ACREL News & Notes
September 2018

An Overview of Public Private Partnerships and Secrets for Making the Deals Work

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Introduction and Types of Project Models

Although relatively new to the United States, public private partnerships, a method of delivering public facilities and infrastructure through partnerships between public and private sector participants, have long been a favored delivery method in Europe, Canada and Australia. People in those regions questioned why America did not deliver more public facilities using this method, but America, as a wealthy nation, has always had the necessary funds to develop and maintain public facilities. But there is nothing like a Great Recession to generate great new ideas.

The first recorded public private partnership ("P3") in the U.S. occurred in 1652 when a private company called Water Works Company of Boston built a channel to transport water to a reservoir for storage and to provide drinking water to local residents.[1] However, P3s were not a preferred delivery method because the government was able to fund its own infrastructure. During the Great Recession of 2008, public funding dried up and government agencies no longer had the funding to develop new projects or even maintain the facilities they already owned. Enter the private sector heroes.

In a public private partnership, the private sector partners with government agencies to jointly design, build, finance, operate and maintain public assets. Through shared risks, rewards, and financing, the public and private partners could bridge the funding gap during the Great Recession to deliver public facilities when the funding for them was not readily available.

To attract private investment, many states around the country have enacted P3 legislation, both empowering public private partnerships within their jurisdictions and establishing uniform procurement guidelines and policies.[2] In most situations, statutes were not necessary to empower the public sector to engage in P3s, as local home rule power imbued government agencies with the inherent authority to procure facilities using a P3 method.[3] However, statutes make procurement procedures more uniform and predictable, enticing private sector investment with more predictable results.

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[1] Vincent J. Napoleon, Diana V. Vilmenay & Nia Newton, *The Use of Public-Private Partnerships As A Model for the Delivery of Goods and Services to the Government-Is This A New Concept in Government Contracting?*, 35 J.L. & Com. 119, 124 (2017).

[2] According to the Association for the Improvement of American Infrastructure, 37 states have P3 legislative authority, 14 states have vertical P3 authority for municipal buildings and the like, and 13 states have P3 water authority. The District of Columbia and Puerto Rico are broadly enabled for P3s.

[3] Home rule power allows for cities and counties to enact ordinances at the local level without approval of the state or the enactment of special acts. *City of Colorado Springs v. Securcare Self Storage, Inc.*, 10 P. 3d 1244 (Colo. 2000); *Johnny Bruce Co. v. City of Champaign*, 24 Ill. App. 3d 900, 321 N.E. 2d 469 (4th Dist. 1974). The rule ensures that a city or county has some control over local matters. *Fla. Dep't of Revenue v. City of Gainesville*, 918 So. 2d 250, 270 (Fla. 2005). Nonetheless, a home rule city or county remains subject to the restrictions of state and federal laws. *Mitchell's Bar & Restaurant, Inc. v. Allegheny County*, 924 A. 2d 730 (Pa. Commw. Ct. 2007).

Public private partnerships take numerous shapes, sizes and structures. A common adage posits "if you have seen one P3, you have seen one P3." Although the options for structuring a P3 deal are nearly endless, the hallmark of P3s is simply the private and public sectors partnering in the joint delivery of a facility. The "pure" P3 model involves a private entity designing, building, financing, operating and maintaining a public facility, usually for a term of decades, after which control of the facility reverts back to the public sector. Regardless of how these deals are structured, an aligned system of incentives between the partners encourages the private sector to absorb more project risk than they would through a traditionally procured project in exchange for heightened financial reward if performance is properly executed.

The availability of private financing is often the most visible factor of P3s, at least initially, to the public sector[4]. P3s are usually financed initially by the private sector, but repaid by the public sector over the term of the project. A number of potential funding sources may be available to supplement or replace the public sector's obligation to repay project expenses, including:

(a) Project based financing, in which some or all of the project's funding comes from revenue generated from the asset itself. University residence halls generate residence fees, convention centers and hotels generate revenue, as do mixed-use developments, tenant leases, toll roads, stadiums, parking, concessions, etc. Some P3s are structured so the developer is paid in whole or part by the revenue generated by the asset they develop, thereby transferring the risk that the asset will not perform financially as planned to the private partner and away from the public sector.

(b) New market tax credits are given to development projects that may open new geographical markets, such as projects that could turn undeveloped or blighted areas into new population centers[5].

(c) Tax increment financing increases taxes to fund development projects[6].

(d) The Water Infrastructure Finance and Innovation Act accelerates investment in U.S. water infrastructure by providing long-term, low cost supplemental loans for regionally and nationally significant projects.[7]

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[4] Other key benefits of P3 projects include the transfer of project risk from the public sector to the private and the ability to leverage the design and operations expertise of the private partner, who spends more time in the industry improving project efficiencies and reducing costs than the public sector.

[5] Code Section 26 U.S.C. §45D permits individual and corporate taxpayers to receive a federal income tax credit for providing equity investments in a qualified community development entity. *New Markets Tax Credit*, IRS, Chapter 1 Congressional Intent. Such investments are expected to create jobs and materially improve the lives of residents of low-income communities.

[6] Many states have enacted modern redevelopment statutes, known as tax increment financing. See Minn. Stat. §469.174-.179; Mo. Rev. Stat. §99.800-.865; Fla. Stat. §163.335-.464. Such statutes authorize local governments to divert increased property tax revenues into a fund which is used to reimburse the expenditures incurred in carrying out the plan.

[7] Pursuant to 33 U.S.C. § 3901-3914, the Water Infrastructure Finance and Innovation Act is a federal credit program administered by the EPA financing water infrastructure projects, such as new construction for, or upgrades to, wastewater and drinking water treatment systems. *Learn About the WIFIA Program*, EPA, https://www.epa.gov/wifia/learn-about-wifia-program It allows entities to borrow up to 49% of a water infrastructure project's cost at an interest rate from the U.S. Treasury, thus lowering the borrowing cost of capital. See 33 U.S.C. § 3912.

(e) The EB5 visa Program allows foreigners to buy visas in exchange for investing in a development project that will create jobs[8].

(f) Sometimes, a portion of P3 projects can be funded out of savings the public owner realizes through increased program efficiency, lower maintenance costs, reduced energy usage, or tax savings. A school board may consolidate three school buildings into one newly developed campus, thereby reducing operations and maintenance expenses, a portion of which savings can be paid to the private partner as part of the project funding. A civic building can be developed to replace a city hall, with heightened efficiencies reducing maintenance and energy costs, a portion of which savings could be paid to the private sector. Common P3 include replacement of street lights and utility meter readers with new energy-based infrastructure greatly reducing energy and operation costs, a portion of which savings are paid to the private sector as part, and sometimes as al, of the project funding.

Standard Deal Structure

Deals are structured in numerous ways to fit the specific circumstances of the particular project. However, a few structures emerge as the more "typical" deal forms.

A popular P3 structure is a lease/leaseback arrangement whereby the public sector leases the property to the private sector to develop, operate and maintain the facility. During the operations period, the private partner leases use of the facility back to the public sector in exchange for a predetermined lease payment and/or other remuneration. A variation of this structure, often used for property tax savings, involves the public sector leasing the property to a private nonprofit company, who in turn hires the developer for the construction and operations in accordance with the public sector lessor's requirements. The nonprofit lessee then subleases the property back to the public sector to use the facility.

Sometimes P3s are just typical real estate deals, where the private sector redevelops property to spur economic development and pays itself back from revenue generated by the development. These projects often utilize mixed-use development to revitalize neighborhoods or help fund construction of new civic buildings.

Property swaps are also common. A government agency owning an administrative building on prime real estate can partner with a developer to build a new office on less valuable property in exchange for deeding the valuable parcel to the developer, who could then develop the property as its own. This structure works well where public funds for development are not readily available.

Municipalities often partner with developers on a more local level, whereby the city provides tax relief, utility infrastructure or other enticements for local development designed to rejuvenate underperforming neighborhoods.

Industry Sectors Conducive to Public Private Partnerships

[8] The EB-5 immigrant investor visa program is an employment-based program providing investors with a means of obtaining a green card though a capital investment of $1 million (or $500,000 in a targeted employment area) in a new commercial enterprise that creates at least 10 full-time employment positions. See 8 U.S.C. §1153(b)(5). This program is administered by the U.S. Citizen and Immigration Services.

In the United States, most P3s have been in the transportation sector. Toll roads and bridges have been built with a P3 model.[9] In most of these projects, the public sector pays for the project from its own funds, but payments are conditioned upon the developer meeting predetermined performance standards in the timing and cost of development, availability of the road to travelers, level of road maintenance, etc. This payment structure is referred to as availability payments, because payments are made only as long as the asset is available for public use.[10] Alternatively, the developer could be paid for transportation projects, in whole or part, by retaining a predetermined portion of the toll revenue generated by the project.

Higher education has also been a leader in U.S. P3s. Residence halls are the most common opportunities, because of the readily identifiable revenue streams generated by those facilities that can be used to help fund the projects. Universities have also used the P3 model to develop live/work/study spaces, new business incubator complexes, stadiums, parking garages, medical schools and more.

Finally, counties and cities have developed convention centers, hotels, civic centers, parking garages and downtown redevelopments using the P3 model.

Benefits to the Public Sector

Although access to new capital sources is the most visible public benefit of a P3, other benefits make the model beneficial. Although P3s often take longer than a traditional project to procure, once the shovel is in the ground, construction is usually quicker than a traditional project. The developer makes the majority of its financial return when the facility is operating, so there is a mutual desire for the facility to open as soon as practicable. Although construction is expedited, the developer cannot cut corners on quality because the developer must operate and maintain the facility for decades thereafter, requiring design and construction standards to ensure the most efficient and cost-effective operations possible. Speed and efficient development concepts benefit the public sector.

Although P3s can be more expensive to develop then traditionally procured projects because of the higher procurement costs involved for both partners, project costs over the entire project lifecycle, including the time the developer operates the facility, are almost always cheaper

[9] Recently completed and pending public-private partnership transportation projects include the Port of Miami Tunnel, I-595 reversible express toll lanes in Fort Lauderdale, the Eagle Project (increasing rail and bus transit throughout the Denver metropolitan region including 122 miles of commuter rail, 18 miles of bus rapid transit service and the redevelopment of Denver Union Station); the Elizabeth River Tunnels (new two-lane tunnel under the Elizabeth River connecting the cities of Norfolk and Portsmouth, Virginia and modifying the existing tunnel to increase capacity); the Goethals Bridge Replacement (a new six-lane cable bridge from Staten Island to Elizabeth); The Purple Line Project (16-mile, 21-station light rail transit line in Maryland); and Presidio Parkway - Phase II (a replacement of the southern access to the Golden Gate Bridge in San Francisco, California). For a large list of projects, see https://www.fhwa.dot.gov/ipd/p3/p3_projects/project_profiles/dbfom_availability_payment_concessions.aspx.

[10] Availability payments are made by the public agency based on particular project milestones or performance standards. Project milestones can refer to the completion of the facility by a certain deadline, while performance standards can be measured operationally. Examples include minimizing lane closures for maintenance purposes, efficient incident management, or snow removal. *BATIC Institute: An AASHTO Center for Excellence, http://www.financingtransportation.org/funding_financing/financing/other_finance_mechanisms/availability_payments.aspx*

than traditionally procured project due to the operational and maintenance efficiencies incorporated into P3 design and construction methodology. When traditionally procuring development projects, the public sector usually dictates the project design the resulting bids must price. When negotiating P3 projects, the public sector leverages private design expertise[11]. By partnering, the public sector can learn ideas from its private partner about how to reduce development and operation costs using design and development techniques of which the public partner was not aware. For instance, in the I-595 toll road reversible express lanes in Fort Lauderdale, Florida, the developer introduced the State to a less expensive, longer lasting asphalt mix than had previously been used in Florida. Developers bring ideas for energy and cost savings and more efficient operations than would have been utilized in a traditionally procured project.

Finally, the public agency's ability to transfer risks inherent in operations, development, and usage to the private sector reduces project risk for the public. Risk transfer is a key element in successful P3s.

Risk Transfer

There are three categories of risks that can be transferred in P3 projects: development risks, operational risks, and political risks. These risks should be allocated among the public and private partners based upon which is best able to absorb the risk. Development risks are usually allocated to the developer, while political risk usually remains with the public partner. Arbitrary risk allocation can doom a project.

Development risks include cost overruns; construction delays; complications with land acquisition, usage, and zoning; labor and material shortages; and unforeseen property conditions. Operational risks include increased maintenance needs, low public usage of the facility (and the corresponding low revenue derived therefrom), high capital replacement needs, and facility downtime due to service failures.

Development and operational risks are often managed through use of contractual key performance indicators ("KPI"). Each risk is objectively defined and measured, such that the parties are rewarded or penalized depending upon how well they manage the risk, For instance, a KPI could set a maximum annual maintenance cost. Higher costs could be borne by the developer, while savings from lower costs could be shared with the developer as a reward. The key to managing risk is to 1) identify the various risks, 2) allocate them to the partner best equipped to manage them, and 3) objectively define success in managing the risk and implement financial incentives and penalties based upon actual performance.

Political risk is different. Many projects are fraught with political opposition or misunderstandings about P3s. Union resistance is also a threat. Unpredictable political risks include changes in laws and tax policies over the contract term. The public partner manages most political risks, although the private sector may bring some public relations expertise to bear. Well organized public relations campaigns and constant, transparent communications with all project

[11] This same benefit can be realized through a design/build delivery method, where the public and private sectors partner on design concepts, just like in a P3, but without the financing, operations and risk transfer aspects of a P3.

stakeholders and opposition leaders can identify and address problems before they become obstacles.

Perhaps the most important factor for a successful P3 project is a political champion, someone with sufficient political influence and commitment to the project to carry it through opposition and challenges. The political champion must gather the consensus needed from all stakeholders to keep the project on track.

Conclusion

Public/private partnerships are still relatively new in the U.S. and the number of moving parts inherent in procuring, structuring, and negotiating these deals is daunting. Proper planning and preparation are needed to ensure success. Public agencies should retain qualified and experienced consultants, including legal, financial and technical expertise. Not only does this help keep the public partner organized and prepared, but it also signals stability and predictability to the private sector, attracting more qualified bidders. If handled correctly on an appropriate job for P3s, public/private partnerships can be a good solution to a governmental entity's limitations in funding and expertise. If handled poorly, it can be frustrating and expensive. Learning P3 fundamentals and retaining qualified advisors can guide a public agency through the quagmire of uncertainty and on to successful realization of that legacy project.