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To P3 or Not To P3

Lessons learned in funding infrastructure to avoid the short end of the stick

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Public-Private Partnerships (P3s) can have substantial value when used to procure and deliver infrastructure, particularly if they are the only practical way to get a project done. But because of both their complexity and the fact that each P3 project is usually unique, they are often beyond the expertise of government staff to analyze, structure, and negotiate without expert assistance (unless the government is satisfied with getting the short end of the stick). When considering a P3 project, the following are some things to consider.

A P3 may be the only way – There are often a number of ways to accomplish a typical infrastructure project. For a given infrastructure project, there may be different types of financing available, different types of procurement, and different models for operations. For some projects, not all options may be available, including due to timeframe or political requirements. When other options are not available, a P3 may be the only way to get a project done, or done within a set timeframe, financial, or political constraint. Before formally moving to a P3 due to constraints such as timeframe or politics, it may be advisable, if possible, to question how important and valuable it is to meet those constraints; once a government formally starts down a P3 route, it may be difficult, for a variety of reasons, to explore other options.

P3s are likely to be financially expensive- P3 typically use taxable financing. All things being equal, tax-free borrowing is always less expensive than taxable borrowing and taxable borrowing is always less expensive than equity funding. In some cases, P3s may be able to use tax-exempt funding, and there may be factors that somewhat offset these basic facts of financing, including risk allocation, interest during construction, and timing.

P3s can address issues that may be politically impossible to otherwise address – By private control and/or contractual arrangement, P3s can avoid issues with governmental workforces, with political difficulty in setting market rates for revenue streams, with problems of getting funds approved for maintenance, etc.

Risk transfer will likely be a significant issue – It is highly likely that risk transfer, both from and to the government, will be a significant issue. Some risk issues will be obvious; others will be subtle and difficult to detect. With sufficient time and effort, the government's consultants (attorneys and risk experts) will hopefully detect and resolve the risk issues. The government will pay a cost for any risk transfer away from the government, and many decisions will need to be made about how much risk to accept. Another issue is that there may be temptation for the government to accept risk in the future (because no government official who made the decision will likely be around to pay the price if the risk decision doesn't work out). This can really give a negotiating advantage to the private party.

P3s may have tremendous flexibility to structure financing (the good) - This ability can help solve cash flow problems for government, reduce costs, or meet other constraints of the government.

P3s may have tremendous flexibility to structure financing (the bad) - P3s can be structured to push costs into the future, potentially in a manner that may not be financially prudent, but may be politically attractive. This problem can be masked by using what could be argued as artificially high discount rates when comparing future costs, thus undervaluing potential adverse impacts in the future. Additionally, the author would argue that some consultants may unintentionally use an artificially high discount rate that may not be suitable for P3 analysis. A high discount rate may be based on solid theory, but a theory designed for different purposes and situations.

Lifecycle will introduce complexities – Some P3s may tout both lifecycle management (keeping assets working and in good shape) and lifecycle cost savings. Value for Money (VfM) analysis is often used to show those apparent savings, as well as attempting to quantify risks. This is often done to compare P3s versus traditional government procurement. But there may be ways for governments to accomplish similar, if not identical, lifecycle savings. In addition, long-term forced and preset maintenance while good in many respects, does have some disadvantages, such as financial inflexibility. In any event, performance standards for lifecycle and maintenance built into the P3 contract are critical. But how well these performance standards work over the life of a contract may be questionable since the private party is usually much more knowledgeable than governments about lifecycle maintenance performance and associated contract terms, and the expert consultants a government uses may not be able to completely overcome that disadvantage.

Staff time and costs required to properly oversee P3 analysis and negotiation cannot be overstated- The amount of time from various high-level government staff to properly oversee project development, procurement, analysis, and negotiation cannot be overstated (regardless of the use of consultants). Both a financial and operational lead may be needed. Frequent policy level decisions will be needed and the decision-makers will need to understand complex situations and alternatives. At some point, the governmental participants may be forced to cut corners because there is not enough time in the day. The private side will take advantage of that time constraint, every step of the way. Because of the complexity of P3s, it is likely to take more time to develop and deliver them than some other types of procurement (such as design-build), and the costs of consultants are likely to be more than a government is used to. These costs (for both the government and the private party) also mean that P3s are generally not suitable for small projects that cannot bear these high transaction efforts and costs.

Timeframe will be an issue – Using the "time is money" argument, the private party providing the P3 will typically push an aggressive timeframe. The timeframe, if not adjusted, may make it more difficult or impossible for the government to effectively analyze or negotiate. The government (and perhaps even the government's consultants) will likely significantly underestimate the time required for project development, procurement, analysis, and negotiations. On the other hand, it is important to

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remember there is a cost to delay, whether it is construction cost increases, uncertainty in interest rates, or the risk and costs the private party incurs. Another factor to be mindful of is that the private party will know the issues very well, while the public side likely will not. Also, be mindful that poor design or contract structuring will most often hurt the interests of the government and not the private party.

You'll get what you asked for and paid for, and it may not be enough – This sounds obvious and it is, but the implication is that costs will likely be higher than the contract provides. Be prepared for amendments. Because of time constraints, it is likely that some important items will be missed. Or it could be that the government's management costs of the project will be higher than anticipated. Of course, this may not happen, but it is reasonably likely due to the lack of government experience, time pressures, and the complexity of P3s.

Be wary of too much reliance on analytics, especially if you or others who may use it don't fully understand it and its limitations – VfM is sometimes touted as a definitive answer to P3 analysis. VfM may be helpful, especially to identify and quantify risks, or to give a flavor of lifecycle savings, but be wary of it being used as a "be all and end all." Consider it as just another analytical tool (with many input assumptions) that may or may not be appropriate to invest in. Similarly, you will need some kind of PV analysis, but be sure you understand and control the assumptions and know the implications of the different assumptions. For example, as mentioned previously, the author believes that too often a high discount rate is used which may not be an appropriate rate for P3 analysis.

Consultants are essential but are not a panacea- Most P3 expert consultants make money from P3s and are not necessarily unbiased. In addition, all consultants like to make their clients happy. The government client may be predisposed to doing a "deal" and may wish to ignore or downplay considerations such as risk or whether there are alternatives, etc. Also, if a consultant is given a cost constraint or a time constraint, meeting that constraint will be a primary goal. Keep those things in mind when selecting consultants, developing a consultant's scope of work, and when receiving advice from consultants.

Legal, Legal, Legal – It's like "location, location, location" in real estate. Having an expert attorney, probably at least two, both who care beyond just being paid money, is crucial. My consistent experience has been excellent with having at least two or three attorneys, one or more with specific expertise and one with broad municipal expertise who then works very closely with city operational and financial staff as appropriate. Those government staff also have to be willing to spend the time necessary with the attorneys, and other consultants, in order to work out thorny issues.

This article provides a limited list of some of the matters to address when considering P3s. P3s can be very beneficial, particularly if they can deliver a valuable project that cannot otherwise be done, or if you can get a project built such as a toll road with minimal risks to taxpayers by having bondholders, equity, and operators take most of the risks. But there are many types of P3s and each will have significantly different characteristics. P3s are not boilerplate like a bond issue can be. P3s are extraordinarily complex (not just the financing). They are beyond the means of governments to analyze without a lot of assistance. Unfortunately, P3s may proceed in a manner that makes it difficult to properly analyze and negotiate. GFOA has a recommended practice on P3s which implies a similar level of caution as suggested in this article and provides quite a few suggestions. Even that best practice may understate the complexity and the issues. The GFOA best practice is at (http://www.gfoa.org/public-private-partnerships-p3).

In summary, there are many cautions in using P3s, but they are a powerful tool and can and should be considered for appropriate infrastructure projects. Because of their costs and complexities, not to mention their usually higher financing and transactional costs, a careful assessment should be made early on as to the necessity of exploring a P3 approach. Ideally, there should be a recheck along the way to ensure the P3 is still the best solution.

The author, John Gross, is the Finance Director/CFO for the City of Long Beach, California, and has been heavily involved with two large P3 projects. He has spent many hundreds of hours working on them. Fortunately, he has been able to work with excellent consultants, attorneys, fellow dedicated employees, and very good P3 partners.
John thanks Michael Palmieri of p3point for his willingness to review and provide valuable, constructive comments to drafts of this article.