TAKING THE MYSTERY OUT OF PPP

Public-private partnership, also called PPP or P3, is a hot topic. It is also a nebulous concept that can be used (and interpreted) in different ways. In this article, we explain the fundamental principles involved in a PPP agreement.

A public-private partnership is a form of agreement that transfers delivery of a public service from the public party to the private party. The spectrum of such agreements can be very broad – for example, transport (bus/rail/etc.), transport infrastructure (motorways/ports/etc.), construction and operation of public facilities (schools/hospitals/offices/prisons/stadia/etc.)[1]

A PPP agreement can have the following fundamental purposes:

Asset Monetization – the public party transfers the right to use an asset with fee-generating potential to the private party for a fixed period in exchange for an up-front payment, and perhaps a share of future profits

Infrastructure Investment – the public party contracts with the private party to construct/provide infrastructure assets

These types can be regarded as variants on a basic theme, which is to provide the best possible public services at the lowest cost with – and this is the "private" in PPP – a reasonable profit to the private party.

Because of the profit element and the availability to the public party of elements such as tax-exempt financing that may not be available to a private party, PPP schemes may not be a lesser-cost solution than having services provided directly by the public party.

However, PPP schemes should have a better record for on-time delivery (whether it relates to construction or operation) because, without this, the private party will not be paid, or will be paid less an incentive that is generally lacking in the case of a public party. Additionally, PPP schemes should limit the risk of cost overruns and include robust performance monitoring mechanisms and appropriate monetary incentives to ensure that they are met.

DBFOT – The Elements of PPP

The elements of a PPP scheme revolve around Design (D), Build (B), Finance (F), Operate (O), Transfer (T) (collectively, DBFOT). Every scheme normally will contain the "O" element, but the others will depend upon the specific situation. Each element is explained in more detail below.

Design

Design implies that a new asset is to be built, or an existing asset refurbished or expanded. Under traditional procurement, the public party separates design from construction and tenders for construction based upon final construction specifications prepared by the public party. With a PPP, the emphasis is on outputs rather than inputs, meaning the outputs are measured (e.g. a motorway capable of carrying x number of vehicles per day/a hospital that can serve x number of patients per day) and not the final plans of how such a facility should be built The goal is to encourage the private party to innovate and design efficiently, thereby reducing the cost to the public party.

Build

A PPP scheme will require an asset to be built/produced on time and on budget, that is, to be based on a fixed-price turnkey contract. This is not actually a requirement of the public party, because said party will only start paying under a PPP agreement when the asset is completed and put in service. Also, user fees ordinarily cannot be increased due to cost overruns or delays in construction. A fixed-price turnkey contract will be a requirement of both the investors in the private party and the lenders to the private party, neither of whom are willing to accept the risk of cost-overruns or delays.

Finance

Financing is the responsibility of the private party. The public party may assist through various means, such as by making land available on lease or as an equity contribution to a special purpose vehicle established to provide the services, or guaranteeing a portion of the financing. All financing structures seen in project finance, leveraged finance or structured finance can be used.

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1 Here is a definition of PPP by the Irish government; "A PPP is an arrangement between the public and private sectors (consistent with a broad range of possible partnership structures) with clear agreement on shared objectives for the delivery of public infrastructure and/or public services by the private sector that would otherwise have been provided through traditional public sector procurement. PPP projects focus on a whole life, integrated approach to the procurement of large scale public assets and/or services.

A particular arrangement or project may constitute a PFP where the following key characteristics are present:

- shared responsibility for the provision of the infrastructure or services with a significant level of risk being taken by the private sector, for example, in infrastructure projects, linking design and construction with one or all of the finance, operate and maintain elements;
- long-term commitment by the public sector to the provision of quality public services to consumers through contractual arrangements with private sector operators; and
- better value for money and optimal allocation of risk, for example, by exploiting private sector competencies (managerial, technical, financial and innovation) over the project's lifetime and by promoting the cross-transfer of skills between the public and private partners " Department of Public Expenditure and Reform, Republic of Ireland, Circular 4/2007: Accounting for Public Private Partnership (PPP) Projects in the 2007 and subsequent years Appropriation Accounts.

Operate

The PPP agreement will set a period of operation. In Europe, such periods are generally 20-30 years; in the US it has run as long as 99 years (Chicago Skyway). The period must be long enough for the private party to repay its financing costs and obtain a return on its investment, plus a reasonable "cushion" to provide lenders and investors comfort. The public party will need to monitor operations through review and approval of operating manuals and procedures, establishment of performance criteria relating to the assets and services that are provided, and penalties if they are not.

Transfer

At the end of the agreement, the asset will revert to the public party. Without such reversion, a PPP scheme would be a privatization, where the government would no longer be delivering the services, but turning this responsibility over to the private sector, which may or may not be subject to separate regulation, e.g., utilities or waste collection. This structure provides ultimate protection to the public party – the government is not transferring to the public party an unrestricted freehold right to a public asset, the government can renegotiate or retender the agreement when the term ends, or the public party can recommence delivery of the services by the public party. An important part of the agreement involves specifying the state of the asset at the time of turnover. The public party will require that appropriate heavy maintenance be performed during the term of the agreement, and the asset should not be in need of heavy maintenance for a reasonable period following turnover.

Also, it is in this respect that a PPP agreement differs from an agreement for provision of services by a private party. For instance, private parties provide all types of services to public parties, such as cleaning, maintenance, security, IT, communication, teaching, etc. These can involve the "D", "B", "F" and "O" elements, because the private party may need to design the assets for service delivery, build them, finance them and operate them, as it will just receive periodic payments as the services are provided. However, the assets will remain with the private party at contract end.

Type of PPP

If the public party operates a revenue-producing but illiquid asset, it can turn over operation and the right to revenue to a private party in exchange for an immediate payment. This is the well-known situation with the Chicago Skyway and Indiana Tollroad. The arrangement could be "FOT", since the private party would need to find financing, would take over operation and transfer at the end of the term. It could also be DBFOT, if renovations and improvements to the existing asset are required Infrastructure investment can be structured as BOTs, DBOTs, FOTs or OTs, all depending on the particular needs of the parties.[2]

Structuring the Private Party

Because of the BFO elements, and the different skills and tasks they involve, the private party is generally a consortium of a contractor, investment and operator that forms a special purpose vehicle to act as the contracting party with the public party. In turn, it subcontracts with the contractor and operator on the basis of an Engineering Procurement Construction (EPC) lump-sum turnkey contract with the contractor, and an operating contract with the operator. The terms of both of these agreements must be back-to-back with the terms of the PPP agreement, in order to pass through contractual risks to the appropriate substantive parties, and not leave them with the SPV, which will have as its main asset its rights under the PPP agreement. To the extent possible, these sponsors will seek to ensure that financing is on a project non-recourse basis. Similarly, equity, contingent funding and guarantee requirements will be the subject of extended review and negotiation among the parties.

Who Pays?

Payment mechanisms (referred to as "unitary charges" in the UK) to the private party can be categorized as:

User Fees – the private party has the right to charge users of the service,

Shadow Payments – users of the service do not pay, but the public party pays the private party a fee for each user.

Availability Payments – the public party pays the private party a fee for making the asset available and providing services. The fee is not based upon demand, but deductions may be made if the asset is not fully available or if the level of service fails to meet specified standards.

Subsidy or Guaranteed Payments – under a system where the private party takes demand risk (user fees or shadow payments), the public party may agree to pay a subsidy if demand fails to achieve certain agreed levels, or may agree to make additional payments to enable servicing of debt.

In the case of user fees, a key question is the permissible fee level. The public party may be taking substantial political risk if it permits user fees to be raised without restriction. On the other hand, the private party is incurring substantial risk by agreeing to restrictions. Inflation and currency risk are additional factors to be taken into account when restricting fee levels.

Where a private party is not taking demand risk with availability payments, the public party should be free to establish and collect payments from users. Such payments may help the public party cover a substantial portion of the expense of the availability payments. However, if shadow payments are used, no user fees should be collected or, if collected, only on terms pre-agreed with the private party. The reason is that the level of shadow payments would have been set assuming free use of the asset and services, and imposition of fees would reduce demand and negate the project's financial model.

The payment to the private party of a capital grant (a larger up-front payment) can materially reduce financing costs to the private party and, consequently, continuing future payments.

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2 In fact, the acronyms are much more extensive, and reflect the "marketing' approach in project finance continually to invent "new" products – thus, for example, DBFO (Design Build Finance Operate), DBOM (Design Build Operate Maintain) and DBM (Design Build Maintain). A recent variation is a DCFOMM – see Project Agreement for the Design Construction, Financing Operation. Maintenance and Management of the New Long Beach Court Building, available at http://www.newlbcourlbldgproposals.com/

Multi-year Payments from the Public Party and Off- or On-Balance Sheet Treatment

If the public party is to make payments to the private party, such payments will cover an extended period. The private party will be incurring substantial financial obligations on the assumption that the public party's payment obligations are valid and enforceable throughout the entire contract period. In many jurisdictions, it is permissible for a public party to incur multi-year obligations, but in many others it is problematic and, in almost all, such obligations involve restrictions on the level of public debt.

A key element for project viability therefore may be whether the public party's payment obligation is treated as on-balance sheet or off-balance sheet. In the European Union, a Eurostat decision states that a public party's payment obligation may be treated as off-balance sheet if the private party is responsible for construction risk and either the demand risk or the availability risk. Although this principle is straightforward, applying it to specific situations remains complicated, as few PPE arrangements are black and white on allocation of all relevant risks.

The Tender Procedure and State Aid

Because of the complicated nature of a DBFOT arrangement, the procedure for tendering a PPP contract can be very expensive and time-consuming. Sponsors must agree consortium arrangements and analyze, structure, place and negotiate bids with the help of financial, legal and technical advisers. The public party may request that each bidder shows committed financing, which is particularly difficult when there may be several competing groups and only a limited number of financiers.

If the terms of the tender are changed materially during the process, issues of state aid could arise if the tender occurs in the European Union. State aid to private parties is permissible only if such aid does not distort competition. Any payment by the state to a private party, or the grant of a right to use an asset and collect fees, is potentially state aid. If the payments or right to use is made pursuant to a contract granted in an open tender, the state aid should be permissible because the tender procedure is deemed to ensure that the payments/right to use are granted on the most favorable terms for the public party, and therefore do not distort competition.

Conclusion

PPPs may be analogized to another form of contracting enjoying current popularity outsourcing. Both are similar due to the need to specify the asset and level of service to be provided, to measure performance, and to agree appropriate payment mechanisms. PPP transactions are challenging due to the wide range of issues that arise due to the scope of the DBFTO elements. The element of partnership is key. The public party is motivated by its duty to serve its citizens and taxpayers. The private party is motivated by the desire to earn a reasonable profit. Historically, neither party is used to accommodating the other party's primary incentive. If one or the other is forgotten or not accommodated by the terms of the contract, the project will not succeed. On the other hand, if all parties work in partnership, a PPP can become a win-win-win.

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