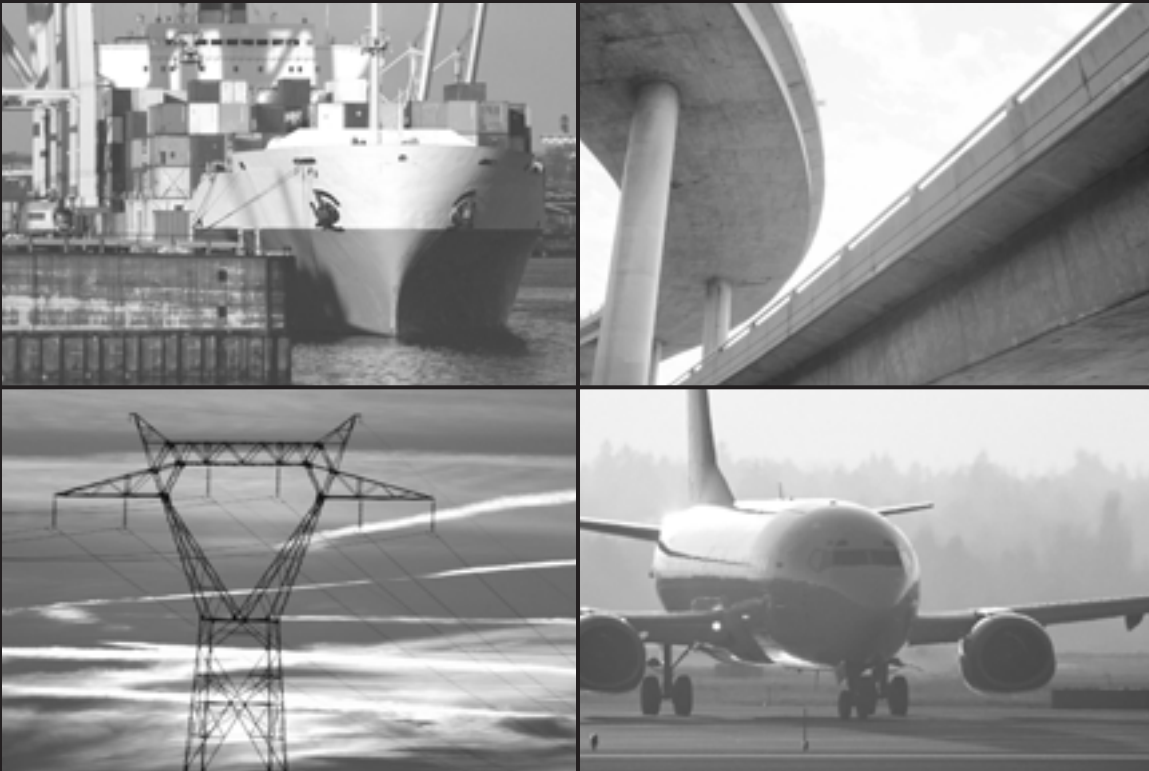


CROSSROADS

Deal Architecture

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Goodmans



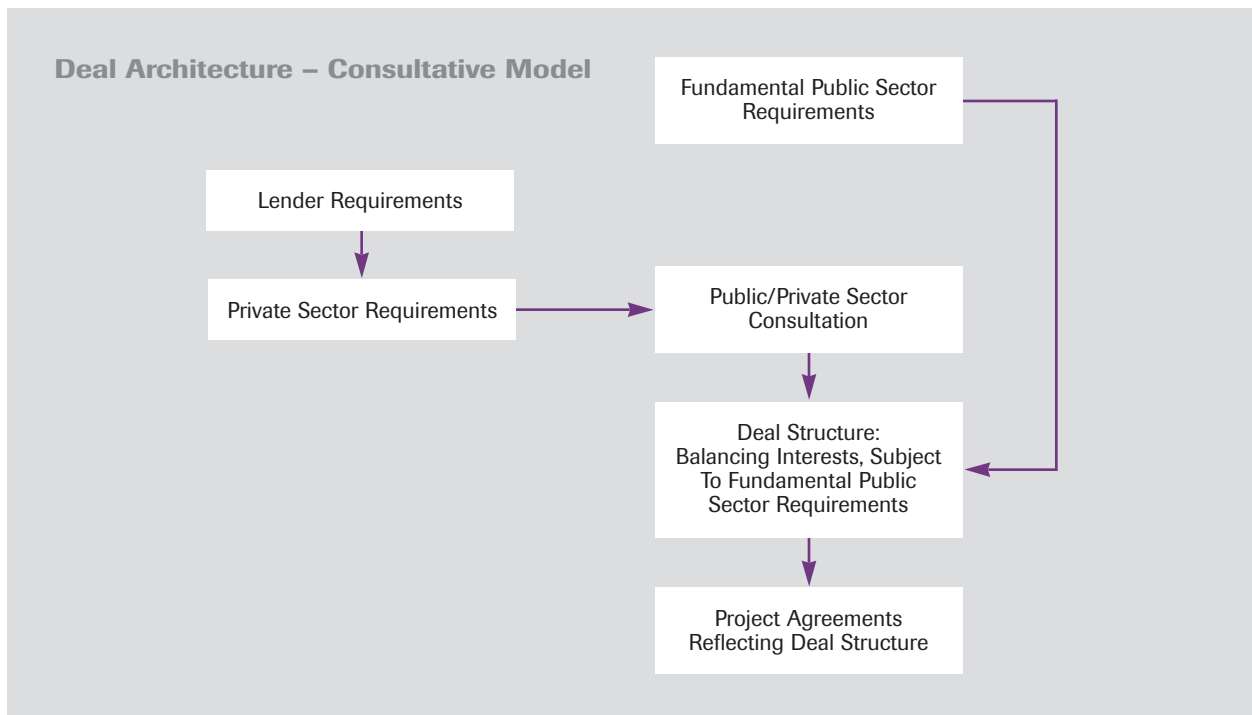
Introduction

Goodmans and KPMG, two leading firms that provide infrastructure renewal and procurement services in Canada, have joined forces to provide you with *Crossroads* – a regular publication designed to provide practical articles on current trends and developments in these areas.

In the first two issues of *Crossroads*, we discussed the various infrastructure renewal delivery options and the key selection criteria to help determine the best delivery option for any project. In this third issue, we describe select issues relating to deal structure.

Structuring The Deal

In the past, the structuring of public-private infrastructure projects has traditionally been the exclusive preserve of the public sector party. Generally, government sought to unilaterally determine the structure, often only with regard to its interests. The private sector party was required to accommodate this mandated structure, usually with relatively little opportunity to make alterations that would assist it in achieving any structuring benefits associated with the project. Today, governments are starting to see the advantages of a more consultative approach to deal structuring and are giving the private sector some opportunity to participate in the creation of deal structures that better recognize the needs and interests of both parties. This trend requires both participants in the project to have a greater appreciation of the requirements and expectations of the other in order to achieve the appropriate balance in determining the ultimate deal structure. Please refer to the chart below for an illustration of the consultative model for deal structuring.



Each deal structure provides different advantages and disadvantages to the participating parties and differs in the degree of risk and control assumed by the private sector and conversely, the degree of risk retained and control relinquished by the public sector. To gain acceptance by both public and private sector parties, a deal structure must balance, implement and anticipate the short and long-term objectives of both parties. What follows is a discussion of some selected process, legal and negotiation issues to consider under this general topic.

Enabling Legislation

Often, the possible range of deal structures will be dictated by the existing or specifically created legislative or regulatory framework applicable to the project (or to a program of projects).

In order to avoid lengthy delays and costly and embarrassing challenges to the authority of the government to engage in a specific project and a specific structure, legal counsel must do a thorough analysis of existing legislation to determine whether and to what extent government has the power and authority to proceed with the project and the proposed structure. Often, because existing legislation is deficient in certain respects, newly created, stand-alone legislation will be required in order to ensure that government has all the authority it needs in order to proceed. The drafting of such legislation can often be very tricky, given that it will generally be prepared and sometimes passed before the details and structure of the project have been fully determined. The legislation must, therefore, be sufficiently broad and permissive to authorize a myriad of possible structures and to anticipate resulting potential issues. Experience has shown that the time and attention given to this part of the process yields dividends in terms of enhancing the efficiency and progress of the deal and ensuring its marketability and financeability. Clear and unequivocal legislative authority for the project and proposed structure, provides comfort to the private sector and its lenders by demonstrating a clear commitment on the part of the government to proceed with the project and an unassailable foundation upon which the project may be implemented.

Without such clear legislative authority, the potential risk of a successful challenge to the right of the government to proceed with a transaction brought by interest groups opposed to the deal is greatly increased and difficult to defend.

Some examples of effective project specific legislation in Canada are listed below:

- *Capital Investment Plan Act, 1993*, S.O. 1993, c. 23
- *Civil Air Navigation Services Commercialization Act, 1996*, c.20
- *Fredericton-Moncton Highway Financing Act*, Chapter F-23.1
- *New Brunswick Highway Corporation Act*, Chapter N-5.11
- *Highway 407 Act, 1998*, S.O. 1998, c.28
- *Improving Customer Service for Road Users Act*, S.O. 2001, c.18
- *Province of Ontario Savings Office Privatization Act, 2002*, S.O. 2002, c.8, Sched. H

Appropriate Legal Structure

Even if a consultative process is used, it is still generally the case that at the outset of any infrastructure project, the public sector must determine its fundamental requirements for the project in question. The flexibility afforded to the private sector will always be limited to those areas or matters that do not prejudice or jeopardize these fundamental requirements.

For example, if the government determines that a particular risk or project completion deadline will be transferred to the private sector, then the structure will invariably accommodate the government objective, whether or not this reflects an appropriate balance of the interests of the participants. As a further example, if the government wishes, for public policy reasons, to confer economic benefits on a region or a group as part of the project, the private sector will have limited opportunity to influence this objective. As this example illustrates, it is important for the private sector to accept that the government is not strictly (or even primarily) motivated by a profit objective but may have public policy objectives that conflict with the profit principle driving the private sector.

As well, the public sector may require that the legal structure provide a tax neutral result, whereas the private sector may desire a structure that avoids or minimizes taxes to the greatest extent possible. Income tax, GST, capital tax, property tax and other taxes all need to be considered.

The private partner will have a significant interest in the legal structure to ensure that it can implement the project properly and at the same time, raise the necessary financing. As well, the private partner must select an appropriate internal structure (especially if it is comprised of more than one entity) that takes into consideration tax efficiency, exposure to liability, public sector qualification requirements and lender requirements.

Risk Allocation

An important element in project structuring involves an allocation of the various project risks. Risk should be allocated according to the specific circumstances of each project, taking into account the political climate, regulatory framework, environmental factors and differing capital market situations. As such, optimal risk allocation for projects will vary. Generally, however, when allocating risks, the following considerations should be taken into account:

- Risk should be allocated to the party best able to minimize and manage the risk, either through insurance or financial or operational risk mitigation strategies;
- Where no party has a clear, comparative advantage in managing the risk, it can be shared; and
- Risks should be clearly allocated prior to the submission of proposals, since vagueness will force proponents to build sizable contingencies into their bid amounts thereby eroding some of the value to the public sector.

Economic Regulation

In deciding on the form of economic regulation of the private partner, the public sector must determine (among other things) whether rates of return should be limited and if so, the nature

and extent of the regulation to be imposed. This determination will be based upon a number of factors, including project financing liability under different regulatory regimes, public acceptance and political sensitivity, and competitive market rates of return taking into consideration the risk allocation profile of the deal. Whatever form of regulation is put in place, a rigorous financial analysis of the proposed project should be performed prior to procurement in order to confirm that the deal has been structured in a financially viable and even-handed fashion. It is in the area of economic regulation that the interests of the private and public sectors can diverge most sharply. This can be the case both where the private sector earns third-party revenue from the project, as is often the case for airports, and where it earns revenue directly from government, as in the case of a hospital. Thought must be given at the procurement stage as to how the interests of each party are best balanced. The type of regulation imposed and the degree to which the public sector will have an ongoing right to regulate and control the financial return generated by the asset, must be balanced against the impact such regulation and ongoing control will have on the value of the asset and the attractiveness of the opportunity to the private sector.

Restrictions on Competition

To enhance the financial viability and value of a project, the cash flow of the project in the form of revenue from operations may be protected through restrictions on competition. For example, a time limited undertaking on the part of the public sector not to construct, enhance or expand infrastructure that competes for the same user population, and not to allow such infrastructure to be constructed, enhanced or expanded by others, may be appropriate and may increase the value of the project to the private sector.

However, the very fact that the public sector is proceeding by way of a public-private partnership tends to indicate that public sector financing for competing infrastructure is not readily available, and that competition is generally of relatively little concern to either proponents or their lenders (but there are numerous factors to take into account which are not addressed here). It should also be noted that aside from restrictions on competition, the cash flow of a project can be enhanced by providing for ancillary revenue, including, in the case of a project involving a real property component, revenue from the development of real estate adjacent to the project land.

Security

In most public-private projects, the private sector project company will be required to assume various financial risks and obligations. As such, the procurement process will require that the private sector party establish its financial credibility. If the private sector project company is not well capitalized, and will be subject to ongoing financial obligations, then government may require that the obligations of the project company be guaranteed by the members of the consortium or the parents of such members or that other suitable security be provided. As well, governments will often require that the lenders to the private sector party submit comfort letters, or in some cases, firm commitments to provide the necessary financing for the project. The lender, in turn, will assess the various project risks and determine the nature and extent of the security required from the private sector company and against the project.

Generally, because of the scope and complexity of most large public-private infrastructure projects, only the most well-capitalized and well-financed companies will be qualified to participate.

Integration of Legal Agreements into Procurement Process

Legal agreements document and implement the deal structure of the project. The manner in which they are incorporated into the procurement process is a key element of procurement management. Four methods are available to integrate legal agreements into the process. These are listed in order of increasing negotiability of contract terms: (i) forms of agreement issued; (ii) forms of agreement issued with invitation to comment; (iii) forms of agreement issued as basis for negotiation; and (iv) no agreements issued.

Several key objectives may be influenced by the manner in which the legal agreements are integrated into the process, namely, value (in particular, the optimization of bid amounts), fairness (in particular, the establishment of a level playing field among proponents), and timely closing. Value and fairness are in part achieved by issuing relevant information to all prospective proponents (at the Request for Qualifications stage) and to all proponents (at the Request for Proposals stage) in a timely manner and in a way that does not discriminate among proponents. Timely closing is achieved by drafting the legal agreements for the project in an even-handed fashion that takes into account the interests of government, the private partner and the private partner's lenders, and by attaching them to the Request for Proposals documentation so that bidders and their lenders know exactly what is expected of them.

Goodmans LLP

Based in Toronto, with offices in Vancouver and Hong Kong, Goodmans is recognized internationally as one of Canada's premier transaction law firms. *Lexpert* called us a "corporate powerhouse", and the *National Post*, "a testament to smarts over size". We rank among the very best lawyers in Canada in our fields of practice, not only in our own estimation but also in the opinion of recognized independent guides to the world's leading lawyers including, *Lexpert*, *Chambers and Partners*, *Euromoney* and *Law Business Research*.

With over 190 lawyers and offices in Toronto, Vancouver and Hong Kong, Goodmans provides a complete spectrum of legal advice and representation to domestic and foreign business clients ranging from entrepreneurial businesses to multinational corporations across a wide range of industries. Goodmans' **Procurement and Infrastructure Renewal Group** has been at the forefront of the most important public infrastructure development projects in Canada, such as Highway 407, the Fredericton-Moncton Highway Project in New Brunswick (which was awarded the 2003 Gold Award for Infrastructure from the Canadian Council for Public Private Partnerships) and most recently, the Toronto Waterfront Revitalization Initiative.

KPMG LLP

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KPMG's **Public-Private Advisory Group** is one of the leading advisors in Canada for public infrastructure development projects involving both the public and the private sectors. Founded in the 1970's, it has been involved on both the owner and the bidder side of transactions across Canada, the United States, Latin America, Europe, and Asia, typically for projects in the \$100 million to \$1 billion range. KPMG has centres of excellence in public-private advisory work in Toronto, London (England), and Melbourne.

In one of their most recent landmark deals, members of KPMG's Canadian, UK and Irish firms advised Ireland's National Roads Authority in the implementation of its N4/N6 Kilcock-Kinnegad highway project, the first public-private partnership in the Irish road sector and Project Finance International's 2003 Infrastructure Deal of the Year.

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