

Picking through PPPs' termination for convenience provisions

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Termination for convenience is an element of a PPP transaction where public and private interests truly compete. While not all jurisdictions condone the concept, and not all PPP agreements include an express right of termination for convenience, termination for convenience has become a fairly standard component of PPP contracts in North America and elsewhere.

An authority would have numerous reasons to want to retain a right of termination for convenience. The UK Treasury's updated guidance document *Standardisation of PF2 Contracts (December 2012) (Current UK Guidance)* states the intention of all parties to a Contract should be that it will run its full course. There may be circumstances, however, in which the Authority is no longer able to continue the relationship it has with the Contractor under a Contract. For example, there may be a policy change which makes further provision of the Service redundant. In order to cater for such circumstances, the Authority may wish to retain the right to terminate the contract voluntarily.

This rationale may have greater force in an availability payment social infrastructure project, where an authority may want to cease making availability payments for a facility that it determines is no longer needed. It is less convincing in projects where the private parties have assumed revenue risk. Nonetheless, termination for convenience provisions are universally drafted to give the authority a unilateral unfettered right to terminate. This raises the possibility of termination for less defensible reasons, such as political expedience (for instance to assuage anti-PPP sentiment) or simple financial gain (for instance, if the value of the asset rises faster than expected, the authority can buy it back at a price lower than its fair value).

Termination for convenience is commonplace in the global PPP market and most PPP projects therefore have an inherent termination for convenience risk. Accordingly, compensation regimes that mitigate termination for convenience risk are a crucial component of every PPP transaction that may be terminated for convenience. The importance of these compensation regimes is even greater in North America, and particularly the US, where market dynamics often require the private party to assume greater project risks and termination compensation based upon the fair market value of project equity is generally not available.

Termination for convenience risk

A financial investor (as opposed to other participants, such as construction companies, that may receive the bulk of their return before completion) pursues a PPP project to earn development fees and to acquire a long-term yield producing asset. As either a part of its business strategy, or if its circumstances change, the financial investor may wish to monetise its investment at the highest realisable value.

Affecting the value of its equity will be a wide range of circumstances, some of them beyond the investor's control but which it has accepted (for instance traffic risk, changes in interest rates, economic conditions or O&M costs) and some of which the investor seeks to manage effectively in order to generate value (for instance mitigating construction risk through proper contracting and supervision and performance of the project agreement according to plan).

If circumstances move against the project, or the private party ineffectually manages risks and/or fails to meet the requirements of the project agreement, the value of the equity will decrease. If circumstances move in favour of the project, or the private party effectively manages risks and/or performs better than expected, the value of the equity will increase.

And the differences in value can be significant. By way of illustration, the equity in a greenfield project that was structured to produce a 13% internal rate of return (IRR) under the base case at financial close might be priced to yield a return of only 9%-10% when sold to more risk averse investors, such as pension funds, interested in purchasing the equity after construction is complete and the project has exhibited good performance during ramp-up.

The interest of a financial investor is therefore, first and foremost, that the project agreement not be terminated for convenience. However, if it is terminated, the investor will seek to be compensated for the actual value of the investment that is lost, which should include any increase in the value of the equity that it has created. To the extent the authority has the right to terminate for something less than the actual value of the investment, the private party must assess termination for convenience risk in the same manner as any other project-related risk.

In effect, the value that a financial investor ascribes to a project will be reduced by the value of any call option that the authority insists on embedding in the project agreement. If the market in which such projects are procured is even roughly efficient, this call option could come at the expense of offsetting adjustments to other project parameters (for instance lower up-front payments, higher availability payments, lower revenue sharing, and so on). More fundamentally, the incentive of the private party to manage the asset in order to increase its value will be lower, to the extent that an authority can appropriate such value through a termination for convenience mechanism.

A private party's assessment of the risk of termination for convenience must take into account at least two factors: the probability of this termination occurring, and the financial consequences to the private party if this termination takes place.

With respect to the probability of termination for convenience occurring, a private party may have some ability to assess the likelihood of, for example, the project becoming redundant or obsolete over the term of the project agreement. However, a private party is not particularly well equipped to assess, price and mitigate the risk of changes in political winds and the motives of governments over a multi-decade period. All that can be said with any certainty is that the probability of termination for convenience decreases as the cost to the authority of invoking termination for convenience increases.

The financial consequences of termination for convenience depend on a complicated interplay of at least three factors:

1. The method of calculating the termination compensation;
2. The level of performance of the project in relation to projections (and hence the increase in equity value that hangs in the balance); and
3. The point during the term of the project agreement at which termination for convenience takes place.

For the purpose of this article, we assume that the interests of lenders are adequately addressed through either swap termination payments or make-whole payments, and that they are made whole from a fair market value point of view on termination for convenience.

Overview of termination payment methodologies

The following are the standard methods of calculating compensation for termination for convenience that are generally in effect in the global PPP industry, including North America. However, unlike the UK, where the private party has the option to pick its calculation method, different jurisdictions in North America either prescribe a single method of calculation, or give a more limited number of options from which to elect.

These options are summarised as follows:

Fair market value calculation

Under this methodology, compensation is based on the market value of the equity on a going concern basis calculated immediately prior to the termination date based on a variety of assumptions, including that there is no authority default and the equity is freely transferable.

The fair market value calculation has been an option on UK projects from the inception of PPP and has been adopted in jurisdictions like Australia and New Zealand. In Canada, only Alberta and British Columbia have offered the fair market value calculation option. In Alberta, it is the sole option and the payment for equity on termination for convenience is equal to the reasonable damages (including for loss of its bargain). In British Columbia, it is one of two options (along with the backwards looking base case calculation, discussed below).

In a limited review of PPP transactions in the U.S. market, we did not identify a jurisdiction or project where the fair market value calculation was the basis of compensation on termination for convenience, other than in Texas, before the passage of new state legislation regulating compensation on termination for convenience. It is, however, the basis of compensation for authority default in the Denver FasTracks Eagle PPP and Chicago Skyway projects.

In all cases, the fair market value calculation allows the private party to receive full value for its equity. The private party does, however, bear the risk of the project not proceeding according to plan, in which case the authority would be able to exercise its option for a price that may fall well short of the private party's investment in the project.

Backwards looking base case calculation

Under this methodology, compensation is determined as an amount which, after accounting for payments already received, gives equity its base case return up to the termination date. In other words, the private party receives a topping up payment. Where equity has already hit its base case return, no payment would be due.

When a project is operating above its base case projections and the private party has been enjoying a larger than expected dividend stream (putting it on track to produce a higher than expected IRR), the backwards looking base case calculation has the effect of clawing back a portion of those excess returns by reducing the termination compensation to the extent necessary in order to bring the IRR back down to base case levels for the period prior to termination for convenience.

On the other hand, where a project is failing to achieve its base case projections, the termination payment under the backwards looking base case calculation would indeed top up the private party to its base case return for the period before termination for convenience. As a result, this mechanism provides the authority with both the means and the incentive to appropriate the increase in equity value in cases where a project outperforms its base case, but renders the possibility of a meaningful top up in the downside case more unlikely.

In negotiating the backwards looking base case calculation option on a project, private parties must be alert to the manner in which this calculation methodology works if, as is often the case, equity contributions are backed by a letter of credit but not funded until after senior debt is fully drawn. In such a case, a backwards looking base case calculation computed on the basis of contributed (rather than committed) capital could be even more confiscatory.

Ontario appears to be the only jurisdiction that offers only the backwards looking base case calculation as an option. This was also the only option in the Miami Tunnel project in the early days of Florida's PPP programme, but Florida now also offers the forward looking base case calculation, discussed below. British Columbia offers the backwards looking base case calculation alongside the fair market value calculation option, and a number of US projects offer the backwards looking base case calculation as an option alongside the forward looking base case calculation. These include East End Crossing (Indiana), Presidio Parkway (California) and I-595 (Florida).

Forward looking base case calculation

Under this methodology, compensation is equal to the present value (as of the termination date) of the net cash flows

which would have been paid to the private party through the end of the term had there been no termination, discounted at the base case IRR. This calculation produces the same number in all scenarios of project performance.

In the case where the project is operating below its base case projections, the forward looking base case calculation provides no top up for prior sub-performance, but rewards the private party with a termination payment computed as if the project would perform according to base case for the remainder of its term. In the case where a project is operating above its base case, the forward looking base case calculation has the effect of appropriating to the authority the future (but not the past) out-performance.

The forward looking base case calculation is well established in the U.S. and was an option in East End Crossing (Indiana), Presidio Parkway (California) and I-595 (Florida). No Canadian jurisdictions appear to have adopted this calculation methodology.

Comparative example

The effect of these methods may be illustrated with a simple example of a 40-year concession, with a three-year construction period during which the private party invests \$100 million per year. Upon completion, the base case contemplates level annual distributions in an amount sufficient to generate an IRR of 13%. Consider an upside case in which those distributions grow at 2% per year after completion, and a downside case in which they shrink at 2% per year after completion. If there is a termination for convenience at the end of the 20th year of such a project, the resulting termination payments would be as follows:

Project performance	Forward looking base case calculation	Backward looking base case calculation
Below base case	\$355 million	\$580 million
Base case	\$355 million	\$359 million
Above base case	\$355 million	\$95 million

As will be evident, the Backward looking base case calculation can produce extreme variability in the amount of the termination payment and will provide a powerful incentive for the authority to exercise its call option on a successful project, while making it burdensome to take back an underperforming project.

Termination for convenience risk in North America

Private party

The Current UK Guidance explicitly states: The Contractor should receive a termination payment which leaves it in the position it would have been in had the Contract run its full course. For this reason, the Current UK Guidance gives bidders the ability to select a market value-based calculation of compensation on termination for convenience. But in recognition of the reality that each project has a different risk profile, and both bidders and authorities have varying degrees of risk tolerance for future events, the other close-out options have been developed as described above.

Except for those jurisdictions and projects described above, the North American market does not presently feature a market value-based calculation of compensation, because authorities have not had to offer it. Bidders take or leave the compensation mechanism available under current market conditions, in which there is often more equity chasing projects than there are projects in which to invest.

It is certainly not a given that bidders will select the fair market value option when given a choice. An informal review of the ten latest projects in British Columbia, which offers a fair market value calculation as an option, along with the backwards looking base case calculation, indicates that bidders are equally split in choosing between the two calculation options.

Government

Failing to offer market value-based compensation on termination for convenience may have hidden costs for governments:

Anecdotal evidence and common sense suggest that a private party will make a more competitive bid (for instance higher up-front payments, lower availability payments, less reluctance to share revenues, and so on) if the asset it is taking over cannot be confiscated at the discretion of the authority for less than its actual value. Alberta offers a parallel to this approach in that the public sector does not require the private party to share any refinancing gain. Its view is that if a private party considers there to be a potential for refinancing gain, it would rather see that possible benefit fully priced upfront in the bid, rather than hope to receive a benefit at a later date.

Market value compensation would assist in the creation of a liquid secondary market for the PPP sector by making equity more freely transferable without the limiting overlay and analysis of termination for convenience risk.

A liquid secondary market would make it easier for a developer/risk taker to sell its equity to the more risk-averse investors, such as pension funds, that would otherwise not participate in the greenfield infrastructure sector. This will allow risk capital to be recycled and available for redeployment in new PPP projects.

Conclusion

The available options for calculating compensation on termination for convenience are more limited in North America than those available in PPP markets elsewhere. The lack of a fair market value option in most North American jurisdictions leads to a range of non-commercial outcomes for both the private party and the public authority.

Until a public authority actually terminates a project, and confiscates a significant amount of value, the North American PPP sector is unlikely to seriously focus on this issue. In the meantime, the private party must carefully analyse, quantify and price termination for convenience risk.

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