The Commercial Law Development Program
Presents
Public-Private Partnership Webinar Series

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Commercial Contracts in Public-Private Partnerships

Today's Presenters

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Topics for Consideration Today

- Recap how PPPs differ from traditional design build contracts
- How flow-down agreements work to achieve the objectives of PPPs
- How security devices work to promote P3 objectives
- Issues and Challenges in PPP subcontract performance

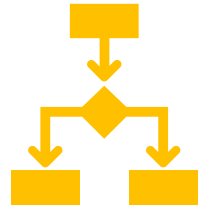



Key PPP Terminology

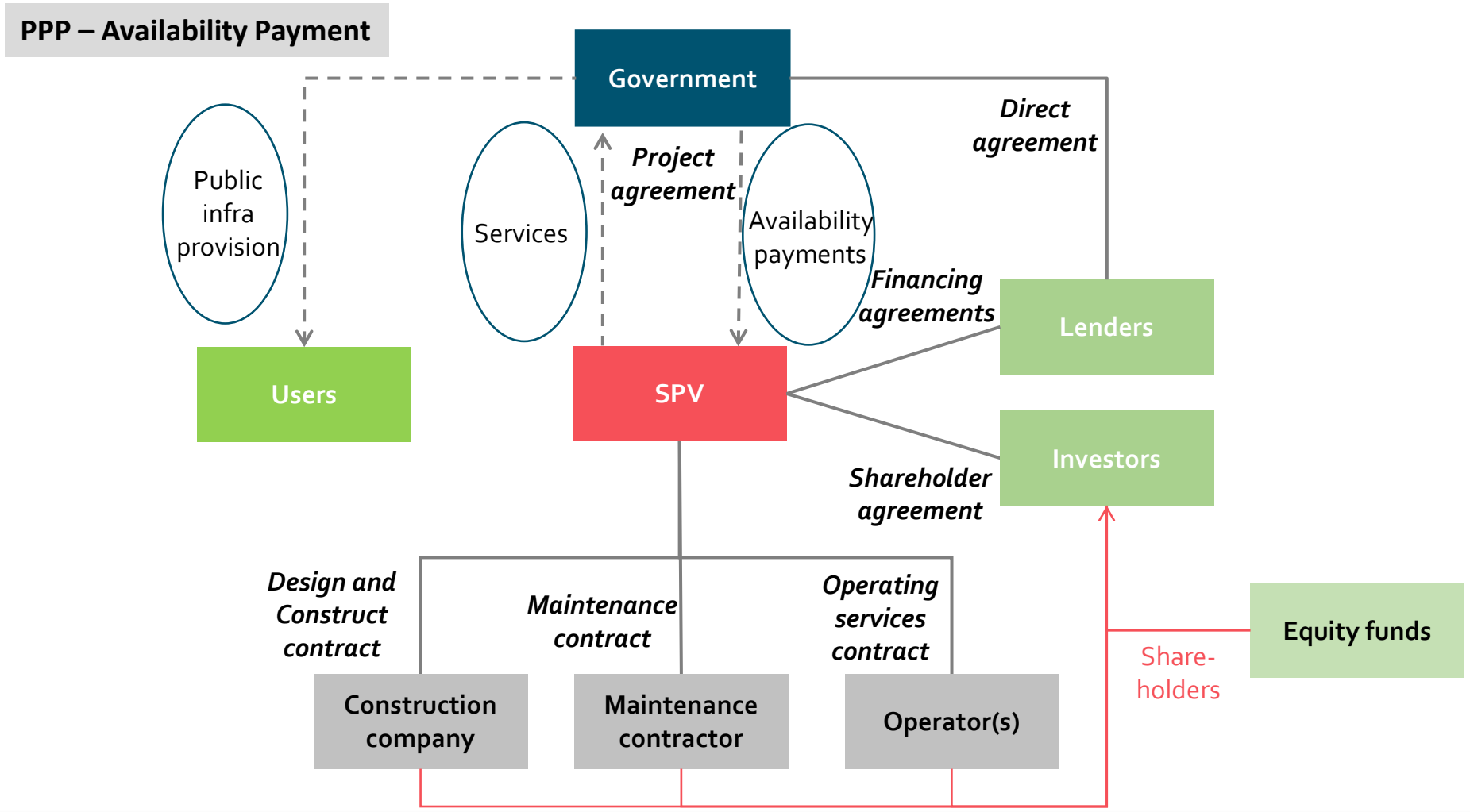
- **Project Company** – Also called a Special Purpose Vehicle (SPV)
- **Construction Contractor** – also called Design-Build Contractor, EPC Contractor
- **Concession Agreement** – also called Project Agreement, Comprehensive Agreement
- **O&M Contractor** – also called Operator, Maintenance Contractor, Facilities Manager
- **Major Maintenance** – also called Lifecycle, Rehabilitation

PPP Commercial Contracts Overview

- The **Project Agreement:** is the overarching PPP contractual relationship between the government agency and the private sector Project Company
- The **Project Company**: is a newly-created SPV formed to raise project financing (non-recourse debt and equity) and execute agreed scope of work
- The Project Company **"drops down"** applicable risks and responsibilities to its major subcontractors on a **"back-to-back"** basis for a **fixed price**.
- Major subcontractors typically include at least a Design-Build Contractor, plus one or more O&M Contractors



Typical PPP structure



Fixed-price Subcontract Advantages

- A main avenue for accomplishing **"risk transfer"** from public to private sector in PPP projects
  - Assign each risk to the party best able to manage it
- Major subcontractors bear the financial risk of cost overruns on fixed price contracts, and in return lenders, equity investors and government benefit from price certainty – a major differentiator and value driver of PPPs
- Well-structured fixed price contracts enable PPP projects to be efficiently financed on a non-recourse basis at high leverage

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Fixed-price Contract Disadvantages

- **Rigidity**
  - PPP projects usually entail a series of long-term contracts which are integrated by the SPV.
  - Construction change orders or other scope changes can have knock-on effects on other aspects such as O&M, financing, and /or revenue projections.
- There is a price associated with **each risk** borne by the private (sub)contractor.
  - Contingencies are factored into the price to account for uncertainty.
  - A Value for Money assessment should be undertaken early on to identify the optimal risk allocation between private and public
- Repeated financial losses on large, complex DB Contracts has led some major private contractors to exit the PPP/DB market.

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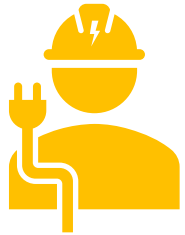
Design-Build (DB) Contracts

- Construction risk is one of the **largest risks** of any infrastructure project.



- DB Contracts are a **major value driver** of PPPs integrating construction, O&M and financing responsibilities, but DB Contracting can also be implemented on its own without the O&M or private financing

- Rather than government designing a project and bidding out its design:
  - Government establishes minimum technical requirements and
  - Allows the private sector to design and build to those requirements in the most innovative and efficient way possible

Design-Build vs. Public-Private Partnership

- **Design-Build**
  - Design services and construction work under one contract
  - Procurement may be based on “best value”
  - Design risks shift to design-builder

- **Public-Private Partnership**
  - Design-Build-Finance-Operate-Maintain = “purist” PPP model
  - Opportunities for innovation and life-cycle cost considerations
  - Owner pays developer availability payments or revenue
  - Facility returns to owner at the end of period of performance

Fixed Contract Term

- **Design-Build**
  - Commences on contract execution / notice to proceed and ends upon project completion (subject to warranty period)
  - O&M services under separate contract / performed by owner
- **Public-Private Partnership**
  - Commences on financial close and ends when asset is handed back to the owner (~20 to 30 years) **OR**
  - Fixed operating term commences upon project completion (or later of project completion and required completion date)
  - Factors to consider:
    - Reasonable rate of return on investment to developer
    - Preferred condition of asset upon return to owner
    - Technological life of the asset / major upgrade or refurbishment timing

Extendable / Dynamic Contract Term

- **Extendable Contract Term**
  - Fixed term with possibility of extension under limited circumstances:
    - Relief event
    - Change Order

- **Dynamic Contract Term**
  - Commences on financial close and ends when milestone occurs:
    - Agreed net present value of revenue stream / rate of return is reached
    - Repayment of debt
    - Other

O&M Contracts

- Structure **varies** by sector, jurisdiction, and type of project
- Includes aspects such as:
  - Routine operations
  - Major maintenance/rehabilitation
  - Toll collection (e.g. roads)
  - Facilities management (e.g buildings)
  - Vehicle maintenance (e.g. rail/transit)
- O&M contracts are **usually** fixed price, third-party subcontract(s), but in some cases can be “self-performed” by the SPV
  - Typically the O&M contract price is indexed annually for inflation

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Subcontractor Considerations

- The DB Contractor and O&M Contractor typically engage (many) **smaller subcontractors** to perform the work
- While government does not have a direct relationship with the subcontractors in PPPs, there remains a desire to ensure that the major contractors are treating their smaller subs fairly
  - e.g. labor conditions, prevailing wages, on-time payment, safety conditions.
- Subcontract provisions need to be **"back to back"** with the Design Build which in turn is **"back to back"** with the Project Agreement
- Changes at the subcontract level must function in conformity with the operational and structure assumptions on which the project viability rests

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Performance Security

- Rating agencies, lenders and equity investors require major subcontractors to provide performance security to back up their contractual commitments
  - This is to ensure that the contractor will not easily walk away if things go wrong
- Major PPP subcontractors must have sufficient financial strength

- Typical performance security for a DB Contractor includes:
  - **Liquidated damages** – In case construction completion is delayed beyond scheduled date, DB Contractor must pay SPV an established daily LD rate
  - **Liquid security** – in the form of a Letter of Credit or on-demand performance bond
  - **Parent company guarantee(s)** – up to a liability cap of 35-50% of the DB Contract value

Liquidated Damages

- Typical in **Design-Build** Contracts (between SPV and DB Contractor), but not always included in Project Agreements (between government and SPV)
  - AP payments/revenues typically don't start until construction completion
  - Exception for PPP is when reduction in AP/revenue payments are insufficient to cover owner's direct and quantifiable financial losses
- Pre-determined amount of damages for failing to deliver the project timely
- Enforceable:
  - Actual damages uncertain
  - Reasonable estimate of losses
- Various options:
  - Commences day after the substantial completion deadline, or grace period following substantial completion deadline
  - Amount increases after time thresholds
  - "Cap" on amount

Performance Bonding

- **On-demand security / bank guarantee**
  - Ensure contractor will satisfactorily perform contractual duties
  - Increases the likelihood the project will be completed on time
  - Protects owner from losses resulting from contractor default
  - Underwriting provides an additional prequalification process
- Consider legal requirements governing **performance bonds** in the jurisdiction
- Consider whether **other protections** are adequate:
  - No availability / revenue payments during D&C phase (PPP)
  - Cash flow waterfall (PPP)
  - Parent company guarantee

Private Sector Perspective: Vertically-Integrated Companies

- Relationship of the major private project parties (i.e. Project Company, DB Contractor, O&M Contractor) depends on whether they are independent companies or related parties
- Worldwide, there are a number of **vertically-integrated conglomerates** with divisions that can fill each of the major roles in a PPP project – i.e. equity investor in the Project Company, DB Contractor, O&M Contractor
- Some vertically-integrated companies are more focused on / driven by contruction contracting, while others focus more on equity investment and/or operations
- At bid stage, vertically-integrated companies can make trade-offs to **optimize the competitiveness** of their overall bid, e.g. by accepting a lower return on equity because they mainly want to win the large DB Contract

Private Sector Perspective: Bidding Dynamics

- Even when bidding consortiums consist of related parties, there is a **tension between** the interests and appetites of the parties.
- All team members **want to win** the bid, but they want the other disciplines to be the ones to "sharpen their pencil," for example:
  - Equity investors reducing their required equity IRR
  - DB Contractor reducing its DB Contract price (incl contingency and margin)
  - O&M Contractor reducing its O&M Contract price
  - Lenders tightening interest rates and terms
  - Traffic & Revenue experts increasing their revenue projections (when applicable)

Foreign Exchange Risk

- Particularly in emerging markets, there are often aspects of foreign exchange risk that pose **challenges** in PPP commercial contracts
  - For example: if the funding for the project is denominated in local currency, but the subcontractor has significant costs in hard currency (e.g. USD, EUR) related to imported equipment, raw materials, management costs and/or consultants.
- **Solutions** include:
  - DB Contractor pricing the DB Contract in multiple currencies to match its cost profile
  - SPV bearing and hedging the FX risk (adds to the project cost)
    - The Currency Exchange Fund (TCX) is a DFI-backed financial institution offering long-term FX swaps to hedge “exotic” currencies
  - Government offering (partial) FX risk protection by providing (part) of the project funding in hard currency (creates contingent liability)

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How does a PPP work: Road Project Illustration

	Conventional	PPP - Availability Payments	PPP - User Fee Payments
Planning approval risk / land acquisition	public	public	public
Construction risk	public	private	private
Operations and Maintenance risk	public	private	private
Demand / revenue risk	public	public	private
Financial risk	public	private	private
Regulatory risk	public	shared	shared
Force Majeure	public	shared	shared

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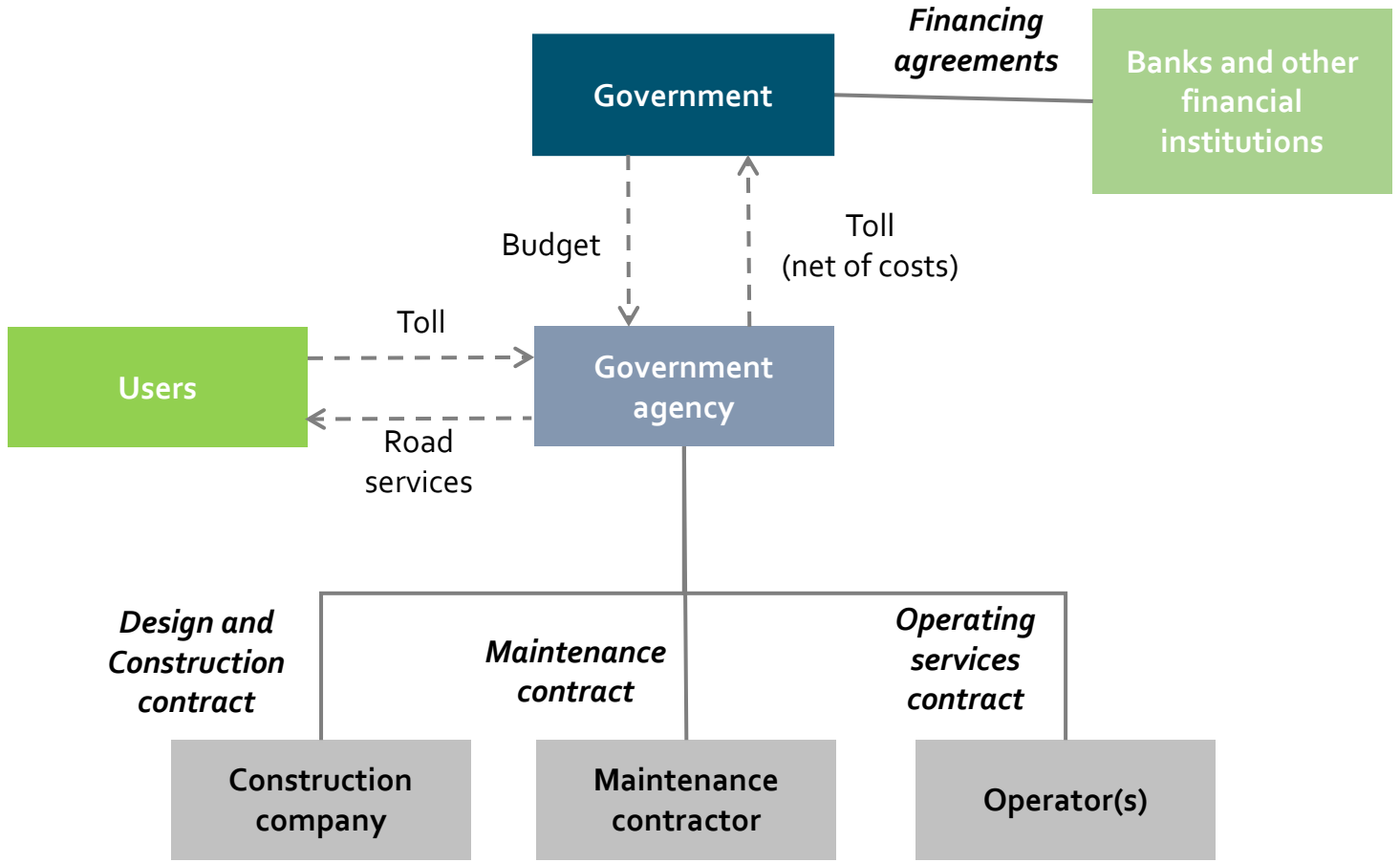
Typical Conventional Structure (Toll Road)

Conventional procurement



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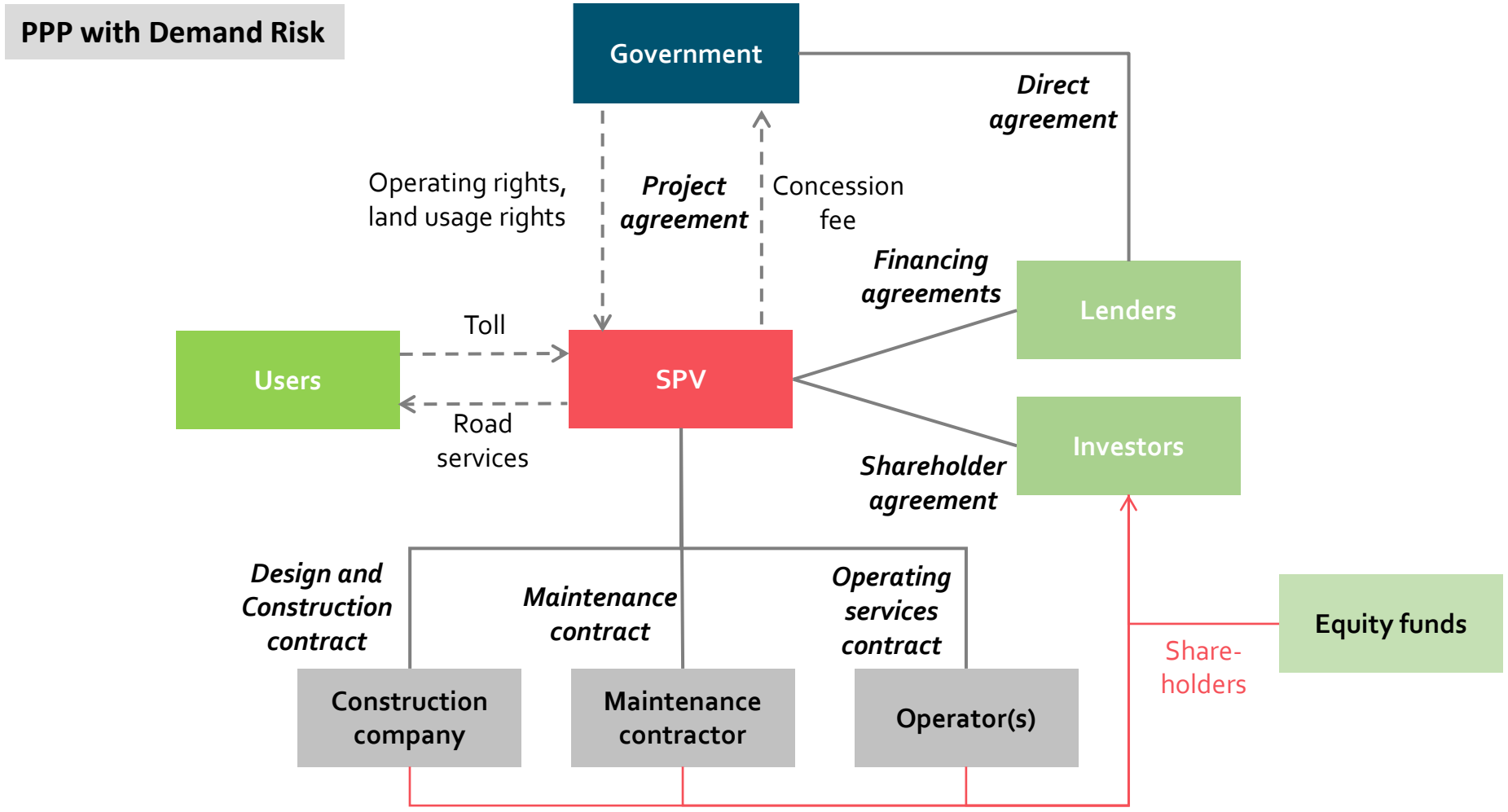
Typical PPP Structure (Toll Road)



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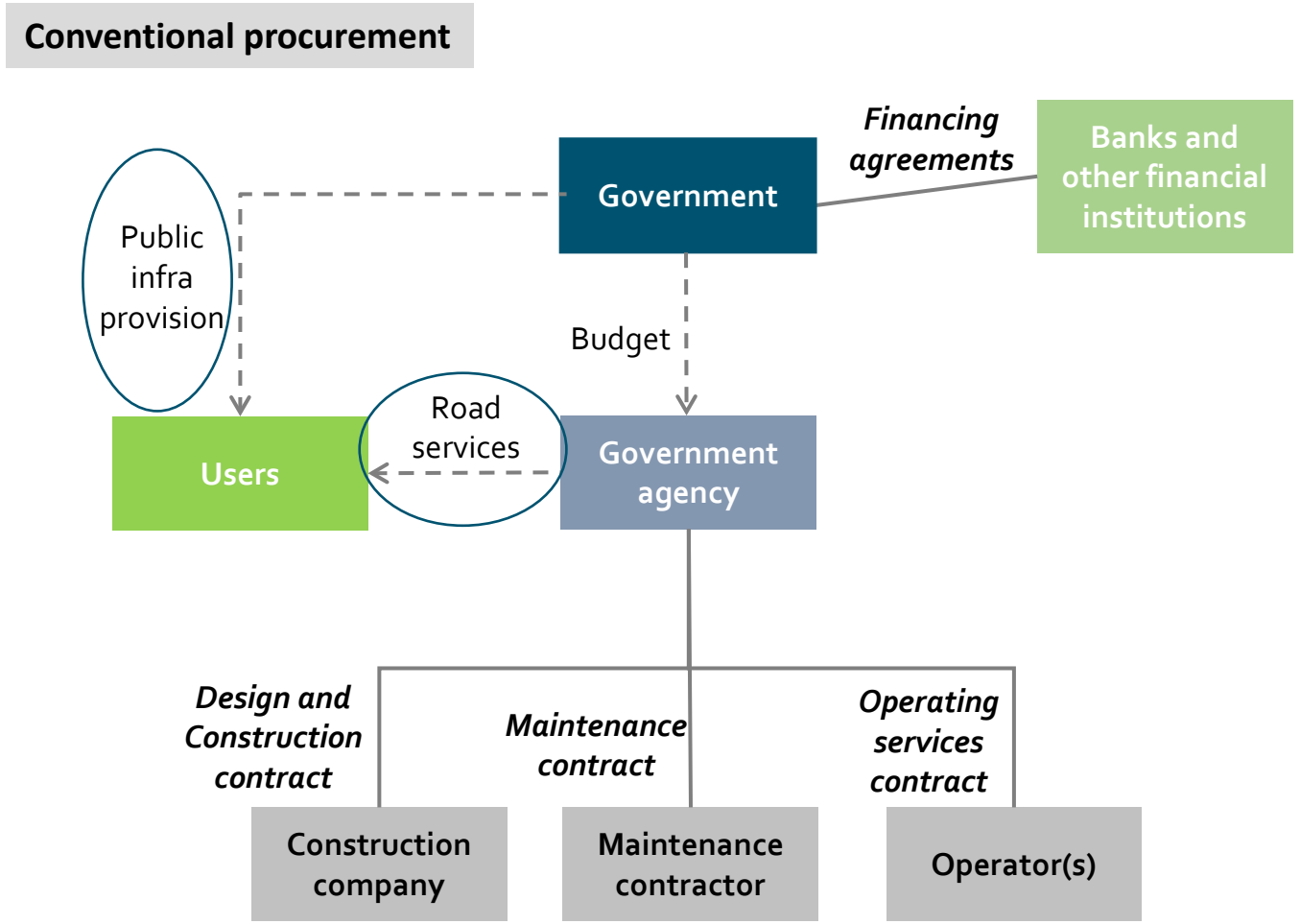
Typical Conventional Structure (Untolled Road)



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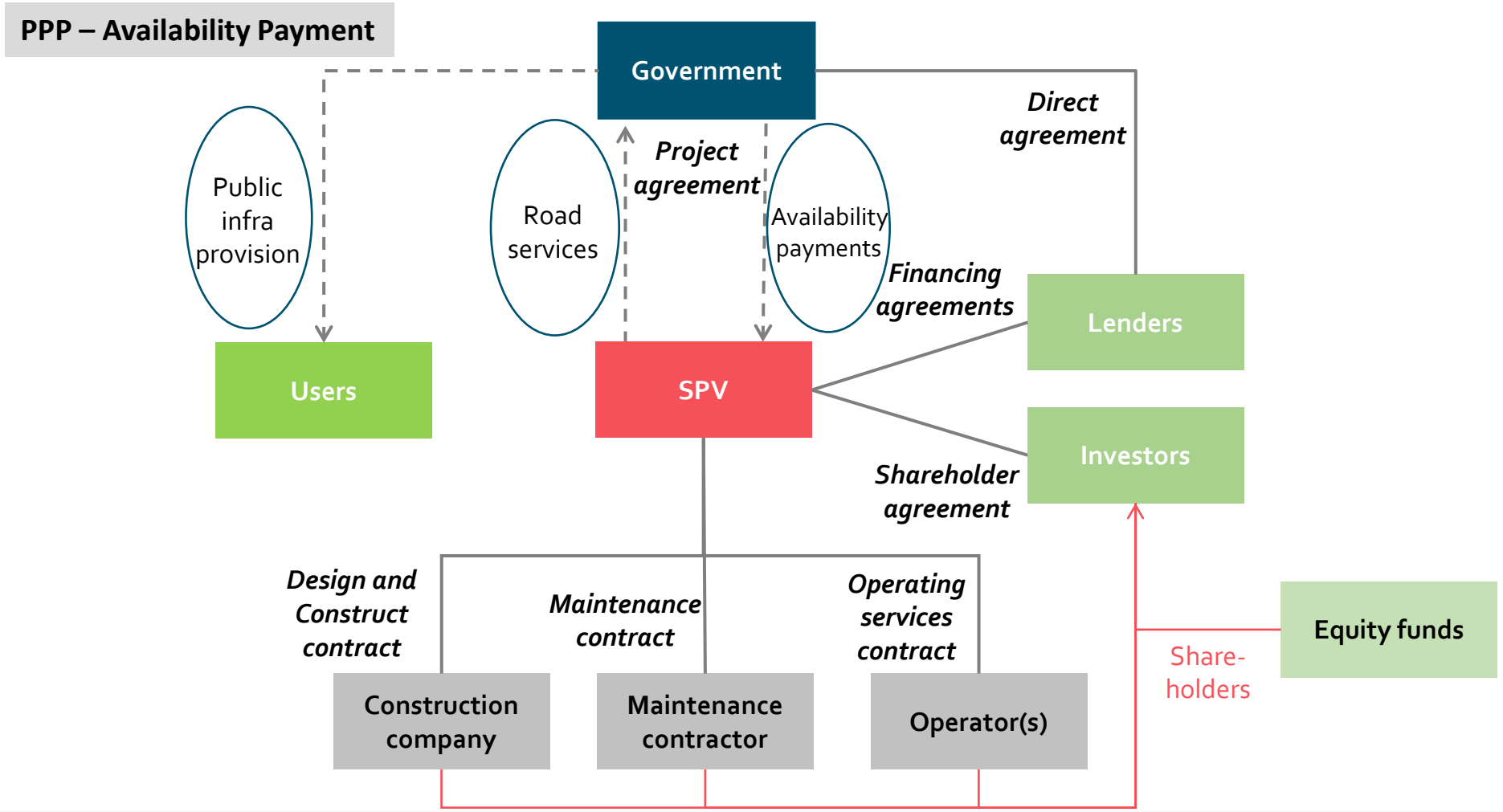
Typical PPP Structure (Untolled Road)



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Summary and Conclusions

- Benefits of PPP Procurement are substantial but **not every project** is suitable for PPP

- Where PPP is the delivery method of choice, critical structural and operational assumptions must be reflected at every layer of the contractual arrangements

- When problems arise in subcontractor performance, the deal structure must provide remedies to ensure the problem is isolated and addressed

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- **Project Agreements**
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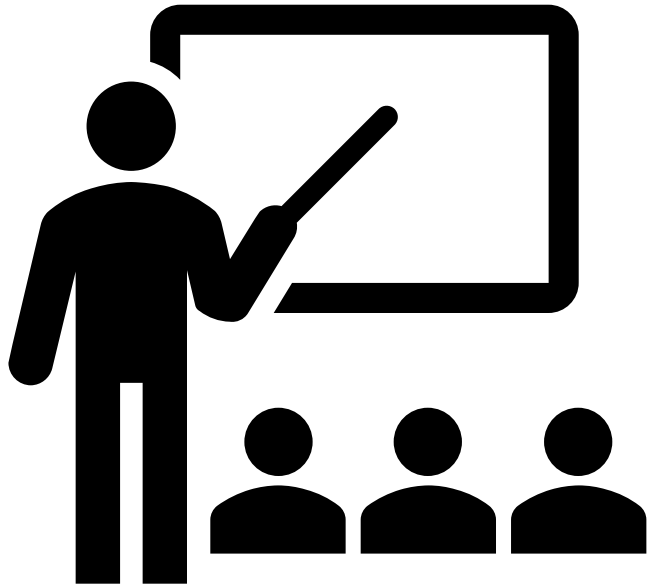

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Go to:

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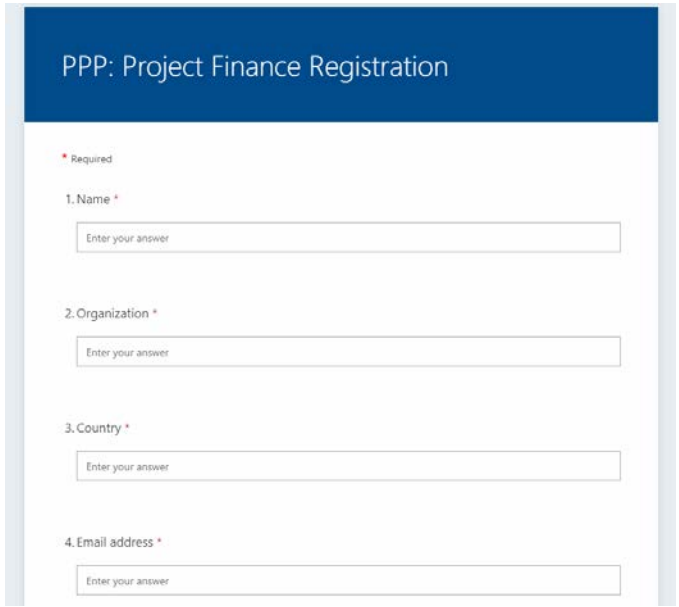

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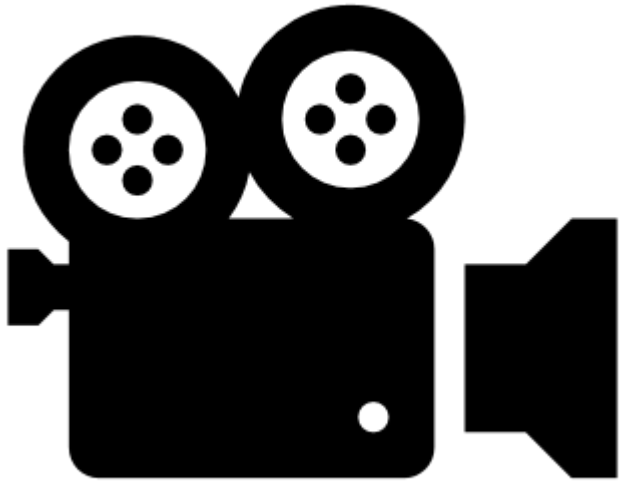

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