

Oil Rigs and Bus Stops: A Family Resemblance

In recent years there have been many attempts in the Czech Republic to define, or at least describe, PPP. These have ranged from the simple (a way to procure both works and related services in a single procurement procedure) to the complex (a way to employ private sector efficiency by transferring as a single package both construction and operational risks, including lifecycle risk, to the private sector for a fixed price) to the pragmatic (a way, something like a leasing arrangement, to obtain an asset and related services in return for monthly payments during the period of use only).



► Christian Blatchford

This article offers a different description based on the fact that PPP forms a part of the project finance family. By looking at projects from the areas of oil, gas and electricity generation also belonging to that family, and by comparing and contrasting PPP projects with these, it is hoped that a "family resemblance" will emerge which will help us better to understand PPP.

First, though, let us quickly remind ourselves of what project finance means in broad terms. Project finance involves the financing, generally provided to special purpose company owned by the project sponsors, of the development of an asset which will later generate revenues for the repayment of such financing. In project financings it is clearly important, among other things, that the relevant asset is properly developed and maintained and that the revenues generated by it are both predictable and stable.

Asset Development

Exploration for crude oil, and the successful exploitation of an oil field, is a highly risky and expensive endeavour. If successful, however, revenues will be generated which should more than repay the financing of the same at little or no cost to the public sector. For these reasons the process by which a public sector entity (whether the ministry of energy or similar state organ or a state-owned oil company) enables a private sector entity (usually a consortium of international oil companies) to undertake the development of an oil project is relatively informal. The public sector entity will usually, pursuant to a tender developed by it, enter into a production sharing agreement (a "PSA") with, or issue a licence or concession (in a very simple sense) to, the private sector entity which permits exploration and the development of project assets at the cost and risk of the private sector entity (perhaps subject to certain obligations as to minimum drilling levels, etc.) and which also governs, in the event that oil is later found and extracted, the terms on which such oil is to be shared between the public sector entity and the private sector entity.

Oil and electricity generation projects may also involve considerable development risks.

By contrast, a PPP project will usually have its origins in a public sector entity defining a need for the construction of a certain asset

and/or provision of related services (for instance, bus stops in a city centre, a hospital or a waste disposal facility, along with related services including at least to the maintenance of these assets). The public sector entity is likely to own or have relevant rights to use the site on which the relevant asset is to be situated and to have procured zoning permission in respect of its it. The risk to the private sector entity that the asset will be impossible on commercial terms to develop and service is minimal. (Or if it exists, for instance where a motorway project is required to be funded by tolls which are unlikely to cover project costs, they should be obvious at the outset and deter private sector involvement in the project.) Also, it is likely that most or all of the revenue required to fund the project will be provided by the relevant public sector entity itself. Given this relative lack of development risk to the private sector entity, and the likely burden of payment on the part of the public sector entity, it is unsurprising that public sector entities are very exacting in procuring PPP projects, requiring interested private sector entities to prove satisfaction of detailed qualification criteria and to submit offers to satisfy the detailed requirements of project. The procurement process to be followed is defined in detail under European and Czech procurement laws and is overseen by the Czech Competition Authority and, to a limited extent, the Ministry of Finance.

Project Revenues

As already mentioned, once a project asset has been developed, the revenue it generates will be essential in repaying the financing of such development.

Oil project PSAs ensure that project costs, including debt service costs, are recovered through the extraction by the private sector entity of so-called "cost recovery petroleum" prior to the division between the public sector entity and private sector entity of their respective shares of so-called "profit petroleum".

The revenue from a project involving the supply of natural gas, on the other hand, is created by a so-called "take or pay" obligation under the relevant gas sales agreement (a "GSA"). This requires the buyer to purchase a minimum quantity of gas from the seller each year for a certain price where the buyer will have to pay that price even if it does not off-take that minimum quantity. (In the next following year, as well as taking the minimum quantity of gas for that year, the buyer will be entitled to take at no payment the "make-up gas" which it could have taken, but did not, in the previous year,

PPP

thereby restoring the buyer's overall financial position.) As a result of this arrangement the seller, as the private sector entity developing and operating the project, achieves the predictable revenues necessary to repay the financing of the project's development.

A similar position has historically been achieved on electricity generation projects (although the deregulation of electricity markets has blurred both the relationships between energy generators and transmission and distribution entities and the nature and amount of the payments made to generators). The basic principle is that the relevant purchaser pays the generator under a power purchase agreement (a "PPA") by way of two elements: first a capacity (or availability) charge in return for the generator making available to it the capacity to supply a certain volume of electricity and second an energy charge in return for the actual supply of electricity. The first element should cover the generator's fixed costs, including its debt service obligations, while the second element should cover its variable costs, including the cost of fuel.



PPP projects strongly resemble electricity generation projects in terms of revenue structure in that the public sector entity pays the private sector entity, in consideration of the latter's provision to it of an asset and related services, a payment which breaks down into an availability element and a services element. The availability element is payable whether or not the asset (or its relevant part) is actually used by the public sector entity or end users, while the service element will vary to some extent based on the actual take-up of the services. The relationship between these two elements and the fixed and variable costs of the project largely mirrors the relationship found in electricity generation projects.

Protection of Project Revenues

Even predictable project revenues must be stable if a project financing is to be a success. Again, a brief review of other areas of project finance can shed light on how PPP functions in this regard.

Under a GSA on a gas project, a failure by the seller to supply gas is treated similarly to a failure by a buyer to take the same, that

is, through relevant payment provisions. Usually gas which should have been, but was not, supplied (so-called "shortfall gas") is sold by the seller to the buyer at a discount and this payment adjustment serves as the buyer's only remedy in relation to the seller's failure to supply. The arrangement therefore addresses the seller's breach of contract in a predictable way rather than through an unpredictable claim for damages. Even if, as may be the case on developing world projects, there is an obligation on the seller to compensate the buyer for any losses caused by a failure to supply gas, these losses will exclude consequential losses such loss of profit and loss of business opportunity and will always be capped at a level which will not materially affect project revenues.

The consequences of a failure to supply electricity under a PPA can be very similar, involving the exclusion of consequential losses and caps on liability. Rather than employing the concepts of shortfalls and discounts, however, a PPA is likely to impose liquidated damages on the generator as a relatively restricted and predictable alternative to claims for damages.

PPP projects behave in a similar, but rather more sophisticated, way to gas and electricity generation projects. Payments from the public sector entity to the private sector entity in consideration of the availability of the project asset and provision of related services are subject to deductions in the event of unavailability (for instance, on an accommodation project, darkness or excessive noise levels in a defined space) and/or poor service provision (for instance, failure to mend a cracked window within a defined time period, although the cracked window could also give rise to unavailability, in which case only the unavailability deduction and not the service deduction would apply). In projects where payments are made not by the public authority entity but by end users, the private sector entity may be obliged to make a compensation payment out of the project revenues to the public sector entity and/or such end users.

In the UK PPP projects will not be approved unless the entire amount of the relevant public sector entity payment is at risk from deductions. This is the principle of "no service, no payment" or, more precisely, "no availability and services, no payment". Historically, however, there were projects in which the availability payment (or a part of it) was ring-fenced so that debt service was protected in any event. It is interesting to note anecdotal evidence that banks are asking for, and getting, exactly this ring-fencing on early Czech PPP projects.

Where deductions apply under a PPP payment mechanism it is usual for these to be the sole remedy of the public sector entity against the defaulting private sector entity, thus ensuring a predictable alternative to claims for damages. It should also be noted that, even where "no service, no payment" can reduce to zero a project's revenues, this risk is usually addressed through obligations on subcontractors to the private sector entity contracting with the public sector entity to make up lost revenues to the extent caused by sub-contractor default.

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Condition of Underlying Asset

Projects in all of the areas discussed in this article will, by definition, require that the relevant project asset is maintained in a condition which allows the generation of revenues necessary for the project's success.

Given the high levels of risk and cost in respect of oil projects, it is unlikely that any express obligations requiring such maintenance will be imposed by the relevant public sector entity on the private sector entity (although an obligation to decommission project assets can be expected upon expiry of the project term). The situation is similar in the areas of gas supply and electricity generation. Compliance with mandatory regulations, particularly in respect of the environment, may, however, require the undertaking of certain maintenance and replacement obligations by the private sector entity.

The same principles apply of course to PPP projects. It is usual, however, for PPPs to go considerably further. Deductions for unavailability and poor service provision can apply in the case that asset maintenance and replacement obligations are not properly fulfilled by the private sector entity and these deductions will motivate it to discharge such obligations. Also, since the public sector entity will require the project asset to be handed back to it at the end of the project term, it will impose on the private sector entity a certain

condition with which such asset must comply at such time. It may even be the case that the public sector entity imposes an express obligation on the private sector entity to undertake lifecycle replacements in certain amounts and/or at certain times. It is arguable that this contradicts the philosophy of PPP projects delivering measurable outputs rather than merely satisfying defined inputs. During the negotiation of such projects, however, one sometimes hears it stated that since the public sector entity, through availability and service payments, effectively pays the private sector entity the amounts needed for such lifecycle replacements it is only fair that these replacements are actually undertaken.

There are, of course, many other members of the project finance family, including projects relating to alternative energy generation, mineral extraction, international pipelines and liquefied natural gas (or LNG). It is hoped, however, that the short review of key aspects of oil, gas and electricity generation projects above has also shed some light on PPP projects. I have aimed not to provide a legal or dictionary definition of PPP but rather to show how a PPP project comes to life and, at the appropriate time in its development, both serves the purpose for which it came into being and repays the finance which made that possible.

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