Private parties in public construction projects

Sponsored column

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SOUTH African public construction projects are increasingly being funded by private entities by way of Private-Public Partnerships (PPPs).

PPPs are provided for in both national and municipal legislation, and can be defined as a contract between an organ of state and a private party which performs an institutional function or uses state property, and in which the private party assumes substantial financial, technical and operational risks in the design, financing, building and operation of a public project.

In exchange for this risk, the private party enjoys the benefit of generating income through fees from the organ of state or private persons utilising the services provided by the project.

Typical examples of PPP projects are where a national or municipal organ of state identifies the need, in upholding its Constitutional obligations, to develop infrastructure projects and stimulate the economy, but does not have a budget sufficient to undertake the project.

It is here that a PPP will step in to provide the finance and design, building and operational skills required for the project.

The private party will form a special purpose vehicle (SPV) to implement the project. This SPV will usually be a company or trust and limits the liability of the PPP.

Financiers then lend money to the SPV which in turn will engage contractors and subcontractors to execute the project.

The SPV will generate revenue from the project once completed and will service its debts from that revenue.

While PPPs provide an excellent opportunity for the growth of emerging private enterprises, the private party must be mindful of the risks it assumes when becoming involved in such projects, particularly with regards to project financing.

The inherent risks for the financiers are overrunning budgeted costs, projects not being completed timeously (or at all), and the danger of poor quality or defective construction work being executed, leading to remedial costs.

To be effective and profitable, a PPP must ensure proper risk allocation.

For example, good management of the obligations imposed by the public party, the choice of either a lump sum or re-measurable construction contract, and the various dates or phases of completion must be realistic to prevent delays and the resulting increased costs.

It is therefore crucially important for the proper contractual framework to be in place between the PPP, the SPV, the organ of state and its contractors to ensure that all parties are aware of and comply with their obligations.

PPP projects benefit society by developing infrastructure and stimulating the economy. Provided that risk is properly managed through the PPP's participation in contract administration, these projects will continue to benefit both the private and public sector, and fill the void often left open by budgetary constraints.

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