To P3 or Not to P3

BY JOHN GROSS

Public-private partnerships (P3s) can bring substantial benefits and value to the procurement, delivery, operation, and maintenance of public infrastructure — although care needs to be taken. Sometimes a P3 is the only practical way to get a project done, but P3 transactions are always complex, and every project is unique, which can make them challenging. Without expert assistance, P3s are usually beyond the expertise of government staff to analyze, negotiate, and structure. In addition to the need for expert assistance, P3 transactions require a major commitment of time and effort by government staff to be successful. Without the appropriate expert assistance and staff time, the government is likely assured that a negotiated P3 transaction will not be as good as it could be — and in the worst case, it may not have been the appropriate transaction to use. This article identifies a number of areas to consider for any potential P3 transaction.

THE ONLY WAY TO GO?

A government can typically find one or more ways to finance a capital project, get a design accomplished, procure a contractor, and operate and maintain the venture. Rarely is a P3 the only model available to accomplish these tasks, and for many government projects, P3s will not be the best solution when compared with other approaches.

However, a P3 may be the best option, or perhaps the only option, for delivering a project in some circumstances, particularly in the case of complex projects where more is involved than basic construction and financing. Examples where P3s may be particularly appropriate are complex land acquisitions, particularly those integrated with private development activities; high-risk projects with significant revenue streams that are difficult for a government to manage; issues with governmental workforces; governmental restrictions; ongoing maintenance issues; political considerations; timing or risk constraints; a need for upfront cash; and financing limitations.

GFOA's *Public-Private Partnerships* advisory (available at gfoa.org) notes that governments should pursue a P3 only if the project itself is consistent with the goals and strategies of the organization. That is a key foundation, and there are many additional factors that need to be considered when evaluating P3s.

If a government wishes to consider a P3, it should evaluate other approaches either concurrently with a P3 consideration, or potentially before the P3 approach is assessed. The inherent complexity of P3 transactions may make it difficult to detect some potential issues in the early stages of evaluation. Once a government formally begins working toward a P3 deal and negotiating, political and other considerations may make it difficult to properly explore other options later. Appropriate use of expert consultants and attorneys can help guide a government to appropriate evaluations approaches early on and/or identify issues while the P3 negotiations are underway in time to make adjustments or change course, if need be.

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COST AND RISK ARE IMPORTANT CONSIDERATIONS

P3s often use taxable financing, including taxable debt (bank loans, private placement, capital markets) and taxable equity. As a result, all things being equal, P3s typically have higher financing costs than government tax-exempt financing. But all things are not always equal. P3s can sometimes use tax-exempt funding, and there may be factors that offset higher intrinsic interest rate and equity return costs for P3s. For example, in current markets, proceeds from a typical governmental borrowing during construction can have high negative arbitrage that significantly increase costs. P3 financing may be able to help reduce negative arbitrage more easily than typical governmental financing. Also, a P3 project may be able to resolve hurdles (e.g., land acquisition, control over a revenue stream, etc.) that a typical government project could not. In those cases, although a P3 project might have higher financial costs, the P3 delivery of a project may be more beneficial to the government than no project at all.

A P3 allows for risks to be transferred away from the government and to the private P3 entity. A government must be willing to pay for any risk transfer away from government to the private party. A typical example of low risk for government on

a P3 project is a toll road where bondholders and equity investors take most of the risks (financing, construction, maintenance, traffic flow) and, as part of the transaction, the P3 also controls the toll rates.

Notwithstanding a government's desire to reduce risk, risk transfer can and will go in both directions in a P3 transaction. Some risks will be obvious, while others will be subtle and may not be detected, understood, or properly quantified by the government. Private P3 partners are usually very experienced with P3 risk. They will try to have a government take on as much risk as they can or make the government pay for the risk the P3 partner assumes. With sufficient time and effort, the government's consultants (attorneys and risk experts) will hopefully detect these issues and help the government find and negotiate an acceptable risk and cost balance between the government and the P3 partners.

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A common example of a complex P3 risk that a government may take on is the risk associated with the potential future failure of a special purpose vehicle or "project company" that was set up in the form of a limited liability corporation to undertake a P3 project. The project company will typically have few or no assets other than the original equity and debt proceeds the project company raises for the project. What are the risks to the government if something goes wrong with the transaction (for example, with construction problems and cost overruns, or with operating issues such as revenue shortfalls), and the project company has no assets remaining to fix the problem (since the company likely used it all to build the project and/or make debt service payments and distribute dividends)? Will the original equity investor and/or debt providers put more money into the project company to bail it out? Will the original equity investor still be in control of the project, or will they have sold out? And will the new equity investors be willing to bail out the project company, or will they see that as bad money after good?

During the development, structuring, and negotiation of a P3, the government needs to make many decisions about how much and what kinds of risk to accept. Some governments may be tempted to accept risks or high costs in the future, since it is unlikely that the elected or non-elected government officials involved in making those decisions will be in office many years later when there may be adverse impacts. A government's willingness to accept future risks and/or high future costs can give the negotiating advantage to the P3 private party and, not incidentally, make it easier to achieve a final P3 "deal."

P3 COMPLEXITY REQUIRES EXPERTISE AND TIME COMMITMENT

The sheer complexity of the 1,000 or 2,000 pages of a P3 contract and the many separate pages of design specifications that go with it mean the government and its expert advisors require sufficient time and expertise to vet the project, the project design, and the P3 contracts. One ramification of inadequate analysis or review is that the project may not provide all the desired functionality and performance that was intended or needed. Later amendments to the original P3 contracts to address these issues will likely increase the cost to the government.

Developing and negotiating a good P3 transaction not only requires outside experts, but also requires a major (and often

difficult to achieve) time investment from high-level government staff to work in concert with the experts for what may be thousands of hours over a long period of time. The need for appropriate staff, consultants, and time to properly oversee a P3 analysis and negotiation cannot be overemphasized. Typically, informed higher-level staff is needed because the issues are complex and often subtle, but with important cost and risk or design ramifications. Decisions will be needed by the government on an ongoing basis during project development, contract structuring, and the negotiation process. Unfortunately, governmental participants may cut corners on their time required because they have a "day job."

The private party for the P3 will likely push the argument that "time is money," along with an aggressive timeframe that may make it difficult for the government to analyze aspects of the P3 or to effectively negotiate all the complex components of the contracts. Because of a government's inexperience with P3s, and potential optimism by the government's consultants, the government may substantially underestimate the time and resources required for project development and definition, analysis, and negotiation. Rushing P3 contracts and any associated design typically has an adverse effect; examples include construction cost increases and uncertainty in future interest rates, as well as other elements

GFOA's Tips for a Successful P3 Agreement

In its *Public-Private Partnerships* (P3) advisory (available at gfoa.org), GFOA recommends that finance officers understand what is at stake and make informed, strategic decisions on whether or not to pursue P3 opportunities. Not fully understanding the overall financial implications, including what the public entity may forfeit, can result in P3 agreements that may not serve the public interest or may be detrimental to the long-term financial health of the organization.

The following list includes some of the considerations involved in pursuing a P3 agreement.

- Make sure the government has the legal and regulatory capacity to enter into a P3 agreement, and check for contracting or procurement policies or requirements that indicate how the agreement should be handled.
- Make sure the project addresses a public priority and is consistent with the government's overall strategic plans and financial policies.
- Consider whether the process will be competitive, and if not, what the justification is.
- Compare the financial risk and legal analysis of the project to a public-sector alternative to make sure the P3 is really the way to go.
- Analyze the revenue projections, demand, and other assumptions used in the P3 evaluation — or hire a third party to do it.
- Determine how the government will monitor performance; create check-in milestones, executive reporting, and service-level targets; and address any failures to achieve the results.
- Consider the amount of flexibility the government has during the P3 term in responding to changing demographics or needed services, or the ability to renegotiate the agreement.
- Make sure project risks and risk transfer elements are clearly articulated and understood by all key stakeholders.
- Include a comprehensive and realistic statement of transaction costs in the project proposal.
- Work out the potential positive or negative bond rating impacts on the government.
- Include public outreach mechanisms (e.g., community meetings, informational newsletters) to provide transparency and ensure adequate feedback.
- Look for external resources (e.g., professional associations, state agencies, or non-profit organizations) that can help the analysis and drafting of the agreement. P3 agreements are typically complex and require access to specialized financial, legal, and technical skill sets.

that may be specific to the project. A government and its consultants need to make the best possible initial decisions about time and resources required, while retaining the flexibility needed to make adjustments during the process, if necessary.

ANALYSIS USING DISCOUNT RATES AND VALUE FOR MONEY

P3s generally offer a more flexible way to structure financing for a project. They can help solve a government's cash flow problems, reduce costs, or meet other constraints. On the other hand, that flexibility can also allow a P3 project to be structured to push costs inappropriately into the future. Having costs (or risks) pushed into the future might appear politically attractive today, but it may be financially imprudent for the long term (e.g., a very long debt service timeframe or inappropriately higher costs in the future). Further, this problem can be masked by the use of questionably high discount rates — whether intentional or not — or other questionable assumptions when analyzing and comparing future costs. (A high discount rate lowers the present value of the future costs.) For example, discount rates are often set based on the cost of financing for the project. While this rate may be appropriate for some analysis, it may not always be appropriate for P3 analysis. A more obvious potential problem is structuring the P3 to provide an upfront payment to the government in return for the P3 partner gaining access to, and control over, a long-term revenue source. While an upfront payment can be appropriate, a concern is that its size may not correctly value the associated revenue stream (one possible reason is, again, the discount rate). In addition, the upfront cash may tempt a government to make arguably poor decisions, such as the use of funds to temporarily plug holes in an operating budget.

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P3s are often structured with performance, design, and maintenance standards to provide cost savings through lifecycle design and management (keeping long-lived assets in good condition). Long-term forced and preset maintenance, while good in many respects, may come with some disadvantages, such as financial inflexibility. The effectiveness of the proposed performance standards should be carefully analyzed and negotiated to ensure that the government receives the long-term service goals of the project. There may well be ways for governments to accomplish similar lifecycle performance outcomes without the use of P3s, although political pressures to defer maintenance is a common, and difficult to overcome, fact of governmental decision making.

Value for money analytics are sometimes touted as a definitive answer to P3 analysis, particularly where lifecycle management is involved. Value for money can be helpful, especially in identifying and quantifying project risks, or providing comparisons of lifecycle savings or financing differences, but like many other complex analyses, it requires the use of many assumptions. Value for money should be regarded as an analysis tool, and just one of many inputs in making P3 decisions. Analyzing and vetting the assumptions used in value for money is necessary to ensure that it is producing meaningful results and that the results are correctly interpreted. Governments should be careful to avoid using value for money analysis at face value without sufficiently

understanding the assumptions and the limitations of the analysis.

CONSIDERATIONS FOR CONSULTANTS AND ATTORNEYS

Consultants, including expert legal assistance (usually including external legal assistance) to the government, are essential when entering into a P3 deal, but they are not a panacea and can lead to misplaced confidence. Regardless of advisors, the government needs to make all the decisions, but getting good analysis and advice is critical to being properly informed. Different expertise may be required, depending on the type of project and the planned structure of the transaction. Expert consultants make money from P3s, and they are not necessarily unbiased. In addition, all consultants have a goal of making their clients happy. If a government is predisposed to doing a P3 and if a government politically wishes to downplay considerations such as risk or alternative approaches, a consultant may not stand in their client's way. Also, if a consultant has a cost constraint and/or a timeframe constraint, that will limit what the consultant can do and may the result in a less than ideal P3 transaction for the government. Finally, and perhaps most importantly, a team of consultants cannot replace the need for adequate high-level government staff and government attorney time spent working closely with the consultants and attorneys. Understanding and negotiating a P3 typically requires a substantial level of effort on the part of high-level government staff (as many high-level decisions for the government are required), regardless of the number of outside consultants. These factors all need to be considered when budgeting funds and staff time for considering, developing, procuring, and negotiating a P3 project.

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Expert legal advice is crucial, probably requiring at least two attorneys with access to additional legal expertise, because of the very broad nature of the P3 transaction. It is desirable for the in-house attorney to have as a broad and deep a background as possible. Another attorney on the transaction might be an expert in the specific type of transactions involved (e.g., land transactions). Other specific legal expertise may also be needed (e.g., bankruptcy advice to deal with protections associated with potential project company failures). In any event, the attorneys and consultants will need to work closely with city staff decision makers to ensure that the best decisions are made and are appropriately reflected in the P3 documentation. Those government staff members need to be willing to commit the time necessary with the attorneys and other consultants to work out the difficult issues.

CONCLUSIONS

P3s can bring substantial benefits and value to the procurement, delivery, and operation and maintenance of public infrastructure. Sometimes a P3 is the only practical way to get a project done. P3s are a powerful and potentially valuable option to a government.

But P3s should be considered with great caution. They are also always unique, very complex, and difficult to understand. They have high transactional costs and require a major commitment of staff time, attorney time, and expert consultants to ensure the government achieves an appropriate "deal." A P3 proposal may initially sound very exciting, but they are typically advantageous only in special circumstances. When appropriate, P3s can be an excellent, and perhaps the only, solution. Because of the potential difficulty in changing course with a P3 once it is formally under negotiation, governments should consider reviewing other options first and then make an assessment as to whether a P3 might be the better approach.

GFOA's *Public-Private Partnerships* advisory advises a similar level of caution and provides quite a few suggestions — see the "GFOA's Tips for a Successful P3 Agreement" sidebar for more information.

JOHN GROSS is the finance director/chief finance officer for the City of Long Beach, California. He has been heavily involved with two large P3 projects and has spent hundreds of hours working on them. Fortunately, Gross notes, he has been able to work with excellent consultants, attorneys, fellow dedicated employees, and very good P3 partners. He thanks Michael Palmieri of p3point for his detailed review and valuable suggestions for this article.