

Covering concessions or how to flip a coin

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The subject of concessions has come to the forefront in Latin America as a result of the need to carry out large amounts of work on the infrastructure which can only be financed by private capital. The governments are therefore privatising strategic sectors such as energy, the drinking water supply, telephones, roads, etc. or they are transferring the running of these sectors to private companies which are in charge of their construction and development.

Since public assets are being dealt with, the governments wish to assure their correct use and operation. Also, since they are works of a great technical and economic magnitude, the concessionaire's investment can only be compensated in the long term. This circumstance gives rise to the fact that the concession contracts have a duration of between 10 and 20 years, and sometimes up to 30.

To cover against breach of contract, the government requires the concessionaire to take out one or more bonds.

The main problem which reinsurers are faced with is the duration of the bonds which are requested. These are normally required for the same length of time as the term of the contract, and it is very difficult to underwrite a risk which will have a life of 15 years. An underwriter would need a crystal ball to foresee what might happen during this period of time.

One solution has been the division of bonds into periods of shorter duration. Renewable bonds of 3 or 5 years have been provided, and these terms are considered reasonable by reinsurers. This however immediately raises another question: what happens if, after the 3 or 5 years are over, the insurer can not (due to lack of reinsurance) or does not want to renew the bond, and the contractor can not find a substitute? The most plausible response is that the beneficiary would call the bond, arguing that one of the obligations laid down in the contract is the existence of a bond for the period of the contract.

In Colombia, a legal decree obliges the policyholder to renew the guarantee when it expires, if the duration of the guarantee is less than the duration of the contract.

In Argentina, a clause has been added to the wording of the bond which stipulates that the bond is automatically renewed "unless the insurer notifies the insured and policyholder six months in advance of the expiry date of the insured period of the company's decision not to renew the policy. In no case can the giving of notice and the non-renewal of the bond constitute cause for the bond to be called."

It is therefore explicitly laid out in writing that once the term has expired the guarantee is no longer effective, and its non-renewal does not imply its execution.

However, since nothing is ever that easy, there is a point of view which argues that, as the bond is conditional on a contract, this clause should be included in the contract for it to have validity. There is also a school of thought which argues that even if it were included in the contract it would still not be valid as it is not laid down in law. The legal profession will have the final word.

It has been possible in some concessions in Colombia to separate the construction phase from the later running, which gives rise to two types of well differentiated bonds. The first type being a traditional bond, although, given the complexity of the project, it is necessary to bear a global vision of the scheme in mind when underwriting. The bond for the posterior running of the project still has the problems which were earlier mentioned, to which another is frequently added: the guarantee also includes the payment of the concession royalties.

The bond for the construction period tends to have an acceptable duration, but a very high value. It is here that the reinsurer plays its most important role, by providing capacity. The value of the bond is radically reduced in the posterior opera-

tion phase, and some insurers have decided that the solution is to retain these bonds for their own accounts.

This would, without doubt, seem to be a good solution, but some reinsurers have already been known to comment that they would never work with cedents which are exposed to such high levels of risk.

With the existence of so many contradictory opinions, it might seem that the only option open to the reinsurer when confronted by a risk of this nature is to flip a coin in order to decide whether to accept or not. Given the rather unprofessional nature of this procedure however, I would instead suggest an in-depth study of variables such as:

- **Financing.** In these projects the financing comes from the concessionaire itself, and not from the government, as is the case in normal public works. It is important to know that the type of financing which is used will allow the concessionaire to cope with the financial liabilities which it will be confronted with, without taking into account the income arising from the operation of the service itself, and which may not be as is initially foreseen.

- **Concessionaire.** In general, the concessionaire is a consortium of several companies with at least one foreign component and one local. We should be in no doubt about the technical and economic capacity of all of them, and their legal situation should be clearly defined, especially as regards joint liability.

- **Counter-guarantees.** If they are already important in the world of bonds, then here they take on an especially important role. It is recommendable that there should be a joint counter-guarantee for all the members of the consortium in favour of the consortium as a whole, in addition to others which may be considered necessary in each individual case.

If the result of this study is positive and it has been shown that the reinsurer may not renew a limited-term bond, and, in addition to this, this does not imply payment, we would seem to be confronted by a special type of risk - but not one which is impossible to cover. What would however seem impossible at this time is agreement in the insurance and reinsurance markets as to the advisability of working with concessions.