



Securing Construction Risk on Canadian P3's: The Landscape Is Changing

While letters of credit (LOC's) continue to be an important element in performance support packages, there is a growing trend toward including performance bonds as part of the package. Project stakeholders can take considerable comfort from knowing that a design-build contractor maintains a strong facility of surety credit, that there is an exhaustive course of due diligence being performed behind the scenes by a surety company, and that surety credit has been pledged to the project under a surety bond.

A significant program of surety credit involves due diligence by a surety company on every aspect of a contractor's business on an ongoing basis and over long periods of time. Individual project transactions are scrutinized on their own merits, but also in the context of a contractor's overall program of work. A contractor and its surety are in continual dialogue about the contractor's long-term business strategy and management, capitalization, risk management discipline and project execution. Together a contractor and surety routinely analyze the contractor's entire backlog of projects (not just the bonded projects) and can forecast financial performance. New project opportunities are discussed and considered in the context of the outstanding backlog and business plan to ensure that the construction organization has the required resources and expertise to perform contracts as and when required, and if a project doesn't 'fit' the plan or may put existing projects or the organization at undue risk the contractor may decide to take a pass.

One of the only certainties on a project is that things will change. Infrastructure projects in Canada, including P3s, are becoming larger and more complex, with longer procurement and construction schedules. There are more moving parts to manage over longer periods of time and with large amounts of (ultimately) public money at stake. In developing its internal credit and risk modeling for its contract surety business, Travelers studied the detailed financial, operation and claims data on hundreds of contractor defaults. There is a strong correlation between longer project durations and the probability of a contractor failure. While P3 projects may attract far more scrutiny and due diligence earlier in the process than conventional construction delivery methods, the surety process brings a unique and essential perspective that is not project-centric and that is focused on the long term health of the contractor.

The continuing use of LOC's in performance support packages is one of the many indicators that sureties monitor. Referring to the continuing requirement for LOC's from contractors on Canadian P3 projects and the increasing risk of LOC aggregation for a contractor, Standard & Poors notes in its 2008 Global Project Finance Yearbook that, "It is likely that contractors that have taken on significant exposure might be pushing against LOC limits or other balance-sheet ratios, so that less encumbering support features, such as surety instruments, might be considered by construction providers in the future." The experience of several years and dozens of P3 projects has allowed the Canadian construction market to become thoroughly familiar with the risks and rewards associated with these opportunities. In light of this experience, many contractors are having a hard look at their increasing LOC exposure and reconsidering the real risks and costs. Contractors are revisiting the use of surety bonds where they are not already required.

There is also a growing trend for government sponsors, in specific circumstances, to advance public funds early in the project during construction. Structured as milestone payments this funding takes some of the pressure off the debt elements on these projects. As an enabler during the recent market downturn this has been a positive trend and there is some indication that, in modest proportions, the early advance of public funds in Canadian P3 projects may be here to stay for some time.

The desire for risk transfer and for tapping the ingenuity of the 'private' market has meant that proponents and their financing stakeholders have taken the lead in designing performance support packages and construction security that suited their appetite for risk and cost. As we see government sponsors put public funds 'in the ground' earlier in projects through advance milestone payments, it may now be appropriate for government sponsors to re-visit the benefits of requiring that surety instruments be part of these support packages.

The Canadian P3 market has shown that it can be flexible and resilient, and a slightly more prescriptive approach to the use of surety bonds by government sponsors when public funds are part of the project financing structure is not likely to be an obstacle to the innovation, entrepreneurial drive and essential value for money that can be realized through P3 projects.

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