TOLL HIGHWAYS IN FINANCIAL DISTRESS: THE WINDING ROAD TO TERMINATE THE CONTRACTS

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ABSTRACT

Spain has extensive experience in the promotion of toll highways through contractual public private partnerships (PPPs) in the form of concession contracts. The Central Government has awarded thirty-two contracts since 1967, fourteen of them in the last two decades. Over time, Spain has been developing a broader legal framework to regulate these contracts. However, in 2013, nine out of the fourteen toll highways awarded between 1999 and 2006 filed for bankruptcy after years of financial distress. Most of these projects had been in operation for less than eight years and were severely affected by optimistic estimates of traffic demand and the economic crisis of 2007.

Given the imminent termination of the contracts, the government, the concessionaires and the financial institutions began to position themselves strategically, and adopted different measures to safeguard their own interests. Their decision-making has been highly motivated by a legal provision —known as State's Financial Liability— that guaranteed a termination payment to the PPP contractor in case bankruptcy was not attributable to the private sector.

This research shows the causes that motivated the bankruptcy of the contracts, and studies the strategical behavior of the different stakeholders involved according to their specific interests. From this case study, some lessons are provided on the correct way to design termination clauses in PPP contracts with the aim of safeguarding good service to the user while, at the same time, avoiding opportunistic behavior.

1. INTRODUCTION

Since the 1960s different Spanish governments have resorted to public-private partnerships (PPPs) as a means to construct and upgrade roads (Baeza, 2008). During 2018, the toll highway network in Spain consists of 2,957 km, of which 2,457 km are owned by the central government. Toll highways represent approximately 17% of the high-capacity road network, that is most of the high capacity network in Spain is free of charge (Ministerio de Fomento, 2019).

Toll highways in Spain have maintained most of their distinctive features over time. These are usually greenfield projects that were awarded through competitive tendering based on the open-procedure. They have been characterized by the allocation of most risks to the private sector, but also by the provision of an important termination guarantee by the government, the State´s Financial Liability (*Responsabilidad Patrimonial de la Administración o RPA)* (Ortega, Baeza and Vassallo, 2016).

This guarantee has been one of the most controversial issues of the concession regulation in Spain, since, in case of early termination of the contract, it commits the government to pay to the concessionaire the amount of capital costs (expropriation and construction costs) not yet depreciated at the time the contract expires. A new legislation passed in 2016 changed the concept by setting that, if the contract termination was not prompted by the government, the amount of the RPA will be the market value of the project. However, this new regulation does not apply retroactively.

The RPA and the government´s propensity to renegotiate contracts encouraged aggressive bidding behavior. Previous research has shown that Spanish bidders overestimated traffic forecasts and underestimated the capital investments in their bids as a strategic decision to win the tender at all costs (Baeza and Vassallo, 2010).

2. THE FINANCIAL PROBLEMS OF THE SPANISH TOLL HIGHWAYS

After twenty years, the central government recovered the toll concession approach to build new highways in 1996. The need to contain the country’s public deficit to comply with the European Union requirements to control government expenditure was one of the main reasons for returning to the concession approach.

Most of the toll highways included in this new program intended to supply greenfield alternatives to alleviate increasing congestion on sections of the existing toll-free highway network, especially those giving access to the city of Madrid.

However, in 2012 and 2013, nine of the fourteen toll highways awarded between 1999 and 2006 filed for bankruptcy after years of financial distress and negotiations between the government, concessionaires and lenders (see Table 1).

Currently, it can be claimed that the results of the latest toll-highway package have not been as expected. There are three main reasons for this situation: traffic underestimation, costs overruns during the expropriation and construction phases, and the economic crisis.

Highway	**Length (km)**	**Concessionaire**	**Year of award/ commissioning**	**Year of bankruptcy**
R-3 Madrid-Arganda	33.1	ACCESOS DE MADRID	1999 / 2004	2013
R-5 Madrid-Navalcarnero	29	ACCESOS DE MADRID	1999 / 2004	2013
Santiago-Alto de Santo Domingo	56.6	ACEGA	1999 / 2003	-
Ávila-Villacastín	23.1	CASTELLANA	1999 / 2002	-
Segovia-El Espinar	27.7	CASTELLANA	1999 / 2003	-
León-Astorga	38	AULESA	2000 / 2003	-
R-2 Madrid-Guadalajara	64.1	HENARSA	2000 / 2003	2013
R-4 Madrid-Ocaña	53	MADRID SUR	2000 / 2004	2013
M-12 EjeAeropuerto	8.8	EJE AEROPUERTO	2002 / 2005	2013
AP-36 Ocaña-La Roda	148	MADRID LEVANTE	2004 / 2006	2013
AP-41 Madrid-Toledo	60	MADRID TOLEDO	2004 / 2006	2012
AP-7 Cartagena-Vera	114	AUCOSTA	2004 / 2007	2013
AP-7 Circunvalación de Alicante	28.5	CIRALSA	2004 / 2007	2013
Málaga-Alto de las Pedrizas	24.5	GUADALCESA	2006 / 2011	-

Table 1 – Toll highway concessions awarded by the Central government from 1999 onwards

Firstly, the forecasts included in the economic-financial plans of the toll highway concessions were, in all cases, very optimistic. As a result, ever since the highways came into operation, actual traffic flows have been much lower than originally forecasted (Baeza & Vassallo, 2012).

Figure 1 summarizes the traffic deviations in the highways analyzed since their commissioning to the present. These deviations are measured as the percentage of actual traffic over that foreseen by concessionaires. Therefore, values below 100% show traffic overestimations.

The figure also differentiates those highways that ultimately went bankrupt (represented by dots) from those that stayed afloat (represented by triangles). The green line shows the average trend of traffic deviations for all the highways included in the sample.

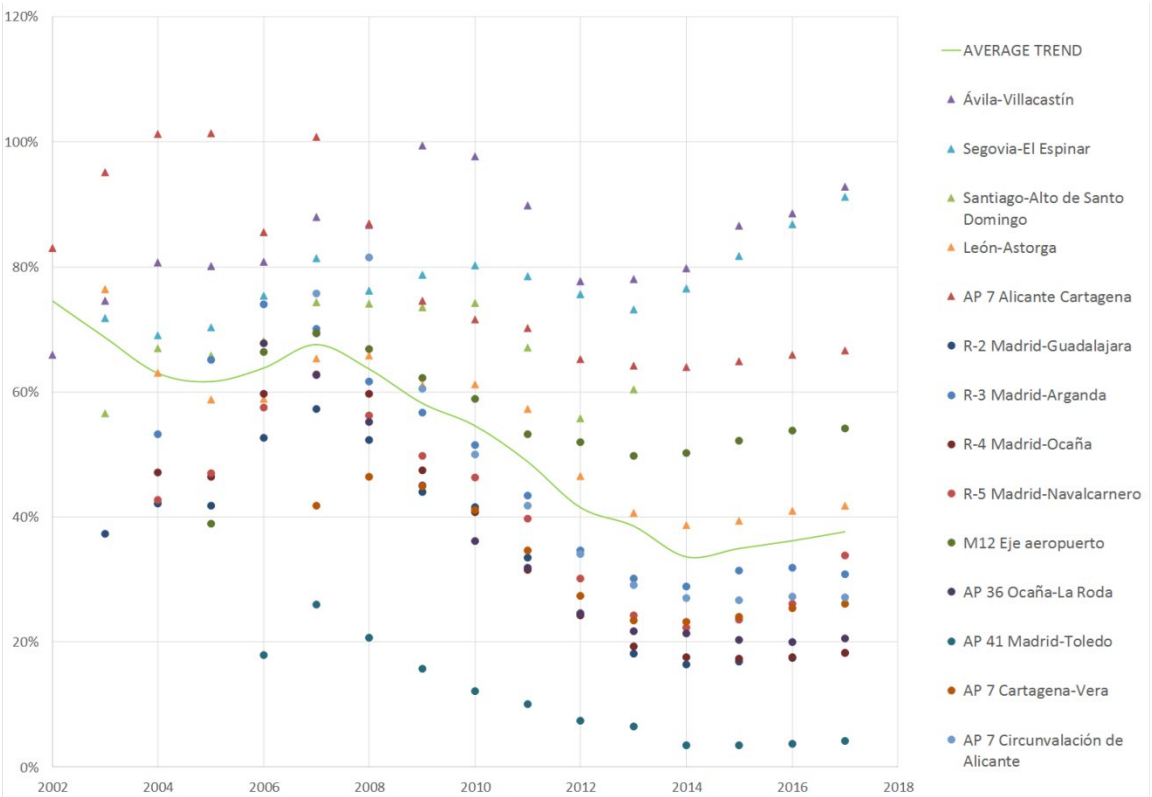

Figure 1 – Traffic deviations in the Spanish toll highway concessions since their commissioning

Secondly, the underestimation of construction costs conducted by the concessionaires in their bids was far from negligible (Vassallo et al., 2013). For example, the year in which the R-3 and R-5 highways came into operation, the cost overruns were 33.70%, and those of the Eje Aeropuerto exceeded 25%.

Moreover, the higher additional costs experienced by the highways were mainly due to expropriations. The cost of acquiring the right-of-way ultimately became much higher than expected as a result of a Supreme Court ruling stated in 2008 on how to quantify the price of land. The Supreme Court understood that highways are general road systems intended to create a city due to the existence of evident urban expectations (Baeza & Vassallo, 2011).

Finally, the impact of the economic crisis in Spain has been one of the greatest among the European countries. The country was in recession for seven quarters, which was reflected in negative GDP growths in both 2009 and 2010, and then it stabilized for a short period of time to fall back into recession for eleven quarters between 2011 and 2013.

Road demand on toll highways, which is very correlated with the evolution of the country's macroeconomic variables such as GDP per capita or industrial GDP (Gomez et al., 2015), was severely affected.

3. THE STRATEGIC BEHAVIOR OF THE STAKEHOLDERS

The strategic behavior followed by the main stakeholders involved in the process is studied in this section. The stakeholders considered are sorted into three different groups: the government, concessionaires and lenders.

3.1. Government

The general optimism in the country when the concessions were awarded led the government to conduct very optimistic feasibility studies assuming very high traffic growths and urban development expansions.

Between 2010 and 2012, the government approved a set of measures aimed at rebalancing the economics of the contracts to keep the concessions afloat. It began by granting subordinated public participation loans (SPPL) and compensation accounts.

On the one hand, SPPLs covered the expropriation costs exceeding 175% of the costs initially estimated by the PPP sponsors. The interest rates payable by the concessionaires over the life of the contracts would depend on the future revenues of the toll highways, with a minimum cap rate of 1.75%. On the other hand, the purpose of the compensation account was to provide liquidity to the concessionaire whose traffic and income were too low. Through the compensation accounts, the concessionaires would receive from the government the difference between 80% of the toll revenues originally expected and the actual revenue during a period of three years.

In 2012, a new conservative government took office in Spain. One of its priorities was to reduce the national public deficit and since highway traffic was not recovering, he opted to cancel the granting of additional SPPLs to the concessionaires, as well as the compensation accounts.

The subsequent declaration of bankruptcy of the nine aforementioned toll highways put the government in a complex situation. At that point, the maximum RPA related to the concessions bankrupted amounted to over €3.56 billion (Baeza & Vassallo, 2014), in a context where Spain was in the midst of a severe economic recession.

In addition, the Supreme Court ruled that the government was responsible for paying the additional costs of expropriation to landowners. To avoid paying twice, the government approved Royal Decree-Law 1/2014 that modifies the public procurement law on the valuation of state aid for land expropriation.
Under this provision, the government was allowed to reduce the RPA compensation to each concessionaire in the amount of money corresponding to the expropriation costs paid directly by the government when the SPV failed to meet its obligations to the owners.

3.2. Concessionaires

The optimism previous to the recession, the high competitiveness of the Spanish market, and the existence of the RPA guarantee encourage bidders to adopt aggressive strategies.

Between 2010 and 2011, the granted SPPLs represented a total of €532 million. With respect to compensation accounts, a total of €71.52 million were granted in these years. These measures eased the financial problems of the concessionaires for a few years. However, as traffic levels did not recover substantially, they ended up being useless in the long term for both the government and concessionaires.

After the government withdrew the state aid previously mentioned, private companies sued the government in court for withdrawing what had already been pledged, but the initiative was not successful.

Some sponsors negotiated with the lenders the restructuring of the debt to avoid insolvency. However, this option was finally not viable and triggered the start of a series of bankruptcies. Between 2012 and 2013, nine toll highway concessions were declared bankrupt. The reasons for synchronized bankruptcies are not clear. Sponsors might have thought that this situation could help them reach a better agreement in the negotiation phase given the fact that the government should avoid reimbursement of the RPA at all costs.

3.3. Lenders

The estimates conducted by the shareholders based on the feasibility studies produced by the government, along with the RPA and the seniority of their debt were sufficient for the lenders to join the project by providing large loans. The most common financial structure was a mini-perm (short-term loan) that had to be refinanced after few years of operation. However, the shortage of traffic and the excess of costs meant that the concessionaires could not refinance their mini permits (short-term loans), so long-term financing remain dependent of future government aid.

After the withdrawal of state aid, banks were no longer willing to accept a negotiated solution so sponsors ended up declaring bankruptcy. In this situation, financial institutions in Spain were required by law to create provisions for the total amount of credit granted to the bankrupt company. This measure had a great impact on the balance sheets and profit and loss accounts of the banks.

4. MEASURES TAKEN AFTER DECLARING BANKRUPTCY

The government proposed that an existing State-owned company called SEITTSA absorb bankruptcy toll roads without paying any compensation to the concessionaires. In return, creditors would have to waive around half of the senior debt outstanding at the time, which was around €2 billion. The remaining liabilities —around another €2 billion— would be entirely acquired by the main national banks in exchange for a 30-year treasury-backed bond. This bond would be issued by SEITTSA with a nominal value equal to the remaining liabilities, and a 4% guaranteed interest rate equivalent to the Treasury 30-year bond rate at that time. The most important banks of Spain (Santander, BBVA, Caixa, Bankia, Sabadell, Popular) would buy the liabilities of other banks with minor participation, most of them foreign ones. The main advantage of this solution for the government was that it avoided the payment of the RPA and its immediate consequences on the public deficit. However, some foreign banks, which financed few specific projects performing above the average, felt disadvantaged by a solution based on the average behavior of the portfolio.

In 2015, the Madrid Commercial Court initiated the liquidation process for the companies Autopista Madrid Levante, and Eje Aeropuerto, after no agreement was reached. The opening of the liquidation phase was an important date for the government because, once this phase was effective, the depreciation count for the final RPA calculation was stopped.

Some concessionaires managed to appeal to the courts to return to the negotiation phase, thus activating again the depreciation of the assets and reducing the value of the RPA. For this reason, between 2016 and 2017, lenders began selling their senior debt to hedge funds with the aim to recover at least part of their losses as soon as possible.

Cuts in these transactions ranged from 60% to 70% of the outstanding value of the loans. This clearly shows the little hope of lenders to achieve a good outcome in the liquidation process.

Hedge funds bought a large share of the senior debt from bankrupt concessions. Their strategy was to liquidate the firms as soon as possible to obtain the maximum value of the RPA.

Since the hedge funds had eliminated any possibility of restructuring the outstanding debt, the government decided that the nationalization of the toll highways with the subsequent payment of the RPA was the only solution to end the conflict.

In July 2017, the government decided that SEITTSA (a state-owned company) would take over both the toll roads that were already in the liquidation phase and those that would be liquidated in the future. In 2018, the liquidation plans of eight concessionaires were approved and SEITTSA gradually absorbed the toll roads.

At the date of this document, the government was carrying out the due diligence to estimate the final amount of the RPA liabilities to be paid, as well as the value of the new assets managed by SEITTSA.

5. CONCLUSIONS

The bankruptcy of highway concessions in Spain has had very negative reputational consequences since the credibility of the PPP model has been seriously damaged.

From the analysis performed, some lessons are pointed out. The first lesson is that the concession model requires risk allocation approaches resilient to economic cycles. If traffic flows are very sensitive to the evolution of the economy, it is advisable to apply other models, such as payment for availability, regardless of whether the government decides to charge users or not.

The second lesson is that guaranteeing a government termination payment in case of bankruptcy does not provide the right incentive for interested parties. On the one hand, this approach encourages the government to do everything possible to avoid termination of the contract, which can extend the litigation process without finding a good solution for the society. On the other hand, concessionaires take advantage of this guarantee to obtain cheap financing from lenders who do not pay much attention to assess the real viability of the project.

The third lesson is that legislation and contracts should be much better prepared to properly regulate the possible early termination of a concession. The lack of regulation seems to be the main cause that explains the long litigation processes and the difficulty in reaching a final solution to the problem.

Finally, one of the worst consequences of the process was the impact on the reputation that the negative experience has had on the concession model, the government and the legal system. This reputational aspect has been particularly sensitive for the general public and foreign institutions.

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