

PPP Resources

IP3's Public-Private Partnership Information Series – April 2007

US PPP Market on the Upswing: Some Thoughts from Abroad

Jacques Cook, Esq.

About the Author



Jacques Cook, a lecturer at IP3, is a partner in the Washington, DC office of Peckar & Abramson, P.C. One of the leading law firms in the construction industry, its lawyers are involved in some of the largest and most complex infrastructure projects in the U.S.

Abstract

US highway contractors are likely to be active in the PPP market in the US. However, for them to become more fully engaged will require some adjustment in their management of construction risks. This article examines the US PPP market and some of the legal and financial issues that will confront US contractors entering the field for the first time.

Introduction

Over the past twenty years, the world has seen a proliferation of innovative approaches to financing and delivering public services. Nowhere has this been more notable than in the procurement of basic public services such as energy, transportation, health and sanitation and the use of Public-Private Partnerships (PPPs). Although there is no universal definition of PPPs, it is generally recognized that a PPP exists wherever there is a contractual relationship between the public sector and a private sector company designed to deliver a project or service that traditionally is carried out by the public sector. PPPs come in a variety of shapes and sizes ranging from small service contracts to full-blown multi-billion dollar concessions and divestitures.

To some extent, it is fair to say that each PPP is *sui generis*, and consequently that there is no body of law or regulations which applies to all PPP contractual arrangements. However, it is becoming increasingly obvious as it works its way into virtually every jurisdiction in the US and overseas, that there are some common legal issues and concepts in PPPs which affect the negotiation, drafting and management of these contractual arrangements and require the support of experienced counsel. Construction contractors will be directly impacted in PPP transactions and will need the services of counsel who are intimately familiar with their industry as well as the special requirements of working within a PPP framework.

PPPs: an Overview of the Market

In relation to the global PPP market, the US share is still low. In 2006, according to statistics compiled by PriceWaterhouse Coopers, \$9.2 billion in new PPP projects were closed in the Western Hemisphere representing 14% of the total PPP projects worldwide. However, in the UK alone over \$18.4 billion in PPP transactions were closed in that same year. PPPs also are heavily concentrated in the transportation sector, which accounts for over 60% of PPP projects worldwide.

IP3 PPP Resources is a publication of the Institute for Public-Private Partnerships; providing expert training and technical assistance to clients worldwide in the fields of PPP, public policy, regulation, and competitive utility management. www.ip3.org

This helps explain why the US PPP market has lagged behind the European and Asian markets; until recently, the state and federal governments financed the bulk of US highway construction with direct grants from highway trust funds and tax free municipal bonds. Toll roads also still represent only 3.1 % of national highway system in the US and contribute only about 4.5% of the funding for highway construction. But the FHWA has ominously warned that, with an aging transportation infrastructure and dwindling resources in the nation's trust funds to pay for badly needed upgrades and new roads, bridges and tunnels, the US faces a looming crisis unless new sources of financing can be mobilized. The magnitude of this challenge is evident in recent statistics from the ASCE's¹ Report Card for America's Infrastructure, 2005, that estimated US *annual* infrastructure capital requirements for the period 2005-2025 will average \$286 billion, with a little less than half of that amount required for highways.

Although the US share of the PPP market is still relatively small, with the investment shortfall in our transportation sector and mounting political and economic pressures to alleviate congestion on our highways, PPP toll roads are expected to gain ground here as our leaders search for innovative and effective methods of attracting new capital and technology to meet these pressing needs. Because risks are transferred in PPPs to the parties or party best able to manage the project risks, there is strong evidence to show that PPPs result in improved project performance, lower life cycle costs and fewer construction delays and cost overruns. In addition, because PPPs free up public resources that would otherwise be tied up in the specific project, the public sector has more resources available to apply to other priorities that cannot be funded with a PPP. In the UK, for instance, there is empirical evidence that in non PPP projects, cost overruns during construction occurred in 73% of projects applying traditional government procurement while only 22% of PPP projects experienced cost overruns; project construction delays were also much lower in PPP projects compared to traditional government procurement. The logic for using PPPs therefore seems compelling although there is still some political resistance to this innovative financing tool.

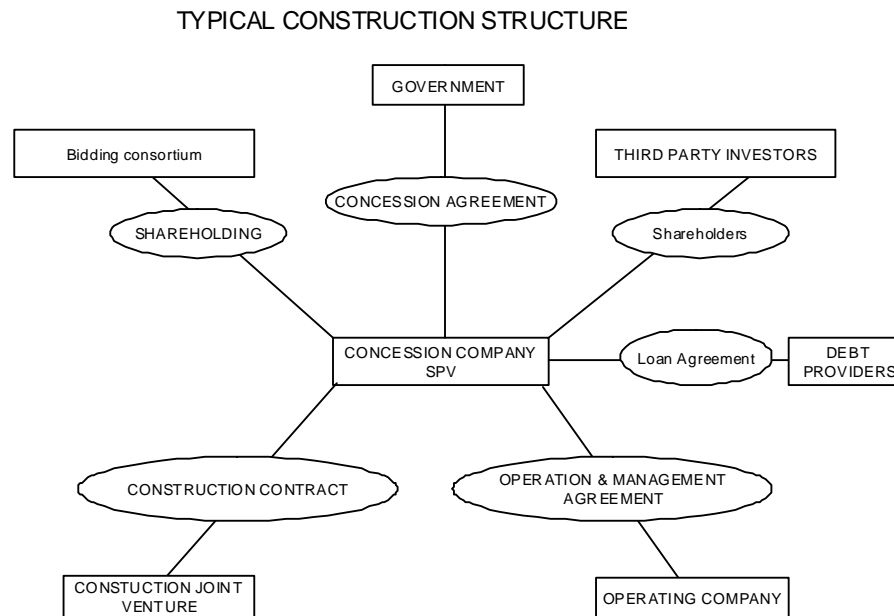
Recent PPP projects in the US give further reason for optimism about the future of PPPs. The Indiana Toll road project, the Chicago Skyway project, the Pocahantas Highway in Virginia and the SH-121 in Texas all were awarded in the past year and resulted in substantial lease payments to the state authorities. Perhaps attracted by the substantial front-end fees paid by developers in these transactions, it is expected that more transactions will come to the market in those states that are aggressively developing PPP highway projects. But while these figures are impressive, they represent only a small fraction of the possible projects that could be eligible for financing under the PPP umbrella.

Construction Contractors and PPPs

While the prospects for PPPs look encouraging, we have learned from other projects overseas in Chile, Brazil, Mexico and the UK that these projects involve a change in the way the construction contract will be managed from both a legal and financial point of view. In highway concessions, for instance, the Design Build (DB) contractor will be operating under a limited recourse project finance structure where his obligor will be a special project concession company, which is a corporate or partnership shell with virtually no hard assets and a single source of revenues. See Figure 1.

¹ American Society of Civil Engineers

Figure 1 – Typical Construction Structure



Because of the limited recourse nature of the financing, the secured lenders will normally insist in PPP concessions that there be a fixed price, lump-sum turnkey construction contract to mitigate cost overruns. This construction contract will therefore carry more financial risks for the contractor than the average cost plus project and may require higher prices, as well as more expensive insurance coverages.

Since the sponsor parties will unlikely guarantee all of the financing during construction, the DB Contractor will need to understand how to address any payment risks he faces if for reasons unrelated to the contractor performance under the DB Contract, the lenders cut off funding before all invoices are paid in full. Similarly, management of the surety bonds will need to be carefully adjusted to this structure to make sure that sureties are also comfortable with the owner liability issues that could arise.

But perhaps the most challenging feature of PPP for contractors is the need to understand fully the risk allocation mandated under the PPP Agreement between the project company and the government. There are several points in this agreement that directly impact the contractor. First, the construction milestones in the PPP concession will have to be imported into the DB contract along with the penalties for delays. Obviously, to avoid possible delay penalties, the owner and the lenders will usually want to include a cushion which will give enough time to resolve any issues before the final deadline for completion under the PPP. Contractors will need to consider whether such a cushion is realistic and whether there is enough flexibility to avoid heavy penalties for minor delays.

Another issue that often arises relates to the *force majeure* clause. The Force Majeure provisions in the PPP Agreement and DB contract should be mirror images to ensure that there is no mismatch. Moreover, insurance coverage if needed for these risks should be coordinated to avoid

any obvious gaps. As noted on the attached risk matrix, insurance will play an important part in the PPP construction project.

Figure 2 - Construction Period Risk Matrix

Risk	Party Responsible	Mitigant
Cost Overrun due to Contractor	Contractor	Fixed Price lump sum turnkey contract
Cost Overrun beyond control of Contractor	Insurer	Insurance Proceeds
Cost Overrun due to force majeure	Developer	Contingent Equity
Cost Overrun beyond contractor control – change of law (import duties)	Developer/Government	Standby Debt Facility
Cost Overruns not within contractor control – subsurface conditions/environmental	Developer	Standby Debt Facility
Completion Delay due to contractor fault	Contractor	Liquidated delay damages usually capped. Sufficient to pay penalties.

In any PPP Agreement, the lenders and sponsors are exposed to an early termination risk. This can occur in the following circumstances: (i) unilateral termination by the conceding authority; (ii) mutual agreement of the parties; (iii) default by the conceding authority; (iv) default by the concession company; (v) termination due to an extended force majeure. In each of these circumstances, the affected parties, including the construction contractors, will need to understand fully the financial risks they will face and seek to ensure that sufficient funds will be available based either on a government compensation formula or on an auction of the remaining period of the concession to some third party. Termination of the concession before completion of the construction could in some instances expose the contractors and their subcontractors to financial risks if there are likely to be insufficient funds to pay off the senior lenders in the financing and there remain any uncovered invoices. Moreover, in the event of a default under the concession caused by the DB contractor, the latter would need to cover penalties and liquidated damages as well as possible claims from the secured lenders.

Finally, we have seen that most PPP Agreements and concessions require special dispute resolution provisions. The emphasis in these agreements is on avoiding the escalation of issues into full-blown legal disputes. Accordingly early warning project monitoring, partnering, facilitated negotiations, conciliation and mediation and use of third party experts are often the best mechanisms for managing disagreements. We often find that many of these concessions prescribe Dispute Resolution Boards (DRBs) composed of experts appointed by the parties, which provide an informal and expeditious mechanism for resolving disputes and preventing costly and potentially unsuccessful full blown litigation or arbitration. DB contractors should make sure that they are comfortable with these dispute resolution procedures and also seek to resolve issues in the most expeditious manner possible consistent with the limitations imposed by the concession and its project finance structure.

Most transportation experts agree that a new paradigm for PPPs is needed in the US, which transfers more of the operational and financing risks to the private sector. With the recent large highway PPP projects in the US we may be seeing the first of many more of European style concession/ DBFOs and more ambitious financing initiatives for highway construction. These projects have involved structured project finance with substantial changes in the risk allocation between the public and private sectors. But public acceptance of these projects and their endorsement by the political leadership in many of these states is still ambivalent. It is critical therefore that these projects be perceived as successful PPP ventures. It is therefore important that the US jurisdictions experimenting with these new procurement techniques make optimum use of the experiences gained in other countries to avoid the setbacks that many of these programs faced in their earlier years.

Please address questions about this article to the author at jacques_cook46@msn.com.

Copyright ©2007 Institute for Public-Private Partnerships, Inc. All rights reserved