



Federal Highway Administration  
Docket No. FHWA–2014–0006  
Draft Availability Payment Public-Private Partnership (P3) Model Contract Guide

Comments from the American Subcontractors Association (ASA), The Surety & Fidelity Association of America (SFAA), and National Association of Surety Bond Producers (NASBP) to address Section 2.5 of the Draft Availability Payment Concessions Public-Private Partnership Model Contract Guide

The Surety & Fidelity Association of America, the National Association of Surety Bond Producers, and the American Subcontractors Association appreciate the opportunity to comment on the Federal Highway Administration’s Draft Availability Payment Concessions Public-Private Partnership Model Contract Guide (Guide). We believe it is important for there to be established best practices regarding performance and payment security for public-private partnerships (P3s), especially as the U.S. DOT works to expand access to its credit programs. We support the U.S. DOT’s effort to provide technical assistance tools to project sponsors through model contract provisions for P3 projects. While we understand that the U.S. DOT has taken an educational and not a prescriptive approach, we are concerned with the guide’s treatment of performance and payment security relative to other less certain security mechanisms. U.S. DOT should advance performance and payment bonds (with the public procuring entity named as an obligee on the bond) as a best practice. The Association for the Improvement of American Infrastructure (AIAI), an organization comprised of leading construction and development entities in the P3 community, has listed requiring performance and payment security as a best practice in its own Best Practices Guide. There are sound, well-recognized public policy reasons for requiring performance and payment security for P3s; and the FHWA’s Guide should reflect that.

The Guide states that “FHWA’s primary role is that of a provider of funding” and therefore it has a keen interest in making certain that the funding is protected and used appropriately. The U.S. adopted a policy over 100 years ago that the key to protecting the public interest on public construction projects, which includes assurance of a completed public improvement, protection of public funds and payment of subcontractors and suppliers, is surety bonding. These interests are as applicable to a P3 project as they are to traditional design-bid-build projects. Bonding ensures the completion of the contract and payment to covered subcontractors and workers on the job. That policy is contained in the federal Miller Act, state Little Miller Acts, and local ordinances, which require bonding on public works projects. The federal government recognizes the value of surety bonds and codified the federal requirement back in 1893 under the Heard Act, which was updated in 1935 in the Miller Act. The Miller Act still is the law of the land and has

been viewed as a best practice for well over one hundred years. Every state in the United States has a “Little Miller Act” that continues to require the use of surety bonds as a best practice at the state level. These public policies have assured the successful completion of construction projects and protected businesses for decades. Those public policies hold true regardless of who is providing the revenue stream for these projects.

The value of bonds for construction projects is the same regardless of the procurement method, whether it is the more traditional design-bid-build or a P3. A primary benefit of the bond is that the surety responds if the contractor defaults. The payment bond guarantees that covered subcontractors, suppliers, and laborers on the job will get paid. Subcontractors, suppliers, and laborers on public works projects must rely on the general contractor’s payment bond for protection. If no payment bond is required, these parties are left with no means to collect for their services and supplies if the contractor is unable or unwilling to pay them. Many subcontractors and suppliers on public works projects are small contractors that have limited resources to absorb an event of non-payment. The payment protection of surety bonds often is of the greatest value to women and minority contractors who most frequently are smaller and less able to absorb this risk. Protection of small, women-owned and minority-owned business is a public policy objective achieved with a payment bond, regardless of the procurement method.

The performance bond guarantees the public works construction contract will be completed according to its terms. The surety holds the financial risk should the contractor fail to complete the construction contract. For a traditional public works project, if a performance bond is not provided, the federal, state, or local budget and taxpayers take on the risk should the contractor default, and thus bear the burden of re-letting work and paying any excess completion costs. When a performance bond is in place, the full amount of the bond is available to complete the contract in the event of the contractor’s default. On a P3, the ultimate objective is a completed public improvement. Private funding typically only covers a portion of the project financing. The taxpayer and government entities continue to provide a significant portion of the funding for these projects, whether through loans, grants or user fees, and they deserve the same protection as on other projects. Lenders often provide no more than 20-30% of the financing. Equity contributions frequently are even less, often less than 10% of the contract value and typically are deferred to the very end of the project. In a P3, the Guide states that that project lenders will step in only if there is a reasonable chance of success of “reviving” the project. If the developer’s default is related to the design-build contract (which is where most of the risk lies) then the chance of project revival is enhanced with a surety stepping in to complete the construction contract.

Construction is risky business. We should not be lulled into a false sense of security to believe that any company is too big to fail. Big is big; but big does not necessarily mean strong. One only needs to look back fewer than 20 years to see a list of well-established and well respected large heavy construction companies that have filed for bankruptcy—names like Morrison Knudsen (1905-1995), Guy F. Atkinson (1926-1997), and J.A. Jones (1890s-2003). A more recent name is Modern Continental (1967-2008), the largest contractor on the Big Dig (the Boston Central Artery/Tunnel Project). In 2000, Modern Continental was a \$1.3 billion company with over 4,000 employees. While Modern Continental’s problems started with a default on a wastewater treatment plant project, the issues it encountered on the Big Dig

(including a guilty plea to 39 federal charges) led it to file for bankruptcy in 2008. The successful completion of the Big Dig should be credited to the surety that managed the claims and financed Modern Continental to complete its projects and ultimately filed a proof of claim in the bankruptcy for hundreds of millions of dollars.

Even more recently, Ballenger Construction Company (1937-2012), a large Texas road contractor, filed for bankruptcy in December 2012 leaving millions of dollars in unpaid bills from subcontractors, suppliers, and others on 20 bonded transportation projects with a total value of \$356 million. About \$112 million of work remained on the Ballenger contracts when the company went out of business. Ballenger was founded in 1937 and was “large”. It had 550 employees, all of whom were laid off. Ballenger’s sureties again are managing the claims and making sure the projects get completed and the subcontractors and suppliers who timely file proper claims are being paid.

Even more recently, Grupo Tradeco, a Mexican-based construction firm, left hundreds of millions of dollars of unfinished Texas Department of Transportation work. Multiple sureties have engaged and completion efforts are underway. Undoubtedly, geographic diversity, language barriers and cross border differences will add to the complexity of these defaults. In short, in the context of construction firms, no firm is too large to fail.

Requiring performance and payment bonds on the construction portion of a P3 will protect the public entity and its taxpayers. Delay on any project, public or P3, is to be avoided if at all possible. The protection of a payment bond frequently is what keeps a construction project moving. When subcontractors perform, they need to be paid promptly for the work. In fact, failure to pay subcontractors typically will result in suspension of work and delay of the project. This delay, spread over an already accelerated construction schedule, could impact not only Substantial Completion but the possibility of missing the Long Stop Date. Having a surety bond and the established direct interaction with subcontractors increases timely payment and enhances the likelihood that subcontractors and suppliers will continue to perform and focus on project completion. The public interest demands that payment bonds be in place on P3s to ensure that subcontractors and suppliers get paid promptly for work performed if the construction contractor defaults on the project. Payment to these entities cannot spread over the long life of a P3 contract.

The Guide addresses four areas to which we want to bring additional insight and clarity:

### **Who Will Suffer a Loss in a P3 Model?**

*...[In] a P3 project, the “first loss” is suffered by the equity providers to the Project, and the “second loss” (which only arises if the losses are greater than the level of the equity committed to the Project) is suffered by the senior lenders to the Project. To the extent that there is a “third loss” (which would only arise if the cost to complete the Project was greater than the aggregate of the equity and debt committed to the Project), that loss would be suffered by the Department following the termination of the Concession Agreement, but only to the extent that the level of termination compensation payable by the Department to the Developer results in a loss to the Department. In the event of a*

*termination of the Concession Agreement, however, the level of compensation payable by the Department to the Developer will typically take into account the amount it would cost the Department to complete the construction of the Project, meaning that (all other things being equal) the Department should not suffer any loss as a result of the termination of the Concession Agreement.*

This analysis does not capture the whole picture and ignores the ultimate public entity objective—to deliver a completed public improvement. Politically, the risk to the public entity remains the same, regardless of the procurement method. Taxpayers have a direct interest in seeing roads, airports and bridges completed on time and properly maintained. If there are problems or a contractor defaults in the construction portion of a P3, the public entity will get the same pushback that it gets when something goes wrong in any other type of public works project. For example, the Maryland Transit Administration currently is developing plans for the Purple Line for the light rail in Maryland. The political fallout if the project were to be terminated when it is only partially completed would be disastrous. The public will not care if the investors are covered or the developer has a loss. They only will care about a partially completed project with no financing plan to finish the work. The bottom line is that the public entity remains responsible for delivering a completed public works project to the taxpayers. That risk cannot be and is not shifted to the private partners.

Further, it is unclear what is meant in the Guide’s statement about how the bond “travels” with the bonded contract, which may be the concession or the design-build agreement. Even if it were the latter, which is more appropriate and typical, there are multiple obligees who represent the project stakeholders and have rights against the bond. We recommend that the DOT be made a dual obligee on the bond in a P3 to secure any potential losses it may suffer due to default of the bonded contract. This has been and remains a best practice in the surety industry. If the termination of the concession agreement or the design-build agreement is due to the default under the design-build contract, then the bond will come into play upon declaration of default and subsequent demand. The Guide also states that the DOT likely still would pay the developer in the event of a default for cause in order to avoid unjust enrichment of the DOT. If bonds were required, this would not be the case. With bonds in place, ultimately, the DOT pays for and receives a completed asset.

### **U.S. P3 Market Differs from Foreign Markets for Sound Public Policy Reasons**

We have found that the performance and payment security implemented for a P3 project in a certain country reflects the performance and payment security mechanisms used in that country for projects procured in more traditional ways. The U.S. is the only country that requires, by statute, bonding of virtually all public works projects. Other countries have different approaches to public funds, and many do not include protection for subcontractors and laborers on any public project. They also do not look for the security posted on a public construction project to address completion of the contract or to pay workers, but rather require only a small demand guarantee. Many countries require only a 5% to 10% LOC as the security on any public construction project, and their P3 projects follow that approach. In the countries that do require a higher-percentage conditional guaranty, that same percentage normally is required for P3 projects as well. Here in the U.S., we have a procurement system that guarantees that significant funds will be available to pay for completion of the work and payment of workers in the event a

contractor defaults on a public works project. Other countries treat P3s like any other public construction project, and P3s in the U.S. likewise should be treated as any other public construction project and require bonding. There is no reason to adopt a foreign approach to P3 projects here, especially when such approaches derive from different historical and public policy contexts.

### **Bonding Assures Contract Completion and Payment of Subcontractors and Suppliers**

It must be understood that bonds are required on public construction projects in the U.S. to protect public budgets, taxpayers and subcontractors, suppliers, and workers on the job—not private partners and their investors. The latter are sophisticated parties that have the expertise and resources to negotiate financing arrangements and P3 agreements on terms that are acceptable to them. Bonds are required to protect the public interest, increasing the likelihood that the construction contract will be completed and that subcontractors, suppliers, and workers will be paid promptly. If there is a contractor default, the surety is going to bear the expense of adjusting the claims and managing the process.

The payment protection available for subcontractors, suppliers, and workers and the contract completion protection for public entities should not be compromised and reduced because some financiers and concessionaires are comfortable with less security. Changing the fundamental U.S. protections solely to accommodate the financial interests of equity investors or financiers is misplaced. Bonding 100% of the construction portion of P3 projects still remains the best option in the U.S. for payment and performance security. The Guide states that there is a range of amounts for bonds among state laws with some states requiring 10% bonds. Requiring bonds this small is rarely, if ever, the case. It is far more likely that the lowest amount required would be a 25% bond, and the most typically required bond amount is 100% of the contract price.

The Guide notes that if a concession agreement requires the design-build contractor to provide a specified form and amount of bonding, this could create an “unfair advantage or disadvantage” for a bidding team given that contractors with higher financial qualifications will have to provide the same level of performance security as a contractor with lower financial strength. We question the basis for this statement as the payment and performance security amount is the level at which the owner and concessionaire will protect themselves against the contractor’s default. Bonding actually levels the playing field. The performance and payment bonds also strengthen the bidding team’s ability to complete the project and pay its subcontractors and suppliers as compared to other forms of security. The assessment in the Guide regarding an unfair advantage would be true for letters of credit and parent company guarantees, which, unlike surety bonds, are based on relative financial strengths. These instruments also do not provide for contract completion like performance bonds.

### **Parent Company Guarantees Are Not an Adequate Substitute for Bonding**

The Guide notes that some state DOTs may require the design-build contractor’s payment and performance obligations to be covered by a parent company guarantee, which will “provide a robust balance sheet with sufficient assets to stand behind the obligations of the Design-Build Contractor...” We are unaware of any DOT that allows a parent company guarantee in lieu of statutorily required bonds. The Guide also states that the guarantee is only as strong as the financial commitment from those signing on to it. The use of a parental guarantee does not

provide anywhere close to the protection that is given by having an unrelated third party, whether such security is given by a financial institution or a surety company. Even if a guarantee by any corporation were allowed, a parental guarantee of the contractor's obligation would only be as good as the assets of the company issuing the guarantee. Further, enforcing an indemnity action in a foreign country is a complex legal endeavor. Will a State be equipped to deal even with a U.S. Chapter 11 bankruptcy proceeding, much less foreign bankruptcy statutes and rules for a domestic project with foreign financing and investors? This places an unnecessary burden on the public partner.

Because the fortunes of the parent company and its subsidiaries are intertwined, it would be a rare case if the financial problems or insolvency of the parent company did not significantly impact the contractor and vice versa. If the parent fails, the guarantee is essentially worthless. As a practical matter, if the contractor defaults, in all likelihood a bankruptcy would be filed and the Department would stand in line with all the other unsecured creditors with their claims for funds to get its projects completed. There is strong public policy behind the statutes that call for the guarantee on public works projects to be from an independent entity regulated for solvency and claims paying ability and practices. One added benefit of the surety bond is that subcontractors and suppliers have a direct right of action on the bonds, securing their payment. This is an added protection for the smaller and more vulnerable subcontractors who perform work yet do not receive timely payment.

### **Conclusion**

The first "P" in any P3 is "public." The end result of a P3 is a project that provides a public service or facility. A P3 is just another method to deliver a public works project, just like design-bid-build by a general contractor, design-build, and the construction manager methods. Arguably, the risk to the public entity is increased in a P3 since the public entity is responsible to the taxpayers to deliver a public service or facility, but the public entity does not choose or control the construction contractor and could suffer financial loss if the private partner defaulted. Construction of public works should be bonded because public money pays for the P3 project in the long run, and such public funds are at risk in a P3 the same as in any other method of delivery.

### ***American Subcontractors Association***

*ASA is a national trade association representing subcontractors, specialty trade contractors and suppliers in the construction industry. ASA members work in virtually all of the construction trades and on virtually every type of horizontal and vertical construction. ASA members frequently contract directly with construction owners, including various government entities. More often, they serve as subcontractors dealing with construction owners through a prime contractor. More than 70 percent of ASA members are small businesses.*

### ***National Association of Surety Bond Producers***

*Founded in 1942, the National Association of Surety Bond Producers (NASBP), [www.nasbp.org](http://www.nasbp.org), is the association of and resource for surety bond producers and allied professionals. NASBP members specialize in providing surety bonds for construction contracts and other purposes to companies and individuals needing the assurance offered by surety bonds. NASBP members engage in contract and commercial surety production throughout the United States, Puerto Rico,*

*Guam, and a number of countries. They have broad knowledge of the surety marketplace and the business strategies and underwriting differences among surety companies. As trusted advisors, professional surety bond producers act in many key roles to position their clients to meet the underwriting requirements for surety credit.*

***The Surety & Fidelity Association of America***

*The Surety & Fidelity Association of America (SFAA) is a District of Columbia non-profit corporation whose members are engaged in the business of suretyship. Member companies collectively write the majority of surety and fidelity bonds in the United States. SFAA is licensed as a rating or advisory organization in all states and it has been designated by state insurance departments as a statistical agent for the reporting of fidelity and surety experience. SFAA represents its member companies in matters of common interest before various federal, state, and local government agencies. SFAA has departments handling: statistical information, regulatory filings, publications, government affairs, membership, and both surety and fidelity bond underwriting.*