The Commercial Law Development Program

Presents

Public-Private Partnership Webinar Series

Project implemented by:

Public Private Partnerships: Subcontracts and Finance Documents

About CLDP

- **Mission:** Improve the legal environment for business worldwide
  - Established in 1992
  - Provides legal technical assistance on behalf of the U.S. Department of Commerce

- **What we do:** CLDP partners with developing and post-conflict countries to implement commercial legal reforms that support U.S. foreign policy goals.
  - Government-to-government technical assistance helps host countries:
    1) Modernize their commercial legal environments
    2) Support their economic development

Today’s presenters

James W. Head

- Partner, Energy & Infrastructure Team at Hunton Andrews Kurth LLP, an international law firm with attorneys in the United States, Africa, Asia, Europe, and the Middle East
- A decade of experience working on project finance and infrastructure, with a focus on public-private partnerships, both in the United States and abroad

Chris Alderman

- Associate, Energy & Infrastructure Team at Hunton Andrews Kurth LLP, an international law firm with attorneys in the United States, Africa, Asia, Europe, and the Middle East
- Advises on domestic and international project-financed infrastructure projects

Today's agenda

1) Review – PPPs and Financing Models

- What is a public private partnership?
- How can governments finance infrastructure?
  - Host Government Financing
  - Resource-based Infrastructure Financing
  - Project Financing

2) Subcontracts

- Flow-Down Provisions Generally
- Subcontracts for IPPs
- Subcontracts for Road Concessions
- Subcontracts for PFI School Projects

3) Finance Documents

- Sponsor and Corporate Documents
- Financial Structuring and Hedging
- Lenders' Cash-Flow Controls, Security and Enforcement

What is a public private partnership?

- **There is no universally accepted definition, but the concept is well understood.**
  - **The World Bank defines a PPP as follows:**

Any contractual arrangement between a public entity or authority and a private entity to provide a public asset or service, in which a private party bears significant risk as well as management and operational responsibility.

1. **A contractual arrangement**

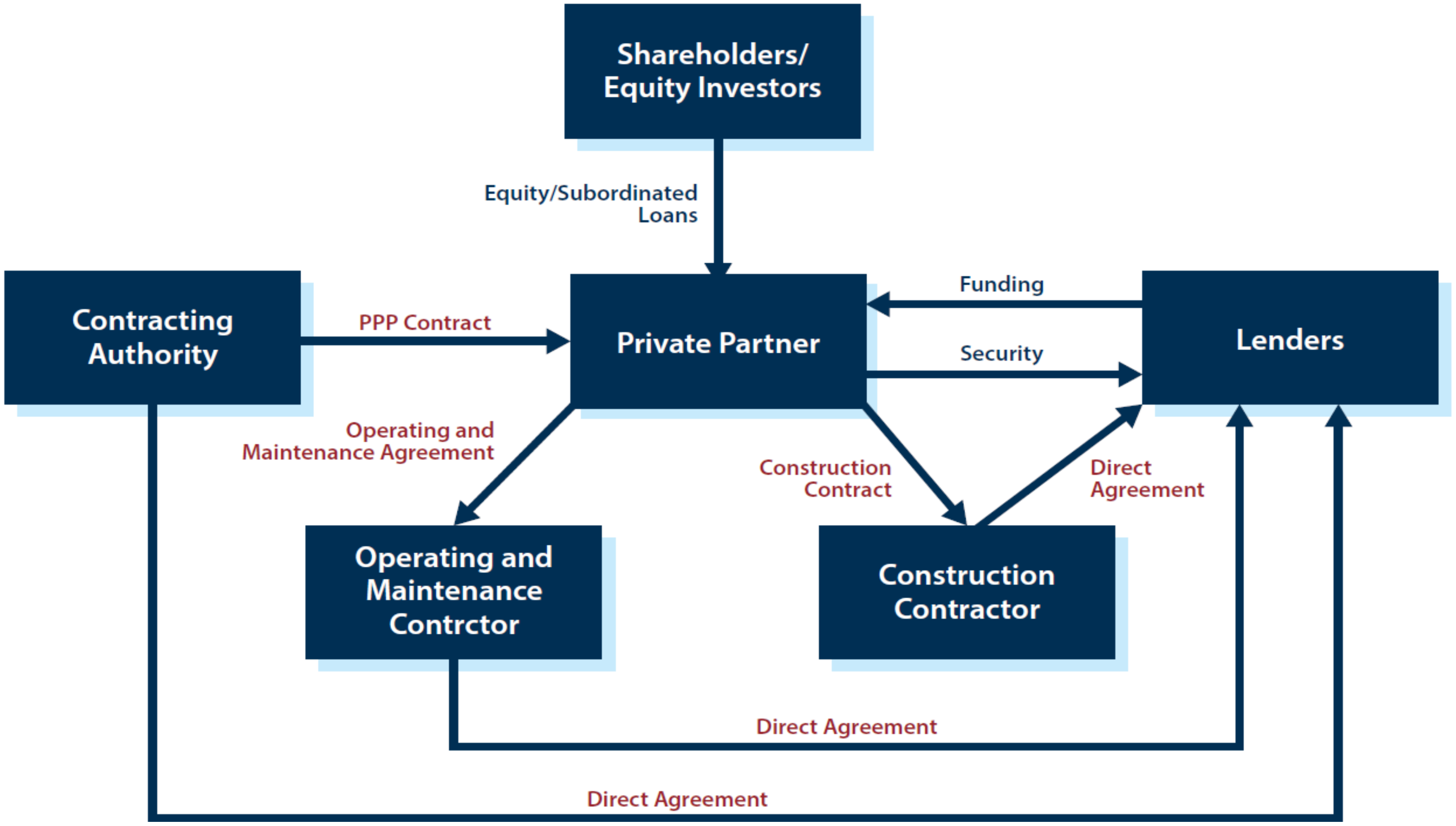
   The relationship of the parties and their rights and obligations in the partnership are defined primarily by contract, not by law.
2. **Between a public entity or authority and a private entity**
3. **Provide a public asset or service**

   Asset or service being provided – often infrastructure – is for public benefit.
4. **The private party bears significant risk**

   Private party is chiefly responsible for development and delivery and typically bears the risk of failure, including risk of financial loss.

   Private party is typically compensated for the risk with corresponding financial reward.

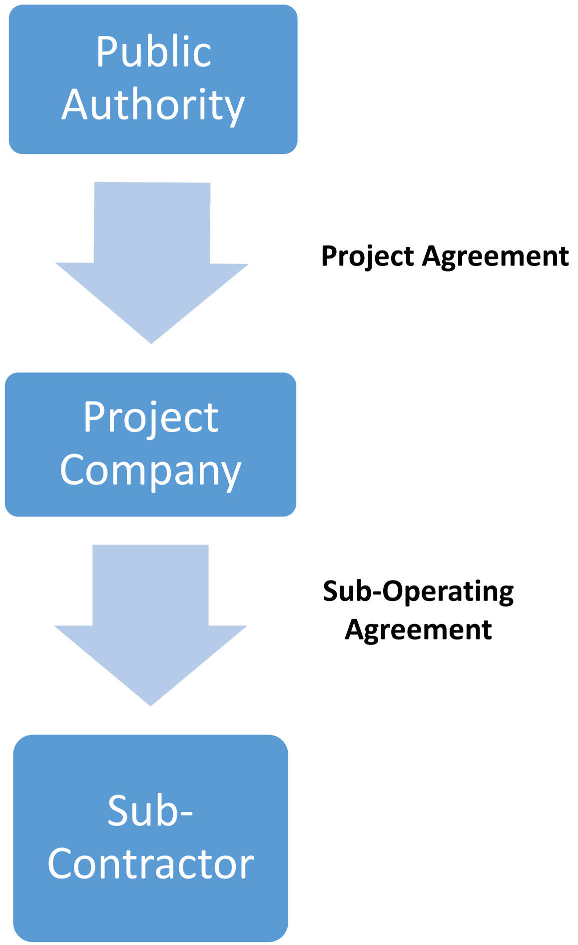
What is a public private partnership?



Public Private Partnerships: Subcontracts

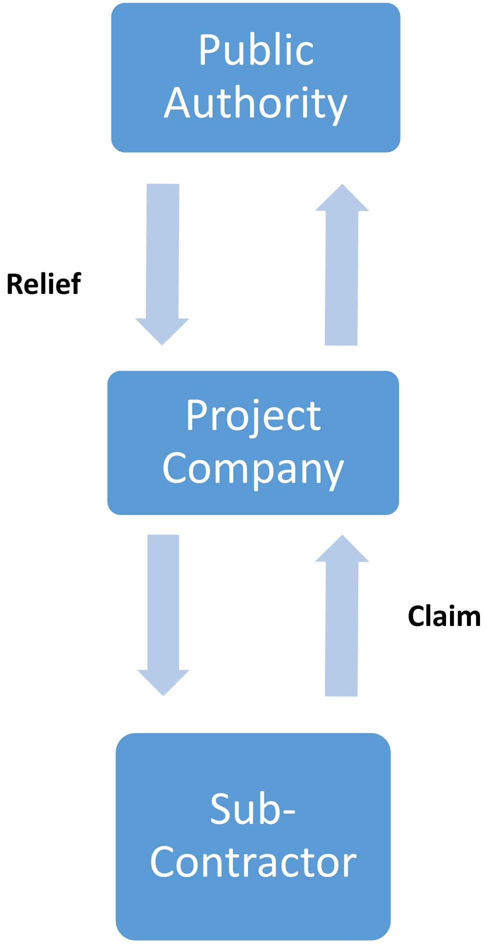
Subcontracts

- **What are Flow-Down Provisions?**
  - **Under principles of project finance, the Project Company <u>must</u> pass-down, on a back-to-back basis, with no variation whatsoever, <u>all</u> design, build, operations, and maintenance obligations to credit-worthy Sub-Contractors.**
  - **Flow-Down Provisions provide a market-tested and approved mechanism to achieve this requirement.**
  - **Features include:**
    - **Verbatim contractual language**
    - **Requirement of cooperation**
    - **Provision of information**
    - **Maintenance of relationships with stakeholders**
    - **Mechanism for deciding what gets submitted to Public Authority when the Project Company and the Sub-Contractor disagree**
    - **Pay-if-Paid**

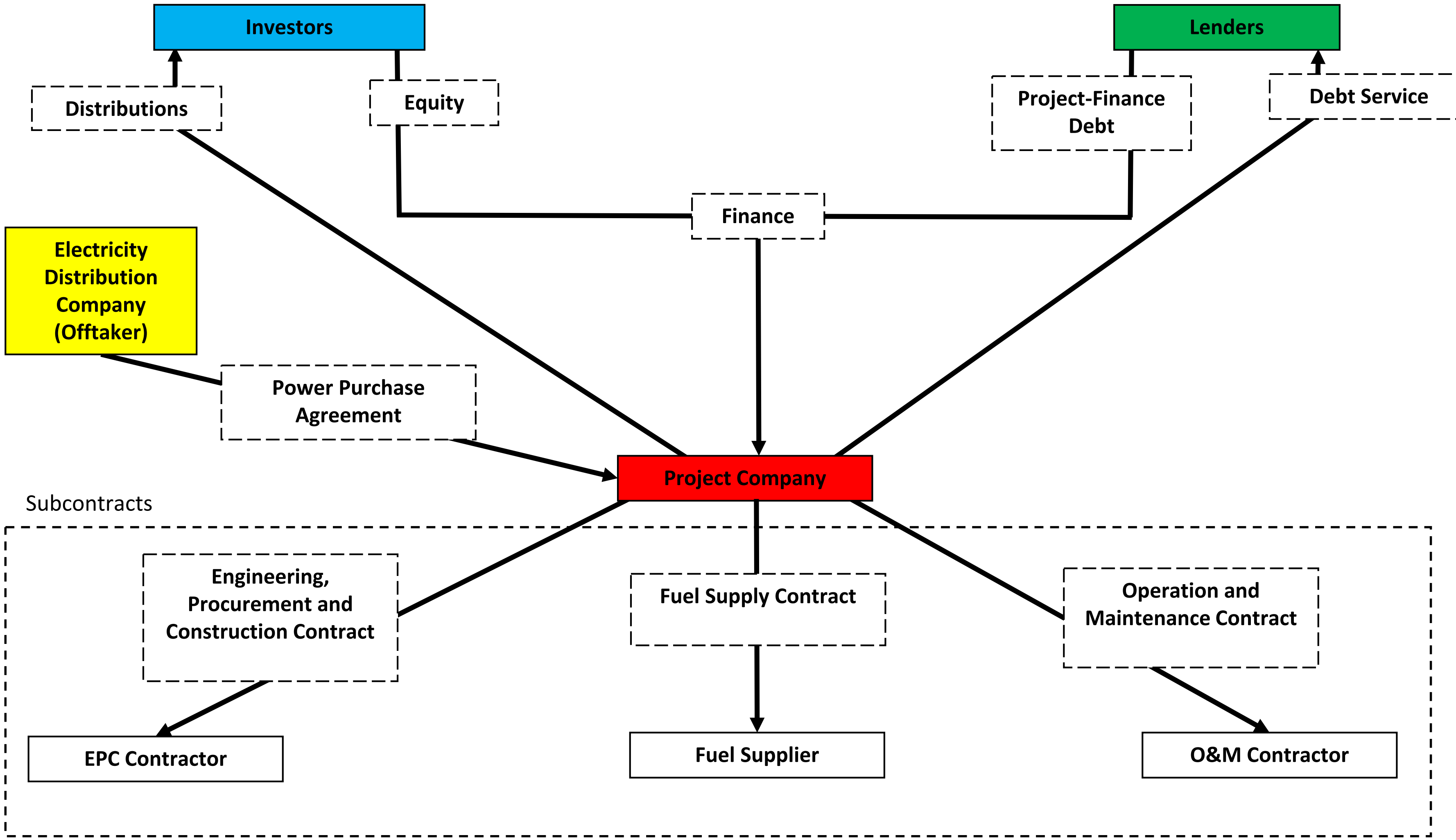


Subcontracts

- **What is Equivalent Project Relief?**
  - **A way for the Project Company to pass-through any claims of the Sub-Contractor to the Public Authority**
  - **Relief given to the Sub-Contractor from the Project Company on back-to-back terms with the relief given to the Project Company from the Public Authority**
  - **Only available to the Sub-Contractor to the extent the Project Company receives the same relief from the Public Authority and then only for the amount received by the Project Company**
  - **Claims brought by the Sub-Contractor may be pursued by the Project Company directly or the Project Company may allow the Sub-Operator to pursue on its behalf**
  - **Sole and exclusive liability of the Project Company for claims brought by the Sub-Contractor subject to equivalent project relief**

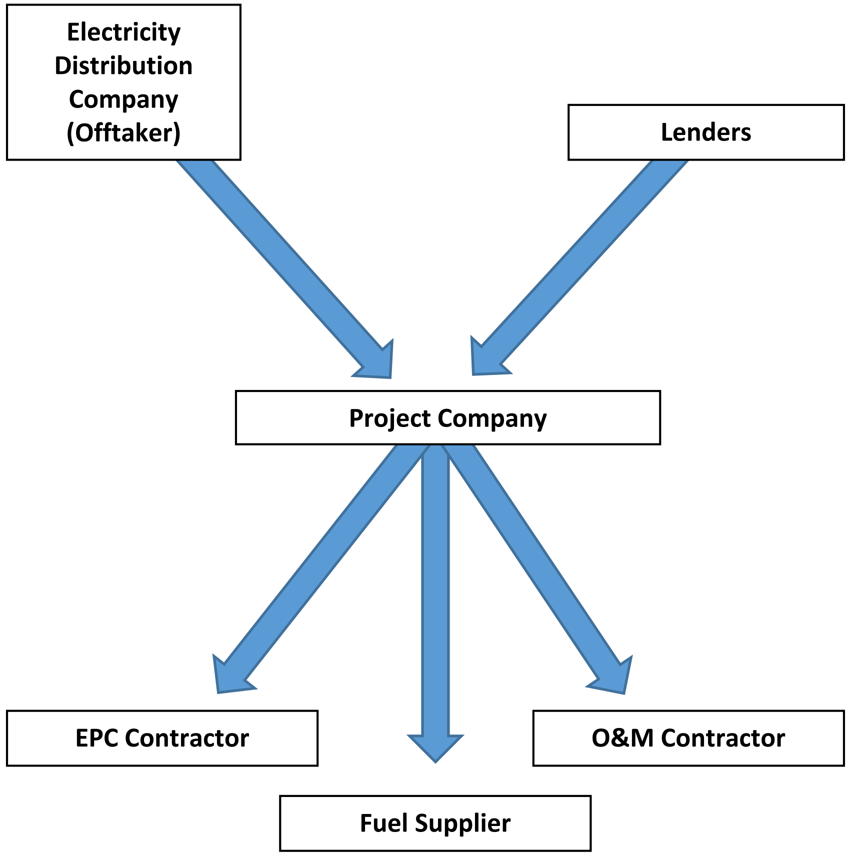


Subcontracts (IPPs)

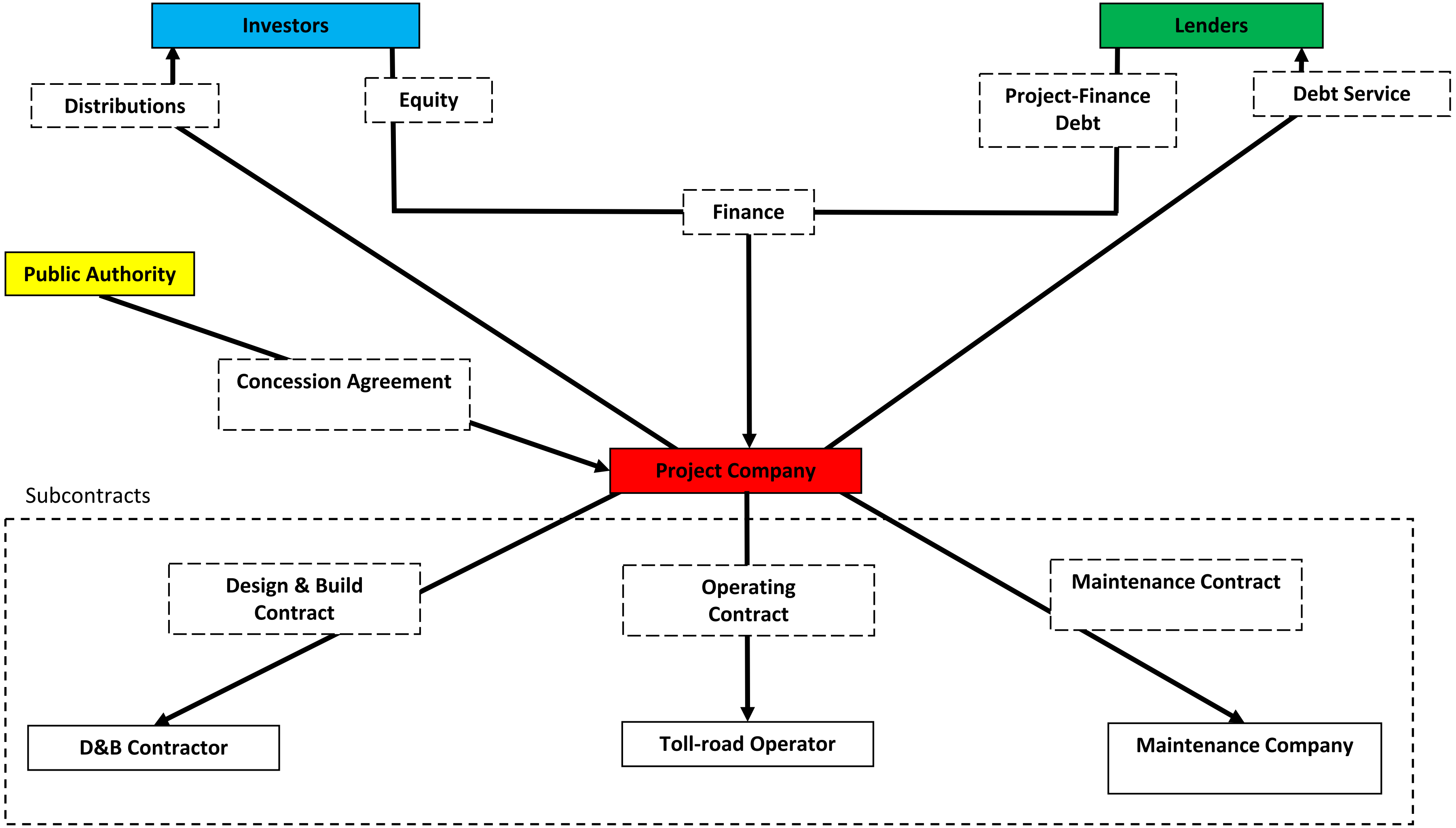


IPP Subcontracts

- Project Company will push all of its key risks under the Power Purchase Agreement (PPA) to its Subcontractors
  - EPC Contractor – Design, construction and commissioning of the generation facility on a fixed price and schedule
    - Cost overruns, timely completion
  - Fuel Supplier – Timely delivery of conforming fuel to the generation facility
    - Cost risk, penalty payments for insufficient quantities
  - O&M Contractor – Operation and maintenance of the generation facility following commissioning
    - Performance standards, operating costs

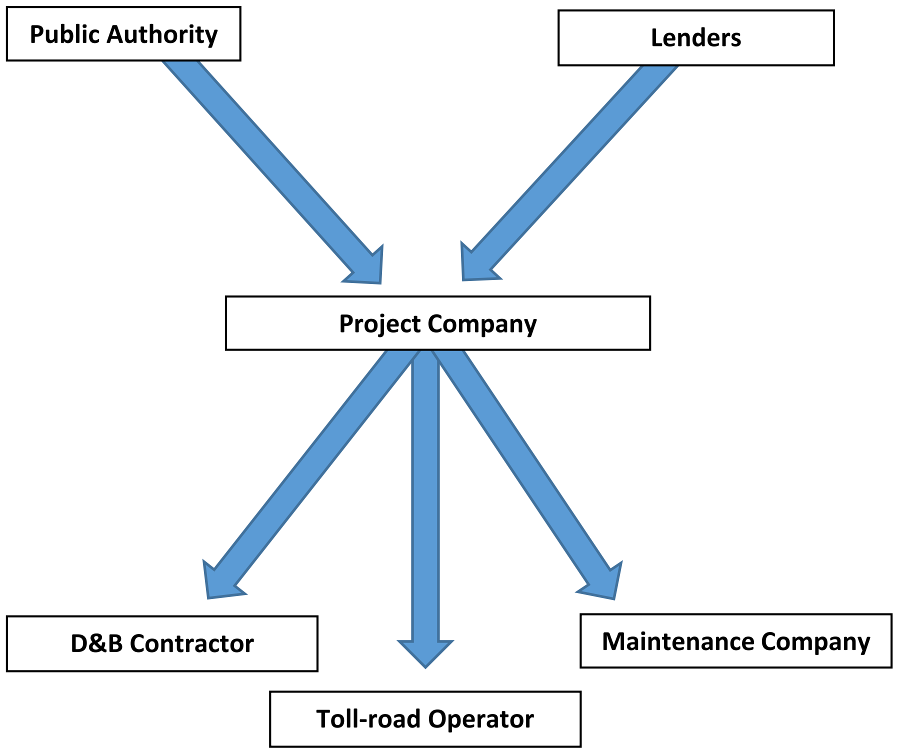


Subcontracts (Concession)

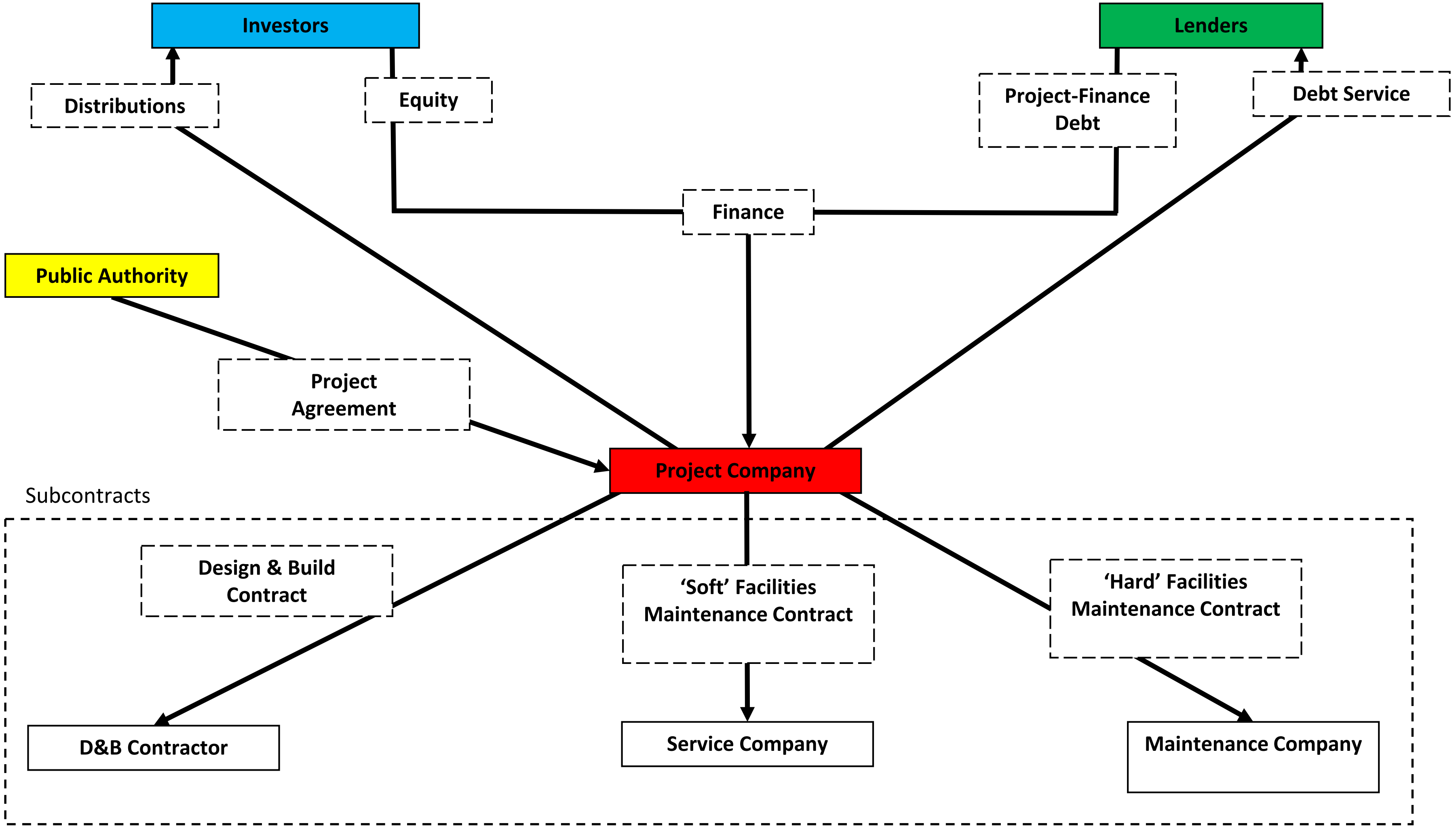


Concession Subcontracts

- Project Company will push all of its key risks under the Concession Agreement to its Subcontractors
  - D&B Contractor – Design and construction of the road and related works (e.g., tolls) on a fixed price and schedule
    - Cost overruns, timely completion
  - Toll-road Operator – Operation of tolling facilities
    - Operating costs (toll collection), some repairs
  - Maintenance Company – Maintenance of the road
    - Could be separate contracts for different services (road repair, debris collection, major maintenance)
    - Maintenance costs, performance standard penalties (incident response)
  - Demand Pricing Regime (Congestion-based Pricing)
    - Traffic congestion and toll pricing will remain with the Project Company

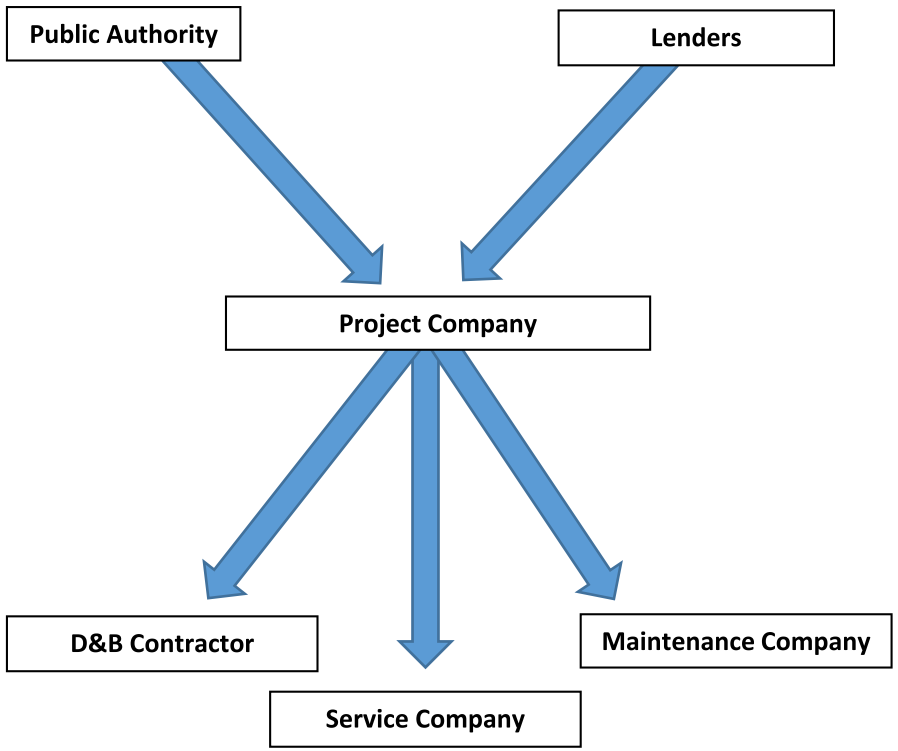


Subcontracts (PFI - Schools)



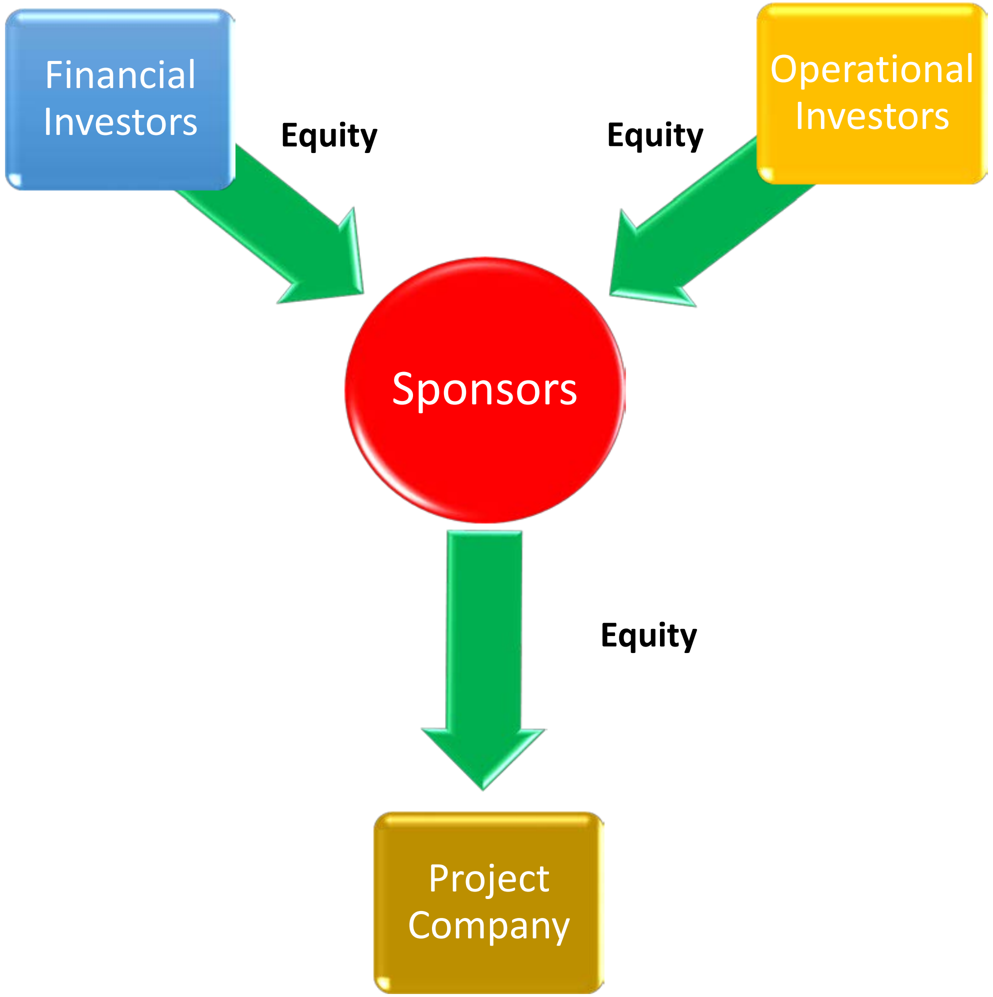
PFI Subcontracts

- **Project Company will push all of its key risks under the Concession Agreement (PFI Model) to its Subcontractors**
  - **D&B Contractor – Design and construction of the school on a fixed price and schedule**
    - **Cost overruns, timely completion**
  - **Service Company – Provision of certain services (security, cleaning, and catering)**
    - **Performance Standards, operating costs**
  - **Maintenance Company – Building maintenance, capital improvement and replacement**
    - **Performance standards, operating costs**



Public Private Partnerships:
Finance Agreements - Sponsor and Corporate Documents

Sponsors and Other Investors



Secondary Investors and Restrictions on Trade

- **A Sponsor business model may depend on selling its investment in the Project Company after the project is completed and generating revenue**
- **Potential investors include:**
  - **Contractors building up an infrastructure investment portfolio**
  - **PPP investment funds**
  - **Insurance Companies**
- **Public Authorities and lenders often require that the Sponsors retain their investment until construction is complete**
  - **Relying on Sponsors to manage the project through the most risky phase – construction**
  - **Sponsors with skills required for long-term operation may be required maintain their interests for a longer period**

The Investment Decision

- **Will the Project provide an adequate return?**
  - **What is the investor's own cost of capital?**
    - **Weighted Cost of Capital (WACC) – the weighted average costs of its own equity and debt funding**
  - **What is the cost of equity?**
    - **Must take into account the general risk premium applied to any company compared against a risk-free investment in government debt, and the particular risk premium which the stock market attributes to the company's business**
- **Equity IRR –**
  - **Derived from**
    - **The initial investment in the Project Company's share capital**
    - **The dividends on this capital over the life of the project**
    - **Any residual value (e.g., from sale of project land at the end of the PPP contract)**

$$WACC = \left(\frac{E}{E+D}\ x\ Re\right) + \left(\frac{D}{E+D} x\ Rd\ x\ (1 - T\%)\right)$$

- **E = market value of the company's equity**
- **D = company's outstanding debt**
- **Re = return on equity, express as rate of return**
- **Rd = return on debt (cost of borrowing expressed as rate of interest)**
- **T% = effective tax rate**

Capital Asset Pricing Model

$$Re = Rf + \beta\ (Rm - Rf)$$

- **Rf = the risk-free rate (cost of government debt)**
- **Rm = the market-risk premium (i.e., average rate of return which investors expect from investing in the equity market**
- **β (beta) = the risk premium for the particular company's business compared to the market as a whole, if the company risk is the same as the market as a whole β = 1**

Structure of the Project Company

- Party to the core contractual and financial relationships for the project
- In project finance, a separate – Special Purpose Vehicle (SPV) – is formed
  - No recourse to Sponsors beyond equity investment
  - Lenders take first priority of project cash flows
  - Protects against problems with unrelated businesses

Project Company

- May be owned directly by Sponsors or through a Holding Company
  - May be required by lenders
  - Potential tax benefits
- Often formed as a limited liability company or a partnership
  - Sponsors would be limited partners

Shareholder Agreement

- **Where there are multiple Sponsors, a Shareholder Agreement will be executed among the Shareholders**
  - **Often done at or before financial close, once the Project Company has been established**
  - **Often supersedes the previously executed Project Development Agreement**
  - **Shareholder Agreement will cover:**
    - **Subscriptions to equity and shareholder subordinated debt**
    - **Board representation**
    - **Governance issues such as conflicts of interest (e.g., where a Subcontractor is a Sponsor and there are voting matters related to the relevant Subcontract, the Subcontractor's director may not be allowed to vote)**
    - **Appointment and authority of management**
    - **Budgeting**
    - **Policy on distributions**
    - **Voting of shares at Project Company meetings**
    - **Sale of shares by Sponsors**

Management and Operations

- **Project Company may not be formed until late in the project-development phase**
  - **Formal management structure may not exist until after the Project Company have been formed**
- **Generally preferable that the Project Company retain minimal staff**
  - **General manager (reports to the Board of Directors)**
  - **One or two assistants**
- **Manager usually serves as the point of contact for the Public Authority and the "face" of the Project Company**

Lower Risk ⟷ **Higher Risk**

Lower Risk:

- **No permanent staff**
- **Key functions are subcontracted**
- **Supervision and corporate function carried out by third parties**
- **Directors are only permanent presence**

Higher Risk:

- **Retain all aspects of the Project in-house**
- **May only subcontract construction**
- **Approach often used for Concessions**

External Advisors

- **Sponsors can employ various advisors during the bidding and project-development phase**
  - **Legal Advisors**
  - **Technical Advisor**
  - **Planning and Environmental Consultant**
  - **Market Consultant**
  - **Accountant**
  - **Insurance Advisor**
  - **Financial Advisor**

Public Private Partnerships:
Finance Agreements – Financial Structure and Hedging

Financial Model

- **The financial model is a tool employed during the bid and project-development phase**
  - **Owner may use a financial model to determine project feasibility prior to tendering a RFP**
  - **Bidders will use a financial model to calculated its main output during the bidding phase – its price**
  - **Will be reviewed as part of lender's due diligence**
  - **Project Company will continue to use the model for budgeting, and, if applicable, calculating any refinancing gain**

Financing Costs

Money is not free – lenders will collect a premium from the Project Company for the availability and use of funds, as well as to cover its own costs

- **Credit Margin – 0.75%-1.5% over the lender's cost of funds (LIBOR or another benchmark), often based on the risk profile of the Project**
- **Additional Lender Costs**
  - **Liquidity or capital costs**
  - **Taxes**
  - **Market Disruption**
- **Commitment fees – paid by the Project Company to keep the undrawn funds available**
  - **Provides lenders a reasonable return on the risk during construction while not earning the full loan margin**

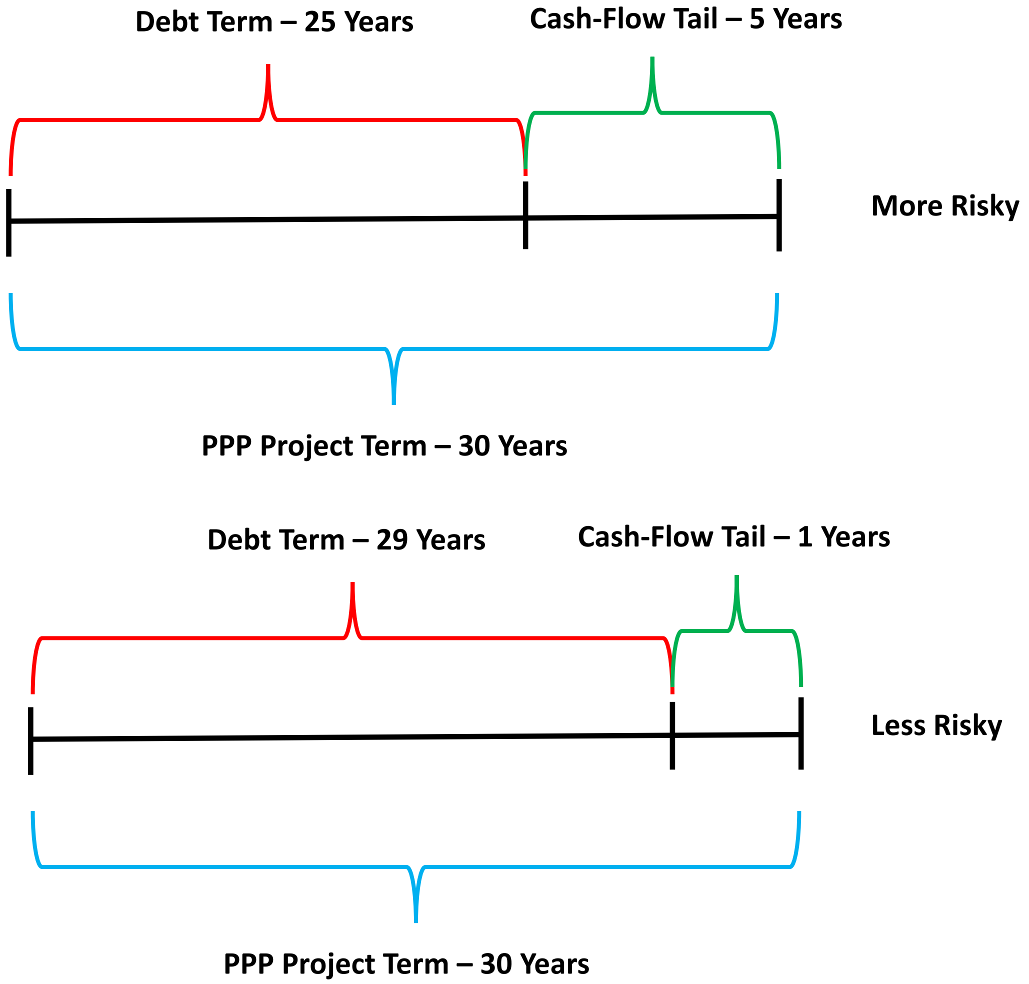
- **Fees – Lenders will charge fees for arranging and underwriting the financing based on the following factors:**
  - **Size and complexity**
  - **Time and work involved**
  - **Risk to any success-based fee**
  - **Bank's return targets for the work**
  - **Length of time carrying the syndication risk**
  - **Re-allowance of fees to sub-underwriting or participating banks to induce participation**

Debt Profile

- **Debt Term – Often 20 years or more to match the natural life of the project, making it affordable for the Public Authority**
  - **Newer PPP markets often have shorter loan terms until lenders become accustomed with the associated risks**
  - **Longer term loans have lower debt service payments, making the cover ratio better**
- **Repayment Profile – "levelized" debt service payments over the life of the loan**
  - **Based on an annuity schedule that will be "sculpted" over the term of the loan due to fluctuations in project cash flows**
- **Average Life – The average number of years that the loan principal is outstanding**
  - **Way for lenders to assess how rapidly their risk reduces over the term of the loan and make sure the repayment schedule is overextended**
  - **Lenders may have average-life limitations as part of their credit policy**

Debt Profile

- **Cash-Flow Tail – Period between the scheduled final repayment of the debt and the end of the PPP contract**
  - **Service Fees continue to be paid**
  - **Built-in safety margin in the event the Project experiences lower cash flows or other difficulties**
  - **Cash-Flow Tail can provide some assurance that the debt is paid off, although later than expected**
  - **The greater the revenue risk in the Project, the longer the Cash-Flow Tail that will be required**
    - **Higher Service Fees to repay the debt on a shorter term**
    - **Distributions to Investors will be pushed further to the back of the cash flow**
  - **Bidders will want the shortest Cash-Flow Tail possible**
  - **Public Authorities should avoid PPP contracts with long Cash-Flow Tails**



Debt Profile

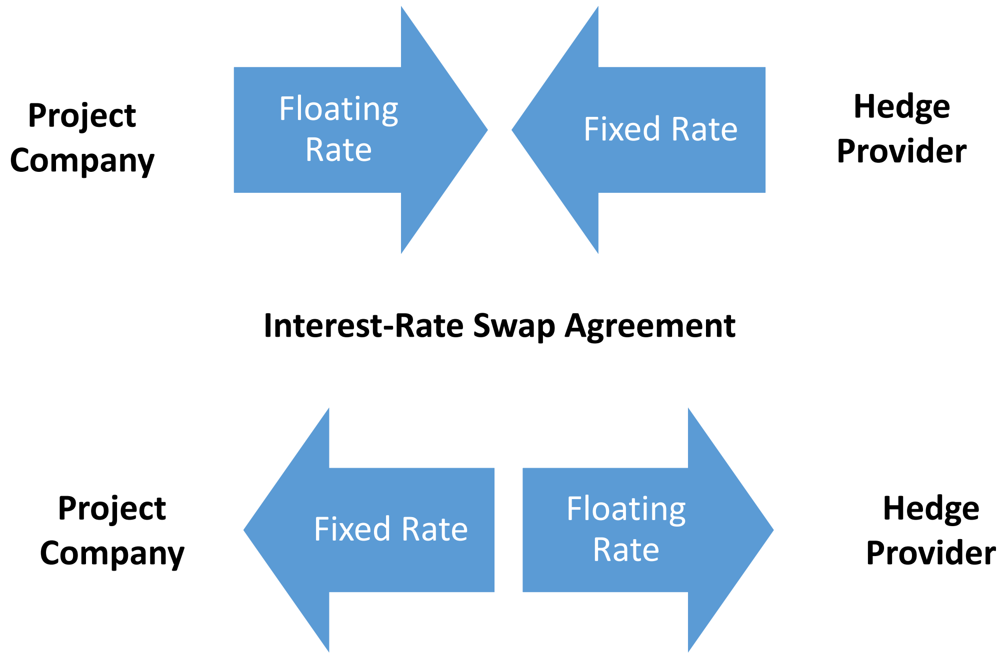
- **Flexible Repayment – 2 payment schedules**
  - Target repayments
  - Minimum repayment
- **Balloon Repayments – a way to lower the debt service to align with the Service Fees**
  - 25 year PPP Contract to be financed over 15 years, but with a 25-year payment structure
  - Often assumes the debt will be refinanced before the balloon payment is due
- **Cash Sweep – requires some or all of the cash flows to be used for debt prepayment instead of being distributed to investors**
  - Often used in conjunction with balloon repayments
  - Incents refinancing of the debt before the balloon payment
- **Debt Accretion – allows drawdown of debt and an increase in the loan amount (interest is added to the principal amount)**
  - Repayment of the does not begin until much later into the term of the PPP Contract
  - Often used for very long concessions (50 years or more)
- **Contingent Funding – additional funding on hand to meet unexpected events**
  - Adding a contingency to the capital expenditure budget
  - If not needed the undrawn funds will be cancelled
  - If additional "standby" equity or debt is provided, this will be used before the contingency amount is drawn

Cover Ratios

- **Traditional long-term corporate lending ratios are not appropriate for project finance**
  - **Short-term liquidity is assured through reserve accounts**
  - **Long-term corporate lending only looks at the ability to pay interest and not the ability to repay debt**
  - **Residual value of a Project Company's assets cannot be assumed because it is based primarily on Project contracts**
- **Amount of debt to be raised is primarily determined on the projected ability to pay debt service, with a comfortable safety margin**
  - **Cash Flow Available for Debt Service**
  - **Annual Debt-Service Cover Ratio**
  - **Loan-Life Cover Ratio**
  - **Project-Life Cover Ratio**

Financial Hedging

- **Interest-Rate Risk**
  - **Commercial banks do not generally lend at fixed rates over the term of the debt (cannot fund the loan with matching deposits)**
  - **"Floating" interest rate – the interest on the loan is adjusted at set intervals (e.g., every 6 months) to current market rates for short-term deposits with a credit margin**
- **Financial Hedging mitigates interest-rate risk**
  - **Service Fees could be adjusted for movements in the floating-interest rate**
    - **Concessions – users will not like continuous changes in pricing**
  - **Interest-Rate Swap – the exchange for an obligation to pay interest on a floating-rate basis for an obligation to pay interest on a fixed rate basis**
    - **The Project Company will pay the Hedge Provider the difference between the floating rate and agreed-upon fixed rate if the floating rate is lower than the fixed rate**
    - **The Hedge Provider will pay the Project Company the difference between the floating rate and fixed rate if the fixed rate is lower than the floating rate**



Financial Hedging

- **Inflation Issues**
  - **Nominal v. Real**
    - **Nominal – includes the effect, if any, of inflation (in the context of a payment, the amount paid (or expect to be paid) in ‘money of the future’)**
    - **Real – excludes the effects of inflation (in the context a payment, money paid today, even if at a future date)**
  - **Services Fees may be quoted by bidders on a real basis, subject to indexation for inflation**
  - **Debt service is normally a fixed series of payments on a nominal basis**
  - **Inflation Index**
    - **The Public Authority has to consider the most appropriate inflation index for indexing PPP payments**
      - **Index should relate to the business sector in which the Project Company is operating**
      - **A general consumer-price index (e.g., CPI) should be used**

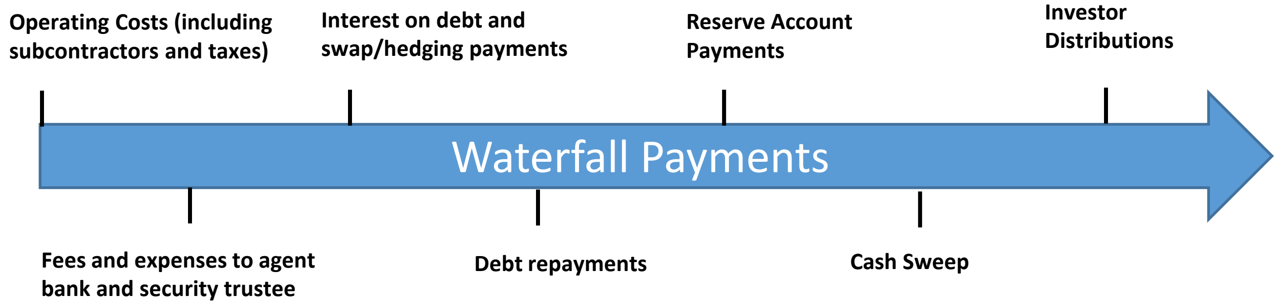
Public Private Partnerships:
Finance Agreements – Lenders’ Cash-Flow Controls, Security and Enforcement

Control of Cash Flow

- **Project Company cash flows are closely controlled by the lenders during all phases of the project**
  - **Construction Phase – to ensure funds are spent as planned**
  - **Operation Phase – to ensure cash flow is applied according to agreed priorities**
- **Disbursement Account**
  - **Project Company will submit a draw request in advance of the of the date that funds are required, may include:**
    - **Payment requests from subcontractors, certified by a Technical Advisor**
    - **Summary of the purpose for other required draws**
    - **How costs are to be funded (i.e., equity or debt)**
    - **Compares monthly and cumulative project costs with the construction budget**
    - **Demonstrates that enough funds remain available to complete the Project**
    - **Demonstrates compliance with other draw conditions**

Control of Cash Flow

- **Cash-Flow Cascade**
  - **During operation, lenders will control cash flows through the "waterfall" (order of priority for payment)**
- **Reserve Accounts**
  - **Waterfall payments are paid into Reserve Accounts, which serve to protect the Project Company's liquidity should there be a temporary shortage in revenues or increase in operating costs, build up funds for a particular purpose, segregate special funds (e.g., insurance proceeds)**
  - **Debt Service Reserve Account (DSRA)**
  - **Debt Payment Reserve Account**
  - **Maintenance Reserve Account**
  - **Change in Law Reserve Account**
  - **Insurance Proceeds Account**
- **Controls on Distributions to Investors**
  - **Project Company will have to satisfy certain cover ratios before funds will be distributed to investors**



Security

- **Lenders Security ensures that:**
  - **Lenders are involved at an early stage if the project begins to go wrong**
  - **Lenders can take over and run the project if necessary**
  - **Third parties (e.g., unsecured creditors) do not gain any prior or *pari passu* rights over the project assets**
  - **Project assets are not disposed of without the lenders' agreement**
  - **Lenders can 'encourage' cooperation by the Project Company if it gets into trouble**
- **Security Over Contracts and Financial Assets**
  - **Lenders will expect assignments rights over:**
    - **PPP Contract**
    - **Subcontracts, and any bonds or guarantees for these contracts**
    - **Insurances**
    - **Any continuing advisory contracts**

Lenders' Security Package

Cash Flow Control
Contracts and Financial Assets
Project Company's Shares
Step-In Rights (Direct Agreements)

- **Lenders will also take security over the Project Company's financial assets:**
  - **Pledges of the Project Company's bank accounts**
  - **Assignment of the Project Company's right to receive payments of equity from the Sponsors**
  - **Assignment of shareholders' claims under subordinated loans**
  - **Assignment of the Project Company's right to receive any payment due to it if the financial hedge is broken**
  - **Assignment of insurance policies**

Security

- **Security Over Project Company Shares**
  - **Lender's take security over the investors' shares in the Project Company**
    - **Enables the lenders to take over management of the Project Company more quickly than through contract assignments**
    - **Negative Pledge provisions**
  - **Holding Companies**
    - **Common for Project Company to be owned by an intermediary holding company who shares are owed by investor and pledged to lenders**
- **Direct Agreements**
  - **Tri-party agreement between the lenders, Project Company, and Public Authority acknowledging the lenders' position and consenting to the lenders taking an assignment of the contracts as security**

Events of Default

- **Events of Default (EoDs) allow lenders to take action against the Project Company**
  - **Defined set of triggers in the finance documents and often includes a ‘catch-all’ for EoDs under the PPP Contract (i.e., a default under the PPP Contract = a default under the finance documents)**
  - **An EoD often does not trigger a default until the Project Company has been given an opportunity to cure (some EoDs do not have a cure period – e.g., bankruptcy)**
  - **Project and finance documents should include provisions that require the Project Company to take certain actions to prevent an EoD in the future (e.g., a remedial plan)**
- **Options to lenders following an EoD:**
  - **Waive**
  - **Drawstop, if the Project is under construction**
  - **Require net cash flows be applied to reducing debt of be held in a separate account under the lenders’ control instead of distributed to investors**
  - **Enforce lenders’ security**

Intercreditor Issues

- **Each lender will have its own loan agreement with the Project Company**
- **To ensure that the finance transactions work together and that the Project Company does not find itself in the middle of a fight between lenders a Common Terms Agreement (CTA) will be used**
- **CTA provides a common approach for the lenders to administer financing to the Project Company**
  - Waterfall
  - Voting on amendments
  - Waivers to loan documents
  - Amendments to project contracts
  - Duties of the Collateral Agent
  - Common Reps and Warranties of the Project Company
  - Covenants of the Project Company

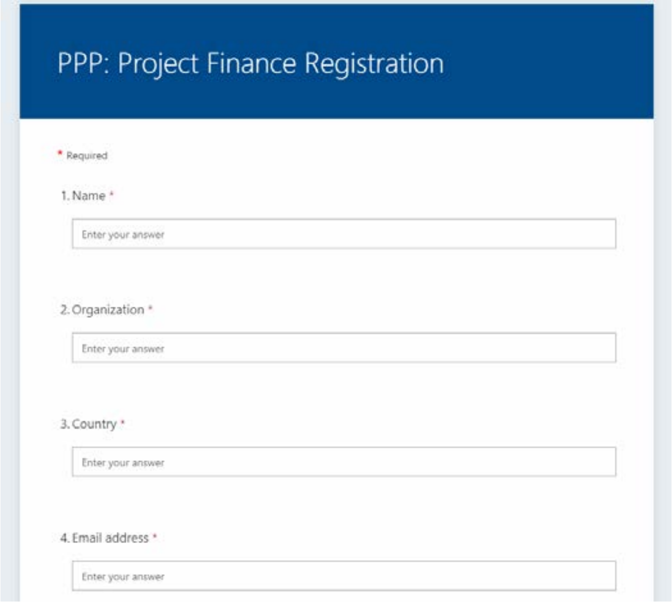
Questions and Comments?

CLDP PPP Pre-Recorded Webinar Series

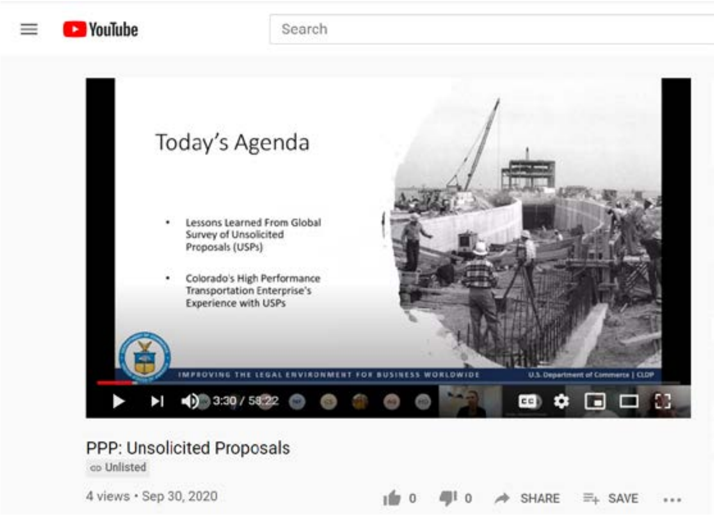
Go to:

www.cldp.doc.gov/PPP

Register



Watch



CLDP Survey and Webinar Assessment

- Receive certificate upon satisfactory completion
- Find link to survey and webinar assessment in ‘thank you’ email

Tel: +1 202 482 2400

1401 Constitution Avenue,
NW, Washington,
DC 20230

www.cldp.doc.gov

Lindsey Scannell
Senior Counsel
Asia-Pacific Portfolio
LScannell@doc.gov

Adam Goodman
Attorney-Advisor
Asia-Pacific Portfolio
AGoodman@doc.gov