

# Why surety gets the job done on P3 projects





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Public-Private Partnership projects (P3s) involve a complex mix of new relationships and risk transfers for the private sector. This alternate project delivery model can benefit from the services and risk insights that a surety is uniquely capable of providing to the general contractor, which in the end, can benefit other stakeholders, such as owners, developers/concessionaires, project lenders and the taxpaying public.

There's no doubt that the aging infrastructure in the United States and Canada is costing both economies countless hours of lost productivity and efficiency.

Travel delays due to congested roads that can't handle the increase in passenger cars. Shipping interruptions due to clogged railways. Collapsing bridges that endanger lives and shut down commuters and commercial trucking. There's no doubt that the aging infrastructure in the United States and Canada is costing both economies countless hours of lost productivity and efficiency. In its 2016 report on U.S. infrastructure, the American Society of Civil Engineers estimated that it will take more than \$10 trillion in investment by 2040 to repair the country's aging infrastructure and reduce the productivity losses to the U.S. economy.<sup>1</sup> Canada faces similar challenges, with one-third of its municipal infrastructure considered to be at risk of rapid deterioration according to the 2016 Canadian Infrastructure Report Card.<sup>2</sup>

Infrastructure repairs face a tough funding fight, as national, state/province and local governments struggle to meet demands on their budgets and encounter public opposition to increasing taxes. That's why the use of alternative contractual arrangements for large, complex and critical infrastructure projects known as P3s has grown over the last few decades, particularly in Canada, Europe, Asia and Latin America.

The burgeoning use of P3s around the world has been driven by benefits of sharing resources and risk. For the public entities, theoretically they benefit from greater project efficiency, increased ability to leverage existing capital base, higher quality workmanship with aligned interests of designer/builder/maintainer, and more cost-effective results than traditional procurement methods. Public entities are also able to tap into the expertise of private firms to manage large-scale, long-term projects. P3 projects can provide the private sector with a greater role in the design, construction, and operation of public infrastructure, and also offer a long-term revenue stream over the length of the concession period (typically 20 to 30 years).

According to the National Council for Public-Private Partnerships, a P3 is defined as "a contractual agreement between a public agency (federal, state or local) and a private sector entity. Through this agreement, the skills and assets of each sector (public and private) are shared in delivering a service or facility for the use of the general public. In addition to the sharing of resources, each party shares in the risks and rewards potential in the delivery of the service and/or facility."<sup>3</sup> For contractors involved in a P3 project, the proverbial "devil is in the details" holds true, as the nuanced contract language in P3s may involve risks not found in traditional procurement and contractual models.

Currently, 33 states in the U.S., one territory and the District of Columbia have passed legislation enabling the use of P3s for public projects.<sup>4</sup> In Canada, the federal government and nearly all of the provincial governments have adopted enabling legislation that permits the development of P3 projects.

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## Growth of P3 projects



Between 1985 and 2011, nearly 2,000 projects were built worldwide using the P3 model.<sup>5</sup> Europe accounted for 699 of these projects, with 406 in Asia and Australia. The United States accounted for 377 and Canada for 200.<sup>6</sup> The average size of P3 projects in the U.S., however, is much larger, averaging USD 800 million per project versus about USD 400 million for Canada and about USD 200 million for the UK and Germany.<sup>7</sup>

Since the late 1980s, P3s in the U.S. and Canada have been used primarily for building roads, bridges, tunnels, light rail systems, wastewater facilities, healthcare facilities, prisons and schools. A brief list of high-profile P3 projects in these two countries by year of financial close includes:

- California 91 Express Lanes (1992)
- Moncton, Canada Water Treatment Facility (1998)
- Royal Ottawa Hospital (2004)
- Trans-Canada Highway (2005)
- Brampton Youth Justice Facility (2007)
- I-495 Capital Beltway (2007)
- Royal Victoria Hospital (2009)
- Florida I-595 Corridor Improvements (2009)
- I-35 Trans-Texas (2009)
- Mounted Police Headquarters, British Columbia (2010)
- Hampton Roads Bridge–Tunnel, Virginia (2010)
- South West Detention Center, Windsor (2011)
- Toronto Pearson International Airport Air Rail Link (2011)
- San Antonio Water System (2014)
- Florida I-4 (2014)
- Hydro-Quebec Data Centre (2015)
- Pennsylvania Bridges Project (2015)
- Saskatoon Bridges Project (2015)
- LaGuardia Terminal Building (2016)
- Maryland Purple Line (2016)

Zurich in North America issued surety bonds for many of these projects. The surety bonds eliminated or reduced the amount of letter of credit security required to be provided by the involved contractors.

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## No two P3 projects are alike – and neither are the risks

But there is one common element in all P3 projects: The structure and function of P3s may present greater responsibilities and pose a higher degree of risks for the private contractor than with traditional projects.

In a traditional infrastructure project, the contract is directly between the public owner and the private construction company, and is built based on a public design and paid for with public funds. Under a P3 arrangement, the public entity contracts with the private partner (referred to as the developer and/or concessionaire), who in turn hires and pays the construction contractor for the project. In some cases, the public entity commits funds to repay the private partner over a long period of time, possibly ranging up to 99 years, using revenue from tolls or other sources. The goal of a P3 is to maximize cost and schedule certainty during construction, while spreading public funding of infrastructure delivery costs across the long-term use of the project.

A P3 project can be delivered in a variety of arrangements, including build-finance, design-build-finance and design-build-finance-maintain. Each variation offers a different level of collaboration between the public-private partners and is the reason why each P3 project has its own complex and unique structure and contractual needs. But there is one common element in all P3 projects: The structure and function of P3s may present greater responsibilities and pose a higher degree of risks for the private contractor than with traditional projects. These risks depend largely on the type of contract the parties decide to enter, such as design-build-finance or design-build-finance-maintain. By making the private sector responsible for managing more risk, public entities can reduce their own financial exposure.

The P3 model is based on the principle that the risks associated with the delivery of infrastructure should be transferred to the contractual party that is most able to manage them. The emphasis placed on this risk transfer stems from the fact that large-scale projects are often characterized by higher costs and more potential sources of uncertainty. These uncertainties can lead to significant losses or additional costs for the developer/concessionaires and general contractors involved. With general contractors taking on more of the risks in a P3 project, it is critical for them to obtain the services and risk insights that a surety can offer.



# Contractors may assume additional risk exposures in P3 projects

Potential Risks	Typical traditional contractor responsibility	Potential responsibility shifted to contractor in P3s
Dependent on multiple project stakeholders that are not direct parties to the construction contract	No	Yes
Actual damages liability for variable project financing and debt breakage costs	No	Yes
Restricted ability to seek schedule relief or compensation for additional costs	Maybe	Yes
Differing site conditions and accuracy of background survey data	No	Yes
Full permitting risk, including major environmental permits	No	Yes
Long-term liability exposure for maintenance, structures	Maybe	Yes



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## P3s require the same protection as traditional arrangements

A surety performance bond guarantees that the public works project will be completed according to the construction contract.

In the U.S., the Miller Act requires traditional federally funded public projects to be bonded and all states have some form of “little Miller Acts” as well. A surety payment bond guarantees that covered subcontractors, suppliers, and laborers on the job will get paid. A surety performance bond guarantees that the public works project will be completed according to the construction contract.

Even though a private entity undertakes the P3 financing, construction risk does not go away. In fact, the risk can actually increase depending on the structure arrangement and contract. Therefore, it only makes sense that a P3 project should obtain the same type of surety protection benefiting a publicly funded project for several reasons, including to help:

- Ensure a project will be completed by providing both liquidity and construction knowledge and experience
- Protect taxpayer and investor dollars in case of default by contractor
- Provide economic security for local subcontractors and suppliers, who are often small business owners

Outside of North America, the majority of developers/concessionaires use Letters of Credit (LOC) to secure P3 projects, as low-percentage and on-demand project security is typical of both private and public construction procurement in Europe, Asia and Latin America. However, as stated earlier, the size of P3s in the U.S. and Canada requires a level of protection that LOCs cannot provide. While project owners may think an LOC has an advantage over a surety bond because the instrument is payable on demand, LOC coverage is limited in several ways:

- An LOC typically covers only 10 to 15% of project cost, while actual costs in the event of default tend to run much higher. This protection is significantly lower than surety payment and performance bonds that often cover 100% of the value of the project, depending on the scale of the project.
- A default of a general contractor or a key subcontractor on a large, complicated construction project unleashes an incredibly complex series of events that need to be managed before the project can resume toward completion. Such a default can create a crisis mode that few owners are prepared to manage. The LOC itself does not help to get the project completed, whereas an experienced and knowledgeable surety team has resources to step in to expediently get the project back on track. An owner may not have the same level of construction experience, nor does it maintain ongoing relationships throughout a project’s construction as a surety may have.
- If an LOC is called upon, it is usually during a crisis situation where different parties with competing interests are primarily concerned with vying for payment and not focused on getting the project completed.
- LOCs do not contemplate managing claims and liens against a project, as the role of the issuing bank begins and ends with honoring a demand for payment.

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# Beyond the bond: surety commitment to the project

The right surety is committed to staying involved throughout the project, becoming familiar with the project details and building relationships among all parties.

P3 construction is complex in the U.S. and Canada due to the size of the project, the challenging work conditions and the many different subcontractors and types of workers. Experienced surety professionals deeply understand the nuances of the procurement process and project risks, and act as advocates for the contractor and the project overall. A contractor who has a strong relationship with a surety benefits from the surety understanding the total project and financial risks the contractor is currently facing across their existing project portfolio. This insight helps the contractor determine the level of risk that they will need to manage on a new P3 project.

A surety team should get involved on a P3 project as early as the RFQ and RFP contract phases, assisting a contractor in assessing and assuming the appropriate levels of risk. The right surety is committed to staying involved throughout the project, becoming familiar with the project details and building relationships among all parties. This is a valuable service, especially when the surety can help resolve construction issues before the work is in danger of being halted.

As the use of P3s continues to grow in North America, contractors will benefit from having a surety relationship in these ways:

## **Help reduce proposal costs**

- Developing P3 project proposals can take years of effort and cost contractors millions of dollars. The cost of putting together a proposal can quickly escalate when the procuring agency has not developed standardized processes or documentation. An experienced surety is well-equipped to help contractors minimize these costs by sharing best practices and lessons learned on past project pursuits in different geographies with different procurement agencies.

## **Provide assistance in identifying project risks and risk allocation issues**

- Risk allocation amongst multiple project stakeholders and the complex interdependence of contractual relationships remain key challenges on all P3 projects. Contractors invest significant time and resources to negotiate the risks and project obligations passed down from the developer/concessionaire. Sureties with P3 experience can also provide market standard guidance and insights around key contract language accepted by stakeholders on past projects.

## **Tailor bond language to meet P3 project stakeholder needs**

- The surety industry continues to develop P3 bond language that further enhances the broad coverage of high-percentage performance and payment bonds by incorporating terms, such as explicitly securing payment of liquidated damages, quantifying surety response timelines, establishing expedited claims processes and incorporating funding agent and public owner step-in rights. An experienced surety can help tailor bond language to meet the needs of various P3 project stakeholders, such as concessionaires, lenders and rating agencies.

There is one key distinction between the U.S. and Canada procurement process for P3 projects. In Canada, there has been an evolution toward standardization of the contractual and financing documents among all the provinces, based on previous project agreements. This standardization, along with the universal federal and provincial support for P3s, is the reason why Canada is often referred to as the “model P3” country. However, the role of the surety during the procurement process in Canada is still key to ensuring each project’s risks are being equitably represented between the public and private parties.

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## Key practices: Getting the P3 job done with surety

No matter how experienced contractors are with traditionally financed public projects, P3s bring a whole new level of complexity and risk. In addition, the cost of putting together an RFQ/RFP for a P3 can be substantial, so as a contractor, you want to make sure you are creating a well-thought-out approach, including surety protection to increase the attractiveness of your proposal. Your surety bond provider can help you navigate many aspects of contractual risk transfer, financing and on-site risks. Consider utilizing some key practices in working with a surety on a P3 project, such as:

- Involve your surety as early as possible, even starting with the RFQ, so they can become familiar with all the parties involved and the project parameters.
- Review your entire scope of risks with the surety underwriters, including the larger scale of liability and additional exposure as changes occur during the project.
- Ask your surety to assist you in identifying project risks and risk transfer issues to be addressed through the contract to help ensure an appropriate level of shared risk.
- Have your surety advocate that the bond requirements be written at the design/build level, not at the development/concession level, to help the contractor avoid finance and long-term maintenance obligations that should be retained by the developer/concessionaire.
- Check that your surety has extensive claims knowledge and experience on larger, more complicated P3 or public projects.



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# In the end, surety protects everyone's reputation

P3 projects are high-profile projects, such as bridges, tunnels, airports, highways, and rail systems that millions of people will use. For stakeholders, such as owners, government officials, project proponents and others, there's no place to hide from public scrutiny and criticism if a P3 project is severely delayed, has significant cost overruns or is in default. Although the surety bond is held between the contractor and the developer/concessionaire, it also serves other important stakeholders by providing additional assurances that the contractor is capable of performing the work and paying all the subcontractors, suppliers and workers on the job. The owner also knows that the surety protects the taxpayers from extra costs and works to resolve issues on the project.

There is much hope riding on the future of P3s to play a role in helping to rebuild and repair the aging infrastructure in North America. Use of a surety bond serves to protect the reputation of all parties in delivering on the payment and performance of the project.

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