by Mark Spykerman and Erick Creach

Negotiating Public-Private Partnerships For Public Works Projects

Public-private partnerships or "P3s" are currently marketed to municipalities as a "new and novel" way to fund and implement public works projects, such as transportation, utility, or park and recreation facility improvements. While there has been some expansion in the types of projects using a P3, the truth is that the underlying legal structures are not new or novel, and the P3 typically will not create any new revenue source to fund a project. P3s still can be a valuable tool for municipalities; however, like any financing tool, a P3 will be beneficial only if the municipality identifies its financial and/or operational objectives and uses the most appropriate P3 arrangement to meet those objectives.

A public-private partnership is any contractual arrangement under which a public entity and a private entity agree to share risks and/or revenues arising from the design, construction, finance, ownership and/or operation of a project. In most instances, the written agreement implementing a P3 is not a "partnership" in the corporate sense, but rather a contract where each party has certain rights and responsibilities. Many municipalities already have agreements in place that fit within this broad definition, such as energy savings contracts, utility system management or operating agreements, and tax incentive agreements associated with economic development projects.

More recently, P3 arrangements have been proposed as a new source of funding or financing to improve public infrastructure. While P3s can be used to finance, construct or operate public works projects, a revenue source to pay the cost of the project (such as taxes or user fees) must still be identified. Furthermore, a P3 structure will only be superior for a municipality, in comparison to a traditional approach (where the municipality designs, finances, owns, operates and maintains its project), if:

(1) the P3 arrangement reduces the overall cost of constructing, operating and/or maintaining the project by virtue of efficiencies gained from the private entity's access to capital or expertise; and/or

(2) the P3 arrangement shifts significant financing, construction or operation risks to a private entity.

P3s can be adapted to fit a variety of needs and objectives, but often take one of the following forms when used by municipalities:

Design-Build Partnership: A Design-Build Partnership may be the oldest and most commonly used form of public-private partnership. Under this structure, the municipality and the private entity partner to develop a conceptual design for a new public project or renovations to an existing public facility and then complete the project to those design standards. Payment is a negotiated fixed fee (or an objectively determinable fee) that is payable only when the project is completed and delivered to the municipality. The private entity should bear most, and ideally all, of the risks associated with construction delays or cost overruns. The private entity is also responsible for obtaining interim construction financing necessary to complete and deliver the project to the municipality on a turnkey basis. At that point the municipality is responsible for funding the total agreed purchase price. Through this structure, the private entity has the potential to derive a profit (and it bears the corresponding risk of loss) based on its ability to control the cost incurred to complete the project. Missouri has codified the process for a municipality to enter into a Design-Build Partnership arrangement in

Section 67.5060 of the Revised Statutes of Missouri.

Design-Build-Finance Partnership: The Design-Build Partnership arrangement can be modified to allow the municipality to take possession and control of the project upon its completion, but to pay the private entity the purchase price for the completed project over time. Under this structure, in addition to delivering the completed project at an agreed price, the private entity also must secure long-term permanent financing for the project that will be retired from periodic payments from the municipality, including, in some instances, amounts raised from the sale of tax credits or participation in other tax incentive programs. The municipality's ongoing payment obligation to the private entity usually is funded from taxes, operating revenues, and/or user fees paid by the public. The Design-Build-Finance Partnership structure is used less often in public works projects because a municipality's cost of financing on a tax-exempt basis often is substantially lower than a private entity's cost of raising equity or borrowing funds on a taxable basis.

Design-Build-Operate/Maintain Partnership: In a Design-Build Partnership or a Design-Build-Finance Partnership, the P3's performance obligations are complete when the project is delivered to the municipality. In a Design-Build-Operate/Maintain Partnership, the private entity also has ongoing responsibilities related to the operation and maintenance of the project. The private entity's ongoing maintenance obligations may be documented as a separate warranty or maintenance contract, and payment to the private entity may be made in a single lump sum when the project is delivered or paid in periodic installments. If the private entity also assumes the obligation to operate the project, payments are usually structured as periodic installments over the contract term.

Operate or Operate/Maintain Partnership: In instances where the municipality has an existing facility, an Operate or Operate/Maintain Partnership may be utilized to arrange for private management or operation of the facility. While these arrangements may seem as simple as any other contract entered by the municipality, there are potential pitfalls that must be addressed. The municipality must comply with any applicable competitive bidding requirements and, if the facility was financed with the proceeds of a tax-exempt bond or other obligation, the municipality must ensure that the contract does not inadvertently violate any of the rules, regulations or covenants associated with the financing. Generally, if a facility was financed, the municipality's bond counsel should be consulted prior to beginning negotiation of a management or operating agreement.

Economic Development or Tax Incentive Partnership: Missouri law provides several tools for granting tax incentives in exchange for economic development or using tax incentive tools to finance or induce the construction of public infrastructure by a private entity. A common example of this type of P3 is a municipality using tax increment financing or special tax district revenues to reimburse a private developer for the cost of public infrastructure improvements. This type of P3 arrangement usually is documented in a development agreement that spells out the private entity's responsibilities to build, operate and maintain the desired economic development project and associated infrastructure, in exchange for the municipality's commitment to fund or reimburse the private entity for a portion of the costs.

Depending on the specific circumstance involved, P3 arrangements may have several advantages for the municipality. A P3 arrangement may fast-track design and construction and achieve overall project savings by tapping into specific technical expertise of the private entity. A private entity may contribute to construction financing where it would otherwise be infeasible, inconvenient or risky for the municipality to do so. If a private entity is used to operate or maintain the project, the municipality may be able to negotiate a lower operating cost, or it may fix its operation and maintenance expenses for the duration of the contract term. This may help a municipality with budgeting and reduce or eliminate the need to establish repair and maintenance reserve funds. Finally, a P3 structure may allow the municipality to attract economic development and investment to its community and achieve commitments to maintain and operate that private investment over an extended time frame.

There are some potential disadvantages of P3s. The private entity may not have the financial wherewithal to adhere to a long-term arrangement for operation or maintenance. If the private entity files for bankruptcy, the municipality's ability to obtain remedies for a breach of contract may be limited. Accordingly, there is a risk that the municipality will be left to find another private partner or must complete, operate or maintain a facility itself if the original private partner does not perform. For these reasons, significant due diligence must be completed to fully understand the capabilities and financial strength of the private entity before entering into a P3. Performance guarantees, liquidated damages, termination rights, performance thresholds and other terms typically will need to be negotiated in a P3 agreement to mitigate these risks.

Before undertaking any P3 arrangement, the municipality should evaluate the overall cost of participating in the P3 versus the cost of independently constructing, operating and/or maintaining the project. If a P3 arrangement is undertaken, a non-exhaustive list of items that the municipality will need to address in a properly negotiated P3 include:

- the scope and duration of the P3;
- the financial viability of the project or facility following its completion;
- the financial and technical ability of the private entity to complete and/or operate the project;
- the revenues that the municipality will commit (or tax revenues it is will forgo) in furtherance of the P3;
- any economic development, job creation, elimination of blight, public nuisances, or other economic or social factors that will be improved by participation in the P3;
- the performance metrics and other thresholds for various levels of municipality involvement; and
- the remedies available to the municipality if the private entity defaults on its obligations.

If these items cannot be addressed to a municipality's satisfaction, it may be better served using more traditional means of construction, financing and operating the project.

Finally, the municipality should engage advisors (legal and otherwise) that are knowledgeable in municipal law, various financing alternatives for public works, and the construction and operational aspects of the specific project. These advisors should be engaged early in the process to ensure that the negotiated P3 structure is legal; does not violate any outstanding financing documents or agreements; will achieve the contemplated economic results; and adequately protects the municipality in the event of a default by the private entity.

Mark Spykerman *and* **Erick Creach** *are shareholders in Gilmore & Bell, P.C. (www.gilmorebell.com), a leading public finance law firm with offices in Missouri, Kansas, Illinois, Nebraska and Utah. Spykerman and Creach have assisted numerous municipalities with financing public works projects, both through traditional tax-exempt bond financings and public-private partnerships. They may be contacted by email at mspykerman@gilmorebell.com and ecreach@gilmorebell.com or by telephone at (314) 436-1000.*