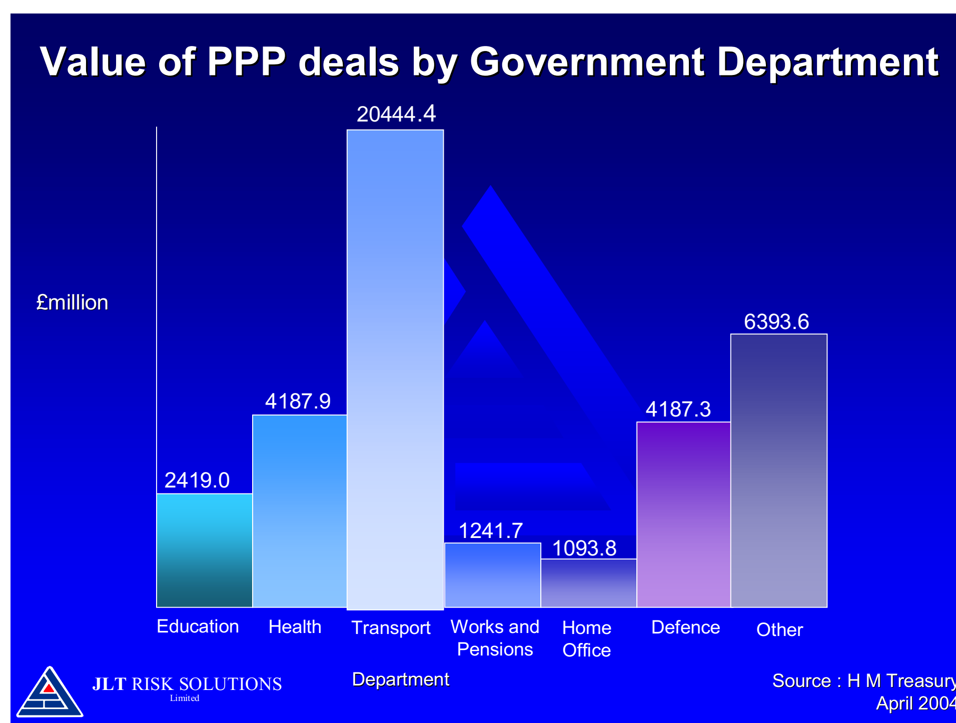
PPP IN THE UK

PPP, or the Private Finance Initiative (PFI) as it was previously known in the UK, was initially set up by the Conservative Government in 1994 to allow the private sector to take a greater participation in the provision of public sector services. Rather than using public resources to provide the services, private sector companies undertake that role in return for payment over a concession period, typically lasting 25 or 30 years.

The UK Government has always been keen to express PPP as the acquisition by the public sector of a service, rather than an asset, although construction of an asset has generally been an important feature of PPPs let to date. The ethos is very much that the assets are a means to the provision of the service, rather than the end result in itself. Accordingly, the Government might, for example, style its requirements as the provision of services to cater for 800 low security prisoners, rather than placing an order for a low security prison which has a capacity for 800 prisoners. The requirements of the service properly lead the design of the asset. The distinction can be a fine one, but one which is necessary both for political and accounting reasons.

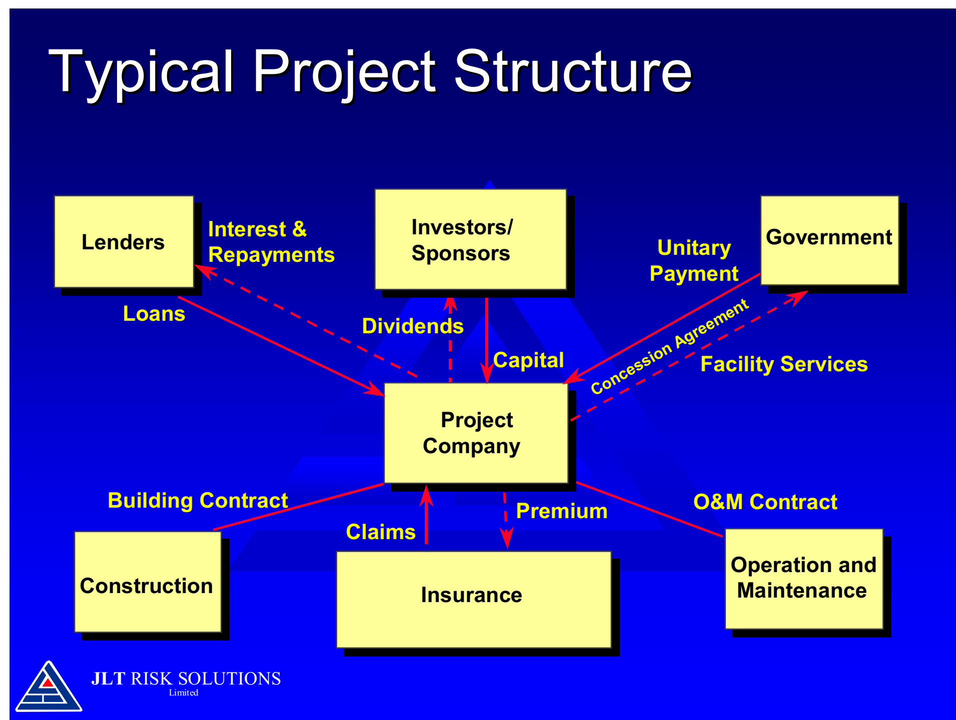
PPP projects now encompass a wide range of services including roads, prisons, hospitals, schools, office accommodation, information technology projects, waste management, training facilities, satellite services and more. Changes in Government and its political agenda influence the nature of the projects let. For example, under the previous Conservative Government, Road projects were much to the fore. Under the current Labour Government, there has been a shift to schools and hospitals. The government has let 626 PPP projects to date with a capital value of circa £40,000m – about 40% of this capital value relates to three contracts for the modernisation and maintenance of sections of the London Underground system. The following diagram shows the value of PPP deals let by Government Department:



With the concession periods being 25 to 30 years, the bulk of which is operational, the UK Government has always been keen to see a greater involvement by operators or facilities management companies. However, given the initial levels of capital construction, the operators did not have the same appetite for PPP projects shown by contractors who, not unjustifiably, saw PPP as a much needed injection of income into their businesses. With a large number of projects now having moved from the construction phase to the operational phase, some contractors have been selling their stakes in those PPP companies to recycle funds for further PPP projects.

PROJECT FINANCE

PPP projects are funded by way of project finance. In simple terms, project finance is essentially the lending of money to a project, secured solely on the future expected revenues of that project, however earned. In the event of the project going seriously awry, the Lenders have limited or no recourse to the Borrower and thus the debt can be accounted for off the Borrower's balance sheet. This is clearly advantageous to companies wishing to fund projects as their balance sheets do not show the considerable liabilities which can be attached to PPP projects. The following diagram illustrates a typical project structure:



From the Lender's perspective, project financing deals are inherently more risky because of the lack of recourse which Lenders are entitled to. As the lending is secured only on expected revenues, failure of the project to achieve the revenue earning stage prejudices the ability of Lenders to recover their outlay. Consequently, financiers seek an arguably greater degree of control over the structure and execution of a project finance deal than perhaps any other type of financing. The risks are further compounded by the underlying principle of PPP which is to maximise transfer of risk away from the Government and into the private sector. Consequently, certain risks which were more normally classed as employers risks under conventional contracts are now firmly in the domain of the concession company and their contractor. It is for this reason that project finance gives the greatest challenge to the insurance market in achieving acceptable and economic solutions to the insurance problems.

There has been a demand for increased width of coverage from traditional insurance policies, not only during the initial construction phase of the project but also going forward over the duration of the concession period. The lack of certainty of premium costs over the 25 to 30 year concession period has been an issue when it comes to forecasting for the financial model, which forms the basis of PPP lending. Other problems derive from the inherent complexity of the PPP deal, with a vast number of contracts at all levels. Brokers and Insurers now need to have a greater understanding of the documentation involved, and take recognition of the increased measures required by Lenders to ensure that they are able to enforce security over the insurances put in place.

RISK ANALYSIS, ALLOCATION AND MANAGEMENT

The Government requirement to transfer as much risk as possible to the private sector is contrary to the requirement of lenders, who would much rather see no risk retained by the borrower at all. The realities of the commercial world dictate that some risks, which initially fall to the borrowing company, must remain there to be effectively and economically managed.

With most PPP projects, there are four key risk carrying parties involved in the contracts. These are:

- The Government
- The Concessionaire/ Special Purpose Company (SPC)
- The Contractor and/or Operator
- The Lenders

In the majority of projects, the Contractor and/or Operator has an equity stake in the Concessionaire/ SPC. In all PPP projects, the Contractor works very closely with the Concessionaire/SPC in the development of the specification and performance requirements for the facility that is to be constructed.

A well-worn phrase in the PPP sector is that "risks should be managed by the party best able to manage it". The risks which are intrinsic in the project must be divided between the various parties to be managed by each of them. Much of the wrangling involved in negotiating the close of a PPP deal is connected with the allocation of risks under the terms of the contracts. Often, this process is assisted by the use of a risk matrix which is produced following a risk analysis exercise. The key to such a matrix is the efficacy of identification and analysis of such risks prior to agreeing the allocation.

At the outset of each project, the Concessionaire will attempt to identify all of those risks to which the project may be exposed. This process is very much based on experience, and such experience is being acquired and added to by those who see PPP as a key component of their future revenue streams. Having identified the range of risks, the next step is to analyse and determine the frequency and impact of each on the project. This analysis will then form the basis of negotiations with regard to risk allocation. Foremost in the mind of each party to those negotiations will be their own ability to manage any risks, and the likely costs involved. As with any other contractual negotiation, acceptance of risk brings with it a premium.

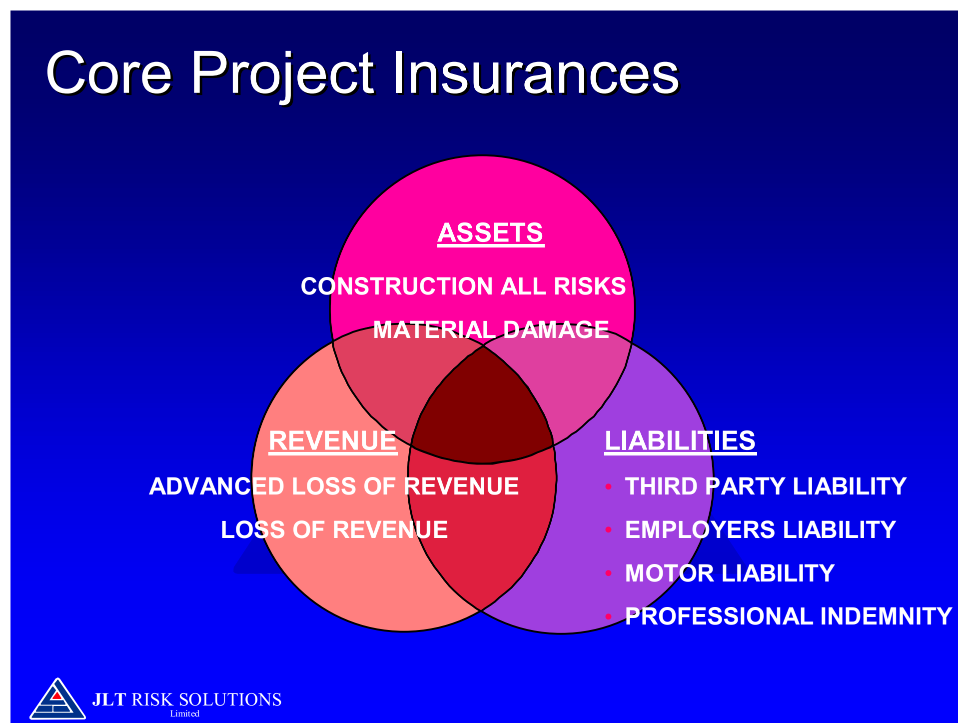
Having taken on a risk, either willingly or unwillingly, the Concessionaire has several options in managing the risk:

- Physically managing the exposure, perhaps by the implementation of loss prevention measures;
- Pricing the consequences of the risk. That is, setting aside a cash reserve to meet the financial effects should the risk actually manifest itself;
- Transfer the risk to another party within the project by contract; or
- Transfer the risk to the commercial insurance market by purchasing an insurance policy.

Of course, it is the last option which concerns the participants in the commercial insurance market.

CORE PROJECT INSURANCES

The core project insurances for PPP projects in the UK are:



The insurance provisions are now a major section in the project agreements with the Government and Lenders carrying out their own due diligence on the insurance programme for the project proposed by the concession company. The Construction All Risks/ Material Damage, Advanced Loss of Revenue/ Loss of Revenue and Third Party Liability elements of the insurance programme are generally project specific (as opposed to utilising, say, the contractors annual insurance programme) and covers all parties with an interest in the project – The Government Authority, the Concessionaire, the Lenders, the Contractors and the subcontractors. The reasons for this are:

- Lenders requirements
- Avoids disputes between the participants insurers as to who is liable
- One policy excess applies
- Certainty as to scope and conformity of cover
- The project is ring fenced from losses on other projects
- For the construction phase, there is a known premium cost for the period

It is highly unlikely that any PPP project in the UK would be sanctioned by the Lenders without protection for the all important revenue streams, i.e. Loss of anticipated revenue (delay in start up) during the construction phase and loss of revenue (business interruption) during the operational phase.

LENDERS REQUIREMENTS

Key Lenders contractual requirements that must be catered for in the project insurance programme are:

Non Vitiation (and subrogation): It is fundamental to the Lenders that their right to recover under the project insurances is not prejudiced by any act, neglect, error or omission (a vitiating act) made by another insured party. As a minimum, the Lenders will require this protection for themselves and the Concessionaire (ie the borrower). Typically, policies provide this protection to all insured parties with a waiver of subrogation against all parties except, in the case of subcontractors, where rights of subrogation are acquired against any subcontractor in consequence of a vitiating act by them.

Reinstatement (Economic Test): In the event of serious loss of or damage to the facility, the Lenders want the right to receive cash from insurers by way of indemnity (as opposed to having to reinstate the facility) if the economics of the project have changed such that it no longer makes sense to continue with it.

Loss Payee Provisions: The lenders will require that the proceeds of any Material Damage and Business Interruption claim are paid into a specified bank account so that they can keep control of insurance funds. In respect of third party liability claims, insurance monies can be paid to the claimant unless a project party has already indemnified the claimant out of its own funds, in which case the insurance proceeds will also have to be paid into the specified bank account. Lenders will generally agree that losses up to a specified threshold (perhaps £250,000) incurred by the Contractor or subcontractors may be paid directly to the relevant party.

Contribution: Lenders will require the project policies to be primary to any other policies held by the insured parties.

Non payment of premiums: The premiums are paid by the Concessionaire. Lenders will require that in the event of non-payment, insurers will give them notice and the lenders will have the option to pay the premium, thus maintaining cover.

Other contractual requirements that do not have to be catered for in the project policies but which relate to insurance are:

Security: The Lenders generally require that the project insurances are placed with insurers having a minimum specified Standard & Poors rating or who are approved by the Lenders.

Premium Increases: In the financial model for the project, assumptions have to be made as to premium costs over the life of the project (25/30 years). Premiums for the construction phase are fixed for the period but for the operational phase the insurances are generally annually renewable and if the assumptions made prove to be wrong, this may jeopardise the financial viability of the project. Therefore, there will be a clause in the project agreement that says that if premiums exceed a specified threshold, the extra cost will be shared between the Concessionaire and the Government Authority. The parameters of this mechanism are subject to negotiation on each project. This sharing arrangement does not apply where the premium increases are due to the claims experience on that particular project or increases in insurance premium tax.

Currently, the threshold suggested by the Treasury at which compensation is triggered (90% of increases over a doubling of cost in a five year review period) is commonly thought to be too high and is an area for substantial negotiation on each project. The Treasury is developing a new insurance cost index intended to be introduced at the beginning of 2005 such that compensation will be in line with average market price movement.

Uninsurability: The Concessionaire is required under contract to maintain certain insurances. Over the lifetime of the project should risks become uninsurable, the Government Authority will be required to become the insurer of last resort. “Uninsurability” is defined in the contract. This definition has changed recently. The Concessionaire must demonstrate that the Concessionaire “and comparable businesses” would choose to cease to operate in the absence of contractual unavailability protection. There is a non-exhaustive list of factors to take into account when considering whether a decision to cease to operate would be made including the likelihood of the risk occurring, the financial consequences, and any other available mitigants.

INSURANCE SOLUTIONS

PPP has been a significant driver in the development of the traditional insurance products - for example, non vitiation cover, property/business interruption insurance for operational roads and motorways (which have never been previously insured in the UK) and multi-class packages offering seamless cover from construction to operational phases – but it has also tested the boundaries of non traditional insurance products, such as:

Non damage delay covers: Liquidated Damages/ Force Majeure

Latent Defects insurance

Environmental Liability/ Cost Cap / Loss of Revenue

Project Professional Indemnity insurances

Cost Overrun insurance

Cancellation - Bid costs

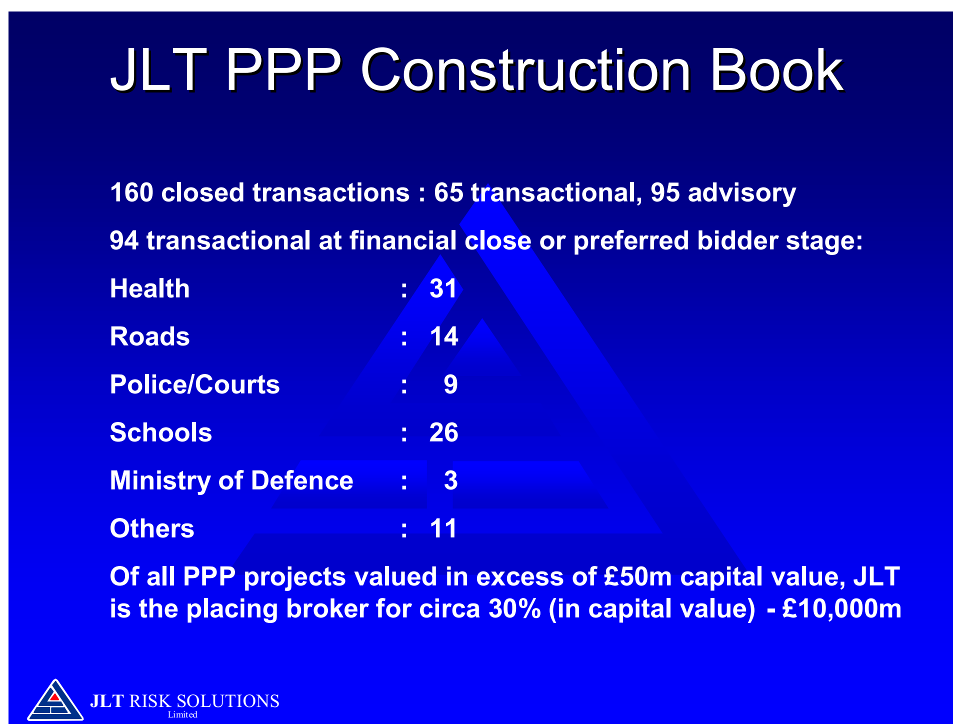
Lifecycle – Whole Life Defects insurance

Change in Legislation: capital costs

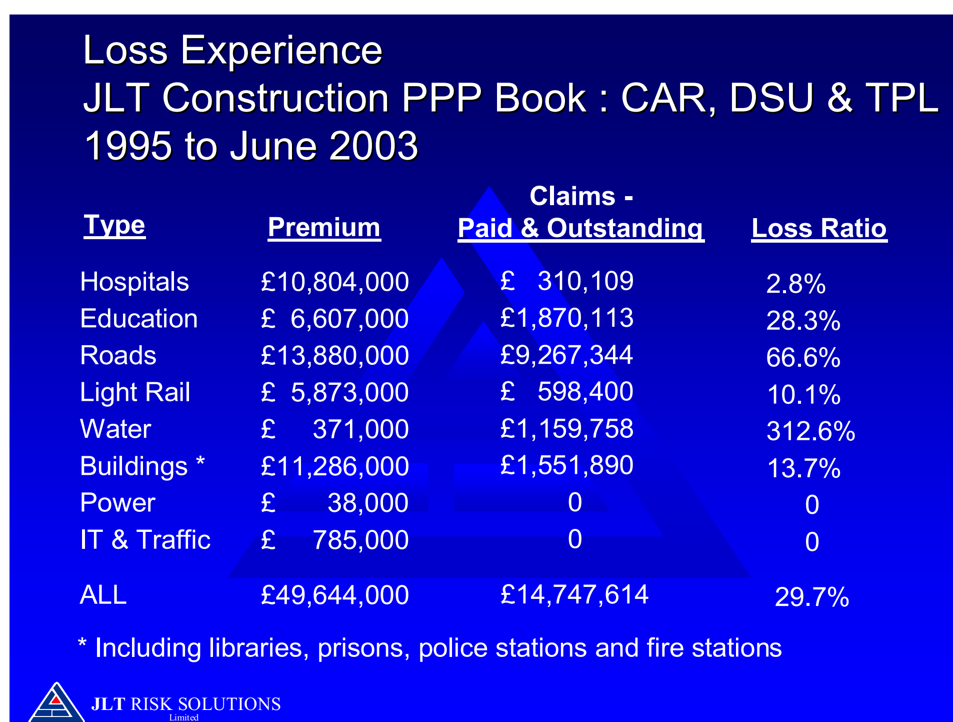
ART solutions eg Residual Value, Volume Risks – such as failure to attain traffic predictions on a motorway project

CLAIMS EXPERIENCE

The following table summarises my own company's experience in PPP. I include this not as an advertisement for JLT Risk Solutions, but to demonstrate the basis for the statistics contained in the subsequent diagram



The following diagram shows the loss experience on the book of construction PPP business placed by my company:



Why the good results?

In my opinion relevant factors are:

- Through necessity, PPP has introduced a more disciplined and sophisticated approach to risk analysis and management.
- The Contractor works closely in partnership with the concession company to define in detail the specification and performance criteria of the facility that is to be built before the project commences. The asset is purpose built for the delivery of the service.
- The Lenders and the Government Authority each employ their own technical advisors to review the Contractors design and construction programme so there is double or treble checking of these critical matters.
- PPP work has demanded and attracted a higher calibre of personnel within construction companies.
- Margins are much better for contractors on PPP projects than traditional construction contracts but the potential downside is greater which focuses the mind on risk.
- In the majority of cases, the Contractor has an equity stake in the Concession company. By taking on equity stakes in PPP projects, contractors have more influence in the bidding consortium, a more significant role at concession company level and can manage their risks more effectively than if just a contractor. In many cases the O&M contractor who is responsible for the maintenance of the facility in the operational phase is also a member of the same company group as the contractor. The contractor, therefore, has a vested interest in the long term performance of the facility.
- Bidding costs (perhaps £1.5m on a £100m capital value project to get to best and final offer stage – when the concession company is down to one of two) preclude all but the most resourceful organisations. There have been some efforts at standardisation of contracts but there is still a long way to go on this. The legal costs incurred on PPP projects are substantial.
- Revenue earned from the project is linked directly and indirectly to the management of risk.

In Conclusion

To quote the CEO of Skanska UK:

"Based on Skanska's experience, PPP has been an overwhelmingly positive experience. Our business has grown into something better. PPP has forced us to integrate our approach internally, with customers and with our subcontractors. Each party involved in a PPP scheme has to think more. What is the ultimate benefit our client wants? We have had to come to terms with the fact that it is actually about a set of outcomes or functions that will be undertaken a generation after the build phase has ended. As such, we have learned how to better understand our customers and to think beyond the life of the construction project itself. PPP has provided an incredible learning opportunity for our industry".

The consensus in the UK construction industry is that PPP is delivering better quality facilities on time and to budget.

PPP is now well established in the UK having been embraced by both Conservative and Labour governments. It has provided the UK insurance market with the opportunity to write a significant book of new and profitable business. PPP is growing in other parts of Europe and elsewhere, presenting a similar opportunity to insurers in those territories.

David Braybrook, Chartered Insurance Broker
Partner
JLT Risk Solutions Ltd (A member of the Jardine Lloyd Thompson Group)

IMIA Conference, Rome
September 2004