

# PPP – THE KEYS TO SUCCESS

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## ABSTRACT

Public-private partnership (PPP) projects are complex financial and legal structures used by many countries around the world to develop infrastructure projects. To attract private financing, the fairness of the allocation of risks between the public and private sector is one of the key aspects to the success of a PPP project. This article analyses how risks should be best allocated and what concerns the investors and lenders might have when deciding to bid in or finance this type of project. All of these will be correlated to the level of experience in PPP of the country trying to implement a PPP project and having regard for the characteristics of different legal systems and jurisdictions.

## PRIVATE-PUBLIC PARTNERSHIPS – KEY FEATURES

The definitions of public and private partnerships vary because they describe a wide variety of arrangements involving the public and private sectors. PPP projects are a “further refinement” of private finance initiative (PFI).<sup>1</sup>

This article refers mainly to availability-based PPP, which involve a private party that designs, finances, builds or rebuilds and subsequently is operating and maintaining the necessary infrastructure, while the public authority pays for the services provided by the private partner.

This is why in developing countries, this type of PPP structure might raise issues such as the affordability of the projects because the payments are made from public funds and not through user payment mechanisms. The latter are concession agreements or so-called “user-fee PPP.” The demand risk of user-fee PPP is a significant challenge that might cause the failure of a project. For availability-based PPP, there is a risk on long-term payments because such payments may rely on annual budget approvals. Chart 1 is a typical legal scheme on availability-based PPP.

<sup>1</sup> Bruce, L., *PFI/PPP Update*, 2014 lecture, page 1.

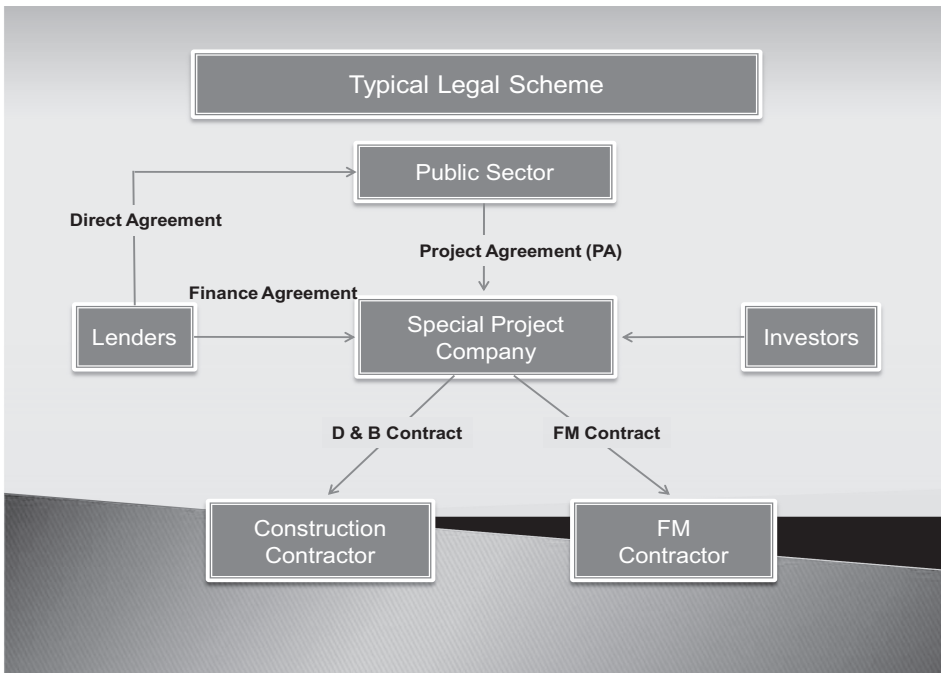


Chart 1: Legal scheme of an availability-based PPP

In summary, the public sector commits to pay to the special project company (SPV), financed by the private sector, a yearly amount (unitary payment) against the special project company making available to the public sector the required building and the associated facility management (FM) services (soft/hard/life cycle) — availability payment risk project.

The SPV has no previous business record and is created specifically to carry out the project. Consequently, the SPV subcontracts the construction activities to a construction contractor and the operation of the facility to an FM contractor, ensuring that no residual risk remains with the SPV.

Normally, the financing structure of a PPP project is a combination of private equity provided by the private partner (“the Investors”), and the financing (“the Debt”) provided by the lenders such as banks or through financial instruments such as bonds.

The equity investment is “first in, last out,” meaning that in principle, any losses the project suffers are borne first by the investors, and lenders begin to suffer only if the equity investment is lost.<sup>2</sup> Because equity investment bears higher risk, the returns for the equity investors are expected to be higher.

<sup>2</sup> Farquharson, E, Torres de Mastles, C, Yescombe, ER with Encinas, H, *How to Engage with Private Sector in Public-Private Partnerships in Emerging Markets*, The World Bank and PPIAF, 2011, page 53.

Since equity is more expensive than debt, in conclusion, the more financing the project will obtain, the lower its overall funding costs will be.

The technique of obtaining PPP financing is called “project finance,” which has been defined in several ways. In a complex definition, it could be used to refer to a nonrecourse or limited recourse financing structure in which debt, equity, and credit enhancement are combined for the construction and operation, or the refinancing, of a particular facility in a capital-intensive industry, in which lenders base credit appraisals on the projected revenues from the operation of the facility, rather than general assets or the credit of the sponsor of the facility, and rely on the assets of the facility, including any revenue-producing contracts and other cash flow generated by the facility, as collateral debt.<sup>3</sup>

In fact, 70 to 90 per cent of the total funding requirement could be obtained through project finance, depending on the perceived risks of the project. Because lenders are not allowed to take securities over the assets of the project because it is a public asset, the securities of the lenders are usually limited to the Contract between the public authority and the private sector company and the cash flow deriving from the Contract.

Another view on non-recourse or limited recourse concepts is that the simplest way for a sponsor to obtain financing is to form a sole purpose company (which may or may not be a subsidiary) to raise all the finance necessary for the project through that company and grant the lenders full security over every asset that the company owns and over the shares the lender owns in that company.<sup>4</sup>

## ADVANTAGES AND DISADVANTAGES OF PPP PROJECTS

Within the context of the financial crisis in 2008, recognising the importance of infrastructure for economic growth and facing constraints of public resources, PPP bring a major advantage to developing the infrastructure of a country by using private capital and transferring the risks from the public sector to the private sector, in which they can be better managed. One key motivation for governments to procure and deliver infrastructure projects via PPP models is the assumption that PPP deliver greater value for money (VFM) than conventional delivery methods.<sup>5</sup>

Therefore, the private sector partner assumes the worry of securing capital investment as well as maintaining and operating the building or the asset,

<sup>3</sup> Hoffman, SL, *A Practical Guide to Transactional Project Finance: Basic Concepts, Risk Identification, and Contractual Considerations*, 45 Bus Law 181, fn 1 (1989) cited in Hoffman, SL, *The Law and Business of International Project Finance* (Cambridge, 3rd Edition) page 4.

<sup>4</sup> Vinter, GD, Price, G and Lee, D, *Project Finance: A Legal Guide* (Sweet & Maxwell, 2013) page 192.

<sup>5</sup> Hovey, P, *Risk Allocation in Public-Private Partnerships: Maximising value for money*, IISD, August 2015.

leaving the public authorities to concentrate on their areas of expertise. This is advantageous because they can manage the risk efficiently and thereby reduce costs and increase profitability.<sup>6</sup> Also, increasing efficiency in government investment allows the government to re-direct funds to other important socio-economic areas.

Involving the private sector in the process also means better infrastructure solutions, a way of introducing new technology, management skills, and innovation in providing better public services through improved operational efficiency. The National Audit Office (NAO)<sup>7</sup> in the UK took the same view. The NAO considers the “timely Completion”<sup>8</sup> of the project an advantage, faster completion and reduced delays being measures of performance. By involving the private partner, the PPP/PFI scheme delivers “high standards projects”,<sup>9</sup> and these high standards are better maintained through the life cycle of the project.

Public private partnerships have also drawbacks. PPP are considered more expensive than purely public financing due to higher private sector borrowing costs and high transaction costs in general.<sup>10</sup>

Problems reported with PPP/PFI procurement include high costs in tendering, complex negotiations, costs restraints on innovation, and differing or conflicting objectives among the project stakeholders.<sup>11</sup> Therefore, development, bidding, and ongoing costs in PPP projects are likely to be higher than for traditional procurement process. The government should therefore determine whether the greater costs are justified. Several PPP units around the world have developed methods for analysing these costs and looking at value for money.<sup>12</sup> Also, the time required to set up the contractual arrangement and reach financial close may increase project implementation time.

If a project is to be successful, risks must be allocated in an economically and efficient manner among the participants. Because the private sector takes over most of the risks of the project, the investors also reasonably expect to be compensated for accepting those risks, which will increase the government’s costs. Also, the profit of the project can vary depending on the assumed risk, competitive level, and the complexity of the project to be performed.

<sup>6</sup> Merna, T and Njriu, C, *Financing Infrastructure Projects*, 2002, page 119.

<sup>7</sup> NAO (29 Nov 2001), page 25.

<sup>8</sup> NAO (Feb 2003), page 4.

<sup>9</sup> NAO (Feb 2003), page 5.

<sup>10</sup> *Overcoming Constraints to the Financing of Infrastructure*, page 3.

<sup>11</sup> Akintoye, A and Beck, M, *A Framework for Risk Assessment and Management of Private Finance Initiative*, 2001, chapter 17.

<sup>12</sup> <https://ppp.worldbank.org/public-private-partnership/overview/ppp-objectives> (last accessed 10 April 2020).

### Fair Allocation of Risks

Risk has been defined as “uncertainty in regard to cost, loss or damage.”<sup>13</sup> A successful project must incorporate a risk management process, during which risks are identified, analysed, quantified, mitigated, and allocated so that no individual risk threatens the development, construction, or operation of the project in such way that the project is unable to generate sufficient revenues to repay the project debt, pay operating expenses, and provide an attractive equity return to investors.<sup>14</sup>

In all countries using PPP, the key issues that arise repeatedly that determine the success of the transactions are: (i) the process followed by the public bodies for procuring PPP transactions; (ii) the allocation of risks for PPP transactions, which is very closely linked to (iii), the manner in which PPP transactions are financed.<sup>15</sup>

However, the main asset of the private sector in a PPP transaction is the Contract executed with the public sector, defined as the project agreement (PA) or the PPP contract, since ownership of the building and the site remain with the public sector and therefore cannot be given as a security to the lenders. In consequence, the project agreement must be well drafted and well balanced to attract investors and lenders.

Key risk management steps include:<sup>16</sup>

- identifying risk (both direct and indirect);
- identifying any project-specific risks (e.g., geographical/political);
- determining the likelihood and consequences of risk occurring (both pre and post construction completion);
- determining which party is best placed to manage the risk (e.g., level of control exercised and the cost of assuming the risk);
- allocating risk efficiently (“optimum” rather than “maximum” risk transfer); and
- pricing risk.

In the construction industry, risks tend to be allocated on the basis of commercial requirements and bargaining strength. But this scenario does not necessarily provide the most effective and efficient risk management.

Allocation of risks may also vary between markets, depending on the appetite of the private parties and the level of competition.<sup>17</sup>

However, in PPP, the general concept that “risks must be allocated to the party best able to manage them, at the lowest cost” applies. Therefore, risks must be defined, identified, and measured and either retained by the

<sup>13</sup> O’Hardy, C, *Risk and Risk-Bearing* 1 (1923) cited in Hoffman, SL, *The Law and Business of International Project Finance* (Cambridge, 3rd Edition) page 27.

<sup>14</sup> Hoffman, SL, *The Law and Business of International Project Finance*, page 27.

<sup>15</sup> Vinter, GD, Price, G and Lee, D, *Project Finance: A Legal Guide* (Sweet & Maxwell, 2013) page 469.

<sup>16</sup> Sutti, *Successful PPP Models*, 2010.

<sup>17</sup> Farquharson et al., page 39.

public sector or transferred to the private partner through specific contract terms and appropriate payment mechanisms.

In some countries, the law allocates certain risks to the public or to the private sector for political reasons and, in such contexts, any contractual arrangements will have no legal effect.

Another principle in allocation of risks in PPP states that risk allocation should be about managing not only occurrence, but also impact.<sup>18</sup> The distinction between occurrence and impact should be clarified from the perspective of the parties best able to manage the occurrence of a risk and the party best positioned to manage the outcome of the risk.

This exercise of risk allocation is one of the most important steps in assessing and developing the bankability of the project.<sup>19</sup>

### **Public Sector Risks**

Allocating risks to the private partner that are better managed by the public partner may lead to low interest from the private sector in the PPP project or may even make the project un-bankable.<sup>20</sup> If the private party accepts such risks, this may lead to higher costs than necessary to manage the risks or ultimately to the failure of the PPP. Similarly, allocating risks to the public sector that the private sector can better manage may not maximise the potential of VFM.<sup>21</sup>

This is one reason the public sector must undertake some certain risks during the performance of the Contract that statistically should be taken by the public sector to make the project bankable. First, a key issue for the private partners is dealing with the state rather than a region or a municipality. More precisely, it is important to know from the beginning that the public authority is making or guaranteeing to the private partner payments such as unitary payments and compensation on termination.

Secondly, it is also important that the public sector bears the financing risks such as currency (local currency versus foreign currency), inflation, and interest rates. The combination of these three factors has a significant impact on the bankability of a project and the duration of the operation phase reflects this.

### ***Currency exchange risk***

There will often be interplay between currencies within the context of a project.<sup>22</sup> The diversity among the project participants can create complex currency exchange interfaces. For example, in project finance, the

<sup>18</sup> Hovy, P, page 2.

<sup>19</sup> Farquharson et al., page 39.

<sup>20</sup> *PPP Motivations and Challenges for the Public Sector*, EPEC, 2015, page 19.

<sup>21</sup> *Ibid*, page 19.

<sup>22</sup> Delmon, J and Scriven, J, *A Contractor's view of BOT projects and the FIDIC Silver Book*, 2001, page 56.

lenders are often foreign entities that will finance the project in foreign currencies, while the project revenues are generally denominated in local currency. Because the exchange rate between the currency of revenue and the currency of the debt can differ, the cost of the debt could increase dramatically.

### ***Inflation***

In developed markets, the private sector bears the risk of inflation. In emerging countries where the economy is unstable, the public sector bears the risk for inflation because it always affects project cost.

### ***Interest rates risk***

Interest can be charged at a fixed rate, a variable rate, or a floating rate. However, project finance debt tends to be at a fixed rate to provide a foreseeable and quite stable repayment profile over time to reduce fluctuations in cost of infrastructure services. The private partner prefers that the public sector bears such risk; however, in many PPP transactions and especially in the UK, it has become customary to hedge long-term interest rates and for the public sector to require that this be done.<sup>23</sup>

### ***Legal recourses and permitting***

Large projects involve significant preparatory administrative activities such as obtaining permits and authorisations. The risks associated with these activities should not be transferrable to the private partner in a PPP. The government should be responsible for obtaining planning approval for the projects. Also, the public sector should bear any further changes in the planning due to variations proposed by the public sector.

The government should compensate for any unreasonable delays related to any legal recourse of a third party to the planning. The government should implement a specific regime applicable to third party recourse to avoid legal actions preventing PPP development.

It is advisable that within the context of developing PPP projects, the government should take measures to simplify any permitting procedures.

In conclusion, any delays in issuing permits or obtaining right of way for the project should be a compensation event, and the private partner should be awarded both time and money.

<sup>23</sup> Vinter, GD, Price, G and Lee, D, *Project Finance: A Legal Guide*, page 147.



***Site risks: pre-existing contamination and unforeseeable ground conditions***

In cases of unforeseen site conditions, many standard contracts provide for the contractor to be entitled to claim for time and money.<sup>24</sup> In contrast, in PPP, the public partner is expected to take full risk of undiscovered on-site pre-existing contamination and unforeseeable site conditions. When information about contamination of the site is insufficient, the public sector bears the risk of time and cost implications.

***Government-initiated variations***

A PPP agreement always includes clauses to allow the public partner to vary the scope of the works. Very often, government officials might change their minds before completion of the works or during performance of the services; however, it is advisable that a PPP contract include a limit on the size and nature of variations that the government can request. In these circumstances, the Contract should allow the private party sufficient time to contact the designers and construction sub-contractors to prepare a response. Also, any material changes in the infrastructure or services will have financial implications and the private party and its financiers should assess. In conclusion, the government should pay all the costs related to the assessment of such variations and for any works caused by them.

**Shared Risks*****Change in law***

Like any other contract, in a PPP contract, the parties must comply with the applicable legislation. Given the long-term nature of PPP projects, unanticipated change in law may occur. Change in law is a political risk that cannot be controlled by the private partner and are regarded as more under the control of the public authority.

Generally, change in law is a shared risk. A distinction arises if a change in law is “general” or “discriminatory.” A general change in law (e.g., tax legislation or environmental law) affects either all businesses in the country or all those involved in the sector in which the PPP contract is situated. A discriminatory change in law expressly applies to the project or to the private party and not to similar projects or to other persons. The public authority bears any costs arising from discriminatory changes in law because discriminatory changes of law are public sector risks, while a general change in law is a shared risk.

<sup>24</sup> See e.g., FIDIC Conditions of Contract for Construction for Building and Engineering Works Designed by the Employer (1st Edition) – The Red Book (1999) clauses 4.12. and 17.3.(h) and NEC3 clause 60.1(12).



### **Comment**

Governments may at first be reluctant to grant protection to private partners from change in law because such grants might be unavailable to other businesses and investors in the same country. Such resistance seems preferential compared with other parties that accept and manage risk.

It is important to specify that without specific contractual provisions, in common law jurisdictions, the change in law risk would lie entirely with the private partner because any obligations under the Contract would be performed only subject to the PPP contract. In contrast, in civil law jurisdictions, the private partner may rely on fundamental legal principles, such as hardship provisions, that give relief from adverse financial consequences of certain circumstances.

However, widespread market practice across civil and common law jurisdictions have shown that the private sector is unwilling to enter PPP contracts on such a basis because both lenders and equity investors require express contractual certainty in relationship to the potentially significant impact of changes in law.<sup>25</sup>

In conclusion, several aspects must be considered:

- (i) The allocation of change in law risk is a key bankability point and will be particularly relevant in jurisdictions in which change in law is less predictable, or more likely, such as emerging markets in contrast with developed countries.
- (ii) General change in law is a real risk factor, so a risk-sharing approach is advisable for the parties, except for discriminatory change in law and specific change in law, which should be allocated to the public authority.
- (iii) The private partner should be given relief from breach of contract, and if such event occurs, he or she should be entitled to an extension of time and any compensation if it is implemented in the PPP contract.

### **Force majeure**

*Force majeure* was originally a civil law concept, but it is now widely used in commercial contracts, including those governed by common law. Within PPP contracts, risk of *force majeure* should be shared between the public and private sector. The reasoning for this allocation starts from the assumption that a *force majeure* event is outside either parties' control and neither is better placed than the other to manage the risk of such occurrence or its consequences.

However, many civil jurisdictions have a concept of *force majeure* under the general law, so parties cannot derogate from the scope of the legal

<sup>25</sup> Guidance on PPP Contractual Provisions, World Bank Group, 2017, page 45.

concept and cannot amend or create their own definition. In contrast, in common law jurisdictions, the parties have no restrictions from mutually agreeing on the scope of the *force majeure* and the consequences of such event occurring.

Whether they are common law governed contracts or civil law governed contracts, most PPP contracts will have a *force majeure* clause to give certainty to the parties and avoid delays. Also, this is essential to make the project bankable to lenders and equity investors.

Because the private party is likely to be more affected by such events, within the Contract framework, the key issues to be dealt with are whether and how the private party will be compensated on the occurrence of such an event (e.g., increased costs or loss of revenue), whether a prolonged *force majeure* event (typically in excess of six to twelve consecutive months) will trigger termination of a PPP contract, and what compensation will be paid (the principle is that financial consequences should be shared). Similarly, it is advisable to distinguish *force majeure* provisions from hardship clauses, which deal with unexpected circumstances in which performance becomes more onerous for a party without being impossible. This is specific for civil law jurisdictions and is not usually found in common law contracts.

Another difference between civil law and common law jurisdictions is that the legal definition of *force majeure* in civil law requires the event to be “unforeseeable” and “unavoidable,” while in common law, it is coupled with the “reasonableness” test regarding a party’s inability to control or to prevent an event, even if it is in fact foreseeable.

Generally, it is recommended that *force majeure* provisions in PPP contracts mirror *force majeure* provisions in other project contracts in terms of both definition and consequences.

### **Insurance**

Under a PPP contract, insurance often receives little attention. Availability of insurance, levels of cover, and deductibles will, however, have an impact on the risks being taken by the public authority, the project company, and the lenders and so should be central to negotiations.

Each project requires specific insurance coverage based on the risk inherent to a particular project. The parties need to consider what risks need to be insured and whether such insurance is available in the host country. Since 9/11, certain types of insurance coverage are either impossible to obtain or have become increasingly difficult or very expensive to obtain.<sup>26</sup> Furthermore, insurance costs are major bid cost items.<sup>27</sup>

<sup>26</sup> Chew, A, Wood, G and Storr, D, “An Overview of Risk Allocation in Recent PPP Infrastructure Projects in Australia” [2005] ICLR 300.

<sup>27</sup> Chew, A, Wood, G and Storr, D, “PFI/PPP Project Agreements, Risk Allocation Issues to Consider in Flow-Down of Risks” [2005] ICLR 101.

The private party is generally obliged to effect and maintain a whole range of insurances: a construction all-risks policy (CAR), professional indemnity insurance (PI), third-party liabilities insurance, director's liability insurance, and business interruption insurance. For each kind of coverage, the PPP contract should set out the basic features of the policy, the minimum level of coverage, the principal exclusions, and the maximum deductibles (i.e., thresholds below which the insurance company will not pay out).

The PPP contract will need to deal with other important insurance matters. For instance, it may be in the authority's interest to agree to indemnify the PPP company if a risk becomes uninsurable (or insurable only at a prohibitive cost); and the authority (and the lenders) will require the insurance policy to be concluded with insurance companies of a minimum financial standing.<sup>28</sup>

It is critical that the PPP contract contains un-insurability provisions. Equity investors and lenders may seek protection in the PPP contract for the private partner in case required insurance coverage becomes unavailable, less extensive, or costlier. Without express contractual protection, un-insurability risk will typically lie with the private partner (which will also be in breach of its obligations to maintain the unavailable insurance). This is likely to attract a pricing premium (if indeed it is bankable), depending on the circumstances of the PPP project and the risk assessment conducted by the private partner and its lenders.

Some jurisdictions may address un-insurability through general law provisions or may not recognise the concept of un-insurability. The public partner should therefore take specialist advice on how relevant contractual provisions may interplay with general law.

When there is known risk of un-insurability with respect to a particular required insurance at the time the PPP contract is being negotiated (for example, insurance against terrorism or vandalism), this can be addressed through bespoke contractual provisions.

The effect of un-insurability provisions is typically that if a particular risk becomes uninsurable in accordance with the agreed-upon contractual definition (and not as a result of a private partner's actions), the parties will negotiate a mutually satisfactory solution for managing the risk, failing which the public authority will become the insurer of last resort.

### ***Relief events***

Relief events are events that entitle the private partner to an extension of time. They are distinguished from compensation events, which entitle the private partner to full relief of costs and extension of time.

<sup>28</sup> <http://www.eib.org/epcc/g2g/annex/7-insurance/index.htm> (last accessed 10 April 2020).

While force majeure is a shared risk, certain relief events give the right for the special project company to receive time but no money. These events are best managed by the SPV, although they might not necessarily be under its control. Therefore, the SPV bears the financial risk of the relief event but has no rights of termination.

Typically, relief events are strikes, other than strikes of the public sector's employees and force majeure type events such as fire, explosion, lightning, flood, and bursting or overflowing of water tanks. Other examples could be any failure or shortage of fuel, power or transportation or any failure by any statutory undertaker, utility company, local authority or other like body to carry out works or provide services. Any blockade or embargo that does not constitute a force majeure event is also considered a relief event. In conclusion, the private sector bears the financial effects of delays caused by relief events.

## Private Sector Risks

### *Design and construction*

In most conventionally financed projects, it is accepted that the design and construction risks are allocated to the private sector. A strong motivation for using PPP is that allocating these risks to the private party means optimising the design and construction for better whole life management. Design development allows the private sector, during the tender process, to optimise the design to optimise value for money for the public sector. Consequently, design and construction risks will generally be allocated by the SPV to the construction contractor because the construction contractor designs and builds the project.

In practice, the construction agreement defines the requirements of the project very specifically and completely, on back-to-back apportionment. The effort to transfer all project risks to the project participants is known as back-to-back risk allocation.<sup>29</sup> However, in practice it is very rare when a project achieves a back-to-back risk allocation.

Delmon suggested few mechanisms that could be used to achieve a back-to-back risk allocation:

- (i) provisions drafted using terms and language mirroring those of the PPP contract;
- (ii) including “if and when” language or “pay-when-paid” and “time-when-time” clauses in the subcontract documents. The law may restrict these conditional clauses in some jurisdictions;<sup>30</sup> and

<sup>29</sup> Delmon, J and Scriven, J, A contractor's view of BOT projects and the FIDIC Silver Book 2001, page 52.

<sup>30</sup> In the UK, such provisions are regulated by the Housing Grants, Construction and Regeneration Act 1996.

- (iii) including in subcontracts documents an overriding provision that imposes on the project participants an obligation to perform so that the project company will not be in breach of its obligations.

If the project company has any liability to pay either delay or performance liquidated damages to the public authority, this should obviously pass through to the contractor to the fullest extent possible. Any gap or inconstancy may defeat the back-to-back allocation of risk and leave additional residual risk with the project company.<sup>31</sup>

As a conclusion, the building contractor in a PPP project takes considerably more risk than it would under a traditionally procured project. However, the building contractor, who often is a shareholder in the SPV, can gain considerable advantages, for example, re-financing benefits.

### *Facility management services*

In recent years, it was encouraged that PPP contracts provide FM services. The need to drive costs down and improve productivity encouraged public authorities to outsource FM services to the private sector. Due to the private sector's expertise, innovation, and skills, PPP are used in a wide spectrum of sectors such education, health, defence, transport, waste management, and public utilities.

### *Latent defects*

Latent defects are a construction risk borne by the private partner, which is liable to remove any defect, either apparent or latent. A distinction is made between a new infrastructure and the disclosed defects with the existing infrastructure and the undisclosed latent defects of an existing infrastructure, which should remain under the liability of the public sector.

Also, each country has specific mandatory laws related to latent defects that provide for a period of time, usually 10 years, while the contractor remains liable for latent defects even if the contractual liability for defects has expired.

### *Handback requirements*

At the end of the term of the PPP agreement, the private partner hands back the facilities and assets to the government in a condition that meets the conditions specified in the Contract. Since the increase in the public-

<sup>31</sup> Delmon, J and Scriven, J, page 54.

private contracts is only recent, practical government experience with ends of contract is negligible.<sup>32</sup>

Therefore, the private partner is responsible for complying with the handback requirements, including exit plans, procedures, standards, and reporting. The aim is to ensure maintenance and service quality performances up to the last day of the Contract.

Such requirements provide for the asset to be in good condition and operating order, excluding reasonable wear and tear. The asset must continue to function per the technical requirements and detailed design. The private partner should prepare a handback report. Any failure to meet the handback test procedures and standards during the handback testing will require repeating the failed handback test.

### **Investors' Issues**

Mobilising the necessary funds to satisfy the growing demand for infrastructure investment will require scrutinising of the contractual conditions by the banks and investors. Apart from a fair allocation of risks, in practice, investors will expect to be agreed construction contracts with strong international contractors able to operate in the market concerned.

### ***Long stop date***

A well-prepared contract will provide for a long stop date to allow for a reasonable period between the target completion date and the long stop date, (at least nine months), which triggers the right for the public sector to terminate the project agreement for default by the special project company.

### ***Completion of the works of the project***

The investors will show interest in the process to assess the completion of the works in a PPP project. The intervention of a truly independent engineer jointly appointed by the public sector, special project company, lenders, and construction contractor will satisfy investors' requirements. Also, investors should be aware of the local laws on taking over of the works at the completion and after the expiry of the defects liability period, because in many countries mandatory laws rule the taking over process.

<sup>32</sup> <https://ppiaf.org> (last accessed 10 April 2020).

***Payment mechanism***

Payment mechanism should be carefully drafted. Availability-based PPP will usually involve a payment mechanism under which the public authority will make long-term, regular payments to the private partner against the provision of the services as set out in the Contract.

***FM services benchmarking and market testing***

FM services benchmarking and market testing are opportunities for the public sector to re-tender FM services at agreed-upon intervals to get better FM services pricing. Most PPP contracts include value testing clauses that set out the procedure for aligning the cost of different services with market prices.

While benchmarking means the contractor compares its costs with the market price of equivalent services, market testing means re-tendering by the private partner of the relevant service. Any later increase or decrease in the cost of the service should be reflected by an adjustment to the unitary charge. The scope of services subject to value testing differs widely between different contracts, but in most cases, it includes only soft FM services (i.e., cleaning, caretaking, grounds maintenance).

***Deductions and caps on deductions***

Deductions are penalties applied by the public authorities if facility management (FM) services are not properly performed. In such a case, the public authorities apply a reduction to the fee payable to the SPV for such services. If those deductions/penalties reach a certain level/cap, then this triggers the public authorities' right to terminate the PPP agreement on the basis of the SPV's default.

***Third-party revenues***

Third-party revenues (TPR) are those revenues of a PPP that are not coming from the public authorities, but from another source. For example, for a hospital PPP, the public authorities will make an "availability payment", for the availability of the asset once built and for the FM services. This represents the main revenue of the SPV.

However, the investors may have considered in their financial model that they will open shops at the hospitals, shops that will be privately operated and generating revenue. That revenue is not coming from the public authorities, but from third parties, and thus are called TPRs.



***Lenders direct agreement***

The prospect of termination of the PPP contract by the public partner for a private partner's default is a big concern for the lenders. Even when compensation on termination will be paid to the private partner (as discussed in above), the amount may not cover the entire debt amount. Therefore, this concern motivates lenders to engage directly to try to save the PPP contract so the debt can be repaid as scheduled and in full. This engagement is done through direct agreements that entitle the lenders to organise step-in rights to enable them to rescue the project. In contrast, parties to the Contract should verify that local PPP laws do provide that neither party can assign its rights under the PPP contract.

While their validity and enforceability have rarely (if ever) been properly tested in courts in any jurisdiction, the formal existence of step-in rights gives lenders comfort in terms of bankability. Step-in rights also provide a framework within which the parties can come together to negotiate solutions in a default/termination scenario, subject to the mandatory law (for example, receivership, bankruptcy and public procurement rules).<sup>33</sup> Step-in rights give lenders the right to novate the private partner's rights and obligations under the PPP contract to a substitute private partner at their choice, subject to the preliminary consent of the public partner.

The parties should sign direct agreements on the same date as the PPP contract. They represent a condition precedent for granting the financing of the project. One major concern regarding the execution of a direct agreement is that in some jurisdictions, there may be mandatory rules, particularly under the public policy rules applicable to insolvency procedures and public procurement regulations that might prevent enforcing or granting a lender's step-in rights.

In conclusion, it is recommended that when drafting PPP laws, officials should include the entry of the public sector into direct agreements. In practice, it is also advisable that the private partner be party to the direct agreement and to acknowledge and consent to its terms.

***Lock-up period***

A lock-up period is the period during which the investors commit not to sell their shares in the borrower (SPV), i.e., to remain invested in the deal. There are normally two different lock-up periods, one set by the bank, specified in the finance documentation, and one in the PPP agreement set by the public authority. Lock-up periods can also be different for each investor. Typically, contractors are permitted to exit earlier.

<sup>33</sup> *Guidance on PPP Contractual Provisions*, page 89.

Therefore, PPP contracts might include a lock-up period that restricts the change of the shareholding structure of the SPV for a certain period of time. It is advisable that such period should not exceed five years after commencement of operation of the asset. This also adds flexibility to attract investors, and it is a key element to promote development of the secondary market.

### *Sharing of refinancing benefits*

The principle of sharing refinancing gain has developed over time out of the experience of early PPP markets such as the UK.<sup>34</sup> Briefly, refinancing means changing or replacing the existing terms on which debt obligations have been incurred. Given the long-term nature of PPP contracts, refinancing might become necessary when the market conditions or the risk profile of the project has changed. However, any refinancing may affect other terms in the PPP contract, so the public sector's consent should be required.

Refinancing should bring better financing terms (interest margins reserve account, extension of maturity, etc), or gearing can be obtained, especially after completion of construction and commencement of operation.

An interest margin is the rate of profit that a bank claims as remuneration when they lend money to a borrower. Typically a bank would apply interest that would comprising two components: (1) the cost of money typically calculated at the Euro Interbank Offered Rate (Euribor), which represents the interest rate at which the bank will get financing on the market; this rate is published and is currently negative; and (2) a margin called a "spread", which is the bank's profit and reflects the level of risk inherent in the deal. For example, the bank could propose a six-month Euribor (-0.250%) plus a margin of 450 basic points (or 4.5%); thus, the interest rate under the loan will be 4.250%. When refinancing a deal, for instance, at the end of a construction period, a borrower tries to reduce the margin, hence the interest rate, by explaining that the project is now "less risky".

Generally, when refinancing a project, a borrower tries to improve all the terms of the loan, so as to pay less and create value. There are various tools for accomplishing this:

1. extending the maturity of the loan; the borrower will repay in a longer period (say, 20 years instead of 12);
2. reducing the interest rate applied by the bank;
3. asking the bank not to require that an amount of cash be put on a reserve account as security for repayment of the loan (typically, six months of repayment under the loan);
4. asking for a better gearing.

<sup>34</sup> UK PF2 Guidance, 2012.

The “gearing” is the ratio between how much of its own money an investor is required to invest in a project before the bank will finance the balance of the project’s costs.

For example, if the amount to be financed for a hospital in PPP is €120 million, the bank may say I want a gearing of 20:80. So, the investor will have to invest 20% of 120 (i.e., 24) before the bank will lend 96. That reflects also the level of risk of the project. After the end of construction of the PPP, the project is less risky as construction, since construction has been successfully completed and the investor can ask the bank to apply a more aggressive gearing, say 10:90. In such case, the bank will increase the amount of the loan and the investor will be able to get reimbursed by up to 50% of the money it has invested.

Sharing the refinancing gain is another very important aspect of PPP arrangements. A 50:50 sharing is typical and fair.<sup>35</sup>

### *Termination events*

The grounds for termination and the consequent payments can be complex. The investors are very interested in how the termination clause is drafted. It is advisable that PPP contracts provide for reasonable cure periods.<sup>36</sup> The most difficult part is the distinction between breaches that are irremediable and breaches that can be remedied.

It is recommended that only material and repeated breaches should trigger termination of the PPP contract, for example, if accumulated deductions during the operating period exceed a given amount.

### *Settlement of disputes*

A PPP contract should include a dispute resolution clause specifying how disputes should be resolved. Selecting the appropriate dispute resolution method is key to any assessment of the bankability of the PPP project by the private partner and its investors and lenders.

The public partner may prefer to select its local courts as the forum for the resolution of any disputes under the PPP contract. This selection may be made for several reasons, including familiarity, compatibility with local PPP legislation and because the PPP contract is usually governed by the local law. The costs of litigation before local courts may also be much lower than before certain foreign courts or in international arbitration.

However, private partners will be reluctant to agree to having disputes determined by local courts. They may be concerned that the local courts are unreliable, potentially more favourable to the local parties, inefficient, and prone to significant delays when a speedy resolution is needed.

<sup>35</sup> This sharing is also recommended by South Africa PPP Guidelines.

<sup>36</sup> Also known as grace period.

In these circumstances, private partners may push for the inclusion, as an absolute condition, of international arbitration for solving complex international disputes in a fair and predictable manner. For example, English courts often determine disputes arising under foreign, non-English law and do so by hearing expert evidence on that foreign law.

In contrast, it is assumed that foreign courts might not be a preferred option by the public partner, but this option needs to be considered as a necessary compromise to ensure that the PPP project is bankable.

Also, a provision for the resolution of specific technical disputes by an independent expert is recommended. Most commonly, private partners will prefer international arbitration to resolve disputes. The advantages of arbitration over court litigation are well known; therefore, one main issue that can arise is local limitations on forum selection. This means that under applicable laws, the public partner is allowed to agree to refer disputes to a foreign court or to international arbitration.

For example, there could be general prohibitions or limitations under local law relating to concession agreements to refer all disputes relating to a PPP project to foreign jurisdiction or foreign-seated arbitration. In these circumstances, specific waivers and approvals may be needed to agree contractually to arbitrate internationally. Specific permissions may be required, and certain formalities may need to be followed. Issues of capacity and authority may arise.

In emerging and developing countries, it is advisable that private partners require local law opinions to address these issues at the outset of negotiations.<sup>37</sup>

If the parties agree to arbitration, it is absolutely critical to specify the seat of that arbitration. The key selection factors are whether a jurisdiction is considered arbitration friendly, if the national arbitration law and local courts are supportive of the arbitration process and will not interfere with arbitration proceedings unnecessarily, and whether it is a signatory to the New York Convention (one of the key instruments in international arbitration that applies to the recognition and enforcement of foreign arbitral awards and the referral by a court to arbitration).

The PPP contract will be part of a wider network of agreements between various parties.<sup>38</sup> Therefore, concerns about the consolidation and joinder related to the Contracts and parties should not be disregarded.

### **Appointing experienced advisers to the public sector**

In emerging and developing countries without PPP track records, appointing reputable, experienced advisors by the public sector is another key to the success of a PPP project. Professional advisers should be used

<sup>37</sup> *Guidance on PPP Contractual Provisions*, page 110.

<sup>38</sup> *Guidance on PPP Contractual Provisions*, page 113.

when their skills will add value to the project's preparation, procurement, and management activities, but the objectives and leadership of the project should remain the public sector's responsibility.<sup>39</sup>

In countries with limited or no PPP experience, the knowledge and experience of a legal advisor, technical advisor, financial advisor, and lead advisor are required. The latter has a relevant role, especially in countries that are new to PPP. A lead advisor assists the government in coordinating the work of all advisers and managing the interface between government officials and the other advisers. Advisers are typically involved at each stage of a PPP project. The advisory budget for the public sector can be refinanced after financial close.

However, the role of local lawyers in the success of a project should not be underestimated. An understanding of local law during the structuring of the project and during negotiations with the host government and local participants requires identification and selection of local lawyers as early as possible in the project. For example, if there are any general prohibitions or limitations under local law, compliance with applicable laws and regulations of each government is an important due diligence item.

Before appointing advisors for implementing and developing a PPP project, there is an initial point zero, at which external and policy advice could be given by The World Bank Group. Its analysts have the capability to respond to the challenges offered by countries with very low technical or institutional capacity or little prospect in approaching PPP projects in the near future. The World Bank Group's private- and public-sector arms respond to the challenges that developing countries face with PPP, mainly by helping them make smart choices about market structure, sector reform, private sector involvement, type of PPP, improvements to the enabling environment, and execution of specific PPP transactions, thus allowing these countries to become more sophisticated and mature PPP markets.<sup>40</sup>

Finally, there are many factors that can restrict the successful implementation and delivery of a PPP project. Government should ensure that a suitable PPP project is one that delivers the most benefits for the costs involved when compared with alternative forms of project delivery.

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<sup>39</sup> Farquharson et al., page 103.

<sup>40</sup> *Overcoming Constraints to the Financing of Infrastructure*, page 4.