

# Particular Primary Principles of Public Private Partnerships

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# Introduction

- **Highways, water and wastewater treatment facilities, buildings, all targets for PPP's**
- **One type of PPP has project capital funded by private sector and 'repaid' through long-term operating arrangement**
- **Could be toll on highway, lease on building etc.**

# General Characteristics

- **Successful PPP's include:**

Shared vision and goals

Trust and respect

Measurement of success

Key partner involvement from the beginning

Champions (leader)

Leadership

Clear ground rules, roles and responsibilities

Communication

Consensus based decision making



# General Characteristics

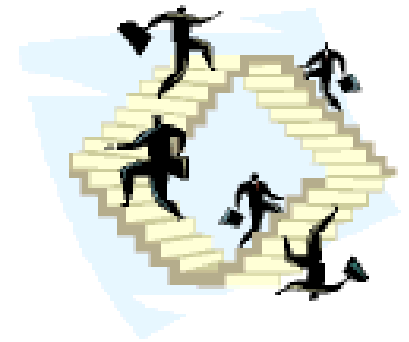
- **Unsuccessful PPP's include:**

- Inequality of power

- Lack of trust

- Unclear expectations

- Unclear lines of responsibility and accountability



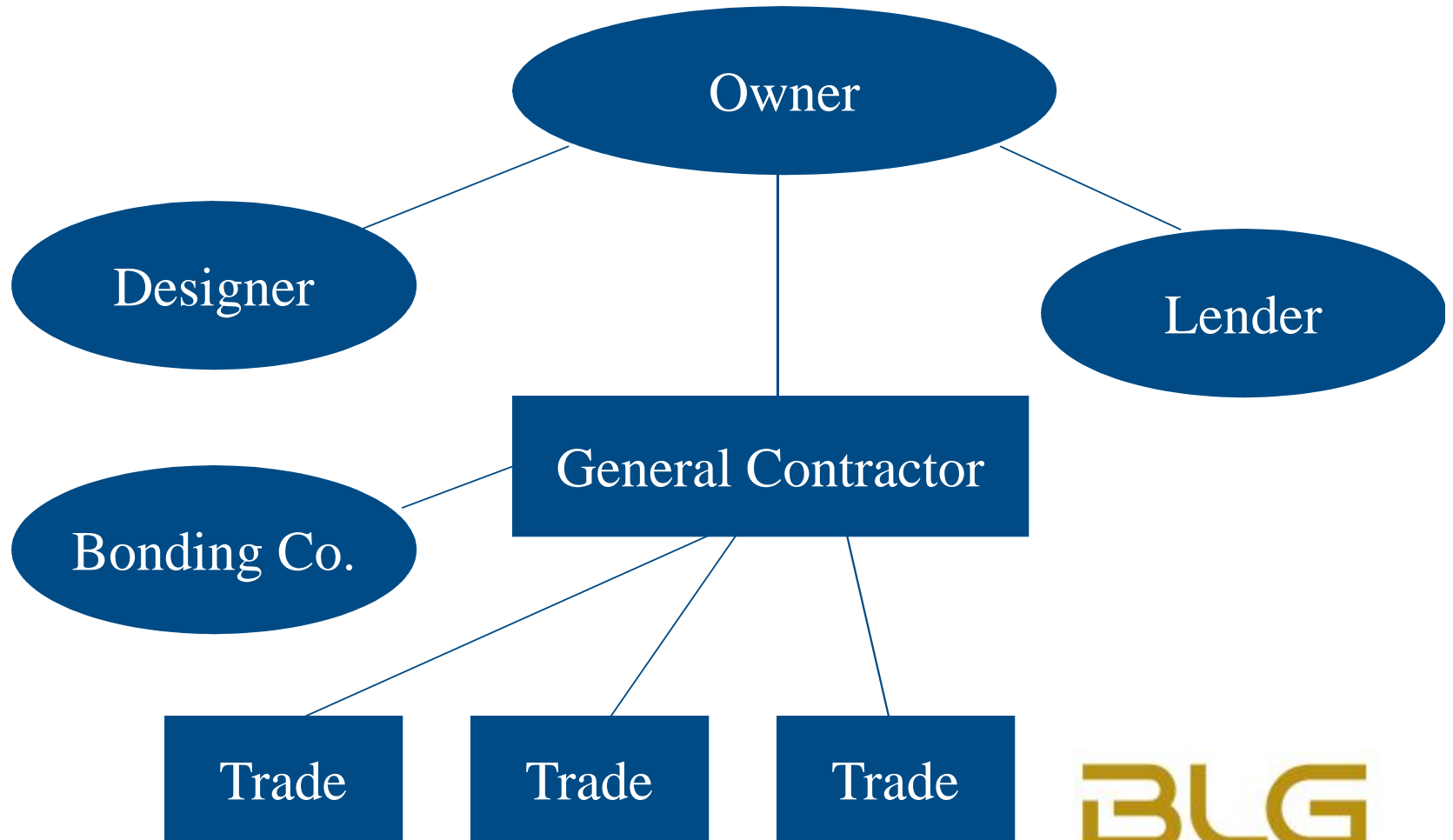
# Cost Certainty v. Fair Risk Allocation



- Cost certainty

- Fair risk
- allocation

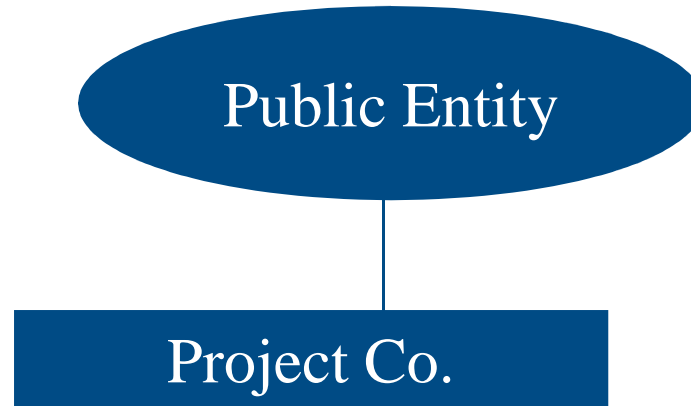
# The “Traditional” Contract



# Traditional PPP

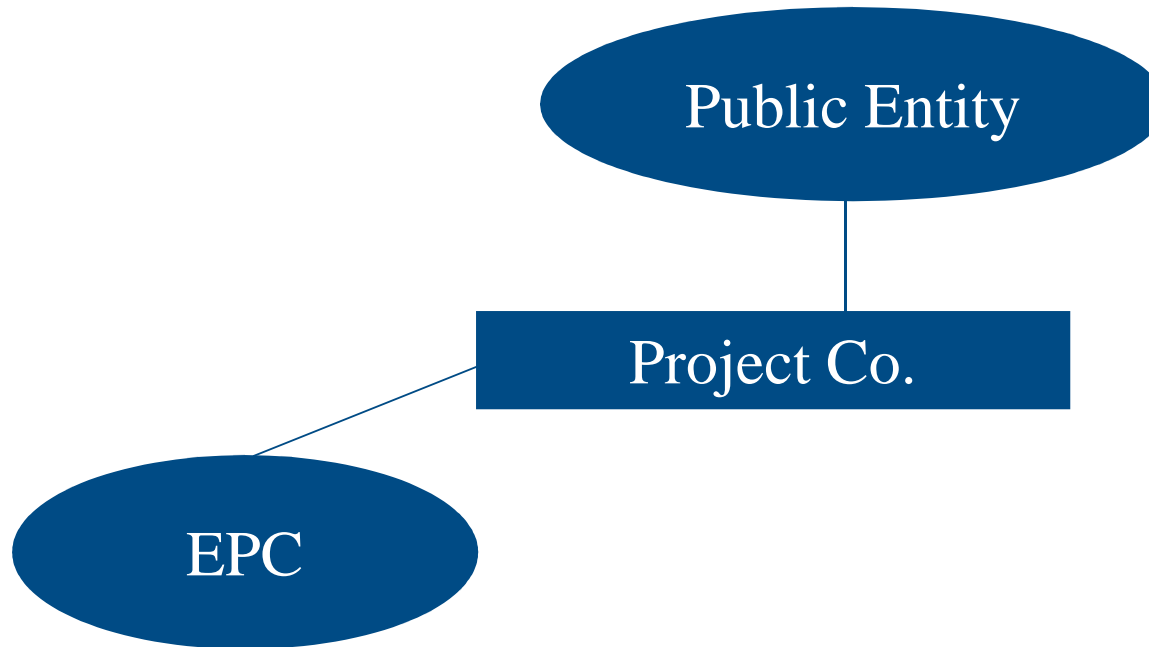
Public Entity

# Project Agreement

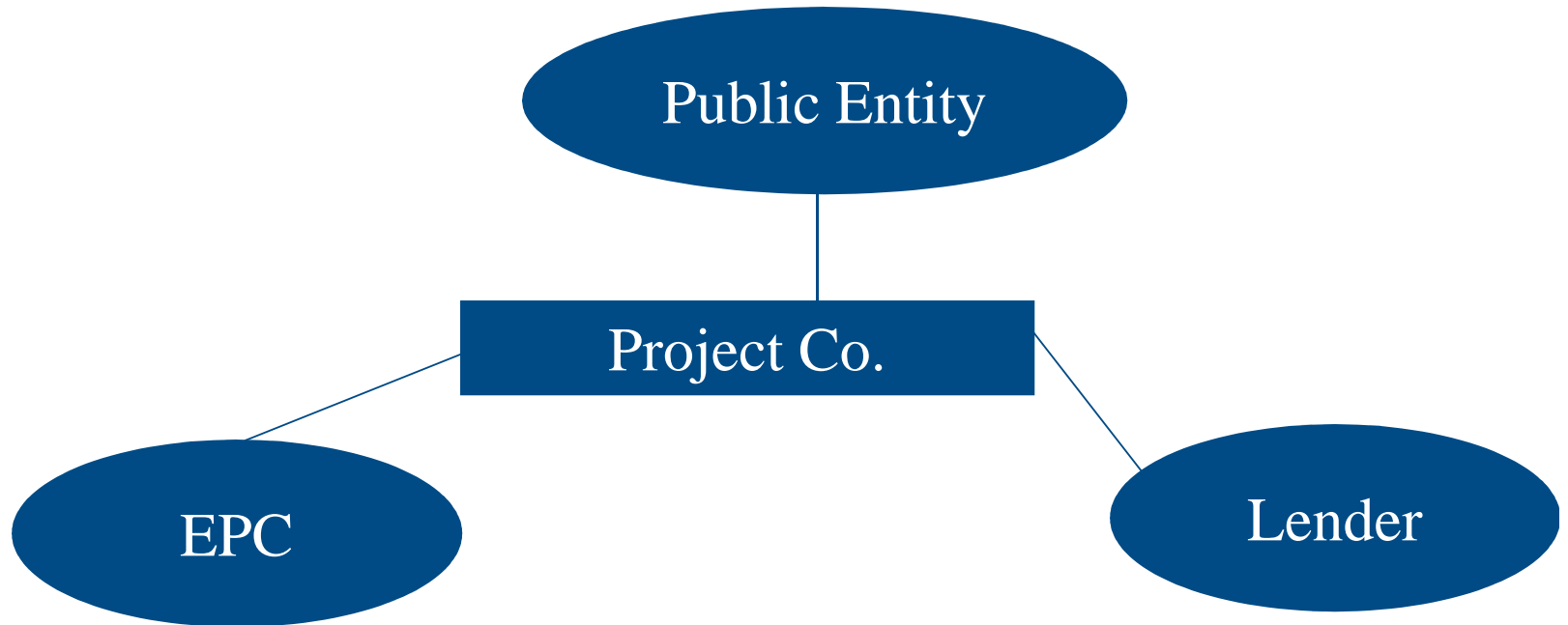




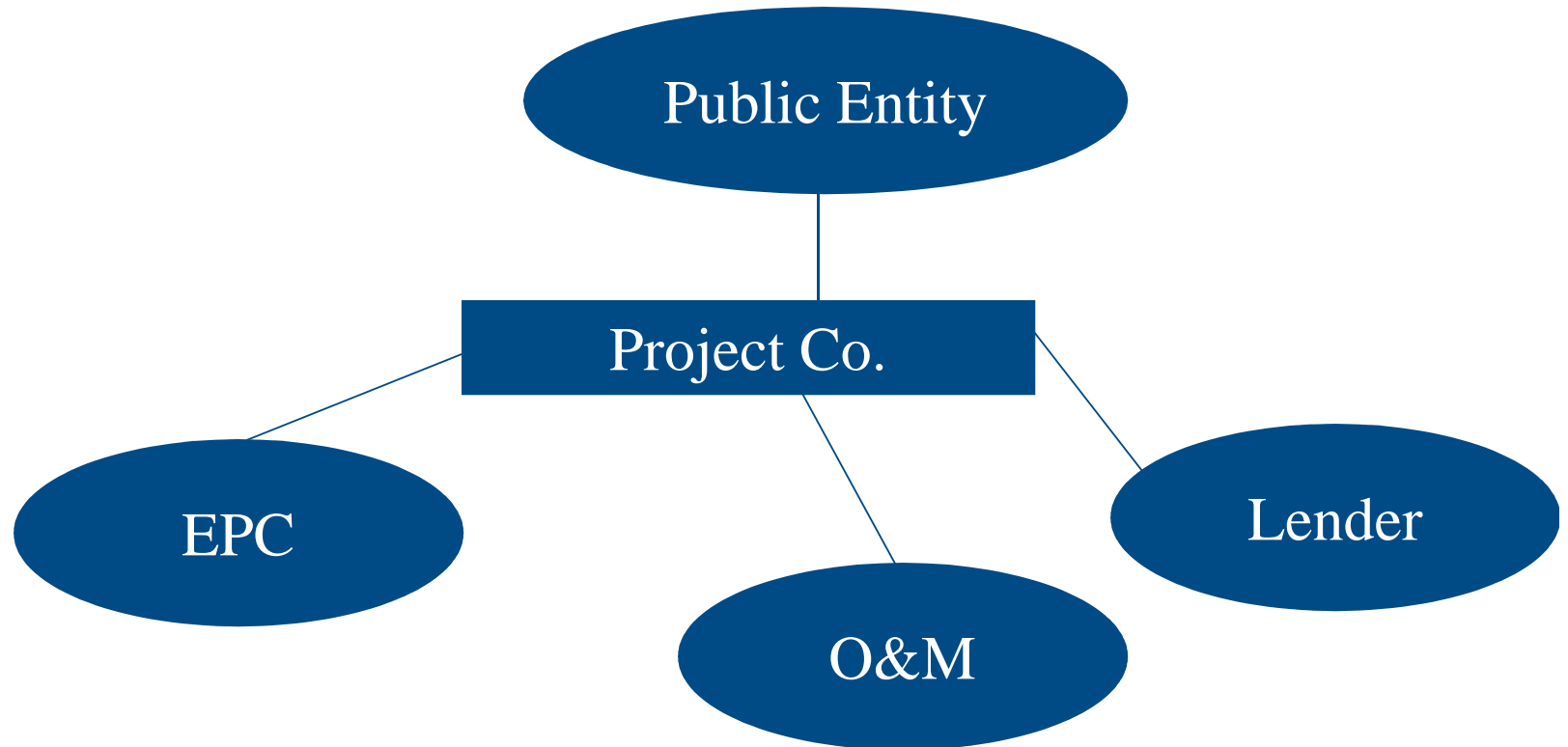
# EPC Contractor or Design Builder



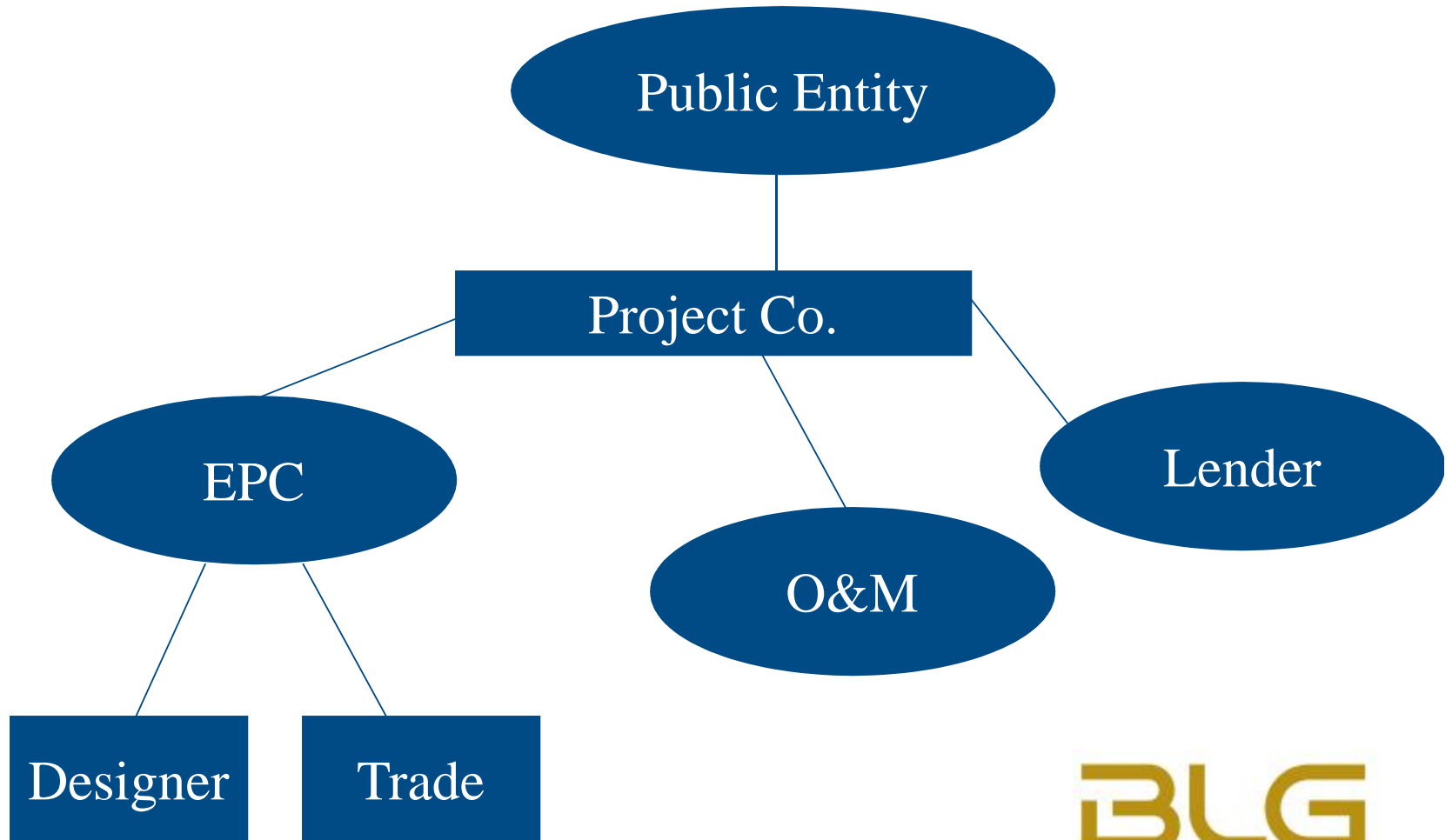
# Lending Agreements



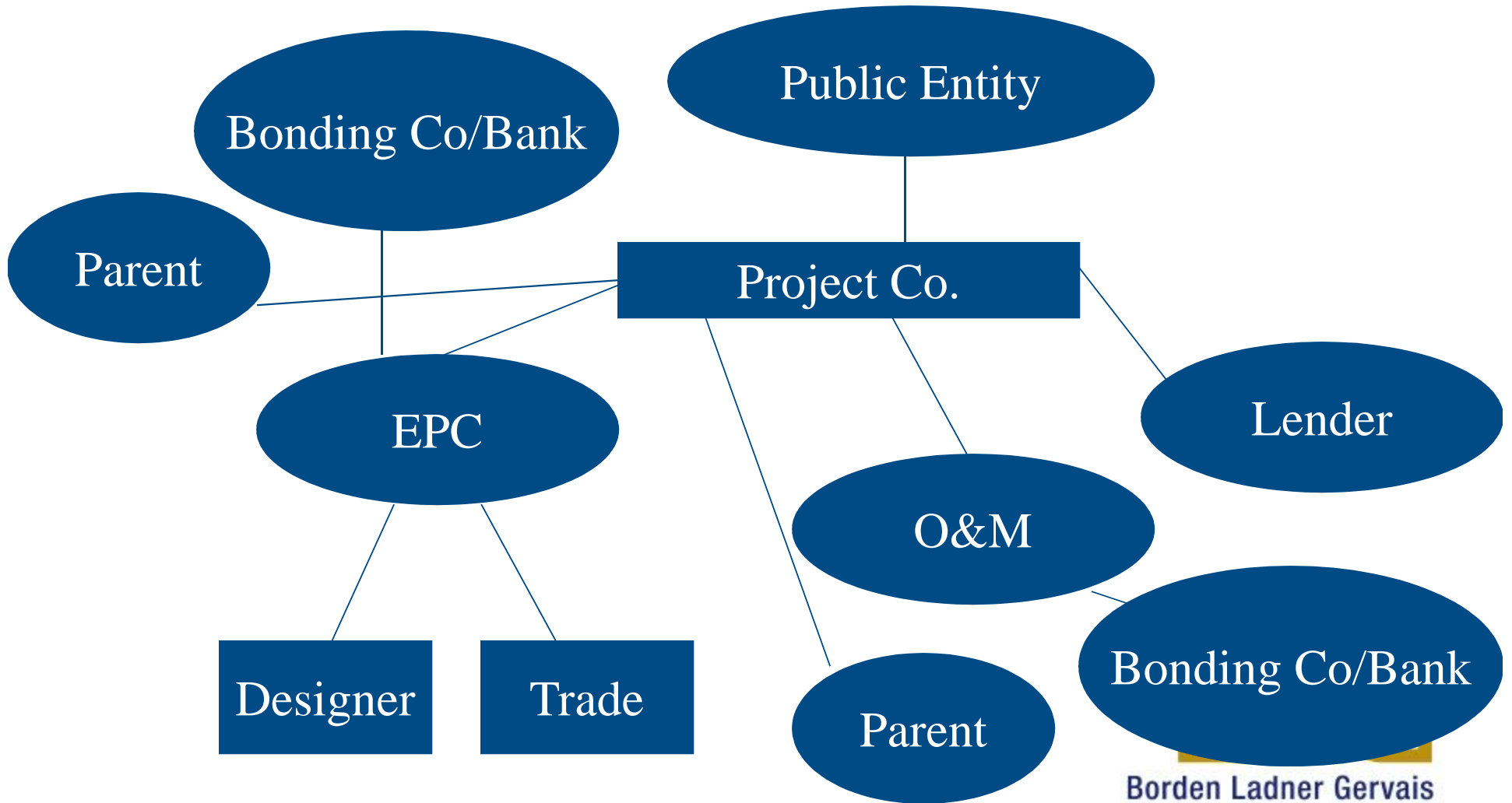
# Operations & Maintenance



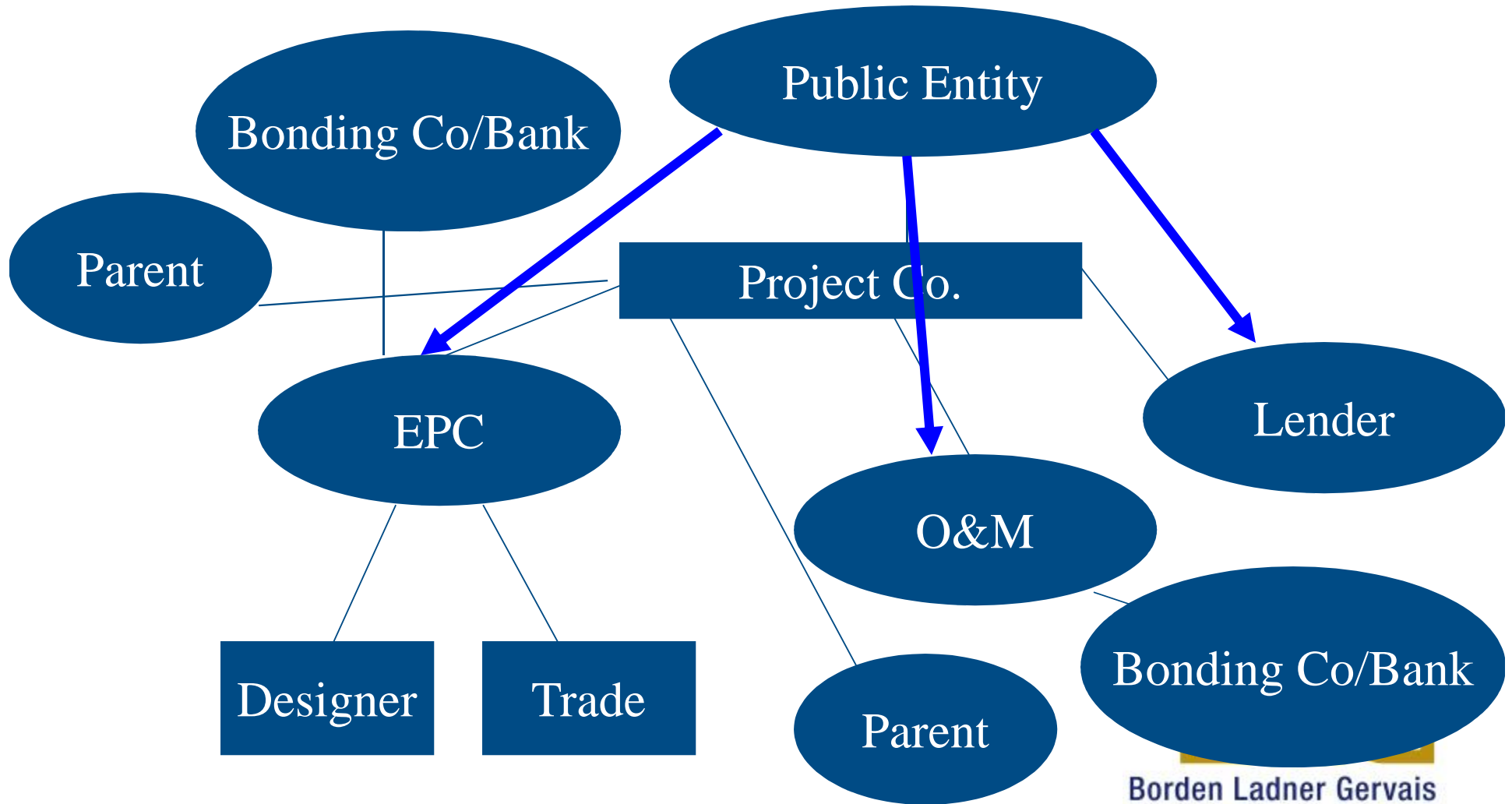
# Designers/Trades



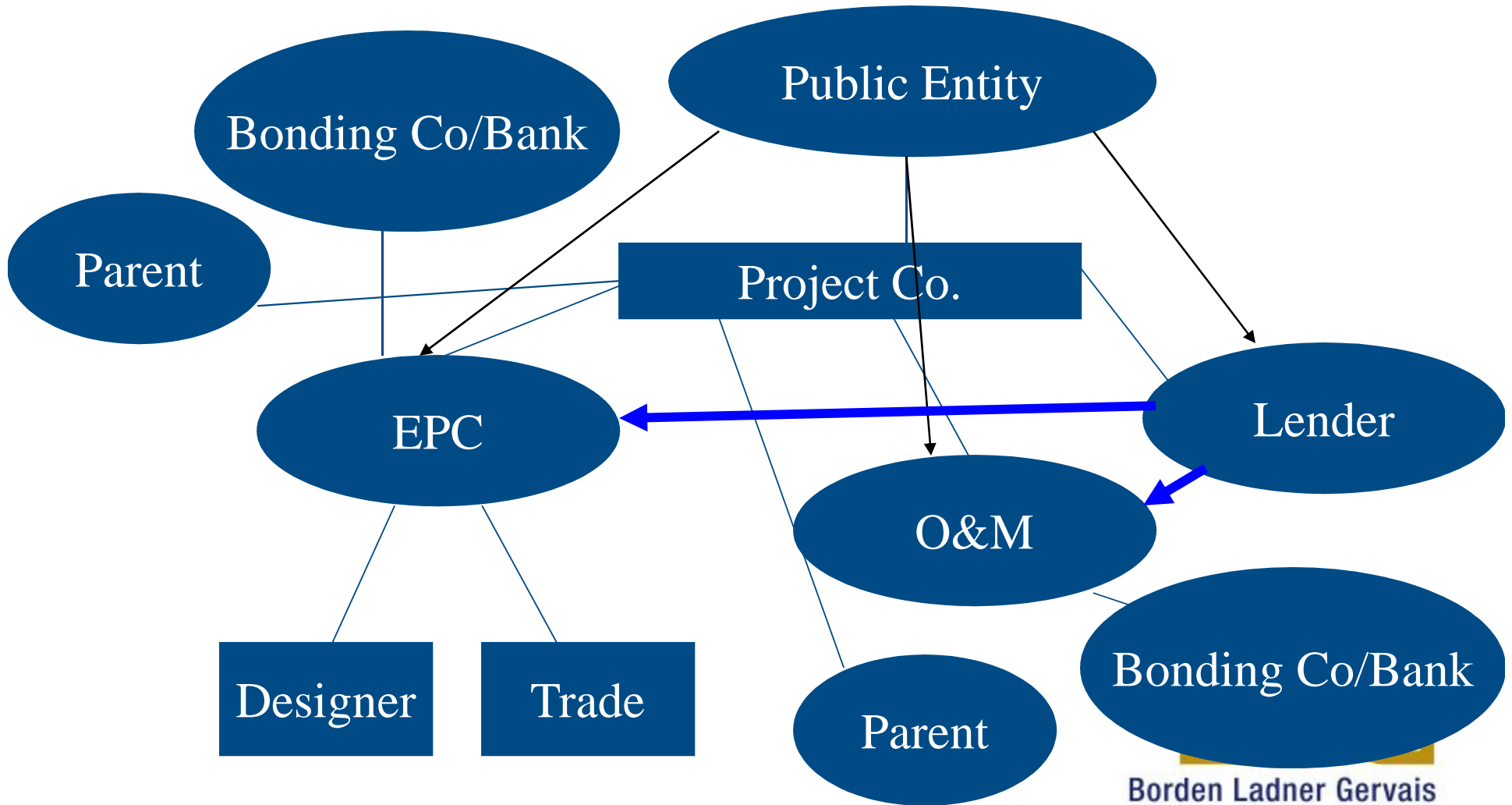
# Security



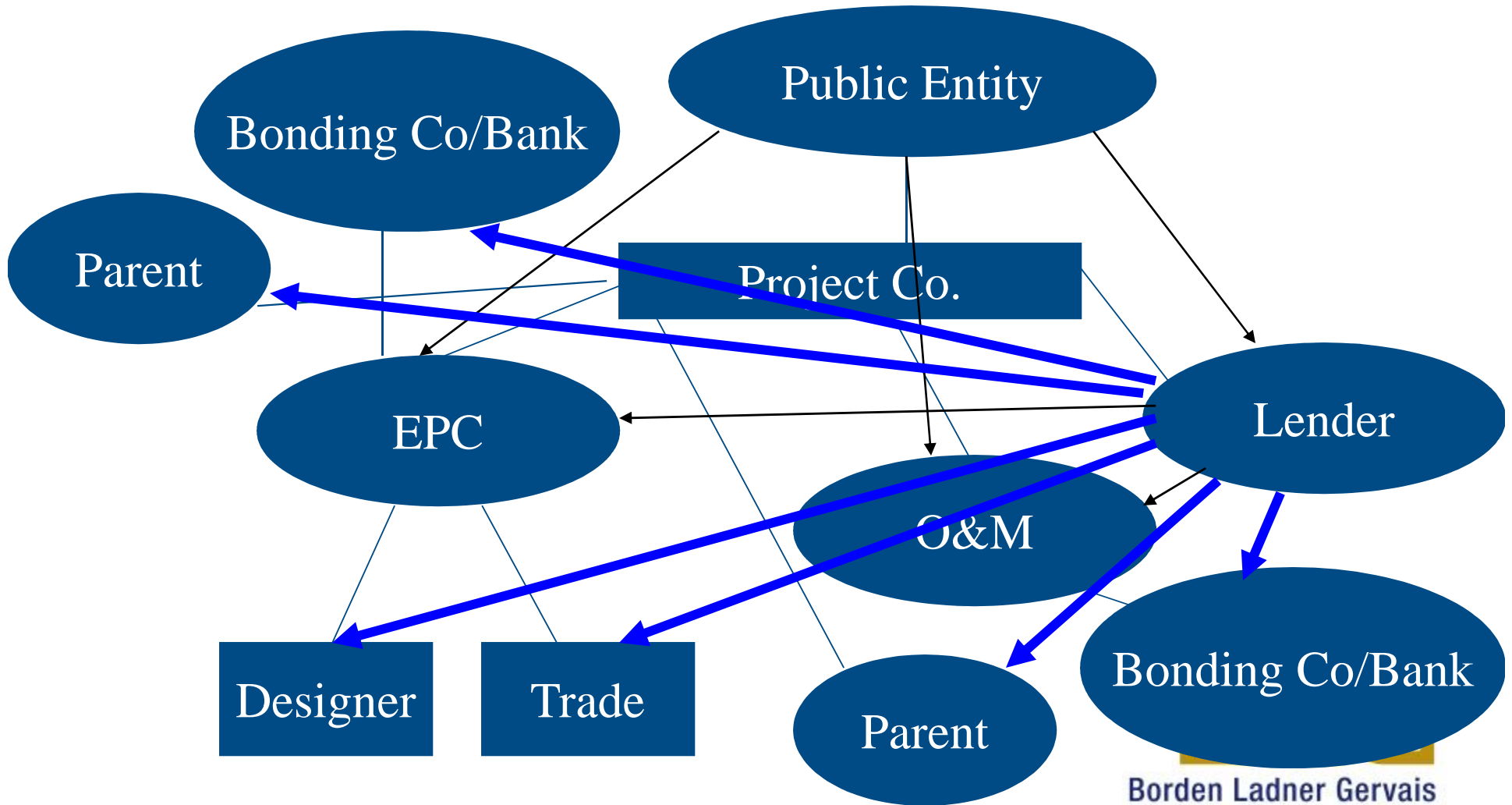
# Collateral Agreements w/ Public Entity



# Direct Agreements w/ Lenders



# Direct Agreements w/ Lenders





# PPP Overview

- **PPP Features:**

- Public and private partners share risks and rewards, and contribute resources based on relative strengths
- Projects vary in terms of duration and nature, depending on type of service being provided

# PPP Overview

- **“Ideal” PPP opportunity:**
  - Large in scale and capital intensive
  - Technical challenges or required capabilities which exceed that of public sector
  - Identifiable revenue stream, and clearly definable and measurable output (facilitates project assessment)
  - Competitive market
  - Value for \$ (Public Sector Comparator (UK) / Capital Asset Management Framework (BC))

# PPP Overview

- **“Ideal” PPP opportunity (cont):**
  - Some UK government analysts have found that traditional procurement has a better performance for “standard” projects, while PPP structures have a better performance for “non-standard” projects

# Benefits and Pitfalls – Public Sector Perspective

- **Benefits**

- Cost savings
- Procure capital assets from private sector in a fast and date-certain manner
- Transfer of risks that have not traditionally been well managed by public sector
- Free up public body to focus on strengths (e.g., policy development)
- Potential enhancement of revenues

# Benefits and Pitfalls – Public Sector Perspective

- **Benefits (cont)**

- Potentially improved care of capital asset (e.g., “lifecycle” approach)
- Access private sector’s comparative strength in innovation, competitiveness and efficiency

# Benefits and Pitfalls – Public Sector Perspective

- **Pitfalls**

- Perception - PPPs continue to be a tough sell in Canada
- Complexity – lack of expertise / resources
- Failure to conduct effective risk assessment, appraisal of long-term options, etc.
- Unreliable service
- Failure to appropriately monitor service quality
- Lack of competition

# Benefits and Pitfalls – Public Sector Perspective

- **Pitfalls (cont)**

- Loss of control by government
- Increased user fees
- Leakage of rewards and potential for incremental costs on account of clashing cultures
- Loss of institutional memory / ability to evaluate service delivery

# Benefits and Pitfalls - Private Sector Perspective

- **Benefits**

- Secure, long-term investment opportunity under the relative security of a government contract
- Generally provides steady, predictable cash-flows, insofar as projects are often natural monopolies that satisfy a relatively inelastic demand
- Private financing imposes tighter discipline over project, increasing likelihood of success



# Benefits and Pitfalls - Private Sector Perspective

- **Benefits (cont)**

- Enables sponsors / contractors to add value over the entire life of the contract, rather than tendering a single construction bid.

# Benefits and Pitfalls - Private Sector Perspective

- **Pitfalls**

- Uncertain deal flow
- Onerous bidding requirements (costs can exceed \$2MM)
- Lack of standardization
- Poor process management
- Political interference

# Benefits and Pitfalls - Private Sector Perspective

- **Pitfalls (cont)**

- Construction cost escalation
- “Living in a Fishbowl” – transparency requirements
- Failure to appropriately allocate risk

# Commercial Viability

- o Is there a sound market for the project or service?
- o How will current and future competition affect the viability of the project?
- o How are the running costs expected to escalate?
- o How reliable is the supporting infrastructure? Is a guarantee available from the public entity?

# Commercial Viability

- o How reliable are the input supplies (e.g. fuel), and are alternatives available?
- o Does the project company have the resources and skills to successfully implement and manage the project throughout the operation period?
- o Is the technology which will be implemented established and reliable or is it innovative and uncertain? Conversely, will the technology soon become obsolete (i.e. information technology projects)?

# Risk Allocation Feasibility

- o Will there be excessive risk which cannot be flowed to the EPC and the O&M contractors?
- o Can liquidated damages be specified for default by the EPC and the O&M contractors, or will such clauses appear to be illegal penalty clauses?
- o What is the probability of default by the offtaker, and can this risk be mitigated?



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# Risk Allocation Feasibility

- o What level bonding and insurance is available to shift risk to third parties?
- o What liability limitations will the EPC and O&M contractors insist on?



# Debt :Equity

o Increased certainty of repayment leads to higher potential debt





# Public Entity

- o Statutory authority
- o Unilateral modification risk
- o Level of comfort



# Pre-Contract Process

- o RFQ

Credit worthy contractor

Skilled contractor and designer

The “fixed price” myth

# The “Fixed Price” Myth

Labour  
Materials and Other Costs  
Contingencies  
Risks Allocated to Contractor  
Profit and Overhead



“Stipulated Sum”

Changes Due to Alterations  
Changes Due to Design Errors  
Risks Allocated to Owners



“Extras”

# Pre-Contract Process

- o RFP

  - Good profit margin available for contractor

  - Does not represent significant portion of contractor's work

- o Preferred proponent

  - Streamlined process – cost of process

# Post-Contract Considerations

- o Lender's primary objective is to have principle repaid with interest
- o Minimize risk borne by project company
- o Mitigate risk by transfer to third parties (subcontractors; insurers; bonding companies; other lenders)

# Transfer of Risk/Obligation

- **Goal:** Optimize levels of risk and obligation for each party



# Post-Contract Considerations

Each party should be assigned the risks that:

- o economically impacts that party more
- o it can efficiently mitigate
- o it can transfer to a third party (i.e. an insurer)
- o is within its control

# Managing Risk

- **Risk:**

- “The possibility of suffering harm or loss”
- “What I need is a list of specific unknown problems we will encounter”  
(*Lykes Line Shipping*)



# Managing Risk

- **First Principles**

- Formal identification, quantification and allocation of risk is essential to a successful PPP
- Goal should be to optimize (not maximize) levels of risk and obligation for each party – e.g., the allocation of a given risk to the party best able to manage it
- Allocation of risk should be transparent

# Managing Risk

- A prime cause of project stress is often project exposure to counterparty risk, rather than inherent project risk

# Managing Risk – Process Risk

- Significant bidding cost for both owner and bidders
- Risk of owners changing process mid-stream (e.g., Whistler)
- Trying to keep costs down in bidding process difficult and may lead to bad bid
- Fairness; transparency

**“It is easy to be tender to one who is fair;  
Harder yet to be fair to one who tenders”**

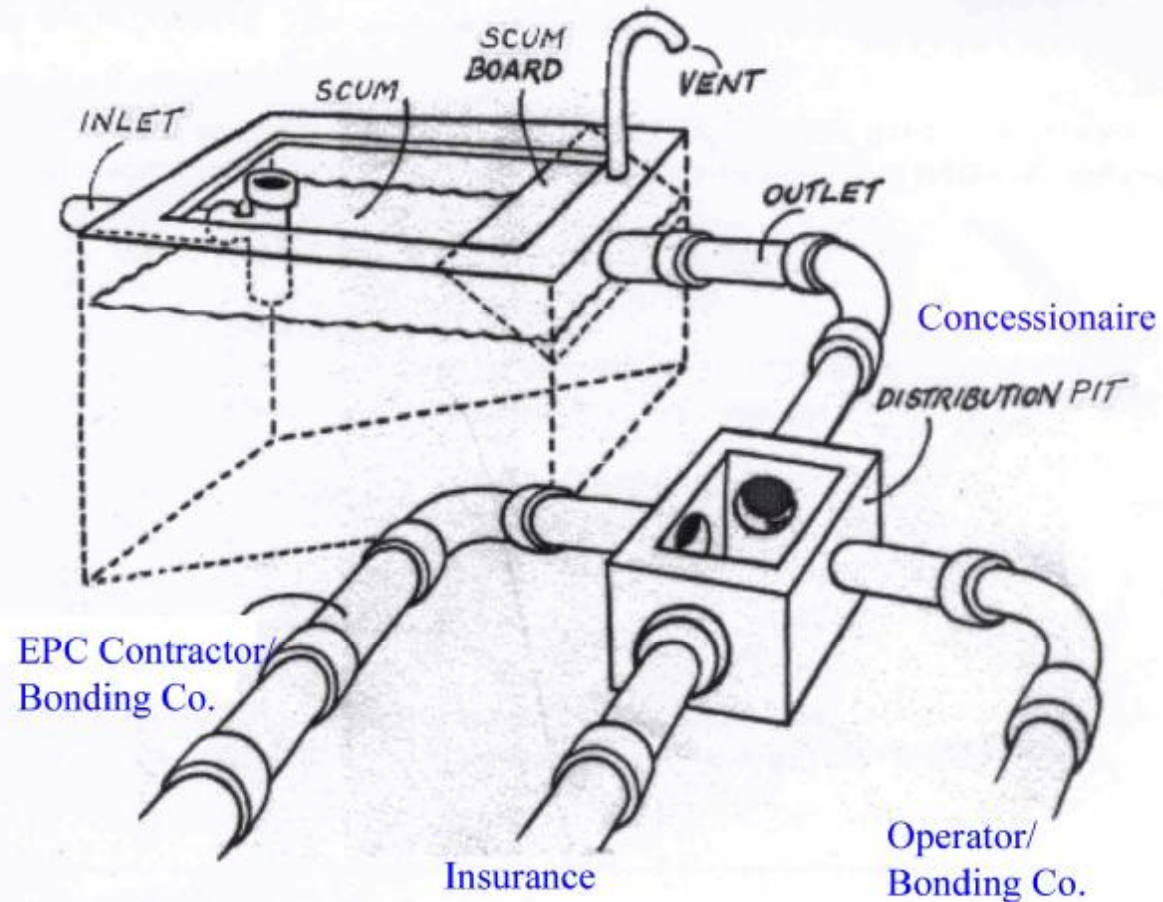
# Managing Risk – Interest and Bargaining Power

- **Parties' differing interests will affect risk transfer expectations:**
  - Public entity
  - Concessionaire
  - EPC contractor
  - O&M contractor
  - Subcontractors and suppliers
  - Bonding companies
  - Lender

# Managing Risk – Risk Allocation Considerations

- **Each party should be assigned risks that:**
  - has the greatest impact on it
  - it can efficiently mitigate and manage
  - it can more easily or cost-effectively transfer to a third party (e.g., an insurer)

# Managing Risk – Risk Allocation Considerations



# Managing Risk – Risk Allocation Considerations

- Any risk can be allocated, for a price
- Cost of allocating unforeseeable / unquantifiable risks could be excessive
- Consider sharing risks

# Risk Allocation Considerations

Level of Concern	Probability of Occurrence	Impact (time/\$\$)
Low	Low High	Low Low/Mod/High
Low-Mod	Mod Low	Low Mod
Low-Mod	Low Mod	Mod Low/Mod
High	Low/Mod	High
Unacceptable	Unquantifiable	Unquantifiable



# Managing Risk – Transfer of Risk / Obligation

- Change in Law
- Cost overruns
- Defects/warranty
- Dispute risks
- Environmental
- EPC contractor default
- Force majeure
- Supplier default
- Input demand
- Offtaker default
- Operational
- Permits
- Concessionaire default

# Managing Risk – Transfer of Risk / Obligation

- Project revenue
- Public entity default
- Schedule
- Set-off
- Site acquisition
- Site - geotechnical
- Site - environmental
- Site - fossils
- Step-in rights
- Third party default
- Variations

# Managing Risk – Transfer of Risk / Obligation

- **Risks typically retained by Public Sector:**
  - Approvals
  - Majority, if not all, demand risks
  - Changes in interest rate between selection of preferred proponent and financial close
  - Procurement risks (e.g., lack of bidders and delays in procurement process)
  - First nations

# Managing Risk – Transfer of Risk / Obligation

- **Risks typically transferred from Public Sector to Concessionaire:**
  - Design
  - Construction
  - Permitting
  - Lifecycle
  - Industrial relations

# Managing Risk – Transfer of Risk / Obligation

- **Special considerations in transfer of risk from Concessionaire to EPC and O&M Contractors:**
  - Concessionaire will want to ensure that there are no stranded risks
  - Consider contracting approach to transfer risks (generic sub-contract; “drop-down” or “back to back”)
  - “Equivalent Project Relief”
  - O&M specific issues – liquidated damages, long-stop date, security for performance

# Change in Law

- e.g. stricter legislative requirements; tax laws
- should flow with nature of change
- public entity should retain some risk



# Cost Overruns

- place risk on EPC and O&M contractors
- “fixed price” contracts / optimal model for owner / sponsor



# Concessionaire Default

- use equity funds first, personal guarantees from sponsors
- step in rights
- breach when operational - termination sum
- bond requirement – flowed down to EPC and O&M?





# Design / Warranty / Latent Defects

- EPC and O&M contractors à cause identification?
- availability of insurance
- cap on liability à gap risk



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# Dispute Risks

- obligation to mitigate
- well-written contracts that are pro-actively administered (e.g., good governance)
- dispute process definition
- neutral referees

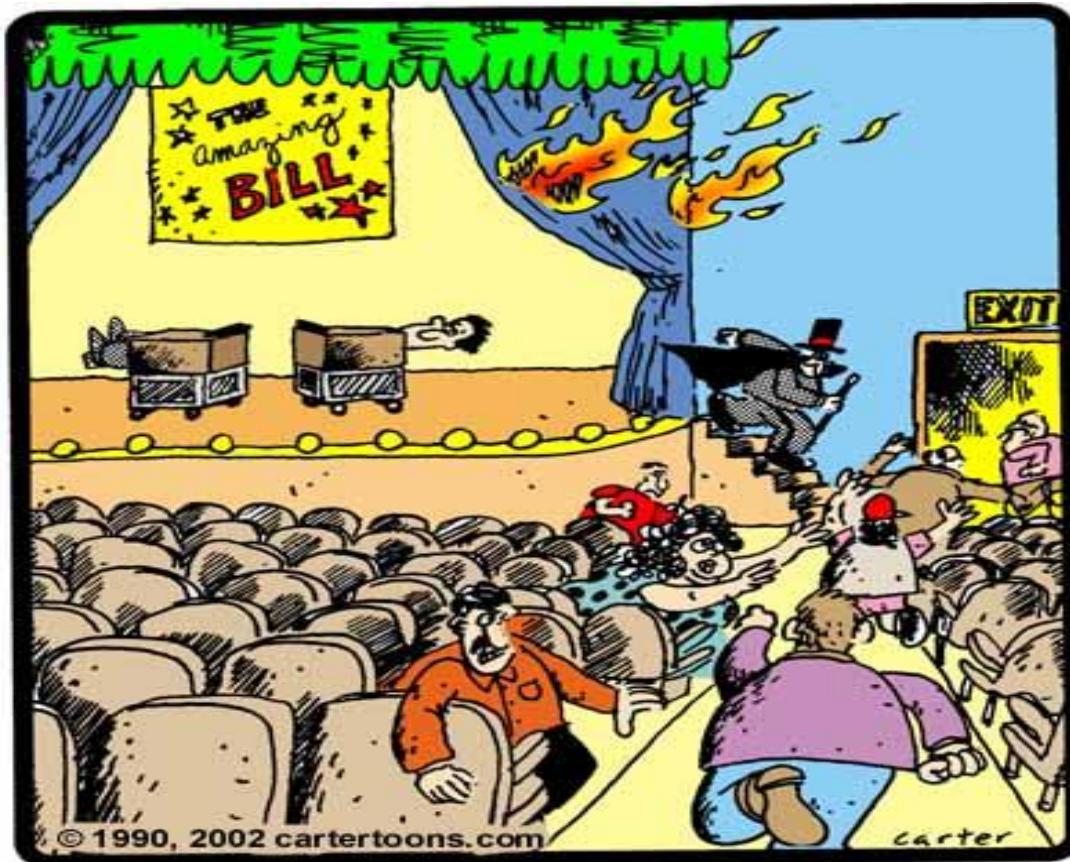


# Environmental

- related to change of law and site conditions
- generally shared by EPC contractor and public entity



# EPC Contractor Default

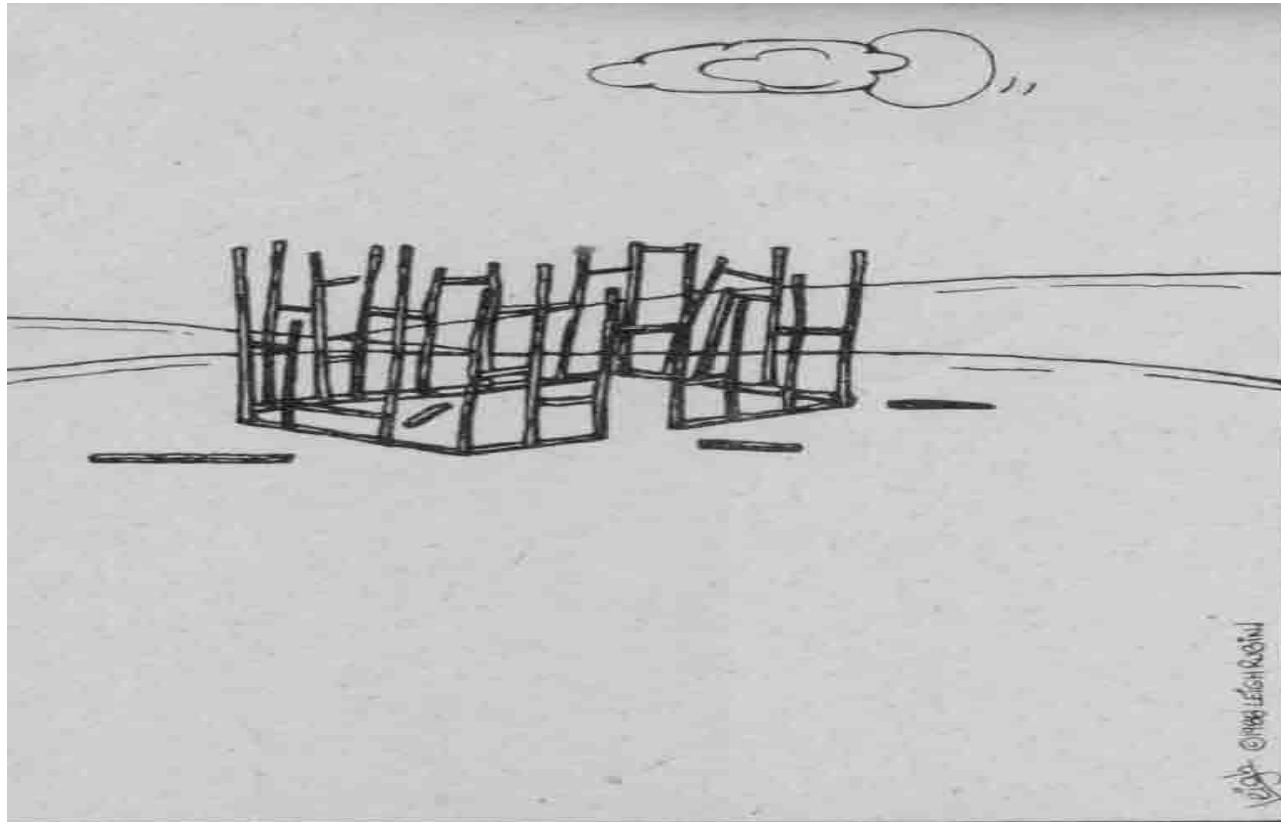


# EPC Contractor Default

- EPC contractor and bonding company
- bond will only cover 60-75 % of debt, so lenders will require a competent and credit worthy EPC contractor



# Force Majeure



Fire, ignited by a bolt of lightning completely gutted the atheist's meeting hall. Unfortunately for them their insurance policy did not cover acts of God.

© 1993 Leigh Rubin

# Force Majeure

- spread: public entity, lender, insurer, EPC, O&M
- uninsurable: damage from nuclear explosion



# Input supplier default

- O&M contractor
- third parties e.g. fuel suppliers





# Input demand below contract minimums

- all parties suffer if expected demand not met
- O&M contracts with input suppliers could allow for reduced input quantities
- supply certainty v. supply flexibility



# Offtaker / End-user default

- is the product or service disposable on the free market?
- “take or pay”
- consequential costs for products or services not accepted?



# Operational difficulties

- EPC (design issue) and O&M (performance)
- remuneration linked to performance
- escalator provisions
- new technology?



# Permits

- government support agreement
- lender may require permits before debt is extended – not possible for ongoing operational permits.



# Project Revenue

- all parties (except the EPC) potentially suffer when project revenue is lower than expected
- lender especially vulnerable



# Public entity default

- deep pockets
- termination payments in concession agreement to protect lender and concessionaire



# Schedule

- EPC contractor, third parties
- fixed completion dates, liquidated damages
- possible time extensions for force majeure events



# Set-off

- lenders want debt service guaranteed
- pay set-off immediately, or pro-rate over time





# Site acquisition

- public entity – expropriation powers



# Site conditions - geotechnical

- site history research and testing useful, but not conclusive
- capped contingency - risk sharing between EPC contractor and public entity



# Site conditions - environmental

- hidden pollution or hazardous waste
- public entity / premium by EPC contractor / gap risk
- lenders may require expenditure of equity funds first
- aggressive environmental legislation



# Site conditions – fossils

- public entity / premium by EPC contractor / gap risk



# Step-in rights

- lender will prefer long lead time – 6 months
- contractors prefer short lead times



# Third party default

- third party performance critical to project success (e.g. utilities relocation, supporting infrastructure development)
- place risk (incentive) on third parties
- allocation of any retained residual risk (“gap risk”)



# Variations / changes

- cost of specification changes to be covered by public entity
- require concessionaire and lender approval for changes to specifications or scope of project



# Strategies for flowing down risk

- Models for Concessionaire duty delegation
  - mirror provisions
  - short form



# Financing Considerations – Overview

- **Role of Project Finance:**
  - Formation of capital using project debt and equity so as to undertake the purchase / construction of a capital intensive project
  - Lenders rely firstly on cash flows, and then on assets of project for payment of interest and principal (limited recourse)
  - Dependable project cash flow must support the project's capital structure
  - Financial viability of project is dependant on contracts.

# Financing Considerations – Overview

- **Equity Players in Canada:**
  - Contractors
  - Financial Institutions  
(e.g., Macquarie Bank, ABN AMRO)
  - Specialist PPP companies  
(e.g., Plenary Group)

# Financing Considerations – Overview

- **Equity Provider Expectations:**
  - Non financial
    - Strategic decision making
    - Selection of consortium members
    - Control and leadership of consortium
  - Financial
    - Return on invested capital
    - Minimum running yield
    - Stable, long-term cash flows
    - Financial commitment of consortium members to support obligations

# Financing Considerations – Overview

- **Equity Provider Expectations (con't):**
  - Contractual (with government)
    - Similar to lenders
  - Contractual (with consortium)
    - Similar to lenders

# Financing Considerations – Overview

- **Three distinct sources of PPP debt funding in Canada:**
  - Capital markets – long term lending; pricing is driven by credit rating; typically underwritten by banks
  - Institutions – structured like capital markets; complete own credit analysis
  - Banks – led by European banks
- **Lack of depth in Canadian capital markets**

# Financing Considerations – Lender Expectations

- Some sponsors have lenders committed as part of consortium. Others hire an advisor to determine best debt solution
- Credit assessment
  - External rating required for capital markets (e.g., S&P or Moody's)
  - Banks will complete an internal assessment
- Tenor – long term funding
- Pricing – up-front commitment fees; firm margin

# Financing Considerations – Lender Requirements

- **Concession Agreement**
  - Full input, sign-off with independent counsel
  - Independent / objectivity for key decisions
  - Step-in rights
  - Compensation on termination
- **EPC Agreement**
  - Independent review and sign-off that asset can be designed and built for time and cost
  - Ongoing independent monitoring of progress
  - Security
  - Key payment tests / holdbacks

# Financing Considerations – Lender Requirements (con't)

- **O&M Agreement**

- Independent report outlining key operational risks, ability of operator to meet performance requirements
- Likelihood / magnitude of possible performance failures
- Sign-off that sufficient cost is budgeted

- **Insurance**

- Independent review of what insurances should be carried
- Sign-off at close that insurances are in place
- Naming of lender on policies



# Financing Considerations – Lender Security

- **Typical security includes:**

- Project Company - First ranking secured creditor over all assets and undertakings
- EPC and O&M Contractors – Step-in rights, liquid security, performance bonds and parent guarantees
- Insurance – first loss payee position

# Conclusion

- **Some Lessons Learned**

- Communication between owner and private sector partner needs to be open, detailed, engaging and frequent – lack of communication between partners is a major cause of PPP failure
- The private consortium requires a cohesive group of leaders, to enable decisions to be made quickly and effectively
- Recognize and address challenges of working in a public / private environment

# Conclusion

- **Some Lessons Learned (cont):**

- Public entity and sponsor must recognize mutual dependence, and work co-operatively
- Given ongoing / potential public scrutiny, discussions and major decisions should be documented. Pro-active disclosure can serve to reduce the chance of future controversy.

# Conclusion

## • Industry Observations

- Realistic time schedule is required to contain bidding costs
- Lack of flexibility in PPP contracts has been a problem
- Lack of project management expertise in public sector is a problem
- Who you ally yourself with is as important as the project you are bidding on

# Conclusion

- **Industry Observations (cont)**
  - PPP projects have brought depth and maturity to the construction industry – requires companies to work in an integrated way across divisions, and to mitigate and manage project risk in a disciplined manner. Companies are learning to say no to procuring parties when something is not possible.
  - PPP sponsors are able to develop expertise as multi-service providers, thereby distinguishing themselves from the competition.



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# Thank You!

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