Our infrastructure contracts: from the ideal project to the bankable project

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There is currently much debate about what is the “best” infrastructure project delivery method. Design-build-finance-maintain? Collaborative model? Alliancing? Another way? Even though the labels may change, one underlying reality remains: The structure best suited to financing, whether private or public, stands the best chance of success.

After exploring the reasons why infrastructure financing needs to be modernized and reviewing emerging models, our series is finally getting to the heart of the matter: the contractual framework and risk allocation. This is where a project transitions from just a vision to reality.

That is because, while risk allocation may be viewed differently by various stakeholders, the requirements of the financier or public authority are what ultimately dictate a project's success or failure. Stakeholders would therefore be well advised to keep this in mind right from the design phase.

The bankability of a project, that is, whether it can actually be financed on acceptable terms, is a matter of contractual discipline aimed at stabilizing costs and revenues, making risks manageable and establishing a management structure that can deal with deviations without letting the project spiral out of control. Put another way, a project is financed risk by risk, each one (supply, construction, operation, or refinancing) must be assessed, mitigated and contractually assigned to the party best positioned to manage it. The same principles apply whether the goal is to secure bank financing or simply stay within a public budget. Given the length of this article, we can only provide a brief overview of these principles.

Project financing in short: special purpose vehicle, financial model and off-balance-sheet

The most common structure, especially in public-private partnerships (PPPs), is a special purpose

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vehicle (SPV), which, depending on the type of project, is an entity created to contract with the public authority, own the future infrastructure and carry the debt. This entity raises equity capital from developers, builders, operators and investment funds, and debt capital from banks, bond investors and development finance institutions. In limited-recourse project financing, the purpose of an SPV is the resulting compartmentalization: lenders are repaid from the project's cash flows, without a security interest (or with a limited security interest) in the shareholders' assets. The idea is not new. A famous predecessor is the Suez Canal Company, a joint-stock company founded in 1858 to carry out a single project by raising capital based solely on the project's potential.[1] What has changed is the financial model underpinning the transaction: It has become far more sophisticated. It is now a complex labyrinth of Excel sheets, with a continuous thread of cash flows under the firm control of the lenders, with all project documentation bringing the model to fruition within a coherent, "closed system." The model thus dictates how rigorously due diligence is conducted, how cash flow allocation is prioritized (operations, reserves, debt service and distributions), and how strictly dividends are capped as long as safety margins are not met.

This financing structure is not the only possible option. For example, for smaller projects or less liquid markets, we often see full-recourse corporate financing. Here, SPVs backed by corporate guarantees facilitate closing when pure non-recourse financing is out of reach, but the result is that project compartmentalization is reduced and shareholders face more exposure. No matter which model is available or chosen, the project owner and developer must be as disciplined as a lender, even if no financier needs to be brought on board. A project carried out and paid for with public funds must be just as thorough as a private one: A budget must be kept and value for money achieved through the same assessment of risks and the same search for the party best placed to assume them.[2] Even when no funds are sought from a bank, a banker's perspective is still indispensable.

Bankable income

The risk differential is considerable between a model with contractually secured or regulated revenues and one left to the mercy of fluctuations in demand, prices or government decisions. A project's risk profile will ultimately dictate interest rates, acceptable debt levels and even whether the project can achieve financial close. The solutions depend on the type of project. Examples include pricing regulated by a credible regulator for a transport project; long-term purchase agreements at a fixed price or a price linked to raw materials in the energy or petrochemical sectors; or availability payments in PPPs, where compensation is based on the provision of services under the contract rather than on the number of users. Of course, much civil infrastructure generates no income from users, instead, the public authority compensates the operator for availability. In all cases, the cash flow must be predictable and viable, but the payment mechanism must be enforceable and within the financial capacity of the final paying party.

While availability payments in a PPP shift demand risk, they also concentrate revenues with a single public authority, and that authority's creditworthiness will dictate whether other guarantees, such as budgetary safeguards and dedicated payment mechanisms, are required. A toll project is bankable if traffic assumptions are conservative, toll rates are adjustable and social acceptability is addressed in advance. In addition, predictable revenues at a rate that covers debt service open the door to signing a credible—and therefore bankable—operating contract. In an industrial project, a solid offtake agreement must substantiate the financial model's projections, and when a cost cannot be fixed in advance, it must be linked to the revenues it drives, through indexation or cost pass-through, so that the two vary in tandem rather than in opposite directions.

Assessing, mitigating and allocating risks

The essential preliminary step before drafting any contract is to identify risks, evaluate their probability and impact, and determine appropriate mitigation measures for each. Only then can the

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contractual framework be established, allocating each residual risk to the party best suited to assume it. Debt financing is only available for risks that have been identified, quantified, and allocated. This is why lenders demand consistency: If the SPV guarantees a service standard to the public authority, it must be able to “procure” this exact standard from its contractors. Otherwise, the SPV will retain the risk and the project will become difficult to finance.

Construction provides the most compelling illustration of this principle. To establish the price of a project, a market-tested cost estimate is conducted (ideally through real bids), and then a fixed-price, fixed-deadline turnkey EPC contract is concluded. Lenders favour this specific structure precisely because it establishes the cost of completion. The contractor includes a margin for its own contingencies, which represents the price of certainty. Any residual default risks are covered by performance bonds to ensure project completion if the contractor falters, letters of credit guaranteeing the reimbursement of advance payments, payment holdbacks and late penalties. These mechanisms ensure that, whatever happens, the project will be delivered on budget, in compliance with the financial model.

However, even though we prefer fixed-price EPCs, they are not used across the board. In Quebec and Ontario, more flexible procurement is often used, such as EPCM, alliancing and progressive design-build, where the contractor is engaged early in the process but the price is not locked in from the outset. A target price is established during the draft-design phase, featuring a risk-and-reward sharing mechanism for overruns and savings, typically capped, to align interests without placing the entire risk burden on one party.[3] However, the golden rule of finance still holds true: the less certain the price, the greater the uncertainty, leading the lender to require higher equity, completion guarantees or shareholder support—driving up financing costs to account for the risk.

The contract must be structured for the long term, as infrastructure projects are financed over decades in a changing world. Legislative changes, superior force, climate and geotechnical hazards must all be anticipated to prevent an external event from triggering a default. In addition, lenders are often granted step-in rights through direct agreements with the public authority, allowing them to take back control should the contractor default on its obligations, thereby avoiding termination and ensuring service continuity. When they are well-designed and have precise triggers and realistic remediation deadlines, such mechanisms also serve the public interest by providing a window for corrective action before the government has to step in.

Capitalization and leverage

The level of financial leverage and the quality of the SPV’s capitalization are direct determinants of bankability. Shareholders often have an interest in maximizing debt, as it is generally less expensive than equity and increases returns. The lenders, for their part, want an SPV that is sufficiently capitalized to absorb shocks and maintain incentive alignment. If the equity portion is marginal, financial close is often more difficult and contractual protection requirements may increase. Should the economic balance deteriorate, an operator with limited financial exposure may prefer to withdraw rather than incur prolonged losses, leaving the public authority facing a forced renegotiation. Minimum equity requirements, combined with restrictions on the sale of shares prior to commissioning and a stabilization period, are specifically designed to avoid such misalignment.

Lastly, when a public authority awards a contract before financing is fully committed, the interval between the award and financial close exposes it to renegotiation pressure, because lenders will impose conditions precedent as they finalize their due diligence. To mitigate this risk, the public authority will adopt a banker’s perspective by including credibility requirements for the financing plan right from the tender stage. Where appropriate, it will also incorporate incentive or disciplinary mechanisms, such as bid bonds, more advanced financing commitments, optional pre-arranged financing. Over time, bankability requires that the contract cover the allocation of refinancing risk and the allocation of refinancing gains, if any, so as to avoid difficult future negotiations on value for

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money.

The mechanics of public intervention

Public intervention is compatible with the market, provided that it is intended to remove specific barriers rather than replacing the market. A public subsidy or loan can fill a viability gap, offset the lack of long-term maturities or mitigate an excessive risk premium. Partial guarantees and credit enhancement, which allow an institutional guarantor to cover a portion of the default risk, help to make private commercial debt available at a lower cost. Other financing structures can go even further. The public authority can waive most of its defences against the lenders once the work has been completed and accepted. This is called “debt assignment,” a typical example being forfaiting, a well-known mechanism used in European PPPs. The public authority’s debt thereby becomes almost unconditional and can be transferred to the banks, which no longer carry project risk, but instead take on direct exposure to the public authority. This drives financing costs down. Of course, the intent is never to use public funds to serve private interests or to manage them any less rigorously. Ultimately, any commitment of public funds calls for the exact same discipline in risk management and contractual structuring.

Conclusion

We can all dream of a better world, but we need to give ourselves the means to build it. Private financing comes at a cost, and that cost justifies the discipline it forces on a project. A non-recourse lender only signs off on what they have assessed, quantified and mitigated, and such an exacting approach benefits the entire project. Whether a banker is involved or not, structuring contracts in this way is the best guarantee of success.

Sir William Cornelius Van Horne, who directed the construction of the Canadian Pacific Transcontinental Railway, completed in 1885 in less than half the planned time, is quoted as saying “It has always been a profound belief of mine that the things which people regard as next to impossible are the easiest things to do”.[4] Yet the man was anything but a dreamer. He knew that the subsidies, in money and land, would only be paid as railway sections were completed, inspected and commissioned, and he was known for his iron discipline in payment sequencing and the choice of contracting partners. Still today, such a rigorous approach is what turns a project that exists only on paper into one that is actually built.

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