Understanding Public Private Partnerships

Colorado PPP Symposium

November 18, 2010

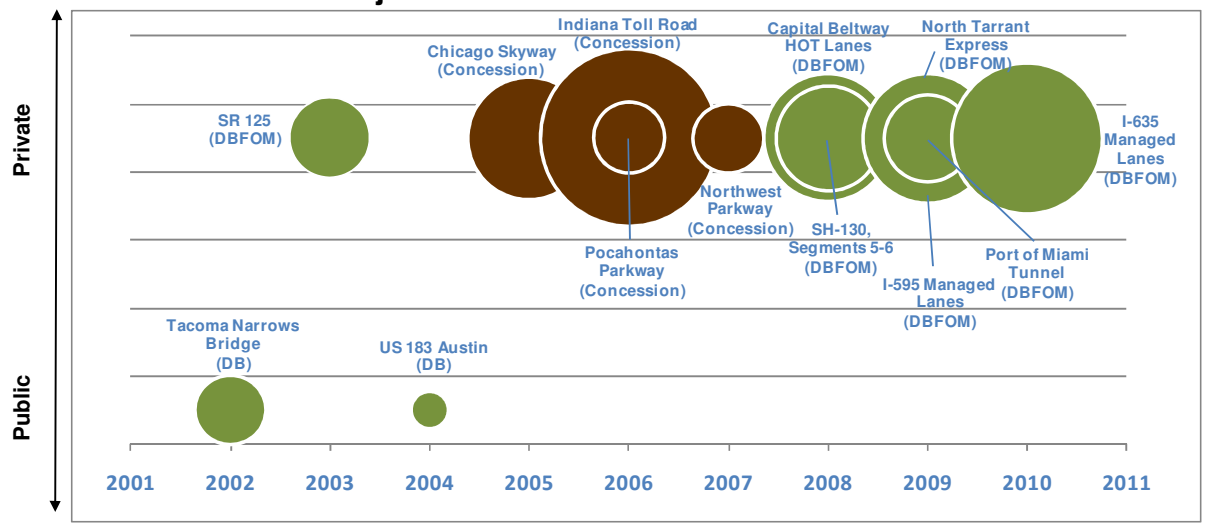
KPMG

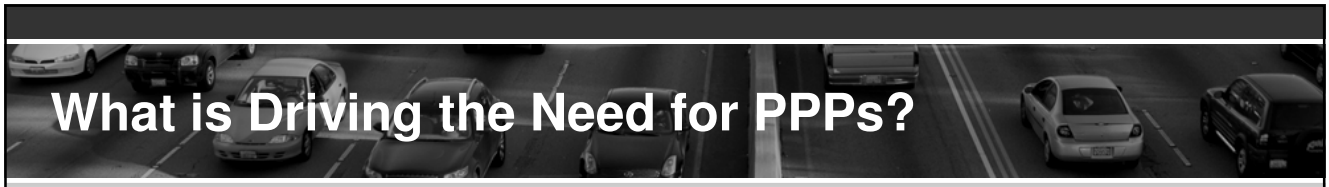
Hogan Lovells

What is a Public-Private Partnership (PPP)?

"A form of project delivery resulting in a contractual agreement between public and private sector partners that allows for more private sector participation than is traditional."

Recent US PPP Projects





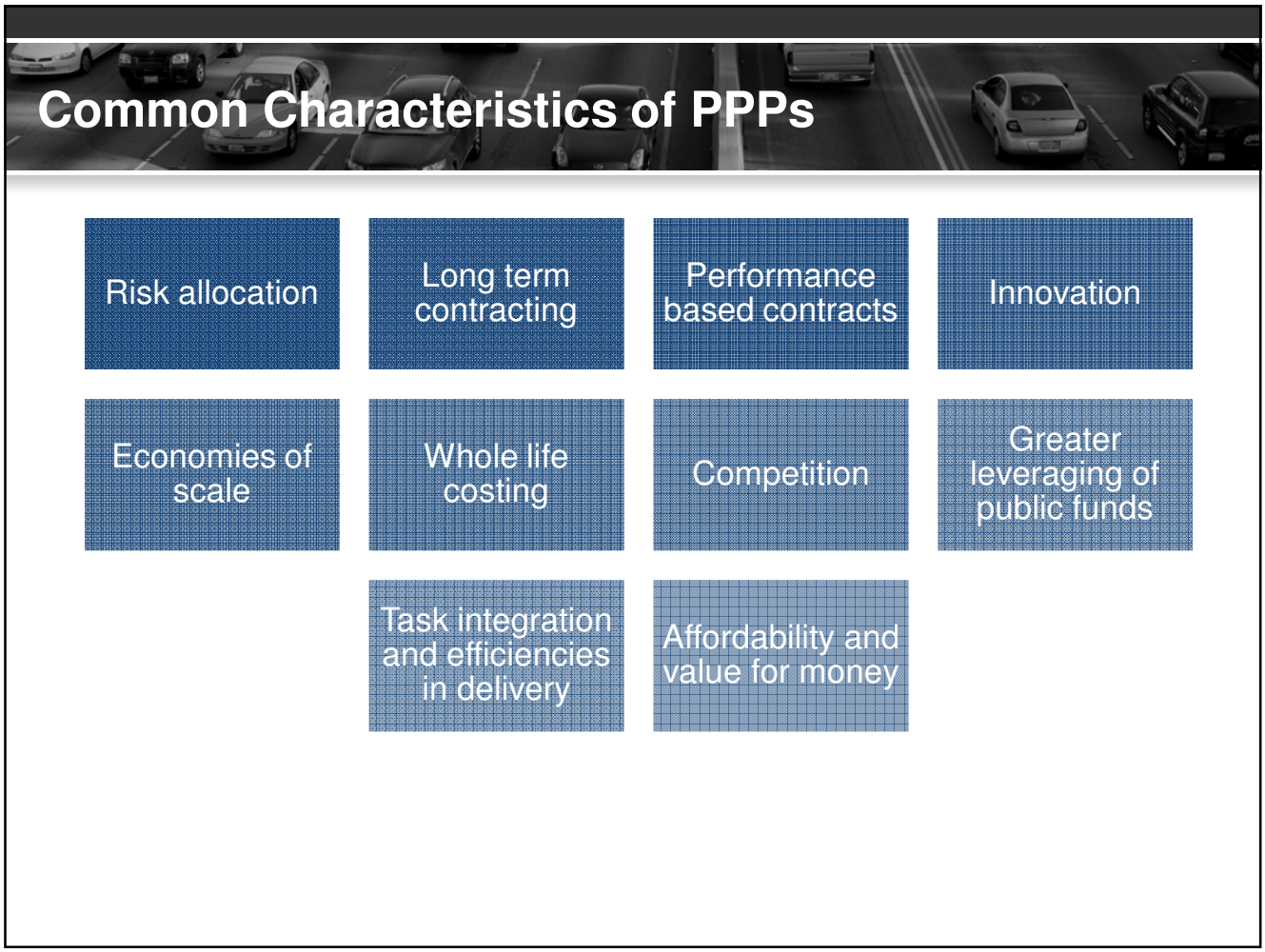
What is Driving the Need for PPPs?

Driving the need

Governments faced with several problems:

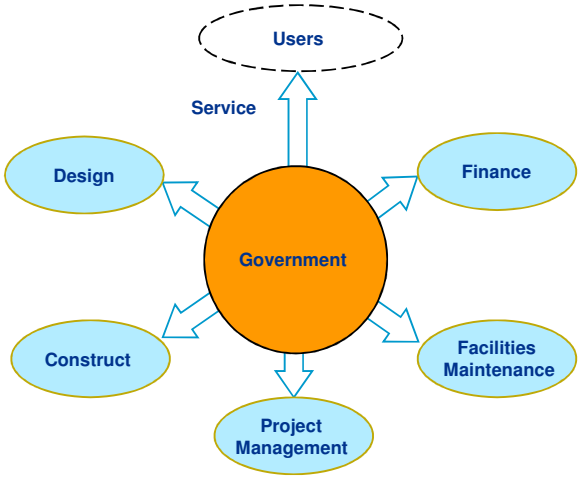
- Aging infrastructure
- Growing population in urban centers
- High level of services
- Construction costs increases
- Budgetary constraints:
  - Slower revenue growth
  - Resistance to tax increases
- Cost overruns and delays in traditional procurements

Meeting the Need

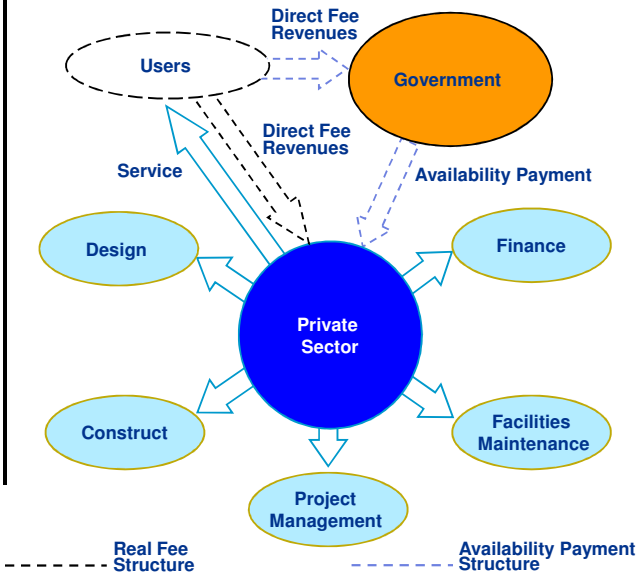

Common Characteristics of PPPs
Risk allocation
Long term contracting
Performance based contracts
Innovation
Economies of scale
Whole life costing
Competition
Greater leveraging of public funds
Task integration and efficiencies in delivery
Affordability and value for money

How are PPPs Structured?

Traditional Procurement Structure



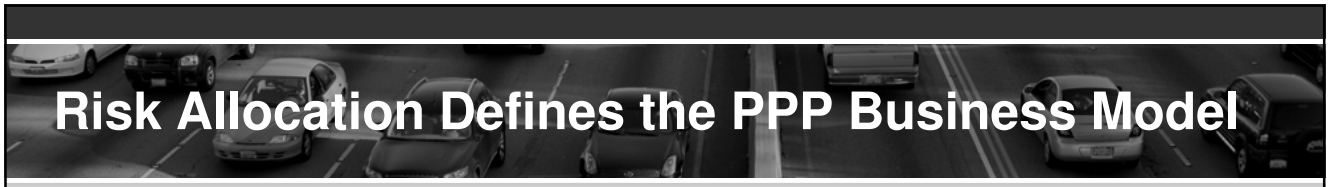
PPP Structure



PPP Business Models

The risk sharing balance should determine the type of P3 used

The PPP model chosen will have a major impact and should reflect careful consideration of the project objectives and the level of risk transfer appropriate for that particular project.

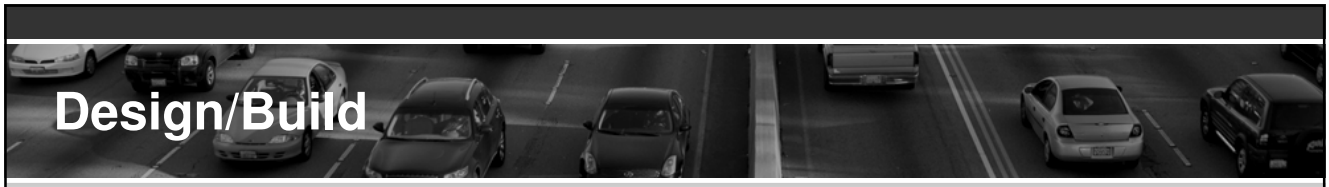


Risk Allocation Defines the PPP Business Model

	Design	Construction	Operate Maintain	Financing	Traffic	Revenue
Design Bid Build (Traditional)	○	○	○	○	○	○
Design Build	●	●	○	○	○	○
Design Build Operate Maintain	●	●	●	○	○	○
Design Build Finance Operate Maintain (Availability Payment)	●	●	●	●	○	○
Design Build Finance Operate Maintain (Shadow User Fee)	●	●	●	●	●	○
Design Build Finance Operate Maintain (Real User Fee)	●	●	●	●	●	●

○ – Risk retained by Public Sector

● – Risk transferred to Private Sector



Design/Build

Designer and contractor hired under single contract

- Selection usually based on best value

Private partner takes majority of design and construction risk

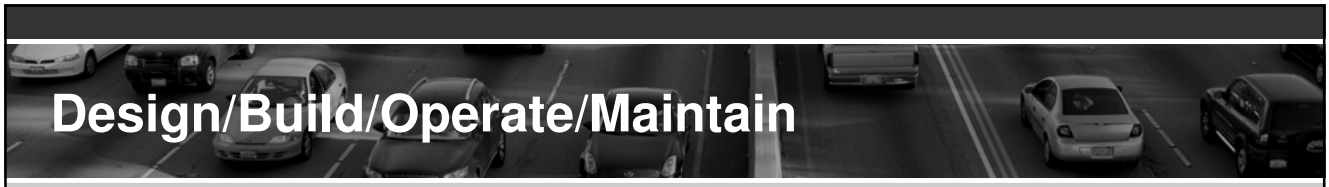
- Introduces private sector innovation
- Greater cost and schedule certainty

Public sector has single point of contact

- Design and construction disputes typically remain between designer and contractor

Public sponsor retains obligation to fund

Public sector retains full operational and maintenance obligation



Design/Build/Operate/Maintain

Similar attributes to Design/Build

Private partner has long term operational and maintenance responsibility

- Acts like an extended warranty

Transfers life-cycle costs to Private Partner

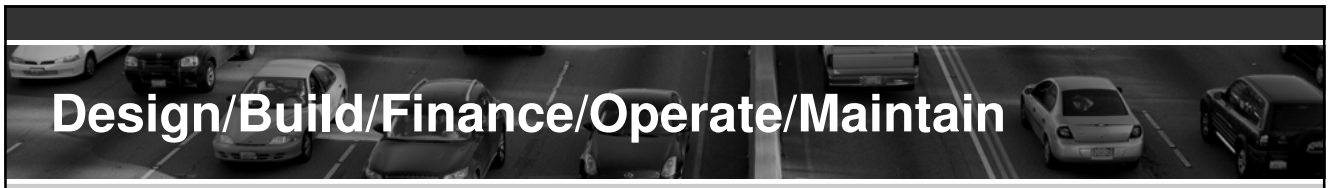
- Balances upfront capital costs v. long term maintenance costs

Public Sponsor responsible for revenue and financing

Maximum term of 15 years

- May be longer if Private Activity Bonds are used

Suited for facilities with specialized operational and/or maintenance requirements



Design/Build/Finance/Operate/Maintain

Similar to DBOM

Private Partner is responsible for financing

Public Sponsor responsible for revenue stream

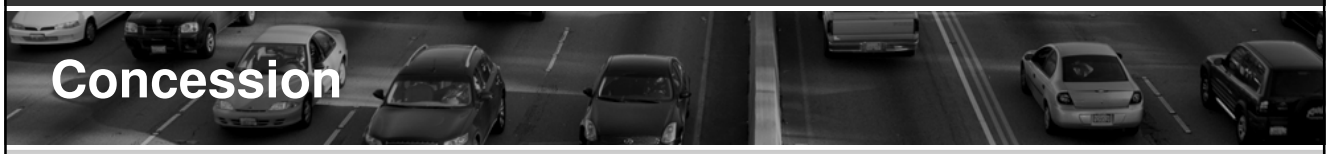
Applicable to both revenue and non-revenue facilities

Also referred to as Availability Payment

- Private Partner required to have facility “available”
- Annual payment is a function of facilities “availability”

Suitability

- Where transfer of revenue risk may not be best value for money
- Transit projects



Concession

Greatest degree of risk transfer to the private sector

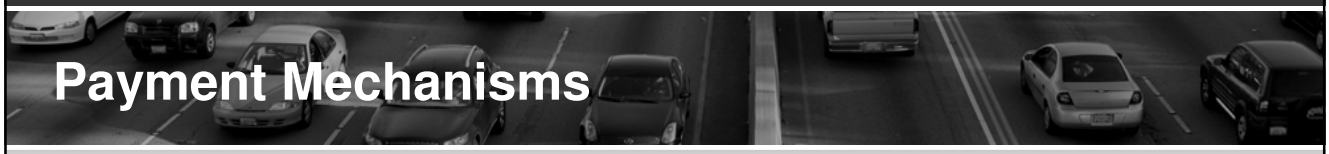
- Design, Construction, Revenue, Finance, Operations, Maintenance, Capital Renewal
- Potentially includes capacity expansions

Public Sponsor retains least control

- Rate Setting
- Operational/Performance Standards

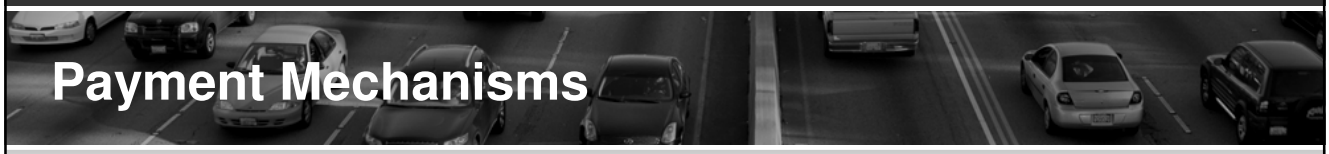
Payments to Public Sponsor

- Upfront payment
- Revenue Sharing
- Unplanned refinancing
- Excess revenue



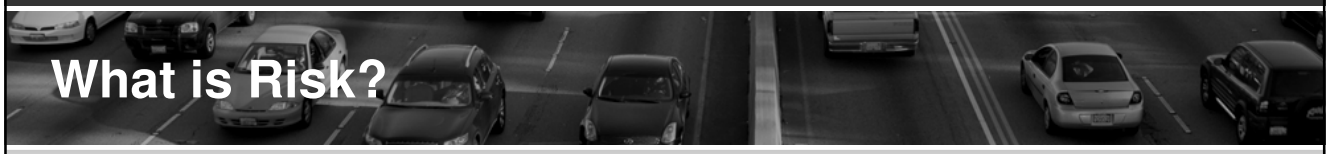
Payment Mechanisms

Payment Mechanism	Description	Advantage(s)	Disadvantage(s)
Real Tolls (Hard toll, HOT, Congestion pricing)	Developer collects tolls directly from the users of the facility	Developer takes risk related to usage, demand and collection of revenue Established direct link between usage and compensation	Public acceptance of real tolls Developer requires higher return because it retains usage and demand risk
Shadow Tolls	Public authority pays the developer a user fee based on the usage of the facility	Developer takes risk related to usage Revenue payments are usually capped	Public authority takes risk related to revenue



Payment Mechanisms

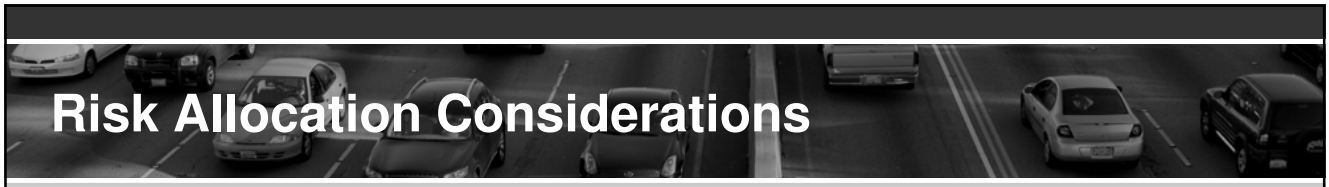
Payment Mechanism	Description	Advantage(s)	Disadvantage(s)
Availability Payment	Public authority pays the developer a periodic unitary payment based on availability and performance of the facility	Availability payment is fixed subject to indexation Deductions to payments for unavailability and poor performance Developer requires lower return due to guaranteed payment stream (subject to deductions) Creates budgetary certainty for public authority (payment does not increase based on usage) Encourages developer to keep facility open and performing to standards	If usage does not meet forecast, then the public bears the risk of a redundant asset/loss of toll revenue Does not incentivize developer to improve service – only operates to avoid payment deductions Public authority must make commitment to long term payments (similar to debt service and O&M outlay)



What is Risk?

Risk is an uncertain event or condition that, if it occurs, has a positive or negative effect on at least one project variable

- Time
- Schedule
- Project or Program Development
- Financing
- Design/Engineering/Construction
- Operations and Maintenance
- Revenue
- Changes in Law
- Termination



Risk Allocation Considerations

Individual project characteristics will drive risk allocation strategy

Risk should be allocated to party best suited to manage the risk

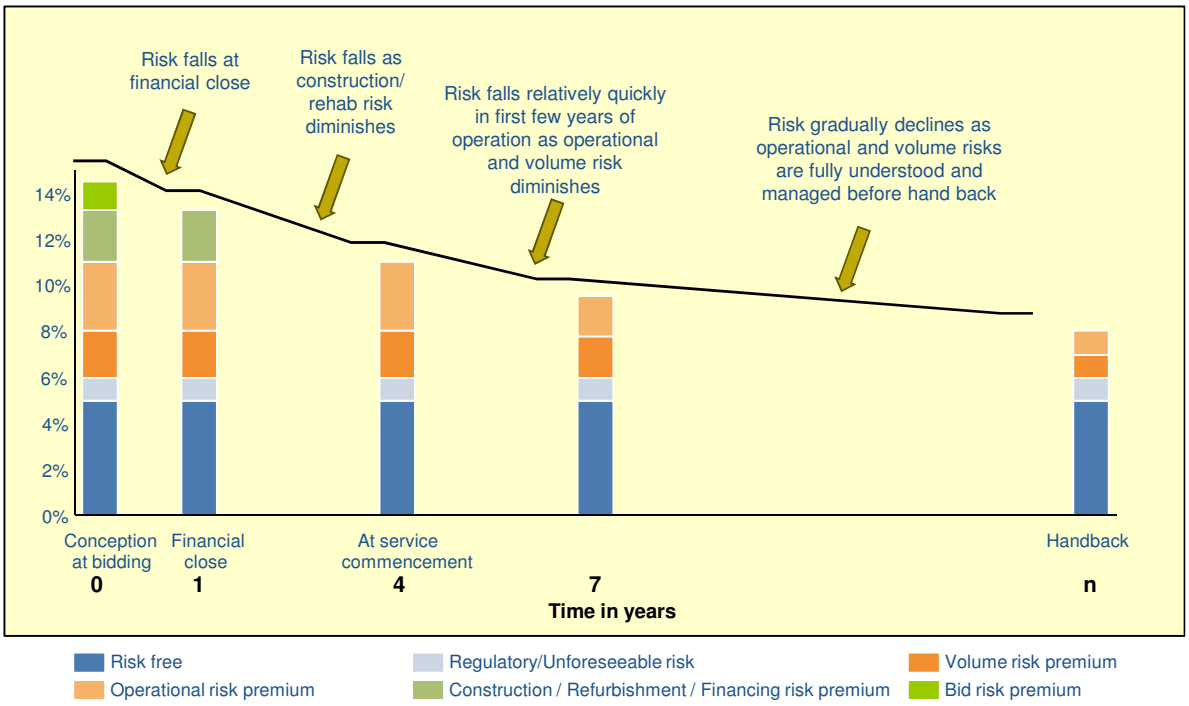
Risks are more often allocated to private sector due to

- strong project control
- ability to spread risk over time
- equity cushion

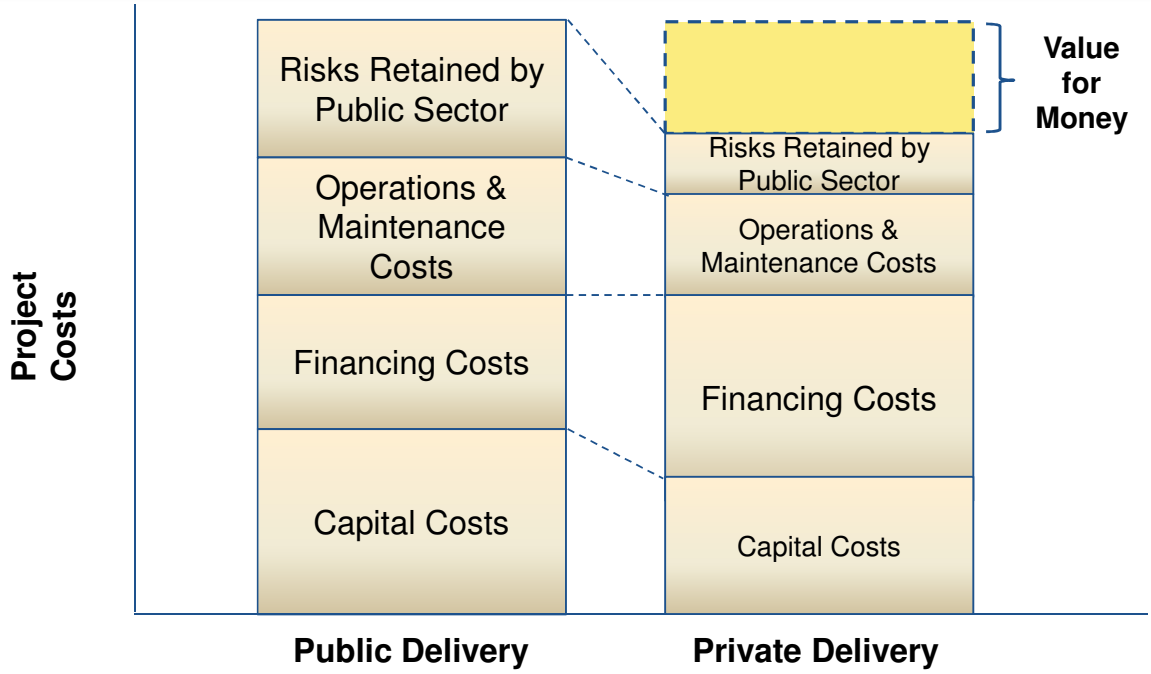
If neither better situated to manage risk, share it

Value for money is maximized by the optimal allocation of risk

Evolution of Project Risk Profile

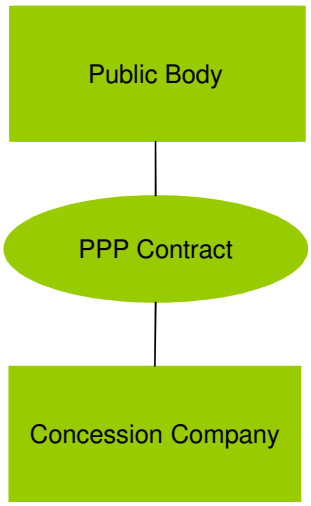


Value for Money: Assessing the value of private participation



Not to scale – illustrative only

PPP Contract Structure



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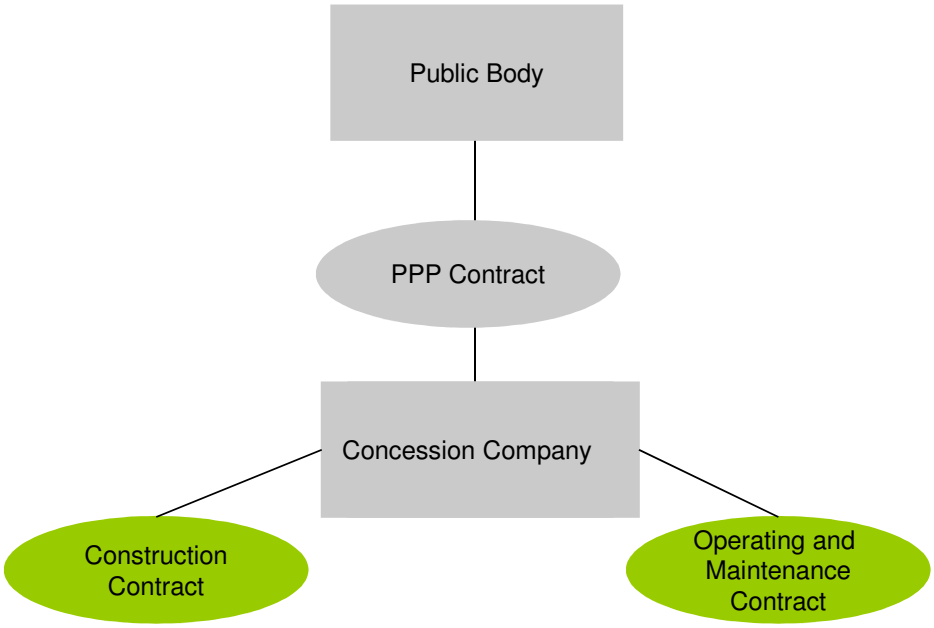
PPP Contract Structure



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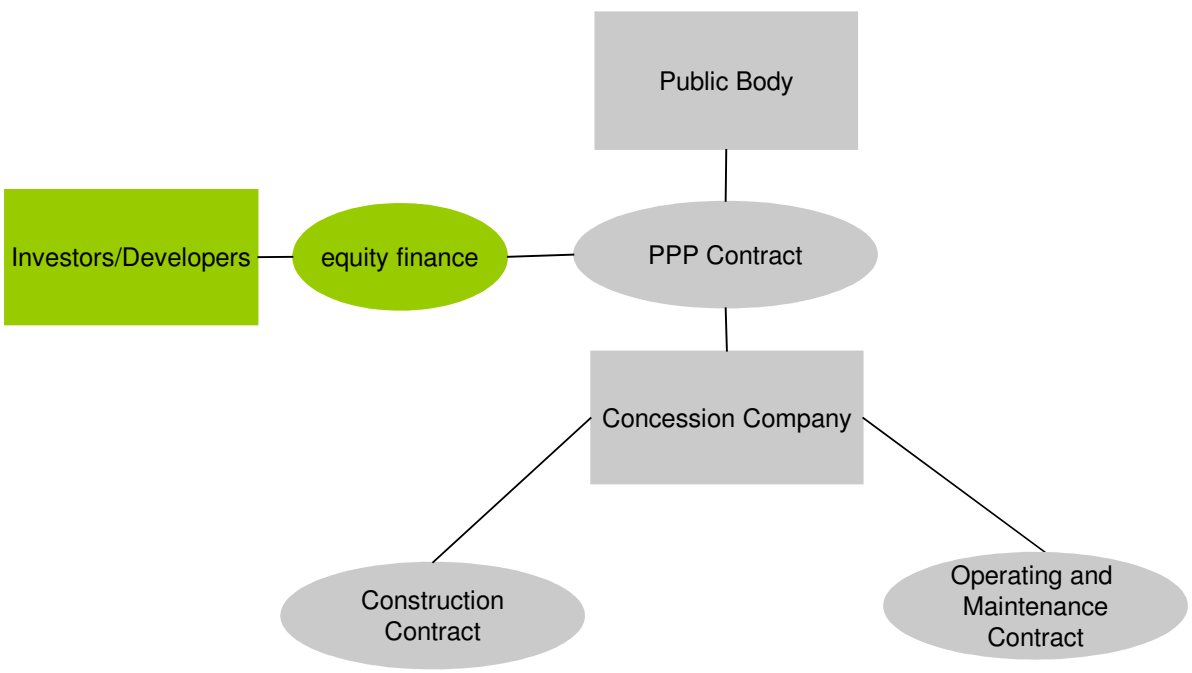

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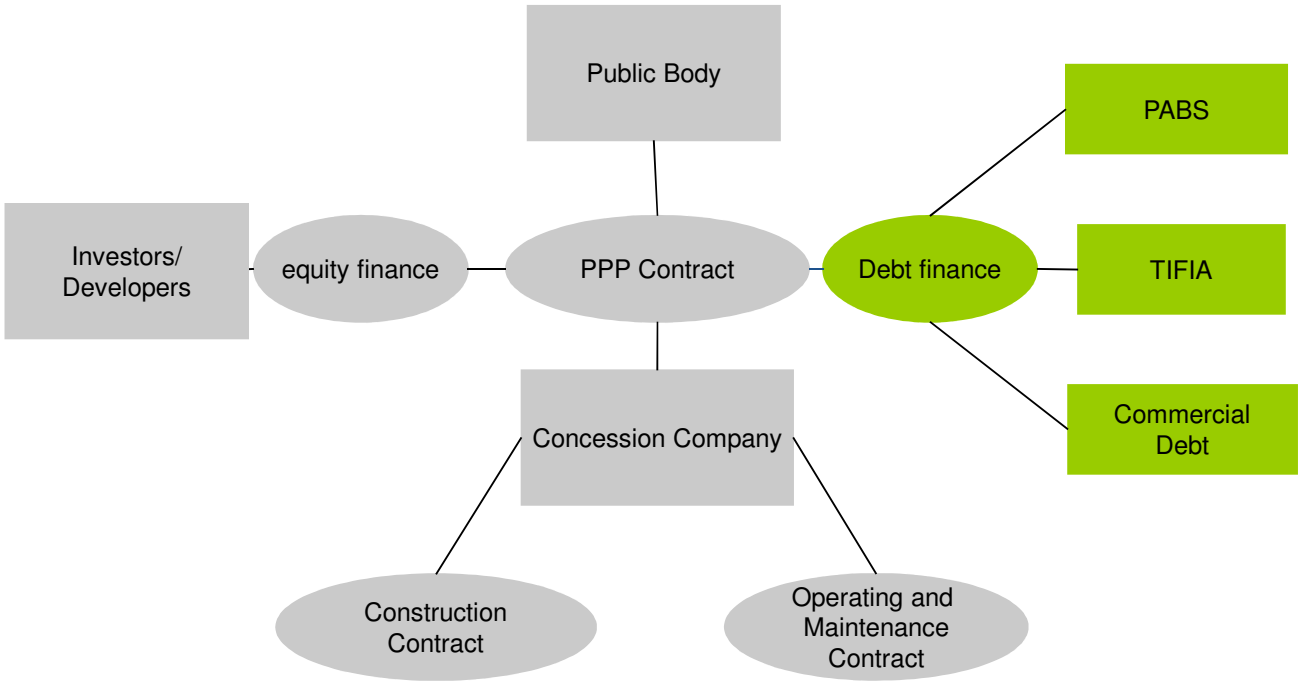

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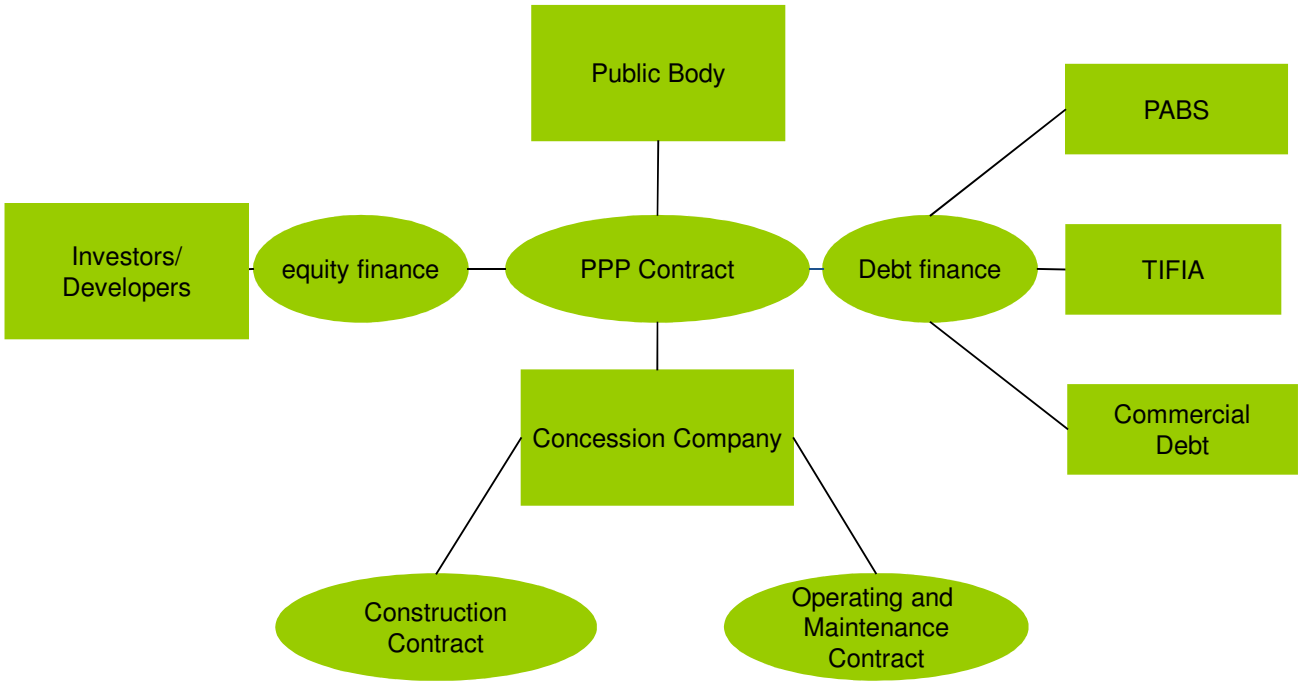
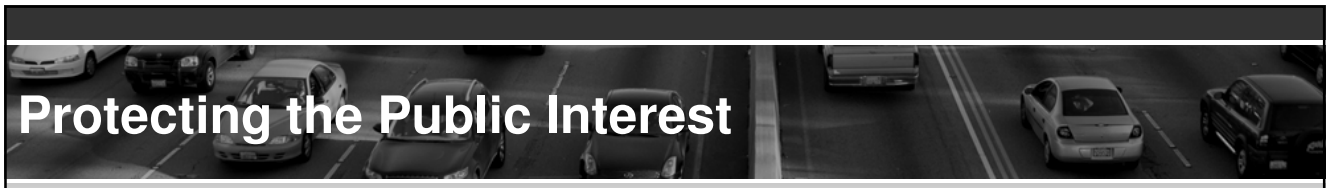
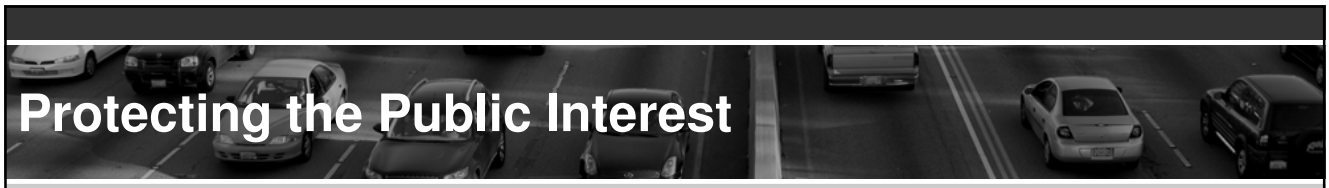




Protecting the Public Interest

When and how could the "public interest" be at risk?

- Setting and controlling fares/tolls?
- Policing excessive returns?
- Responding to poor service delivery?
- Insolvency of private partners?
- Termination of the concession?
- Expiry: What happens to the assets?



Protecting the Public Interest

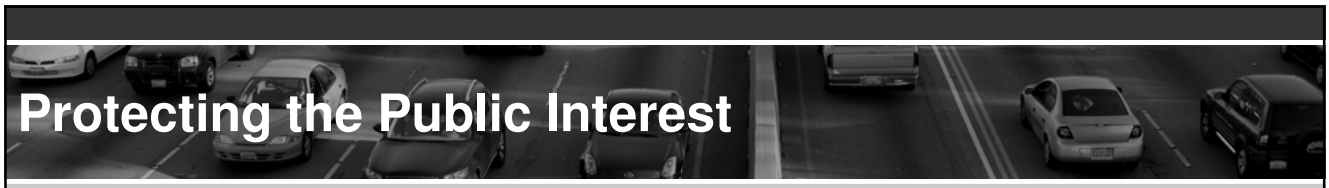
Setting and controlling fares/tolls

- Demand risk with public or private sector?
- Availability payment structures
- With demand risk, balance various factors:
  - degree of freedom to set tariffs
  - policy considerations
  - "value" of the concession to the private sector
- Contractual formula or independent regulation
- Certainty and scope for political manipulation

Protecting the Public Interest

Policing excessive returns?

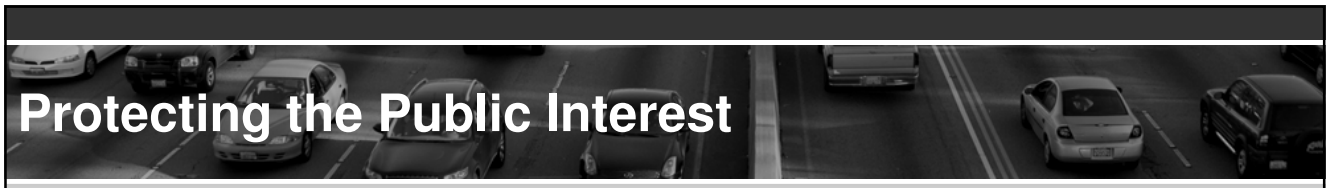
- “Super-profits"
  - deal priced in competitive environment
  - should upside be capped?
- Refinancing gain
  - reduced risk profile after construction
  - reduced risk profile of maturing market
  - public sector share in any gain?
- Equity disposals



Protecting the Public Interest

Responding to poor service delivery

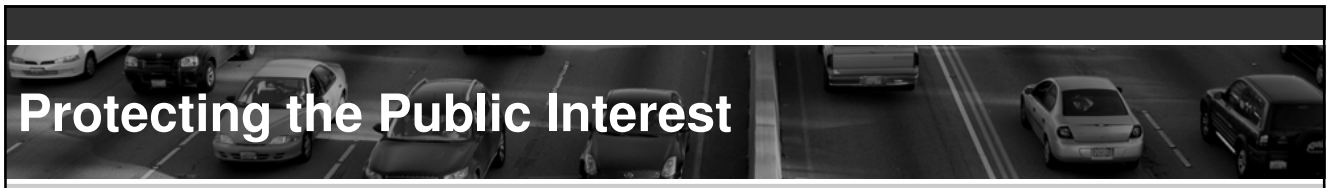
- Calibration and operation of payment tools
- Performance monitoring regime
- Escalation of remedies:
  - warning
  - direct specific action
  - termination
- Step-in and self-help remedies
- Responding to emergency situations



Protecting the Public Interest

Insolvency of private partners

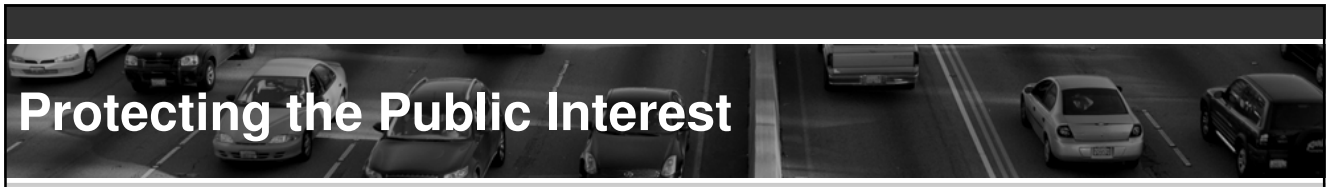
- Concession company:
  - visibility and time to plan
  - commercial debt incentivised to assist
  - ultimate control of assets
  - take in-house or hand to replacement contractor
  - "work-out" most likely in practice
- Sub-contractor:
  - private partner incentivised to manage
  - control over unsuitable replacement
- Provider of finance



Protecting the Public Interest

Termination of the concession

- Ultimate right if service is not acceptable
  - long term inadequate service
  - one-off "material" failure
- Ability to control ownership of assets
- Public sector windfall?
- Compensation to private financiers
  - bankability and cost of capital
  - basis of calculation

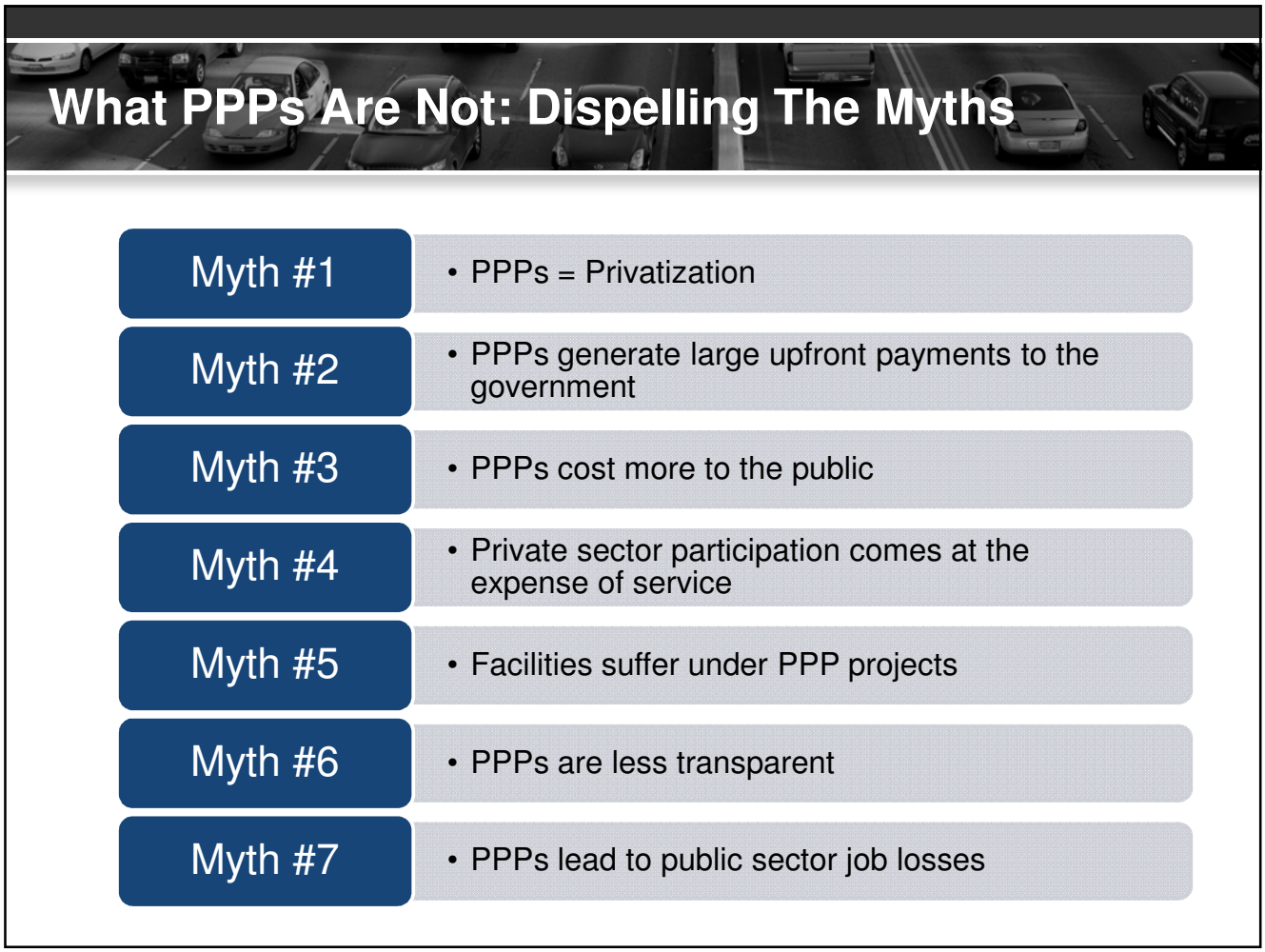


Protecting the Public Interest

Expiry: What happens to the assets?

- Public sector direction
  - decided at the outset
  - option close to expiry
- Main options
  - revert to public ownership
  - private sector retain decommissioning risk/residual value risk
- Asset condition at expiry
  - requirement for specified condition?
  - retentions/reserves in final years of concession


How the Public Sector Can Facilitate Success
Create institutional certainty
Educate the public about PPP's
Prioritize and screen projects
Appoint senior government "champions"
Create a clear decision making hierarchy
Be an effective counterparty with sufficient resources and experienced external advisors
Adopt standardized procurement practices
Clear accountability and transparency of the procurement process
Be prepared to provide credit support to projects


What PPPs Are Not: Dispelling The Myths
Myth #1
• PPPs = Privatization
Myth #2
• PPPs generate large upfront payments to the government
Myth #3
• PPPs cost more to the public
Myth #4
• Private sector participation comes at the expense of service
Myth #5
• Facilities suffer under PPP projects
Myth #6
• PPPs are less transparent
Myth #7
• PPPs lead to public sector job losses

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