



Is Israel re-inventing the wheel in the latest PFI Tender?

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Israel's Ministry of Defense recently ran a tender process with respect to the construction and operation of a new military training base. The tender was for a BOT concession contract to build and operate, in a 25 year term, what is known as the "Training Base City" in southern Israel. Bids (including engineering, operation, financial and teleprocessing proposals) were submitted in May, 2011, following which two preferred bidders were selected for a "second stage" bidding process that was defined in advance in the tender documents.

This tender marked the first foray of the Ministry of Defense into the world of BOT/BOO/PFI agreements. Unquestionably it had the nature of a military operation with the expected rigidity. On the other hand, one can't but admire the originality and innovativeness that has characterized the Israeli military since before the establishment of the State of Israel. For the bidders, the financiers and the professional advisors this form of tender is undoubtedly incredibly challenging as it pushes the boundaries of common practice and usual chronology.

The second stage of the tender was unprecedented in Israeli project finance transactions and, to our knowledge, around the globe. In this stage, set as 180 days from the announcement of the 2 top bidders on July 28, 2011 (based on the combined scores of the engineering, financial, operation and teleprocessing proposals), the two bidders were effectively required to finalize the full set of financing documents (underwriting at least 75% of the senior debt required for the project) as well as the project agreements (EPC, O&M and other material contracts) prior to submission of a revised financial bid at the end of the 180 day period. This structure was chosen in response to a series of failed projects (including the Tel-Aviv light rail project and the "Highway 531" project, in which the designated winning bidders were unsuccessful in achieving financial closing, leading to the abandonment of those projects).

Thus, the preferred bidders were required to meet the following interim deadlines:

- Day 40 – Presentation of the bank arranging the financing, including submitting a signed term-sheet with the bank for the financing and the identities of the bank's advisers (technical and otherwise);
- Day 50 – Presentation of the "Teleprocessing Contractor" (providing documentation evidencing such contractor's adherence to the tender's strict prequalification requirements, as well as an executed term-sheet with the contractor providing for the full assumption, on a back-to-back basis, of the concessionaire's teleprocessing obligations);
- Day 90 – Submission of executed agreements with the EPC, O&M and Teleprocessing contractors;
- Day 140 –
 - submission of revised EPC, O&M and Teleprocessing contracts that incorporate comments from the tender committee and the financiers; and

- draft facility documents suite (credit agreement, accounts agreement, inter-creditor agreement, equity injection agreement and subordinated shareholder debt agreement), including nearly all exhibits (security agreements were submitted towards Day 180);
- Day 180 – submission of a revised financial bid (including a price proposal and audited financial model) along with fully executed:
 - EPC contract;
 - O&M contract;
 - EPC-O&M interface contract
 - Teleprocessing contract;
 - full suite of financing documents with all appendices, including commitments by lenders to finance at least 75% of the project's senior debt.
- All of the above having been revised following input from the tender committee provided between day 140 and day 179. Bidders were given very short deadlines to process comments and negotiate them with the various counterparties to the different transaction documents;

Following the 180 day submission (within two days!), the tender committee chose one preferred bidder. This preferred bidder received 90 days to achieve financial closing based on its pre-negotiated and approved facility and project agreements. In fact, the concession agreement was executed and financial closing was achieved prior to the 90-day deadline.

In all other projects, banks and bidders typically conclude a term sheet prior to the bid submission date. However, only later does the winner present its final financial model, including the income flow from the tender issuer to potential financing entities for the structuring of the loan facility. In this case, the arranging bank and the other financing were expected to commit to fund the project when the final construction, operations and maintenance costs were either not finalized or needed to be kept as well preserved secret so as not to give the other bidder any advantage in the competitive process provided a challenge for all parties involved.

Divide and conquer?

As described above, even before a winner was declared, each top-two bidder was required to organize a consortium of lenders to finance at least 75% of the senior debt required for the project. The result of this dynamic was that Israel's top commercial banks and institutional lenders, limited in number as they are, were split into two separate camps. This scenario greatly empowered each consortium of lenders in its negotiations with its top-two bidder. A consortium became free to conduct hard line negotiations with the bidder – After all, competing financiers were already in the camp of the other bidder. The bidder was left with two options: Accept the consortium's dictates, or face the risk of failing to achieve financing (and forfeiting a large bid bond). On the other hand, all that the lenders' consortium stood to lose was its chance to finance the project and the opportunity to recover its transaction costs (see below). From our perspective representing the losing bidder, this seemed to result in a costlier (and more conservative) financing package.

Who bears the transaction costs?

The government committed (and met its commitment in this regard) to defray the costs of the top-two bidder (and its consortium of lenders) who was not chosen as the preferred bidder in the preparation of its updated bid, in the amount of up to NIS 6,000,000 (contingent upon showing expenses in at least this amount). The cost of preparing the winning bidder's updated bid is presumably covered as part of its price proposal. In such a manner, Israeli taxpayers are effectively paying for the preparation of two bids, and in exchange, the government is greatly increasing the probability that the winning bidder will be successful in achieving a full financial closing. This is an unmistakable commentary by the Israeli government – the costs of scuttled financial closings are too high, and even the imposition of prohibitively high bid bonds cannot be relied upon to ensure financial closing of major projects (and their forfeiture is not sufficient to cover the costs of such failures).

What about litigation?

Israeli tenders, including PPP tenders, are often accompanied by litigation following the announcement of the winning bidder. Shapir, the second place bidder, publicly announced that it was looking forward towards other projects rather than towards litigation and opted not to challenge the tender committee's selection of the winning bidder. However, the third-place bidder, which did not participate in the "second stage," petitioned the Tel Aviv District Court in an effort to prevent the signing of the concession agreement, claiming that the tender committee

has prevented it from exercising its right to review the tender documents. The case was eventually dismissed and the concession agreement was signed, although certain elements are still being contested in court.

Furthermore, this tender process is not invulnerable to challenge under Israeli tenders law. The underlying principle of tender law and practice is preservation of equality throughout the process. In this case, the second stage bidders' were required to submit to the tender committee's review all the main legal documents, such as the facility agreement, EPC Contract, O&M contract and Teleprocessing Contract. In all of these cases the tender documents themselves provided minimal requirements for terms to be included therein. However, the tender committee, in a broad interpretation of its discretion to approve these documents, provided very detailed comments. Even with the best intentions there is a lot of room for error when reviewing hundreds of pages of legal documents which may be structured quite differently, and in a very short time. Thus, one bidder may have received a demand to amend a provision in one way while the other bidder did not receive a comment on a similar provision. This is a potential pitfall in this type of process, which could be mitigated by the tender documents containing either forms of the major contracts or far more detailed mandated terms and conditions.

Conclusion

Having selected the winning bidder the Ministry of Defense and achieving financial closing is so far pleased with the result. Prior to the first drawdown of funds and construction commencement it is premature to declare if this is a true success. In fact, the real test will be construction completion and commencement of the operational phase. Nevertheless, the process proved that it is possible, in Israel, to substantially complete the financing of a large BOT project in just a few short months, far less than ever achieved before.