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AMERICAN INSURANCE ASSOCIATION

December 8, 2015

The Senate Committee on Commerce
The Honorable Wayne Schmidt, Chairman
Billie S. Farnum Building
125 West Allegan
Lansing, MI 48933

Chairman Schmidt,
Sponsor Kowall
and Committee Members:

Thank you for allowing us on behalf of The Surety and Fidelity Association of America and the American Insurance Association to provide written testimony relative to the package of bills before you dealing with Public Private Partnerships or P3s. We regret that we can't be there in person today but look forward to working with you on this important issue.

Government entities in the United States have understood the importance of surety bonds and have required bonding for over a century to provide performance and payment assurance for the nation's infrastructure projects. Although procurement methods have evolved—including the increased use of public-private partnerships (P3s) under consideration in Michigan SB 627--the construction risks remain the same, making surety bonds just as relevant and important today in the P3 legislation in Michigan.

The surety's underwriting of a bond is crucial to the success of public works projects. The surety provides a bond only to contractors that, after the surety's evaluation, are capable of performing the work. The surety examines the contractor's expertise in the work, ability to work in the region where the project is located, all the jobs that the contractor has on-going, overall management and financial standing to complete the contract, including its capital and record of paying its obligations. By issuing a bond, the surety provides the public contracting entity with assurance from an independent third party, backed by the surety's own funds, that the contractor is capable of performing the construction contract.

The performance bond guarantees that the public works project is completed according to the construction contract. If a performance bond is not provided, the public entity and its taxpayers take on the risk should the contractor default, and bear the burden of re-letting work and paying any excess completion costs. The completion costs for a defaulted project cannot be estimated with certainty, but typically are higher than anticipated. By contrast, when a performance bond is in place, the full amount of the bond is available to complete the construction contract in the event of the contractor's default.

Public entities often do not have adequate resources to perform all of the tasks that the surety does, either in prequalification of contractors or adjusting the claims that result from a contractor default. Bonding is a cost-effective way for a public entity to protect itself and the project in the event of default.

The payment bonds guarantee laborers, subcontractors, and suppliers that they will get paid for their work and materials. Payment bonds are a critical protection for small, emerging, and minority contractors, since they are more likely to start as subcontractors on projects. Without bonds, subcontractors and suppliers either have to risk losses from nonpayment that they cannot afford, or not work on the public jobs for which they are qualified. Construction is a risky business, and performance and payment assurance is necessary.

A P3 is simply another method to deliver a public works project. Although the public works project in a P3 is not financed initially with public funds, public funds in the form of some future revenue stream (e.g. tolls, availability payments, tax credits, loans) are committed to the private partner upfront in the P3 agreement and ultimately are the source of funding and the profits/return on investment for the private partner and the investors.

The end result of construction in a P3 is for the public use and benefit. The chief interest of a public entity is whether the public works project will be available for the public to use and whether subcontractors and suppliers get paid. That interest is the same no matter if the public works project is delivered through a P3 or a more traditional method of procurement, and as such we believe Michigan SB 627 should require bonding. We recommend that Section 11(c) be amended as follows:

Revise (c) to refer to portions of the project other than construction and create a new paragraph (3) to deal with the construction:

(c) **With respect to portions of the qualifying project other than construction, reconstruction, rehabilitation, improvement and repair,** p~~P~~rovisions requiring that the private party or 1 or more of its prime contractors provide proposal, performance, or payment security. Performance or payment security if required may be in the amounts determined by the public authority and in the form of bonds, guarantees, letters of credit, committed equity, or any other type of financial instrument, or any combination of the foregoing, each as determined by the public authority.

(3) **The public-private agreement shall contain a** p~~P~~rovision requiring that the private party or 1 or more of its prime contractors provide proposal, performance **and** or payment ~~security~~ **surety bonds to secure the construction, reconstruction, rehabilitation, improvement and repair portions of the qualifying project. The amount of such bonds shall be the total cost**

<u>of said construction, reconstruction, rehabilitation, improvement and repair. The notice requirements, eligible claimants and suit limitations under such bonds shall be governed by MCLA § 129.201 *et seq.*</u>

Add "and sureties" and the end of Sec.5 ((c) (ii)(B) on page 3

(ii) Agreements between the public authority and 1 or more of the following:

(A) A private party
(B) A private party's lenders **<u>and sureties</u>**
(C) <u>F</u>ederal, state and local governments

As Michigan looks to enact authority for the state and local public entities to let projects in the new P3 method, it should also eliminate an outdated provision in the Little Miller Act in 129.202 regarding the required performance bond. The last sentence requires that "the bond shall be solely for the protection of the governmental unit awarding the contract." When this provision was enacted in 1915, state procurement codes typically addressed only traditional procurements that involve contracts directly between the public entity and the private construction contractor that performs the work so that contractor's performance bond guarantees the contractor's performance solely to the public entity.

P3s, however, involve contracts between the public entity and the private partner, who in turn contracts with the team that performs the construction and other functions under the P3 agreement. The private partner, not the public entity, hires and supervises the construction contractor in a P3 and requires the contractor to obtain a bond to secure its construction obligations to the private partner.

As public entities have gained experience with P3s, they have demanded to be named as a dual obligee on the construction contractor's bonds to the private partner to further protect the public interest. Since public money pays for P3 projects in the long run, public funds are at risk in a P3 the same as in any other method of delivery. Under a P3, the public owners no longer chooses and manages the construction contractor, but remains responsible to the taxpayers to deliver a public service or facility, and could suffer a financial loss if the concessionaire's contractor defaults.

We recommend that 129.202 be amended as follows:

Sec 2

The performance bond shall be in an amount fixed by the governmental unit but not less than 25% of the contact amount, conditioned on the faithful performance of the contact in accordance with the plans, specifications and terms thereof~~. The bond shall be solely for the protection of the governmental unit awarding the contract.~~

Thank you to the committee for their time and consideration of our request. We look forward to working with you on this important issue.

Sincerely,

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