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4 Key Questions For Evaluating PPP Opportunities

Law360, New York (March 07, 2014, 1:32 PM ET) -- Public-private partnerships are all the rage, as governments seek new ways to deliver public infrastructure, facilities and services in the face of daunting budget limitations and doubts about older procurement modes. PPP projects and future prospects in states such as Virginia, Indiana, Texas, Illinois and California have led European companies with large PPP portfolios to dive into the U.S. market. Many well-qualified U.S. companies are not familiar with the differences between the PPP and traditional procurement models.

We have advised clients over the years on numerous PPP transactions, from airports to courthouses to toll roads to railroads, among others. From that experience, we offer four questions that are key to evaluating any PPP, particularly for U.S. companies entering this increasingly popular field.

What Is a “PPP”?

Despite its name, a public-private partnership is not a partnership in the legal sense. Rather, it is a contractual relationship between private sector providers of project development and services and a governmental entity, which establishes a distribution of obligations and risks with a different risk/reward profile and within a different legal framework than traditional procurement methods.

The differences arise principally from the underlying government rationale for the project and potential political risk, the underlying legislation for the proposal or bid process, the nature of such process, and the resulting contract with the governmental entity. Since PPPs come in different shapes and forms, you should approach each one bearing that name without preconceptions. Every one is at least a little different.

Why Is the Government Proposing a PPP?

Generally, U.S. governmental entities are quite conservative when it comes to procurement, so it takes some motivating factor to compel a change to a new procurement method. Hence, a crucial first step is to examine the government rationale.

Some PPPs are geared so that a governmental entity can “monetize” an asset and raise funds by selling or leasing an asset to the private sector. Another rationale is to tap into the operating expertise of the private sector. Both of these rationales were behind the PPP at the Luis Munoz Marin Airport in 2013. These were also behind the recent PPP attempt at Midway International Airport, which was halted when the city of Chicago determined that the process could not guarantee an undisclosed threshold dollar amount to make the PPP worthwhile.

A very different governmental rationale would be to meet a recognized need for added capacity on a major highway but to transfer financing, completion, and operating risks to the private sector, as was the case with the series of Indiana I-69 toll road PPPs. Even within this “meeting a need” model, there are variations in whether (1) the governmental entities make construction progress payments or pay when substantially completed, and (2) the private sector receives a stream of payments over time, known to many as “availability payments,” or depends on the asset’s revenue-generating capacity, with methods such as toll road payments.

Yet a different government rationale for a large-scale project may be to meet a public need. For example, flood control works where the nature of the asset does not generate revenue or significant profit potential and there is no compelling private sector business model. These types of projects may be said to be policy driven but ultimately present risks to the private sector because the project may not provide reliable revenue.

This appears to be the reason why Sao Paulo abandoned its effort for a PPP to build flood control structures. The potential bidders apparently were dubious about the reliability of payments from the government for “flood control services” if the massive capital investment were to be made.

In considering why the government is pursuing a PPP, the question of whether there is enough political will and support to carry it out is critical. A PPP announced by a state’s executive branch may be dead on arrival because the majority in that state’s legislature is adamantly and ideologically opposed to PPPs, assuming such approval is needed or because there is a change in administration.

Also, political risks vary greatly depending on the underlying asset or project of a PPP. A court project PPP (paid for by a surcharge on lawsuit filing fees and availability payments) may not gather much attention, but projects that involve probable rate increases, such as increases for water rates and highway tolls, have inherently higher political risk profiles.

Is There an Adequate Legal Framework to Support the Proposed Transaction?

Once you are satisfied with the reasons a PPP is being considered, it is then vital to ensure that the legislative framework for the PPP is complete, intelligible and workable. The legislative framework largely provides the parameters for the bid/proposal stage and the resulting contract.

An increasing number of jurisdictions now have special PPP laws that effectively exempt PPPs from most traditional procurement laws. Some, like Puerto Rico’s, set up specific authorities to spearhead PPP efforts in cooperation with other governmental entities; others may provide the authority to a particular governmental entity like a highway authority.

Key items to pin down include the extent of powers delegated to the contracting authorities, specific requirements for the PPP bidding and award process, limitations and requirements on the bidders’ source of materials, project employee wages and benefits, use of subcontractors and the like, and dispute resolution provisions.

Is the Specific PPP Bidding Process and Proposed PPP Contract Acceptable — and Financeable?

A typical PPP statute provides greater flexibility in the bid/proposal stage than a typical procurement statute. How such flexibility has been utilized in a particular PPP needs to be examined carefully. It can result in two-stage processes with short-listing, revisions to the process of the government requirements, and a wider scope of negotiated contractual terms.

If the statutory framework permits it, a PPP bid/proposal project can also include greater flexibility in the design of the final product or asset to be delivered. Broadly speaking, a so-called social infrastructure project such as a school, hospital or prison may provide certain parameters relating to capacity, functionality and size of the facility but grant wide discretion in design and other elements of the project such as ongoing maintenance. This is one element of the PPP model that offers the potential for greater rewards for the private sector based on incentivized innovation and cost saving.

The bid proposal stage also poses distinct challenges. For example, large-scale PPPs often involve bidding by a consortium. This requires clarity as to which entities forming the consortium need to be prequalified, at which stage of the process prequalification is necessary for which type of participants, and the related levels of disclosure about each participant. This can prove challenging to large-scale institutional investors, particularly government-related pension funds.

Similarly, there may be prequalification requirements for the consortium arrangements that can be tricky. Would the consortium need to produce a letter of intent, memorandum of understanding, or binding agreements among its constituents? What level of evidence is required regarding the financial wherewithal to undertake the project and when does that need to be demonstrated?

Negotiation of the PPP contract usually takes place during the bidding process with potential prequalified bidders providing comments to the governmental authority in an iterative process prior to the bid or award. The nature and scope of the contract changes are another departure from most procurement processes. PPP contracts tend to be long-term contracts, which are sometimes effective for 30 years or more. Many involve performance or service standards that may evolve over time.

Accordingly, each PPP contract should be examined from the outset with great care by operating experts, as well as financial, construction, and legal experts. Even with PPPs, post-award renegotiation is typically infeasible, at least in the early years.

Conclusion

In the U.S. and internationally, more and more government projects are undertaken as PPPs. Hence, for your company to be competitive, you need to know how to quickly evaluate which PPPs make sense for you to pursue and the best way to engage in the promising PPP processes.

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