



The Use of Public Private Partnership for Special Districts and All Levels of Governments

By: Frank V. Zerunyan, J.D. and Steven R. Meyers, J.D.

You've probably heard, "This is a great day for the district and public private partnership" as often as a government regulator saying, "we want to work with you." Yet the phrase "public private partnership" is both misused and misunderstood.

Shorten to PPP or P3 for brevity, this arrangement is not business as usual. Rather P3 delivers public infrastructure and capital improvements by transferring risk and reward from public to private.

This means the risk of project specifications, long-term financing, or life-cycle maintenance costs is shifted to the private partner who also gains the reward—in the sense of long-term, financial profitable payments to amortize the initial capital investment—in exchange for assuming transactional risk. The public agency obtains "turn key" infrastructure at a fixed cost often with long-term maintenance and operation guaranteed by the private partner.

Recognizing its benefits, various forms of governments worldwide are increasingly utilizing P3 over the traditional procurement and delivery methodologies to hire, integrate and maximize expertise and tap into resources for the planning, design and construction of infrastructure projects. Recently, California public entities are increasingly seeking P3 over a primarily public financing and ownership model due to the state's imminent need for renewed and expanded infrastructure.

While P3 has a long proven record internationally, leveraging the private sector to socially benefit the public sector is a fairly new phenomenon in California (and in the United States). As a result,

public officials are now grappling with a rapidly expanding array of alternative delivery methods available to the public sector and often find themselves perplexed about P3's variations and benefits. For instance, much is written about the use of P3 for transportation and utility infrastructure, as well as fee generating facilities such as toll roads, rapid transit lines and water related projects; however, less attention is given to the use of P3 for social infrastructure, such as civic buildings, schools, courthouses, prisons and hospitals.

Individual variations of P3, notably social infrastructure, can potentially provide a range of benefits or meet major policy objectives for various levels of governments, including special districts, if competently and appropriately applied. Aside from gaining a new alternative for delivering public infrastructure in these challenging economic times, P3 allows governments to build needed infrastructure, realizing the following benefits:

- Reduced construction and lifecycle cost;
- On time and on budget delivery;
- Reduced initial cash requirement, as front-end cost is spread over lifecycle of asset;
- Savings from innovations and efficiencies in design, as conceptual designs are paid for by the private sector;
- Sharing of development risks among the concessionaire, design and construction teams;
- Reduced operating and life cycle costs for the public sector due to private sector investment in ongoing maintenance and capital improvements; and
- Accelerated schedules enabled by concurrent design and environmental review.

Regarding social infrastructure, the public, private and even nonprofit sectors have developed different definitions to suit their needs. However, the National Council for Public Private Partnerships adopted the following broad but helpful definition to facilitate the use of P3 in developing social infrastructures:

“A Public Private Partnership (P3) is a contractual agreement between a public agency and a private sector entity. Through this agreement, the skills and assets of each sector (public and private) are shared in delivering a service or facility for the use of the general public. Each party shares in the risks and rewards potential in the delivery of the service and/or facility.”

Under this definition, P3 ranges from concessions for services to long-term facility leases or facility agreements for the delivery of a public infrastructure. While a typical conventional delivery involves “Design/Bid/Build” with a greater participation and risk taken by the public sector, P3 often

covers “Design/Build/Finance/Operate/Maintain” so greater participation and risk is instead assigned to the private sector. P3, therefore, effectively maximizes the core competency of both public and private sectors.

continued on page 48

The use of public private partnership [continued from page 29]

P3's use dates back to the 1960s and 1970s in various shapes and forms yet it still remains a relatively unfamiliar methodology in the delivery of public social infrastructure in the U.S. In contrast, the governments of Great Britain, Spain, Australia, Canada and others have over the past two decades perfected and standardized their use for the delivery of public infrastructure.

Take for example the United Kingdom which has had several hundred P3 projects there. A study by the country's Audit Office shows life cycle savings of 17 percent over conventional projects. A similar study in British Columbia shows savings of 9 percent. More importantly, the same study in U.K. shows that 73 percent of conventional projects were delivered over budget and 70 percent were late. Whereas, 22 percent of P3 projects were over budget and only 24 percent were late.

Despite these measured benefits, P3 for social infrastructure have been slow to materialize in California. This is due in large part to unfamiliarity and a long-standing focus on front end costs, labor issues, lender intransigence and use of tax exempt financing mechanisms. However, all this is rapidly changing as necessity continues to dictate the use of alternative delivery methodologies to replace the aging infrastructure in California and throughout the U.S. More to the point, the benefit of single point accountability to design, build, finance, operate and maintain the facility is an increasingly understood and attractive option to governments as opposed to the conventional finger pointing in a "Design/Bid/Build" process. The P3 structure accommodates this single point of accountability and enables the public and private sectors to lock in long-term operating and maintenance commitments at the front end, removing the risk of future shortfalls. The P3 structure also motivates the private sector to deliver a better product rather than the cheapest product.

Public agencies, increasingly aware of this emerging trend and market sector, are more open to solicit design, build, finance, operate and maintain bids for social infrastructures ranging from city halls, police departments, libraries, schools, arenas and community centers. In response, states are legislating to open the field to integrated project delivery models such as

California's Performance Based Initiatives, all the while creating jobs and protecting the interests of current stakeholders, including unions. In fact, P3 for social infrastructure results in little or no loss of union jobs; most P3 projects put forth prevailing wage anyway.

With huge infrastructure deficits, both public and private sectors need to look for cost-effective and timely methods of designing and building social infrastructure. P3 can be one such method provided that these sectors foster an open and true partnership. In fact, P3 promote cooperation between the public and private sector at all project stages. To achieve success, public participants must have full political commitment to the process along with clear and measurable objectives. The best P3 projects tend to have discretionary approvals, design criteria and a suitable site in place. The clearer the project by the public sector, the more meaningful the response is from the private sector. Regardless, the private sector appears ready to assist the public sector under exclusivity agreements until a clear project is defined and entitled. However, until a development agreement is executed, the public sector is expected to carry the front-end costs, but these costs could be reimbursed to the public sector upon financial close.

What is an effective P3?

To be effective, P3 needs to be managed as a mature relationship between the public and private sectors with full recognition of their mutual responsibilities. P3 relationships are very different from privatization, in which the market and price mechanisms define the

service provided. The private sector's involvement in the building and maintenance of public infrastructure is not a novelty. P3 ensures that team member contractors are bound into long-term maintenance contracts and shoulder the responsibility for the quality of the work they provide. With P3, the public sector defines what is required to meet public needs and remains the client throughout the life of the contract. The public sector's contract solidifies the delivery of the outputs the public sector sets and includes rights under the contract to change the output required from time to time. With the ability to make deductions for poor performance, the public sector ensures the quality and continued effective delivery of public services. Consequently, with P3 the public sector can bind the private sector to deliver investment in better quality public services while maintaining frontline services in the public sector. Firms like California P3 Infrastructure Group, LLC can help in drafting and negotiating these procurement contracts.

What are the benefits of P3?

The benefits P3 can offer, in terms of on time and on budget delivery and life cycle costing, all flow from ensuring that the many different types of risks inherent in a major investment program are borne by the party who is best placed to manage them. For example, construction risk or the risk associated with the building design is with the builder. This way, the private sector is incentivized by having its capital at risk to perform well, and takes responsibility for the work it undertakes. This does

not mean that the public sector is devoid of any risk in the P3. In fact, as a matter of policy, it behooves the public sector to retain certain risks as opposed to transferring them by contract.

The key risks that the public sector does not seek to transfer in entering a P3 scheme—which it retains in the same way in for example conventional social infrastructure procurement (school, city hall, police station, etc.)—are usually:

- The need for the facility on the date given and the adequacy of its overall size to meet public service needs. Presumably government is best suited to know its public needs. So for example, if the government underestimates the number of offices and conference rooms required to meet demand, it must pay the costs of expanding the available facilities just as it would had it built a conventional government building;
- The possibility of a change in public sector requirements in the future. If the needs of public services change, the government retains the responsibility to make alterations in both conventionally built and P3 facilities. However, provisions for flexibility to cover changing requirements in P3 may be addressed in the procurement contract;
- Whether the standards of delivery set by the public sector sufficiently meet public needs. The public sector retains the risk involved in planning the provision of public services, and specifies a procurement of facilities that meets those requirements, in both P3 and conventional procurement;
- In most cases, the public sector is responsible for the extent to which the facility is used or not over the contract's life. For example, if the demand for the particular use or services in the area drops significantly, the government would continue to pay unitary charges for the P3 project in the same way it would continue to own and maintain a conventionally procured infrastructure.

All in all, the public policy issues remain with the government policy makers.

On the other hand, in a P3, the risks the government usually seeks to transfer by contract to the private sector over the term of the contract (typically 15-35 years) are specifically identified and limited. In a typical P3, these would involve the following:

- Meeting required standards of delivery. So if, for example, the project's design was unable to provide the required service needs, the private sector would need to pay the cost of rectifying the design to meet those requirements and receive payments;
- Cost overrun risk during construction. If, for example, ground conditions are discovered to be unstable after construction begins, and the building requires considerably more extensive foundations, the private sector would cover those extra costs in order to complete the building to the required standard. The government's unitary charge payments would not increase. In conventional procurement, the government would be forced to cover these costs;
- Timely completion of the facility. If, in the example of unstable ground conditions cited above, the facility was completed and delivered late to the public sector, no payments would be made to the private sector until it was available;
- Underlying costs to the operator of service delivery and the future costs associated with the asset (mainly lifecycle costs); and

continued on page 50

- Risk of industrial action or physical damage to the asset.

Since under P3, the private sector's capital (and not just its profit) is at risk, the private sector has a very strong incentive to maintain high and reliable service standards throughout the life of the P3 contract. Some additional P3 benefits and contrasts to general procurement include:

- New services are more likely to start on time since the private sector contractor does not get paid until it delivers. The record of conventional procurement is poor in this respect, with frequent delays before public assets become operational;
- A better understanding of the total costs to provide the required service. In P3 procurement, the public sector client can clearly define at the start the service it requires while the private sector partner gives a price for the total cost of that service—covering both the upfront cost of new investment and the ongoing recurrent costs such as maintenance. This helps avoid short-term outlooks by focusing on the long-term needs of the public sector;
- More efficient use of public money. In the past, some conventional public procurement has gone heavily over budget, consuming funds which could otherwise have been invested in other public services. Under P3, the public sector only pays for the service it has

contracted for—at the price it has contracted for and only when that service is available. Under conventional procurement, the public sector is forced to fund cost overruns, and pays out whether or not the service it needs is actually available; and

- Contractors are incentivized to deliver the required service over the whole life of the asset. The private sector partner only gets paid if it maintains standards throughout the length of the contract (15-35 years). This means that in designing, building and maintaining a P3 project, the private sector has a strong incentive to ensure high standards are built in and maintained across the whole life, as it would be forced to remedy defects and make repairs in the future.

Legal Standards

It is beyond the scope of this article to provide a detailed summary of the applicable law in California, which authorizes P3 arrangements. Under the Public Contracts Code, public infrastructure has been traditionally delivered through the design-bid-build process whereby the public agency prepares detailed specifications and awards a contract to the lowest responsible bidder. The alternative project delivery method of design-build, now statutorily recognized¹ authorizes competitive negotiation and consideration of other factors such as financing options, bidder experience, lifecycle costs and performance on other projects. Within this statutory framework, a P3 structure can be negotiated.

In 1996, the Legislature adopted the California Infrastructure Financing Act

(Gov't Code Sections 5956 et seq.) while limited to fee producing infrastructure also invites competitive negotiation. There are unfortunate limitations in the IFA such as a 35-year limit to transactions and public hearing requirements for fee increases, making future revenue streams for amortization of debt uncertain.

Finally, some public agencies (though not all) are permitted to engage in lease-lease back transactions, which also provide legal structure to P3 agreements. It's important to note that currently no statutory scheme exists as the exclusive soup to nuts authority for P3 transactions.² Substantial growth is anticipated in the sector, making P3 a real viable trend in infrastructure delivery.

To conclude, P3 meets the enormous needs for social infrastructure upgrades. They enable each sector to focus on its core competencies; the private sector in designing, building, financing, operating and maintaining facilities and the public sector in focusing its core responsibilities on crucial areas such as public safety, land use control, community service and economic development. ■

Frank V. Zerunyan, J.D. is a Principal in California P3 Infrastructure Group, LLC and an Adjunct Associate Professor at the University of Southern California, School of Policy Planning and Development. Steven R. Meyers, J.D., is the founder of Meyers Nave, a public agency law firm of 90 lawyers practicing throughout California.