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# Structuring and Financing P3s

April 1, 2004

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**Structuring the P3**

One of the most difficult, time consuming and important challenges facing the public sector is how to structure the Public-Private Partnership (the "P3") to adequately protect relevant public policy and public interest objectives and concerns, while attracting the desired level of private sector involvement, private investment and risk transference to the private sector.

It is extremely important to ensure that the public sector is aware, at the outset of the process, of any limitations on the public sector's ability to structure the particular project in a certain way. By way of example, before structuring a sophisticated independent corporate entity intended to shield the public sector from liability for project financing, determine: will project financing be available without an adequate guarantee from the public sector entity; or will financing be so much more costly in the absence of such financial support or guarantee from the public sector entity that it will not bear the scrutiny of tests for best value and cost effectiveness that are critical to the project.

There are many ways in which a P3 project can be structured. The following are examples of some structures that can be utilized.

1. After finalizing an agreement with the preferred proponent that is satisfactory to both the public sector and the private sector, the public sector can enter into a Concession Agreement with either the private sector company or consortium, or a special purpose corporation incorporated by the successful proponent. In situations utilizing a special purpose corporation or where the project work is being done by a party other than the party receiving the concession, further contracts, such as Design-Build Agreements and Operations and Maintenance Agreements, can be entered into with the party or parties actually doing the work. The public sector often requires that Design- Build and Operations and Maintenance Agreements be assigned to it as collateral security for performance of the concessionaire's obligations under the Concession Agreement. The length of a Concession Agreement depends on the type of project, and the terms of one agreement may vary considerably from the terms of another.
2. Ontario municipalities may now incorporate municipal business corporations under the newly-enacted Regulations under the *Municipal Act*. Such a municipal business corporation can have expanded objects and powers to facilitate various types of P3 projects and commercial undertakings. A municipal business corporation may also permit the public sector and private sector to structure their risk/reward allocations and equity investment through shareholdings in the corporation. So long as appropriate structures are implemented, it may be possible for a municipality to utilize a municipal business corporation to shield the municipality from liability.
3. In some P3 transactions, the public sector retains title to lands and enters into a lease with the private sector. Under the terms of the Ground Lease, the private sector constructs a building or facilities on the leased land. The private sector is also responsible for operating and maintaining the building or facilities, or arranging for the operation and maintenance of the building and facilities. At the end of the Ground Lease, whether by expiry of the term or early termination, the leasehold interest of the private sector is at an end and, usually, the buildings and facilities then become the property of the public

sector.

4. In some P3 transactions, ownership of the lands is transferred in fee simple by the public sector to the private sector. The private sector then undertakes the design, construction, operation and maintenance of the project. At some point in time and subject to specified payments by the public sector to the private sector, title may revert to the public sector.

In choosing the appropriate structure for the P3, the public sector should be mindful of the following:

1. How will governance be handled? Governance deals with, among other things, how decisions are undertaken. In a P3 project, there are decisions that traditionally might have been made by the public sector and which are either made by the private sector alone or jointly by the public sector and the private sector. The issues of who makes decisions and whether public sector approval is required fall within the topic of governance.
2. Is it anticipated that the private sector is going to contribute equity in the project? If so, the public sector may want to structure the transaction utilizing a corporation so that the private sector can contribute equity to and obtain shares in the corporation.
3. The public sector must always be mindful of the twin needs for accountability and transparency. These are unique requirements faced by the public sector and it is important that the public sector be cognizant of these needs when structuring the P3 project.
4. What control will be had by the public sector over fares, tolls or other revenue from the project, and which contract will embody those controls?
5. What rights will be had by lenders if private sector financing is obtained for the project? The public sector needs to consider this while the project is being structured because lenders will not provide private financing unless the rights, obligations, and responsibilities of the public sector partner, the private sector partner, and the lender are acceptable to all three.
6. The public sector should consider what will happen if the private sector partner defaults during the term of the Concession Agreement, Ground Lease or other governing document. If the service being provided by the private sector partner through the P3 project is an essential service, the public sector will need to either step in directly or arrange for another party to do so as soon as possible to prevent disruption in the essential service.

**Financing the P3**

This section briefly describes the sources, types and attributes of both public and private financings for P3s and some important and related issues.

### *Public Financing Sources*

**Municipal** usually equity in a municipal infrastructure project.

**Provincial** for example, the former Ontario SuperBuild Corporation, Golden Horseshoe Transit Investment Partnerships and Transit Investment Partnerships initiatives.

**Federal** Canada Strategic Infrastructure Fund. *Timing and Politics* In Ontario, unlike in some other provinces, there are often two separate agreements—one for each of the federal and provincial funders. This results in two bipartite agreements as opposed to one tripartite agreement.

This fact gives rise to certain complexities. While the two agreements have to be separately negotiated, they must mesh properly in areas relating to, for example, the conditions of funding, timing of funding and defining expenditures qualifying for funding. If they do not, a host of logistical difficulties can result that can negatively impact the project. We will deal with some of those issues below. Separate negotiations increase the time required to finalize documentation. The project schedule must accommodate sufficient time from the announcement of funding until the agreements are completed so that funds can flow and construction can start. Lengthier time requirements can increase the risks to funding associated with political change or interest group opposition or adverse media coverage. Excessive delays in finalizing documents can jeopardize project schedules or budgets.

*The Final Agreements*

The terms of the final agreements from Senior Government funders can give rise to some challenges for the P3 project that need to be anticipated and dealt with appropriately.

**Unfunded Expenditures**

(a) Funding agreements usually require equal one-third contributions from each of the municipality, the province and the federal government for defined Eligible Expenditures on a line item basis. The requirement that each funder make a one-third contribution for each Eligible Expenditure on a line item basis means that if an expenditure is ineligible for funding from one funder, it is automatically ineligible for funding from the other funders.

(b) Many expenditures, especially those related to soft costs, may be capped or may not fall within the definition of Eligible Expenditures under one or both of federal and provincial funding agreements.

The combination of (a) and (b) can result in some necessary expenditures being ineligible for Senior Government funding. This, in turn, means that if the project is to proceed, the public sector partner or the private sector partner may have to fund some unanticipated expenditures.

**Cash flow Issues**

Sometimes there is a lag between when the funds flow from the Senior Government under funding agreements and when expenditures have to be made in order for the project to proceed.

For example:

(a) Under many Senior Government funding agreements, funding flows when certain conditions are met and at the 30, 60, 90 and 100 per cent completion milestones. However, under traditional construction relationships, payments to contractors and subcontractors must be made much more frequently in order for construction to proceed.

(b) Senior Government funding agreements often provide that funding flows only after expenditures have been made and applications have been submitted and reviewed.

(c) Senior Government holdbacks are often larger in amount and lengthier than the holdbacks that are permitted under typical construction contracts and subcontracts.

As a result, either the public sector or private sector partner often have to fund cash flow and working capital requirements of the project and to bridge finance between the time when expenditures are practically made for the purposes of the project and when Senior Government funding is actually received.

### ***Private Financing***

*Types*

Private financing can be in the form of equity or debt.

Equity will usually come from the private sector partner and debt can come from the private sector or private financing entities such as banks, pension funds or insurance companies.

*The Essential Business Case*

Regardless of the form of private financing or how it is provided, private financing will be achieved only if there is a fundamental business case that establishes the commercial reasonableness of the investment.

First, if private at-risk capital is to be obtained, it must be established that there is a way of quantifying the risk and that a commercially acceptable rate of return can be delivered for the risk being taken.

Ensuring a rate of return is often problematic in a public infrastructure project. They are often money-losing by definition—witness losses of public transit operations on a combined operational and capital basis or even an operational basis alone. Techniques to segregate money-making and money-losing operations (or government guarantees, shadow tolls or subsidy commitments) may be necessary in order to attract private financing to certain portions of otherwise money losing projects.

If a project does have the opportunity to establish a business case to attract private financing, the business case needs to be supported by commercially acceptable evidence. Some examples follow:

- full review and analysis by credit rating agencies and the issuance of a credit rating.
- investment grade ridership, utilization and revenue forecasts.

These undertakings obviously give rise to cost and timing issues that need to be addressed at the outset.

*The Impact of Private Financing on Structure*

If the public sector requires at-risk financing by the private sector, it must be prepared to release some control over the management and operation of the project and some of its ability to restrict or control user fees and revenues generated by the project. In other words, in order to transfer risk, the public sector must offer some control over management and revenues to the party accepting the risk. This can be problematic when the project invariably relates to the providing of a public service and requires the protection of a public interest. For example, how far is a municipality willing to go in giving up control over prices for essential services in order to attract private at-risk investment? The objective is to work on these issues in a timely fashion to achieve the appropriate protection of the public interest, given the commercial realities of attracting private financing.

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