



The historic Woodrow Wilson Bridge crosses the Potomac River in Alexandria, Va. The old bridge is in the foreground and the new, taller bridge under construction is in the background.

Insurance, Surety and Risk Management II

Surety & Infrastructure

In spite of expected increases in contractor failures, surety providers can remain afloat through a careful and well-considered approach to underwriting and risk management

Surety Market Report 2012

This year is expected to be another difficult one for the construction industry. Not only is the environment tough for contractors of all sizes who are struggling to find work and obtain adequate margins but also for owners dealing with budget and staffing issues. The U.S. unemployment rate is 8.2%, as of May, but is 14.2% for the construction industry, two points down from the same time last year. While the nation added 69,000 jobs in May, the construction industry lost 28,000 with 40% of those losses in the heavy and civil engineering segment.



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April’s Architectural Billing Index was 48.4, showing a decrease in demand for design services. Some regions of the country have fared better than others, though. There is modest growth in the Northeast and Midwest, but declining billings have hit the South. The West, which in the mid-2000s was a booming market, has been hit the hardest.

With a drop in consumer confidence, nearly nonexistent public spending on infrastructure projects, economic turmoil in Europe, and political instability worldwide, the economy likely will not recover at the rate we had all hoped. “The Surety & Fidelity Association of America predicts an uptick in frequency and severity of losses in 2012 and into 2013. Industry executives remain optimistic, though, that disciplined underwriting and management will carry most sureties through the next few years and not affect capacity,” says Timothy Mikolajewski, chair of the SFAA Board of Directors and president of Liberty Mutual Surety.

SMALL

The weak economy is taking its toll on small contractors. Those who have suffered substantial losses and have run out of backlogs will have a hard time obtaining surety credit, and price and terms are competitive, as there are several sureties in this market. “Having seen surety continue to be profitable through the downturn, many insurance company executives have encouraged existing surety operations to grow, while several companies with no surety operations have entered the market,” says Rod Williams, executive vice president and chief underwriting officer, Liberty Mutual. Capacity in this market segments remains plentiful for financially sound contractors. “As contractors want to grow, there is more than sufficient capacity for accounts with qualified balance sheets, but contractors need to understand that if they want to grow revenues, they must first improve their balance sheet strength to justify the additional bonding capacity,” says Mike Foster, executive vice president, underwriting, Merchants Bonding Company.

MIDDLE

“Contractors of this size also have felt the pains of this down economy but are generally doing a good job of managing their companies effectively through it,” says Mike Noe, executive vice president, construction services, Travelers Bond & Financial Products. Surety executives agree that with the lack of state and local government projects, successful business management has been the key to success, especially with smaller and larger firms entering this market. “Over the last three years, smaller firms have endeavored to reach up into

the middle market, while larger firms have looked into this segment to maintain volume. Mid-sized firms have been squeezed in the process,” explains Mike Cusack, managing director, Alliant Insurance Services. Executives say that good accounts—those that reduced overhead and cut controlled costs early on—will have no problem obtaining surety credit in this highly competitive market. “This is the ‘sweet spot’ for most sureties,” says Carl E. Dohn, Jr., NASBP president and president of Dohn & Maher Associates. “Accounts with issues that are directly related to the economic slowdown can get surety credit, though it depends on how impacted they are and how realistic their plans are for the future. Accounts that are heavily in debt will find surety credit more difficult to obtain, and it will be on a lower basis than in the past.”

As with the small market, competition in the middle market has been promoted by the new influx of reinsurance capital in this market segment. “Because other lines of insurance in recent years have had marginal returns compared to surety, reinsurer capacity is likely to continue entering this surety product line,” says Doug Hinkle, senior vice president and chief underwriting officer, CNA Surety.

LARGE

Like the small and middle markets, the price and terms remain highly competitive in the large market. The competition from new market entrants has been challenging. “The push of the mid-market firms reaching up, combined with mega contractors’ renewed willingness to focus on smaller project pursuits, has impacted the large contractor segment. Larger firms are caught in this competitive vortex,” says Alliant’s Cusack. For the most part, though, large contractors’ balance sheets have survived the economic downturn. “Many well-run firms have created a strong market niche where they can thrive because of their knowledge and expertise. Generalists are experiencing many of the difficulties of middle market segment firms and need to increase their communication level with sureties to maintain sufficient surety capacity,” says Mike Bond, head of surety, Zurich.

MEGA

“There are only a handful of sureties that write accounts in this range,” says NASBP’s Dohn. “Some are handled solo, but many are handled through a co-surety arrangement with two or more sureties sharing the exposure.” Competition in the mega market is relatively lower than in the smaller ones, due to the limited number of sureties playing in this market. “This segment of the market is seeing the most activity. In the U.S. and many other countries, major infrastructure projects are high on the priorities list; therefore, the construction market’s growth is very much tied to large multinational companies that are most

(city, county, state) and their attached revenues improve,” says William Misero, senior vice president and chief underwriting officer, Arch Surety. Executives say that public budget deficits coupled with political and financial turmoil in the U.S. and in Europe hinder investments in the commercial, transportation and infrastructure projects that are needed. “The state of the construction industry continues to be challenged by reduced public funding and spending and lack of demand on the private end of the market,” says Travelers’ Noe.

A noticeable trend is contractors voluntarily closing their doors for business. “There simply is not enough work to

“Firms with special expertise and the ability to partner strategically are benefitting from those unique capabilities and find themselves well-positioned in this competitive market.”

— Mike Bond, Head of Surety, Zurich



qualified to address large infrastructure projects that currently dominate construction activity,” says David Hewett, executive vice president, XL Insurance. There is adequate capacity for mega contractors; should this segment suffer significant losses, though, capacity would become greatly restricted. “The key to success in this market is geographic and product diversification. The ability to engage with long-standing customers and bring unique capability, structure and vertical integration across continents gives these contractors a leg up compared to those who have to battle it out in the hard-bid U.S. market,” says Anthony Romano, senior vice president, surety, Chartis.

CONTRACTOR FAILURES

Sureties have begun to report increased losses, especially among small contractors and some specialty contractors, and an increase in payment bond claims. The bad news is that 2012 is expected to bring an increase in both frequency and severity of contractor failures. The good news, though, is that industry executives do not expect capacity and underwriting to be significantly impacted. “Responsible underwriting in

generate sufficient gross income to cover overhead for many contractors. Some contractors have simply closed their doors, not wanting to risk the remaining hard earned capital in an industry unlikely to recover until 2014 or 2015 or maybe beyond,” says Henry W. Nozko, Jr., president, ACSTAR Insurance Co. Bid lists are longer on nearly all projects, which is driving decreased margins. “With the increase in construction costs related to materials and fuel, profit margins may grow even thinner before showing any improvement,” warns XL’s Hewett. “This is the tipping point for many contractors, straining their financials and leading to additional failures. For the construction risk management industry, including sureties, this is a critical time to contribute to helping the industry shore up risk management practices to prevent losses.”

Many contractors are expected to fare well even in this tough market. “Firms with special expertise and the ability to partner strategically are benefitting from those unique capabilities and find themselves well-positioned in this competitive market,” says Zurich’s Bond. For struggling contractors, sureties advise that contractors not only think



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— Mike Noe, Executive Vice President, Construction Services, Travelers Bond & Financial Products

years past, proactive downsizing and cost containment at the contractor level and a robust post-2008 hangover of high-margin construction business all have contributed to the soft landing the industry has experienced during the first few years of this recession,” explains Chartis’ Romano.

Executives expect the construction environment to remain tough given the reduction in government funding for construction. “We think the construction economy has bottomed out and will recover slowly as the municipalities

about surviving the weak economy, but also that they plan ahead for when the construction environment turns around. “When the economy does improve, there may be a new problem,” says Jim Tressel, vice president and senior contract underwriting officer, Liberty Mutual. “Contractors that cut overhead, especially people, may struggle to manage growing backlogs. Contractors should keep this in mind as they make critical decisions about their business.”

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“The current economy is dictating that businesses, even surety providers, reevaluate how they do business, where they do business, and with whom they do business.”

— David Hewett, Executive Vice President, XL Insurance

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VALUE & PROTECTION

Given that contractor failures are expected to increase, executives say surety bonds are more important than ever. “There is an enormous amount of performance risk in construction. Surety bonds are a proven tool to protect owners and general contractors from project risks,” says Douglas Wheeler, regional director of surety & performance security, Aon Risk Solutions. “Furthermore, contractors and private owners should be aware that losses due to the failure of a contractor default are preventable,” says Travelers’ Noe.

Surety bonds also are cost effective. The price of the bond is a small price to pay, given what is at stake should the contractor, subcontractors or suppliers fail to do their jobs. CNAs Hinkle says that several circumstances are likely to contribute to contractor default. “Many contractors are running with low backlogs of work, low margins and weakened balance sheets. Public owners are more prone to debate and litigate over construction issues, because of budgeting constraints, and owners do not have the money to deal with changed conditions that lead to disputed cost overruns. Also, excessive competition and lack of work has resulted in increased subcontractor defaults that likely will continue going forward.”

“The third-party financial backing and risk transfer of a financially solid surety should the subcontractor default more than makes up for the expense of the bond,” says Tom Rees, vice president and senior contract underwriting officer, Liberty Mutual. “Specific to subcontractors, sureties look favorably on subcontractor bonds, which can sometimes result in increased capacity for the general contractor,” says Rees.

Another benefit of having a surety bond is the prequalification process. An owner and general contractor has assurance that the project will be completed according to plan and budget. “Surety underwriters are trained to evaluate contractors and determine the proper levels of projects and programs that a contractor can undertake,” says Merchants’ Foster. All sureties agree that being without a bond just is not worth the risk to an owner or contractor’s financial standing or reputation. “Subcontractors have been working on slim margins for the past four years, and there is an elevated potential for defaults. Having a surety prequalify and guarantee their performance is a smart way for general contractors and private construction owners to protect their businesses,” says NASBP’s Dohn.

Even private owners have recognized the value of surety bonds and more have begun to require bonds on their projects. Also, some sureties report that over the last year general contractors increasingly have used surety bonds to manage subcontractor default risks. “Many of these subcontractor bond requirements are coming from general contractors who previously relied on alternative products,” says Merchants’ Foster. The increased use of surety bonds in private construction is a positive development but is not enough.

“While we have noticed some increased requests for bonds for private construction, there has not been enough to offset the decline in surety for public jobs attributable to the economic downturn,” says Rod Williams, executive vice president and chief underwriting officer, Liberty Mutual Surety.

SURETY OUTLOOK

Larger writers have performed well over the last few years, thanks to most contractors having entered the recession with strong balance sheets and healthy backlogs. Even though losses are expected, larger sureties expect to remain profitable and continue to perform well into next year. Unfortunately, smaller sureties may not fare as well. “In 2011, unlike their larger competitors, the results of some smaller to mid-tier writers left their management looking to retrench, increase underwriting discipline and, in some cases, turn over leadership in the hope that 2012 is not a repeat performance. Smaller writers cannot sustain another two or three years of the loss activity that surfaced in 2011,” says Alliant’s Cusack.

Regardless of which party wins the White House in November, the same problems will persist—state budget deficits, federal debt, a sluggish U.S. economy, lack of jobs in the public and private sectors—and will continue to plague the construction and, therefore, the surety industry. “The calendar year results reported to the SFAA may not be showing the underlying stresses being felt across the industry. Given the challenging marketplace firms have been operating in for the past few years, there certainly is the possibility results could deteriorate,” says Travelers’ Noe.

Small and mid-sized construction firms that have been taking jobs with slim margins and did not reduce overhead at the beginning of the economic downturn are expected to struggle to stay in business. For now, surety capacity remains plentiful for well qualified contractors. Only time will tell if and how the industry will get through the next few years and if capacity will be affected by the expected losses. As long as loss ratios remain reasonable, capacity should not be affected. Executives say that unanticipated losses, however, could lead to restricted capacity. “Conservative and consistent surety underwriters should benefit from the increased loss activity as opportunistic surety capacity dwindles and affected sureties work to reposition their portfolios,” says Zurich’s Bond.

“The current economy is dictating that businesses, even surety providers, reevaluate how they do business, where they do business, and with whom they do business,” says XL’s Hewett. ■



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EXECUTIVE PERSPECTIVES



What are you seeing in terms of creative financing for infrastructure projects?



Nate Zangerle
Senior Vice President & Chief Underwriting Officer, Specialty Surety Liberty Mutual Surety

Creative financing such as public-private partnerships (PPPs) and design-build-finance (DBF) programs are increasing in the U.S. This is because 1) government entities at all levels are facing financial challenges, and 2) both political parties are pushing for private investment to take on a larger role in meeting the critical U.S. infrastructure gap.

Congress and the federal government have proactively supported creative financing by adopting a statutory framework that allows the use of federal funds on PPP projects. However, broad adoption of PPP projects in the U.S. has been limited as only approximately 31 states have enabling legislation for PPP projects, the enabling legislation that is in place does not take a uniform approach, there is insufficient funding for federal programs such as Transportation Infrastructure Finance & Innovation (TIFIA), and there is a volume cap on tax-exempt private activity bonds (PABs).

Even with these factors, creatively funded projects are increasing. In addition to the I-595 Broward County PPP Project, the Florida Dept. of Transportation (FDOT) has been looking for creative ways to bridge funding gaps for smaller projects through a DBF program. Despite the financing challenges faced by the construction and surety communities, FDOT is moving forward with a \$1.2-billion DBF program.

The infrastructure needs in the U.S. are significant, and traditional government funding sources are not sufficient to meet these needs. Accordingly, the creative funding trend will accelerate in the coming years. It is imperative to find a surety partner that has both the underwriting and legal capabilities to handle the complexities of bonding these creatively funded projects.



Aaron Toppston
Director
Aon Infrastructure Solutions

Although the U.S. market remains fragmented, we are seeing increased activity in PPPs for major infrastructure projects. Some “true” PPPs include the Ohio River Bridges East End in Indiana, Mid-Currituck Bridge and I-77 HOT lanes in North Carolina, and Goethals Bridge in New York. One notable project is Colorado’s US-36 HOT lanes, which leverages alternative financing through toll risk but includes a construction completion payment and the option to have CDOT perform O&M in lieu of the concessionaire.

Many projects use DBF or gap finance to deliver projects that may not be possible under traditional financing mechanisms. For example, Florida has several DBF projects in play, including I-75 and SR 9B, and Georgia

reinvented its West by Northwest project under DBF. These DBF projects offer the advantage of increased project planning and risk mitigation, which are required to be successful in non-recourse project finance, but do not have 30-plus-year O&M contracts.

Along with this increased activity comes a renewed focus on efficient risk mitigation and performance security to meet the needs of owners and lenders. Bidders pursuing alternative finance projects must meet these risk transfer requirements through a combination of traditional and innovative products, plus appropriate contractual risk transfer, to fully realize the competitive advantage available in a well-structured project.



Mike Bond
Head of Surety
Zurich

We are seeing many creative financing techniques in response to the shortage of public funding for infrastructure spending. Gap financing, which generally calls for a portion of the project costs to be paid through available public funding and another portion to be financed by the contractor, is being actively utilized in a number of states such as California, Florida, North Carolina and others. Privatization, whereby a project such as a bridge is financed through a private entity and tolls, is another method used to finance much-needed infrastructure. Finally, PPP is a project delivery and financing method that incorporates the financing, design, build, operation and maintenance of a project. PPPs are gaining traction in many states with Virginia and California taking a leading position. While each of the creative techniques has unique attributes, the common threads are the increased risks that are placed on the contractor’s balance sheet and the enhanced stress created by the legal complexities inherent in these projects. In order to take advantage of the opportunities of these infrastructure projects, contractors need to partner with sureties who have underwriting, legal, and claims experience and expertise to help assess and manage the risks and provide the surety capacity to successfully manage these projects.



David Hewett
Executive Vice President
XL Insurance

A continued weak economy and severe budgetary constraints have both the private and public sectors looking at new ways to work together to create opportunities and get much-needed infrastructure and public works projects off the ground. The result is more complicated methods of project delivery. Even more recently, states are working in cooperation with one another to develop a comprehensive multi-state plan for key

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infrastructure projects that have multi-state applicability. States are also creating quasi-public entities to develop PPP infrastructure projects and work to creatively finance those projects through a complex mix of private debt, TIFIA funds, availability and/or use payments, public municipal bonds, and investment by public pension plans. These creative approaches are driving the market.

Today's creative financing also creates complexity. Therefore, new project delivery methods require sureties to step up their game. Success for sureties will require them to understand these more complex risks and bring more value to the transaction. Leaders in the surety market are taking a more collaborative and innovative underwriting approach to more effectively underwrite the risks associated with new delivery methods. Sureties must have the legal, financial and underwriting expertise to properly analyze the risk and develop market solutions to mitigate risk. Our industry must innovate and respond to market conditions—understand these new and complex risks and develop solutions that are appropriate for market conditions. Surety is more critical than ever as infrastructure projects grow in size and complexity and the financing becomes increasingly complex.



Michael Cusack
Managing Director
Alliant Insurance Services

There has been an evolution of alternative procurement methods in the construction industry that have focused on creating new financing structures for construction projects. One of the first meaningful private finance initiative (PFI) or PPP initiatives began decades ago in the United Kingdom. Public agencies in the UK partnered with developers and contractors and, in essence, “lease-back” public assets in order to expedite funding. The UK PFI market expanded for years, and is now one of the more mature PPP models in the world. To date there have been hundreds of PFI projects, from bridges and highways to hospitals and public schools, that have reached financial close. While the PFI model has been successful, there have been reports in the UK about the potential need for more scrutiny around the value-for-money proposition that is embedded in a PFI/PPP project life cycle. While PFI can bring projects to market faster than the traditional design-bid-build or DB bid delivery models, UK experts are beginning to question the longer-range value to the public provided by PPP facets such as concessions, operations and maintenance.

In North America, there is a robust PPP market in Canada. The Canadian politicians, consumers and financial institutions have embraced the PFI concept and, so far, believe there is longer-term value to the public and the economy in bringing strategically important projects to market quicker and having private companies take the risk of maintaining these assets for 20 to 30 years.

In the U.S., certain state governments have only recently started to view PPP as a viable alternative to traditional delivery methods. The challenge to the PPP/PFI model in the U.S. will be getting nationally recognized broad and consistent legislative support for the process. If the federal government doesn't take control of the process and PFI is forced to revert

to a political grassroots state-to-state issue, the adoption of any meaningful PPP progress, on a national scale, will take years, regardless of how the process may help fast-track the asset creation of critical projects during a period of state and federal budget challenges.



Has a decrease in public funding for infrastructure projects impacted your contractors and the surety industry?



Mike Noe
Executive Vice President,
Construction Services
Travelers Bond & Financial Products

The lack of money in local, state and federal budgets is having a clear impact on our contractors across the country. During the last few years of this down economy, one of the positives for our clients was the strength of public spending due to the federal stimulus package. With private sector spending down across the board, the governmental spending helped many of our clients keep their heads above water.

What we are seeing now are the effects of low backlogs coupled with low margins—more operating losses with challenging times likely still to come. As a result, balance sheets are starting to feel the strain, and it is affecting how companies are looking at their overall organizations. With so much uncertainty around future projects, many firms are continuing to pare back their staffing levels to the absolute minimum, while others are in more of a “wait and see” mode. Our clients have become quite astute at managing through this down economy; however, the lack of any clear solutions for project funding presents a very challenging environment in which to manage for any construction company.



Carl E. Dohn, Jr.
President, National Association of
Surety Bond Producers
President, Dohn & Maher Associates

In the upper Midwest, the lack of available tax revenues necessary to meet the continuing needs for repair, maintenance, modernizing and expansion of infrastructure has had a resounding effect on area contractors. Their balance sheets have continually eroded as revenue and profit margin levels have plummeted. Many sewer and water contractors have drastically reduced their workforce, a few have shut down temporarily, and several have closed their doors forever over the past four years.

No public body has enough tax revenue to meet its budgeted needs for infrastructure nor is there much optimism that they will in the near future. When a project is funded and put out for bid, the list of bidders is long and the resulting low bid all too often has little, if any, profit potential for the low bidder.

The City of Chicago is proposing a \$7.4-billion infrastructure program, and the Illinois Toll Highway has a \$1.4- to \$2-billion widening project for I-90. One concern with the Chicago program is that the City of Chicago plans on doing a significant portion of the work with city workers instead of contracting it

out to local construction firms. The remainder of the city and the tollway program will be for larger accounts since the vast majority of the work is large in scope. Small- to medium-sized contractors will get a relatively small portion of this work. This situation may eventually lead to more contractor defaults, which may negatively impact the surety industry.



William Misero
Senior Vice President & Chief Underwriting Officer, Surety Unit Arch Insurance Group

Yes, infrastructure contractors have higher investments in fixed assets and need an adequate and steady stream of revenue to maintain proper equipment utilization levels and cover their overhead. The current levels of public funding are not adequate to support the current number of infrastructure contractors. The result will be continued consolidation and contractor failures. Bond premiums from infrastructure projects are a significant portion of a surety's total premium. The prolonged downturn will pressure both loss and expense ratios.



Anthony Romano
Senior Vice President, Surety Chartis

The surety industry lives and dies with public infrastructure funding. This represents the largest component of premium writings within the industry. Reductions in funding have driven changes in how carriers approach the market. Many carriers have redirected their focus in pursuit of commercial surety in order to subsidize for lost revenue on the contract side. This has increased capacity and reduced pricing, terms and conditions within that space. The spending reductions have also created behavioral shifts. As a result of the funding situation, and the pressure carriers are experiencing in order to continue providing high margin returns to their P&C management, carriers will remain very customer attentive, proactive in problem solving and will show much more flexibility in crafting solutions. No carrier can afford to lose business, particularly at the high-margin upper end of the market.



Doug Hinkle
Senior Vice President & Chief Underwriting Officer CNA Surety

Without question the decrease in public funding has negatively impacted our heavy civil and highway construction group of accounts. Often in a recession with reduced public spending, public owners will focus their limited resources on larger, higher-return projects which can mean an even greater decline in small- to medium-sized projects.

In this regard, national firms have fared better than their smaller competitors in terms of both revenue and profit margin. Continued, long-term economic growth in the private sector is the only sustainable driver of improved public sector finances and, accordingly, improved public sector construction

spending. Those contracting firms that have prepared for the potential of reduced public construction spending will be in a much better position to manage their way through the cycle. Not all firms operating in the industry today will survive and as is traditionally the case, loss activity will affect some sureties far worse than others.



Mike Foster
Executive Vice President, Underwriting Merchants Bonding Company

It is difficult to measure how the lack of sufficient infrastructure funding is impacting contractors as well as our overall industry. Due to a declining amount of work in certain areas, contractors are being forced to expand their geographic area of operations. More contractors are traveling further distances to bid on work at lower margins. This is not a sustainable operating procedure. Highway contractors are being forced to complete work at lower costs, in fewer days and produce a better quality, or "smoother," product. Contractors, being the entrepreneurs that they are, have figured out methods to satisfy owners who are constantly more demanding. Many infrastructure projects are being bid and completed substantially below budget which is enabling owners to locate funding that they previously thought would not be available. Additionally, many owners understand that there may never be a better time to get the largest "bang for your buck" if you are planning on building a structure. As usual, the contractors who are well managed and closely monitor their debt continue to survive. Unfortunately we do not see any improvement in funding for infrastructure work until after the November elections.



Henry W. Nozko, Jr.
President ACSTAR Insurance Co.

The decrease in public funding for infrastructure projects and for all other public projects has noticeably impacted contractors and the surety industry. According to the U.S. Census Bureau, annualized public construction put in place dropped from \$293 billion in March 2011 to \$276 billion in March 2012. Further complicating the plight of the public sector, all non-residential construction during 2012 has actually declined from an annually adjusted \$563 billion in January 2012 to \$558 billion in April 2012. The impact is significant. There is simply not enough work to generate sufficient gross income to cover overhead for many contractors. As a consequence, claims for the surety industry will rise. Some contractors have simply closed their doors, not wanting to risk their remaining hard-earned capital in an industry unlikely to recover until 2014 or 2015 or maybe beyond. Other contractors have not, will not or cannot reduce overhead to a level that will sustain profitable operations at substantial reductions in revenue. For those contractors that can find some magical way to reduce overhead to match a subsistent level of revenue and survive over the next two or three years, we might see a 7- to 10-year growth cycle, creating a robust construction industry recovery.



Surety Industry & DOT Program Helps Small Contractors Obtain Surety Bonds

By Sam Carradine

One of the challenges facing both the surety and construction industries is providing access to surety credit in order to increase the participation of small and emerging contractors in transportation and infrastructure work. Towards this end, the U.S. Dept. of Transportation, in partnership with The Surety & Fidelity Association of America (SFAA), launched the Bonding Education Program (BEP) in 2010. The BEP, based on SFAA's Model Contractor Development Program (MCDP)®, is designed to provide information to small businesses on how to secure surety bonds and to assist them in obtaining bonds for

contracts related to the maintenance, rehabilitation, improvement, or revitalization of our nation's modes of transportation and their related infrastructures.

After a successful pilot phase in three cities—Atlanta, Chicago and Dallas—the BEP had a national rollout in ten additional cities in 2011, with another 14 cities coming onboard in 2012. Surety professionals, including members of local surety associations, SFAA and the National Association of Surety Bond Producers (NASBP), conduct a series of educational workshops designed to provide information to the participating contractors related to improving their

companies' operations and thereby making it easier to be bonded or to increase their bonding capacity. The BEP also includes bond readiness activities, in which surety professionals work one-on-one with these contractors in assembling the materials necessary for a complete bond application and in addressing any omissions and/or deficiencies that might deter the successful underwriting of a bond.

Early tracking reports indicate that the BEP is enjoying marked success and several of the contractors already have been approved for bond lines and now are successfully bidding bonded transportation infrastructure work.

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What to Expect When Shopping for Surety Outside Your Home Country

By Michael Yang

When international contractors first come to the U.S., they are often overwhelmed. Along with exceptionally litigious owners and tough local competition, the U.S. serves up bonding and project completion requirements that are unlike anywhere else. But as you smartly navigate the U.S. surety market, you will find some pleasant surprises as well.

Local Differences

More often than not, a foreign contractor coming to the U.S. is used to having the option to provide a bank guarantee/letter of credit, a corporate guarantee, or a nominal percentage surety bond at the onset of a local project. This is not necessarily the case in the U.S., where the process for obtaining a surety facility can be quite stringent. Financial transparency is paramount. A contractor is expected to provide a full three years of audited financial statements for the surety's review and should be willing to establish a local U.S. company, appropriately capitalized in line with the surety capacity required. In addition, past project experience/successful track record, a strong business plan and face-to-face meetings are required to build a successful contractor and surety partnership.

In addition, the contractor's parent company must agree to indemnify the surety for claims paid out. They are likely to find the level of surety required much greater than it is at home, typically 100% of the project or contract price in the U.S. and 50% in Canada, as opposed to maybe 10% of a contract price mandated back home. Amounts may be legislatively dictated: The Miller Act, for example, requires every contractor bidding on a federal project worth more than \$100,000 to post a performance bond and a payment bond covering all labor and materials for subcontractors.

For those contractors who plan to bolster their U.S. presence through a merger or acquisition, it is important to make certain that the target company already has a surety line in place as this might give some indication of the firm's financial strength and track record.

Also, as mentioned earlier, surety bonds are required for certain U.S. public construction projects, so surety capacity is paramount to a contractor's ability to succeed in the U.S. However, contractors should note that surety lines are not automatically transferable; therefore, it is important that the contractor maintain the asset and profit base of the target company to ensure that the target still qualifies for a surety line post acquisition.

Of course, U.S. firms venturing into foreign territories find themselves on unfamiliar ground as well. Depending on local regulations and tariffs, the cost of surety can be vastly different from place to place. Lead time for issuing a bond varies overseas (but almost universally lags the swift turnarounds found in the U.S.). Bond wordings may be unique to a jurisdiction. Also, there often are residency requirements, both for the contractor and the surety.

Universal Benefits

Once contractors have a surety bond in hand, whether in the U.S. or elsewhere, they are typically quite pleased to realize that they have not tied up working capital, as they would have to secure an LOC. Capital is there to be invested for growth.

Moreover, if a claim arises in the course of the project, it is not automatically paid out by the surety as it is by a bank holding an LOC. Rather, the surety investigates and pays only what is merited. The contractor's interests (and cash) are protected.

Whether you are securing a surety in the U.S. or abroad, the selection of surety is critical if the benefits are to be reaped. Certain criteria are especially important when shopping for surety outside one's home turf and can help keep a contractor on firm footing in any market. This includes:

A large global footprint. In many places—from Japan to Brazil—a surety must have a local office and license in order to issue a bond on a local project. Moreover, the surety should be able to service both the parent company as well

as its subsidiaries. Hence, when looking at opportunities across borders, it pays to look carefully at a potential surety's global reach.

Understanding local languages and cultures. Negotiating a surety bond—and a surety claim—is certainly best done by experts who know the local landscape and speak the local language. Contractors and owners in China understandably have a higher comfort level when their surety has an office in Shanghai and they can sit down with an underwriter fluent in Mandarin and have a claim negotiated by someone who can address the issues directly, one on one, in the local language.

A potential long-term partnership.

Is the surety committed to the market and to growing with its contractors? A Chinese contractor that was building small schools in South Carolina two decades ago today is handling one of New York City's major infrastructure projects with the same surety. That's a track record a surety can have confidence in.

Experience. Just as jurisdictions are unique, projects are too. The more different types of projects a surety has handled, including public-private partnerships and other project financing deals, the better equipped it will be to help its client tailor a contract that is fair for the contractor and acceptable to owners. An experienced surety also can give a contractor the benefits of lessons learned from its peers, enabling clients to sidestep issues that have tripped up others.

In today's world, contractors of all sizes can tackle projects across international borders. A quality surety will help them do that most successfully. So whether you are working internationally now or not, it is wise to choose a surety today considering the opportunities tomorrow may bring. ■

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Performance Bond and Long-Term Warranties Are Key Surety Considerations in Today's Market

By Robert Duke

Over the last several years, surety companies and their contractor clients have noted an increased frequency of long-term warranty requirements on road construction projects. For example, the Pennsylvania Dept. of Transportation (DOT) had established a seven-year warranty requirement for asphalt concrete pavement. The Texas DOT included a warranty requirement of 15 years covering the thin polymer overlay for one of its projects. In addition, sureties and contractors have come up against warranty requirements covering road surfaces and other components extending 15 to 20 years. A 2008 report by the American Association of State Highway and Transportation Officials noted that over two-thirds of state highway agencies have established long-term warranties in at least one project between 1995 and 2006. Anecdotal evidence suggests that the occurrence of long-term warranty requirements may be higher today.

From the perspective of the state DOTs, the use of long-term warranties seems understandable. DOTs have been turning to innovative contracting techniques in order to meet the growing demand to construct and maintain high-quality and safe highways. Historically, state-funded inspections and materials testing have been the primary means to ensure high-quality roads. However, reduced personnel levels and funding have negatively impacted the extent of quality assurance activities undertaken by state DOTs.

To address this challenge, states have implemented extended warranty requirements in connection with highway construction contracts. In essence, the warranty requirements serve as supplements to the reduced inspection and materials testing activities as a mechanism to enforce quality requirements. Under these warranties, the contractor is responsible for correcting defects in its work that are due to faulty materials and workmanship or correcting any shortfall from established specifications regarding the road surface. It is often difficult to determine the line between faulty workmanship and

materials versus inadequate design or road-use beyond expectations.

State law and good public policy dictate that public construction projects over a certain size must be secured with a performance bond and a payment bond. A performance bond secures the contractor's obligation to fully perform the project. If the performance obligations include the warranty obligations, the performance bond conceivably could be covering the warranty obligations. Although the DOTs' desire to use long-term warranties is understandable, these warranties present challenges from a contracting and bonding perspective. Long-term warranty bond requirements

A long-term warranty increases the risk to the contractor as it carries a potential liability well after the project is completed.

may limit bond availability, limiting competition for highway construction contracts, and ultimately increasing costs.

A long-term warranty increases the risk to the contractor as it carries a potential liability well after the project is completed. Given the long duration, it is difficult for the contractor to estimate future financial obligations, adequately and accurately price for the risk, and make the sufficient financial reserves to cover the potential liability.

When a surety writes a bond for a contractor, it is making a judgment about the contractor's financial and operational viability. As the duration of the bonded obligation becomes longer, and the surety must assess the contractor's operation for periods of time well into the future, the certainty of the judgment may be lessened. This is the case with a bond that has a long-term duration.

In addition to the uncertainty involved in underwriting a contractor far into the future, the method of payment for the work under the warranty also increases the risk to the contractor and the surety. As the contractor progresses during the construction period, the contractor generally is paid only for work put in place. If the contractor defaults and the project is incomplete, the balance

of contract funds should be available for the surety to complete the project. However, under most contracts, the contractor is paid fully upon final completion, leaving no contract balances to fund any warranty work. Therefore, if a surety must step in to complete the warranty work, it does not have any contract funds available to mitigate its loss.

To compensate for the increased risk due to the diminished certainty of underwriting and the method of payment, sureties typically raise their underwriting standards and provide long-term bonds only to the largest and most financially sound contractors, precluding many smaller contractors who are fully qualified

to do the work to bid on these projects.

There are ways to reconcile DOTs' need to assure quality and establish workable bonding requirements. SFAA recommends that the warranty be limited to three years. With adequate design, engineering and inspection, this length of time protects the owner but does not subject a contracting company to financial hardship for defects which are out of its control. Issues that arise several years after completion generally are issues related to the product. Warranty protection with a longer duration would be provided more appropriately by a manufacturer's warranty. The amount of the warranty bond should be a percentage of the final contract price (such as 10%) and required to be submitted at final acceptance of the construction project.

Quality in highway construction benefits all, and warranties could be a part of a DOT's quality control program. However, warranty requirements should be reflective of what can be obtained reasonably from the construction and surety industries. ■

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Gap Finance Trend for Public Projects Brings New Risks for Contractors to Consider

By Stan Halliday

As states struggle to fund transportation projects, delaying payments to contractors can be one way to manage funding shortfalls. As a result, an emerging trend has arisen in several states with some states choosing not to pay contractors for their work through traditional monthly progress payments. Instead, significant payments often are deferred until long after the job is completed.

This deferral may create a payment “gap” that can potentially serve as a problem for contractors. In some cases, gaps can exceed tens or even hundreds of millions of dollars. Few, if any, contractors have the capacity to finance these sizes of gaps internally and many contractors also do not want the debt assumed to fund such gaps to appear on their balance sheets.

While there are a number of options contractors may consider to finance the work, the fact that significant payment dollars are being deferred creates some new and additional risks that should be fully considered prior to entering this type of contract. These are some valuable lessons and best practices that may help bridge the knowledge gaps that may exist related to this gap financing:

1. Waiver of Owner Offset Rights

On most traditional construction or design-build projects, DOTs retain the right to offset future payments to the contractor in case warranty issues arise on previously performed and approved work. This practice is not viable on a gap project, however, as the money being used to offset the prior deficiency likely already has been advanced to the contractor through the established lending arrangement and now is owed to a lender or other third party that does not have direct responsibility for the construction defect or other problem. If the owner is not willing to waive its offset rights on gap finance projects, it certainly will impact lenders’ ability to extend credit to finance the project.

Fortunately, the public owner has strong existing guarantees to address this risk in both the contractor’s indemnity pledge, as well as the

performance bond and warranty bond guarantees of its surety.

2. Priority of Funding

Appropriations for departments of transportation occur at the state legislative level and are normally done in annual or two-year increments. Typically, the state would stop work on a project should the funding appropriation not occur. On a gap financed project, lenders may advance payments prior to funding being authorized. In order to provide lenders greater incentive to advance funds, states should prioritize these projects for payment over other existing jobs and future work to be performed during the fiscal year.

Significant payments are often deferred until long after the job is completed, creating new and additional risks.

3. Recourse vs. Non-Recourse Financing

Many contractors may not want to take the risk of non-payment from the state due to these scheduled gaps. Lenders are more experienced and comfortable assessing this type of risk. Thus, it may make sense to try to establish a “non-recourse” lending structure that could involve a third-party intermediary or special purpose vehicle to borrow the funds. Without this type of arrangement, the contractors may have to guarantee repayment of the funds should the state fail to pay.

4. Lender Default Risk

Since contractors are relying on lenders to have funds available over a long period of time, there always is a chance the lender could default. If the lender is not available to make the loan, the contractor or its third-party intermediary is responsible for obtaining replacement financing. If the financing cannot be replaced, however, the contractor may have to self-finance this risk.

5. Special-Purpose Vehicles (SPV)/ Project Escrow Accounts

An SPV is a legal entity that can execute a contract and assume debt in a manner that is non-recourse to the contractor. The SPV structure likely will call for the funds to be held in escrow and disbursed at the proper time to the correct parties. The SPV is an intermediary in the payment process; the DOT (assuming it approves the work as it progresses) has an ongoing financial commitment to and contractual arrangement with the SPV, who in turn holds the construction contract with the contractor. Both the SPV and the state, through a dual obligee rider, would be named as obligees on any performance bonds issued by the surety to guarantee project performance. We believe use of such a vehicle may help secure non-recourse financing.

6. Surety Step-In Rights

Both the surety and the lender are creditors in the event a project/contractor fails. The surety must have the ability to step in and complete the job. That is why it is essential, in advance of any problem, to have clear guidelines about how the rights, assets and financial claims of the lender and surety will be prioritized, balanced and protected. Thus, this type of contract requires early and frequent communication between the contractor’s surety(ies) and its lender(s).

7. Performance Delays/Liquidated Damages

Delays, both anticipated and unforeseen, are always a risk for any construction project. That is why performance and payment bonds that guarantee the projects to the state are open ended and expire with project completion. There are no specific expiration dates on these instruments. This is not the case for financing or lending arrangements, which have a stated expiration date that may trigger re-payment prior to funds becoming available from the state. Any thoughtful financing plan needs to consider these differences.

8. Warranty Obligations

Owners should not be able to use deferred payment funds to mitigate unmet warranty obligations (see waiver of offset rights above). If there are any defect or warranty issues that arise after substantial completion and/or final acceptance, the owner's remedies should be limited to the contractor's indemnity obligations and the surety's performance and warranty bond protections.

9. Timing of Lender Commitment

One common issue is that lenders typically prefer to defer making a lending commitment until the contractor has been identified as the successful proposer. Unfortunately, not having a firm lending commitment can impact the proposal terms as contractors often give a bid bond guarantee that may equal 5% to 10% of the contract value

at the time of the bid. If the contractor is unable to successfully finalize its lending arrangement, the state could require it to forfeit the bid bond for failing to execute the contract. It is critical to involve the lender early in the proposal process and try to get a reasonable commitment prior to the proposal date.

10. Third-Party Indemnity Obligations

Third-party lending agreements may contain risks that fall outside a typical construction contract. Contractors should carefully assess any new indemnity obligations it is being asked to assume. Contractors should be careful about accepting responsibility for any new items they would not typically retain and control on a construction project. The risks should flow to the party that

controls or has direct knowledge of the item in question.

The funding challenges affecting our state governments and municipalities are significant, especially given the state of today's economy. We are seeing more contractors being asked to provide financing solutions to try to address infrastructure needs. Gap financing is one methodology that has been gaining momentum and will continue to evolve over time. By remaining aware of the potential risks this type of financing may create, contractors will be in a better position to protect and ensure the viability of their business into the future. ■

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Public-Private Partnerships Address Public Infrastructure Funding Gap

By Nathan Zangerle and Stephen Rae

U.S. Congressional delay in passage of a long-term plan for our infrastructure needs is causing more states to examine public-private partnerships (PPPs) as a means to bridge the infrastructure funding gap. What are PPPs? PPPs started in the United Kingdom in the early 1980s. Although the U.K. used the name private finance initiatives (PFIs) versus PPPs, it employed the same schemes for designing, financing, constructing, maintaining and operating an asset for the benefit of the public under a long-term project agreement. The PPP sponsor usually is a limited-purpose entity that may hold title or a concession right to operate the asset over the project term, which typically is 25 years or more. Besides the UK, PPPs have been used frequently in other parts of Europe, Latin America, Australia, Asia and Canada. Although the U.S. has seen limited use of PPPs so far, the first PPP project actually happened 23 years ago when the \$323-million E-470 Tollway project began east of Denver.

PPPs are not limited to tollways.

PPPs can be used for hard infrastructure projects such as roads, bridges, highways and mass-transit, or social infrastructure projects such as schools, courthouses and hospitals. The revenue streams from hard or social infrastructure assets typically are structured in two ways: either toll or availability concessionaire agreements. Toll concessions carry demand risk (will the toll revenues be achieved as modeled), while availability concessions carry the credit risk of the public owner that is contractually obligated to pay the PPP sponsor (assuming the asset is available and meeting performance metrics). Availability payments represent off-balance sheet transactions by the public owner, whereas toll payments transfer risk back to the private sector (user fees) and does not constitute a long-term funding commitment by the public owner.

The key concepts of PPPs are accelerated project delivery, leveraging private sector capital to meet infrastructure needs and risk transfer to the party best able to understand, control and minimize that risk. The private

sector generally is viewed to be in a better position to manage those risks so that PPP projects usually are brought in on time and within budget. In order to proceed down the PPP path, a state must have enabling legislation in place that put the PPP construction project outside the normal public procurement requirements and related regulations.

A PPP project typically starts with a regional governmental entity (RGE) soliciting proposals from the private sector to design, finance, build, maintain and operate an asset to meet or provide a public service. It is important to note that PPP sponsors incur significant pursuit costs in putting together a PPP proposal, and even though an RGE typically will provide a stipend to cover some portion of the proposal costs, the stipend will not cover all the pursuit costs. After evaluation of the proposals, the RGE will enter into a project agreement with the successful PPP sponsor. The PPP sponsor will provide equity for the project and secure project

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financing through a number of sources or lenders. The financing structure is the key to a successful PPP. The PPP sponsor also will enter into a contract with a design-build entity to design and build the asset, and the PPP sponsor will enter into a contract with an operation and maintenance contractor who will operate and maintain the asset during the project term. The PPP sponsor also will need to provide project guarantees to the interested parties (RGE and project lenders) to offset primarily the construction phase risks, including, but not limited to, an asset completion guarantee (typically a surety bond) and

a liquidity guarantee (typically a letter of credit or financial guarantee insurance).

What does this mean for the construction community? Absent the political will or financial ability to fund critical infrastructure needs in the U.S., PPPs will continue to move forward as a significant model for building mega projects such as highway capacity expansion in heavily congested urban areas. Through the risk transfer process, contractors may be exposed to or asked to share in the substantial pursuit costs. The contractor also needs to understand the potential contract performance metrics, any pass-through liquidated damages tied to project performance specifications, warranty provisions, and

the impact of delay damages upon the cost of extended financing. And while contractors are accustomed to bearing asset completion risks, there also is the potential for the contractor to be brought into the PPP sponsor's liquidity guarantee obligations. As such, it is imperative that contractors fully understand the indemnification obligations amongst the PPP sponsor, RGE and project lenders and the extent to which any of these obligations flow down to the contractor. ■

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Where are the Surety Losses In the Current Climate?

By Paul Healy

With a sharp drop in construction spending in 2008, along with a spike in construction unemployment (more than 20%), the pot quickly started stirring about big surety losses. The economy has remained stagnant and margins thin for more than four years. This has caused industry chatter to grow with speculation about contractors going out of business and mounting surety losses. Competition is keen, and there still is a strong appetite for work, which is keeping and intensifying the bid margin pressure.

The Surety & Fidelity Association of America recently reported another low loss ratio year (13.4% at year-end 2011 and more recently, 22.7% at 3/31/12). This is a continuation of a profitable string going back more than five years. In fact, the 2011 year-end results include some significant loss recoveries and reserve releases from prior year reserves. The largest surety is reporting a negative loss ratio based on \$131 million in reserve releases. If the industry results are adjusted for a modest normalized loss ratio for this market, it would bump up the industry loss ratio approximately five points, which would still be a profitable result in the low 20s. So where are the losses?

There are several reasons for the profitable surety results. Before we get to those, however, it is important to note that the surety industry has incurred losses and has a good track record, especially among the largest sureties, which have responded to defaults, and in some cases, managed wind downs without a loss. Close to \$1 billion in losses and loss adjustment expenses were reported in 2011. While the loss ratio is profitable, we have seen the surety product respond to protect owners, tax payers, general contractors, material suppliers and others against nearly \$1 billion in 2011 and in excess of \$2 billion since 2008.

Many believe that losses are coming but taking longer than originally expected. The first quarter results for 2012 suggests the trend may soon be heading to higher losses. There are several reasons for the modest loss activity so far:

1. The downturn clearly was visible and highlighted by the collapse of the housing market and the financial crisis on Wall Street. As a result, contractors, developers, bankers and sureties reacted quickly to adjust business plans and overhead. We did not see losses prominently develop

from the construction industry being overextended when the economic brakes hit. In addition, many firms have been reluctant to pursue work at low margins, and many have adjusted their business plans to operate at lower top-line targets for extended periods of time.

2. Many construction companies had strong balance sheets when the downturn began. It was common for contractors to report record sales and profit levels in the mid-2000s through fiscal 2008. This led to big cash positions and tangible net worth, which the sureties love, that exceed the traditional measures sureties have used to calculate surety capacity. With new work hard to come by, contractors trimmed overhead and chose not to load up with low margin work. Many of these firms have strong war chests and can last a long time with modest profits or losses.

3. The surety industry has developed strong risk management tools to advise their clients and mitigate risks. Historically, for example, legal professionals at surety companies were focused on managing losses. Today, more have been moved to the front end of the underwriting process to analyze contracts before the bid process. Sureties also have made greater use of technology to help with forecasting financial performance and identifying early trends. Large portfolios (the five largest sureties have more than 50% of the market) have geographic, type-of-contractor and size-of-risk diversification.

4. The lack of marketplace opportunities have kept backlogs lower and therefore balance sheets less leveraged. With most contractors using 50% or less of the surety capacity available to them, the balance sheets simply are not working as hard as they would in an expanding marketplace where surety capacity was at a premium.

It is more likely to see contractor failure rates and surety losses increase when there is strong economic activity. When contractors begin growing again, their operations will require cash to fund new backlogs. The inventory of backlog acquired during the low margin phase of the cycle will not throw off the cash flow of a high margin backlog that many used to fund their growth in the mid- to later 2000s. This may be the time that contractors need more bank and surety credit to fund new work—just when their financial statements are reflecting negative financial performance.

Several of the largest sureties have

reported that more than one-third of their books of business are reporting net losses based on 2010 fiscal year ends, up from 10% in 2009 and 20% in 2010. Audits from 2011 are coming in now, and many expect the operating losses to be present in more than one-third of the market.

In addition to a cash shortfall in an accelerating backlog market, there also is a potential people issue. Contractors reduced staff during the slow times and are reluctant to add key workers until they have acquired new work. They may not be able to find the right people for newly acquired work in an expanding market. They could end up with a new backlog but the wrong people running the work.

Good surety loss ratios keep the surety market strong and competitive, which generally is good for contractors. There is plenty of capacity for good credits with single bonds available in excess of \$1.5 billion for strong joint venture teams.

In a dramatic shift from the mid-2000s, when many firms were looking to get more surety capacity, today most have considerably more than they need and, therefore, competitive choices. Surety underwriting has intensified based on concern about the impact of market stress, which will increasingly make it harder for poorly performing firms to find easy surety credit. This should moderate the number of bidders on larger projects. Surety pricing also is competitive with stable to declining rates. There remains valid industry concern about an increase in contractor defaults (none of the top 10 writers has a loss ratio greater the 20%, but 11 of the next 25 have loss ratios over 40%, indicating some loss activity with smaller contractors and specialties).

As usual, time will tell. ■

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The Role of Surety in PPP Projects

By Geoff Delisio

Public-private partnerships (PPPs) represent a fundamental change in the project procurement process that both contractors and those who serve the contracting community must thoroughly understand. This method of procurement is used in various parts of the world, especially in the United Kingdom, Europe and Canada. While there have been single projects undertaken at specific locations within the United States, the broad use of this method to date has been by the Armed Forces for the upgrade and construction of military housing at military bases nationwide. Based upon the publicly available bid lists, there is an increase in state infrastructure projects proposing a PPP format for 2012 and 2013. A derivative of PPPs, gap financing or design, build, finance (DBF) projects

have recently been added to the bid listings in several states for 2012.

The Basics

Broadly speaking, PPP refers to a procurement process by which the talents and capital of the private sector are brought to bear by undertaking tasks that have historically been the responsibility of the public sector. This can include providing both short- and long-term project financing, design and construction of the project, the operation of an asset, as well as the maintenance of assets over time.

The underlying theme of the PPP process is “value for money.” The public is being provided something of value for the money that the private sector is being paid. By connecting all the responsibilities related to an asset over time, the end

result will be a better performing asset at an overall lower life-cycle cost. PPPs look for a design that will make the asset more efficient to run and maintain and ensure the design, construction methods and materials used are of a quality that lowers the maintenance costs.

The marketplace generally refers to two main categories of PPPs—Greenfield and Brownfield projects. A Greenfield project generally refers to a newly constructed asset being brought into public use. In contrast, Brownfield projects refer to existing assets with ongoing operations and maintenance that will be transferred to the private sector. In either situation, the underlying agreement between the public and private sector tends to be long-term (30 to 50 years) with the asset returning to public care at the end of the term.

The private entity that enters into a contract with the public body generally is known as a Concessionaire. The contractual structure usually involves the governmental body providing the

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Concessionaire a lease to an existing asset or to the land upon which a new asset will be built. In turn, the Concessionaire entity, generally a single-purpose entity with several owners, will contract with multiple parties that serve specific roles within the project such as design, financing, construction, operation and maintenance. Third-party financing will be combined with an equity piece from the Concessionaire to fund the transaction. The Concessionaire is paid a fee based upon the availability of the asset (i.e. is it available and working), and in some cases the fee is based upon the use of the asset by the public. The Concessionaire uses these fees to pay off the debt used to fund the original purchase of the existing asset and construction costs with a return to the investors.

New Roles

All involved with a PPP take on new roles as compared to a traditional public agency-driven procurement. The governmental body is no longer the “owner” in the traditional sense of the word. The leaders with the governmental entity are guided

by the desire to implement strong public policy and at the same time safeguard the public. The Concessionaires now become the owners and operators of public assets with multiple employees who perform the services that run them.

Contractors and suppliers are bringing significant value and expertise to the project as team members. Generally, these projects are undertaken on a zero-change order basis because once the financing has been closed there are no additional pots of money to fund changes. The key in the overall project is getting the asset fully functioning as soon as possible because it is only then that the Concessionaire will see revenue flow. This combination of competency and value added places a premium on strong, skilled contractors that can partner with the Concessionaire in providing a world class project.

Surety in PPP

Surety has been overlooked, underutilized, and not appropriately understood within the PPP arena. Surety bonds require the contractor to “qualify” for the product through a rigorous underwriting process

both at inception and throughout the duration of the relationship. Qualified contractors are an integral part of the PPP delivery process and value proposition.

In a construction project where completion time and operational performance is vital, performance and payment bonds covering the design-build contract is of benefit to all parties. An incomplete project does not generate revenue, debt payments to the lenders, or return to the investors. The payment bond provides subcontractors and suppliers with peace of mind that they will get paid for services and materials provided to the project. The use of surety bonds is a direct benefit to the governmental body attempting to balance the use of the private sector with good public policy.

The risks that a contractor faces are multi-faceted and constantly changing. Owner/payment issues as well as claims and disputes on other projects, impacts upon their business plan and strategy caused by the broader economy, and lack of qualified personnel are some of the risks that the contractor faces. A PPP project is exposed to these through their relationship with the contractor. Surety companies have a dynamic, ongoing underwriting process that constantly monitors a multitude of operational and financial factors. This real time monitoring brings value to PPP projects through the use of surety bonds.

As the role of the major players within a PPP do not follow the traditional scheme, all are confronted with new and different opportunities that need to be managed accordingly to ensure success. For contractors with the skills and talents to provide value-added insight and function as members of a broader team with the ultimate goal of ensuring that a new asset generates cash, PPPs represent significant potential. Sureties view PPPs as an opportunity for qualified contractors, but the risks demand the support of a surety that has demonstrated experience with customers in solving their problems and reducing their risks. Performance and payment bonds supporting the design-build aspect of the PPP project provides tremendous benefit to all and help deliver successful PPP projects. ■

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