are key to the management of the PPP contract and to the payment mechanisms, and they should be specifically tailored to meet the monitoring requirements. A distinction must be made between the monitoring mechanism formulated and implemented by the private partner and any actual monitoring undertaken by the monitoring team. The private partner should have the primary responsibility for the former, and the PPP contract should clearly provide how the monitoring team will conduct its own monitoring, which will constitute the basis for the calculation of performance penalties or deductions. Objective performance criteria should always be used as far as is possible, but other methods of measuring performance may



be appropriate in certain projects. For example, there may be qualitative aspects of performance to which it may be difficult to apply penalties or deductions objectively, but which are nevertheless important to the users of the services such as the helpfulness of staff or the quality of catering in a hospital DBFOM (design-build-finance-operate-maintain) hospital PPP contract. Three possible approaches for measuring these aspects of performance are the use of end-user satisfaction surveys, the use of “mystery shoppers”<sup>3</sup>, and sampling<sup>4</sup>.

### Incentive schemes for monitoring purposes

The PPP contract must clearly stipulate the consequences of any failure by the private partner to perform to the minimum standards of the required output specifications. The principle should be that penalizations (either penalties or deductions) are applied in a manner that is appropriate and proportional to the non-performance of the private partner. The ultimate threat of termination is reserved for very severe cases of non-performance by the private partner. The PPP contract should include a schedule detailing the level of penalties imposed for each failure to meet a required output specification. Alternatively, the payment mechanism must be clear as to how to calculate the deductions or abatements. There should be a clear link between the seriousness of the failure, the value of penalties or deductions accrued, and the potential financial impact on the private party. For example, a failure to clean the courtyard of the school should not accrue as high a penalization as a failure to provide heat during the winter cold days.

In availability based contracts, where the penalization is applied in the form of deductions or abatements, depending on the specific payment mechanism used, a failure may or may not have an immediate financial impact on the payments payable by the PA. It is possible for payment deductions to only start once performance deteriorates below a particular level, or alternatively for them to accrue on the first failure. It might also be appropriate to have a ratchet mechanism (an increase in the level of the penalty or deduction when the failure reoccurs) in the contract to deal with a recurrent failure to render a particular aspect of the services. The ratchet mechanism can be useful where the financial cost of penalizations, which accrue in respect of each such failure, is insufficient to provide an appropriate incentive for the private partner to rectify the failures. However, seeking improvements is not about extracting more from the private partner against its will, but about working together to improve quality, performance, Value for Money, or other aspects in a way that benefits both parties.

The payment mechanism contained in the PPP agreement should provide incentives for the private partner to seek improvements in performance. If prices are fixed, they can

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<sup>3</sup> Use of qualified individuals to test aspects of the services

<sup>4</sup> Monitoring is to be done on a sampled basis, the methodology for sampling, including sample size and frequency, should be agreed in the contract.

increase their profit by improving efficiency. If profits are shared, they are motivated to improve economy. The PA can also provide incentives to the private partner for early commencement of services, if this is affordable and provides Value for Money. It is important that the PA does not take all of the benefit of performance improvements for itself, as this will deter the private partner from identifying such improvements. The PPP contract should provide incentives for performance improvement, which could be both financial and non-financial. The incentives should also be linked to circumstances in which the private partner can provide added value. Added value means bringing something to the partnership that is genuinely worthwhile and beyond what was originally envisaged in the PPP agreement. Some examples of adding value could be: - Eliminating aspects of the service that are no longer required; - The use of new technologies that translate in cheaper and more effective services; - Changes in procedures or working practices that provide more efficient ways of delivering the service; - Opportunities for innovation, where the private partner is given the chance to implement new solutions that result in improvement of the performance of the service.

One additional consideration for user-pays PPPs is including in the contract the sharing of returns between the public and private parties above a benchmark or base case return on equity. The reasoning is that it is appropriate to incentivize the private partner to benefit from its efficiencies while permitting the PA to benefit from financial efficiencies that arise from economic factors that are outside the control of the private partner, but have resulted in a financial benefit (for example, revenue may be higher than expected because general growth in the economy has been higher than expected).

## Managing the budget

Budget management during the operations phase of a PPP contract is closely related to the financial model of the contract. On the basis of the financial model the monitoring team is supposed to review long-term prospects and risk exposure. It should also use the financial model to consider price variations and compensation payments in terms of the PPP contract, to calculate any potential refinancing gain (if the contract requires the private partner to share this with PA), as well as the amounts payable in the event of variations. The contract should require the private partner to prepare financial statements and enable the PA to monitor key financial indicators, such as gearing<sup>5</sup>, debt cover ratios and internal rate of return, as well as calculation of the compensation sums due by the PA in the event of an early contract termination. The monitoring team should also ensure that during the operations phase the management of contractual payments takes into consideration forecasting values with the actual values, resetting the assumptions used to update forecasts based on actual data, restoring key historic data (both financial- and performance-related), and performing financial control analyses.

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<sup>5</sup> The amount of debt relative to equity

## Managing renewal funds

The revenue collected by the private partner by way of a unitary charge payment, user fees, or a combination of user fees and PA payments will include amounts to cover the private partner's anticipated expenditures on maintenance and renewal of assets over the life cycle of the PPP. The monitoring team must ensure that the money needed for such maintenance, overhauls, and renewals not be paid out as distributions to shareholders. This task is carried out through the scrutiny of financial statements, and audits conducted on those statements as well. The financial model will have provided for the anticipated costs in accordance with a schedule prepared by the private partner, which is to be closely monitored at operation stage. The need for provision of a life-cycle renewal fund in the contract is related to the concept of depreciation. Depreciation is recognition from an accounting perspective that the value of an asset declines over time, while the life-cycle renewal fund is recognition from a practical perspective of the need to build up cash to meet the costs of periodically renewing the asset to restore its value and functionality. In this regard, the private partner is rewarded for efficiency in managing such a fund in that at the end of the PPP contract period, the cash balance remaining usually belongs to the private partner. The monitoring team needs to ensure that the assets are maintained and renewed. It should therefore have the ability to conduct a final survey toward the end of the contractual period. At that time, it needs to either withhold payment of the unitary charge, or require that the private partner put a performance bond in place if the assets are not restored to the required standard (normally of remaining residual life at the end of the contract period). The private partner should also prepare a maintenance and renewals report which shows the costs incurred and payments made to and from the renewals fund, any deferrals of maintenance and renewals, and a revised and updated renewals plan for the remainder of the contract period.

## Variations and change management

Variation management is closely connected with PPP contract management and relates to the creation of mechanisms to enable changes to the PPP contract. Such changes may be necessary as a result of a change in circumstances that could not be anticipated or quantified when the PPP agreement was signed. The four main categories of variation types include: 1. Variations that involve no additional costs; 2. Small works variations; 3. Public partner variations; and 4. Private party variations. The monitoring team must become familiar with all of the intricacies of each variation procedure and ensure that the correct steps are followed whenever the need for change arises.

1. In circumstances where a proposed variation involves no additional costs for either party, no formal variation procedure is required. The project management team

and the private partner should meet to discuss the best way of implementing the proposed change. If the variation will result in a reduction in costs, then an agreement about how to distribute such savings must be reached. Entering into such an agreement goes beyond the mandate of monitoring team, which can serve as facilitator to the process that results in an amendment to the contract. In the case of a variation proposed by the PA, savings should accrue to the public partner and/or end users, while savings derived from a variation proposed by the private partner should be divided between the public authority, the private party, and end users.

2. Some PPP contracts should include a small works variations procedure, designed to provide an efficient mechanism for dealing with minor additional works required by the public partner at the operation stage of the project. For example, the PPP contract can foresee for the private partner to provide a schedule of rates for a range of likely small works at the beginning of each year.
3. PA-initiated variations should be limited to changes to the services requirements, the specified constraints on inputs, and the limits or scope of the project insurances. If the PA wishes to make a change to the project deliverables, it must first submit a variation proposal to the private partner. The variation proposal must describe the nature of the variation and require the private partner to provide an assessment of the technical, financial, contractual, and timetable implications of the proposed change within a specified period. Depending on who provides the funding, payment for the variation should be made by any necessary adjustments to the user fees or unitary payment (if the private partner is financing the variation) or other forms of payment. Disputes between the parties relating to a variation (which does not involve a decrease in the scope of the service or adversely affect the private partner's risk profile) must be resolved in accordance with the dispute resolution procedure.
4. Managing private partner-initiated variations involves firstly the monitoring team. If the private partner wishes to introduce a variation, it must submit a variation proposal to the PA through the monitoring team, setting out the details of the variation and the likely impact thereof on the PPP contract — particularly in relation to unitary charge payments. Generally private partner-initiated changes should be at no cost to the PA or end-users, although there may be cases where the change is beneficial to both parties and the PA is willing to contribute to the cost or increase the user fees. If the PA decides to accept the proposal, it will need to make any necessary arrangements for payment depending on the funding regime that has been agreed.

Well-developed PPP contracts provide flexibility in order to accommodate changes that might occur during the operations phase. The need for flexibility to implement variations in a PPP typically arises due to either the need of the PA to implement a new policy initiative, or specific needs of the project change. Variation clauses in the PPP contract should provide efficiency for the PA in implementing changes. However, the PA should ensure that any changes are subject to the same degree of scrutiny and control as would

apply to any similar investment or action that was implemented outside of a PPP contract. The change process in the PPP contract should not be regarded as a way of circumventing ordinary government processes, and care should be taken to ensure that any changes offer Value for Money. There is a perception that PPP contracts do not provide long-term flexibility and can impose significant costs on if there is a need to modify the asset or vary the services provided by the private partner at some point during the life cycle of the project. Enhanced flexibility, in particular directed to accommodate changes in user needs, is important for PPP long-term projects. It may be achievable through well designed change management contractual clauses necessary to limit potential abuses. However, enhanced flexibility will inevitably come at the cost of lower predictability, a higher risk for the investing private sector party, and reduced effectiveness of the competitive selection process. If the PA needs a very high degree of flexibility for change in the project, this suggests the project was not suitable to be a PPP in the first place.

In cases where changes of the PPP contract occur and are not provided for in the contract itself (which often happens due to the lengthy duration of PPP projects), the processes and procedures must be clearly stipulated and followed by both parties to the contract. During any change process, the contract monitoring team needs to address these issues and strike a satisfactory balance between encouraging the private partner to manage its risks; and preventing poor performance by the private partner from endangering the viability of the PPP contract. PPP contracts can be designed to minimize major renegotiations at a later stage. Contract renegotiations require careful analysis and a dialogue between the parties before contract changes can be agreed on and implemented. Whereas some renegotiations are efficient, others represent a form of rent-seeking opportunism and should be discouraged. Renegotiations of significant aspects of the PPP contract have considerable implications for the parties and are, in principle, forbidden and regarded as undesirable due to: competitive bidding distortion, elimination of competitive pressure positive effects and reduction of overall economic benefits of PPP contracts. In some cases, the changes that are not envisaged within the PPP contract are dealt with by agreeing that the private partner may perform the work, subject to certain conditions, such as providing the service at cost in addition to an agreed mark up. If this is not to the satisfaction of the PA, an external bidding process should preferably be implemented. Consent by the competent decision-making authority within the PA, including following up of the necessary procedures and protocols for that purpose, is always necessary to make changes effective.

## Debt refinancing

Once a project has successfully reached its operations phase, the risks for lenders are lower and banks will accept a lower interest rate. Refinancing is defined<sup>6</sup> as one of, or a

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<sup>6</sup> See EPEG Guide on managing PPP during their contract life, 2014.

combination of the following: A reduction in the debt pricing; Extension of the debt maturity; An increase in the gearing. It occurs when lenders are prepared to relinquish some of their contractual protection as the project risks are reduced. The commercial rationale of such an exercise is that by restructuring its financing arrangements, a private partner is able to raise more debt for the same debt service amount. The PPP contract might foresee that the benefits of such an exercise are shared between the private and the public partner. The refinancing gain is in the form of increased or accelerated distributions to the equity investors. In this case, they are paid out as an extraordinary dividend or an early prepayment of shareholder loans at the time of refinancing. Where the public partner receives a share of the refinancing gain, this is typically as a once-off capital amount paid by the private partner or, in the case of availability based PPPs, possibly as a decreased unitary charge payment over time.

Refinancing gains can be significant for large infrastructure PPPs. The benefits of refinancing contract clauses are basically: 1.the private partner is incentivized to perform well under the PPP contract so as to increase the confidence of refinancing investors and to maximize the refinancing gain; 2.the public partner is also incentivized by the prospect of a refinancing gain share to cooperate with the private partner, and to deal with potential risks to the PPP that are in its control, as well as potential increased risks not under its control; and 3.a refinancing can make the financing much more efficient and transfer value that would otherwise have gone to lenders, project sponsors, users, and taxpayers.

But as experience shows in more developed PPP markets, refinancing does come with some risks: 1.a refinancing that incurs additional debt may also increase the contingent liability of the PA in an event of private partner default if a percentage of the outstanding debt has been guaranteed by the PA; 2.refinancing that involves re-gearing of the debt equity ratio may change the risk profile for the project; 3.refinancing gain shares that inappropriately understate the risk taken by the PA or overstate the efficiency of the private partner lead to negative public perceptions about PPPs, and therefore a gain sharing that cannot be justified as being in the public interest.

Refinancing gains are generally calculated by comparing the distributions that are payable with refinancing to those without refinancing. Distributions generally take the form of dividends paid to shareholders or repayments of shareholder loans. The refinancing gain is normally calculated as a net present value of the projected equity cash flows using a discount rate that reflects the nominal, post-tax internal rate of return (IRR) of shareholder equity used in the base case financial model. As with many other aspects of PPPs, it is important to anticipate the issues as much as possible and set out detailed provisions on refinancing in the PPP contract, if such an exercise is projected to occur in the lifespan of the project. It is a recommended practice that the monitoring team brings the refinancing issue to the attention of more specialized government entities and experts that undertake detailed analysis in terms of contingent liability and fiscal risk management. The final approval shall be based on those professional analysis. If the refinancing takes place in the regular execution of the PPP contract or the loan contracts,

no approval is required. These include cases where the refinancing has either taken place in full account of financial model and approved as such, or arises solely from a change in taxation or accounting treatment, or occurs in the ordinary day-to-day administration of the loan contracts and affects any syndication, sell-down, cession or grant of any rights of participation or security held by the lenders. In such cases the monitoring team has the responsibility to make sure the refinancing is executed in accordance with the procedure prescribed in the contract.

## Issue management and dispute resolution

The key activities and good practices associated with issue management and dispute resolution are much the same in the operations phase as in the construction phase. Please refer to the sections that deal with this matter in the construction stage of the project, pages 15 and 19 of this report.

## Termination

Early termination of a PPP contract is truly a last resort and must follow a whole range of processes, commencing with an act of default by one of the parties, or some continuing force majeure. From a monitoring team perspective, the focus should be on avoiding termination by managing performance adequately, identifying and mitigating risks that might lead to a default, dealing with defaults in good time and in accordance with the PPP contract, and managing disputes in accordance with the Dispute Resolution Process (DRP)

Termination for public party's default indicates a severe failure of the contract management system. It triggers substantial compensation payments from the public purse and leaves the PA with an asset for which it may have no operator. The events that can bring upon the PA's default are those events that are so severe that completely frustrate the private partner's ability to perform its obligations under the PPP contract, such as non-payment of monies owed to the private partner, expropriation of the right of use of the assets, and actions that prevent the private partner from performing its obligations. PA's default is triggered by a breach notice from the private partner and would have a remedy period. Such a notice must trigger alarm at the highest levels of public authority, and immediate action to avert termination.

It is essential that the monitoring team is well informed of all potential events of private partner default. There are a large number of potential defaults, which range from performance defaults to insolvency of the private partner and even cross-defaults under the loan agreements. The monitoring team should not be caught unaware, provided it monitors the performance and financial indicators of the private partner. Private partner

default will lead to termination if the steps taken to remedy the defaults are not considered adequate by the highest authority in the PA. This may be avoided by explicit requirements for remedial plans in such events, and then close monitoring of such plans. Lenders should be given every opportunity to step in and even to exercise pre-emptive rights to dispose of the private partner rights and re-tender these to a new private partner. The monitoring team should thus carry out continual assessments of the likelihood of termination and, if termination becomes a real possibility, communicate with lenders and decision makers. Decisions to terminate the PPP contract should be taken after consideration of the financial and non-financial consequences of doing so.

### Expiry of PPP contract

The expiry of a PPP contract is inevitable but the lack of preparedness in managing this expiry leads to difficult and costly transition periods at the end of the PPP. The good international practice suggests that at least three years prior to the expiry of the PPP contract, the PA should start to examine its options on whether to re-tender the PPP. At the same time, the monitoring team should ensure the mechanism for evaluation of asset's condition, as provided for in the contract, is put into effect. The evaluation consists in comparing the actual condition to the residual life required in the PPP contract for assets that continue to be part of the PPP. If the condition of the asset is below that required, a remedial plan including the calling of asset condition security must begin. As a means of ensuring that the private partner complies with its obligations in relation to the condition of the assets at the expiry date, it is not uncommon to require that the private partner provides the PA with acceptable security, but the requirement to provide this security should have been included in the PPP agreement. Another approach is to require the private partner to retain funds equal to a percentage of the yearly revenues (or the payments) to fund a reserve for any necessary investment to meet the obligations in relation to the condition of the assets at the expiry date. A transition program must be devised to ensure continuity of services. The performance management regime will also require close attention as the private partner will not be focused on the long-term sustainability of services. At this late stage in the life of the contract, termination is not a useful remedy for breach of obligations and the lender oversight will have disappeared once the debt is paid off by the private partner. Transfer of all intellectual property rights on expiry will also be necessary, particularly in cases of PPPs with high-technology requirements or unique technology solutions. Transfer of employees may also be required, be it from the private partner to a new operator or to the PA. As such, legislation governing such transfers must be followed.

A hand-back/exit strategy is necessary for the monitoring team to manage the last stage of the contract. Such a strategy should be based on the provisions contained in the PPP agreement in relation to termination and expiry. It should also demonstrate the institution's capacity to bring the project to an end efficiently and ensure ongoing service. This may



be achieved either by continuing the functions in-house or by setting up a process to outsource these functions. The exit strategy should include:

1. An analysis of options, within the parameters of the PPP agreement, for continuing the service after termination or expiry, and an initial recommendation on the preferred option;
2. Plans for organizing a post-implementation review of the project, which should assess key deliverables, Value for Money, quality, and project innovation, and be carried out within six months of the expiry or termination date.
3. The steps that will be taken to integrate the lessons of the project into the day-to-day work of the institution;
4. An implementation plan based on the hand-back procedures set out in the PPP agreement;
5. Plans to deal with the implications of any employee transfers from the private party to either the institution or a successor body;
6. An estimate of the resources and personnel that the institution will allocate to managing the exit strategy; and
7. Plans for a closure event to celebrate the achievements of the project and prepare PPP agreement management staff and end users for their new role.

The exit strategy should be reviewed at appropriate points throughout the term of the contract. It should be revised as necessary to ensure that robust plans are in place three years in advance of the expiry of the project term.

## PROJECT MONITORING IN THE APPLICABLE LEGAL FRAMEWORK

The legal basis for the monitoring of PPP projects in Kosovo is first to be found in the Law No. 04/L-045 “On Public Private Partnership” (LPPP). The LPPP not only provides for the procedure to be followed in approval of PPP projects, the authorities responsible, and the requirements to be met, but also the basis for successful PPP projects throughout their life cycle. Of particular importance, as far as the regulation of PPP monitoring is concerned, is the provision in the LPPP of the authorities competent to discharge monitoring responsibilities in a PPP project. Article 17 of LPPP “The competencies of PPC” lays down in paragraph 2, item 2.9 and 2.10 the following:

*2.9 oversight and review of performance compliance and project execution;*

*2.10. review and approval of proposed amendments and modifications to Agreements on the basis of value-for-money and similar considerations;*

Thus, the LPPP vests upon the Public Private Partnership Committee, which consists in five very high government officials and meets in ad-hoc sessions, the highest authority in terms of controlling the execution of the PPP contracts on the part of the public authorities, and making the relevant decisions in case amendments and modifications to such contracts become necessary during the performance. But, the authority of the PPC, vested by the LPPP, should be seen in a broader spectrum as the same Article, in item 2.13 provides for an open-ended authority in terms of administration of the PPP projects by the PPC:

*2.13. making other relevant decisions relating to PPP.*

Of course, the responsibilities of the PPC, as designed by the LPPP, require permanent support by the PPP Central Department (PPP CD). Therefore, relevant to monitoring of PPP projects, the LPPP provides in Article 18 “Central PPP Department”, paragraph 2, item 7:

*2.7 monitor and issuing opinions regarding the level of compliance of the Contracting Authority and the Private Partner with the terms of an Agreement;*

The monitoring responsibilities are completed by Article 19 “Rights and Responsibilities of the Contracting Authority”, which provides in its paragraph 1:

*1. The Contracting Authority shall enjoy all rights set forth in the Agreement, including without limit, the right to inspect the activities of the Private Partner under the Agreement and to ensure its strict compliance with the terms of the Agreement.*

Further down the same Article, paragraph 2, item 4, such a responsibility is supplemented as follows:

*2.4 establishment of a professionally qualified contract management team to monitor and enforce strict compliance by the Private Partner with the terms of the Agreement;*

The last provisions on the responsibilities of the contracting authority with regard to monitoring the progress of the PPP project though must be read in conjunction with Article 5, paragraph 3 in the LPPP:

*3. In accordance with the provisions set forth in Article 17 of this law, with the prior approval of the Government and when required in the public interest, the PPPC shall have the authority to enter into a Public-Private-Partnership on behalf of the Republic of Kosovo for the provision of public services or public infrastructure which are within the competence of the Government of the Republic of Kosovo or any of its Ministries or Agencies.*

Such a provision automatically makes the PPPC contracting authority for all PPP projects approved by the Government of Kosovo, vesting on the PPPC all the monitoring responsibilities for those projects.

The above provisions in the LPPP lay down the basis regulation of the monitoring of PPP contract execution. To supplement the regulatory framework in the LPPP, the PPPC has enacted the Directive No. 5/2013 “On Regular Reporting Method of Public Authorities to PPPC” (Directive). The Directive deals with the regular reporting to PPPC by the PAs that have entered into a contractual or institutional PPP agreement, scheduling such reporting on annual basis. The Directive defines the scope of the reporting in its article 2, paragraph 1 as “issues related to project implementation”<sup>7</sup> and lays down the content of such a report in its article 4:

- *General information about the project o Contracting Parties*
  - o *The main goal of the project*
  - o *Date of signing the agreement*
  - o *Date of entry into force of the Agreement o Project Duration*
  - o *Ownership of assets*
- *Fulfilment of obligations by the Private Partner*
  - o *Investment Obligations*
  - o *Operational Obligations*
  - o *Maintenance Obligations*

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<sup>7</sup> Article 2.1 of the Directive No. 5/2013: *The Public Authority that has entered into a contractual or institutional Public Private Partnership agreement should report on regular annual basis to the Public Private Partnership Committee through the PPP Central Department on issues related to project implementation.*

- o *Paid Concession Fees*
- o *Other Payments*
- *Private partners general financial overview for the previous financial year*
- *Disruption and possible suspension of the Agreement for the reporting period*
- *Implementation of possible penalties*
- *Disagreements*
- *Change of agreement*
- *Fulfilment of obligations by the Public Authority*
  - o *Payments made by the public authority to the private partner (in case of public contract)*
  - o *Contract Management Team*
  - o *Ensure Vacant Enjoyment*
  - o *Other Obligations*

However, the Directive does not limit the reporting responsibilities of PAs towards the PPPC just to annual regular reporting. The Directive provides for the right of PPPC to request from PAs report on specific issues beyond those subjected to the annual regular report<sup>8</sup>.

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<sup>8</sup> Ibid, Article 2, paragraph 2: *Besides regular reporting, PPPC reserves the right to request from Contracting Authority to report on specific issues not related to this report, as defined in paragraph 2.9 of Article 17 of Law no. 04/ L-045.*

## FINDINGS AND CONCLUSIONS

The legal framework in force clearly enables the PPPC to discharge its power of control over the execution of PPP contracts, not only through regular reporting, but also through ad hoc inspection, whenever adequate. The PPPC reserves the right of review and approval on amendments to PPP contracts, whereas inclusion of such a right in any PPP contract at the drafting stage is implicit in the law.

LPPP explicitly provides for the right of the PPPC to act as a contracting authority for PPP projects under the competence of central governmental institutions. The acting of PPPC as a contracting authority means undertaking contract management responsibilities in the most important PPP projects in Kosovo, in terms of both impact and financial consequences.

The contract management though, requires significant continuous commitment that can hardly be expected to be met by the engagement of a sole a committee that meets on an ad hoc basis. Thus, the contract management responsibilities implicitly lay upon the shoulders of the PPP CD. The legal framework is silent as to specific provisions regulating the procedure and protocol on discharging such contract monitoring responsibilities between PPP CD and PPPC. Contract monitoring in such PPP projects will require a range of activities that extend to far more intensive than the annual, or ad hoc reporting provided for in the legal framework. The specific contracts are supposed to provide details not only for reporting purpose, but also for any aspect of contract management in such cases. However, the coordination between PPP CD and PPPC for successful contract management on central government institutions' sponsored PPP projects is not a matter to be provided in those specific contracts. The PPP CD might want to consider drafting and proposing for approval by PPPC of an internal regulation, even in the form of a sublegal act, for the procedures and protocols on effective coordination and decision making in execution of PPP projects PPPC acts as a contracting authority. Such a regulation must include and go beyond the provision of Monitoring Division tasks and responsibilities, currently documented in a non-formal paper by the Monitoring Division.

Adequate staffing of the Monitoring Division within the PPP Central Department is a prerequisite in ensuring proper monitoring of PPP contracts, as required by the LPPP. In this regard, the complexity of monitoring tasks during the executions the PPP contracts, both concessions or public contracts, require qualified and experienced personnel, able to detect, report any breach of the PPP contract, or need for performance improvement, and contribute to the remedy or amendment if required. A successful monitoring team in complex PPP contracts must make use of not only legal and economic/financial skills, but construction engineering knowledge as well in order to properly discharge monitoring responsibilities during the construction stage of the PPP contract. The current personnel of the Monitoring Division, although in possession of an excellent qualified experience in PPP monitoring, is less than adequate as far as the number of officials is concerned. The staff of the Monitoring Division is currently composed of only one member, apart from the

Head of the Division, which is less than the membership required to form a single monitoring team. The complexity of the Airport concession contract alone, in which the PPPC with the permanent support by PPP CD is acting as a contracting authority, requires additional personnel to handle the needs of the continuous monitoring operations, let alone the monitoring responsibilities in other projects and other responsibilities deriving from regular annual report monitoring to PPPC at national level. Thus, the need for completing the staff of the Monitoring Division with at least two new members, one of whom preferably with construction engineering background, appears to be urgent.

The responsibilities of the PPP Central Department include extensive involvement in the approval of PPP project, as well as in the monitoring of the execution of the PPP contracts. The division between these two main responsibilities is paramount in the lifespan of a PPP project. Though in terms of structure the current management of Central Department has had the necessary wisdom and experience in making such a division clear by provision of two separate and independent structures inside the Department, such a division appears to be lacking at normative level. Such a division becomes even more acute in the current understaffed state of the Central Department, as a concurrent exigence for establishment of an evaluation team alongside a monitoring team within the Department is simply impossible at the state of the personnel available. Involvement of Monitoring Division personnel in evaluation of a PPP project proposal might compromise the whole project at a later monitoring stage, on basis of conflict of interest. Given that a review of the PPP related applicable legal framework is ongoing, the Department might consider including the necessary division of evaluation and monitoring functions by an act of normative power, even at the bylaws level. That might serve as a measure in discouraging the creation of situation similar to the current understaffing of the Department in the future.

The existence of special monitoring tools is of enormous help in carrying out the monitoring responsibilities throughout the lifespan of a PPP project. A monitoring team equipped with proper tools does not have to improvise and develop specific actions, relevant to situations it faces, in discharging the monitoring responsibilities to different situations in different projects. Such monitoring tools are currently missing in the operation framework of the Monitoring Division within the PPP Central Department. A good start in this regard might be the creation of the most important monitoring tool, as defined by the PPP international theory and good practice: the Contract Management Manual. It must be emphasised that whereas the Monitoring Division has all the required experience and expertise in the field, and can do even without a Contract Management Manual, such a tool might take extreme importance in the hands of Municipal Monitoring Teams for the management of their PPP projects. There is extensive record and examples of such a document in the PPP related international literature. The content of this manual, as

proposed by one of the most reputable and leading institutions in the PPP global knowledge - European PPP Expertise Centre, is provided below as a suggestion<sup>9</sup>:

**Introduction**

- Purpose of the document
- Background to the project/contract (origin, commercial structure and objectives key aspects of procurement)

**Governance**

- Boards and committees
- Communication and information processes
- Decision-making processes
- Delegated powers
- Stakeholder management (including end-users)

**Structure of Authority's team**

- Organisation chart
- Roles and responsibilities
- Key contacts

**Structure of private partner's team**

- Organisation chart
- Roles and responsibilities
- Key contacts

**Construction period management**

- Meetings (type, purpose, frequency, attendance, outputs)
- Key specification requirements
- Data collection, validation and recording
- Reporting
- Accounting aspects (especially balance sheet treatment)
- Risk management process
- Managing changes

**Service period management**

- Meetings (type, purpose, frequency, attendance, outputs)
- Key specification requirements/performance targets
- Help desk
- Data collection, validation and recording
- Reporting
- Risk management process
- Payment mechanism and process, including budgetary and accounting aspects
- Reviews
- Managing changes
- Dispute resolution

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<sup>9</sup> See EPEC's : Managing PPPs during their contract life. Guidance for sound management, 2014 available at: [https://ppp.worldbank.org/public-private-partnership/sites/ppp.worldbank.org/files/documents/epec\\_managing\\_ppp\\_during\\_their\\_contract\\_life\\_en.pdf](https://ppp.worldbank.org/public-private-partnership/sites/ppp.worldbank.org/files/documents/epec_managing_ppp_during_their_contract_life_en.pdf)

One must remember that any action in the monitoring of contract execution is specific to the particular PPP contract at hand. Each PPP contract must provide for its own particular performance indicators, specific reporting and monitoring requirements, mirroring such performance indicators, and reporting requirements in that regard. However, the operation of the monitoring for successful performance and delivery under a contract should take a standard form and involve the cooperation between the private partner's and public authority's monitoring teams. Periodic reporting to the PPPC is a standard requirement for all PPP projects and require a certain standardised level of information and quality to be followed. Therefore, the need for Standard Operating Procedures (SOPs) in the field of PPP monitoring is quite obvious, although it might only be implicit in the legal framework. The creation of SOPs, as far as monitoring of PPPs is concerned, might be quite a time consuming and difficult task for the PPP Central Department, especially at the current state of understaffing. But, at the end it would not only deliver on the specific legal responsibilities of the PPP CD such as *issue standards and recommended practices and procedures relating to PPP*<sup>10</sup>, but it could also facilitate the discharge of monitoring tasks and increase the monitoring capacities of all actors involved at any level, from private partner's management team of the project to municipal monitoring PPP teams, up to the Monitoring Division within the PPP CD. Harmonisation, standardisation and codification of monitoring procedures and activities takes particular importance and meaning in the era of electronic and digital development. The current, digital development at all sectors of economy offers a limitless range of opportunities. With the help of digital tools, PPP CD could turn monitoring of the PPP contracts in a codified standard process easily to be checked, controlled and corrected whenever necessary, by all stakeholders involved in the process. Development in this direction might be costly at present, but planning ahead and setting milestones in a mid-term to long-term commitment process should be of particular interest for decision makers within and beyond PPP Central Department. Monitoring of PPP contracts is a relatively long process and might sometimes require involvement of more than one generation of PPP monitoring officials, even within the PPP Central Department. The current composition of the Monitoring Division, having succeeded another team in at least one of PPP ongoing contracts, is the living example to that finding. Thus, in order for monitoring procedures and activities to be standardized, they should take no relevance to the composition and monitoring teams and to the personalities of people delivering on monitoring responsibilities. The development of codified SOPs, enacted via regulatory acts at the level of either PPP Committee, or PPP Central Department, will certainly help establishing standardised successful monitoring of PPP contracts in a non-time sensitive fashion.

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<sup>10</sup> See Article 17, 2.2 of the Law No. 04/L-045 On Public Private Partnership