

# Managing Risk in PPP Projects through Legal Documentation



**PREPARED FOR PRESENTATION AT THE EXPERT  
ROUNDTABLE ON PRIVATE-PUBLIC PARTNERSHIPS  
SPONSORED BY  
THE MENA-OECD INVESTMENT PROGRAMME AND  
THE EXECUTIVE PRIVATISATION COMMISSION OF  
JORDAN**

**Amman, Jordan  
September 6, 2007**

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# Introduction and Scope



- Public-Private Partnerships (PPPs) are used in developed and developing economies to design, finance, construct and operate infrastructure projects
- PPPs allow private sector to participate in development and operation of major projects that
  - public body acting alone cannot do
  - cannot be done by a private body alone because
    - ✦ level of risk is greater than a private body willing to undertake, **or**
    - ✦ significant rights derive from public sector that are necessary for implementation of the project, **or**
    - ✦ project aims to deliver what is commonly seen as a public-sector service

# Key Benefits from a Public Private Partnership



- Public sector looks to the private sector to provide *finance* and *expertise*
- Financial component
  - takes costs off budget of public sector
  - puts private sector “reality check” on ability to consummate project
- Expertise component
  - gives private sector competitive component to public sector projects
  - gives public sector ability to retain expertise that it might not otherwise be able to provide or afford

# Defining a PPP



- A Public-Private Partnership:

...is a contractual agreement between a public agency and a private sector entity.

Through this agreement, the skills and assets of each sector (public and private) are shared in delivering a service or facility for the use of the general public. In addition to the sharing of resources, each party shares in the risks and rewards potential in the delivery of the service and/or facility.

- Definition emphasizes that PPP involves

- risks that are ***shared***
- risks that are ***documented*** and ***allocated*** in a manner that suits
  - ✦ the nature of the project,
  - ✦ the specific risks involved,
  - ✦ the relative ability and willingness of the parties to assume risk

# Acknowledgement and Management of Risk



- “Risk” is the chance of an event occurring that would cause actual project circumstances to differ from those actually assumed when forecasting project benefits and costs.
- Risk
  - can never be eliminated
  - can be allocated so it is borne in an agreed-upon fashion
- Risk is generally allocated through legal institutions and instruments – partly through statutes and other legal regulations, and partly through the negotiation of the legal agreements that embody the project
- The principle of risk transfer may be expressed as follows: The party best able to manage a given risk is the party who should bear that risk

# Fundamental Requirements for PPPs



- Three prerequisites for successful PPPs:
  - A credible legal and regulatory framework that protects private sector interests and property rights and enables commercial contracts to be legally enforced
  - Government agencies with the necessary authority to grant concessions and licenses, whether through specific concession laws or other implementing legislation or regulation
  - Mechanisms to permit the resolution of disputes and potential conflicts of interests in a cost-efficient, fair and enforceable manner
- Risks not covered in statutes and other government actions are typically covered in contract negotiation

# Types of Risk to be Considered



- **“External risk”** -- matters that arise outside of the confines of a project
  - Change of government
  - Change of law
  - Change in public desire
  - External risk may be addressed in PPP contracts but are fundamentally outside the project itself and may be outside the control of the parties.
- **“Internal Risk”**
  - Particular to the project or the way it is constructed and operated
  - Generally subject to the control of the contracting parties
  - If internal risk matters not subject to precise control by contract parties they are agreed through negotiation to be allocated in a specified manner

# How is Risk Managed?



- Risk is generally managed
  - by avoiding it altogether or
  - by arranging for the cost to be borne by another party through an insurance or other reimbursement arrangement
- No “tabula rasa”
  - Norms that have emerged over years of practice set the standards for how most risk allocation will proceed in documentation of a project
  - Government party will be expected to bear the risk of its own errors and omissions in design and structure of a project
  - Government party will be expected to bear the risk of changes in law or political structure that affect the viability of a project.
  - These cases, deemed to be within control of the government – or at least, not things for which the private sector party would be expected to bear responsibility



# Considerations in Risk Allocation



- Principles embodying the management and allocation of risk are embedded in complex legal documentation
- Risk allocation is not a science – must be negotiated
- Legal documentation itself may contain warranties, conditions and exceptions to ensure risk elements of performance under the agreements allocated to the parties who agree to absorb and bear the risk
- Who bears risk?

# Who Generally Bears Risk?



- Government:
  - Matters within control of the government
- Private Sector:
  - Matters for which the private sector party would be expected to bear responsibility
  - Risks arising from the building, operation and management of the project – the matters for which the public sector entity has turned to the private sector for its expertise – will generally be borne by the private sector project company
- Lenders:
  - willing to take credit risk (*i.e.*, the business evaluation they have made that their loan will be repaid in a timely manner)
  - unwilling to take other risks, which are therefore borne by the borrowers

# Considerations in Risk Allocation (1)



- Most significant financing for a PPP project through debt provided by banks or bond purchasers
- Thus, significant premium on ability of project company to achieve sufficient cash flow to permit it to meet its financial obligations
- One of the critical risks is **demand risk** – the risk that there will not be sufficient demand for the service to be provided under the PPP arrangement and the consequent likelihood that the project company will be unable to repay its financial obligations from project revenues.
  - Demand risk is very difficult to estimate, especially in developing economies where forecasting demand is a difficult exercise. The public sector commonly assumes that the private sector should take demand risk.
  - Private sector, when it assumes demand risk, increasingly asking for more support from government side in the form of subsidies, grants or guarantees in order to mitigate the effects of demand risk assumption
- Another critical risk is **political, legal and regulatory risk**
  - This emanates first from a concern that the public sector will unilaterally change the rules – for example, after a change in government
  - May be insurable

# Considerations in Risk Allocation (2)



- Related concern from private sector's perspective is the government's right to terminate or "step into" a project and take it over from the private sector
- Typically addressed through contractual clauses which:
  - in the case of a "step in," relate only to emergency access and where there has been a material service default (which includes continuous or repeated nonmaterial defaults)
  - in the case of termination, seek to ensure that "cure periods" are fair and that as far as possible, the conditions under which termination or government "step in" may occur, are clearly specified and limited to material defaults so as to avoid hair-trigger termination events

# Limiting Risk with Insurance



- Insurance is component of limiting financial risk, but not an alternative to appropriate and meaningful risk allocation effected through the contracting process.
  - Insurance is a means of compensating for loss, not for preventing the loss
  - If the subject of a PPP is an essential public service, insurance proceeds, money damages or other financial recompense will not necessarily compensate the public users of the project for the loss of the service or facility.
  - Insurance provides the insured party only with the assurance that if the agreed-upon performance does not occur that party will not lose financially. Thus, insurance prevents a financial consequence of a loss, but not the loss itself.
- Not all losses are insurable
  - A party desiring insurance must have an “insurable interest.”
  - That exists if the party seeking the insurance owns or has another relationship to the property or transaction being insured such that the party that is the beneficiary of the insurance will benefit from the survival of the insured property, or will suffer from loss or damage to it, or may incur liability in respect of it
  - An insurance company will not write insurance for a risk that has already occurred or that is reasonably likely to occur
  - Insurance will not cover a loss arising because the economics of a business deal are bad
- Availability of insurance depends upon the willingness of insurers to underwrite the risk – that is, to accept that they will pay if the insured loss occurs.
  - Premium will in large measure be a function of the likelihood and ability to manage the risk they are willing to underwrite
  - Projects such as PPP’s are large enough that a syndicate of insurers may be needed to provide the coverage, meaning that a large community must be convinced to accept the risk to be insured.
- A PPP project will generally have various types of risks, some of which may be insurable and others not
- Some types of risk (such as nationalization, riot and insurrection, war and forced abandonment) are subject to a different type of insurance cover known as political risk insurance. Depending upon the location and the particular circumstances of the governments involved, political risk insurance may be more or less available.
- Thus, while insurance can be a financial benefit for parties in a PPP project, it is not a panacea and will not be available to compensate for every kind of loss that can occur.

# The Role of Legal Institutions and Documentation



- Risk managed, allocated and avoided through precise and comprehensive legal documentation
- Legal documentation includes
  - project documentation
  - appropriate underlying legal regime -- gives security and comfort to both public and private partners
- Host governments must remove impediments that prohibit private participation in infrastructure
- Two important obstacles limiting effective concession rights:
  - laws and regulations that prohibit or restrict the private ownership and operation of public services and
  - foreign investment in infrastructure sectors
- Fundamentally, it is important to ensure that private participation is permitted and protected

# Role of the Underlying Legal Regime



- Host governments must remove impediments that prohibit private participation in infrastructure
- Two of the most important obstacles regarding concessions are laws and regulations that
  - prohibit or restrict the private ownership and operation of public services and
  - prohibitions on foreign investment in infrastructure sectors
- If the underlying legal regime does not permit the types of arrangements contemplated by the PPP project, the overall risk of failure – and of compromising the rights and liabilities of the participants – will be heightened if indeed the project can proceed at all

# Clarity and Specificity of Language and Documentation



- Clarity and specificity of language in contractual documents is the most critical component of managing expectations and limiting risks arising out of documentation
  - Vital to make sure that the understanding between the parties is amply and correctly described
  - With complex documentation such as PPP agreements, the existence of so many variables and details to be resolved makes it especially important that both counsel and principals pay close attention to minutiae, particularly with respect to resolving ambiguities and options that might apply upon the occurrence of specified conditions
  - It is important to note that this is not a task that can be undertaken solely by lawyers; the principals must be sure to participate
- Importance of Local Counsel
- While documents may be based on models, they are not mere forms to be filled out



# Notice and Cure Periods



- Notice and cure provisions give the party who is required to perform an obligation formal notice of its failure to perform and an agreed upon period of time within which to cure its default before the consequences of non-performance are invoked. They can thus be seen effectively as provision that help ensure that the agreement is performed as intended
- Notice and cure provisions must provide enough time to actually allow cure by the party charged with performance. They should not be “hair-trigger”
- Information flow is critical in order to evaluate, foresee and forestall problems

# Dispute Resolution Mechanisms



- Investors will be concerned that all the rights they benefit from under the law of the host country and the provisions of the relevant contracts can be enforced as written
- Alternative dispute resolution mechanisms (such as arbitration and mediation) can be considered, especially if there is any suspicion that the courts of the host country will not treat a foreign investor fairly

# Illustration of Typical Risk Allocation in a PPP Project; Negotiating Variables



- Seven categories of risk that may commonly be expected to be encountered, or that should be planned around, in a PPP project. The categories of risk include:
  - Design or Development Risk
  - Construction Risk
  - Revenue Risk
  - Financial Risk
  - Unexpected Event Risk
  - Performance Risk
  - Environmental Risk

# Conclusions



- PPPs can provide significant public benefit by allowing the public sector to engage the private sector to design, build and operate resources that might otherwise be thought to be in the domain of the public sector
- Because these projects tend to be large and complex, the attendant risks are significant and must be mitigated in order to permit a fruitful relationship between the parties
- Many risks can be allocated among the parties to a PPP project so that they are borne by the party best able to control them and bear them
- Legal documentation will play a significant role in establishing the nuances of the relationships between the parties to a PPP project and must be carefully negotiated to ensure that legal institutions are appropriate to the endeavor, that risks are borne by the appropriate party, that suitable notices and cure periods are provided to avoid unnecessary defaults but permit adequate performance monitoring, and that dispute resolution mechanisms are appropriate to the circumstances

# Acap Partners Ltd



- Acap Partners Ltd advises on and establishes investment structures in post-conflict, frontier and transitional economies
- Principals have extensive experience in
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