

Bonding P3 Projects

Government entities in the United States have understood the importance of surety bonds and have required bonds for over a century to provide performance and payment assurance for the nation's infrastructure projects. Although procurement methods have evolved—including the increased use of public-private partnerships (P3s) in the U.S.—construction risks remain the same, making surety bonds just as relevant and important today. Bonding is a tool that protects taxpayer and investor dollars and supports economic empowerment, sustainability, job creation and legacy wealth for contractors and subcontractors, and the surety industry remains ready to provide bonding for all types of construction delivery mechanisms, including P3 projects.

Frequently Asked Questions about P3s and Bonding

What is a public-private partnership (P3)?

A P3 is a long-term contractual agreement between a public entity and a private partner in which the private partner, in exchange for compensation, invests its own assets and delivers a public service or facility. In such agreements, the public entity grants the exclusive rights (“concession”) to the private partner (“concessionaire”) to engage in an activity that would otherwise be a public responsibility and compensates the private partner. The P3 agreements currently in place or under consideration have lifetimes of 30 to 99 years.

How are P3s used?

P3s have been used to a much greater extent in other countries to design, finance, construct, operate, and/or maintain many types of public services and infrastructure: transportation, water infrastructure, wastewater facilities, court houses, prisons, hospitals, and schools. In the United States, the P3 is more of a case of first impression. The experience with P3s is limited; however, the current level of interest in P3s is high at both the state and federal levels.

How do P3s work?

Every P3 is unique in that it is the result of negotiations between the public and private partners and P3 agreements can take many forms. The following are the most common P3 structures:

- 1) *Design-Finance-Build-Operate-Maintain*; The private partner can be involved in some or all of these functions. In this structure, the private partner finances a public service or facility and is compensated, usually over the term of the P3 agreement. The compensation can be the right to collect revenues associated with the project (e.g., private partner constructs road and collects the tolls for 30 years) or periodic payments from the public entity based on performance (e.g., payment is triggered at milestones in the P3 agreement if the infrastructure is operating as required). In some P3s, the public entity pays the private partner pre-established “availability payments,” which are rent-like

payments based on certain periods of time. The payments are made if the contractually obligated construction or performance specifications are met. When the public entity makes periodic or availability payments, the funds come from public funds.

- 2) *Sale/Long-Term Lease*; The public entity “sells” an existing public asset (e.g., a government building/ parking lot) to the private partner through a long-term lease, under which the private partner gives the public entity a cash payment upfront. The private partner gets the long-term revenues either from lease payments (public building) or the revenue stream from users (parking lot). This often is called the “monetization of a public asset.” The public entity usually retains ownership and the public asset is returned to it upon expiration of the P3 agreement.
- 3) *Build/Leaseback*; The private partner invests the costs to construct a public building, and the public owner agrees to a long-term rental after construction.

Who are the private partners?

The entities involved as private partners generally are infrastructure equity investors and lenders, developers, and construction/engineering firms. In most P3 agreements, the private partner is referred to as the concessionaire.

How are P3s different from other public works projects?

Under traditional methods of construction of public works projects, the public entity lets a contract to a private construction company, based on a public design and with public financing, to pay the contractor. Contracts are let through a competitive bidding process and awarded to the lowest responsible bidder, who completes the project and turns it over to the public entity. The public entity must obtain funding, hire a designer, solicit bids, oversee the construction project, and ensure the operation and maintenance of the facility over its lifetime.

Under a P3, the private partner may participate in the design, finance, construction, operation, and/or maintenance. The public entity usually starts with a Request for Qualifications to identify and retain a qualified private partner/concessionaire. The prospective private partners submit proposals. After review, the public entity invites those that it believes are qualified to bid in a final round in which bidders submit detailed plans. The selection criteria may vary with the type of project, and the winning proposal may not be the least costly. The public entity and the private partner negotiate a P3 agreement.

Do all P3s involve public construction?

The answer is yes when a P3 involves design, build, finance, operate, and/or maintain, because these arrangements generally involve public infrastructure construction, either transportation or more recently, social infrastructure. There are other P3 relationships where public construction may not be involved in the P3 arrangement. For example, in Sandy Spring, Georgia, almost all municipal services have been outsourced to CH2M Hill, including police department, fire department, and trash clean up services. At the federal level, the Federal Emergency Management Agency (FEMA) is known to have many P3 relationships for disaster or emergency management.

Why are P3s such a big issue in the United States now?

Currently, the need for infrastructure improvement in the U.S. far exceeds the available funds at the state and federal level. In its 2013 Report on American Infrastructure, the American Society of Civil Engineers (ASCE) gave the overall grade point average of the current system a D+. The estimated investment needed by 2020 to restore it is \$3.6 trillion. The Federal Highway Trust Fund, which funds the federal government's surface transportation programs with revenues from the federal fuel tax, has not had enough money to fund its current obligations since 2008. It has received around \$50 billion from the general revenues to address shortfalls and it is predicted to run out of money in 2015. Most state and local government budgets have been cut and they lack even the funding levels that they had prior to the Great Recession to complete all the needed infrastructure projects, so the financing available through a P3 is attractive to public entities.

Why is legislative authorization needed for P3s?

State law varies, but state and local governments may not have the authority to encumber government property with a lease or otherwise with a private partner.

Additionally, existing procurement codes typically address public works projects that involve contracts directly between the public entity and the contractor that performs the work. P3s involve contracts between the public entity and the private partner/concessionaire, who in turn contracts with the team that performs the construction under the P3 agreement. The private partner, not the public entity, hires and supervises the contractor in a P3. Existing public procurement laws address construction projects, but P3s also can contain elements other than construction. The private partner may design, construct, finance, operate, and/or maintain a public infrastructure project. Over the last decade, states have needed to amend their procurement codes in a similar manner to authorize other new methods of delivery, such as design-build and construction manager-at-risk, for the same reasons.

In addition, under P3 agreements, public entities commit public funds to repay the private partner over a long period of time. Legislators want to provide a statutory framework for P3s as the impact of these projects will be felt for generations. P3 legislation typically contains detailed requirements for the procurement process for a P3 and the terms and conditions that must be included in the P3 (concession) agreement.

Why should surety bonds be required on P3 projects?

The value of bonds for construction projects is the same no matter the procurement method.

One of the primary benefits of bonding is the surety's prequalification of contractors. The surety's underwriting of a bond is crucial to the success of public works projects. The surety provides a bond only to contractors that, in the surety's estimation, are capable of performing the work. The surety examines the contractor's expertise in the work, character, ability to work in the region where the project is located, current work in progress, and overall management as well as its capital and record of paying its obligations. By issuing a bond, the surety provides the public entity and the taxpayers and subcontractors with assurance from an independent third party, backed by the surety's own funds, that the contractor is capable of performing the construction contract.

The other primary benefit of the bond is that the surety responds if the contractor defaults. The payment bond guarantees that covered subcontractors, suppliers, and laborers on the job will get

paid. Generally, mechanics liens cannot be asserted against public property. Subcontractors, suppliers, and laborers on public works projects must rely on the general contractor's payment bond for protection. If no payment bond is required, these parties are left with no means to collect for their services and supplies if the contractor is unable or unwilling to pay them. Many subcontractors and suppliers on public works projects are small contractors that have fewer resources to absorb an event of non-payment. The payment protection of surety bonds often is of the greatest value to women and minority contractors who most frequently are smaller and less able to absorb this risk.

The performance bond guarantees that funds will be available to complete the public works project according to the construction contract. For a traditional public works project, if a performance bond is not provided, the federal, state, or local budget and taxpayers take on the risk should the contractor default, and thus bear the burden of re-letting work and paying any excess completion costs. When a performance bond is in place, the full amount of the bond is available to complete the project in the event of the contractor's default. Governmental entities do not have adequate resources to perform all of the tasks that the surety does either in prequalification of contractors or in the servicing of claims brought on by contractor default.

P3s may add some new twists to the basic issue regarding bonding on public works projects as discussed below.

If the private partner finances the project, is it still a public works project?

The private party merely finances the project; the public still ultimately bears the cost and obtains the benefits of the project. The private party always is repaid with public funds in any P3. For example, the private partner that pays the upfront costs to rebuild a public road typically gets repaid through a license to collect the tolls for the next 30 years. A P3 is a new source of financing for the public entity, not a new revenue source. Private money has long been used in public works projects. One of the traditional ways state and local governments fund public works projects is through issuance of municipal or other revenue bonds, which private investors purchase. For over 75 years, the federal government has granted tax exemptions on interest paid on bonds issued by state and local governments to finance public works projects in order to encourage such private investment. A P3 is a new way for public entities to access the capital market.

If the private partner has the risk of construction in a P3, why should bonding be required?

The private partner may design, construct, build, finance, operate, and/or maintain a public works project under a P3, and appears to assume the risk involved in the construction portion of the P3 in terms of schedule and costs, including any cost overruns, contractor defaults and re-letting of construction contracts. If the public entity no longer chooses and manages the construction contractor, are bonds still needed to protect the public entity and taxpayers in the event of the contractor's default and payment of subcontractors, suppliers, and workers as the risk has shifted to the private partner? The simple and decisive answer is yes.

The first "P" in any P3 is "public." The end result of a P3 is a project that provides a public service or facility. A P3 is just another method to deliver a public works project, just like design-bid-build by a general contractor, design-build, and the construction manager methods. Construction of public works should be bonded.

Public money pays for the P3 project in the long run, and such public funds are at risk in a P3 the same as in any other method of delivery. Arguably, the risk to the public entity is increased in a P3 since the public entity is responsible to the taxpayers to deliver a public service or facility, but the public entity does not choose or control the construction contractor and could suffer financial loss if the private partner defaulted.

The private partner also can and has failed for reasons unrelated to the construction portion of the P3. If the private partner's financing fails and causes a default when the construction portion of the P3 is not yet complete, the public entity may have to take control of the project. Without a surety bond that includes the public entity as an obligee, the public entity would have to fund, manage, and possibly re-let the construction part of the project. Requiring performance bonds on the construction portion of a P3 will protect the public entity and its taxpayers in the event that the private partner defaults and the public entity takes control of the P3 just as they do in any other public works project.

With respect to the payment of subcontractors and suppliers, when subcontractors perform, they need to be paid promptly for the work. The public interest demands that payment bonds be in place on P3s to ensure that subcontractors and suppliers get paid promptly for work performed if the construction contractor defaults on the project. Payment to these entities cannot spread over the long life of a P3 contract.

Politically, the risk to the public entity also remains the same. Taxpayers have a direct interest in seeing those roads completed on time and maintained. They also want school projects delivered for the start of the school year. If there are problems or a contractor defaults in the construction portion of a P3, the public entity will get the same pushback that it gets when something goes wrong in any other type of public works project. The bottom line is that the public entity remains responsible for delivering a completed public works project to the taxpayers. That risk politically cannot be shifted to the private partner.

If the public entities prequalify the private partners that can bid for a P3, why do contractors that perform the construction in the P3 need to be bonded?

The public entity prequalifies the private partners that can bid and be selected in a P3. In most cases, the contractor performing the construction portion of the P3 is the private partner or is affiliated with the private partner. If the public entity has determined that the private partner is qualified to perform under the P3 agreement, why should the public entity require bonds?

The public entity is prequalifying the private partner for many things, and construction is simply one part of those contractual responsibilities. The construction, however, is the piece that most impacts the taxpayers and subcontractors and suppliers on the project. Construction is extremely risky, and contractors perform more than one project at a time. It is not uncommon that the loss that causes the collapse of a company is not the job the contractor is performing for a particular public entity, but one of its other projects.

One of the key benefits of having a surety is that the surety has a broader view. Sureties look at the 3Cs—capital, capacity, and character. Sureties provide a robust review of all the activity in which a contractor is engaged. Once a contractor gets in trouble on one job, its effects are felt on all the jobs. When a surety determines that there is a problem with the account, it manages the entire situation, not just one job or the bonded jobs. A governmental entity does not have the

access to information about all the projects in which the contractor is engaged nor does it have the resources to provide the degree of scrutiny and management that a surety does. In a P3, to the extent the public entity scrutinizes the ability of the contractor to perform the construction, it will be reviewing only the contractor’s ability to perform the work under the P3 agreement, rather than looking at the broader picture as the surety does.

If a bonded contractor defaults, its surety supports the contractor with the strength of its balance sheet. Also, the surety industry can avail itself of risk mitigation strategies that spread the risk of loss, including co-surety for mega projects or reinsurance. If a large contractor defaults and the projects are not bonded, each owner or obligee has to negotiate its own resolution and manage the completion of the project and payment of subcontractors and suppliers. Surety companies are equipped to manage these types of defaults and have claim departments that do just that.

The recent failure rate in the construction industry shows that construction is a risky business. The contractors, subcontractors, and suppliers that the private partner/concessionaire hires for the construction element of the P3 can default on their performance. The value of the surety bond is the prequalification of the contractors that are able to do the job in the first place to prevent construction losses. In the event of a default, the surety steps in and pays to complete the contract up to the value of the bond.

Surety in the 2000s

Building, heavy/highway, and specialty trade contractors

In Business	Survivors	Failure Rate
2002	2004	
853,372	610,357	28.5%
2004	2006	
850,029	649,602	23.6%
2006	2008	
1,155,245	919,848	20.4%
2009	2011	
897,602	702,618	21.7%
2011	2013	
986,057	735,159	25.4%

Source: BizMiner



Since large sophisticated contractors participate in P3s, should they be required to be bonded? Big is big; big does not necessarily mean strong. One only need look back less than 20 years to see a list of well established and well respected large heavy construction companies that have

filed for bankruptcy—names like Morrison Knudsen (1905-1995), Guy F. Atkinson (1926-1997), and J.A. Jones (1890s-2003). A more recent name is Modern Continental (1967-2008), the largest contractor on the Big Dig. In 2000, Modern Continental was a \$1.3 billion company with over 4,000 employees. While Modern Continental's problems started with a default on a wastewater treatment plant project, the issues it encountered on the Big Dig (including a guilty plea to 39 federal charges) led it to file for bankruptcy in 2008. The successful completion of the Big Dig should be credited to the surety claim department that managed the claims and financed Modern Continental to completion of its projects and ultimately filed a proof of claim in the bankruptcy for hundreds of millions of dollars.

Even more recently, Ballenger Construction Company (1937-2012), a large Texas road contractor, filed for bankruptcy in December 2012 leaving millions of dollars in bills to subcontractors, suppliers, and others on 20 bonded transportation projects with a total value of \$356 million. About \$112 million of work remained on the Ballenger contracts when the company went out of business. Ballenger was founded in 1937 and had 550 employees, all of whom were laid off. Ballenger's sureties again are managing the claims and making sure the projects get completed and the subcontractors and suppliers who timely file proper claims are being paid.

Large contractors need the surety's prequalification in a P3 just as in any other public works project. The surety does not look just at the contractor's qualification to complete the public works project upon which the contractor submits a bid. Rather, the surety reviews all the contractor's works in progress to make a determination that the financing, equipment, workers, and other resources will be available and on location when the new project starts.

To the extent that a P3 has construction elements, the construction risk is the same under a P3 as any other delivery method, and construction is a risky business.

Who should be required to obtain the bonds for the construction portion of a P3?

Most often the private partner is a consortium/team of companies that forms to develop the P3. These companies form a Special Purpose Vehicle (SPV). The individual companies in the consortium become shareholders in the SPV and their liability is limited to the amount of capital they have invested in the P3. The individual companies in the consortium create the SPV to make a clear legal separation between their respective companies and the consortium and its P3 project. If the private partner is an SVP, it likely will not be able to obtain the required bonds. The SPV has no assets of its own and there is no recourse against the SPV in the event of the contractor's default. The surety needs to evaluate the construction risk in issuing bonds and that exposure is with the design build contractor not the SPV. If the private partner is the construction contractor, then the contractor should be required to obtain the bonds. In most instances, however, the private partner should be required under the P3 agreement to obtain bonds from its design build contractor.

If P3s have worked in other countries with limited bonding, why can't that work in the U.S.?

P3s have been used in countries with vastly different procurement systems than the U.S. Other countries have different approaches to public funds, and many do not include protection for subcontractors and laborers on any public project. They also do not look for the security posted on a public construction project to address completion of the project or to pay workers, but rather require only a small demand guarantee. In essence, the public entities in many other countries

require a small amount of money to be available upon demand if the contractor defaults so that they can re-let the contract. These countries often do not limit the guaranty that must be provided to a surety bond, but rather permit letters of credit (LOCs), and sometimes even parental guarantees and other forms of security. Some countries require 30% to 50% bonds. Many countries require only a 5% to 10% LOC as the security on any public construction project, and their P3 projects follow that approach. In the countries that do require a higher-percentage conditional guaranty, that same percentage normally is required for P3 projects as well.

The U.S. is the only country that requires 100% bonding of virtually all public works projects. The U.S. adopted a policy over 100 years ago that the key to protection on public construction projects is surety bonding, which ensures the completion of the contract and payment to the subcontractors and workers on the job. That policy is contained in the federal Miller Act and the state Little Miller Acts, which require bonding on public works projects to guarantee payment for completion of the contract and payment of subcontractors and suppliers. These public policies have assured the successful completion of construction projects and protected businesses for decades. Those public policies hold true regardless of who is providing the revenue stream for these projects.

Many of the private partners in P3s are foreign companies that are familiar with the public procurement system in their own country and have not been required in the past to comply with the requirements in the U.S. of large penalty bonding on public works projects (i.e. bonding 100% of the contract price). Here in the U.S., we have a procurement system that guarantees that significant funds will be available to pay for completion of the work and payment of workers in the event a contractor defaults on a public works project. Other countries treat P3s like any other public construction project, and P3s in the U.S. likewise should be treated as any other public construction project and require bonding. There is no reason to adopt a foreign approach to P3 projects here at home.

Should surety bonds be changed to meet the expectations of foreign private partners and encourage investment in P3s in the U.S.?

It must be understood that bonds are universally required on public construction projects in the U.S. to protect public budgets, taxpayers and subcontractors, suppliers, and workers on the job—not private partners and their investors. The latter are sophisticated parties that have the expertise and resources to negotiate financing arrangements and P3 agreements on terms that are acceptable to them. Bonds are required to protect the public interest, increasing the likelihood that the construction contract will be completed and that subcontractors, suppliers, and workers will be paid promptly. If there is a contractor default, the surety is going to bear the expense of adjusting the claims and managing the process. The payment protection available for subcontractors, suppliers, and workers and the contract completion protection for public entities should not be compromised and reduced because some financiers and concessionaires are comfortable with less security. Changing the fundamental U.S. protections solely to accommodate the financial interests of equity investors or financiers is misplaced. Bonding 100% of the construction portion of P3 projects still remains the best option in the U.S. for payment and performance security.

Should the Operations and Maintenance (O&M) also be secured?

Public owners should be just as interested in securing the obligations under the O&M portion of a P3 project, as they are on the design and construction portion. In practice, public owners are

seeking guarantees of the performance of these O&M obligations that involve long durations, and they typically have sought surety bonds or other forms of security.

Can surety bonds be used as security for the O&M obligations?

Surety bonds frequently are used to secure O&M contracts. These O&M bonds are of limited duration and written on a regular basis. The long-term nature of many P3 projects, however, makes it more difficult for the surety to issue a bond for the duration of the P3 agreement. Sureties can and have provided O&M bonds that guarantee the payment and performance protection needed on the O&M portion of the P3 contract with careful contract and bond language. Under these O&M bonds, the private partner, (the concessionaire or special purpose entity) is the obligee and the public owner is an additional or “dual” obligee.

Can the O&M portion of a P3 project be bonded separately from the design-build portion of a P3?

Typically, the design-build work and the O&M work are separate contracts running to the private entity. Performance and payments bonds for the O&M work would only cover O&M obligations to be performed after substantial completion of the construction portion of the P3.

What do the O&M bonds cover?

The O&M performance and payment bonds on a particular P3 project would cover only the O&M obligations to be performed *after* substantial completion of the construction contract. Those O&M obligations would be set forth in a separate O&M contract and not combined or subsumed within the design-build contract. The O&M bonds would specify that they cover O&M payment and performance defaults that occur during the specified term of the O&M bonds. An appropriate bonded obligation scope would require that the O&M bonds be liable for operation costs incurred for services provided during the term of the bonds up to the O&M bonds’ expiration date, and for maintenance costs incurred in order to remediate maintenance issues that arose during the term of the O&M bond.

What is the duration of O&M bonds?

The term of O&M contracts can range from 1 to upwards of 40 years. Since a surety’s ability to underwrite the long-term future financial health and capabilities of a contractor, based on past and present performance is limited, a surety likely will not be willing to issue O&M bonds for such durations. O&M bonds with shorter, renewable terms—anywhere from one to five years—are commercially viable. Bonds with longer durations are not. The benefit of the bond to the obligee is that the surety reviews and re-underwrites the O&M throughout the duration of the O&M contract, providing insight into the contractor. Therefore, it is important that an O&M bond include a clear and unambiguous statement of an acceptable bond term and that the bond form specify that the surety shall have no obligations for defaults that occur after the expiration of the bond term.

What is the bond amount of an O&M bond?

The O&M bond should contain a fixed bond amount in a stated amount. A variable bond amount, based on calculations and various factors contained in the O&M contract, lacks the specificity that the surety needs to issue a guarantee and can create confusion for all parties. A simpler and recommended approach is for the bond amount to be expressed as a dollar figure that approximates the amount to be paid to the O&M contractor for O&M services rendered during the bond term.

Would the O&M contractor's failure to renew or replace the O&M bond upon expiration of its stated term be a default under the O&M bond?

The failure of the O&M contractor to renew or replace its bond as required by the O&M contract cannot be a default under the terms of the bond since the contractor is not in default of actual performance under the O&M contract or agreement. Therefore, only defaults in the performance of the O&M contractor's performance of work in the operation and maintenance of the public asset should form the basis for a claim against the bond. If the contractor cannot provide a renewal or new bond, the obligee's remedy is to terminate the contract and engage another contractor that is bondable.