PPP's and other independent projects in the Gulf:

What contractors and consultants need to know to take advantage of this growing trend

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Ben Cowling & Emma O’Brien
Clyde & Co
Presentation to the ICES
Background

- PPP / PFI model now an established model for governments in many countries to procure major infrastructure and to outsource statutory duties for the provision of services to the public.

- Countries favouring PPP model:
  - UK, Australia, Canada, South Korea

- Not a new model:
  - Independently financed projects have a long history
  - Defining feature is project finance
  - Implications of this flow through contracts, payment mechanisms, supervision, termination rights etc.

- Types of infrastructure:
  - Power / Water
  - Transport (roads / rail)
  - Social (hospitals, universities and schools/waste management)
  - Defence
Overview

- What are PPPs / independent projects?
- What are the perceived benefits and downsides?
- How are PPPs / independent projects relevant to the Gulf region?
- What does a PPP look like in practice?
- ...but what does all this mean for me? (Contractors / Sub-contractors / Consultants)
- Questions?
What are PPPs / independent projects?
Contracting out risk in the project

- All projects involve risk,
  - i.e. possibility of a different outcome than expected
- Various types of risk in projects
- Different contractual models allocate risk in different ways
- PPPs allocate the most risk to the private sector of all models
  - Contracting out of delivery and availability of an asset over its life cycle – “whole of life” outcome

<table>
<thead>
<tr>
<th></th>
<th>Build only</th>
<th>Design, Build</th>
<th>Design, Build Operate</th>
<th>Privatisation / PPP</th>
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<tbody>
<tr>
<td>Design risks</td>
<td>Security</td>
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<td>Operation risks</td>
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<td>Financing risk</td>
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<td>Demand risk</td>
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(Orange is private sector risk, Blue is public sector risk)

Table adapted from Macquarie Bank presentation, Riyadh infrastructure conference, 2010.
Simplified contract structure: Employer engages on “Build only” basis

Source of funds: General reserves or public sector borrowing

$ Employer / Government

Designer / Engineer

Construction Contractor

Subcontractors

Subconsultants

Suppliers

Operation & Maintenance Contractor

Subcontractors

Suppliers
Simplified contract structure: Employer engages on “PPP” basis

Employer / Government

- Independent Reviewer
- Project Company (owned by consortium of D&C, O&M and investment bank)
  - Source of funds: Private sector borrowing and project revenues
  - Design & Construction Contractor
    - Subcontractors
    - Subconsultants
    - Suppliers
  - Operation & Maintenance Contractor
    - Subcontractors
    - Suppliers
  - Financier’s Engineer

Project Company

- Independent Reviewer
- Employers / Government
- Source of funds: Private sector borrowing and project revenues
Timelines and Contractor participation – “Build only”

- Construction Contractor’s role limited to Bidding and Building
  - In and out in 2 or 3 years
  - Limited care or responsibility for other components
  - Paid during the course of the project as works are completed
Timelines and Contractor participation – “PPP”

- As project sponsor, Contractor could be involved in project until end of O&M period (say 25 years)
- As Contractor (during D&C period), no construction payments received direct from Government
  - Project revenues only start when construction completed (i.e. during O&M phase) – incentive to complete on time
  - Construction payments made by Project Co from own funding (i.e. project finance) – incentive not to incur extra costs
Cashflows – D&C phase

- Government / End users
  - No cashflows

- Lenders / Investors
  - Construction finance / equity

- Project Company (owned by consortium of D&C, O&M and investment bank)
  - No cashflows
  - Construction payments

- O&M Contractor
- D&C Contractor
Cashflows – O&M phase

- Government / End users
  - Service payments / end user charges
  - O&M payments
- Project Company (owned by consortium of D&C, O&M and investment bank)
  - Lenders / Investors
    - Debt repayment / Dividends
  - O&M Contractor
    - No cashflows
- D&C Contractor
  - No cashflows
Types of PPP projects and revenue streams

- Not all projects appropriate for PPPs. Project must either:
  - generate independent revenue / discrete cashflows, or
  - concern a public service for which Government is prepared to pay a regular, set out amount

- Examples:
  - revenue generating:
    - roads (i.e. tolls) / airports (i.e. landing fees)
  - non-revenue generating:
    - public hospitals / schools / prisons / defence

- For latter, project revenue is “service payment”:
  - Government makes payment to the extent the asset is “available” for use
  - Assessed by audited compliance with KPIs under threat of abatement

- Can also have a mix of service payments and right to receive independent revenue
Defining characteristic – project finance

- Investment bank’s role in consortium to seek funding from range of sources
  - **Debt**: bank debt, capital markets, export credits
  - **Equity**: sponsors, managed funds, direct equity / IPO

- Project finance is limited recourse debt
  - Lenders are taking risk in project itself
    - Debt repaid from project revenues and project assets only
    - No recourse to other assets of consortium members
    - Project fails if cannot recover any shortfall (e.g. LDs)

- Lenders have greater interest in project itself and require degree of control as a consequence
  - Major reason why PPP contracting is so complex

- Infrastructure traditionally seen as safe, long-term investment, i.e.
  - Up to 90% debt finance (prior to global financial crisis)
  - Popular investments for superannuation / pension funds
Bid process

- Government will release RFP with project requirements and design parameters

- To Government, Consortium will bid:
  - D&C solution (i.e. conceptual design, initial programme, proposed counterparties / subcontractors)
  - O&M solution (i.e. operational efficiencies, asset maintenance programme, proposed counterparties / subcontractors)
  - Finance solution (i.e. funding structure, commitment letters)
  - Pricing (for post-construction payments)

- Within Consortium, Contractor will bid:
  - Proposed joint venture arrangements
  - D&C solution (as above)
  - D&C price (on usual basis)
Independent projects?

- Included in this discussion because also project financed and contract structures very similar to PPPs
  - Usually involve process plants (i.e. EPC Contracts), rather than buildings / roads etc. (i.e. D&C Contracts)
  - Usually involve full operation, rather than just FM

- Types
  - Independent Power Projects (IPPs)
    - e.g. gas-fired generation assets
  - Independent Water Projects (IWPs)
    - e.g. waste water projects
  - Independent Power & Water Projects (IWPPs)
    - e.g. combination of generation assets and desalination plants

- Project revenue arises from offtake arrangements, e.g.
  - Government agrees to supply inputs for a set price (gas) and to purchase outputs for a set price (electricity)
  - Project Co makes a profit if electricity price higher than gas price plus cost of conversion
Recap of key messages

- PPP model involves Government contracting out Design, Construction, Operation, Maintenance and Finance of infrastructure and public services

- Consortia of D&C Contractors, O&M Contractors and investment banks put together bids for PPP projects

- Consortia source private funding (including project finance) for the construction of project and pay it back from project revenues after construction complete

- Many types of projects appropriate for PPP model
What are the perceived benefits?

What are the perceived downsides?
Benefits

- **Innovation**
  - Encouraged because whole project contracted out and only project requirements (outputs) specified
  - Recognition that private sector better at innovation than government
    - e.g. commercial opportunities from ancillary services
    - e.g. more efficient processing methods

- **Operational efficiency**
  - Integrated design and maintenance solution
  - Public service traditionally seen as slow and inefficient
  - Long term relationships between project partners brings various benefits including:
    - Continuity of service standards
    - Economies of scale across projects
    - Standardisation of facilities and services across the country/region
    - Standardisation of project documents for use on repeat project
Benefits

● Risk transfer
  • Party best able to control / manage particular risks is allocated that risk
  • Year on year budget constraints mean Governments traditionally do not like variable expenses
    - Governments would prefer to pay higher fixed price for someone else to take the risk of that variability
    - Early finalisation of design also allows greater cost certainty

● Off balance sheet financing
  • Governments do not need to go into further debt to build infrastructure
  • Debt sourced by private sector

● “Value for money” (capex)
  • Private sector incentivised to limit time and cost overruns during construction by PPP model
Focus on value for money

**RESEARCH IN AUSTRALIA**

Total cost of traditional and PPP projects (AUD $ million)

<table>
<thead>
<tr>
<th></th>
<th>Expected cost</th>
<th>Net cost overrun</th>
<th>Final cost</th>
<th>% change</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>FULL PERIOD</strong>*</td>
<td></td>
<td></td>
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<tr>
<td>Traditional</td>
<td>3,082.0</td>
<td>1,087.6</td>
<td>4,169.6</td>
<td>35.3%</td>
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<tr>
<td>PPP</td>
<td>4,484.4</td>
<td>519.3</td>
<td>5,003.7</td>
<td>11.6%</td>
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<tr>
<td><strong>POST-CONTRACT</strong>**</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Traditional</td>
<td>4,532.6</td>
<td>672.5</td>
<td>5,205.1</td>
<td>14.8%</td>
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<tr>
<td>PPP</td>
<td>4,946.1</td>
<td>57.6</td>
<td>5,003.7</td>
<td>1.2%</td>
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</table>

*From original approval of project by Government to completion of construction
** From contract signing to completion of construction

Source: Performance of PPPs and Traditional Procurement in Australia, Infrastructure Partners Australia, November 2007
Downsides

- Tender process longer and more expensive
  - Can be a prequalification requirement that consortia commit to spending a certain budget on their bid
  - May also involve two bids to be fully documented before project awarded
  - Some tender periods can be as long as the construction phase (i.e. 2 to 3 years)

- Greater complexity and volume of documentation
  - e.g. Melbourne City Link PPP project had 125 key contract documents (at financial close) and 75 ancilliary documents
  - Large number of participants
  - Difficult job to manage expectations even within the consortium
Downsides

- Conflict between Government’s political and commercial role
  - Infrastructure projects themselves are often controversial
  - PPP projects also seen as contracting out of Government responsibilities
  - Governments can become over-enthusiastic and take steps too far

- Lower cost of Government borrowing
  - Public debt traditionally cheaper than private debt

- Failure of some very-high profile PPP projects
  - e.g. Building Schools for Future in the UK

- Lack of relevant developed PPP model in the Gulf
  - cf. UK and Australian models
How are PPPs / independent projects relevant to the Gulf region?
PPPs in the Gulf generally

- **Huge demand for infrastructure**
  - ~US$70 billion of investment required in power and water to meet demand by 2015 (2007 estimates)
  - Spending on healthcare services expected to reach ~US$60 billion by 2025; only projects worth ~US$10 billion in the healthcare sector are currently being executed

- **PPPs across the Gulf are mainly in power and water; less so in transportation and social infrastructure**
  - New sectors being tested:
    - Industrial cities (2007)
    - Universities (2008)
    - Road PPP launched in 2009
    - Healthcare expected to follow
PPPs in the Gulf generally

MENA Infrastructure projects

Source: Dealogic and SCB
## Recent Gulf PPPs

<table>
<thead>
<tr>
<th>Project</th>
<th>Sector</th>
<th>Country / Emirate</th>
<th>Year</th>
<th>Deal Size (USD mil)</th>
<th>Tenor</th>
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</thead>
<tbody>
<tr>
<td>Adwea ISTP-I</td>
<td>Water Treatment</td>
<td>Abu Dhabi</td>
<td>2007</td>
<td>400</td>
<td>20</td>
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<tr>
<td>Al Ain University</td>
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<td>Abu Dhabi</td>
<td>2007</td>
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<td>Industrial Cities I/II</td>
<td>Basic Infrastructure</td>
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<td>2007</td>
<td>220</td>
<td>20</td>
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<td>Sorbonne University</td>
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<td>331</td>
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<tr>
<td>Adwea ISTP-II</td>
<td>Water Treatment</td>
<td>Abu Dhabi</td>
<td>2009</td>
<td>400</td>
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<td>Zayed University</td>
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<td>Abu Dhabi</td>
<td>2009</td>
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<td>Shuweihat 2 IWPP</td>
<td>Power / Water</td>
<td>Abu Dhabi</td>
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<td>22</td>
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<tr>
<td>Rabigh Power Plant</td>
<td>Power / Water</td>
<td>KSA</td>
<td>2009</td>
<td>2,400</td>
<td>N/A</td>
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<td>Riyadh Power Plant 11</td>
<td>Power / Water</td>
<td>KSA</td>
<td>2010</td>
<td>2,300</td>
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<td>Al Dur IWPP</td>
<td>Power / Water</td>
<td>Bahrain</td>
<td>2009</td>
<td>1,339</td>
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<td>Salalah IWPP</td>
<td>Power / Water</td>
<td>Oman</td>
<td>2009</td>
<td>750</td>
<td>17</td>
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</tbody>
</table>
Focus on UAE

- Abu Dhabi leading the way
  - Transport infrastructure
    - Mafraq/Ghweifat Roads Project (pending)
  - Universities
    - Sorbonne (financial close late 2008)
    - Zayed University (financial close late 2009)
    - New York University (financial close ?)
  - Schools
    - Abu Dhabi Education Council – 176 public schools and 9 private operators

- Dubai playing catch up
  - Draft PPP law (very recent press)
  - Statements of intention, e.g.
    - RTA regarding Sheikh Rashid Bridge and the Dubai Smile
    - RTA says 30% of projects will use model over next 3-5 years
Focus on KSA

- **Power and Water**
  - Well-established model in KSA
  - SEC says that 30%-40% of future generation will be IPP
  - US$15 billion in investment needed in next 8 years

- **Rail**
  - Saudi Landbridge PPP – taken back by Government

- **Airports**
  - GACA statement in early January

- **Schools and universities**
  - The next big thing?
PPPs in the Gulf generally

- Economic drivers towards the PPP model the same as everywhere else
- Local factors
  - **Pros:**
    - Huge demand for infrastructure and lack of government resources to deliver / supervise…
    - Positive of way of attracting foreign investment into the region…
    - Private – rather than public – finance …
  - **Cons:**
    - Degree of administrative “catch-up” required by governments…
    - Political / economic uncertainty…
    - Letting design go…
    - Government traditionally the largest employer of locals…
    - Temptation to revert back to traditional procurement…
What does a PPP look like in practice?
Generic contract structures

Typical PPP Project Structure

Government Body
eg Ministry of Transport/Health/Education

Construction Contractor

Interface Agreement

Maintenance Contractor

Interface Agreement

“Soft” Facilities Maintenance Contractor

Funders

Direct Agreement

Construction Contract

Maintenance Contract

Services Contract

Project Co

Concession Contract

Direct Agreement
Building Schools for the Future (UK)

- Local Education Authority
  - PFI
    - SPV
      - Building Contract
      - Facilities Maintenance Contract
  - Building contract
    - Partnership for schools
    - Local Education Partnership
      - Private sector partner
      - Facilities Maintenance Contract
Features to focus on: Project Level

- **Service standards**
  - Purchase of services, not assets
  - Service levels are maintained throughout concession period
    - Availability deductions
    - Key performance indicators
  - Enhanced services
    - Incentives to innovation
  - Specialist contractor buying power/work force
    - Market testing
    - Benchmarking

- **Consortium/Project Co**
  - Buy in of shareholders
  - Service continuity/defects wrap

- **Funder involvement**
  - Project stability
  - Standardisation
Features to focus on: Contractor Level

- **Pass down**
  - Project company approach
  - Consequences for Contractors

- **Interface**
  - Involvement with other contractors
  - Interconnection of services
  - No gaps in services

- **Particular issues**
  - Acquiring old assets
...but what does all this mean for me?
(Contractors / Subcontractors / Consultants)
Contractors: Upstream Issues

- Bid management
  - level of risk accepted from SPV
  - funder control
- Pay when paid
- Government Direct Agreement
Contractors: Same Tier Issues

- Interface Agreement:
  - Acquisition of additional risk/obligations
  - Defects liability
- Contractor replacement
- Funder Direct Agreement
Contractors: Downstream Issues

- Achieving pass-through to subcontractors including
  - timing of appointment
  - subcontractor sophistication
- Direct agreements
  - familiarity
  - consequences
Subcontractors

- Level of Risk Pass-Through
- Pay when Paid
- Direct Agreements
Consultants

- **Financier’s Engineer**
  - Acting for funders, not employers
    - Emphasis on Time for Completion
    - Linked to cash flow

- **Independent Reviewer**
  - Appointed by Government Entity
  - Limited involvement
    - Defeats object of risk pass down
    - Involvement: greater expense

- **Traditional Roles**
  - “Traditional” designers;
  - “Traditional” engineer role
  - Feasibility studies
Questions?