

## Better dispute resolution for PPPs

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Privately financed Public Private Partnership (PPP) transactions raise some unique dispute resolution challenges, because of the contractual structure adopted to enable the use of limited recourse debt finance. This article unpacks some of the challenges before suggesting some solutions.

### The basic PPP structure

Most investors in PPPs wish to limit their financial exposure in respect of the project to the equity they invest. To achieve this outcome they establish a Special Purpose Vehicle (typically referred to as the SPV, the Project Company or PPP Co) to:

- enter into the PPP contract with the government agency and hold the right to generate revenue from the project via a service payment from the government agency or the right to directly charge users of the project asset; and
- based on the projected project revenues, raise the equity and debt finance needed to finance the design and construction of the project on a 'limited recourse' basis (meaning the debt financiers can look only to the SPV and its assets for repayment of the debt, and not to equity investors or any of their other assets)

The SPV then subcontracts its obligations to design, construct, operate and maintain the asset, typically to:

- a Design and Construct (D&C) subcontractor pursuant to a fixed price D&C contract; and
- an Operation and Maintenance (O&M) subcontractor pursuant to a largely fixed price O&M contract.

These two subcontracts are commonly called the "tier 1 subcontracts", and the relevant contractors are called the "tier 1 subcontractors". Each tier 1 subcontractor will commonly subcontract some of its obligations to tier 2 subcontractors who, in turn may subcontract various obligations to tier 3 subcontractors, and so on.

The terms of the tier 1 subcontracts are typically back-to-back with the corresponding terms of the PPP contract, as the SPV seeks to:

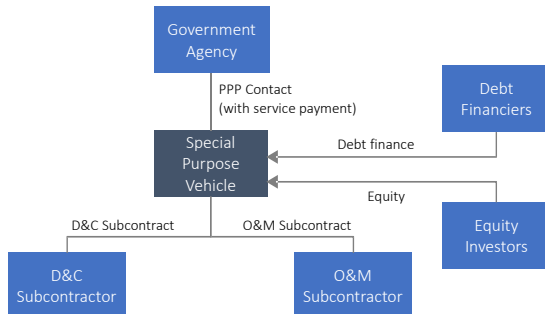
- transfer all its obligations and risks in relation to the design and construction, or the operation and maintenance, of the asset to the D&C subcontractor and the O&M subcontractor respectively; and
- minimise the amount of risk retained by the SPV and, hence, borne by the SPV's equity investors and debt financiers.

This basic contractual structure is shown in the diagrams below, firstly for a service payment PPP and secondly for a user charge PPP. The only difference between the two is the source of the project revenues that are used to pay the O&M costs, repay the debt (with interest), and provide a return to the equity investors. In the first case, that revenue stream takes the form of the service payment from the government agency. In the second case, it takes the form of user charges paid by users of the asset.

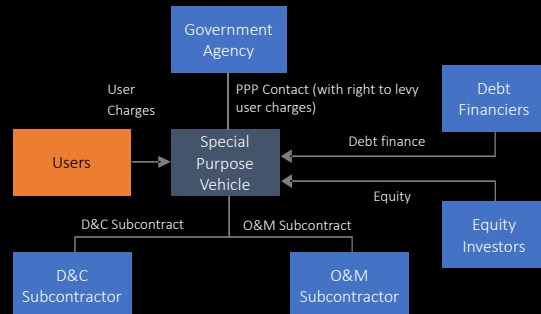
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<sup>1</sup> The views expressed in this article are the authors, and not those of their current or previous employers

Service payment PPP



User-charge PPP



### The dispute resolution challenges

From a dispute resolution perspective, the basic PPP structure gives rise to the following possibilities:

- Disputes can arise under one or more of the contracts in the arrangement.** For example, disputes commonly arise between the D&C subcontractor and the SPV in relation to the claims by the D&C subcontractor for extra time and/or extra money. Likewise, disputes can arise between the O&M subcontractor and the SPV in relation to the performance of their respective obligations under the O&M subcontract.

In each case, the dispute may be triggered by, or give rise to, a corresponding dispute between the SPV and the government agency under the PPP contract. For example, the SPV may have rejected the D&C subcontractor's claim for extra time or extra money because the government agency rejected the corresponding upstream claim submitted by the SPV to the government agency under the PPP contract. Where a claim or dispute under the PPP contract corresponds with a claim or dispute under a tier 1 subcontract (or vice versa), it is commonly called a "linked claim or dispute" or a "pass-through claim or dispute".

Alternatively, a claim or dispute under a tier 1 subcontract may not be triggered by, or give rise to, a corresponding claim or dispute under the PPP contract (and vice versa) because the claim or dispute arises out of contractual provisions or circumstances that are unique to one level of the contracting structure only. For example, the D&C subcontractor's right to claim monthly progress payments under the D&C subcontract is rarely replicated in the PPP contract. D&C subcontractors sometimes deliberately make claims that are unique to the SPV to avoid the procedure in the D&C subcontract that applies to "linked claims" (discussed below). Many SPVs fail to fully appreciate their own distinct obligations to their subcontractors or the government agency, increasing their exposure to claims that cannot be passed through.

Disputes can also arise between PPP participants that fall outside the contractual dispute resolution provisions. For example, the misleading and deceptive conduct claim that was made by the D&C subcontractor against Transport for NSW on the Sydney CBD light rail project was not caught by the contractual dispute resolution process under either the D&C Subcontract or the PPP contract.

Finally, if the tier 1 subcontractor has further subcontracted its obligations, then a linked claim or dispute may be linked at more than two levels of the contracting structure.

- **Each contract will typically have its own dispute resolution procedure.** For Australian PPP projects, the dispute resolution procedure under the PPP contract typically involves:
  - firstly, CEO negotiations;
  - secondly, expert determination, for specified disputes for which expert determination has been deemed suitable; and
  - thirdly, final and binding arbitration:
    - for those remaining disputes for which expert determination was not deemed suitable; and
    - for disputes that have been referred to expert determination, if either party is dissatisfied with the expert's determination.

While it is common for the tier 1 subcontracts to adopt identical dispute resolution procedures, this will still result in parallel dispute resolution processes under each contract, unless the contracts provide for the consolidation of parallel dispute processes.

By way of example, a linked dispute concerning the D&C subcontractor's entitlement to extra money for additional costs arising from a compensation event will, in the first instance result in:

- negotiations between the D&C subcontractor's CEO and the SPV's CEO; and
- parallel negotiations between the SPV's CEO and the head of the government agency,

unless the two parallel negotiation processes are consolidated into a single three-party negotiation process. If the PPP contract and D&C subcontract do not provide for automatic consolidation of parallel dispute resolution processes (as is typically the case), then consolidation can only occur with the agreement of all three parties.

The same applies to parallel expert determination processes, and parallel arbitration proceedings. The authors are not aware of any Australian PPP project that has provided for automatic consolidation of parallel dispute resolution processes for linked claims and disputes.

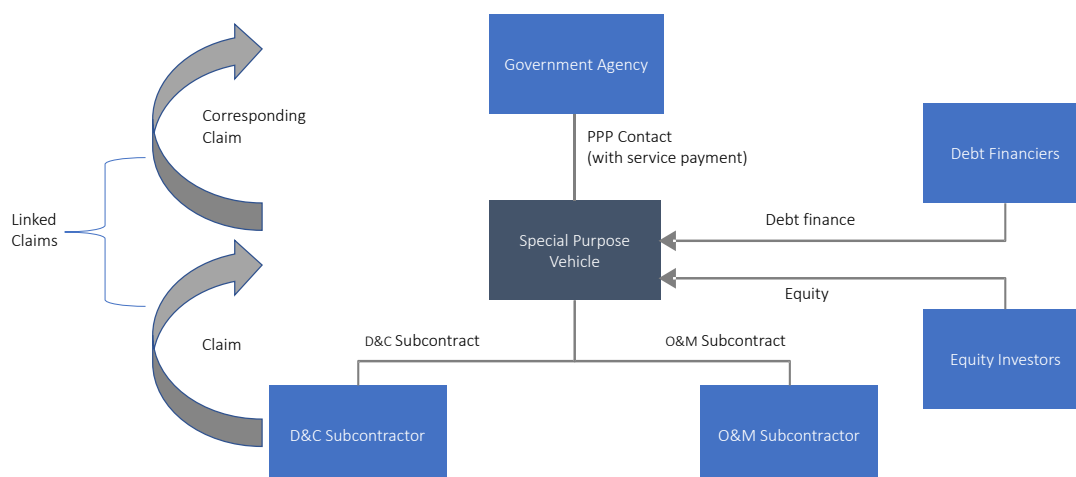
- **The possibility of parallel dispute resolution processes creates the risk of different outcomes.** For example, any agreement reached between the D&C subcontractor's CEO and the SPV's CEO, may differ from what's agreed between the SPV's CEO and the head of the government agency (although the SPV's CEO is in a position to avoid such an outcome).

If the disputes proceed to expert determination or arbitration, the expert or arbitrator appointed to determine the dispute under the PPP contract may reach a different decision

to the expert or arbitrator appointed to determine the dispute under the D&C subcontract. Even if the same person is appointed as expert or arbitrator under both contracts, he or she may still arrive at different decisions due to differences in the arguments or the evidence presented in each proceeding. Further, even if the decision at both levels is consistent, the awards in each proceeding in relation to costs may differ.

The possibility of different outcomes creates a significant risk for the SPV, as it may find that its liability to the D&C subcontractor exceeds what it is entitled to recover from the government agency, or vice versa, giving rise to a ‘liability gap’. This, in turn, exposes the SPV’s equity investors and debt financiers to significant risk. If the SPV doesn’t have sufficient equity reserves to fund the liability gap, its equity investors will need to provide additional equity (above what they previously committed). If the SPV is unable to obtain additional equity for its investors, it may have insufficient funding to fulfil all its liabilities rendering it insolvent. This can also spell disaster for the debt financiers, especially if the SPV becomes insolvent during the construction process.

- **The SPV can typically only settle a dispute with the consent of its debt financiers.** The loan facility agreement will typically contain an undertaking from the SPV that it will notify the debt financiers of all material disputes under the project agreements, and that it will not settle any material dispute without first obtaining the consent of the debt financiers.



### The traditional response: linked claim and equivalent project relief provisions

Australian PPPs have traditionally sought to address these challenges, and minimise the ‘liability gap’ risk, by including linked claim and equivalent project relief provisions in the tier 1 subcontracts. These provisions generally provide that:

- the SPV, upon receiving a claim from the tier 1 subcontractor under the subcontract, must diligently pursue any corresponding claim the SPV has against the government agency under the upstream PPP contract including, if the government agency rejects the claim, by seeking to resolve the upstream dispute in accordance with the dispute resolution procedure in the PPP contract (the **linked claim clause**);

- the tier 1 subcontractor's right to progress and resolve the downstream dispute in accordance with the dispute resolution procedure in the subcontract will be suspended while the corresponding upstream dispute is being progressed in accordance with the dispute resolution procedure in the PPP contract (the **suspension clause**);
- the tier 1 subcontractor accepts that it will be bound by the outcome of the upstream dispute resolution process and that its entitlements under the subcontract in respect of the downstream dispute will not exceed the SPV's corresponding entitlement under the upstream PPP contract (the **equivalent project relief clause**);
- the tier 1 subcontractor must indemnify the SPV for the costs of pursuing the upstream claim, provided the SPV does so as directed by the subcontractor; and
- if the SPV fails to diligently pursue the corresponding claim, the suspension clause will cease to apply, and the tier 1 subcontractor will become entitled to progress its claim through the downstream dispute resolution process.

However, these provisions have some weaknesses, as highlighted by the court decision in *Transurban WGT Co Pty Ltd v CPB Contractors Pty Ltd* [2020] VSC 476, including:

- the likelihood that the equivalent project relief clause will offend the prohibition in Australia's security of payment legislation against 'pay-when-paid' clauses, and therefore leave the SPV and its equity investors and debt financiers exposed to the liability gap risk; and
- the possibility that some claims against the SPV may be unique to one level of the contracting structure only, and therefore fall outside the linked claim and equivalent project relief regime.

For further detail on these weaknesses, see Owen's earlier article titled "Linked Claims and Equivalent Project Relief Clauses", a link to which is provided at the end of this article.

### **Better solution #1 - dispute avoidance**

The usual multi-tiered dispute resolution procedure contained in most Australian PPP contracts is reactive in nature - it sets out the process that the parties will follow *after* a dispute has been formally notified, and doesn't help the parties to pro-actively avoid disputes. As such, it misses a significant opportunity. The NSW Government has, on several of its more recent PPP projects, sought to address this by incorporating a dispute avoidance board into the project's dispute resolution process. Dispute avoidance boards (also known as dispute resolution boards, dispute advisory boards or dispute boards) have proven to be highly effective in avoiding disputes (as well as resolving them), as detailed in the second article linked at the end of this article.

However, those NSW PPP projects that have utilised a dispute board have either:

- only done so at the PPP contract level, and not at the tier 1 subcontract level; or
- created separate dispute avoidance boards at both levels.

Both approaches are sub-optimal.

The first approach is sub-optimal because:

- it doesn't give the tier 1 subcontractor the right to participate in dispute board meetings, or to refer a matter to the dispute board for a decision. Rather, the participation of the subcontractor in the process is either:

- at the discretion of the government agency only, if the PPP contract includes provisions that require the SPV to procure the attendance of its tier 1 contractors at dispute board meeting if requested by government agency, or
- conditional upon both the government agency and the SPV agreeing to permit this; and
- the ability of the dispute board to provide a written decision that is binding on the tier 1 subcontractor is dependent upon the legal effectiveness of the linked claim and equivalent project relief regime.

The second approach is sub-optimal because:

- parallel processes expose the SPV to the risk of different outcomes, even if the members of each dispute board are the same, for the reasons explained above;
- consolidation of the two dispute board processes can only occur with the agreement of all 4 parties (where the 3 dispute board members are, together, the fourth party);
- parallel processes will be more expensive to maintain, especially for the SPV.

Those NSW PPP projects that have utilised a dispute board have also failed to give the SPV the right to have its debt financiers attend the dispute board meetings as an observer. This impairs the ability of the SPV to amicably resolve issues at dispute board meetings, because of the need for the SPV to first obtain the consent of its debt financiers to any settlements. The attendance of the debt financiers at the dispute board meetings avoids the need for the SPV to separately brief them, and enables the SPV to obtain their consent in real time. The debt financier may also encourage their borrower to amicably resolve emerging issues in light of what they learn by participating in these meetings.

Finally, those NSW PPP projects that have utilised a dispute board have generally failed to extend its scope to the avoidance and resolution of disputes under the O&M subcontract and/or the Interface Agreement between the D&C and O&M subcontractors. Even if the term of the dispute board is limited to the design and construction phase of the PPP project and doesn't extend beyond the defect correction period under the D&C subcontract, it is possible that claims and disputes arising out of this phase will also involve the O&M subcontractor (for example, if the dispute arises out of the commissioning activities).

Accordingly, it is recommended for future PPPs that:

- a single dispute board is convened to assist the government agency, the SPV, the D&C subcontractor and the O&M subcontractor to avoid and resolve claims and disputes arising out of:
  - the PPP contract;
  - the D&C subcontract;
  - the O&M subcontract; and
  - the D&C/O&M interface agreement;
- the dispute board is established under a single dispute board agreement (or better still, for the reasons described in the next section, an “umbrella” agreement) between the government agency, the SPV, the D&C subcontractor, the O&M subcontractor and the dispute board members;
- the term of the dispute board agreement expires shortly after the issue of the final payment certificate under the D&C subcontract (following the expiry of the defects liability period); and

- the government agency, the SPV and the O&M subcontractor engage the dispute board members under a new dispute board agreement should they wish the dispute board to continue during the O&M phase of the PPP.

Depending on the materiality of any tier 2 subcontracts, there may be merit in extending the single dispute board arrangement to also cover one or more these contracts. But the additional complexity associated with doing so could outweigh the benefits.

It is also possible to attempt to extend the dispute board arrangement to cover:

- disputes between the SPV and its debt financiers arising out of the debt financing documents; and/or
- disputes between the SPV and its equity investors, or between equity investors, arising out of the equity documents; and/or
- if the D&C subcontractor or the O&M subcontractors is a joint venture, disputes between the joint venture members arising out of the joint venture agreements.

However, the authors do not recommend doing so because:

- we expect it will prove difficult to convince the debt financiers to adopt this approach in lieu of their traditional approach to the resolution of disputes under the debt financing documents;
- the dispute board may require additional skill sets to resolve disputes under the debt financing document or equity documents;
- the SPV, the debt financiers, the equity investors and/or the joint venture members may prefer to keep the above-mentioned disputes private; and
- we doubt the additional benefits would be worth the effort.

## **Better solution #2 – consolidation of proceedings**

As mentioned above, parallel dispute processes create significant liability gap risk for the SPV and, in turn, its equity investors and debt financiers. While the use of linked claim and equivalent project relief provisions in tier 1 subcontracts reduces this risk, these provisions, as traditionally drafted in Australia, have weaknesses. Accordingly, a better approach would be to draft each of the PPP contract, the D&C subcontract, the O&M subcontract, and the D&C/O&M interface agreement to provide for the mandatory consolidation of any parallel dispute resolution processes arising out of linked claims, unless all relevant parties to the dispute agree otherwise. Indeed, an umbrella agreement to which each of these documents refers could be the most efficient way to document:

- the dispute resolution process that will apply under each contract;
- the consolidation of any parallel dispute resolution processes; and
- the establishment of a single dispute board that operates across these contracts.

Accordingly, any parallel expert determination processes, and any parallel arbitration processes, would be combined into a single process, unless all relevant parties to the dispute agree otherwise.

This approach would:

- avoid the need to use linked claim and equivalent project relief clauses (with their associated weaknesses)

- allow the tier 1 subcontractors to participate directly in the process, rather than have the SPV represent their interests;
- allow the SPV to represent its own unique interests, rather than the interests of its tier 1 subcontractor(s); and
- better facilitate the amicable resolution of claims, given all relevant parties will be participating directly in the process.

Many of the institutional arbitration rules, including those published by ACICA, have recently been revised to make consolidation of arbitrations easier. Australian Commercial Arbitration Acts have also recently been amended to promote the consolidation of related proceedings.

## Conclusion

Traditional dispute resolution arrangements for Australian PPP projects have weaknesses. These weaknesses are particularly problematic for the SPV because they expose the SPV to liability gap risk. Equity investors and project financiers are increasingly becoming aware of this risk because of the disputes that are currently in play on some Australian PPP projects. We expect that equity investors and debt financiers will increasingly demand a better response to this risk in the dispute resolution arrangements agreed between the relevant parties in the PPP contracts, including greater use of integrated dispute avoidance techniques and the consolidation of parallel dispute processes.

*You may also be interested in:*

- [Linked Claims and Equivalent Project Relief Clauses](#)
- [Want to avoid construction disputes, delays and cost overruns? Use a Dispute Board!](#)
- [Lessons Learned: The Use of Dispute Boards on a Public Private Partnership Project](#)