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Long-term ties: Managing PPP contracts

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LONG-TERM TIES: MANAGING PPP CONTRACTS

A successful partnership requires a simple framework upon which the parties can build their relationships.

The long-term nature of Public Private Partnerships provides significant legal and administrative challenges. The success of a PPP contract depends equally on a sound contractual framework and a true 'partnership' relationship. Roger Quick of Gadens Lawyers outlines the requirements for successfully managing these contracts.

The success of a public private partnership depends on a successful relationship between the participants to the project. This alone will allow the participants to work together to achieve the project's objectives: the end users of the services should receive quality services; the authority should receive value for money and the private sector contractor should receive a reasonable rate of return on investment. These are potentially conflicting objectives.[1]

A successful partnership requires a simple framework upon which the parties can build their relationships. The use of relationship contracting in the Australian construction industry suggests the model framework.[2]

THE TENDERING PROCESS AND CONTRACTUAL FRAMEWORK

The authority will need to conduct an open and accountable tendering process for the PPP contract. In this tendering process it should seek to understand each of the bidders' partnering abilities in relationship contracting by considering:

- past history in alliances and partnering arrangements or other relationship contracts
- openness to relationship contract, contractual conditions, such as project alliance boards and open book accounting
- willingness to establish a joint working group with the authority, and co-location of the authority's people and the contractor's people
- the attitudes of key individuals in the contractor's organisation to relationship contracting arrangements

The purpose of any PPP contract is to set out the key terms governing the relationship between the authority and the contractor such as the management of risk, the quality of service required, value for money and dispute resolution arrangements, and arrangements to deal with the change which is likely over the period of a long term contract.

Contractors with experience and an interest in relationship contracting are more likely to be suitable for PPP projects because of the similarities between relationship contracting and alliancing and the relationship aspects of a PPP project.

RISK MANAGEMENT

The primary objective of any contract is to allocate risk between the parties. Although there are other philosophies of risk allocation[3], an efficient and widely accepted philosophy of risk allocation is to allocate the risk to the party who is best able to manage it. This is usually referred to as the 'Abrahamson' principle. Under this principle, a party should bear a risk where:

- the risk is within the party's control
- the party can transfer the risk through insurance or as a premium on its services, and this is the most economic and practical way to deal with the risk
- the economic benefit of handling the risk rests with the party bearing the risk

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- the placing of risk on that party is in the interests of efficiency

If the risk eventuates, the loss falls on that party in the first instance.[4] Generally, the authority's risk in a PPP project equates to the delivery of services at a quality below that specified in the contract, or the failure of the PPP project to deliver value for money, either in the short term or in the long term.

From the PPP contractor's point of view, risk equates to the potential increase in the cost of the construction of the particular infrastructure or of providing the services, a shortfall in forecast usage or patronage of the services; and possible liability for liquidated damages or consequential losses because of continued failures.

It is important that the PPP contract be flexible enough to allow the parties to deal with changes in circumstances and changes in the types of risks experienced. Even the best drafted contract is necessarily incomplete because not all possible contingencies can be dealt with at the time the parties enter into the contact.[5]

INTERDEPENDENCY OF RISK AND VALUE FOR MONEY

PPP projects are arguably more efficient than standard government procurement because certain risks in which the private sector has expertise, such as design and construction, allocation of capital or industrial relations management, are transferred to the private sector contractor. Because of the private sector's ability to handle these risks better than the public sector, the services are provided to the end users at a lower cost than that at which they could be provided by the public sector. Consequently, the appropriate allocation of risk is the key requirement in achieving value for money in PPP projects.

The authority has a direct incentive to establish a fair risk allocation in the contractual framework: its prime objective of value for money. If an authority has a risk transfer strategy on a PPP project, that is a strategy of transferring risk to the contractor which the contractor is not best able to manage, the contractor will charge a premium for accepting such risk, and this will result in less value for money being achieved from the PPP project. As a corollary the authority must in conducting the tendering process for a PPP project ensure that a contractor does not attempt to accept inappropriate risks so as to win the PPP project because if a successful PPP project proponent does take inappropriate risks, this is likely to hinder the achievement of value for money.

IMPORTANCE OF CONTRACTUAL FRAMEWORK

If a PPP project is efficient it is because appropriate risks are appropriately transferred to the contractor. Rather than the traditional procurement model, in which the government authority specifies the inputs required to be performed or supplied by the contractor, PPP is output focussed. The authority specifies the required outputs, such as the ability of a road to carry a certain number of axle movements per day, rather than the specific design and construction requirements for the road.

Because of this output specified approach, an authority must be careful not to transfer the risk of the project back to itself by taking a hands-on approach and prescribing how the service should be delivered. Such an approach will stifle innovation and open up avenues for dispute about whether there has been a 'switch-back' of risk. PPP projects very much require an 'eyes-on/hands-off' approach to their management by an authority.

Additionally not all risks are suitable for, or are able to be transferred to, the contractor. As a result, the authority must carefully monitor risks which it is handling itself so as to ensure value for money.

QUALITY OF SERVICE – MECHANISMS TO MAINTAIN IT

The output specification of a PPP usually specifies minimum performance requirements, or guaranteed performance requirements, for the services. There may also be an availability guarantee, that is that the services will be available for periods of time specified in the contract. These guarantees can be linked though the mechanism of payment to a 'gain share/pain share' regime, bonus payments or liquidated damages. In this way the mechanism for payment for provision of the services, puts into effect the allocation of risk. It also allows the authority to incentivise the performance of the services by the contractor.

Certain indicators can be incorporated into the contract allowing the authority to share any gains made by efficiencies obtained by the contractor throughout the project. For example, during the life of a PPP project new technology may be invented which enables the services to be provided at substantially less cost than first envisaged when the parties entered into the contract. In such circumstances the benchmarking and 'gain share, pain share' provisions can ensure that the authority obtains some of this value created. Another example is where the contractor refinances. In refinancing, the contractor may readjust the capital risk on the project and consequently obtain substantial benefits. PPP

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DISPUTE RESOLUTION

The majority of disputes in any form of contract arise because of a disagreement about the interpretation of the contract and which party has been allocated a particular risk, hence the need for the contract to have a clear, agreed and equitable risk allocation. This will reduce the propensity for dispute and enhance the spirit of partnership.

Because of the long-term nature of PPP contracts, the parties should seek to avoid litigation as potentially fatal to the spirit of partnership. Alternative dispute resolution mechanisms should be included in the contract so as to reflect partnership ideals. The most appropriate may be a tiered one, for example:

- internal resolution between the authority's representative and the contractor's representative
- chief executive officer resolution
- determination by an expert
- arbitration

DEALING WITH CHANGE

At the start of a PPP project, the parties agree terms which will govern their relationship over a very long period of time. However, there are obvious limits to foreseeability. Even a well written contract is going to be inadequate because all future contingencies, such as technological change, cannot be foreseen. As a result, a PPP contract must have mechanisms to deal with change so as to ensure the contract adequately governs the parties' relationship over the term of the contract and to ensure that the authority continues to receive value for money. Further, the requirements of the authority and the end users are likely to change over the course of the contract and therefore change procedures must allow the authority's future requirements to be taken into account to the extent that they become identifiable and quantifiable.

Change procedures in a PPP contract may include:

- the right of the authority to order variations during the construction of the PPP project
- the right of either party to suggest changes to the type or scope of services provided during the delivery of the services. Such changes should also take into account mechanisms to ensure value for money, the pricing of the change and how any 'pain share' or 'gain share' from the change can be apportioned.

From the authority's point of view, the contract should have mechanisms to allow any changes to the services to be benchmarked or market tested against similar services so as to ensure value for money and to limit opportunism by the contractor.

If the parties have a good relationship and act in the spirit of partnership, having clear change procedures in the contract will enhance the spirit of partnership because implementing changes on a PPP project should be beneficial to both parties.

IMPORTANCE OF CHANGE PROCEDURES

The National Audit Office in its report on managing PFI projects[6] provides some lessons about PPP contract change procedures.

- The procedures must be robust to demonstrate value for money in a non-competitive environment.
- The parties need to agree early the precise meaning of cost, price, fair business return and value for money.
- Both parties must have a thorough and shared view of the risks involved in providing the new services.
- The authority must take into account the initial deal when negotiating additional services.
- The authority must take into account management overhead by the contractor in bringing new services into the contract.

VALUE FOR MONEY DURING THE LIFETIME OF THE CONTRACT

During the initial tendering phase on a PPP project, an authority can and should ensure that there is a competitive process in bidding for the PPP project. This is sometimes referred to as 'competition *for* the market'. Once the successful PPP contractor is awarded the concession contract, it is essentially a monopoly provider of the services for the life of the contract.

Because of this, the contractual framework should ensure that the PPP project provides value for money over the life of the contract as well as at the time it is entered into. To do this, the contract must deal for example with changed circumstances in the cost of providing the services so as to ensure value for money for the life of the PPP project. This market foreclosure means that the price paid by the authority for the provision of the services needs to be benchmarked and market tested at specified periods throughout the life of the PPP project.

Value for money mechanisms like benchmarking and 'gain share, pain share' are dependent upon open book accounting. Any PPP contracts should contain provisions which enhance communication between the parties, including the flow of financial information. A flow of good financial information between the parties is essential, and enables adequate monitoring by the authority of the cost of the services to ensure that it maintains value for money. Such open book accounting also allows the parties to work in a collaborative manner and provides an objective standard for the spirit of partnership. Similarly, the open book accounting enables the contractor to point out certain problems which the contractor is having and allows both parties to address certain cost blow outs together.

COMPETITION ISSUES

One of the greatest incentives for benchmarking and market testing is to ensure that the PPP contract does not become anti-competitive so as to attract the attention of the Australian Completion and Consumer Commission (ACCC) under Part IV of the *Trade Practices Act* 1974 (Cth) (TPA). There is considerable literature about the competitiveness of long-term contracts.[7]

PPP contracts are necessarily long-term so as to provide sufficient revenue to the contractor to enable it to support the massive investment in the asset to deliver the services. A long term contract has several functions including:

- Enabling the parties to formally allocate risk and responsibilities;
- Implementing restrictions on both parties to ensure that the private sector can maintain a reasonable rate of return while the public sector can ensure delivery of the services over a long period of time;
- Establishing change procedures to govern the impossibility of the contract completely governing the relationship for thirty years.
- These restrictive provisions may require authorisation from the ACCC under Part VII of the TPA or specific empowering legislation from a state government authorising the PPP project.

DEFAULT AND TERMINATION

A PPP contract must deal extensively with default by the parties, how the contract may be terminated and the consequences of termination. This should include having specified compensation payable for termination for default by the contractor or termination for the convenience of the authority.

Generally in the spirit of partnership an authority should be reluctant to terminate to maintain service delivery. A termination for default is evidence that the contract management systems put in place have failed.

COMPLETION

The PPP contract should also contain certain procedures required at the end of the term of the PPP contract. These may include:

- Options to renew
- Procedures to establish the quality of the assets to be transferred back to the authority
- The transfer of intellectual property rights
- Procedures for re-tendering of the PPP contract

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1 National Audit Office (2001) *Managing the Relationship to Secure Successful Partnership in PFI Projects*; Report by the Comptroller and Auditor General: 29 November 2001

2 In the UK the construction industry has striven to develop 'partnering' as a relationship management model which does not require the parties to express their proposed methods of managing the relationship within their contract. This has left the legal effect of the model unclear. By contrast in Australia the construction industry, perhaps under the unexpressed influence of the *Trade Practices Act* 1974 (Cth), has often adopted a second model, the project alliance, whereby the proposed methods are expressed in the contract so that their legal effect is clearer. Both models are within the expression relationship contract used here. The legal theory of such relationship contracts is in the work of American scholars such as MacNeil and others about relational contracts, i.e. long term complex contracts which require extensive personal interaction and cooperation and sophisticated management and measurement of performance for their success (see the seminal articles by A McInnis *NEC: Relational Contracting, Good Faith and Co-operation* [2003] 1 CLR (Pt 1) at p.1 and [2003] 1 CLR (Pt 2)) at p.289. Arguably a long term complex contract such as a PPP concession is one of the best examples of a relational contract.

3 It is tantalising, for example, to consider the need for cooperation as the principle determining risk allocation and management.

4 M. Abrahamson 'Risk Management', paper presented to International Construction Law Conference, Sydney, 19-21 October 1982. See generally 'Introduction to Alliancing and Relationship Contracting'. R Quick March 2002, a presentation to the Queensland Law Society Symposium.

5 C. Pleatsikas & D. Teece, *The Competitive Assessment of Vertical Long Term Contracts* (2001) 29 ABLR 454 at 455.

6 National Audit Office (2001) note 1.

7 *Re AGL Cooper Basin Natural Gas Supply Agreements* [1997] ATPR 41-593. For an analysis of this case and the competition issues associated with long term contacts see Pleatsikas & Teece (2001) note 4; A.I. *Tonking, Long Term Contracts: When are They Anti-competitive?* (1998) 6 CCLJ LEXIS 8; W. Pengilley, *Long Term Supply Contracts: Here Today, Gone Tomorrow?* (1998) 6 TPLJ 203; D. Robertson, *Time and Risk: The Temporal Dimension of Competition Analysis and the Role of Long Term Contracts* (1998) 26 ABLR 273.

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