To P3 Or Not To P3

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It is widely recognized that there is a critical need for construction of new infrastructure and the repair and maintenance of existing infrastructure. Infrastructure includes a very wide range of projects: highways and toll roads, rapid transit, hospitals, airports, bridges, ports, water and wastewater, energy and power, schools, courthouses, sports and recreation facilities, and downtown revitalization. There are also many other types of "public projects" which involve municipal/ local government, senior government (Provincial/ State or Federal), or government agencies.

The objective of this Article and the PowerPoint Presentation delivered by the Panel on this same topic is to help in-house counsel better understand the various ways that infrastructure projects and other public projects can be structured and whether a public-private partnership is the best model for a particular infrastructure or public project. This Article is organized into four sections: 1. What is a Public-Private Partnership? 2. Is a P3 Structure Appropriate for a Project? 3. Risk Allocation 4. Project Governance and Stakeholders. Appendix "A" contains a list of Resources used to compile this Article and the PowerPoint Presentation. Appendix "B" includes copies of two articles (Appendices B1 and B2) that are referred to in Appendix "A" and which will serve as good background reading for in-house counsel. Appendix "C" contains a sample Risk Allocation Matrix.

What is A Public-Private Partnership?

Spectrum of Project Models

There is a wide spectrum of project models for the delivery of an infrastructure or other public project. On one end of the spectrum would be the "traditional model", under which the public sector maintains ownership of the project asset and prescribes the specifications for what is to be constructed and operated. Most project risk in this model stays with the public sector. One of the criticisms of the traditional model has been that a project is often delivered over budget or later than the agreed upon time for delivery.

At the other end of the spectrum of project models is a "privatization". In a privatization, the public sector transfers ownership of the public assets to the private sector. As the owner of the project asset, the private sector will have control of the asset, subject only to any Agreement that may be entered into between the public sector and the private sector respecting the construction, operation and ownership of the asset. The privatization model has not been widely used in North America.

In the middle of this spectrum are public-private partnerships. There are a wide array of public-private partnership structures in and of themselves. The differentiating characteristic of the various types of public-private partnerships will be the degree of control that the private sector has over the assets. Another important differentiating characteristic of the various types of public-private partnerships is whether "private financing" is obtained.

The Essence of a P3

The very use of the term “partnerships” in the term “public-private partnerships” is misleading. There is no legal partnership between the public sector and the private sector in a public-private partnership. The public sector certainly would not want to be in a situation where there is a legal partnership because that would mean that the public sector could very well be responsible for liabilities incurred by the private sector in the ordinary course of the development or operation of the asset. Instead, the use of the word “partnerships” is more akin to the word “collaboration” and simply refers to the fact that the private sector and the public sector are collaborating on a project and allocating project risks between them. Oftentimes, the term “public-private partnership” is short formed to “P3”.

It important to distinguish between the various types of delivery models and the various type of public-private partnership arrangements. Too often, people describe a particular proposed project as a “privatization”, when it is actually a P3 arrangement. Since a privatization involves the private sector’s ownership of the asset and this may not necessarily be the case (and in fact usually is not) in a public-private partnership, this misunderstanding of the nature of the project can result in opposition to a proposed project simply on the basis of a mis-description of what is taking place.

P3 Project Documents

When a P3 is utilized as a project structure, there is usually an Agreement entered into between the public sector and the private sector and which may be called a “Project Agreement”, a “Concession Agreement”, or perhaps a “Ground Lease”. This Agreement will set out what the powers, responsibilities and duties are of the private sector in the delivery and operation of the project asset. In addition, such an Agreement will deal with insurance issues, indemnification, termination (for default or, possibly, “for convenience”), and dispute resolution provisions, as well as many other detailed provisions. There may very well be project financing Agreements entered into between the private sector and the lender providing project financing. In many cases, the private sector utilizes a “special purpose company” that contracts with the public sector and also contracts with the lender.

In most cases, the public-private partnership arrangement will also include a Design-Build Agreement between the special purpose company and a contractor and an Operations and Management Agreement between the special purpose company and the operator. These two additional project agreements are very detailed documents and the public sector will, in almost all cases, require that its approval to the form and content of these documents be obtained prior to their being entered into.

One of the important issues to be negotiated between the public sector and the private sector when a P3 is entered into is the term of the Agreement under which the private sector has the rights and responsibilities set out in the Agreement between the public sector and the private sector. Depending on the type of project and how it is structured, the term can range from 15 years to 99 years. To the extent that ownership of the asset is transferred to the private sector during the term of this arrangement, the Agreement between the parties will need to address repair and maintenance responsibilities, so that the asset is returned to the public sector in a state of maintenance and repair that the public sector expects. Even if ownership of the project asset stays with the public sector, repair and maintenance are important issues.

Is a P3 Structure Appropriate for a Project?

Studies to be Undertaken

Prior to undertaking an infrastructure or other public project, it is important for the public sector involved in the project to undertake a business case study. This analysis should assess what particular type of project model would best suit the particular project. Additionally, the public sector should also consider, prior to embarking on the project, what project risks it wishes to retain and which project risks should be allocated to the private sector. The public sector may consider undertaking a “public sector comparator” to assess what the expected cost savings would be by undertaking the project other than by way of the “traditional model”. It is paramount that the public sector consider which particular type of project model will result in “value for money” for the public sector.

Accountability and Transparency

No matter which project structure or model the public sector chooses for the project, the public sector must ensure that the project is carried out in an accountable and transparent manner. The principles of “accountability” and “transparency” are critical to the public sector. If the public sector contracts with the private sector for delivery of a particular infrastructure project, the public sector remains accountable for delivery of the infrastructure. An often-quoted principle in this regard is “you cannot contract out accountability”.

Factors to Consider

Since privatizations are quite rare in North America, the decision for structuring the project becomes a decision whether to undertake the project using the “traditional model” or whether to choose one of the various types of P3s. In making this decision, the public sector should, among other things:

- Conduct a business case that compares the various models that could be used to undertake the project and compare the costs and benefits of each.
- Undertake financial modelling to determine what the appropriate funding and financing options are and what the anticipated costs of the project will be.
- Determine whether the public sector is prepared to transfer at least some of the control over the project asset to the private sector? If the public sector is not prepared to do that, then the private sector will not be prepared to take project risk and a public-private partnership is not the appropriate project model.
- Has a “total life cycle cost approach” been undertaken to the infrastructure project assets?
- Are there are any regulatory or other legal restrictions on the manner in which the private sector can be engaged by the public sector to undertake the particular project?
- What is the impact of the proposed project on current public sector employees and how would they be affected by the alternative ways that the project could be delivered?
- What are the estimated “pursuit costs” under the proposed project procurement and should any compensation be offered to private sector proponents where a Request for Proposals is issued for the project?

Sensitive Sectors

There are certain infrastructure sectors where privatization is extremely unlikely and where there has also been considerable debate about the use of P3s. One of those sectors is water and wastewater. Even though a P3 in the water sector does not mean that the private sector operator would necessarily own the drinking water facility, many people have expressed outrage that the private sector will “own” a city or town’s drinking water under a P3 arrangement. In reality, the private sector operator will usually only operate and maintain the water facility (and potentially construct the facility if it is to be a new facility) with the city or town maintaining ownership of the water facility. It is important, however, to recognize the sensitivity, both politically and among citizens, to a P3 in the water sector.

Risk Allocation

Optimal Risk Allocation

One of the most important areas for the public sector and private sector to focus in on in a P3 is the allocation of project risks between the public sector and the private sector. “Optimal Risk Allocation” occurs where project risks are allocated to the parties best able to handle and manage the particular risks. Optimal Risk Allocation does not occur where the public sector is able to allocate all project risk to the private sector. The result of all project risk being allocated to the private sector is a project cost that is much higher than would be the case if project risks are optimally allocated. When the private sector is required to accept a particular project risk,

the private sector builds the assumption of that risk into the cost that the private sector charges for undertaking the project. The public sector's approach to risk allocation can vary, depending on the political environment at the time and the level of government involved, and it is important for the private sector to be aware of this in order that the appropriate risk allocation is achieved.

Risk Allocation Matrix

It is not easy to allocate project risks. Appendix "C" to this Article includes a sample Risk Allocation Matrix that lists numerous project risks. A Risk Allocation Matrix is utilized to determine which of the parties ought to bear the risk that is set out. As the Risk Allocation Matrix in Appendix "C" indicates, there are numerous project risks during the various phases of the project. Those risks can include environmental risks, force majeure risks, political risk, the risk of changes in the law, and the risk of increases in cost charged by suppliers and others.

The way in which project risks are allocated will not only impact on the pricing offered by private sector proponents, but will also determine whether the private sector is interested at all in such a project and whether lenders are prepared to provide private financing to the project. When undertaken properly, risk allocation can be a "win-win-win" for all parties concerned, but if it is too one-sided, the project will not be a successful one for at least one of the parties.

Project Governance and Stakeholders

Governance Model

In addition to assessing which risks should be borne by which party, it is important for the public sector and private sector in a proposed P3 project to agree on an appropriate governance model for the project. The governance model will determine how project decisions are undertaken and when approvals are required for particular decisions. The governance model will also be critical when disputes arise between the parties during one of the phases of the project. The particular governance model may depend, in part, on the legal and regulatory framework that applies to the particular project.

Arguments For and Against P3s

There has been considerable debate in North America about the use of P3s in infrastructure and other public projects. In many infrastructure and other public projects across Canada that have been proposed to be delivered using a P3 structure, special interest groups, in particular public sector unions, have opposed the use of P3s for such projects. It has been argued by such groups that the use of P3s results in windfall gains for the private sector, at the expense of the public sector. It has also been argued by such groups that the use of P3s to deliver new infrastructure projects can result in public sector job loss. Finally, it has been argued that P3s should not be utilized because the public sector can borrow the funds necessary to develop an infrastructure project at a lower interest rate than the private sector can borrow such monies through private financing.

On the other hand, many have argued that P3s are an appropriate delivery model for many infrastructure and other public projects. Those favouring P3s have argued that the P3 model will result in the delivery of infrastructure and other public projects "on time, on budget". Many have pointed to cost overruns when the "traditional model" has been used for the construction and delivery of infrastructure and other public projects. Proponents of P3s have also pointed to innovation that the private sector can bring to an infrastructure project when a P3 structure is utilized.

In certain parts of Canada, some municipalities have been wary of using P3s to develop, build, finance, operate and maintain infrastructure and other public projects. In addition to bearing the burden of delivering most of the required infrastructure and having to determine where the funding or financing for the project is going to come from, municipalities are now also bearing the burden of determining which particular model should be utilized. Some municipalities are concerned that, since such projects are delivered in a

“fishbowl” like environment, criticisms from stakeholders opposed to P3s can result in adverse media publicity that can affect the project itself, local politicians, and staff working on the project.

Interestingly, the Canadian Federal Government announced a couple of years ago that its preference was that a P3 structure be utilized when municipalities apply to PPP Canada Inc. (a Federal Crown corporation) for Federal financing for a particular municipal infrastructure project, or that a business case be presented showing why a P3 structure was not used.

Public Sector Champion

When structuring a P3 transaction, from both the public sector’s and private sector’s perspective, it is important that there be a “public sector champion”. This is someone that is involved in the project from the beginning and “shepherds” the project along. For a public sector champion to be successful in his or her role, they must have the respect of the politicians involved in the project, the public sector staff working on the project, and the private sector partner. Looking at successful infrastructure and other public projects, one usually sees that there was an effective public sector champion throughout the project.

Objective Assessment

Clearly, not every infrastructure or other public project should be undertaken as a P3 but, equally clearly, the P3 option should be considered for every infrastructure other public project as part of an overall business case assessment. Much could be gained in North America from a thorough, fair, balanced and objective analysis of both the successful and unsuccessful infrastructure and other public projects which have used the P3 model and the lessons learned from such projects. Such an analysis would be beneficial to both the public sector and the private sector.

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