Public Private Partnerships

Osgoode Certificate in Construction Law
20 November 2012

Timothy J. Murphy
Chief Marketing Partner
tim.murphy@mcmillan.ca
Outline

1. Different P3 Models
2. Typical DBFM Transaction Structure
3. Analysis of Risk from a Lender’s Perspective, & Ways to Mitigate These Risks
4. Special Issues for Contractors: Things to be Aware of, & How P3s Differ from CCDC Deals
What is a P3?

1. Use of private capital for public assets
2. Clear output specifications focus
3. Design and operation innovation
Why use a P3?

- Value for money
- On time and on budget
- Investment in asset maintenance
- Transfer of risk
Build-Finance

- Private entity responsible for financing and construction
- Developer secures sufficient financing and works with contractor to arrive at viable construction price and put forward competitive bid
- Public entity pays and takes ownership after construction certified as complete
- A P3 with training wheels
Design-Build-Maintain

• Private entity responsible for design and construction
• Public entity takes ownership after construction complete
• Private entity continues to maintain the facility
  • Ongoing Maintenance Agreement

Design-Build-Finance-Maintain

• In addition to obligations under DBM, private sector also responsible for financing
Design-Build-Finance-Operate (Maintain)

- Private entity responsible for design and construction
- Public entity takes ownership after construction complete
- Private entity continues to both maintain and operate the facility
  - Obligation to operate lasts for duration of concession period – often 30 years +
- Ownership
  - May remain with the public
  - Private entity may own with ownership reverting to the public after the agreement expires
Concession

- In addition to obligations under the DBFO model, private entity also takes on usage risk
Typical DBFM Transaction Structure

- Authority
  - Direct Agreement
  - Project Agreement

- Shareholders
  - Equity Contribution Agreement

- Lenders
  - Loan Agreement
  - Services Contract

- SPV (Project Co)
  - Construction Contract
  - Interface Agreement

- Construction Contractor

- Service Provider
  - Direct Agreements
Analysis of Risk from a Lender’s Perspective & Ways to Mitigate these Risks
Structural Risk

• What risks does Project Co. bear?
• Which risks are not passed down to a third party?

• Objective: identify which risks are borne only by Project Entity (if any) and which are borne/mitigated via third party support

• Actions: perform detailed analyses of:
  • Project Agreements & Related Contracts
  • Entity considerations
  • Tax considerations
  • Insurance considerations
  • Third Party support
Project Party Risk

Equity Providers
- How much are they contributing?
  - Actual $ 
  - Debt to equity ratio 
- What financial resources are possessed and available?
- How committed are they?

- Actions:
  - Review/analyze financial statements 
  - Review/analyze ability to deal with reputational risk
Construction Contractor

- What financial resources available? Parent Co. support?
- Limitation of liability?
- Third party support?
  - Bonding & subguard
  - Reserves
- Liquidated damages
- Bid price/contingencies
- Technical Advisor review
  - Contractor capabilities
  - Timeline
  - Construction price
  - Contingencies
Key Construction Contract Terms

- Full design and construction risk pass down
- Fixed completion date
- Fixed price
- Liquidated damages
- Security for performance
  - Bands
  - Reserves
  - PCG’s
  - 4C
Key Construction Contract Terms

- Limitation’s on contractor termination rights
- EPR
- Large liability caps and exceptions
  - No insurance
  - Subcontractors
- No/few rights to claim time or money
- Sub-contractor review and sign-off
Service Provider

• Technically capable of performing?
• Financial resources available? Parent Co. support?
• Limitation of liability?
• Third party support?
  • Bonding & subguard
  • Reserves
• Lifecycle obligations
• Technical Advisor review
  • Contractor capabilities
  • Services price
  • Contingencies
Counterparty Risk

- Crown or a Crown agency?
- If not, is there Crown funding or Crown financial support?
Asset Risk

• If the asset is damaged or destroyed, who bears this risk?
  • Construction period
    • Insured risks
    • Uninsured risks
  • Operation period
    • Insured risks
    • Uninsured risks
• If completion of the asset is delayed, who bears the risk?
Payment Risk

- Payment mechanism
  - Likelihood of deduction
  - Magnitude of deduction

- Actions:
  - Ability of Service Provider to absorb deductions
  - Debt service coverage ratio
  - Equity Lock ratio
  - Tail
Special Issues for Contractors: Things to be Aware Of & How P3s Differ from CCDC Deals
Back-to-Back Principle

- Obligations are passed down to contractors on terms identical to those under which they were initially allocated to the Project Co. in the Project Agreement

- Contractor will generally be limited to receiving what Project Co. receives
Equivalent Project Relief

• Contractors should be entitled to relief from the Project Co. under the drop-down agreements that is equivalent to the relief available to the Project Co under the Project Agreement

• Drop-down agreement should include comprehensive regime respecting pass-down of relief and benefits available under Project Agreement

• Most Project Agreements will include:
  • Supervening event provisions
  • Indemnification of Project Co. by public sector entity in certain circumstances
  • Compensation on termination
  • Various provisions that make benefits available to Project Co.
Warranty Periods

- Notion of “owner” is complicated in P3 situations
  - Many parties have ownership-type interests
  - Must determine to whom warranty obligations are owed
- Project Agreements contain implied or express requirement that all works meet technical requirements throughout project term
- Project Co. not typically entitled to relief where deficiencies:
  - Need to be repaired during the project term, or
  - Create performance failures during the operational term
- In general, contractor is obligated to Project Co. in the first instance
- Lenders and public entity also have access to Project Co.’s warranty rights via direct agreements and collateral agreements
• Latent defects versus other defects
  • Latent defects: equity sponsor expectation is that contractor liability extends until the expiry of statutory limitation periods.
  • Other defects: Limited warranty period for defects similar to construction industry standards
• Project Co. gives perpetual warranty throughout the term
  • Term usually exceeds standard industry warranty periods
• Equity sponsors want to increase scope and duration of warranties to minimize stranded risk within Project Co.
Construction Liens

- Drop-down of “no encumbrances”
- Definition of “owner”
- Multiple sites
Liquidated Damages

• Where a delay is caused by a contractor, Project Co. and lenders expect to be made whole by contractor during delay
• Drop-down agreements contain obligation to pay *per diem* liquidated damages to Project Co. for delay
• Contractor may have to accept repayment timing risk on Authority delay
• Quantum determined based on a financial model
• Incentive for contractor to adhere to schedule
• Lenders often require additional security for liquidated damages obligations
Interface Issues

- Interface Agreements between Project Co. and contractors:
  - General obligation of cooperation
  - Specific obligations of cooperation
  - Site access regime
  - Project relief provisions regarding disputes between contractors
  - Liability for deductions and set-offs
  - Other provisions as desired by the parties
Indemnities and Liability Caps

- Typically go beyond construction industry practice
- Scope and substance: consistent with back-to-back principle
- Contractors will want carve-outs to remove exposure caused by actions of the Project Co. itself or third parties
- Project Agreements often limits liability to direct losses
  - Contractors will want to negotiate similar limits
- Obligation on Project Co. to pay breakage costs
  - Contractor will have to indemnify if they cause default
- Financial guarantee of debt obligations can affect bonding
Direct Agreements with Lenders

- To mitigate their risk, lenders enter into direct agreements, allowing them to intervene to prevent default termination, with:
  - The public entity
  - Each of the primary contractors
- Key components of a direct agreement:
  - Notice of default
  - Standstill period
  - Step-in rights
    - Upfront consents to assignment or novation
    - Step-out provisions
  - Ability to transfer project to a replacement project company
Questions?

Timothy J. Murphy
Chief Marketing Partner
tim.murphy@mcmillan.ca