

Lessons for project finance and public-private partnership

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Read with the eyes of a modern transaction lawyer, the Gotthard contains almost every element of a present-day infrastructure financing. There was a special-purpose company, the Gotthardbahn-Gesellschaft, created for a single asset and holding a concession. There were sponsors, the cantons and railway companies of the Gotthard association, which had developed the project and contributed part of the equity-like subsidies. There were public grantors, the three states, whose contributions took the form of non-repayable capital grants tied to milestones and subject to monitoring. The capital structure consisted of shares and secured bonds placed through an international underwriting syndicate. The construction contract for the critical element, the summit tunnel, was a fixed-price agreement with a completion date, liquidated damages and a security deposit. The international treaty that sat above the whole structure regulated tariffs and reserved the host state's sovereign rights. The only element that the Gotthard lacked was the one that modern project finance considers indispensable: a robust contingency arrangement for cost overruns.

The first lesson concerns estimates. The figure of 187 million francs had been adopted at a stage at which the detailed design of the ramps did not yet exist and when the geology of the tunnel was largely unknown. The subsidies, the share capital and the bond issue were all dimensioned on this figure. When it turned out to be about 55 per cent too low, the structure had no room to absorb the difference. Experience with large tunnels and bridges since then suggests that overruns of this order are common in such projects, whose planners tend to underestimate geological and design risks. Lenders therefore require independent technical review of the estimates, contingency reserves, standby facilities and sponsor support undertakings for cost overruns. Each of these instruments responds to the kind of situation in which the Gotthard company found itself in 1876.

The second lesson concerns the allocation of risk between public and private parties. The treaty of 1869 fixed the public contribution and left the rest to the private side. In theory this allocation placed the risk of overruns on the shareholders and bondholders. In practice the states could not let the project fail, because they had already paid large sums, because the tunnel was half built and because a failure would have damaged their political credibility. When the crisis came, the risk returned to the public side, which provided another 28 million francs of subsidies against 12 million francs of new private money. This pattern, in which a formally private risk becomes a public one when the stakes are high enough, recurs in many modern public-private partnerships. It is one of the reasons why governments and lenders today negotiate detailed termination and compensation clauses in advance, so that the consequences of failure are known before it happens.

The third lesson concerns governance. The Gotthard company was dominated by a single personality who was at the same time its president, the head of its construction department, the chairman of its lead bank and a leading member of the parliament that had to approve its subsidies. This concentration allowed the project to be launched at all, since only Escher had the authority to bring together three governments and three banking groups. It also meant that there was no independent check on the estimates and no one with the authority to raise the alarm early. Modern project governance separates these roles through independent engineers, lenders' technical advisers, audit committees and rules on conflicts of interest. The Swiss rules on the independence of directors and on the disclosure of related-party transactions, which apply today to listed companies and banks, have many sources. The Gotthard experience is one of the older ones.

The fourth lesson concerns the relation between contractual risk transfer and the capacity to bear risk. Favre's contract transferred the risk of delay to the contractor through heavy daily penalties. Since the contractor could not bear that risk, his bankruptcy left the company with the unfinished work. Modern lenders assess the creditworthiness of contractors, require parent company guarantees, performance bonds from banks and insurers, and caps on liquidated damages that correspond to the contractor's capacity. They also recognise that a contract which drives the contractor into insolvency harms the project as much as the contractor. The Gotthard contract illustrates, finally, how a harsh contractual regime can shift pressure onto workers. The labour and safety covenants of modern financings, and the Equator Principles to which many international banks

have subscribed, are the institutional response to the human cost that projects like the Gotthard incurred.

In cross-border infrastructure financings in Europe and Asia, these four lessons remain the points on which negotiations turn. The questions put by lenders' counsel today are the questions that the Gotthard conference of 1877 had to answer after the fact: who pays if the estimate is wrong, who decides when the programme must be cut, who monitors the contractor and what happens to the public grantor's rights when the asset changes hands. The last of these questions, as the Gotthard treaty of 1909 shows, can outlive every other element of the transaction.

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