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P3s: Managing Risks And Rewards - Thompson Coburn

Successful P3s—Public-Private Partnerships—can be blessings for state and local governments searching for new ways to finance many types of critical "infrastructure"—roads, schools, prisons, and more—and control operating costs. In typical government contracting arrangements, the governmental entity designs and bids an infrastructure project and the successful private bidder only builds it for governmental operation. In contrast, a typical P3 involves a "design-build" or "design-build-operate" arrangement where the government cedes control of an initiative's design, construction and/or operation to a private contractor—albeit with specified performance parameters—in exchange for reduction in construction cost, operating cost, or financing risk.

Some P3s—e.g., the Indiana toll road contract—allow the private contractor to retain revenues from an existing project over a multi-year period in exchange for a hefty up-front payment and maintenance and operational covenants. Others, like the Chatcomm arrangement spearheaded by Sandy Springs, Georgia, use private expertise primarily to provide services like emergency dispatch while the government and the private contractor share both revenue and capital costs, and the parties collaborate to expand the market for the services.

Interest in P3s is growing as governments search for ways to access expertise, deflect risk, speed up project completion, lower capital and operating costs, avoid public votes and increased taxes, and keep what might otherwise be counted against public debt limits "off the books."

This tool is worth a hard look for any capital-strapped governmental entity in need of new infrastructure. But public officials must approach potential P3 arrangements with eyes wide open and a clear understanding of both prospective benefits and prospective risks.

Similarly, P3s can be a source of profit and accolades for private partners in a P3 venture. But private partners, too, must carefully evaluate potential benefits against a variety of risks: If a private entity accepts responsibility for long-term situations it cannot control or pledges too much of its capital and borrowing power to a single project, then the entity places its overall future at risk.

These arrangements must be carefully structured from both sides of the partnership to create the desired "win-win." Without well-informed attention to detail and more than a modicum of foresight, a P3 can cause significant damage to both public and private reputations and balance sheets.

P3 Types and Considerations: A Very Wide Range

Structuring a P3 is very challenging because P3s come in an almost unlimited variety of flavors, depending on the public entity's goals.

Some types are familiar, like the federal low-income housing tax credit, or LIHTC. That program was intended in part to shift responsibility for providing affordable housing for the nation's working class families from traditional "housing authorities" to the private sector. The LIHTC program shifts cost, operating, and financing risks to the private developer. It accomplishes its goal of providing affordable residential rental units by subsidizing annual debt service and operating costs with

federal tax credits and limiting the rent the private developer can charge. Because this specific type of P3 has a sufficiently long history and is appropriately targeted to one particular purpose, most of the potential “bugs” have been worked out of the structure, and the program is generally considered a success.

At the other end of the spectrum, some P3s are essentially “one offs”—that is, there is no universally accepted and time-tested model for the contract arrangement. Those P3s present greater uncertainties and risks for public and private partners alike. For example, in certain P3 structures, a private company can theoretically guarantee completion. But, if the company lacks sufficient capital to cover its mistakes or has other costly commitments that eat up its capital cushion, the private company could become insolvent during construction and force the public sector to either assume responsibility (and cost!) for construction completion or face the specter of a half-completed highly visible eyesore while the default is litigated in court. Similarly, if a company charged with a project’s long-term operation experiences financial difficulty or insolvency, the public sector could be forced to assume the project’s maintenance and operational responsibility at a cost potentially far greater than what it would have paid the private company.

Conversely, a new mayor or governor may unfairly seek to void a P3 arrangement before the private partner has recouped its costs and made a reasonable return. If the public partner cannot or will not be fair and businesslike in administering its side of the arrangement, the private partner may ultimately win the legal battle but lose the war because legal fees have eaten up all its spare capital and its public adversary is effectively “judgment proof.”

P3 Risk Management: A Framework

The risk that both sides may lose in a P3 deal can increase if the deal is “too good” for either side. An important key to successful P3s is responsible management of risks and benefits—that is, an allocation that is fair to both parties.

In a P3 whose structure is relatively “simple”—for example, the public sector seeks to shift only construction cost and possibly operating cost risk to the private sector—associated public sector risks can be mitigated to a significant extent by careful up front due diligence and by incorporating protections like net worth maintenance requirements or letters of credit into the construction and operating documents. Associated private sector risks can be mitigated by including clear parameters for design and construction outcomes, sharing arrangements for mitigation of unforeseen circumstances, and fair, carefully drafted cost-escalation provisions in the agreements. In long-term arrangements, both partners must recognize that the future is uncertain and that innovation or public policy changes may impact the validity of demand or cost projections.

In P3s that rely on the private sector to generate all of the income required to pay project-related debt, due diligence becomes much more complex. Both public and private sector risks grow exponentially. Future market considerations enter prominently into risk calculi. The failure of a public-private team to accurately predict the future—a nearly impossible task—or appropriately acknowledge and assign or share uncertain long-term risk can crater a project or strangle new related initiatives at any stage of the project’s development or operations. For example, few would have predicted the sustainability movement’s popularity twenty or even ten years ago. Today, sustainability-related initiatives have a conspicuous impact on both private demand and public sector appetite for parking and highway construction on the one hand and mass transit and recycling on the other.

Equally important, both private and governmental entities moving down the path toward a P3 partnership must have the courage to pull off the road when a collision of interests is imminent. That

can be very hard when a company or a government has invested significant amounts of time and money in documenting a deal that has been essentially “promised” to shareholders or constituents. Deal momentum snowballs in the rush to schedule the groundbreaking, fill a gaping budget hole, or announce a big contract to shareholders and deal documentation can easily pick up unintentional debris in the dash to the finish line. If obstacles to a successful relationship seem insurmountable or the deal presents risks that have not or cannot be reasonably allocated or shared in a manner that adequately protects each party’s interests, it may be time to put on the brakes regardless of how near the finish line may seem.

But civic progress and private-sector profits cannot be forged without a willingness to take risks—only large quantities of guts can lead to glory. Less publicized P3 successes match or overshadow highly publicized P3 failures. Success or failure depends on how well each partner plans ahead and how realistic each partner can be.

Important P3 Precepts

While public and private sector motivations vary in each P3, in all P3s the government partner attempts to tap private sector expertise and financial resources while the private partner hopes to make a profit. Successful and unsuccessful partnerships of the past offer valuable lessons and can help both private and public partners considering P3s negotiate deals that make sense for both.

Long-term implications

Government officials and private decision-makers must carefully consider the long-term public policy implications of the deal under consideration. Will it unacceptably limit the government’s ability to monitor and refine long-term strategies to address changing needs? If an agreement prohibits the development of new roads in an area served by a P3 toll road, citizens may be forced to endure unacceptable traffic congestion for the term of an agreement which may last many decades. If an agreement prohibits expansion of a region’s mass transit system to preserve demand for a toll road, that region’s sustainability efforts may be intolerably hampered—and the only remedy may be for the public sector to “buy back” the project at significant cost and re-assume the operating and maintenance burden when the public sector’s primary interest in the agreement in the first place was to shed that burden. If an agreement requires a private company to operate and pay for operating a facility when that private entity cannot control the market for the facility’s “outputs,” the company’s assets can be decimated even to the point of bankruptcy.

As a corollary point, if the P3 contractor will be expected to generate the revenue that will pay for the project, both government and private-sector officials must each assess the long-term “market” for the improvement as accurately as possible. The operating pro forma must make sense for each party and the P3 agreement must allow for changes in that pro forma as new situations develop. It is impossible to make market predictions for two, three, or four decades into the future. New technologies are coming on the market every day and public polices change over time. Such issues can be addressed by reasonable partners: for example, instead of inking a 75-year “all or nothing” term, the partners can agree to 5-year or 10-year agreement increments where each partner may decline to renew the agreement at the end of the incremental term but once the agreement is renewed neither can terminate during the renewal period. That arrangement strikes a balance between predictability and inability to foresee what tomorrow will bring: either party can completely bow out when the agreement comes up for renewal but, if the working relationship has been a good one, it is more likely that each party will view the renewal as an opportunity to tweak the agreement and work out bugs.

Risk allocation

Public officials must think carefully and be reasonable about risk allocation. Each partner must understand, empathize with, and fairly respond to the legitimate concerns of its counterpart. Risk allocation imbalance is dangerous for both sides. If the government unreasonably over-allocates risk to the private sector partner, either no one will respond to the request for proposals or those who do respond will be more likely to fail because they have little experience in evaluating and quantifying P3 types of risks. If the private partner loads too much risk on the public partner, the government will be criticized by its constituents. Appropriately balanced risk is the hallmark of a win-win deal.

A corollary here is that the private sector partner must always remember that all of the terms of a P3 deal are public. Virtually all governments are subject to some type of “Sunshine law” that enables reporters and others to access virtually all of the final documents involved in any deal. Each P3 deal must withstand public scrutiny—if a big or even medium-sized deal cannot pass a “smell test,” it is likely that some reporter will discover the deal’s flaws by poring through the public record.

Non-compete provisions

Each party should think hard before it agrees to overt or “disguised” non-compete provisions. For example, a trash-to-energy arrangement may require the public sector to deliver a minimum volume of trash each month to a privately owned incinerator at a set price for a multi-decade term. Prospectively, that may look like a reasonable private sector “ask” but, in hindsight, such a provision could prevent the government from competing with the private incinerator by diverting part of its waste stream to a recycling facility. As discussed above, consider building flexibility into long-term agreements so that deal terms can change as the future changes. The public sector can be willing to pay more (or receive less on the front end) for future flexibility, or the agreement could include provisions for renegotiation if the public sector wishes to address new policy goals that impact the P3 contractor’s reasonable expectations.

Picking partners

Both parties must choose their partners carefully. A government with an unstable political climate will be a bad partner for an established private company because political battles can lead to capricious reconsideration of decisions and generate bad publicity for the company as political opponents seek to discredit each other. A government with an unfriendly business climate may, wittingly or unwittingly, hamper the project’s success. A private partner with little experience and a thin balance sheet may not be able to adequately evaluate risk or fulfill its commitments without significant insolvency concerns. Careful due diligence on both sides of the partnership is essential for P3 success: mistakes are inevitable and each partner must be able to responsibly and successfully shoulder its negotiated share of responsibility for those mistakes.

Quality assets

Both parties must also look carefully at the quality of the public sector “assets” upon which the deal is predicated. Is there a market for the asset or service? Is that market likely to grow or decline? Will the government partner support or thwart private efforts to sustain and grow the market? Can and will the private partner invest sufficiently in the asset to fulfill the government partner’s goals? What happens if the market assessment was “off”?

No time to experiment

Each party should approach untested technologies with a large grain of salt. P3s should not be viewed by either party as opportunities to experiment: risks associated with experiments are difficult if not impossible to allocate and a failed experiment will inevitably generate bad press.

Unrealistic burdens

Beware of projects that attempt to address too many goals by placing unrealistic burdens on the private partner. If a project is overburdened with requirements that do not relate directly to the core purpose of the project—e.g., excessive minority participation, local training, and workforce requirements—the cost of the project will escalate. The private contractor may understandably pad its budget because it lacks experience in addressing such requirements. The public sector may be accused of overpaying—or accused of failing to insist that the contractor fulfill unreasonable ancillary requirements.

Knowing when to fold

To reiterate: both private and governmental entities moving down the path towards a P3 partnership must have the courage to pull the plug when goals are irreconcilable. If it becomes apparent that obstacles to a successful relationship present risks that cannot be reasonably allocated or shared in a manner that adequately protects each party's interests and gives each party a reasonable chance of success, it may be time for everyone to cut losses—or at the very least ensure that a "no fault" termination option exists at an early stage of a potentially long-term relationship.

Legal authorization

Each party should make sure that federal, state and local law permit the type of P3 arrangement contemplated. While local government charters and other organizational documents are often flexible as to the types of contracts permitted, a local P3 will almost certainly require passage of a specific law that authorizes the particular P3 agreement. On the federal and state levels, special legislation empowering agencies to enter into P3 types of arrangements is almost always required, although many states and the federal government have recently enacted legislation authorizing some types of P3s. On a related note, if federal or state funding is used even in what is essentially a local project, special federal and state requirements will likely apply. Failure to understand those requirements can significantly dampen the victory of an otherwise successful project: federal inspectors general can demand that improperly spent funds be repaid and state auditors can chastise, to the embarrassment of everyone involved.

Seek professional help

Each party must be willing to invest in good professional help in structuring the P3 agreement—and must be willing to pay for that help, even if it ultimately decides to crater the prospective deal. Private parties unused to dealing with prevailing wage, public bidding, and local benefit concerns may find themselves saddled with unanticipated costs and negative media coverage. Public parties unused to negotiating with sophisticated businesspeople may lose on key points if they cannot benefit from equally sophisticated help.

A good investment in quality front-end services from professionals experienced in P3 deals can help public and private partners avoid the pitfalls and achieve the benefits that potential P3 arrangements present.

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This article appears in the current newsletter of the St. Louis chapter of the Association of Corporate

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The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.

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