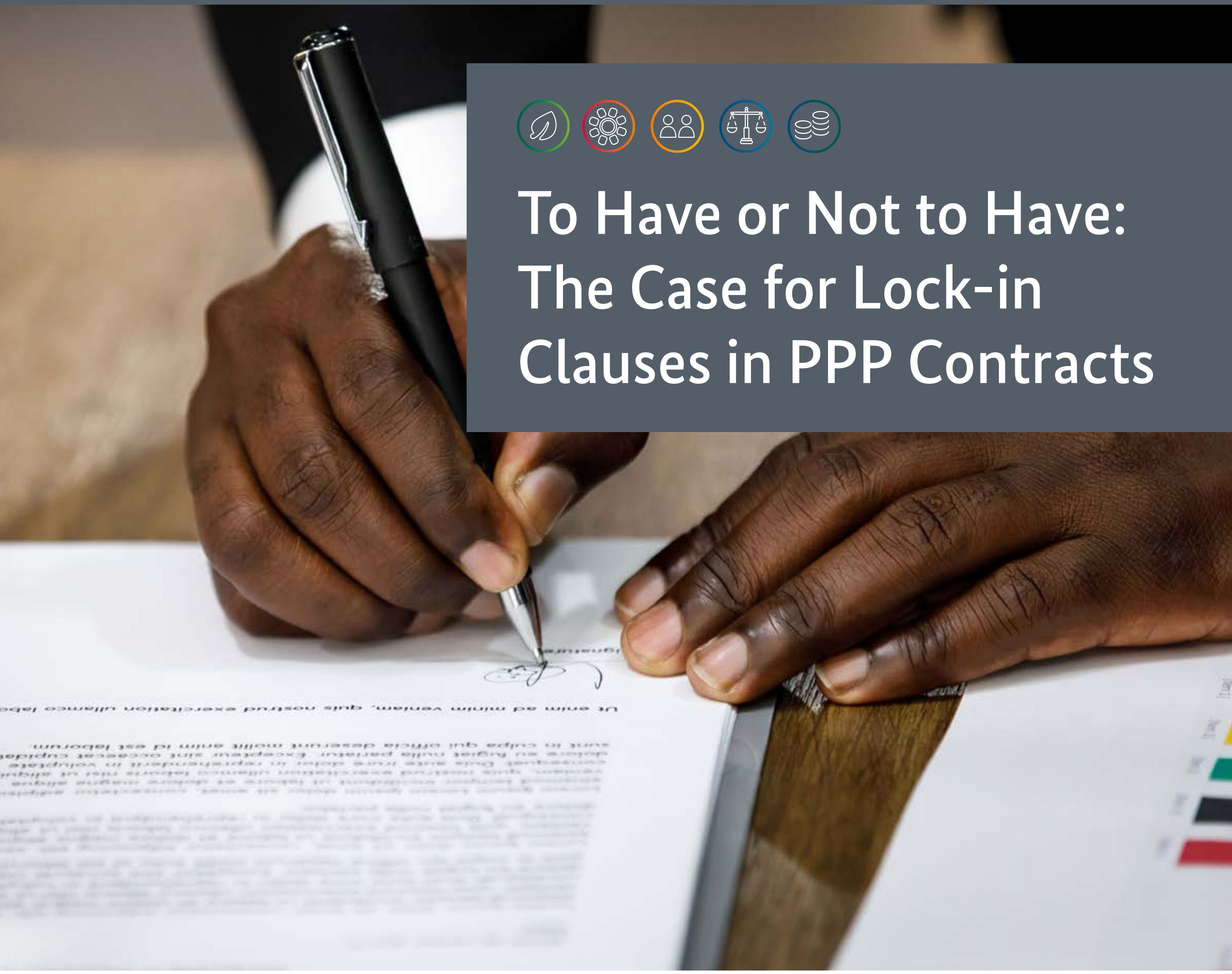
CONNEX

Contract Negotiation Support

CLAUSE INSIGHTS

To Have or Not to Have: The Case for Lock-in Clauses in PPP Contracts



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A Public-Private Partnership (PPP) is typically a long-term contractual arrangement between a public entity (governmental) and a private party. In a PPP, the private party undertakes to deliver a public asset and/or services and agrees to recover its investment either through payments by the public entity or the users of the asset/ services over the project's lifetime.

PPP contracts have become a popular mechanism for governments to collaborate with the private sector in infrastructure development. They are particularly gaining momentum in African countries as many governments are facing dire financial constraints following the lethal duet of the Covid – 19 pandemic and the ongoing Russia-Ukraine war. With many countries, including those in Africa, looking to boost their economic recovery and growth efforts, PPPs provide a viable solution for the continued delivery of infrastructural development.

THE LOCK-IN CLAUSE:

When choosing PPP partners, governments are keen to ensure that they pick partners with a reliable track record in delivering large-scale projects. Realistically, however, it is not practical to expect such partners to remain in the project for its entire term as PPPs can run for a significant period of time – sometimes even beyond 30 years. It is in fact a business model for the more bullish investors to come in upfront and de-risk projects up to the post-construction stage, before selling off their stake. With this in mind, it is important for governments to set up realistic frameworks that help attract credible investments and safeguard them from an investor's early-stage exit, but at the same time acknowledge that they are not indefinitely joined at the hip, allowing some flexibility in ownership.

In this respect, lock-in clauses in PPP contracts are crucial, particularly in African contexts where project risks, uncertainties, and political factors can pose significant challenges to the successful completion of infrastructure projects. A lock-in clause is usually subsumed in a PPP's change of ownership provisions as demonstrated in the example below:

"Change of Ownership

6.1 Notification

Subject to Clause 6.2, if there is any Change of Ownership of the Project Company, the Project Company shall be obliged to inform the Contracting Authority within ten (10) Business Days of any such change being proposed or, in the case of a company listed on a recognised stock exchange, the date on which the Project Company reasonably should have become aware of such a change, if it occurs later.

6.2 Restrictions of Transfers

6.2.1 The following restrictions shall apply:

(a) In the case of a Lead Member, it shall not transfer its shareholding in the Project Company below twenty-six per cent (26%) during the Lock in Period;

(b) in the case of a citizen emerging company, it shall not reduce its shareholding in the Project Company below five (5%) before the Final Completion Date;

(c) any Change of Ownership arising as a consequence of:

(i) the grant or enforcement of security in favour of the Senior Lenders over or in relation to any of the shares of the Project Company, unless a document conferring security over any shares has been approved by the Contracting Authority (such approval not to be unreasonably withheld or delayed); or

(ii) any change in legal or beneficial ownership of any publicly traded shares or other securities effected on a recognised investment or securities exchange in the Project Company's shareholder; or

(iii) any transfer of shares in the Project Company by its shareholder to an Affiliate of the relevant shareholder (ParentCo) or a Related Fund, shall be disregarded for the purpose of sub-paragraph (a) above.

6.2.2 The Contracting Authority shall respond to any request for consent made by the Project Company in accordance with Clause 6.2 within twenty (20) Business Days. Grounds on which the Contracting Authority may decide to withhold its consent to any such change are where the Project Company is unable to demonstrate to the satisfaction of the Contracting Authority (acting on the advice of the Independent Certifier that (i) the financial, business, technical and legal standing of the Project Company or the relevant Shareholder in the case of performance of obligations of that Shareholder shall not adversely change as a result of such change; and (ii) the National Interest Criteria are satisfied.

6.3 Prohibited Person

6.3.1 If any Shareholder becomes a Prohibited Person, the Contracting Authority may serve a Notice on the Project Company requiring the transfer of the shares of the Prohibited Person to another Shareholder or a third party approved by the Contracting Authority in accordance with this Clause 6.3 within thirty (30) Business Days of receipt of such notice.

6.3.2 If the Project Company does not comply with the notice from the Contracting Authority within the specified period, then the Contracting Authority may terminate this Agreement by the issuance of a Notice of Termination for Reasons Other than Default in accordance with Clause 39.7."

RATIONALE

To begin with, the lock-in provisions ensure that both parties make a sufficiently long-term commitment to the project. This provides certainty and **stability for projects**, enhances stakeholder confidence, and can in turn lead to higher private-sector returns and through continuity, contribute to a more attractive investment climate.

They also ensure **better outcomes in terms of project delivery**. The award of any significant long-term contract of necessity, requires a thorough process of evaluation including confirmations relating to value for money assessment, financial standing, technical expertise, demonstrated track record, etc. of the investor consortium members. It would therefore be disappointing – almost disingenuous - to envisage a scenario where the composition of the investor consortium is allowed to change even before the project commences or can be delivered.

From a risk perspective lock-in clauses help **mitigate project risks**, by reducing the likelihood of the initial consortium members seeking early exits due to changing market conditions. It forces such investors to invest in proper project due diligence, scoping, risk management and mapping at the outset, in the knowledge that there will be no easy exit once the PPP contract is signed.

Lock-in clauses also **promote efficiency in project execution**, as parties can focus on delivering quality infrastructure without frequent renegotiations or disruptions. Any suggestion to change the investor consortium's composition can mean lengthy due diligence, and renegotiations of terms, all of which can lead to higher and unplanned costs, project delays and, in extreme cases, the contract's premature termination.

Another issue of note is that even at the stage when the initial consortium members are allowed to sell a stake, many countries have regulations requiring them to retain some minimal stake for an extended period to facilitate knowledge transfer from the initial developer. This is because the initial developer group will often possess some specialized or "institutional knowledge" which is critical for the project's success and must therefore continue to be involved until there is assurance that the new investors can manage the project on their own.

Finally, with issues of politically exposed persons, sanctioned parties, and blacklisted entities gaining prominence, one cannot understate how important it is for governments to know their project counterparties. In fact, many countries are now putting in place beneficial ownership rules, requiring the full declaration of the parties behind significant contracts. This makes lock-in provisions even more critical as a tool through which governments can vet and approve their contractual counterparties throughout the project term.

On the flip side, one can argue that these clauses restrict consortia's ability to divest from projects, and this can deter some investors from such projects, thereby limiting the pool of investors that governments can attract or work with.

Lock-in clauses also complicate the process of exiting the project for consortium members, potentially creating legal and logistical challenges. Typically, an exit would be pegged to certain project milestones being achieved, consent from the governmental counterparty, and demonstration that the new private party investor has similar or better capacity than the existing consortium member among other requirements. This can discourage consortium members from participating in future projects or reduce their enthusiasm for long-term collaboration.

Restricting the transfer of shares also reduces market liquidity, making it harder for consortium members to monetize their investments as and when needed. This lack of liquidity can affect a project's financial viability and attractiveness.

CONCLUSION

All in all, there are pros and cons to lock-in clauses, but the benefits seem to outweigh the cons when the clauses are carefully drafted to balance the need for certainty, stability, and expertise retention, with that of flexibility and investor attractiveness.

It is also worth noting that in a PPP the interests and objectives of the public and private sector actors are often divergent, especially as regards the financial aspects of the project. On the one hand, the public sector's objective is to ensure the optimal development of public infrastructure/assets and the efficient delivery of public services. On the other hand, the private sector's objective is to maximize profit and get a return on investment. Hence to ensure a successful PPP, there must be a balance between these often-competing interests.

With all these in mind, lock-in clauses are arguably a must-have in PPP contracts, particularly in ensuring efficiency, sustainability, risk management and knowledge transfer, amongst others. Therefore, governments and investors should adopt a nuanced approach, evaluating project-specific factors and objectives, to craft well-balanced lock-in clauses that take into account both the short and long-term interests of governments and investors, while at the same time promoting overall project goals.

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