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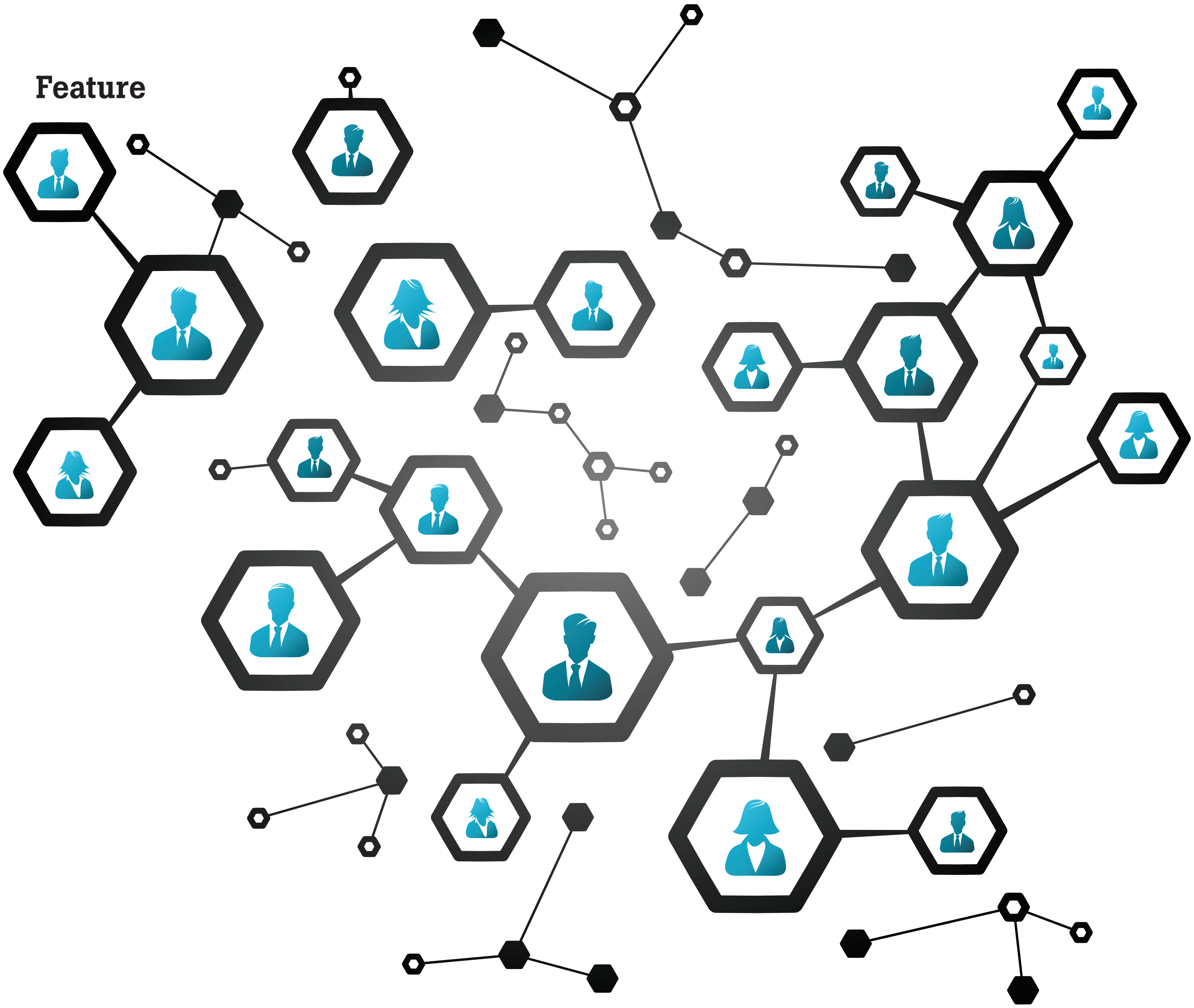

PUBLIC-PRIVATE PARTNERSHIP PROJECTS

BY TODD R. REGAN

Bonding process considerations for bond producers and sureties.

PUBLIC-PRIVATE PARTNERSHIPS (P3s) continue to be a hot topic of discussion, and their use for delivering large, multifaceted infrastructure projects continues to grow in the United States. According to Aon Risk Solutions' *2015 Surety Market Update and Forecast*, there were five closed P3 deals in the U.S. in 2014, with a combined value of $4 billion, and 15 P3 projects in the procurement process in 2015, totaling $15 billion in construction.

Accordingly, bond producers, surety underwriters, and contractors need to understand the particular challenges and risks posed to sureties by P3 projects, both to properly underwrite those risks and to combat the notion that bonds are somehow unnecessary or not properly suited for P3 projects. In order to effectively bond a P3 project, producers and underwriters must have a seat at the table when the P3 partnering agreement is structured to ensure that the bonds meet the needs of the project and the surety's and principal's rights are protected.

THE COUNTRY'S RAPIDLY DECAYING INFRASTRUCTURE AND SHORTFALLS IN PUBLIC FUNDING HAVE MADE P3S, LONG POPULAR INTERNATIONALLY, AN INCREASINGLY ATTRACTIVE MEANS OF PROCURING LARGE INFRASTRUCTURE PROJECTS.

P3s: The background

The country's rapidly decaying infrastructure and shortfalls in public funding have made P3s, long popular internationally, an increasingly attractive means of procuring large infrastructure projects. The American Society of Civil Engineer's (ASCE) most recent "Report Card for America's Infrastructure" gives America's infrastructure a grade of D+ and estimates that a $3.6 trillion overall investment in the county's infrastructure will be necessary by the year 2020. The U.S. Federal Highway Administration estimates that 68,842 bridges nationwide (which is more than 11 percent of the nation's total highway bridges) are currently "structurally deficient." Thus, the need for large-scale investment in the nation's infrastructure is well documented.

In many ways, despite the participation of private players and private financing, P3 projects can be viewed as an alternate method of delivering public works projects. P3s allow government bodies to tap into private sector resources and ingenuity to fund, design, construct, operate, and maintain facilities that benefit the public—facilities that would otherwise have been procured under the typical design-bid-build project delivery system.

P3 projects come in many different shapes and sizes, and a detailed analysis of the potential iterations is beyond the scope of this article. On the highest level, a P3 project will typically involve a public owner or sponsor that enters into an agreement (the partnering agreement) with a private partner (the concessionaire), which is often a special purpose vehicle (SPV) made up of a consortium of private players. The concessionaire typically will also have agreements with lenders and equity investors to finance the project, as well as separate agreements with a design-builder and an entity that will be charged with the long-term operation and maintenance of the facility.

Depending on the structure of the P3, the concessionaire may be responsible for the design, construction, operation, and maintenance of the facility, or one or more of these functions. In return for constructing and operating the facility, the concessionaire may be entitled to collect revenue generated by the completed facility (for example, tolls) or may be entitled to "availability payments," which are rent-like payments received from the public partner based on having the facility in operation for the public use.

Legislative approaches

A particular challenge in the surety underwriting process is the lack of uniformity in P3 enabling statutes on the federal level and from state to state, and even within states for different types of projects (for example, road construction v. school construction). Bonding a P3 project requires producers and underwriters to navigate a labyrinth of differing legislation for any given project. Significantly, only about 34 states presently have P3 enabling legislation, and, of those, only 26 states expressly require payment and performance bonds. To complicate matters further, of those states that do mandate bonds, not all require that the bonds be subject to that state's Little Miller Act. The result is that the producer and underwriter may be faced with a custom, project-specific bond form that, unlike bonds issued pursuant to Little Miller Acts or standard industry bond forms (such as the AIA A312 Bonds), has not been interpreted by the courts and that may not preserve the surety's typical rights and defenses.

Letters of credit

Another concern in bonding P3 projects is that, due to the high liquidity requirements posed by private lenders and investors, sureties may be asked to issue a bond that is more akin to a letter of credit than a traditional surety bond. Delays and missed milestones and completion dates can have particularly significant financial consequences on P3 projects, where the flow of toll money or availability payments is needed to service debt obligations to lenders or to repay equity investors.

Consequentially, there has historically been a preference on P3 projects for letters of credit, which permit the beneficiary to draw down a lump sum of cash on demand in the event of a default. In contrast, performance bonds typically entitle the surety to receive a written declaration of the contractor's default, provide the surety with a period of time to investigate and contest the grounds for default, and give the surety various performance options in order to remedy the default. The desire for liquidity (and to avoid the surety's defenses to performance) has led to the use of letters of credit over surety bonds on P3 projects. Furthermore, because rating agencies have historically given higher ratings to projects that are secured by letters of credit than by bonded projects, concessionaires may be able to obtain financing on more favorable terms when letters of credit are used.

Significantly, according to surety industry representatives, there appears to be some movement of late for rating agencies to accord more credit to surety products than in the past. When bonding P3 projects, producers and underwriters must be wary of efforts to strip the surety's traditional performance defenses from the bond form by turning the performance bond into a demand bond.

Despite the historical preference for letters of credit, there are numerous compelling reasons why P3 projects should be bonded; and NASBP has been on the forefront of this debate. Despite the presence of a private partner, at the end of the day, the project is essentially a public improvement that will ultimately be paid for by public money. Furthermore, when letters of credit are used as security for P3 projects, the penal sum is typically limited to 20 percent of the contract sum. In contrast, the payment bond and the performance bond are each typically in the full amount of the contract value. Consequentially, unlike surety bonds, letters of credit do not guarantee a lien-free completion of the project, nor do letters of credit guarantee the right of laborers and suppliers to be paid for their work. Moreover, sureties prequalify contractors during their extensive underwriting process by closely scrutinizing the contractor's character, capacity, and capital, thereby further ensuring that contractor is qualified to complete the project and lowering the risk of default. Finally, in the event of default, the surety industry possesses the unique knowledge and experience to step in and manage the completion of the project.

Beware of scope and duration

When bonding P3 projects, surety professionals must pay particular attention to the proposed duration and breadth of the bonded obligation. Due to the structure of P3 projects, sureties could potentially be asked to issue bonds covering more than just traditional construction activities. Indeed, underwriters should be wary of efforts to enlarge the scope of the bond to guarantee the concessionaire's financing obligations, as well as the long-term operation and maintenance (O&M) portions of the project.

Care must be taken to ensure that the bonded obligation is limited to traditional construction activities. Oftentimes, the partnering agreement will call for the concessionaire to operate and maintain the facility for 99 years or longer. Certainly, this is not a risk that a construction surety would knowingly take on. One possible solution to this issue is for the surety to issue separate bonds covering the O&M obligations for a limited period of time, subject to renewal on an annual basis at the surety's option. In this manner, the surety can limit the duration of the bonded obligation and avoid an open-ended risk that could run for over a century.

It is also important to ensure that the surety's right of equitable subrogation to use the remaining contract balances to complete the project in the event of default is protected. Under so-called lender direct agreements, in the event of a contractor default, the lender may have the right to step into the shoes of the contractor and take over the project. This, of course, may conflict with one of the surety's most fundamental of rights and must be addressed during the structuring of the P3.

Notably, P3 projects often will use the design-build project delivery method, under which the concessionaire assumes responsibility for both design and construction of the project. The use of a design-build project delivery method raises even more questions for the surety to consider when bonding P3 projects and may increase the surety's risk. Does the performance bond guarantee the completion of the principal's design obligations? Is the surety being asked to insure against design errors and omissions? Does the principal (or surety in the event of default) lose the right to pursue claims against the owner and designers based on incomplete or defective design? Do design subconsultants have the right to assert payment bond claims? These are all additional risk factors that the surety will need to take into account in the process of underwriting P3 projects.

One potential solution is to make use of the Design-Build Institute of America's (DBIA) newly issued performance bond, DBIA No. 620, specifically crafted for design-build projects. As discussed in Bill Quatman's recent article in the Fall 2015 edition of *Surety Bond Quarterly,* the surety community, including NASBP, worked closely with DBIA in the development of new bond forms intended to address the particular issues that arise on design-build projects. Under the new DBIA form, design subconsultants will, as in the past, look first to their E&O insurance coverage for damages caused by design errors or omissions. Only in the event that there are shortfalls in coverage, if the claim is barred by exclusions, or if the policy is depleted, will the surety be liable for the damages caused by design defects.

Another approach, which differs significantly from the approach taken in the DBIA form, is that taken in the ConsensusDOCS 470 Design-Build Performance Bond, which, although it covers the costs of completing the design aspects of the principal's work, expressly disclaims coverage for any damages caused by design defects if the damages in question are of the type that are typically covered under professional liability insurance.

Bonds tailored for P3 projects

In response to the market's demand for liquidity in P3 projects, the surety industry has started to develop bonds that maintain the surety's typical performance bond defenses while adding a liquidity component. For example, Zurich has a developed its "Public-Private Partnership Performance Bond," and XL Group offers a P3 bond called "BuildSecure." These P3-specific bonds commonly have a lower penal sum than typical bonds, usually in the range of 20 to 30 percent of the contract sum. In order to provide liquidity, the bonds incorporate an on-demand feature that requires the surety to make an immediate payment of up to 10 to 20 percent of the penal sum upon the declaration of contract default (the loss mitigation payment). In order to preserve the surety's defenses, the bonds contain a fast-track dispute resolution procedure, whereby claims are submitted to a default review board for an expedited resolution, with all parties bound by its decision. Meanwhile, construction continues while the dispute is pending before the dispute resolution board.

While the use of this new product is in the development stage in the U.S. market, AON reports that the Canadian market has seen more activity with these new products. Their use in both markets is expected to grow in coming years. It should be noted that a surety product with a liquidity component may not be readily available in all surety market segments and requires contractors of a significant size, sophistication, and working capital level. These P3-specific bonds present an innovative approach by the surety industry to the challenges posed by P3 projects, and the surety industry should be applauded for developing surety solutions as procurement evolves.

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