Basics of Risk Allocation in P3 Contracts

Allocating risk: One of the central differences between a standard procurement contract and a P3 contract relates to the allocation of risk between the private partner and the public entity. As a general matter, risks should be allocated to the party best able to bear and mitigate them. Public bodies need to be wary of guaranteeing the private partner's performance or revenues, formally or informally.

Development risk: risk of project going over budget or schedule, poor design

Strategies: Allocate risks to the entity responsible for it. E.g., responsibility for obtaining necessary permits may be allocated to the public entity, while responsibility for designing a project within budget falls on the private partner. Offer performance incentives for reaching certain milestones. Require bonds and other surety to ensure project can be completed if private partner fails to do so.

Operation risk: risk of wear/tear, vandalism, or unforeseen events that damage the project

Strategies: Often operations risk is placed on the private partner. It may be a good idea to share the risk, though, such as setting a maximum cost or annual operating budget that the private partner will cover from its revenues, with the public entity covering the rest. Ensure compensation or reimbursement events and mechanisms for auditing, reporting, default, and taking over the project are well defined, so the public entity doesn't end up paying for problems caused by the private entity.

Demand risk: risk that the P3 project will not be used or needed, leading to less revenue

Strategies: Careful pre-project analysis helps mitigate this risk. Determine how the private partner will be funded—direct use fees or "shadow" fees paid by the public entity. Unexpectedly low demand may result in the public entity paying the private entity to make up for lost revenues or the private partner defaulting and going bankrupt (Indiana toll road). Ensure that the agreement addresses the public entity's duties if it needs to close the project so it isn't giving the private partner a windfall (Chicago parking meters). Address competing projects beforehand.

Competition: Because a P3 generally involves a private partner operating a project in exchange for some type of revenue, other public projects that become necessary may impact the revenue the private partner receives. Ensure the agreement covers competition and non-compete clauses.

Strategies: Restrict the ability of a private partner to prevent the public entity from developing additional projects, especially if such projects were planned prior to the P3. Limit the private partner's compensation to only what will make it whole—no windfall.

Ending or Changing the P3 Relationship: Because of the risks involved in a long-term relationship with a private entity, ensure the agreement provides clear mechanisms for assignment, default, and termination of the agreement by the public entity.

Strategies: Ensure that the private partner cannot assign its interest or rights in the P3 to another entity without the public entity's approval (including bankruptcy proceedings). There may be an exception if the private partner needs to use its interest as security for financing, but make sure the public entity has superior rights and has the ability to review and approve. Make sure the public entity has the right to take over the private partner's duties upon default. Beware of locking in an agreement without any ability to review, amend, or terminate the agreement—periodic review and approval is a good idea.