

**Testimony of  
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**On**

**The International Experience with Public-Private Partnerships**

**Before the**

**Transportation & Infrastructure Committee of the U.S. House of Representatives**

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Good morning, Mr. Chairman and distinguished members of the Committee. On behalf of Fitch Ratings, thank you for this opportunity to provide our views on the international experience with Public-Private Partnerships.

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**The PPP Landscape**

PPPs have been a tool used by governments to deliver needed public infrastructure for centuries. Canals, rail, ferries, water systems, power networks and roads were built privately in exchange for tariff or toll-raising authority or government paid capacity-based revenue streams. Western governments following the Great Depression and post-World War II reverted to a public finance and procurement model for the development of large rail, road, port and airports. They used the public balance sheet and spread costs through the tax system.

The recent trend towards use of PPPs with public payment (availability-based) structures dates back to the Project Finance Initiative (PFI) of the U.K. government with more than 700 PFI transactions completed in the U.K. since the mid-1990s. Over the same period, a smaller but still substantial few hundred PPP projects, were financed in continental Europe. The World Bank, using a broad definition of PPP identified nearly 5,000 private infrastructure projects in low- and middle-income countries since 1984. These include management or lease contracts, concessions, greenfield projects and divestiture of public enterprises. These also include more than 800 water and sewerage projects, more than 1,400 transportation projects and more than 2,600 energy projects.

The track record has been mixed. Governments like Australia, Canada, Chile, Spain, France, Belgium, the Netherlands, Mexico and the U.K. have embraced the concept, and while problems have occurred, they have chosen to make changes and continue to pursue PPPs. The U.S. has been slow to embrace PPPs, but momentum finally seems to be building.

Although there have been many issues with PPPs, this is not necessarily an indictment on PPPs, but instead a reflection of the fact that the complexity of the assets and services presents challenges in finding the right public policy balance that fits within a business, legal and financial framework to bring best value to all parties, most importantly citizens. Further, local sentiments and conditions cause the public policy,

business, legal and financial considerations to differ from jurisdiction to jurisdiction, asset type to asset type, and from project to project. Added challenges are layered on by the political imperatives and schedules of elected officials that can create less than ideal PPP frameworks, and the profit objectives of private parties that justify participation despite inappropriate levels of risk.

While one can view PPPs as a glass half full or as a glass half empty, it is Fitch's view that the former is the better perspective. PPPs can provide public value, but need to be carefully crafted to address all stakeholder concerns. When PPPs are viewed to have failed, the issue is often inappropriate transaction design and application.

### **Responsibility Lies with Both Parties**

Responsibility for problems with PPPs can be assigned to both the public sector (the grantor of the concession) and the private sector (the grantee of concession rights and responsibilities or the concessionaire). When issues of loss of control and too much profit arise, the responsibility lies squarely with the executive and legislative branches of the public sector (i.e. the grantor) that sets the rules of the game. When issues arise from project cost overruns, delays in completion, weaker demand, higher operating costs, lower profits, debt default and concessionaire bankruptcy, the responsibility lies largely with the private sponsor (i.e. the concessionaire).

A key tenet of a PPP is that most risks (permitting, land expropriation, preexisting site conditions, third-party commitments, unproven traffic and revenue, uninsurable event risks) that cannot be commercially mitigated at reasonable cost should be borne by the grantor and those that can be commercially borne at reasonable cost (completion, predictable traffic and revenue, operations, lifecycle maintenance, financing, insurable event risks.) should be borne by the concessionaire. The nature of a PPP also requires considerable interfacing between the two parties given the inability to anticipate every eventuality as the infrastructure is built, operated and maintained during the life of the PPP. This can result in friction when actual conditions differ from what might have been expected.

### **Success Demands Competence on Both Sides**

A well-structured grantor team and a competent concessionaire are better positioned to respond and minimize the adverse effects to both parties. That is not always the case and this unfortunately creates an asymmetrical risk. Grantors are exposed to government/political risk from unanticipated and unplanned obligations, which results in concessionaire delays and costs that may be further exacerbated with the possibility of being only partially compensated or not compensated at all.

The concessionaire is then in the precarious position of deciding each time whether its claim or dispute is worth declaring an event of default. Dispute resolution mechanisms agreed to by the parties can significantly reduce this asymmetry. Nonetheless, an experienced concessionaire would likely build this risk into its required return profile. Concessionaire inexperience and poor performance is also a concern and can result in misestimation of its risk and ability to perform. In this case, the grantor is not obligated and not likely (except in exceptional circumstances where there is mutual benefit) to bail out the concessionaire (and its lenders).

Lastly, there are instances when risks are asymmetrically borne by lenders and not the grantor or the concessionaire. In some cases, grantors reserve their right to change their mind about the nature of the original transaction, which can result in changed scope with a renegotiation between the parties. The incentives of equity and debt may not be properly aligned here. The equity sponsor may be willing to accept lower or even some negative returns on a single project to secure a broader and longer term relationship with the grantor across other profitable projects. Lenders do not often benefit in that equation. In the absence of a requirement for lender approval, changes may be crammed down on lenders.

### **PPP Structures Have Proven to Be Resilient**

While risks abound, one must keep in mind that most risks can be anticipated and mitigated. Many projects have been implemented in many jurisdictions. While the market continues to face new pitfalls, governments and the market have learned from prior missteps. The issues that arise, while problematic, are not deal breakers and sensible minds often prevail with enough mutual benefit remaining for both parties to take the transaction to term.

Defaults in PPP transactions have largely been the consequence of weak project economics (e.g. overestimated demand or poorly estimated costs) rather than friction between the parties or outright default by the grantor. However, there have been instances of grantors retroactively altering the economics of the concession to the detriment of equity and lenders. On balance, Fitch notes that most governments have a large infrastructure deficit and they see PPPs as a way to facilitate progress. This puts much needed pressure on key decision makers to plan better and hold up their end of the bargain as much as possible.

### **Aggressive Leverage Is a Vulnerability**

PPPs and publicly managed assets globally have been vulnerable to the risks of over-leverage. This is further exacerbated in periods of extreme economic or financial stress. In instances of high leverage, the credit decline was greatest when projects with traffic and revenue forecasting risk significantly underperformed their revenue projections. In the U.S., these include the San Joaquin Hills toll road, SouthBay Expressway, Southern Connector, Santa Rosa Bay Bridge, Dulles Greenway, Indiana toll road and Pocahontas Parkway. In Europe, they include the Madrid Radiales in Spain and toll projects in Portugal. The Tequila Crisis in the mid-1990s caused numerous projects to default on their debt in Mexico. In Australia, the Cross City and Lane Cove tunnel projects were also exposed to this risk.

### **Lessons Learned**

Learning from the mistakes of the past is a good way to begin avoiding new ones in the future. As a rating agency, we think about it from the perspective of the risks we analyze. Select examples follow:

Ownership and Sponsors -- Jarvis PLC Concessions, U.K.: Rapid growth from a small contractor to Britain's largest engineering and construction firm in 10 years. It began with its role in the British Rail privatization, then pushed aggressively into PFI projects (motorways and social infrastructure) achieving preferred bidder status by underbidding the risks, even when its finances were strained. Problems in construction ensued as did operational and safety issues, subsequent investigations and financial stress culminated in it having to divest its concessions.

Ownership and Sponsors -- Inversiones Alsacia, Chile: The state made changes to the concession framework post-financing to increase the exposure to demand risk and increase operational performance requirements. The equity sponsor was amenable to the changes to protect its market position to the detriment of lenders who face an elevated risk profile.

Legal and Regulatory -- 407 ETR, Canada: The established tariff regime with no caps or restrictions and the 99-year concession came under considerable criticism a few years after the inception of the transaction. The province challenged the ability to raise tolls unilaterally under the concession and refused to deny license plate renewals for toll violators. The legal challenges by the province went through the full appellate process and the concessionaire won every round. There was a final settlement with the concessionaire making some improvements and setting aside some funds for toll discounts.

Legal and Regulatory -- Chicago Concessions, U.S.: The city of Chicago executed a series of concessions over the past decade for its Skyway toll bridge, municipal parking garages and street parking. Long, 99 and 75-year concessions to maximize upfront payments to subsidize city operational deficits and very liberal tariff regimes have come under considerable criticism. Legal disputes in response to adverse city actions related to the garage and street parking transactions have resulted in an arbitration panel ruling against the city and requiring a \$57.8 million compensation payment in the former case and a negotiated settlement with some give backs from both sides in the latter case.

Completion -- Jarvis PLC Concessions, U.K.: Underbidding of contracts resulted in financial strain; construction schedules began to slip and Jarvis blamed its subcontractors for the problems and did not pay them in certain instances leading to further cost increases, delays and legal disputes. However, despite the severe stress, the projects were completed with additional funding from Jarvis divestitures and additional project debt. All major project parties were adversely affected.

Completion -- Dudley Group Of Hospitals, U.K.: The project encountered additional costs during construction due to additional works being required as part of the refurbishment process. The contractor disputed the costs with the concession grantor, but continued to complete the project as required under the concession documents and design-build agreements. The contractor reported losses nearing GBP100 million on completion in 2005. It subsequently sued to recover costs from the grantor and is reported to have settled for GBP23 million.

Revenue -- Taiwan High Speed Rail, Taiwan: Actual traffic and revenue significantly below projections. Forecasting error on greenfield projects is a legacy issue that continues to manifest itself.

## **In Summary**

**Complexity Provides Strength; Challenges Remain:** The challenge is transferring risk associated with the financing, construction, operation and lifecycle maintenance of an asset or service while maintaining flexibility. The protection to all parties is built into a complex suite of legal provisions that allocate risks to the party, theoretically best able to handle those risks. However, the unique nature of each asset or service and the unpredictable nature of future events can make the risk allocation subject to criticism in hindsight.

**Value Garnered When Risks Anticipated:** The public sector makes the rules, but sometimes it has trouble living by those very rules. Transactions that have significant advance planning and meaningful public involvement to identify key long-term public policy objectives and acceptable tradeoffs create a better risk reward balance, benefiting both the public and private sectors in the long run, and consequently, debt investors.

**Legal Frameworks Are Key:** When risks are allocated to parties best able to manage them economically, then the incentives of all parties are better aligned towards successful execution. Key project risks in construction or operation from unanticipated or changed conditions do occur and can be managed. When all parties have appropriate levels of risk, they are better incentivized to work together to find an amicable solution.

**Size and Complexity Affect Deliverability:** The larger the project and the greater the technical complexity, the more important it becomes that constructors and operators have the technical and financial wherewithal to bear the risk they are taking. At some level of size and complexity, the pool of qualified players and the ability to allocate risk can be limited such that the risk of nonperformance falls back on the public sector and consequently on lenders. An independent, qualified technical assessment of risk is very important to understanding this risk.

**Forecasting Demand Is a Key Vulnerability:** The probability of over-estimation remains high despite decades of experience with forecasting demand on transportation projects. Many greenfield projects over the years across many jurisdictions have suffered from this exposure. While other risks have been manifested in many cases, defaults on debt have largely been driven by underperformance relative to original projections.

**Macro and Industry Risks Remain:** A key assumption is that a normal environment will prevail. However, severe recessions prior to project opening, political risk from high tariff increases, changes in approach from new administrations, lack of fulfillment of third-party commitments, among others, can all have a meaningful effect on the performance of a PPP.

**Concession Renegotiation Risk Must Be Addressed:** As time progresses and the needs of the population and government evolve, it should not come as a surprise that key terms may be subject to debate and renegotiation. It is important that adverse changes to terms be subject to lender approval. The alternative is often optional grantor concession termination, which is often unaffordable. Concession termination scenarios should be understood. While most concessions tend to go to term, understanding the options available to government in the event of termination is important. For governments, very often this scenario is not a viable alternative given the lack of identifiable resources to pay compensation.

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Mr. Chairman, thank you for the opportunity to present our views. I am happy to respond to any questions you and the members of the committee may have.