AN EVERGREEN DOCUMENT TO UNDERSTANDING P3s & BONDING

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IMPORTANCE OF SURETY BONDS

A Surety Bond Is a Credit Instrument; It Is Not Like Traditional Insurance

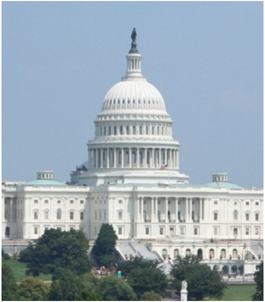
While traditional property and casualty insurance is a two-party agreement, a surety bond is a three-party agreement in which one party, the surety, obligates itself to a second party, the obligee (project owner/contracting authority), to answer for the default of a third party, the principal (contractor). Most surety companies are subsidiaries or divisions of insurance companies and both surety bonds and traditional insurance policies are risk transfer mechanisms regulated by state insurance departments.

Traditional insurance is designed to compensate the insured against unforeseen adverse events. Surety companies operate on a different business model; surety bonds are designed to prevent losses. The surety prequalifies the contractor based on a number of factors, including financial strength and construction expertise (additional information listed below); and the bond is underwritten with little expectation of loss, unlike traditional insurance.

Federal Miller Act

The federal Miller Act (40 U.S.C. § 3131 et seq.), and applicable federal regulations require that prime contractors on federal construction contracts exceeding $150,000 must furnish a performance bond to guarantee its contract performance, thereby protecting taxpayer dollars; and a payment bond to protect payments to subcontractors and suppliers. Typically, without a payment bond, unpaid subcontractors and suppliers on public projects have no payment remedy, as they are without mechanics lien rights on federal property.

Statutory surety bond requirements, such as the Federal Miller Act, provide vital financial security to protect project owners by assuring that interested contractors are qualified to perform the construction contract, and that a reputable and knowledgeable surety stands ready to complete contract performance in the event of contractor default, and that certain project subcontractors and suppliers will be paid. Similar laws known as Little Miller Acts exist in all states in order to achieve the same ends on state construction projects.



Understanding P3 agreements and the Origin of P3s

A Public-Private Partnership (P3) is a contractual agreement between a public agency (federal, state or local) and a private sector entity. In this contractual agreement, the private entity performs a service historically delivered by the public sector. Through this arrangement, the skills and assets of each sector (public and private) are shared in delivering a service or facility for the use of the general public.

Thousands of P3s are operating for the delivery of services or facilities such as water/wastewater, transportation, urban development, and delivery of social services, to name only a few areas of application. According to the National Council for Public-Private Partnerships, today, the average American city works with private partners to perform 23 out of 65 basic municipal services. The use of P3s is increasing as they may provide an effective tool in meeting public needs when public authorities lack funding or resources.

Even in the best of times, governments at all levels are challenged to keep pace with the demands of their constituencies. During periods of slow growth, government revenues are not sufficient to meet spending demands, necessitating painful spending cuts or tax increases. Partnerships can provide a continued or improved level of service, at reduced costs. And equally important, P3s can also provide the capital needed for the development of major facilities. By developing partnerships with private-sector entities, governments may maintain quality services despite budgetary limitations.

Policy Reasons to Include Bonds on P3 Agreements

Under traditional methods of procurement, the public contracting agency receives competitive bids from private construction companies, based on a supplied design, and paid for with public funds. Under a P3, the supplied entity contracts with the private partner, who in turn hires the construction contractor for the public works project and pays the contractor. The public entity commits public funds to repay the private partner over a period of time, typically ranging from 30 to 99 years.

While a P3 infrastructure project may be managed by a private entity, the completed project is for the benefit and welfare of the public and will revert to an asset of the government at some future point. Bonding requirements on projects undertaken for public benefit and welfare through P3 arrangements ensure proper pre-qualification of entities performing construction services; guarantees performance from a solvent, third-party corporate surety; and offers payment protections for certain unpaid subcontractors and suppliers in the event of contractor default.

Furthermore, when the federal government provides loans and/or grants through programs such as Transportation Infrastructure Finance & Innovation Act (TIFIA), and/or the Water Infrastructure Finance & Innovation Act (WIFIA), bonds should be required for the construction portion of the contract to safeguard public funds and to provide payment protection to downstream subcontractors.

Legislative Precedent: Requiring bonds on P3s Receiving Federal Funds

Congress has previously authorized public-private partnerships to address needed construction projects. In 1996, an initiative for privatization of military housing was authorized to address a significant inventory of inadequate or substandard military housing units. The Military Housing Privatization Initiative (MHPI) leveraged private-sector capital coupled with the private sector's expertise in construction and management to reverse this military housing deficiency. Although viewed as a success, the MHPI did experience situations involving significant performance and quality issues. Several situations in 2007 prompted U.S. Senators Saxby Chambliss (R-GA) and Bill Nelson (D-FL) to express to the Secretary of Navy the need for better accountability on military housing privatization projects, including the need for better diligence in vetting project bidders.

Subsequently, in 2008, Congress included in the National Defense Authorization Act for Fiscal Year 2009, which is now codified at 10 U.S.C. § 2885, "Oversight and accountability for privatization projects," mandating surety bonding levels for military housing privatization projects.

Case Examples: P3 failures & federally backed loans

A successful P3 arrangement depends on the proper selection of a partner by the government, preferably one with a strong past performance history and a robust balance sheet. The Indiana I-69 P3 offers an excellent case study concerning why surety bonds should be included at 100% of the estimated construction amount of the project. Delays by the private entity, Isolux, an international company based in Spain, resulted in subcontractors and suppliers being left unpaid for more than nine months.[1]

Because Indiana's Little Miller Act did not mandate that surety bonds be in place for Section 5 of the I-69 P3 agreement, (owing to the fact the Little Miller Act did not specifically address the P3 procurement method), the Indiana Finance Authority chose to accept partial bonds, of a 5% payment bond and a 25% performance bond from Isolux. Of the $325 million construction cost for Section 5, the payment bond secured payment protection of just $16.25 million for subcontractors and suppliers, while the taxpayers of Indiana were protected only in the amount of $81.25 million by the performance bond.[2]

Indiana is not the first P3 in the country to face financial difficulty. The state of California and Texas partnered with Cintra, a Spanish firm, to develop and operate toll roads for San Diego's South Bay Expressway and Texas State Road SH 130. Cintra was able to secure a $438 million Transportation Infrastructure Finance and Innovation Act (TIFIA) loan[3] for the SH 130 P3 project. TIFIA funds also were furnished for the San Diego South Bay Expressway P3, in which the private operator went bankrupt costing the taxpayers of California $80 million.[4]

1. Tuohy, J. (2016, April 15). *INDOT Tells I-69 Contractor to Pay Bills.*
2. Cerney, B. (2016, October 5). *I-69, and Surety Bonds*
3. Hall, T. (2014, June 21). *The Real Story Behind Cintra Nearing Bankruptcy on SH 130.*
4. Hall, T. (2014, June 21)

States & Bonding P3s

The federal government, all states, and many municipalities recognize the value of surety bonds and have required and relied on bonding in public works projects for over a century. According to the National Conference of State Legislatures (NCSL), as of June 2017, 39 states, the District of Columbia and Puerto Rico have enabling laws for P3s.[5] Enabling legislation establishes a framework from the public and private sectors can operate to ensure the interests and goals of the public sector are met. While examples exist of P3s in jurisdictions without state-level enabling authority, these are the exceptions, not the rule.

Over the past several years, there has been a great deal of activity at both the state and most recently, the federal level where lawmakers are considering legislation to arrange financing for infrastructure projects using investments from private entities. More importantly, state lawmakers have recognized the need to require payment bonds to protect subcontractors and suppliers and performance bonds to protect taxpayer funds. As depicted in the chart, since 2012, legislation has been enacted in sixteen states to require bonds on P3 agreements.

5. Rall, J., Reed, J. B., & Farber, N. J. (n.d.). *P3 Infrastructure Delivery: Principles for State Legislatures*

State Enacted P3 Laws

As of June 1, 2018

State	Summary of P3 Statute
Arkansas	Authorizes P3 for public infrastructure projects. For the components of the qualifying project that involve construction, provisions for the: Delivery of maintenance, payment, and performance bonds in the amounts that may be specified by the responsible public entity in the comprehensive agreement. Ark. Code Ann. §§ 22-10-101-505
California	Allows the use of P3s for public building infrastructure projects to require performance and payment bonds. Cal. Gov. Code § 5975 to 5979
District of Columbia	Authorizes P3s for education, transportation, and cultural or recreational facilities, buildings or other facilities that are beneficial to the public interest and are developed or operated by or for a public entity, utility facilities, improvements necessary or desirable to any unimproved District-owned real estate, and any other facility that the District approves. D.C. Code, Title 2, Chapter 2a
Florida	Authorizes counties, municipalities, school board or other local governmental entities to enter into P3s for public facilities. Fla. Stat. § 255.065
Georgia	Authorizes the use of P3s for the state and local governments for any project, except for generation of electric energy for sale, communications services, cable and video services, or water reservoir contracts. Ga. Code Ann. §§ 36-91-110 to 119; §§ 50-5C-1 to 10
Illinois	Enacted a law authorizing a P3 for the development of the South Suburban Airport. The P3 agreement may provide for the delivery of performance and payment bonds or other performance security in a form and amount that is satisfactory to the Department of Transportation.
Kansas	Authorizes the state to utilize Public-private partnerships for public construction projects. A performance bond and payment bond in amounts equal to the full contract amount are required for contracts over $100,000. Kan. Stat. Ann §16-19
Kentucky	Creates a new section under Kentucky Revised Statutes Chapter 65 Summary: Authorizes local governments to enter into public-private partnership agreements for capital projects. KRS §§ 154.15-010 to 154.15-030.
Louisiana	Authorizes the Department of Transportation and Development to enter into contracts for P3 projects for transportation facilities. La. Rev. Stat. Ann. § 48:250.4
Maine	Authorizes the Maine Department of Transportation (DOT) to enter into an agreement with a private entity for the building, operation, ownership, leasing or financing of a transportation facility. Me. Rev. Stat. Ann. Title 23, § 4251
Maryland	Authorizes state agencies to enter into a P3 for public infrastructure projects. Md. Code Ann., State Fin. & Proc. § 10A-101 to 401
New Hampshire	Authorizes the Commissioner of the State's Department of Transportation (DOT) to enter into certain types of contracts with private entities for transportation infrastructure projects, and establishes a public-private partnership transportation infrastructure oversight commission to recommend and advise on requests for P3 proposals. N.H. Rev. Stat. Ann. § 228:107
North Carolina	Enacted a law that creates uniform standards for the design-build and P3 delivery methods of public works projects to state and local government contracting entities. The law permits the State and all local government units to use the design-build and P3 methods for public works projects. N.C. Gen. Stat. § 44A-26
Oklahoma	Authorizes local governments to enter into public-private partnerships for the improvement of real property and associated services provided for a public purpose. Okla. Stat. tit. 74 §§ 5151-5157
Ohio	Authorizes the Ohio DOT to enter into agreements with private entities, including the use of P3s. Ohio Rev. Code Ann. § 5501.71
Tennessee	Authorizes Tennessee counties and municipalities to enter into P3 agreements for transportation facilities. These contracts must include performance and payment bonds as required by the applicable Little Miller Act. Tenn. Code Ann. §§ 54-23-110

For detailed information regarding state bonding requirements relating to P3 agreements, please contact NASBP.

Policy Recommendations

Although procurement methods have evolved—including the increased use of P3s—construction risks remain the same, making surety bonds just as relevant and important in these new contexts. Bonding is an indicia of qualifications and a critical means of risk transfer that protects taxpayer and investor dollars and supports economic empowerment, sustainability, and job creation for contractors and subcontractors. Given the substantial amount of federal funding already involved in the limited number of P3s that have been conducted to date in the United States, it is all the more important to require statutory bonding for the design and construction portion of P3s going forward. Statutory bond requirements will help ensure that contractors are qualified to perform and that payments to subcontractors and suppliers are preserved, as these critical protections are just as relevant on P3 infrastructure projects as on traditional public works projects.