Standardised PPP Provisions: Frequently Asked Questions

<u>PRIVATE SECTOR DRAFT</u>

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Q1 **WHY WAS THERE A NEED FOR STANDARDISATION? WHAT IS ITS PURPOSE?**

A1 The Standardisation addresses the need to provide certainty regarding the key contractual issues arising in Agreements.

The purpose of the Standardisation is to promote a common understanding in the public and private sectors of the technical, operational and financial risks that are typically encountered in PPP projects and of how these risks must be optimally allocated between Institutions and Private Parties involved in PPP projects. A further purpose of the Standardisation is to ensure a consistent approach to affordability, risk transfer and value for money amongst PPP projects (save for sector specific differences), the three core pre-requisites for PPPs in terms of the Treasury Regulations.

Q2 **DOES IT COVER ALL KIND OF PPPS? IF NOT, WHAT IS NOT COVERED AND WHY?**

A2 The main distinction drawn in the Standardisation between kinds of PPPs is based on the funding structure of PPPs. Of the three basic funding structures (project finance, corporate finance or state funded capital contributions), the Standardisation focuses on PPPs that rely on project finance, i.e. limited recourse debt made available by lenders (other than the shareholders or related parties of the Private Party) that is serviced from the cash flows generated by the Project. The project finance structure is the one that is most suited to the objectives of a PPP.

The Standardisation also recognises the distinction made in the Treasury Regulations between PPPs involving the performance of institutional functions by Private Parties and those involving the use of state property by Private Parties for their own commercial purposes. While most of the Standardisation is applicable to the latter type of PPP, it focuses on PPPs in which Unitary Payments are made by an Institution to a Private Party for the performance of Services rather than on PPPs where the Private Party pays a concession fee to the Institution for the use of state property.

Q3 **ARE ANY OF THE STANDARD DEFINITIONS AND CLAUSES NEGOTIABLE? IF YES, ON WHAT BASIS?**

A3 Generally, the standard definitions and clauses must be included in all Agreements for which a Treasury Approval:IIA (as required in terms of Treasury Regulation 16.1) has not yet been issued as at the date of issue of the Standardisation. However, if an Institution has good reason to deviate from the standard definitions and clauses it may do so but only with the prior approval of the National Treasury.

The National Treasury will consider all such requested deviations in light of the Treasury Regulations, particularly, having regard to whether the deviations will impact on the affordability and risk transfer profile of and value for money provided by the relevant PPP project. The National Treasury will also consider any sector specific requirements or alternative funding structures that specifically justify deviation.

Q4 **WHAT ARE THE PUBLIC SECTOR INSTITUTION'S RIGHTS AND OBLIGATIONS UNDER THIS DOCUMENT? HOW ARE THE RIGHTS PROTECTED?**

A4 The Standardisation requires that the Agreement sets forth the Institution's basic right to obtain performance of the Services according to the Institution's output specifications (for, amongst other things, efficiency, quality and quantity). Its basic obligation is to make a Unitary Payment to the Private Party for the Services it actually receives. The basic right is protected by a performance monitoring regime, poor performance penalty mechanism, an independent certifier regime to certify Service Commencement and a fast-track independent dispute resolution regime to deal with technical disputes.

Q5 **WHAT ARE THE PRIVATE PARTY'S RIGHTS AND OBLIGATIONS? HOW ARE THEIR RIGHTS PROTECTED?**

A5 The Standardisation requires that the Agreement sets forth the Private Party's basic rights to design, construct, maintain and operate the Facilities required for the performance of the Services and to receive Unitary Payments for providing Services to the Institution. The Private Party's basic obligation is to perform the Services and to ensure that such performance achieves the Institution's output specifications. The Private Party's basic rights are protected by the same mechanisms that protect the basic rights of the Institution.

Q6 **WHAT HAPPENS IF THE PRIVATE PARTY DEFAULTS ON ITS OBLIGATIONS? WHAT IF THE REASONS FOR DEFAULT WERE NOT IN ITS CONTROL?**

A6 The Institution has contractual remedies in the event that the Private Party defaults. These remedies include financial claims covered by some security, penalties and, in certain instances, an ability for the Institution to step into the Project. In certain cases defaults may entitle the Institution to terminate the Agreement. Equitable relief has been provided for defaults that are not due to the Private Party's default. All possible reasons for non-performance are covered in the Agreement.

Q7 **WHAT HAPPENS IF THE PUBLIC SECTOR INSTITUTION DEFAULTS IN ITS OBLIGATIONS? WHAT IF THE REASONS FOR DEFAULT WERE NOT IN ITS CONTROL? WHAT HAPPENS IF THE REASONS FOR DEFAULT WERE IN NEITHER PARTIES CONTROL?**

A7 The Private Party is afforded protection against public sector default. This includes financial compensation and, in certain circumstances, the right to terminate the Agreement. Equitable relief has been provided for instances where the default is not due to either Party's fault. All possible reasons for non-performance are covered in the Agreement. In other instances the Private Party may be given relief in the form of an extension of time, in lieu of financial compensation.

Q8 **UNDER WHAT CONDITIONS CAN THE PPP AGREEMENT BE TERMINATED? WHAT HAPPENS UNDER EACH SCENARIO? HOW DOES IT AFFECT SERVICE DELIVERY?**

A8 The basic grounds for termination of the Agreement are:

(1) termination as a result of an Institution default. The Agreement provides for a remedy period whereafter the Private Party is entitled to terminate the Agreement and be compensated in full;

(2) termination as a result of a Private Party default. Provision is made for a remedy period within which the default must be remedied whereafter the Institution is entitled to terminate the Agreement. The Private Party is entitled to compensation based on the market value of the Project if there is a liquid market, otherwise compensation is based on the original financial model;

(3) termination as a result of Force Majeure. Force Majeure is very narrowly defined. If a Force Majeure continues for an extended period, the Agreement may be terminated and the Private Party is equitably compensated.

Q9 **HOW IS PRIVATE PARTY'S PERFORMANCE MEASURED? HOW ARE THEY COMPENSATED?**

A9 The Private Party's performance is measured against output specifications that are set by the Institution. The Private Party is responsible for self-monitoring by means of a performance mechanism and has reporting obligations which are stipulated in the Agreement. The Private Party is compensated by the Institution by means of a service payment at specified intervals.

Q10 **HOW ARE PENALTIES ENFORCED FOR NON-PERFORMANCE? HOW ARE THE PRINCIPLES OF PENALTIES, DEFAULTS AND TERMINATION LINKED?**

A10 Penalties for poor performance in the provision of the Services are deducted from the Unitary Payments made to the Private Party. Initially defaults give rise to financial penalties. If the default is material or persistent, then the Institution is entitled to terminate the Agreement.

Q11 **WHO BENEFITS FROM ANY INSURANCE PROCEEDS? WHY?**

A11 The primary beneficiary is the PPP project. The main aim of the insurance regime is the reinstatement and continuation of the Project after the insured event occurs, unless this is not economically feasible. In effect, therefore, as between the Institution and the Private Party, the benefits of the insurance regime are shared.

Q12 **WHAT IS THE ROLE OF THE LENDERS? WHAT ARE THEIR RIGHTS AND OBLIGATIONS?**

A12 The Lenders provide the bulk of the capital required for the Project. They do so on a limited recourse basis which involves them looking primarily to the cash flows (i.e. Unitary Payments received by the Private Party from the Institution) generated by a PPP project to service the debt. The Lenders may also obtain some support from the Private Party's Shareholders and related parties and also security over the Private Party's cash reserves and profits. Since the cash flows depend on the sustained provision by the Private Party of the Services at the prescribed performance levels contained in the output specifications, the debt service is put at risk by the Private Party's poor performance, i.e. the Lenders assume performance risk.

The Lenders have an obligation to the Private Party to advance the capital committed by them to the Project and the right to repayment of the capital so advanced plus interest and their fees and costs. The Lenders also have a preferential right (as against the Private Party) to all compensation received by the Private Party on early termination of the PPP project in discharge of the debt.

The Lenders also have a right in terms of a direct agreement with the Institution to step-in and rescue a PPP project following a default by the Private Party (thereby averting termination by the Institution).

Q13 **DOES THE PRIVATE PARTY PROVIDE ANY GUARANTEES? IF YES, WHAT KIND, AND WHY?**

A13 The Agreement does contemplate appropriate security to be provided by the Private Party in order to provide the Institution with the assurance that the Private Party will perform its obligations especially those in relation to the condition of the assets when they are handed back to the Institution at the end of the Project Term.

Q14 **WHO BEARS THE RESPONSIBILITY FOR SUB-CONTRACTORS (IF ANY)?**

A14 The Private Party bears all subcontractor related risks.

Q15 **HOW ARE PROFITS BY PRIVATE SECTOR DEALT WITH?**

A15 Because of the allocation of technical, operational and financial risks to the Private Party, the Private Party and its Shareholders are generally entitled to the profits generated by the Project.

However, in the instance of any refinancing of the Project, any resultant gains must be shared equally between the Institution, on the one hand, and the Private Party and its Shareholders, on the other.

Q16 **HOW ARE EMPOWERMENT AND OTHER SOCIO-ECONOMIC OBJECTIVES ENSURED?**

A16 Each Institution must stipulate the minimum empowerment requirements in the RFP for its PPP project, reflecting both equity and management control by historically disadvantaged individuals and/or entities, skills training and employment equity measures by the subcontractors and subcontracting to historically disadvantaged entities and SMMEs. The Agreement must incorporate these minimum socio-economic requirements. The Agreement must lock-in the empowerment equity for a specified period and must include a regime for monitoring the Private Party's compliance with its socio-economic obligations. The Institution's entitlement to ensure compliance can be protected rights through the penalty regime involving Penalty Deductions from the Unitary Payments.

Q17 **HOW IS TRANSPARENCY ENSURED?**

A17 The procurement of PPPs must be conducted through a public, transparent and competitive bidding process. This is a requirement of law. This transparency is ensured pursuant to the regulatory framework, which obliges accounting officers and authorities to submit to the National Treasury details of bids received in response to the RFP and the evaluation thereof by the Institution as well as annual reports regarding the ongoing implementation of Agreements. The Auditor-General's office has access to this information and can make this information known to the public. The Standardisation describes the disclosure obligations (not only as to financial matters) that must be imposed on Private Parties to ensure compliance by accounting officers and authorities with their statutory reporting obligations.

Q18 **WHAT HAPPENS IF THERE IS A CHANGE IN LAW?**

A18 The Private Party bears risk of a change in law as would be the case in any ordinary business operation unless the change in law is one that discriminates against the Private Party, in which case it is entitled to financial compensation.

Q19 **IS THERE A LOCK-IN PERIOD FOR ORIGINAL SHAREHOLDERS? EMPOWERMENT PARTNERS? FOR HOW LONG, AND WHY?**

A19 Changes in control of the Private Party require the prior approval of the Institution throughout the Project Term. This is partly to prevent any third party deemed unsuitable by the Institution from taking control of the Project (particularly where that party or a related party may have been previously disqualified in the bid process), partly because such a lock-in reflects the original Shareholders' assessment of the feasibility of and commitment to the Project and partly to avoid accusations of lack of transparency regarding the Shareholders behind the Private Party.

The Standardisation prescribes a lock-in for empowerment equity but does not specify a minimum period as the duration of PPP projects vary greatly depending on the sector and the specific operational needs of the Institution. The minimum lock-in period for empowerment equity must be specified in the RFP. The prescribed lock-in does not prohibit transfers of empowerment equity amongst empowerment entities and individuals. The experience thus far has been that the empowerment thresholds in PPP deals have been far higher than required by present government policies on empowerment targets.

Q20 **DOES ANY PARTY HAVE ANY STEP-IN RIGHTS? WHY? HOW?**

A20 The Institution and the Lenders have step-in rights. In the case of the Institution, its step-in rights are narrow and arise only in limited circumstances not necessarily related to a default on the part of the Private Party, such as the need to address an urgent public interest concern such as health and safety. Since step-in will upset the risk allocation to the Private Party and involve the taking back of risk by the Institution (unless caused by the Private Party), it cannot be employed to address long-term or ongoing problems in a PPP project. If the problem in question is long-term, the solution is not Institution step-in, but termination.

The Lenders' step-in rights are aimed at ensuring the continuity of the PPP project following a default on the part of the Private Party. The Lenders will be motivated to do so to the extent that the amounts received on termination of the PPP project will be insufficient to service the outstanding debt. The fundamental principle of the Lender step-in regime is that the Institution must be no worse off when the step-in is effected, i.e. the Agreement must continue to be performed in accordance with its terms (save to the extent that the termination rights of the Institution will generally be suspended during the step-in period).

Q21 **WHO OWNS THE ASSETS THROUGHOUT THE TERM OF THE PPP AGREEMENT?**

A21 All fixed assets to be constructed or installed by the Private Party are owned by the Institution in instances where the land is owned by that Institution (in some instances, the land belongs to another organ of state and here those fixed assets will belong to that organ of state). The movable assets such as furniture and equipment usually belong to the Private Party (a special purpose company that has been set up specifically to house the Project). On termination or expiry of the Agreement, ownership of all such movable assets as well as possession of all the assets have to be transferred to the Institution. There are also limitations as to what the Private Party may do with these assets during the Project Term, for example they may not be pledged as security or sold unless replaced.

Q22 **WHAT HAPPENS TO THE PROJECT AT THE END OF THE PROJECT TERM?**

A22 At the end of the Project Term the Private Party hands back a working facility to the Institution. The Institution can then either continue to operate the Project itself or if it elects, it can put the Project out to tender again.