

Toronto Forum for Global Cities—The Infrastructure Challenge: Financing and Governance

Presentation on Public-Private Partnerships Project Agreements

- Aim of PPP is to achieve closer partnership between public and private sectors at various levels of government. How does it do so?
- By involving the private sector in the development, financing and operation of public infrastructure, most commonly through the approach largely pioneered under the UK's Private Finance Initiative: the DBFO
- If a particular project is to be structured and tendered as a PPP and if it is to succeed, two pre-conditions must be satisfied:
 - There must be a genuine transfer of risk to the private sector
 - The project must demonstrably generate value for money to the public sector
- But, of course, the first pre-condition typically gives birth to the second. So risk transfer is the paramount consideration in any analysis of the desirability or effectiveness of a P3 project
- In particular, a transfer of financial risk is an essential condition of any P3
 - Private sector is perceived to have an advantage over public sector in the handling of financial risks
 - Transfer of project financial risk generates incentives for private sector to supply services on time and of a higher quality since service payments only begin for the private sector project company when construction of the asset is completed and the services begin to be delivered and continued payment depends on the ongoing satisfaction of performance criteria
- BUT while risk transfer from public to private sector is an essential pre-condition from the public sector's perspective, there is a delicate balance—if the public sector tries to transfer too much risk by making the performance criteria too difficult to achieve or the performance deductions too high, the project will not work
 - Private sector will not accept the risk; or
 - Will demand a higher risk premium thereby impairing the project's value for money

- So, the optimal P3 project agreement will be one that strikes the right balance between the public sector's desire to transfer risk and the private sector's willingness to accept risk on a cost-effective basis. What are some of the key components that factor into making that assessment and development of a "good" project agreement?
- First and foremost, though it sounds almost tautological to say, the agreement must be financeable. This is *the* most fundamental pre-condition of a successful P3 agreement. If the agreement is not financeable, the project will not be capable of being completed. So, what are the conditions of financeability?
 - To answer this question, must first understand the nature of typical P3 financings:
 - ◁ project finance
 - ◁ concession is awarded by government to a special purpose vehicle (SPV) established specifically for the purpose of developing and operating the project in question
 - ◁ SPV's construction and operational obligations are passed on to sub-contractors
 - ◁ transactions are generally highly leveraged (90/10 debt/equity)
 - ◁ debt financing usually provided on limited recourse basis to SPV
 - ◁ no recourse to sponsors' balance sheets
 - ◁ lenders' principal repayment rights are therefore only against SPV, a non-operating entity whose only significant asset is its rights under the project agreement and its entitlement to the cash flow payable to the SPV for the satisfactory performance of its obligations under that agreement
 - So, project risk (credit risk less significant in P3s) is borne by the lenders (as well as the equity). If too much risk is assumed by the SPV such that its revenue stream is threatened, the project will not be financeable. Similarly, since a bankable transaction will require the SPV to offload most of its risk to its subcontractors, it is imperative that those risks be acceptable to the construction and facilities management companies that will be asked to bear them. What, then, are the conditions and criteria of an acceptable risk transfer?
 - Risks to be borne by the private sector cannot be unacceptable or indeterminate
 - From the lenders' perspective, risks must be passed through and away from the SPV
 - The SPV must not be a repository for residual risk that neither the government nor the sponsors wish to take

- Payment deductions must be proportionate and performance standards achievable [mention LEEDS]
- Supervening events regime must be reasonable
- Termination events must be limited and as objective as possible
- Arrangements for termination of the concession must not be expropriatory and the agreement must contain provisions for the payment of acceptable compensation on termination