

DIRECT AGREEMENTS IN PUBLIC-PRIVATE PARTNERSHIPS

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Abstract

Starting from the role of financiers in public-private partnership (PPP) contracts in the Italian context, the paper shows the possible use of a trilateral agreement, internationally known as direct agreement. This can be attached to the main PPP contract (e.g. the concession type). Parties to this agreement are the Authority, the private operator and the financier. Even though it should principally regulate the financier's step-in right, this agreement can also allow a greater participation of all the parties in the project, increasing their reciprocal knowledge, roles and responsibilities. Therefore, it can be useful, especially in an initial phase of recourse to PPPs when parties are not used to operating together and the project is quite complex. Some issues linked to the recognition of a direct bond between the Authority and financiers and the necessity of a correct use of this agreement have also been underlined.

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1. An Introduction to the Italian PPP legal framework and its market.

The current legal PPP framework is outlined in the Code of Public Contracts (adopted by Legislative Decree no. 163/2006), which regulates public works, services and supplies and broadly follows EU laws¹. The Code has been amended three times but its provisions are regularly changed and incremented by Governmental decrees.

The definition of PPP given by the Code covers both contractual and institutional PPPs².

It consists of the following elements: (i) the designing and/or building/operating/maintenance of a work/service; (ii) private capital financing; (iii) long term contract; and (iv) transfer of certain project risks to the private sector.

The Code provides some examples of PPPs such as the works concession, service concession, leasing contract, availability contract, joint venture PPPs, general contractor contract³.

In the course of the following paper, the focus will be on the works concession as the most popular type used in Italy. The concession contract is stipulated between the Authority and a private party (the constructor/operator) called concessionaire, to whom the procurement has been adjudicated. He is responsible for constructing and operating the project throughout its life. In fact he has an exclusive right to exploit the work.

The contract can be structured both as usage or availability-based PPP⁴. Whilst, in the first case, the concessionaire is paid by users through user charges⁵, in the second case he is paid by the

¹ For a general framework on Italian rules regarding public contracts and the impact of European law on them, see M. Clarich, *The rules on public contracts in Italy after the Code of Public Contracts*, 1 IJPL 5 (2013).

² See the Green Paper on public-private partnerships COM(2004)327 which distinguishes these two types of PPPs.

³ For an explanation of these PPP types, see *Italy - PPP Unit and Related Institutional Framework*, EPEC (EIB) publications, August 2012, <http://www.eib.org/epec/index.htm>. The document is available only for EPEC Members.

⁴ E.R. Yescombe, *Public-private partnerships. Principle of policy and finance*, (2007).

⁵ Meaning that the projected commercial revenue allowed the concessionaire to recover investment costs, e.g. the motorways sector.

Authority (availability payments and/or grants) or by a combination of both⁶.

The Code contains various provisions regarding the concession contract, in particular concerning the planning and procurement phases. Theoretically all the EU procurement procedures are adoptable⁷, but the market shows that there is no recourse to negotiated or competitive dialogue procedures. In the Code scarce attention is paid to the implementation phase in matters such as contract management and monitoring, and dispute resolution.

Referring to the procurement phase⁸, it has to be underlined that bids include a design of the project, a draft agreement, a business plan certified by a financial institution⁹, and an outline of the features of the service/operation to be carried out.

Given that an essential element of PPP is private capital financing, the concessionaire needs to sign agreements with lenders (the financier) for the financing of the project. Financial close occurs when all these agreements have been signed and their conditions have been met¹⁰.

Even though the concessionaire and the Authority often need to carry out a considerable amount of work to reach financial

⁶ In such cases, there is a limited or no commercial revenue, e.g. hospitals.

⁷ E.g. open, restricted, negotiated and competitive dialogue procedures. See European Directives 2004/17/CE and 2004/18/CE.

⁸ The Code provides two main procedures which are the public initiative concession in which the Authority takes the initiative from the design phase onwards (article 143, Legislative Decree no. 163/2006) and the private initiative concession (called project finance concession) in which there is a more active role of the private operator (article 153, Legislative Decree no.163/2006). For more details, see *Italy – PPP Unit and Related Institutional Framework*, EPEC (EIB) publications, August 2012, <http://www.eib.org/epec/index.htm>. The document is available only for EPEC Members.

⁹ The business plan is the document itemizing assumptions and basic conditions for the economic and financial balance of both investments and management throughout the concession period. It is certified by a document drawn up by a credit institution to verify its consistency and balance and its capacity for generating cash flows.

See *Italy – PPP Unit and Related Institutional Framework*, EPEC (EIB) publications.

¹⁰ See *The guide to guidance. How to prepare, procure, and deliver PPP projects*, EPEC (EIB) publications, p. 34. See also <http://www.eib.org/epec/g2g/index.htm>.

close, the importance of the relationship between all these parties is often underestimated.

Taking into due account that collecting data on the post contract award phase is difficult as there is no public observatory which follows all of the project cycle of PPPs, an EPEC (European PPP Expertise Centre) research suggests that only a small number of projects procured and awarded have reached financial close, showing that the Italian PPP market is very weak¹¹.

In addition, a study on the healthcare sector indicates that only 12 projects, in the period from May 2002-2011, reached financial close and that the average time from the award of contract to financial close was 23 months¹².

2. Recent legislation concerning the role of financiers

The market has definitely not been helped by the norms regulating public contracts. While, on the one hand, the proliferation of laws can be seen in the regulation of concessions, on the other hand, there has been little interest shown in the bankability of public works. Up to now, the role of financiers has been limited to the financial certification of the business plan (*asseverazione bancaria*) at the stage of the bid presentation and the market has shown this tool to be insufficient.

With a series of recent decrees, the legislator has displayed an innovative tendency, encouraging, at least in theory, an increased participation of financiers in concessions regulation.

The legislator has provided that, for concessions to be procured with the restricted procedure, prior to the presentation of the bid, a preliminary consultation between the public authority and the private operators may be introduced, in order to verify the absence of fatal flaws in the financial viability of the project tendered¹³. In this way the project can be adjusted.

It can be noted that while the restricted procedure has always been a traditionally rigid and fixed one, based on a series of automatic steps, this modification of the restricted procedure

¹¹ See *Italy - PPP Unit and Related Institutional Framework*, EPEC (EIB) publications.

¹² Source: *Finlombarda Survey of project finance in healthcare sector*, X Report (2012)

¹³ Article 144 co. 3-bis, introduced by *Decreto Legge* no. 69/2013, converted with amendments by Law no. 98/2013.

renders it more flexible and similar to the competitive dialogue procedure. At this point, it would be useful to provide guidelines to explain the precise differences between the various tender procedures.

The legislator has also stated that in the call for tenders the bid presentation should be accompanied by a “tangible evidence of interest”¹⁴, that is to say a declaration, undersigned by one or more financiers, affirming their intention to finance the project, taking into account the bid profile and its business plan. This declaration of intent is not a “commitment letter” and does not in any way oblige financiers to underwrite the project in the future.

In any case when a bid is presented, it should provide evidence that a financier has already been involved¹⁵.

Although these provisions may appear ineffective, the legislator has provided that should a successful financial close not be reached within two years from the approval of the final design of the work, the contract itself must provide its own termination¹⁶. While the introduction of a termination clause is definitely a positive innovation for guaranteeing the adjudication of a financially viable project, a period of two years may seem somewhat generous.

In addition, according to the civil principle of conservation of the contract, in the case of there being funding for a part of the project which is economically and functionally autonomous, then the contract should remain valid solely limited to the regulation of this portion of the lot.

In order to guarantee the return of the capital invested, the duration of the concession contract has also been lengthened to 50 years¹⁷.

The legislator has introduced a way to revise the business plan when its basic financial parameters have been changed, if the

¹⁴ So called “manifestazione di interesse”. See article 144 co.3-ter, Legislative Decree no. 163/2006, introduced by *Decreto Legge* no. 69/2013 converted with amendments by Law n. 98/2013.

¹⁵ Provision introduced both in article 143, co.7 and in article 153, co.9, of the Code, by *Decreto Legge* no. 1/2012 converted with amendments by Law no. 27/2012.

¹⁶ See article 144, co. 3-quater, of the Code, introduced by the same *Decreto Legge* no. 69/2013.

¹⁷ Provision introduced in article 143, co.8, of the Code, by *Decreto Legge* n. 201/2011, converted with amendments by Law no. 214/2011.

concessionaire is not responsible. It is therefore essential to determine the concessionaire's lack of responsibility¹⁸.

At the same time the legislator has experimented with de-taxation measures in the place of public grants to guarantee the economic and financial viability of the business plan. Initially, these were experimented in the motorway sector and then extended to all new infrastructures to be realized with a PPP contract¹⁹. On account of the scarcity of public resources, this path augments the possibility of using PPP for projects necessitating State intervention.

Two risks emerge: some works which do not need a public grant could be underestimated in their potentialities in order to obtain the de-taxation measures; the market could shift towards less profitable works because of the certainty of defiscalisation. Therefore a reliable financial structure is of the utmost necessity. A greater collaboration between the public sector and financiers and concessionaires can help to achieve this goal.

A similar tool for this purpose, although with a different method of actuation, consists in awarding a tax credit and/or concession fee exemption²⁰. The sum of these measures cannot exceed 50% of the investment cost.

3. Recourse to a trilateral agreement

Three parties representing different interests can be seen in PPP contracts: the Authority, the concessionaire and the financier.

The interest of the private operators (constructor and financier) is directed towards the maximisation of profits from their activity and minimisation of costs.

The interest of the Authority is a synthesis of the realisation of a work of public concern of good quality together with the limiting of expenditure, but also, indirectly, the assuring of the procurement of private financing for the work.

It is therefore necessary for the Authority to take into consideration the various aspects relating to the constructors and

¹⁸ Article 143, co. 8-bis, of the Code, introduced by Law 98/2013.

¹⁹ Article 18, Law no. 183/2011, so called "*Tremonti Infrastrutture*", modified by *Decreto Legge* no. 83/2012 converted with amendments by Law no. 134/2012.

²⁰ Introduced by article 33, *Decreto Legge* no.179/2012, converted with amendments by Law 221/2012.

financiers. While it is true that the choice of the financier and the financial close do not necessitate the intervention of the public party, there are, however, situations in which all three subjects are involved, an extreme example being the termination of the contract.

When a termination clause is verified, the administration should give notice with detailed motivation not only to the constructor, but also to the financiers who, upon receipt of the notification, may exercise the step-in right to nominate a new builder to take the place of the original concessionaire in the contract, by way of protecting the financing subscribed. During the period necessary for the exercise of this right, each party involved should maintain the regular functioning of its activities in order to guarantee the operation's continuity.

The regulation of these events can be simplified by a so-called direct agreement to be attached to the concession contract. In fact, PPPs consist of a series of related contracts.

Depending on its content, it can be defined either as a proper "trilateral contract", stipulated by the financiers, Authority and concessionaire (if it involves a bargaining between the parties and creates reciprocal rights and obligations derived from their premises) or as a "mere trilateral agreement"²¹.

The direct agreement serves to safeguard both the public and the private interest, by increasing the transparency of information linked to the realisation of the project, and to regulate the right of financiers to step in to replace the concessionaire should he not fulfil his obligations. It confirms the cohesion of a PPP operation and enhances the importance of the project in all its different facets.

The direct agreement, which originated in the British system, can be useful to ensure disclosure and also that the parties respect their reciprocal commitments, above all where the Public Code does not specify a particular and detailed code of conduct (e.g. concerning the step-in right).

²¹ For an analysis on the definitions of contract and agreement in common law system see D. Corapi, *The new contractual dimension of company law in Europe*, 3 Riv. Dir. Comm. e Dir. Gen. Obb. 72 (2011).

In Italy, the terms contract and agreement are effectively used synonymously.

4. The international experience of direct agreements: UK and France.

The term “direct agreement”²² comes from the Anglo-Saxon system where it is also known as “tripartite deeds”. It is the sole legal bond linking the Authority and the financiers.

From the HM Treasury standardisation of PFI contracts document²³, direct agreements should regulate the following:

- Interpretation of the different concepts such as contractor default, step-in period etc.
- Consent to security granted by the private concessionaire to the financiers;
- Notice of termination and existing liabilities. The duty of the public authority not to terminate the contract (for the default of the concessionaire, failure of financial contracts) without having given the financiers advance notice of this intention together with a detailed motivation;
- "No liquid market notice", which permits the parties to terminate the Contract should they all be convinced of the lack of a liquid market;
- Step-in period;
- Step-out period;
- Novation i.e. transfer of the original contractor rights and liabilities to a suitable substitute contractor; and
- Assignment and miscellaneous.

In practice, in the case of a default, whether or not there is a direct agreement, the parties should meet to find a specific solution, but a direct agreement can aid the partnership and make the concession contract more efficient. The UK experience shows that this tool was used more during the PPP's initial phase, whereas now it is rarer.

In France, the PPP Unit in the Ministry of Finance, in a recent publication on standardised clauses in PPP contracts²⁴, provides that the « *Convention tripartite o Accord Direct* » can be attached to the PPP contract and is an integral part of it. This convention can illustrate the necessary funding for the realization of the work and the relationship between the different parties in

²² See footnote 21.

²³ See, H. Treasury, *Standardisation of PFI contracts* (2007).

²⁴ MAPPP, *Contrat De Partenariat. Clausier – type*, Version du 10.10.2011, p. 17.

case of termination of the contract. The following clauses can be envisaged:

- a) The description of the type of funding given to the concessionaire;
- b) Reciprocal commitments of the parties, such as: transfer to the financier of credits (certain, liquid and collectable) of the concessionaire towards the Administration, and the Administration's knowledge and acceptance of this transfer. This becomes effective only after the date of commencement of the work; the step-in right;
- c) In the case of premature termination of the contract, the possibility for the Administration to deduct from the indemnity payable to the concessionaire according to the contract, a sum equivalent to the credits still owing to the financier;
- d) Reciprocal knowledge of the concession contract;
- e) Any eventual invalidity of the contract cannot be applicable to other contracts; and
- f) Modality of communication between all the parties.

The particular nature of the French system lies in the role of the Administration as a strong contractual party. This emerges also from clauses concerning the termination of the contract. For instance, even though the financier may exercise his step-in right, the Authority can always, by stating a motivation, impede the substitution of the concessionaire chosen by the financier. In addition, the Authority can always terminate the contract in the public interest and only the private party is considered liable for breach of contract²⁵.

5. The direct agreement in the Italian Code of Public Contracts: some issues.

In the Italian context, the discipline of "public agreements" is also foreseen within the administrative procedure act²⁶. The agreement is a different way of concluding the procedure from the traditional, unilateral, "act" issued by the Administration. In fact,

²⁵ SCIALOM (MAPPP), *Cancellation and termination provisions in PPP availability-based contracts*, December 2011.

²⁶ Law n. 241/1990.

it is a consensual act which substitutes or integrates the unilateral act.

However, the direct agreement cannot be framed in the context of the administrative procedure which envisages a superior Authority.

As a consequence there are two fundamental points: first, whether the Administration can stipulate this type of contract²⁷ (direct agreement); second, how it can be integrated within the Code of Public Contracts.

Aligned to this, it has to be remembered that contracts which entail expenditure for goods, works or services, are all subject to public procurement regulations. The open evidence procedures are primarily governed by the EU law which stresses the importance of effective competition and the *par condicio* of the participants.

The first question is, therefore, whether the Administration, by stipulating the contract with the concessionaire and the financier, may link itself to a subject (the financier) not chosen through a public procurement.

The answer to this question should be affirmative providing that the direct agreement is in line with the international model as, through it, the Authority acquires neither a financial service nor the construction, operation or maintenance of a work. In fact, only for this type of contract is a public procurement obligatory. The Authority will only become part of a trilateral agreement in order to facilitate the execution and implementation of the main contract (concession) and the coordination of the various events affecting the parties during the long term concession contract including the disclosure of the relative information.

The direct agreement may be part of any of the various contracts related to the concession.

The second question is whether its use is possible. Within the Public Contracts Code there is no impediment to this purpose. In fact, on the one hand, the step-in right is legally foreseen in a norm (article 159, Legislative Decree no.163/2006), on the other hand, the principle of the individual's transactional autonomy, of

²⁷ The terms contract and agreement are effectively used synonymously. See also footnotes 21 and 22.

fundamental importance in the Italian Civil Code, applies also to public contracts²⁸.

However, it is essential to make the correct use of this agreement, which is not standardized in Italy.

Direct agreement clauses must neither give any competitive advantage to financiers nor invert the allocation of risks to the detriment of the Authority. In the first case, an example is if parties agree that, when a new concessionaire cannot be found by the financiers, the Administration itself must step in to replace the concessionaire and assume all his obligations towards them. In this situation the Administration should have the power to launch a new procurement. The concession contract can never become a contract between the Authority and the financier, also because the latter is not selected through a public competition.

At the same time, it should be excluded that, through the direct agreement, the Authority can give guarantees which modify the allocation of risks made in the concession contract, such as guarantees for delays or revenues when they are less than the ones foreseen in the business plan.

Similarly the direct agreement cannot have the purpose of supplementing lacunae in the main contract. Economic/financial issues and clauses relating to the maintenance of the equilibrium of the contract are, for instance, an essential part of the concession.

6. Brief conclusions.

It has been underlined that the realization of a project of public interest is an aim of the Authority and of the private parties, such as the financier who awaits the restitution of the capital invested.

Above all, in Italy, it is necessary that projects should be structured in a more solid way and financiers should be more involved in the partnership.

The discipline of some situations requiring complex coordination between the parties can be defined in such direct agreements.

²⁸ As stated in article 1,1bis, Law 241/1990.

This model will encourage the parties involved to assume their responsibilities and improve the action and knowledge of the Authority.

The direct agreement can help to reach these goals, especially in a period of experimentation such as in the initial phase of recourse to PPP. In this phase, the demand of disclosure and coordination of the various interests involved is of paramount importance.

However, recourse to this instrument should be made correctly. The transactional autonomy of the contractual parties cannot be total. In fact, the content of this agreement is partially defined by the step-in right regulation and the parties cannot pursue aims in contrast with the concession, nor is a diverse allocation of risks allowed.