

Financing Public-Private Partnerships in the U.S. Private Placement Market

Over the past several years, a number of public-private partnership (“P3”) transactions have been financed in the domestic and cross-border U.S. private placement market. Given the need for new infrastructure both domestically and abroad, we anticipate that the number of P3 transactions entering the U.S. private placement market will continue to rise over the coming years, thereby providing an excellent investment opportunity for many investors. To aide in your investment decisions, the following article provides a brief overview of P3 transaction fundamentals, as well as some of the risks that are often associated with such financings.

P3 Transactions Generally

While there is no single definition of a P3 transaction, in its most basic terms, a P3 transaction can be described as “a long-term contract between a private party and a government entity, for providing a public asset or service, in which the private party bears significant risk and management responsibility, and remuneration is linked to performance”.¹ Throughout the world, P3 transactions provide a framework by which private entities are permitted to provide services and to build, operate and maintain infrastructure assets that are traditionally provided, built, operated and maintained by government entities. These include services and assets associated with transportation, water, sanitation, energy, housing, telecommunication, education, health, and criminal justice, just to name a few.²

For purposes of this article, we have focused on P3 transactions involving infrastructure assets and related services. These assets can be very expensive to build, operate, and maintain and typically require a substantial amount of debt financing. Additionally, the concession agreements for these transactions are typically long term in nature, which can make for an attractive investment opportunity for typical U.S. private placement investors.

Transaction Participants

There are a variety of participants in a typical P3 transaction. Although the participants vary from transaction to transaction, they often include the following:

Government sponsor. This is often a special purpose authority that was created specifically to own and operate the underlying asset and to provide the related services, such as a highway or water authority. In other cases, this entity may be the main governmental body for the particular jurisdiction, such as the State level government in which the asset is located. In certain cases, this may even be a governmental body that has been given the legislative authority to enter into the P3 transaction

on behalf of the entity that owns the asset, such as a financing authority.

Private operator. This party, which is often referred to as the “concessionaire”, is the private entity that provides the service or asset that is the subject of the P3 transaction. For many P3 transactions, the concessionaire will be made up of a consortium of industry participants that have joined together to serve in this capacity, with each bringing to the transaction a particular type of expertise and the wherewithal needed to fulfill the concessionaire’s obligations under the P3 transaction.

Borrower/Issuer. This is typically the concessionaire, but may also be a special purpose financing affiliate created solely to finance the P3 transaction.

Debt lenders. Given the size of most P3 transactions, the lending group will often be comprised of a combination of bank lenders and noteholders. The loans and notes are typically secured by the concessionaire’s rights under the concession agreement and by certain other collateral. As a result, an intercreditor agreement is typically required.

Construction contractors. For greenfield assets, this will be the contractor or group of contractors hired to design and build the asset to the extent the same is not performed by the concessionaire itself. For brownfield assets, this will include any contractors hired to design and build any improvements to the existing assets.³

Operation or maintenance providers. In many cases, the concessionaire will subcontract all or a portion of its operation and maintenance obligations under the P3 transaction to third-party contractors. In other cases, the concessionaire may perform these obligations itself.

End-users. The end-users will be the entities ultimately purchasing or using the output and services from the asset. In many cases, this will be the general public.

In addition to the participants described above, P3 debt financings may also involve a number of other transaction participants, including agents, collateral trustees, equity investors, guarantors, letter of credit providers, equipment suppliers, governmental agencies, utilities, counterparties to other project agreements, title insurance companies, surveyors, independent consultants, legal advisors, insurance companies, real property owners, hedge counterparties, rating agencies, prior lenders, the local community, activists or non-governmental organizations and labor groups.

When lending in connection with a P3 transaction, it will be important to understand the role of each of the participants and any risks associated with their involvement.

The Concession Agreement

The primary contract involved in a P3 transaction is the agreement that gives the concessionaire the right to perform the various tasks that have been delegated to it by the government sponsor and, importantly, the right to collect revenues in exchange for properly performing such tasks. Such agreements are commonly referred to as “concession and lease agreements” or simply “concession agreements”.⁴ At minimum, the concession agreement will include the following terms and conditions:

The parties’ responsibilities. Generally, the concessionaire will be responsible for all activities not expressly reserved by the government sponsor. For greenfield assets, this typically includes the obligation to design, construct, finance, operate, and maintain the asset. For brownfield assets, this typically includes the obligation to operate and maintain the asset (and potentially to perform certain improvements to the asset over time).

Risk allocation. Generally, the concessionaire will bear all risks associated with the asset and/or services other than certain risks that are expressly assumed by the government sponsor. The types of risks assumed by the government sponsor are typically limited to risks that are within the government sponsor’s (or an affiliated government entity’s) control, such as changes in law impacting the asset or services. However, the government sponsor may also agree to assume certain risks that are simply too much for the concessionaire to bear at a reasonable price, such as the risk that the entire asset will be destroyed by an event for which the concessionaire cannot purchase insurance.

Compensation. As discussed in more detail below, the compensation paid to the concessionaire will vary depending on the particular type of P3 transaction.

Stated term and early termination rights. Depending on the jurisdiction and type of asset or service, the term of a P3 transaction often lasts between 20 and 99 years. In addition, a concession agreement will typically provide the government sponsor with a right to terminate the concession agreement

early, including, in certain cases, a right to terminate for convenience, due to a force majeure event or due to a breach by the concessionaire. As discussed below, the concession agreement will specify whether a termination payment is required to be paid in such circumstances.

Performance standards. In almost all cases, the concessionaire will be required to design, build, operate, and/or maintain the asset in accordance with some minimal level of performance standards. In addition, most concession agreements will include a detailed set of performance indicators that will be used to verify whether the concessionaire’s performance during any period satisfied these minimum standards.

End of term. Most concession agreements will include a detailed set of handback requirements that will set forth the concessionaire’s obligations at the end of the P3 transaction, including any steps the concessionaire must take to correct any then-existing, nonconforming conditions related to the asset or service.

In addition to the foregoing, concession agreements will include other standard contract provisions, such as insurance requirements, events of default, and indemnification provisions.

Compensation

There are two primary alternatives by which a concessionaire will be compensated under a P3 transaction. The alternative that is used will depend largely on the type of asset or services being provided.⁵

Revenue Based Compensation

For assets or services that generate significant revenues, such as toll roads, the concessionaire’s compensation may be based directly on the amount of revenues generated by the asset. In such cases, the concessionaire will be entitled to keep all, or a significant portion of, these revenues.

Under this type of structure, the concessionaire will bear the risk if revenues are lower than expected and will reap the benefit if revenues are higher than expected. Consequently, the concessionaire will be highly motivated under this type of payment structure to attract as many end-users to the asset and related services as possible, while at the same time minimizing all costs and expenses related thereto.

Availability Payments

For assets or services that may not generate significant revenues, such as a courthouse, the concessionaire’s compensation may be based exclusively on availability payments. Under this structure, the government sponsor will be obligated to make periodic payments to the concessionaire so long as the concessionaire (i) makes the asset and related services available to the government sponsor and/or

end-users, as applicable, and (ii) the asset and related services satisfy the minimum performance standards. The availability payment is typically sized and structured with the intention to cover the costs incurred by the concessionaire in performing its obligations under the P3 transaction (including debt service), as well as some level of profit.

For assets that are intended to produce a certain output (such as a water facility), the availability payment may be coupled with a production payment that will compensate the concessionaire for additional costs that will be incurred if the asset is operating and producing its intended output. By structuring payments in this fashion, the government sponsor can avoid paying production-related costs during times when the asset is not needed and/or is sitting idle. During such times, the concessionaire will nevertheless continue to receive the availability payment so long as the minimum performance standards have been satisfied.

The Risks — From a Lender's Perspective

Of course, the primary question for any lender when considering whether to invest in a P3 transaction is whether the underlying loan will be repaid when due. The answer to this question will require an in-depth review of the economics and the structure of each individual transaction. However, there are certain risks that are common to many P3 transactions, including the following:

The Government as a Counterparty

Whenever a government entity is a party to a transaction, there are certain fundamental issues that should be considered. These include the question of whether the government entity has the capacity and authority to enter into the concession agreement, whether the concession agreement is binding on such government entity, and whether payments due by the government entity are subject to appropriation risk.

Appropriation risk is a risk that is inherent to virtually all P3 transactions. In brief, it is the risk that the underlying government sponsor will not appropriate (*i.e.*, budget and set aside) funds in any particular fiscal year to pay its obligations under the concession agreement. If it fails to appropriate funds, there likely will not be funds available to make payments under the concession agreement. This includes not only periodic payments to the concessionaire, such as availability payments, but also includes one-time payments such as termination payments, indemnification payments, and payments in satisfaction of court judgments. The extent to which appropriation risk exists in a transaction will depend on the terms and conditions of the concession agreement, the identity of the government sponsor and the jurisdiction in which the P3 transaction is located.

In most cases, the only way to analyze the issues that arise when contracting with a governmental entity is to review the legislation (or in some cases, the constitution) that created the

government entity that is party to the concession agreement, as well as other laws of the jurisdiction in which the government entity is located (including applicable case law). Even then, the answer to certain of these questions may not be clear. For example, there have been a number of cross-border P3 debt financings over the past few years where the appropriation risk was generally viewed to be similar to that which exists when dealing with certain governmental counterparties in the United States. However, there was very little precedent and/or case law in those jurisdictions regarding the failure of a government entity to appropriate the necessary funds under a contract. As a result, lenders had relatively little guidance on how a failure to appropriate would actually play out in the courts and in the legislature.

If the law is unsettled in relation to appropriation risk, a lender's decision to invest in the P3 transaction may be based largely on the government entity's reputation and the lender's assessment as to the likelihood that the government entity will honor its obligations under the concession agreement. One indicator as to whether a government entity will be likely to honor its obligations under a concession agreement is the number of P3 transactions that have been executed by the government entity (or its affiliated government entities), as well as such government entity's plans to enter into future P3 transactions. If the government entity is active in the space, it may be less likely to intentionally default under a concession agreement, knowing that any such default will harm its reputation and its ability to enter into these types of transactions for years to come.

Scope of Collateral

It is critical to understand that, in most P3 transactions, the underlying asset is not owned by the concessionaire. Rather, the concessionaire simply has a right or license to use the asset and to provide the related services during the term of the concession agreement.⁶ In some cases, the concessionaire will take ownership of the assets during the term of the P3 transaction. However, even in those cases, the government sponsor will typically have the right to repurchase the asset once the transaction terminates. Thus, the concessionaire will be precluded from encumbering the asset in any way that could impair the government entity's repurchase right.

Consequently, the collateral package that will be available to the lenders in a P3 financing will typically be limited to the equity interests in the concessionaire and the concessionaire's rights under the concession agreement. In almost no event will the lenders be able to foreclose on the underlying asset itself. In fact, in most cases, the government sponsor will explicitly retain a first priority security interest in the underlying asset, which means the debt lenders may be precluded from exercising any rights with respect to their collateral package if the same will impact the rights of the government sponsor.

Fortunately, in many P3 financings the government sponsor will enter into an intercreditor agreement with the debt lenders to clarify the lenders' rights in a default situation. This often includes an agreement by the government sponsor not to exercise certain of its priority rights so long as the debt lenders are attempting to cure a concessionaire default. However, these types of provisions typically vary significantly between P3 transactions and are often highly negotiated. Therefore, lenders will need to closely review these provisions and assess any associated risks.

Termination Risk

Under most P3 transactions, the government sponsor will have the right to terminate the concession agreement for a variety of reasons, including as a result of a concessionaire default, the concessionaire's abandonment of the underlying asset, extreme damage or destruction to the asset due to force majeure type events, changes in law, or the concessionaire's bankruptcy. Many concession agreements will also allow the government entity to terminate the agreement for convenience.

The government sponsor's termination rights are often coupled with an obligation for the government sponsor to make a termination payment to the concessionaire. However, such payment often varies depending on the reason for termination. For example, the termination payment for one type of termination could be based on a fixed amount, the termination payment for a different type of termination could be based on the amount of outstanding debt, and the termination payment for a third type of termination could be based on the fair market value of the concession agreement at the time of termination. For certain other types of termination, such as termination due to abandonment, there may be no termination payment at all. As a result, lenders will need to carefully evaluate the circumstances under which the government sponsor may terminate the concession agreement and the adequacy of any termination payments to repay any outstanding debt. We also highlight that, if there is a termination payment, lenders will need to consider whether the termination payment will be sufficient to pay any contemplated premiums or make-whole amounts.⁷

In our experience, most concession agreements contemplate that the concessionaire will obtain third party debt financing and contain provisions that are designed to provide lenders with certain protections related to terminations, including step-in and cure rights if the concessionaire has breached the concession agreement and the right to replace the concessionaire in the event of a default. However, these provisions may not exist (and will certainly vary from transaction to transaction) depending on the structure and on the government entity involved.⁸

Sources of Revenue

As is discussed above, under a typical P3 transaction, the concessionaire is compensated through either the revenue

generated by the asset or availability payments. Regardless of the method of compensation, lenders will need to consider whether such revenue stream will be sufficient to pay debt service and the circumstances, if any, under which such revenue stream may be interrupted. With respect to revenue based compensation, one of the biggest risks is that volumes (e.g., traffic) will be lower than projected, or that the asset will be unavailable for a period of time and, therefore, unable to generate any revenues at all. With respect to availability based compensation, one of the most significant risks is that the concessionaire, or its contractors, will fail to perform the concessionaire's obligations under the concession agreement in accordance with the required standards, which may give the government sponsor the right to reduce the availability payments made to the concessionaire.⁹ If either of these situations were to occur, there may not be sufficient revenues to pay debt service.

Please also see the discussion above concerning the risk that the concession agreement may be terminated by the governmental entity under certain circumstances. Depending on the termination amount that is payable by the governmental entity in such case, if any, there may be a shortfall in cash available to repay indebtedness if the concession agreement is terminated.

Risk Allocation

As discussed previously, the concession agreement will typically allocate various risks between the concessionaire and the government sponsor. For example, a concession agreement may allocate the risk of damage or destruction to the asset based on the amount and/or cause of the damage. In situations where the damage would be very expensive to fix or if the cause of the damage is uninsurable, it may be necessary to increase the compensation paid to the concessionaire in order to offset that risk. However, where such an increase may not be economically feasible, the government sponsor may simply elect to assume the risk rather than pay the increased price. Lenders will need to understand how each of the various project risks have been allocated and, importantly, how this risk allocation could impact the concessionaire's ability to pay debt service.

Contractor Exposure

In many cases, the concessionaire will subcontract all or a portion of the construction, operation, and/or maintenance of the underlying asset to a third party contractor. In most cases, these subcontracts will simply pass through to the subcontractor all or a portion of the concessionaire's obligations under the concession agreement, as well as a portion of the payment the concessionaire is entitled to receive under the concession agreement.

If any of the concessionaire's obligations under the concession agreement have been delegated to a third-party contractor, it is important for lenders to identify any potential gaps between the

concessionaire's liability under the concession agreement and the subcontractor's liability under the applicable subcontract. If the subcontractor's liability is less than that of the concessionaire's, the lenders will need to understand how the concessionaire will make up any such deficiencies.¹⁰ Of course, lenders will also need to evaluate the underlying creditworthiness of any such subcontractors.

Intercreditor Considerations

Given the quantum of debt involved in a typical P3 transaction, the borrower/issuer will often access the bank market and the U.S. private placement and/or other capital markets for financing. In certain cases, there may also be both senior and subordinated indebtedness. As a result, there is typically an intercreditor agreement that governs the rights of the various creditors with respect to the collateral. The intercreditor agreement will specify the voting regime that will apply to enforcement and certain other matters involving the collateral (including, in certain cases, matters relating to lender consents under the concession agreement). In addition, the intercreditor

agreement will typically specify a pre- and post-enforcement priority of payments "waterfall" specifying how collateral proceeds are to be allocated among creditors and other transaction participants.

Intercreditor agreements utilized in P3 financings tend to be highly negotiated and will need to be evaluated on a transaction by transaction basis to ensure that the voting and other rights of U.S. private placement investors are adequately protected.

Conclusion

We expect that P3 transactions will continue to be an exciting investment opportunity in the domestic and cross-border U.S. private placement market. However, each P3 transaction will present unique risks and rewards. Therefore, before investing in such structures, we strongly encourage you to consult with your legal advisors regarding the risks that may be involved.

For More Information

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1 *PPP Knowledge Lab, What is a PPP*, World Bank Group, <https://pppknowledgelab.org/ppp-cycle/what-ppp>.

2 *Additional Insights*: Note that a P3 transaction is different than a service contract where a private entity simply performs a service under the direction of the government sponsor. Under a P3 transaction, the private entity essentially acts as, and bears the risks of, the "owner" of the asset during the term of the P3 transaction. Despite this arrangement, however, the government sponsor will retain certain oversight rights which, in most cases, cannot be contracted away or waived under law.

- 3 *Additional Insights:* A greenfield asset refers to a new, yet-to-be constructed asset, whereas a brownfield asset refers to an asset that has already been built.
- 4 *Additional Insights:* Depending on the structure of the P3 transaction, there may be more than one agreement that grants the concessionaire the right to perform the various tasks that have been delegated to it. In such cases, the various agreements will need to be reviewed in concert to determine all of the concessionaire's rights and obligations under the P3 transaction.
- 5 *Additional Insights:* When entering into a P3 transaction, the concessionaire may be required to make an upfront payment to the government sponsor. Many government sponsors have used these upfront payments as a way to balance shortages in their overall operating budgets. Recent P3 transactions in the U.S. have involved the following upfront payments: Chicago Skyway — \$1.83 billion (99 years); Chicago Parking Garages — \$563 million (99 years); Chicago Parking Meters — \$1.157 billion (75 years); Northwest Parkway — \$543 million (99 years); and the Pennsylvania Turnpike (did not reach financial close) — \$12.8 billion (75 years).
- 6 *Additional Insights:* In most cases, this right or license will be an exclusive right or license, subject only to any rights retained by the government sponsor. In certain cases, however, we have seen this right or license characterized as a "nonexclusive" right or license. If that is the case, lenders will need to understand what is intended by such designation and confirm that no other entity has been granted a right that interferes with the concessionaire's ability to use the asset and/or to provide the related services.
- 7 *Additional Insights:* In our experience, many P3 transactions are drafted assuming debt financing will be provided by traditional bank lenders. As such, they often do not contemplate the payment of a make-whole amount. Therefore, even if a make-whole amount is payable under the financing documents, the termination payment may not be sufficient to cover such amount unless the transaction documents are amended to provide for such protection.
- 8 *Additional Insights:* For example, P3 transactions involving the U.S. government may prohibit the concessionaire's lenders from stepping into the shoes of the concessionaire to cure a default.
- 9 *Additional Insights:* Where the concessionaire's payment is based on an availability payment, the concession agreement will often include a set of performance indicators and a related formula for calculating the appropriate reduction to the availability payment if the concessionaire fails to perform its obligations in accordance with the standards set forth in the concession agreement. These indicators and formulas are often very complex, and will require an in-depth analysis by the debt lenders.
- 10 *Additional Insights:* For instance, we have seen some P3 transactions where the subcontractors have capped their overall liability to the concessionaire. If that is permitted, debt lenders will need to consider how the concessionaire will pay amounts above and beyond such liability cap. Ideally this situation should not be permitted. However, it may be necessary in order to procure the underlying services at a reasonable price.

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