

PPP projects in the education sector – Key principles



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INTRODUCTION

Public Private Partnership (“PPP”) is a model of public procurement based on long term relationships between central government or other public bodies and the private sector for the delivery of services. It is the emphasis on service provision, value for money and length of relationship that distinguishes a PPP project from a more traditional procurement, where a government may engage a private sector counterparty to construct an asset, or deliver equipment (which the relevant government would then own and manage itself).

The way in which the private sector engages and participates in education projects will reflect the strategy chosen by the relevant public sector body to best achieve its overall objectives. In recent years, central governments in a number of countries have publicly encouraged their local authorities or other government bodies to consider the advantages of contracting with the private sector for the long term provision of capital intensive services through PPP type arrangements. Increasingly, we have seen governments utilise PPP approaches for the construction of primary and secondary schools and universities and the delivery of certain associated facilities maintenance and other education based services under long term arrangements with private sector consortia.

In relation to schools projects, we have worked on single site projects and we have also worked on projects where public sector bodies utilise PPP approaches for grouped education facilities – thus achieving under the umbrella of one long term project the reconstruction and/or upgrading of multiple schools in a particular region, state or borough of a country. We have also been involved in the development of framework agreements between private sector participants and government authorities to provide for ongoing, multi-site education construction works and maintenance and operation services projects (using a mixture of traditional finance, equity subscription and project finance depending upon the nature of the specific project) for extended (long-term) periods of time.

PPP is a technique in which we have extensive experience in a wide range of industry sectors, including the education sector, with a leading reputation for successfully devising innovative and pragmatic structures to appropriately apportion project risks which have proved to be bankable. This paper aims to provide some details of the key principles and issues that will arise on any education based PPP project. While the issues which frequently have to be dealt with in education projects can be easily described in a short form format (an illustrative list is set out in the table below), the best way of dealing with individual risks and issues will be highly dependent on transaction specific factors, so blending experience with innovation and pragmatism will be vital in achieving the aim of both the public sector and the private sector participants.

KEY PRINCIPLES

Two key principles underlying PPP arrangements are:

- the allocation of risk to the most appropriate party (being the party most able to manage those risks, be that the public or the private sector participant);
- payment when and only for services delivered; and
- ensuring value for money (in terms of both the overall cost to government and the level and quality of services delivered) is achieved through the structure and contractual suite of documents entered into.

Typically, education based PPP projects involve the design, construction, operation and financing for a school (or schools) or other educational facilities and/or the refurbishment and upgrade of existing facilities. The operation of the facilities will usually involve both “soft” facilities management services such as cleaning, catering or estate management services as well as “hard” facilities management services such as building maintenance services. Core education services such as the provision of teachers are usually retained by government but in theory there is no reason why such core education services could not be provided under a PPP arrangement.

As with many other accommodation based PPP arrangements, education projects are usually structured so as to bring about a form of step-change in the way services are delivered and contain binding, contractual performance standards designed to maintain quality of service delivery over the full 20-30 year service period.

Most education PPP projects have common features which include in particular the following:

- clear and unambiguous long term contractual performance standards agreed at financial close of the relevant project;
- clear output based services specification document there should always be a degree of flexibility built in to the output specification by way of a formal change mechanism to recognise that changes in circumstances beyond the contemplation of the parties at financial close may occur given the long term arrangements being put in place;
- costs calculated on a whole life basis (which means taking into account the private sector's expectations at financial close of the relationship between the design and build of the relevant facilities, their long term operation and any improvements over the contract term);
- an ability for both the public and the private sector participants increase monitoring and to remove service providers or other sub-contractors for persistent non-performance as an alternative to termination of the PPP project in its entirety;

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- processes and arrangements for regular dialogue and partnership working between the contracting parties; and
- arrangements for harnessing the benefits, economies or other improvements to the services offered by new technology or innovation during the contract term – this is especially relevant in education projects which often provide great emphasis on services involving information and communications technology (ICT), the hardware and software that provides networked computing to teachers and pupils (it is often said that a good managed service should allow ICT to be seen as a “fifth utility”, one requiring constant adaptation in line with general technological advancement). Specific provisions setting out ICT arrangements are often of key importance for procuring authorities in the education sector.

RISK ANALYSIS

PPP projects ordinarily involve limited recourse by project lenders to the private sector sponsor(s). Tight construction timetables, service provision requirements and termination arrangements also put at risk sponsors investment and reputation. As a result, project lenders in particular but also project sponsors will always carry out an exhaustive analysis of the inherent project fundamentals, including the overall robustness of revenue streams and key project risks. Some of these project risks are detailed below, many of which will be applicable to many accommodation based PPP projects and some of which are more particular to education projects.

Construction risks

Ground conditions – a risk common to all accommodation based projects. Unforeseen ground conditions such as fossils, remains, munitions, contamination or other environmental factors can have a serious impact on the timing and cost of a project. In some jurisdictions, it is more common to have government bodies accepting responsibility for non-foreseeable ground conditions resulting in construction delay, but this is not always the case. Where the public sector passes ground risks to the private sector, it will be necessary to ensure the risk is fully passed down to the construction contractor (who will in turn assess and price the risk accordingly).

Completion requirements – any completed facility (including connection of relevant utilities and ICT) must come into operation by passing all relevant tests imposed by government and associated relevant authorities. It is a crucial stage for any project as capital spend is at a high point, there will have been no return on capital to date and the project will be entering into a phase of transition between a contractor who has completed a facility, with the possibility of liquidated damages or temporary accommodation requirements being imposed if problems arise, and an operator taking on an as yet unproven facility who will have the prospect of deductions being imposed for unavailability or poor performance which may be caused (in whole or part) by problems with a relevant

facility. Our involvement in various projects has indicated that there are numerous ways in which this key moment of interface can be appropriately managed, including ensuring:

- that there are clear and unambiguous commissioning and completion tests in place under the contract arrangements;
- where relevant, there are clear provisions relating to the appointment of an independent tester;
- any construction contractor remains responsible during an initial period of operations whilst a facility is proven and that there are appropriate “snagging” rectification arrangements and defects liability; and
- tri-partite arrangements are put in place between the PPP contractor, the construction contractor and the service provider (often in the form of an interface or cooperation agreement) clearly allocating the part to be played by each party in relation to commissioning and completion and providing mechanisms for dealing with claims between each party and dispute resolution (and, importantly, ring-fencing the PPP contractor from the cash-flow implications of any such dispute).
- **Planning and third party consents** – the risks associated with planning and other third party consents or approvals required for any project are often passed by government to the private sector. Where possible, it is recommended that planning risk is alleviated by obtaining at least some form of outline consent at an early stage and to the extent possible, detailed planning consents. Where this is not possible, on occasion contractual mechanisms can be built in to either move commencement/completion dates or provide an appropriate exit if planning proves impossible. Whilst planning and consent risk is mostly mitigated by pass through to subcontractors, it is in any event imperative that the risk is managed through clear processes to ensure all relevant third parties are aware and informed of the development and its requirements at all relevant stages.

Change in law

PPP companies are required to comply with law and governments usually require a contractual obligation in concession agreements requiring their private sector counterparty to comply with law in the relevant jurisdiction. PPP projects are long term in nature and accordingly there is always a risk that changes in law will have to be complied with but are not compensated under the relevant PPP arrangements. It is now widely accepted as market practice that the public sector will remain responsible for compensation associated with discriminatory and specific changes in law (for example, changes that specifically impact upon the relevant PPP project). General changes in law during the construction and operation phases however usually remain a risk that needs to be specifically addressed.

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Sometimes, this can be alleviated by capping or sharing arrangements agreed with public sector bodies. Sometimes, it can be completely passed through (subject to overall caps on liability) to subcontractors. Where other means of mitigation cannot be adequately achieved, lenders and sponsors may need to consider stand-by facilities or direct equity cover.

Demand risk

Unlike many other sectors, demand risk in education PPPs is not usually a key risk that needs to be addressed by the private sector as it is usually (but not necessarily always) a risk retained by government. This is especially the case for school PPP projects, where governments have usually stressed the importance of local schooling authorities being assured in respect of the long term projections for schools (although obviously recognising that the number of students at schools will inevitably differ somewhat from year to year). It is generally considered that school numbers is a risk that best sits with the public sector and accordingly demand risk is not ordinarily an issue in the education sector.

This is not to say, however, that it is not always a consideration. For example, a project for a school or university might have associated with it student accommodation requirements. Passing a level of usage or demand risk in such a scenario might be something considered by the public sector, if it was shown to provide value for money. Where a level of demand risk is passed to the private sector, the method in which this is done its allocation amongst the relevant parties involved in the project may be a central risk underpinning a project's attractiveness to sponsors and lenders.

Public sector step-in

Education is a core service for any government and accordingly public sector bodies will usually seek to retain security related approval rights for private sector personnel and rights to step-in where it considers its core education responsibilities may be jeopardised or for emergency reasons. It is important that the arrangements put in place clearly describe the way in which this can be done, the requirements of the private sector in such circumstances and the compensation/payment the private sector will require under various circumstances.

Damage

In some jurisdictions, vandalism remains one of the primary problems that the private sector will need to address. Where appropriate, arrangements should be put in place addressing responsibility for vandalism, prevention techniques and capping arrangements. PPP contracts will also contain indemnity provisions relating to claims made against the public sector body (for which it requires private sector indemnification), and damage caused (whether by school officials, students or otherwise).

Decant and late delivery

Because of the critical importance of education to governments, and the desire to minimise disruption on students and staff involved in education provision, decanting arrangements are of paramount concern in PPP projects. An education project will often involve either the refurbishment and/or demolition of an existing facility and the construction of a new facility or facilities. In such circumstances, the project will need to address, for example, how education provision can continue during new works phases how and when transfer to new build facilities can take place minimisation of impact on students temporary accommodation requirements if relevant phasing of works in line with academic year considerations and other associated requirements. Education projects will also usually obtain quite stringent requirements with respect to delivery timetables and consequences of late delivery.

Whilst in-built incentives to deliver on time are common to most PPP projects, education projects will often contain more stringent than usual requirements with respect to delivery of facilities. It would not be unusual to see reasonably tight long-stop arrangements with respect to construction and other arrangements for delay including provision of temporary accommodation requirements.

It is important that an education based PPP project contains terms that both adequately protects a public sector body from the risk of delay by establishing appropriate incentives for the private sector participants to complete on time but that also grants the private sector participants appropriate flexibility and contingency to enable it to have confidence that the deliverables can be met.

Termination risks

Because of the significant investments made in PPP projects and the associated reputations of the relevant parties, termination regimes remain one of the key points of negotiation and risks associated with PPP arrangements. There are also different perspectives and views that need to be considered and respected – the public sector body wants to know that ultimately, it has the right to remove and cease a project where, for example, a project is significantly overdue in terms of completion, or where service provision is at such a poor level over an extended period that it has no other choice but to remove a contractor. Sponsors of a project will have committed significant levels of equity and accordingly will want to see a return on their investment. Similarly, lenders will have significant exposure risks in terms of their investment if a project fails on a default basis. Compensation on termination differs according to the basis for termination (fault, no-fault and voluntary termination) and there are reasonably settled positions accepted in the market now for compensation arrangements under all the different termination scenarios. Of course, the overall level of risk taken and general "bankability" of a project may influence

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compensation on termination arrangements, particular for lenders to a PPP project. Because we have experience acting for all major players involved in PPP transactions, we can appropriately advise our clients on market norms and risk mitigation techniques and arrangements in relation to termination related issues.

BANKABILITY

The primary consideration of any lender to a PPP project is a simple one – to ensure it will be repaid what it has lent together with an appropriate level of interest. With an education based project, as with most PPP projects, a lender's main objectives will therefore include protecting the revenue stream (for example, by ensuring deduction risk is clear and properly assessed), creating an adequate security package (for example, by ensuring there is a realisable recourse to sponsors, setting appropriate caps on liability for sponsor recourse, parent company guarantees, on-demand construction bonds if required and/or performance bonds and the like) and pricing finance commensurate with its ultimate view of the risks involved.

Clearly, the cost/revenue analysis is of key importance. Also, as mentioned briefly above in relation to termination, in certain downside scenarios like force majeure termination or certain default termination, lenders will want to know they still have a reasonable prospect of return through recourse to certain levels to the public sector, to sponsors or to additional security providers. A structure that adequately satisfies the risks of a project is therefore fundamental to the "bankability" of the project.

TYPICAL CONCESSION TERMS/TOPICS

Set out below are some typical issues for a PPP project which involves an upgrade or construction and operation of an education facility. How these issues are addressed in practice will be deal-specific.

Typical issues

Topic	Comment
Appointment of a PPP contractor	<ul style="list-style-type: none"> Provisions will be required to describe in outline a private sector participant's basic rights and obligations, also defining the geographical scope of the concession area. In, for example, an education based PPP that involves accommodation and that passes a level of demand and/or usage risk, the PPP contractor may wish to be protected from the public sector developing a competing arrangement. A public sector body may decline to agree not to promote competing arrangements, but economic protection from the consequences of doing so could be provided.
Duration of agreement	<ul style="list-style-type: none"> PPP arrangements usually have a 20-25 year service period. The term will usually run from financial close, so a delay to the completion of a relevant facility may result in a shortening of the service term.
General functions of concession holder	<ul style="list-style-type: none"> The standards to which all works and services must be performed (typically to comply with all laws and with good industry practice) will be set out in a detailed output based specification document. The performance regime will usually be directly linked to the specification document through a payment mechanism that will provide for deductions for unavailability (for example, a classroom cannot be used because of inadequate lighting) and poor performance (for example, a classroom that has not been properly cleaned) against a monthly unitary payment.
Planning and other Consents	<ul style="list-style-type: none"> As part of the general duty of the PPP contractor to comply with applicable law, there will often be specific obligations about the licences and other regulatory approvals which the concession holder must obtain. Environmental and domestic regulatory aspects will also be addressed. Sometimes the relevant public sector body (or a separate authority) may also agree to provide an element of cooperation to assist the PPP contractor's licensing applications to other authorities.
General functions of a public sector body	<ul style="list-style-type: none"> This will describe the main tasks and duties of the public sector, which are often project specific and can be few or can be detailed. Appropriate land rights and access must be specified. If relevant, the basis on which any enabling works will have to be carried out, such as the demolition of existing structures to clear space for facilities, would be set out. As with connecting infrastructure, a key point is the extent of the public sector body's liability if there should be delay or defects in these enabling works. It may deal with the provision of power, water and other utilities, to the extent these are not to be procured by a PPP contractor itself. There may be service level agreements to be entered with the relevant public sector body or other authorities which continue to provide certain services. Non-performance of these services may give some relief (from breach/default responsibility and possibly compensation) to a PPP contractor. There are likely to be regulatory rules required by the public sector body itself which need analysis and contractual implementation. To facilitate viability for investors, the conditions on which licences can be revoked/renewed and the overall exercise of school functions should be clear and objective. If the public sector body is to provide any financial support to a PPP contractor, the

Typical issues (cont'd)

Topic	Comment
	<p>scope of support should be clearly described and the requirements which must be achieved in order for payment to be made should be specified. For example, the proposal to contribute to the cost of construction will need to be documented to ensure appropriate construction milestones have been achieved in order to trigger payment. This will involve liaison with the public sector body's technical and financial team members to ensure the tests are appropriately set and incentivise completion. Any such financial support will have to comply with any applicable rules on state aid and competition (in broad terms, this should not be problematic if the amount is competitively tendered). PPP arrangements will usually only provide for payment after construction is completed and service provision has commenced.</p>
Emergency powers and other authorities	<ul style="list-style-type: none"> • The project agreement may provide for the public sector's intervention powers where academic services are jeopardised and in: <ul style="list-style-type: none"> - emergencies - disaster control - fire fighting - emergency communications - national security etc. • The private sector consortia will need to be aware of and understand the risks associated with such interventions and the project agreement should contain additional protections for a PPP contractor and lenders where such interventions occur.
Transfer of assets, personnel etc	<ul style="list-style-type: none"> • There may need to be provisions providing for the transfer to a PPP contractor the existing facilities at schools or other facilities, such as any existing physical assets, rights of workers and possibly also certain liabilities. Usage, condition and liability issues often need to be negotiated, agreed and appropriately documented. • In education PPP projects where existing employed personnel are transferred to a PPP contractor, provisions need to be addressed dealing with the transfer process and risk allocation.
Site and project disclaimer	<ul style="list-style-type: none"> • To give effect to the transfer of design and construction risk to the PPP contractor, normally the public sector body will disclaim all responsibility for site conditions, requiring a PPP contractor to rely on its own surveys and judgement of known and unknown ground conditions. This may not always offer value for money, however, and sometimes risk can be transferred back to a public sector body where unforeseen site risks materialise.
Technical requirements of a public sector body for the relevant facility	<ul style="list-style-type: none"> • Provisions will need to address functional and other technical specifications of the school for design, construction and operation. • To maximise innovation and risk transfer, these requirements should be primarily expressed as outputs (describing the functional result to be achieved), but in practice an element of input based requirements (describing the method by which the result will be achieved) is common. • There should also be set out the PPP contractor's solution to meeting those requirements.
Design and construction	<p>For an education PPP project, we would typically expect to see set out:</p>

Typical issues (cont'd)

Topic	Comment
procedure	<ul style="list-style-type: none"> • the timetable for completing design and construction of the works needed to develop the education facilities • the process for design approval • the process for changes to the initial design • the access and inspection powers of the public sector body to monitor proper construction • any intervention powers (if any) of the public sector body if there is a breach and • the sanctions which may be imposed for default.
Completion tests and commissioning	<p>Provisions will be required to describe, among other things:</p> <ul style="list-style-type: none"> • the objective tests which establish whether the works have been completed to contractual standards • equipment commissioning tests, to ensure the overall facilities are operationally integrated and functioning to specification.
Performance requirements	<ul style="list-style-type: none"> • This will specify (with detail typically set out in schedules) the operational standards and other requirements, including arrangements for heavy and routine maintenance (including when and how such maintenance is to be carried out and impact on academic services). • The project agreement will often include a system of performance measurement to assess achievement of the functional operational requirements of the facility. • Deductions to the unitary payment are ordinarily based on performance and availability criteria in education PPP projects.
Concession fee	<ul style="list-style-type: none"> • A monthly unitary payment is usually established under a PPP contract. • If there is to be a guaranteed minimum fee (which is not normally the case on education PPP projects as it is against the principle of payment for service provision only), consideration should be given as to whether there are any circumstances where the guaranteed fee should not be payable as a result of external factors.
Controls on changes	<ul style="list-style-type: none"> • A public sector body may seek powers to approve changes in: <ul style="list-style-type: none"> - the organisations used by a PPP contractor to perform its obligations; or - the terms of those contractual arrangements. • It may also wish to approve certain changes in the shareholders of the PPP contractor. This may be: <ul style="list-style-type: none"> - to ensure key organisations such as operators have adequate financial incentive to make the project a success, or - to prevent unsuitable organisations, such as someone considered undesirable for national policy reasons, from becoming interested in the school. • The relevant public sector body may also wish to control changes in the debt financing arrangements, for example: <ul style="list-style-type: none"> - to cap its exposure on termination payments, or

Typical issues (cont'd)

Topic	Comment
	<ul style="list-style-type: none"> - to participate in refinancing gains (often on a 50/50 basis).
External events	<ul style="list-style-type: none"> • The project agreement will need to provide for the effects of various categories of events which are outside the control of the PPP contractor and/or the relevant public sector body. • These circumstances may range from natural events of force majeure, such as earthquakes beyond the design tolerance of the facilities, or cover human factors, such as: <ul style="list-style-type: none"> - acts of war or terrorism, - widespread industrial action, or - breaches resulting in delay or loss. • The effects of such events may be: <ul style="list-style-type: none"> - to protect the PPP contractor from the imposition of sanctions (such as termination) for what would otherwise be a breach of contract, - to grant extensions of time, or - in some circumstances, to entitle the PPP contractor to a specified amount of compensation.
Indemnities	<p>This will set out:</p> <ul style="list-style-type: none"> • the circumstances in which the PPP contractor must indemnify the relevant public sector body (such as liability to third parties for property damage or personal injury) • vandalism risk (which in some jurisdictions is of genuine concern in education projects) • any circumstances in which the public sector should indemnify a PPP contractor and • caps on liability (if relevant).
Insurance	<ul style="list-style-type: none"> • The public sector body will specify the scope of insurance cover which it requires a PPP contractor to maintain. • The implications of uninsurability (and its link to termination) and substantial premia increases should be addressed.
Change of law	<ul style="list-style-type: none"> • While in many jurisdictions the PPP contractor must bear any change in general taxation, the agreement would also usually allocate responsibility for the risk of this or other changes in law, especially discriminatory laws. There are often market accepted positions now in relation to changes in law with respect to education based PPP projects. Changes in law need to be addressed in education projects because, in particular, given the size of new facilities being built, there is always a genuine risk of changes in law necessitating significant capital expenditure in addition to any operational expenditure increases.
Sanctions of the relevant public sector	<ul style="list-style-type: none"> • The public sector may wish to retain specific powers to impose sanctions, short of termination, for breach by a PPP contractor. • These may take the form of: <ul style="list-style-type: none"> - liquidated damages for delay (where it makes economic sense (value for money) to

Typical issues (cont'd)

Topic	Comment
	<ul style="list-style-type: none"> impose such payment obligations) - the imposition of additional monitoring - the reservation of the right to correct a breach itself at the cost of a PPP contractor or - other intervention powers. • As an alternative to termination, a public sector body may wish to have the power to force the removal of non performing subcontractors.
Termination for PPP contractor default	<ul style="list-style-type: none"> • This will set out the events which entitle the public sector body to terminate the concession for breach by the PPP contractor. • To be viable, the defaults should be serious, and, in general, a reasonable cure opportunity should be given before termination rights can be exercised. • Typically there will be a right to terminate if the completion tests have not been successfully completed by a specified "longstop" date (as extended by extension events). • Other termination events might include: <ul style="list-style-type: none"> - insolvency - serious unremedied breach - unauthorised change in control - fraud or corruption etc. • On many education projects, public sector bodies have also sought termination rights for persistent breaches and for material breach. Given the level of investment made in PPP projects, the private sector consortia need to carefully assess termination default events. • There will often be a termination right linked to long term poor performance – it is vital for the private sector that this is appropriately calibrated in terms of the levels that might trigger such a right for a relevant public sector body, as both sponsors and lenders are likely to want to have an ability to take proactive steps to address such poor performance long before a public sector body has any right to terminate a project for poor performance. • An important consideration in establishing the default and termination regime is that of overall bankability. The regime must be acceptable to prospective lenders of the private sector participants.
Termination for default by the public sector body	<ul style="list-style-type: none"> • There will be a limited number of circumstances (which are often limited to fundamental matters) which entitle a PPP contractor to terminate for breach by the public sector body, such as failure to make payment after a specified time.
Termination for force majeure	<ul style="list-style-type: none"> • If external events cause a prolonged (usually at least six months) inability to operate the facilities (or carry out the works) either party may have a right to terminate for this force majeure.
Voluntary termination	<ul style="list-style-type: none"> • The public sector body may wish to reserve the right to terminate the concession prematurely if, for example, it is in the national interest to do so.
Termination compensation	<ul style="list-style-type: none"> • A PPP contract will need to set out in detail the formulae for compensation payable in the different causes of termination. Whilst there are now generally accepted positions with

Typical issues (cont'd)

Topic	Comment
	respect to compensation on termination for different scenarios, arrangements differ from jurisdiction to jurisdiction and this part of a project still represents one of the key bankability requirements.
Other termination consequences	<ul style="list-style-type: none"> • Assuming a PPP type build-operate-transfer structure is adopted, this would provide for hand-over of the facilities and other assets and rights (either to the public sector body itself or to an incoming concessionaire), and deal with outstanding liabilities and personnel issues. • To support hand-over, there may be arrangements for a series of inspections in the years leading up to expiry, to identify refurbishment/reinstatement works and provide for their funding.

This list of issues is intended to provide an introduction to some of the (typically contractual) matters to be addressed in establishing an education PPP project.

Other, project-specific, issues will of course exist and need to be addressed on a project by project basis.

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