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BONDING PUBLIC-PRIVATE PARTNERSHIPS

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Executive Summary

In recent years government spending on public infrastructure projects has tightened as policymakers attempt to reign in the ever-increasing national debt. As a result, Public-Private Partnerships (PPPs) have gained traction as a method of confronting the nation's growing infrastructure challenges. More commonly used outside of the United States, PPPs are contractual arrangements formed between public agencies and private sector partners allowing for private participation in public projects.

The allure of PPPs is that they offer a solution for sharing risk between the public and private sectors and provide a way to move forward with important projects when there were thought to be no feasible alternatives.

In addition to several sectors of the U.S. federal government, many states and local municipalities have passed state enabling legislation allowing them to utilize a PPP approach. The allure of PPPs is that they offer a solution for sharing risk between the public and private sectors and provide a way to move forward with important projects when there were thought to be no feasible alternatives. Although interest in PPPs is growing, many hurdles still exist and must be overcome before they are widely accepted in the United States.

By enabling private entities to accept a larger role in the planning, financing, construction, operation and maintenance of public projects, PPPs provide increased opportunities and a steady source of revenue for private sector participants. However, this increased responsibility also comes with increased risks and creates new implications for surety relationships.

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Introduction

Since 2008, the U.S. economy has taken more blows than a prize fighter. It seems as if when one crisis is resolved two new ones take its place. From the credit crisis to the housing crisis to the persistently high jobless rate to potential fallout from the European debt crisis, the list goes on and on.

Historically, the United States has proven a resilient nation, usually bouncing back strongly from economic downturns. While the nation has not fully recovered from challenges unparalleled since the great depression, it has managed to establish and maintain modest growth. Unfortunately, other economic tests are still lurking in the shadows, many of which have not received the same level of attention but nonetheless could have significant consequences for the nation's fragile recovery. One such challenge is its aging and crumbling infrastructure.

A recent USA Today headline says it all, *"USA's creaking infrastructure holds back economy"*, a reality that is becoming more and more apparent. As the U.S. economic engine once again picks up steam, the nation's aging infrastructure will increasingly struggle to handle the load. With many of its highways, bridges, locks, dams, rail lines, ports and airports deteriorating and/or becoming outdated, economic growth is and will continue to be stifled.[1]

This leaves the United States in somewhat of a catch twenty-two. Policymakers and the Federal Reserve continue to attempt to spur economic growth but the nation's infrastructure will likely be unable to handle that growth. It is highly unlikely, however, that the federal government will provide increased infrastructure investment anytime in the near future – especially while lawmakers continue to debate how best to tame the nation's growing federal deficit. Additionally, state and local governments nationwide are facing budgetary shortfalls. As a result, government investment in infrastructure such as highways, bridges, water systems and schools has fallen every year since 2008.[2]

This leaves the country in a quandary that will continue to fuel political and ideological debate. The problem is that this is time the people of the United States cannot afford to waste. As public funding for projects continues to dry due to ongoing fiscal and budgetary constraints, public officials will be left with no choice but to consider alternatives for funding infrastructure improvements that will enable growth without increasing taxes. One solution that has received increased attention is public-private partnerships (PPPs).

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About Public-Private Partnerships

PPPs are not a new concept – only one that is more frequently being considered. While on the surface a PPP is fairly straightforward –join with the private sector to plan, finance, build and maintain projects that have traditionally only been the domain of the public sector. However, public-private partnerships are anything but straightforward. Each project has a unique set of circumstances that often requires a complicated contractual arrangement. Additionally, PPPs are not authorized by every state usually due to the lack of overall knowledge and the expertise necessary to fully protect the public's interest.[2] Both are important issues, and are why it is important for contractors and others who are interested in being involved with PPPs to have some background on their origin, understand their success abroad, how and why they are currently being utilized in the United States, the different categories by which they are being considered, and the challenges that they present.

PPP Origin & Success Abroad

Comparatively speaking, the PPP marketplace in the United States is far less mature than in many other countries. The origin of PPPs goes back to a period that was not entirely dissimilar to today. In the 1970s and 1980s many countries were experiencing increasing levels of public debt. As a result governments began encouraging private investment in infrastructure to reduce some of the burden on the public sector. Initially, this approach was limited to and negotiated by individual project, it was not until the early 1990's when the United Kingdom introduced the Private Finance Initiative (PFI) that a government program was developed establishing a framework for PPPs. Subsequently, PPPs quickly spread throughout Europe, Australia, Canada, South Africa and parts of Asia, all of which have since experienced significant benefits in highway construction, mass-transit development, airports, seaports, hospitals, schools and utilities.[3] Andrew Adams, VP Surety Division, Canada at Chartis Insurance explains, "the Canadian marketplace took the United Kingdom PFI model and expanded on it. As a result, the PPP market in Canada is quite mature and increasingly complex."

The United States and PPPs

Traditionally, the United States has relied on federal, state and/or local governments to decide, plan, finance, maintain and operate infrastructure projects. However, as deficits have increased and spending has decreased, this has become more and more of a challenge. A closer look at just one sector of the federal government, the U.S. Department of Transportation (DOT), illustrates the overall gap in current infrastructure spending and the projected levels of investment that are actually required to meet the nation's infrastructure needs.

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The recently released DOT conditions and performance report projects that $101 billion per year over the next 20 years would be required by all levels of government simply to keep the highways and bridges in their current state. To make improvements to their current state it would cost as much as $170 billion per year. These estimates are a 48.4 percent increase over the 2000 estimates. President Obama's FY 2013 budget, on the other hand, calls for only $305 billion in highway programs over the next six years– nearly a 50 percent gap in current spending versus additional investment that will still be needed.[4]

According to some estimates, there is approximately $180 billion in available private capital for infrastructure development. Experts believe this number could be significantly higher if the government was more transparent on its willingness to develop true strategic partnerships with the private sector.[5] The government's non-willingness to partner is evident when looking at the numbers: Between 1985 and 2011, a total of only 377 PPP infrastructure projects had been funded in the United States representing only 9 percent of the total PPP infrastructure cost from around the world.[6] Although it is widely agreed that PPPs are not the sole solution to the nation's infrastructure challenges, increased attention should be paid to them by federal, state and local governments in search of a solution.

For state and/or local governments to consider a PPP approach, state enabling legislation must first be passed. These statutes generally transfer power to state agencies allowing them to develop partnerships with private entities for infrastructure projects. The statutes outline the overall requirements of the terms and conditions of the partnership agreement and illustrate the duties of the private entity when contracting with a public entity.[7]

Today, twenty-four states have enacted statutes authorizing PPPs. Many of those statutes allow for PPPs at both the state and local levels. Additionally, 32 states have enacted statutes to establish infrastructure banks that provide the financing of PPP projects in the form of loans, loan guarantees, or bonding. PPPs also are increasingly being embraced and permitted at the federal level including the FHWA, FTA, DOT and FAA to name a few. They were also recently addressed in the Building and Upgrading Infrastructure for Long-Term Development (BUILD) Act (§ 242, et seq. of the American Jobs Act of 2011).

Types of PPPs

Public-Private partnerships fit into one of two categories: brownfield projects or greenfield projects. The contract terms of both projects tend to be similar. Both typically require a long term agreement (usually over 30 years) by which the private sector returns the asset back to public care at the end of the contract term. Both greenfield and brownfield projects will

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usually require a dedicated revenue stream in order to be considered by the private sector. The private entity will expect that an upfront investment will be required by them and therefore will want the asset to provide a method of repayment over the life of the contract.

- A ***brownfield*** project refers to an already existing facility that is transferred to the private sector to handle ongoing operations and maintenance. To date, these have been the preferred project type due to their easily quantifiable risks.[8]

- A ***Greenfield*** project refers to an asset that is newly constructed and newly introduced into public use. To date, greenfield projects have not been considered as frequently as their counterparts. This is because building a new facility also includes the construction risk associated with the project and the uncertainty of exactly how much revenue it will bring in.[9]

Challenges

If PPPs can be part of a solution to the nation's infrastructure challenges, some are asking why they are not more widely accepted. While the answers can depend on who you ask, many would agree that some of the biggest challenges that PPPs face in the United States is the structure of government, the public's concern over cost and the slow adoption by the U.S. insurance and surety market to develop products that fit the PPP model.

An aspect of the U.S. democracy that creates challenges for PPPs is the structure by which the federal government delegates certain powers to each of the 50 states who in turn delegate certain powers to cities and local municipalities. The large number of jurisdictions at all levels of government creates significant hurdles that require great political will, patience and sophistication to overcome. Even if a project receives authorization, there is usually significant lag time between the identification of a need and the final approval to move forward.[10] Anthony Romano Senior Vice President of Chartis explains, "Something has to change if PPPs are going to be more widely accepted but the U.S. political landscape is so mired in bureaucracy that it is not going to happen at the flip of a switch."

Another hurdle is convincing the public that the PPP approach being considered has their best interest in mind. The public often wants to be assured that a PPP will provide them benefits such as delivering new capacity, incorporating new technologies, and meeting new federal, state or local standards.[11] Most importantly, the public wants to be sure that their costs, which are typically paid in fees such as tolls, do not increase in the future.

Lastly, similar to public projects, most public entities mandate that the PPPs guarantee

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results– requirement for financing that is typically addressed with performance bonds. However, PPPs are unique because the private sector plays a larger role in the planning, financing, construction, operation and maintenance of a project. Surety and insurance protection are increasingly more available through a few leading insurers, but the U.S. property/casualty and surety market overall has been slow to develop the necessary insurance and bonding products unique to PPPs. This has created financing challenges for some projects.[12]

Public-Private Partnership Opportunities and Risks

Many types of public projects can be considered candidates for a PPP approach. More and more private equity, institutional, pension fundand individual investors are considering infrastructure as a safe, long-term investment. As a result, private entities, which in this context are referred to as concessionaires, are increasingly looking to enter into PPP agreements for infrastructure projects. The arrangements usually consist of the public entity leasing an asset or land to the concessionaire who will then operate, maintain and/or build it. The concessionaire either contracts with the various project resources and key players, or is structured as a consortium that includes them. Consortium partners can include a developer, designer, financer, construction contractor, operator and maintenance contractor.[13]

Due to the substantial transaction costs typically associated with PPPs, larger and more complex projects are usually preferred. Projects most frequently considered are toll roads, water and sewerage treatment plants, sewerage outfall tunnels, roadway and other transportation related tunnels, PowerStation's, hospitals, schools, prisons and courthouses.

The government body no longer "owns" the project in a PPP arrangement. Instead the concessionaire is now the project owner. The benefit of this approach to the public entity is that it can transfer much of the project's inherent risk to its private sector partners. As a private entity, the concessionaire will utilize the infrastructure asset in a market driven capacity to regain its initial investment and generate a profit. As a result, project participants' – especially contractors – often are asked to take on expanded roles and responsibilities typically not required for publicly funded projects. With these increased responsibilities also come increased risk for the contractor and, consequently, for its surety. Romano explains, "While more and more insurers/sureties are embracing the opportunity this model represents many contractors are not so keen on the idea of facing bigger exposures as a result of their expanded roles and responsibilities."

Surety underwriters need to have an expanded knowledge base as the contracts have evolved from basic construction contracts to complicated legal transactions

Some of the risks posed by PPP structures with which contractors must contend include:

- When partnering in a consortium, the contractor may be operating in unfamiliar roles, and is at risk of conflicting priorities or poor performance of other partners;
- The structure of the PPP may include long-term maintenance requirements that increase financial and operational risk (if a mistake was made costing out the perhaps-unfamiliar maintenance activities, it is a mistake the contractor may have to live with for decades);
- Funding arrangements can be complex and sometimes less assured, especially if they rely in part on future revenue streams;
- The contractor may be required to make an equity investment in the project or assume significant up-front cost; and
- The contractor and other consortium members may run risks – including reputational risk and the financial risk of project delays – by mismanaging difficult public or government relations and community outreach.[14]

Surety and Insurance for Public-Private Partnerships

As with any large construction project, surety bonding is a requirement in a PPP project. With PPP projects, however, the underwriting process is more complex. Adams explains, "Contracts can easily exceed 1,000 pages and have become more and more complex. Surety underwriters need to have an expanded knowledge base as the contracts have evolved from basic construction contracts to complicated legal transactions". As a result, the contractor should anticipate additional due diligence by the surety, and perhaps even direct involvement by the surety in negotiations of the terms and conditions of the Partnering agreement. Features of PPP projects that contribute to additional risk and, consequently, underwriting complexity include:

- Under some PPP arrangements contractors will not only design and build the facility, they will also operate and maintain the project throughout the term of the agreement. These circumstances create additional risks for the surety due to the extended time that the bonding will be required. Additionally, the surety has liability for activities that are outside the range of the typical contractor functions in a surety agreement in non-PPP projects.
- Public entities often require forms that are very broad and will trigger payment in situations not typical to a traditional performance bond. Among the features demanded by

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some public entities are bond forms that are more akin to a letter of credit or guaranties than a typical surety bond. While this may not be a fundamental risk issue for the contractor, it is a significant factor for the surety, and a key reason for a far more rigorous underwriting process.

- PPP projects often are financed by multiple, diversified sources of funding including public bonds or guaranteed loans, shareholder equity and direct user charges such as tolls. This adds risk for the contractor and complicates the job of the surety underwriter since the ability to control and guarantee adequate funding is less assured.[16]

In addition to bonding, contractors require insurance, as do the other participants in the project. Almost every project will require a project specific, dedicated architects & engineer (A/E) and wrap-up insurance program (e.g., CGL, Builders Risk, and Completed Operations/ Public Liability). All partners including public owners, concessionaires, financiers, investors, loan guarantors, infrastructure banks, design-builders and design professionals will require or seek such coverages. As a result, project participants should seek insurance and surety protection from a carrier with expertise in underwriting their unique risks, combined with experience with PPP arrangements. A comprehensive program is essential in avoiding coverage redundancies and conflicts and to reduce overall costs. A thorough loss prevention program combined with risk management expertise also is critical.

Conclusion

The challenge that the United States faces due to its aging and crumbling infrastructure is real. Without a combination of political will, public support and creativity it threatens to be problematic for generations. While not the silver bullet, PPPs can play a significant role in helping to overcome many of the hurdles that the aging infrastructure presents. A glimpse across the pond to Europe provides a preview of the possibilities that PPPs can offer. Unfortunately, there are many challenges for PPPs to overcome in the United States. The good news is that obtaining PPP specific bonding and insurance protection from a financially sound surety and insurer no longer has to be one of them. ■

This Special Report was written by Josh Bradford, Associate Editor, Advisen Ltd. and sponsored by Chartis Inc.

About Chartis

Chartis is a world leading property-casualty and general insurance organization serving more than 70 million clients around the world. With one of the industry's most extensive ranges of products and services, deep claims expertise and excellent financial strength, Chartis enables its commercial and personal insurance clients alike to manage virtually any risk with confidence.

"We understand the unique contractual obligations of P3 projects, particularly around operational and maintenance risk, during and post construction. In response, you can expect Chartis to develop casualty coverage to address these risks for P3 stakeholders." Tom Grandmaison, Chartis' Construction Casualty Leader

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