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## Public-Private Partnerships in California

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Public-private partnerships (“P3s”) cannot completely meet our increasing infrastructure needs, but they should be part of the mix. P3s have been successfully used for decades in Europe, Canada and Australia to develop public infrastructure projects.<sup>1</sup> They have also been available for use in California for nearly twenty years, but they have not been widely embraced by California public agencies despite their benefits. This is the second installment of a two-part article on P3s and “best practices” for addressing California’s infrastructure needs through private funding. In Part I, which appeared in the Public Law Journal’s Summer 2013 edition, the definition of P3s and various forms of P3s were initially examined. The legal framework and enabling legislation for the use of P3s by California’s local government agencies was also covered. In this Part II, we drill down further on P3s, examining the pros and cons of developing infrastructure projects on a P3 basis, and then relay a recent P3 success story and “best practices” for establishing and implementing P3 programs.

### Pros and Cons of P3s

At its core, P3 projects involve private financing and the sharing of a project’s risks and rewards beyond the construction phase between private and public partners. Projects built under a P3 approach can have far-reaching benefits that go beyond the mere completion of infrastructure projects that would be infeasible under a traditional, public funding model. Building projects on a P3 basis generally means that such

projects get built quicker, better and at less cost than would be the case if the project were built under a traditional design-bid-build basis with solely public funds. The reason for this is several-fold. Initially, P3 projects get built quicker because they are usually developed on a design-build basis where the design phase and construction phase occur simultaneously, with design just a step ahead of construction (called fast-tracking in the construction industry), such that the overall duration of the project from design through construction is reduced.

Additionally, the private partner is incentivized to complete the project as quickly as possible, even if the project requires acceleration through additional workforce or overtime, because the private partner is usually not paid until after the project has been satisfactorily constructed and is operating to pre-determined performance requirements. This delayed-payment component also has a cash-flow benefit to the public partner. Instead of incurring significant costs for design and construction at the front-end of a project, as would be the case under a traditional delivery method, the public partner’s costs (or the cost to the users of the public facility) are postponed until construction is completed and then the costs tend to gradually increase for the duration of the P3 agreement. This, in turn, allows the public partner to leverage whatever funds it has “saved” on the front-end, thereby stretching tax dollars for other purposes or to develop other projects that would not be appropriate for pursuit on a P3 basis.

Another significant cash-flow benefit to public partners arising from P3s is that P3 agreements frequently include an upfront cash payment from the private partner. This cash infusion can be used by the public partner to retire existing debt or can be used for other public purposes. Retiring public debt removes liability from the public sector's balance sheet, which positively impacts the public partner's credit rating and reduces financing costs for future borrowing and bond sales. Similarly, the cost to build or upgrade a P3 facility is not on the public entity's balance sheet, which also positively impacts the public partner's credit rating.

Further, in terms of lower costs generally for a P3 project, because P3 projects are typically fast-tracked, labor and materials to construct the project are purchased sooner. This means the escalation costs that normally accompany later-purchased labor and materials due to inflation or other market conditions are avoided.

In addition, P3 projects can be done under a design-build-finance-operate-maintain ("DBFOM") approach by which the obligation to do such tasks are packaged together and transferred to the government agency's private sector partner. Under a DBFOM approach, the full lifecycle costs for the infrastructure facility are generally less than what they otherwise would be under a traditional project delivery method, or even under a design-build delivery method.<sup>2</sup> This is because the DBFOM project benefits from multiple efficiencies. The private partner is incentivized to design and construct the project to the highest standards with best practices for operation and maintenance of the completed facility in mind. If the private partner were to not design and construct to such standards (or tried to cut corners in other ways), the cost to operate and maintain the facility for the

duration of the P3 agreement would be higher and would erode the private partner's rate of return on its investment. Some liken this to an extended warranty for the public partner that can last as long as the term of the P3 agreement.

Aside from time, cost and quality benefits, the P3 approach is also advantageous to public partners from a liability perspective. Specifically, the risks stemming from design and construction of the public facility are shifted from the public partner to the private partner under P3 agreements. Therefore, the private partner is the single point of contact for the public partner, responsible for any shortcomings in a P3 project's design, construction, operations, and maintenance in the case of a DBFOM project. This avoids the "liability gap" that public entities frequently find themselves in, and the inevitable finger pointing that arises between the public entity's designer and contractor, when a facility's performance is deficient and the project was delivered under a traditional design-bid-build method.<sup>3</sup>

There are other, less tangible but equally important benefits that P3 projects can offer public partners. For instance, where a P3 project includes post-construction operation and maintenance by the private partner, the public partner can remove itself from the day-to-day operations and maintenance of the facility (while maintaining appropriate oversight) and focus on its core strengths. So, in the case of a wastewater or water treatment facility, for example, which requires expertise to operate and maintain correctly, the public partner can use the private partner to operate and maintain the facility consistent with the latest innovations, efficiencies and best practices that the private sector has to offer. (These private partner contributions, which would be difficult for many public entities to

match, include asset management and preventive-and-predictive maintenance programs that drive cost-efficient capital investments to assure best lifecycles costs for delivered services.) Thus, the shifting of operation-and-maintenance functions to a private partner allows the public partner to focus on other community services and priorities.

Additionally, in terms of some of the wider-ranging benefits that P3s offer, construction projects generate jobs and increase government tax revenues. According to the Associated General Contractors of America, for each \$1 billion invested in construction, 28,500 jobs are created or sustained, adding about \$1.1 billion to personal earnings and about \$3.4 billion to the nation's GDP.<sup>4</sup> The growth in jobs, personal earnings and revenue for local businesses, in turn, generate additional revenue for public entities in the form of taxes.

Although P3s can offer many direct and indirect benefits, P3s do not come without their challenges. Chief among them is the increased complexity of P3 deals. Despite some common characteristics that P3 projects share, each P3 agreement is unique and there is no "form" P3 agreement used in the United States. The delivery of projects on a P3 basis requires significant legal and technical input to both the public partner and the private partner.<sup>5</sup> Additionally, because P3 projects are relatively rare in California, there is a general lack of familiarity with the P3 delivery model. Therefore, P3 deals currently tend to take a long time to come together, and involve high transactional costs, making the delivery of a project on a P3 basis inappropriate unless the project is of adequate size and cost. However, as P3 programs become more common and standardized in California, P3 deals should become more streamlined, meaning that the

project-cost threshold should decrease for P3 projects.

Further, there seems to be a public perception problem with respect to P3 projects. Some concerns include fears that: P3s cause the total privatization of public infrastructure assets and the loss of public control over such assets;<sup>6</sup> P3 projects cost more than those paid for by public funds;<sup>7</sup> P3s hold the public responsible for the private sector's mistakes;<sup>8</sup> and P3s make the private sector rich.<sup>9</sup> These concerns are unfounded and are prevented by the terms of most P3 agreements. Nevertheless, these concerns exist and can make it difficult for a public entity (and especially its elected officials) to pursue projects on a P3 basis.

### **A Recent P3 Success Story**

Although California's P3 enabling statutes for local government agencies have been in existence for nearly twenty years, there is only one significant project known to the authors that was pursued under these statutes. That P3 project was recently undertaken by the City of Rialto, a city 60 miles east of Los Angeles, on a DBFOM basis. The private partner on that project closed its debt and equity financing for \$176 million in late-November 2012.

Rialto, like many other California cities, has aging water and wastewater systems and treatment facilities. It had deferred rate increases and capital maintenance investments for a decade. It needed to upgrade and expand its systems and facilities, but it neither had the funds nor the public debt financing ability to pay for this work. Instead, it decided to pursue the project on a P3 basis, so that it could finance the project with private funds and avoid significant upfront costs, benefit from the technical, commercial and financial skills and expertise of the private sector, and focus

on its core city management competencies, which did not include operating and maintaining water and wastewater systems and treatment facilities. It should be noted that Rialto put the concession's substantial rate increases to a Proposition 218 vote before entering into a P3 agreement. The residents of Rialto passed the measure, even though the rate increases were set to be twenty-five percent per year for the first four years of the P3's term, and Rialto then finalized the P3 concession procurement.

After three years of negotiation, Rialto and its special purpose joint powers agency, the Public Utility Authority, entered into a P3 agreement with a private entity partner to design, build and finance upgrades and expansions to Rialto's water and wastewater facilities. The P3 agreement required the private partner to construct such facilities and upgrades within the first five years of agreement and required the private partner to operate and maintain the systems and facilities for the agreement's entire 30-year term.<sup>10</sup> A capital improvements plan was established by Rialto, its private partner and various technical experts for the initial upgrades under a collaborative approach with objectives of rectifying deferred capital investments, implementing robust maintenance programs over the concession term and beyond, and optimizing life-cycle costs. It is estimated that the work to upgrade and expand the facilities in the short term will generate 445 construction jobs.<sup>11</sup>

Additionally, under the P3 agreement for Rialto's water and wastewater systems and treatment facilities, the Public Utility Authority's existing debt of \$27.4 million was extinguished and Rialto received an upfront payment of \$30 million from the private partner.<sup>12</sup> Various reserve funds for operations, capital maintenance, and financial security were also established. The

private partner financed the P3 deal through debt and equity. Specifically, it issued \$146 million in 30-year notes to pension plans and insurance companies, and raised \$26 million in private equity.<sup>13</sup> Further, the private partner retained a reputable operator to operate and maintain Rialto's water and wastewater systems and facilities, and the operator committed to retain Rialto's government personnel who had previously worked at the facilities.<sup>14</sup> The private partner is paid by Rialto through a combination of monthly capital charges and operating payments. Rialto finances these payments through water and wastewater user fees and various non-rate revenues.

### **“Best Practices” for P3s**

A P3 program should strive to achieve as many of the potential benefits that P3 projects can offer.<sup>15</sup> The overall premise supporting the development of projects under a P3 approach is that public infrastructure projects can benefit from the private sector's involvement in terms innovations, efficiencies and best practices for design, construction, operation and maintenance of such projects. Accordingly, as a part of a P3 program, strong incentives should be established for the private sector to efficiently and cost-effectively deliver needed public infrastructure.

Initially, however, a P3 program should focus on whether a particular project should proceed on a P3 basis or a traditional, solely publicly-funded basis. After conducting a feasibility study and making the business case for developing a particular project, the determination of whether to proceed on a P3 basis should focus on a rigorous value for money (“VfM”) analysis for the project's entire lifecycle.<sup>16</sup> The VfM for delivery under a P3 method then needs to be compared to the VfM for delivery under a traditional method. If the VfM analysis does

not support a P3 approach, it should not be used for the project.

Additionally, a P3 program should establish criteria to evaluate whether a particular project is appropriate to pursue on a P3 basis. Such criteria could include an evaluation of the project's public benefits. For instance, if the project is needed to deliver immediate benefits, the project is a good candidate to proceed as a P3 given that P3 projects generally get built quicker due to the fast-track nature of their design and construction. Another criterion could include an evaluation of the project's technical complexity. If the project is technically complex, where the benefit of the private sector's expertise in design, construction, operation and maintenance would be better realized, the better suited it is to a P3 approach.

Equally important, a P3 program should emphasize fairness, consistency and transparency. Given that some of the public has a negative perception of P3s, it is critically important that P3 programs consistently adhere to clear evaluation criteria and apply them fairly. Further, the P3 evaluation should be open to public review to ward off concerns of cronyism and the like, and to generate public support for P3s.

A P3 program should also include objectives to be achieved in any P3 agreement prepared for a project that meets all the selection criteria. The overall goal of P3 agreements is to craft them to the strengths of the public and private sectors while respecting the fiduciary duties owed by public officials to their ratepayers and respecting the return on investment that drives the deals for private partners. This overall goal is accomplished through specific objectives. First and foremost is the clear definition of the

technical aspects and the performance requirements for the project in the P3 agreement. It is best to state these as performance specifications that allow the private partner to determine how best to achieve those requirements given that the private partner is in a better position analyze various design and construction options that are able to create post-construction synergies with operation and maintenance of the completed facility.

Other objectives to be achieved in P3 agreements include allocating risks to the party best able to manage them. If certain risks are allocated to a private partner that is not able to control them, the government entity will pay a higher price for the P3 deal than it otherwise would if the risk were retained by the public entity. This is frequently called a "risk premium." For instance, the risk of environmental approvals and permits is best retained by the local government agency, whereas the risks associated with the design, construction, operation and maintenance of a P3 project are appropriately shifted to the private partner.

Another important objective is establishing incentives for the private partner in P3 agreements. A premise supporting the development of projects on a P3 basis is that such projects get built more efficiently than traditionally-delivered projects. The efficiencies that P3s can deliver take the form of lower costs, faster completion, and higher quality design and construction. The private partner should be incentivized in P3 agreements to achieve these efficiencies, and if done correctly, a project's overall lifecycle costs will be reduced while not sacrificing the facility's performance. A further objective is to enhance the local public agency's cash-flow through P3 agreements, which could include requiring

an upfront cash infusion, so that the agency's existing debt can be retired, or requiring that higher user fees not become effective until after the constructed facility becomes operational.

P3 agreements also need to avoid private-sector windfalls by capping the private partner's return on investment. This is frequently done by establishing a rate-setting formula to ensure that the cap is not exceeded, to ensure that rate increases to ratepayers are fixed and predictable, and to ensure that there is a known revenue stream to the private partner. Absent predictability for ratepayers, there is a risk of ratepayer revolt.

P3 agreements should further establish a governmental oversight mechanism that will regularly evaluate the private partner's performance under the P3 agreement. This is needed to maintain transparency for the public's benefit and to satisfy the government entity's fiduciary duties to its ratepayers.

Finally, for P3 programs to be successful, they must have the internal political support of local government agencies and broad-based public support, which can be achieved through education and outreach programs. Local government agencies supporting P3

programs must also be perceived as being stable and committed to P3s. Private partners rightly shy away from the risk of negotiating P3 transactions with state governments, cities, counties or special districts that have a history of electoral instability or bureaucratic impasse. Therefore, local government agencies need to establish themselves as "can do" agencies, where there is minimal political risk that projects will be derailed after time and money have been invested to put together a P3 deal.

### **Conclusion**

Local government agencies have a powerful tool to address their infrastructure needs. That little-used tool is the P3 project delivery method that can be used to develop projects through private funding. P3s can help bridge the gap between the State's public infrastructure demands with the supply of private capital available to invest in P3 projects. Not every infrastructure project is appropriately pursued on a P3 basis, but many larger, technically-complex projects could benefit from the private sector's involvement. The benefits P3s offer extend beyond the particular P3 project to be built and can be wide ranging.

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<sup>1</sup> In the United Kingdom, 700 projects have been pursued on a P3 basis since 1992, and over £ 55 billion in private funds has been invested in the UK's P3s. HM Treasury, *A New Approach to Public Private Partnerships* (Dec. 2012). These projects have included schools, hospitals, roads, prisons, housing, and waste facilities. *Id.* In Canada, over 100 P3 projects have been built under a P3 approach since the early-1990s. The Conference Board of Canada, *Dispelling the Myths: A Pan-Canada Assessment of Public-Private Partnerships for Infrastructure Investments* (Jan. 2010). Additionally, over the past eight years, Canada has used P3s to deliver 34 operational hospitals and 20 currently under construction. Consequently, the nation has fast-tracked the delivery of hospital facilities, improved health care to patients, and significantly reduced costs. Canadian Council for Public-Private Partnerships Database, available at <http://projects.pppcouncil.ca/ccppp/src/public/search->

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project?pageid=3d067bedfe2f4677470dd6ccf64d05ed. By using P3s to design, build, finance and maintain eighteen schools in Calgary and Edmonton, the Alberta government saved \$97 million over thirty-two years compared to a traditional approach (\$634 million instead of \$731 million, a 13% savings). *Id.* The use of P3s also delivered the schools two years earlier than they would have been delivered under traditional delivery methods. *Id.*

<sup>2</sup> A Reason Foundation study found that if California used P3s for correctional facilities, it would save state taxpayers nearly \$2 billion in inmate housing costs over the next five years. L. Gilroy, A. Summers et al., *Public-Private Partnerships for Corrections in California: Bridging the Gap Between Crisis and Reform*, Reason Foundation, April 2011. Similarly, an Australian study that focused on 54 social, transportation, water, and information technology projects comprised of 21 P3 projects and 33 traditionally-delivered projects found that the P3 projects were more efficient in terms of cost and time. Infrastructure Partnerships Australia, *Performance of PPPs and Traditional Procurement in Australia* (Nov. 2007). Specifically, the Australian study found that cost overruns on the P3 projects averaged about 1% (i.e., \$58 million in overruns on \$4.9 billion of P3 projects), whereas the cost overruns on the traditional projects averaged about 15% (i.e., \$673 million in overruns on \$4.5 billion of conventional projects). *Id.* Additionally, the study found that on a value-weighted basis, the P3 projects were completed about 3% ahead of schedule, whereas the traditional projects were completed about 23.5% behind schedule. *Id.* Finally, a recent study conducted by Arizona State University that focused on 12 US highway projects valued at over \$90 million each compared P3 projects to those delivered under a design-bid-build approach and a design-build approach. A. Chasey, W. Maddex et al., *A Comparison of Public-Private Partnerships and Traditional Procurement Methods in North American Highway Construction* (March 2012). That study concluded that cost overruns on P3 projects averaged less than 1% and that the P3 projects were completed slightly ahead of schedule. *Id.* In contrast, cost overruns and schedule overruns on design-bid-build projects averaged about 13% and 4%, respectively, and cost overruns and schedule overruns on design-build projects averaged about 1% and 11%, respectively. *Id.*

<sup>3</sup> Under a traditional design-bid-build delivery method, the public project owner initially retains a designer to fully design the facility and then awards a construction contract to the lowest responsive and responsible bidder. In such situations, the public owner impliedly warrants to the contractor the adequacy and completeness of the design it provides under what is commonly called the Spearin Doctrine. However, the design the public owner receives from its designer is not similarly warranted by the designer. Instead, the designer warrants that its design is only as good as that produced by a reasonably prudent designer under similar circumstances. This can create a “liability gap” for the public owner where there are errors and omissions in the design that do not fall below the designer’s applicable standard of care but nevertheless cause the contractor to incur damages for which the public owner is liable.

<sup>4</sup> Association of General Contractors, available at [http://www.agc.org/cs/2012\\_election](http://www.agc.org/cs/2012_election) (citing Dr. Stephen Fuller of George Mason University).

<sup>5</sup> P3 agreements for existing infrastructure facilities can be more technically and legally complex than P3 agreements for new facilities. Existing public infrastructure facilities have an “as-is” risk that new, to-be-constructed facilities do not have. With existing facilities that are to be upgraded and expanded, one major challenge of a P3 deal is balancing the public partner’s goal of shifting all operation-and-maintenance cost risks to the private partner and the private partner’s interest in not taking on open-ended or undefined cost risks associated with a facility

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that was built many years ago. To overcome these as-is risk transfer issues, P3 deals are often structured around a defined approach for preventative, predictive and corrective maintenance management. This results in a shared responsibility for the as-is risk that is transferred to the private partner over the first several years of the P3 agreement's term.

<sup>6</sup> P3s do not amount to privatization. Although the P3 enabling statutes for local government agencies permit the lease or transfer of ownership of a public infrastructure facility to a private partner, the public facility must be returned to the public partner at the end of the P3 agreement. Gov't Code § 5956.6(a). Additionally, the public maintains control over public infrastructure assets through P3 agreements, which establish performance standards and rate-setting mechanisms to which the private partner must adhere.

<sup>7</sup> P3 projects are not more costly than non-P3 projects if the project is appropriately evaluated. As discussed *infra*, a rigorous money-for-value analysis of a particular project's lifecycle costs is required to determine whether the cost to develop the project on a P3 basis is less than the cost to develop it with public funds. As a part of that analysis, the risks involved in developing the project needs to be considered and monetarily quantified. If the analysis supports proceeding with the project on a P3 basis, it means that the cost for the project over its lifecycle (in terms of the net present value) is estimated to be less than it would cost through a non-P3 approach. Importantly, not all projects are appropriately pursued under a P3 approach.

<sup>8</sup> P3s do not make the public responsible for the private partner's mistakes. A private partner is held to certain performance standards under a properly structured P3 agreement. If the private partner fails to meet those performance requirements, the private partner's revenue is reduced or the P3 agreement may be terminated by the public partner for the private partner's default.

<sup>9</sup> P3s do not make private partners rich. A properly structured P3 agreement has a fee-setting mechanism with caps that are designed to prevent the private partner from receiving a windfall. If user fees generated by a P3 project exceed projections, the P3 agreement should call for the sharing of the reward between the public and private partners.

<sup>10</sup> R. Jensen, *Southern California City Enters into P3 for Its Water and Sewer Systems*, The Bond Buyer, Feb. 20, 2013, available at [www.bondbuyer.com/121\\_234/rialto-california-water-sewer-utilities-pubioc-private-partnership/](http://www.bondbuyer.com/121_234/rialto-california-water-sewer-utilities-pubioc-private-partnership/).

<sup>11</sup> The 20/20 Network, *Saving Cities Through Public-Private Partnerships*, available at [www.the2020network.com/2012/12/saving-cities-through-public-private-partnerships/](http://www.the2020network.com/2012/12/saving-cities-through-public-private-partnerships/).

<sup>12</sup> R. Jensen, *Southern California City Enters into P3 for Its Water and Sewer Systems*, The Bond Buyer, Feb. 20, 2013, *supra*.

<sup>13</sup> Id.

<sup>14</sup> Id.

<sup>15</sup> Local government agencies have not previously pursued P3 projects because they generally seem to have been ill-equipped to develop P3 programs that fully protect the public interest. To overcome this and to advance the goal of developing public infrastructure projects, local government agencies should develop the expertise to establish a P3 program. Many such agencies, however, simply do not have the staff or resources to develop this expertise internally, so they will have to either join forces to develop in-house expertise collectively or rely on outside legal, technical and financial advisers to pursue P3 opportunities. Ideally, however, a specialized, state-wide P3 department or taskforce could be established to assist local government agencies in expanding P3 opportunities by providing technical input, quality control, policy coordination and other assistance. Specialized P3 departments like this have been



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established in 31 countries to promote P3s. R. Puentes and E. Istrate, *A Path to Public/Private Partnerships for Infrastructure*, The New Republic, Dec. 9, 2011.

<sup>16</sup> The importance of a rigorous value for money analysis was highlighted in a controversial report issued by California's Legislative Analyst's Office ("LAO") on November 8, 2012, entitled *Maximizing State Benefits from Public-Private Partnerships*. In that report, the LAO criticized the VfM analyses used to support the development of the Long Beach Courthouse and the Presidio Parkway Project on a P3 basis, concluding that the projects could have been developed for \$160 million and \$140 million less, respectively, if they had been delivered under a traditional, public-financed approach.