Public-Private Partnerships in the United States: Evolving Market and New Opportunities

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About the Authors

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Abstract
The deterioration of publicly-owned infrastructure facilities in the United States, and the government's inability to make the required improvements, has been well documented and much discussed. At the same time, a growing number of private investors—including most notably U.S. public pension funds—want infrastructure in their portfolios. This demand appears likely to grow further. Given this mutual interest in infrastructure and the need for further investment, one would have expected to have seen a plethora of U.S. projects being delivered though public-private partnerships (P3s). While some promising deals have trickled from the pipeline over the past several years, the expected flood of projects has not occurred. While some see a current lack of P3 deal flow and a polarized political debate as reasons to be frustrated, the exact opposite may be true. The U.S. P3 market appears to have moved on from 1 st Generation asset monetization deals and is now making the transition from 2 nd Generation projects done on an ad hoc basis to 3 rd Generation deals that will focus on identifying and potentially selecting viable P3 projects and then advancing at least some of these projects through a well designed P3 program. If at least some state and local government agencies are able to successfully make this transition, then future projects may have an even better long-term alignment of interests and incentives among the relevant partners than what we have been able to achieve to date.

Background and Current Status

The deterioration of publicly-owned infrastructure facilities in the United States, and the government's inability to make the required improvements, has been well documented and much discussed. Over the past decade, a series of public and private sector reports and studies have detailed the declining state of transportation networks, water and wastewater treatment facilities, flood control systems, schools and various other infrastructure assets. [3] These reports and studies have compared our infrastructure to what exists in other countries with whom we are competing in the global economy. The results do not favor the U.S. The need for additional investment is clear and represents a major economic and policy challenge for this country.

At the same time, a growing number of private investors—including most notably U.S. public pension funds—want infrastructure in their portfolios. This demand appears likely to grow further. Watson Wyatt, an investment consulting and advisory services provider, recently estimated that in 2008 the top 10 managers in infrastructure alone managed $72 billion on behalf of pension funds, up from $43 billion in 2007.[4] Earlier this year Probitas Partners estimated that nearly 80 closed-end funds were in the market for over $90 billion in additional commitments, with the majority of such investment to be targeted on brownfield assets in developed countries.[5] State pension systems in North Dakota, California, Maine, Illinois, Alaska, Washington, Texas, New York and New Jersey have already made infrastructure allocations, and more states are likely to follow.[6]

Given this mutual interest in infrastructure and the need for further investment, one would have expected to have seen a plethora of U.S. projects being delivered though public-private partnerships (P3s). While some promising deals have trickled from the pipeline over the past several years, the expected flood of projects has not occurred. This fact has left many would-be investors and other P3 participants in the uncomfortable position of having to explain to their senior management or limited partners what happened to the robust deal flow that had been predicted in places like Texas and Georgia, and to make a personal determination as to whether P3s will be any easier to launch or close in the foreseeable future.

Below is an analysis of the current state of the U.S. P3 sector, which I see as having developed in three distinct phases. I have also included some discussion about where we may be heading as an industry in the coming 12-18 months.

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[3] See, e.g., "2009 Report Card for Americas Infrastructure," March 25, 2009, American Society of Civil Engineers; "Public-Private Partnerships for Highway Infrastructure: Capitalizing on International Experience," March 2009, Federal Highway Administration; and "Performance Driven: A New Vision for U.S. Transportation Policy," June 9, 2009, Bipartisan Policy Center.

[4] Siddharth Poddar, "Study: $72bn managed by infrastructure investors in 2008," InfrastructureInvestor, July 8, 2009.

[5] Probitas Partners, "Investing in Infrastructure, Summer 2009, at p. 19.

[6] Nick Lord, "Into the Void," Project Finance Magazine, June 2009, at p. 39.

1st Generation P3 Projects: Asset Monetization

The Skyway, Indiana Toll Road and two Chicago Parking deals generated great interest in P3s during the last several years. Among these deals' positive attributes was the fact that they caused many U.S. government officials to consider for the first time innovative private financing approaches involving publicly-owned infrastructure; they also accelerated improvements in how certain transportation facilities are operated and maintained. They do, however, have some important negatives. These so-called asset monetization transactions were structured such that they are unlikely to be politically sustainable over the long term due to an imperfect alignment of incentives among the interested parties. First, the large payments—ranging in size from $563 million for Chicago's downtown public parking system to $3.85 billion for the Indiana Toll Road—were made upfront at closing to the government owners of these facilities. The relevant elected officials hope to retain at least a portion of these upfront proceeds in trust throughout the term of the P3 arrangement. Despite these good intentions, they and their successors will experience a great temptation over the near term to divert these funds to competing public policy priorities, similar to what has happened to the tobacco settlement trust funds in some states. This temptation will be especially acute given the financial difficulties many cities and states are now facing. Ninety percent of city finance officers said they are less likely to meet their cities' financial needs this year than last year according to a recent annual survey by the National League of Cities.[7] As a result, most of the upfront proceeds received from those 1st Generation P3 deals will likely be spent long before the 75- or 99-year concession terms expire, and public pressure to renegotiate these deals or even terminate them will grow—especially as higher user fees begin to kick in over the next several years and memories fade as to the initial benefits that were received.

This is not to criticize those in the private sector who concluded these P3 deals, especially those at Goldman Sachs and elsewhere on Wall Street who collected multimillion dollar fees upon financial close.[8] Despite the fact that such 75- and 99-year P3 structures have not been popular in the international context, they were structured so as to meet the stated policy objectives of those city and state officials with whom the private P3 promoters were working at a particular point in time when P3s were largely unknown in this country. I doubt, however, that we will see many more of these types of deals done in the United States. Subsequent asset monetization failures involving the turnpikes in New Jersey and Pennsylvania, Akron, Ohio's sewage system (indelicately referred to as the "stools for schools" deal), Midway Airport, Milwaukee's water system and Alligator Alley support this assessment. I also believe that the asset monetization parking deals being explored in Los Angeles, Pittsburg and Detroit, at least as currently contemplated, are also likely to fail. More and better organized public opposition will largely prevent these types of 1st Generation deals from getting done in the future. In addition, from the public's perspective, the global financial crisis, growing

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[7] Bond Buyer, "Cities See Less-Than Rosy Financial Futures, NLC Says", September 1, 2009.

[8] Chicago paid Goldman Sachs and Loop Capital Markets LLC $12 million in fees on the Skyway deal. Indiana then paid Goldman $20 million in fees in connection with the Indiana Toll Road deal. Eddie Baeb and Justin Baer, "Goldman Sachs's Conflicts of Interest Convulse Chicago, Indiana," Bloomberg, July 17, 2006, available at: http://www.bloomberg.com/apps/news?pid=20601087&sid=aVVhg_jBNeA0&refer=home.

protectionism and the unraveling of the listed-funds model for infrastructure investing have not boosted the credibility or attractiveness of many private sector P3 participants either.

In addition to the foregoing, asset monetization deals also had the unfortunate side effect of further polarizing the policy debate among many in the transportation community, including what one former colleague referred to as "gas tax traditionalists" and "P3 panacistas." This debate made P3 approaches more difficult to implement since, by 2007, "asset monetization" had almost become a synonym for "P3" among many U.S. groups. I emphasize "further polarizing" because many special interest groups were going to oppose P3s in any case whether they were structured as asset monetizations or not. These groups viewed them as a threat to their vested economic interests in the status quo and potentially disruptive of cozy relationships built up over many years with the public owners of U.S. infrastructure. Those in opposition to P3s for primarily economic rather than ideological reasons include:

- municipal bond underwriters and lawyers;
- some general engineering consultants and design-bid-build construction firms;
- truckers; and
- public employee unions.

Public transportation officials likewise became nervous because of the growing political controversy surrounding P3 projects, the long-term nature of such deals, the fear of loss of control, a failure to understand and be able to articulate how private deals get financed and by whom, and a rational fear that any upfront proceeds would be diverted away from further investment into the existing transportation network. At the federal level, congressional fears seem to relate largely to a perceived loss of status in setting the national strategy for transportation policy and a potentially reduced ability to influence which projects are prioritized for completion based on their national significance. This ideological debate has undoubtedly delayed P3 projects and will continue to do so throughout the upcoming surface transportation reauthorization process.

2nd Generation P3 Projects: Managed Lanes and Availability Payments

As has occurred in numerous other countries, the United States has done some initial P3 deals, made some mistakes along the way, learned something from them, and is now doing some more P3 deals. More mistakes undoubtedly will be made in each subsequent generation of deals (especially because the U.S. public sector is highly fragmented at the sub-national level in comparison to most other countries). Hopefully, lessons will continue to be learned from those future mistakes as well.

In comparison to their 1st Generation counterparts, 2nd Generation deals have tended to focus on better utilization of existing corridors and demand management through variable pricing. Concession terms are relatively shorter, and deals are characterized by more revenue sharing, greater risk transfer to the private partner and more of an emphasis on technology transfer and innovation. Also, these deals have had more of a focus on projects where the majority of users will be in-state commuters as opposed to asset monetization deals that relied more on out-of-state users to pay the higher tolls. Lastly, there appears to be more of a focus on providing operations and maintenance which meet or exceed established performance criteria. Examples of what I consider to be 2nd Generation deals include SH 130 Segments 5&6, the I-495 Capital Beltway, the I-595 express lanes in

Fort Lauderdale, the Port of Miami Tunnel and the two managed lanes projects in Texas (North Tarrant Express and LBJ I-635). The I-595 project is worth mentioning in particular. For the first time, an availability payment structure has been used in the United States for a highway project, which allowed the public to retain control over toll rates and thereby address some of the public concerns associated with the 1st Generation P3 projects discussed above.

It is interesting to note that leading P3 critics such as Dennis Enright of NW Financial and the Professional Engineers in California Government typically have ignored the I-495 Capital Beltway and the I-595 projects, which best exemplify how U.S. P3 projects have evolved in recent years. These deals are more difficult for them to criticize because they involve private activity bonds, TIFIA loans and do not have non-compete agreements, so they are just conveniently ignored by these critics rather than analyzed in a thoughtful way.

There have been a number of other interesting P3 deals either recently done or in progress, but I will leave them for another article. These deals include: the Port of Oakland's 50-year concession involving Ports America and Terminal Shipping; the Houston Airport's joint venture (reached on a negotiated basis) with Canada's OMERS pension fund; Chesapeake's Jordan Bridge replacement project involving Britton Hill Partners; the new Midtown Tunnel in Virginia; and CenterPoint's unsolicited bid for Virginia's principal ports. A variety of P3 projects not involving asset monetization are in fact advancing and thus should not be forgotten or dismissed as we evaluate the current state of the U.S. P3 market.

3rd Generation P3 Projects: Programmatic Approach and Focus on VfM

2nd Generation deals are likely to be more sustainable than are their asset monetization counterparts, due to a longer-term alignment of interests and incentives between the public and private partners. 2nd Generation deals, however, suffer from their own set of deficiencies. They typically have moved forward on an ad hoc, project-by-project basis rather than as part of a comprehensive P3 program, and have tended not to use adequate project screening criteria involving strategic and feasibility assessments, and business case models such as value-for-money (VfM) and cost benefit analysis as part of the government agency's effort to identify, prioritize and develop P3 projects. These financial tools have also not been used effectively in the campaign to build public support for a P3 program or for a particular P3 project.

While it is still early days, 3rd Generation projects may also help us move beyond the ideological stalemate we have reached and allow various conventional and P3 delivery methods to be simultaneously compared and evaluated on a more objective basis so that the option representing the highest value for money can be selected and then implemented on the public's behalf. This type of reasonable, data-driven evaluation process was sorely missing from controversial "public-public" partnership deals done to date involving the Dulles Toll Road, State Highways 121 and 161 in Texas and the Pennsylvania Turnpike.

Various government agencies at the state and local level are likewise beginning to realize that it is not enough to have a P3 enabling law. They also need to develop an associated policy, program and detailed process for implementing individual projects. Similar to what has occurred abroad, some government agencies will also form P3 units.[9] In such an environment, there will be a greater awareness of how important it is to utilize a programmatic approach so that the right projects move forward under the right model. VfM and cost-benefit analysis are now key skills to have on public procurement teams, and this need will be met through a combination of internal staff resources and with external advisors. I believe that it is this single development which holds the most promise for a more robust pipeline of U.S. P3 deals in the coming years.

3rd Generation P3 program management and consulting services contracts either in effect or being developed involve the Los Angeles County Metropolitan Transportation Authority, the Florida Department of Transportation, Miami-Dade County, the City of Prescott, Michigan's new P3 office, the U.S. Department of Transportation, California's Public Infrastructure Advisory Commission, Puerto Rico's Government Development Bank and the New York State Commission on Asset Maximization. All of these government agencies hope to apply performance-based decision making more consistently to help prioritize project delivery and funding and use criteria such as total life-cycle costs, congestion relief, economic development benefits and environmental considerations to help ensure that a long-term planning horizon is considered alongside short-term needs.

[9] As developed and developing countries increasingly utilize PPP approaches for procurement of infrastructure assets, they are creating agencies to provide centralized knowledge and a process for approving and implementing large-scale programs of PPP projects. For a more detailed discussion of this topic, see Christine Farrugia, Tim Reynolds and Ryan J. Orr, "Public-Private Partnership Agencies: A Global Perspective," CRGP Working Paper #0039, Aug. 2008. See also "Public-Private Partnership Units: Lessons for their Design and Use in Infrastructure," PPIAF and The World Bank Group, Oct. 2007.

Conclusion

Aside from the obvious impact of the global financial crisis, some see a current lack of P3 deal flow and a polarized political debate as reasons to be frustrated, but the exact opposite may be true. The U.S. P3 market appears to have moved on from 1st Generation asset monetization deals and is now making the transition from 2nd Generation projects done on an ad hoc basis to 3rd Generation deals that will focus on identifying and potentially selecting viable P3 projects and then advancing at least some of these projects through a well designed P3 program. If at least some state and local government agencies are able to successfully make this transition, then future projects may have an even better long-term alignment of interests and incentives among the relevant partners than what we have been able to achieve to date. Hopefully, when that day comes, then many of us will no longer have to dread our sessions with senior management and limited partners to discuss the state of the U.S. P3 pipeline.