Public-Private Partnerships Are Popular, But Are They Practical?

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Public-private partnerships have become a trendy way to finance transportation projects. But there are big questions to ask before entering into a P3.

by Ryan Holeywell | November 2013

This spring, the Washington newspaper *Politico* published a column touting steps the federal government could take to solve the funding crunch that's led to underinvestment in infrastructure. Invoking imagery of Lincoln's railroads, Eisenhower's highways and Kennedy's space program, the authors concluded that governments must allow the private sector to play a greater role in building public infrastructure, lest America fall behind the competition. To illustrate the concept, the authors highlighted a deal the Puerto Rican government made with a private consortium to operate San Juan's airport for 40 years. "It's time," they wrote, "for government at all levels in the United States to partner with the private sector to bring our transportation infrastructure back to world-class levels."

A similar boost for public-private deals came this summer when a Senate subcommittee held a hearing on "innovative financing." Four of the five featured witnesses were there to press the feds to do more to facilitate public-private deals. Several of the witnesses discussed the daunting price tag for upgrading the country's infrastructure to a decent condition—$3.6 trillion by 2020, according to the American Society of Civil Engineers.

The message was clear: America's infrastructure is struggling, but the private sector can help. "No one wants another bridge to collapse, as did the I-35W Mississippi River Bridge," testified a Morgan Stanley official. That tragedy, which killed 13 people, underscores the need for expanded new, federally subsidized financing tools, he told Congress.

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Public-private partnerships (P3s) are clearly on a roll. Last year's congressional highway authorization vastly expanded the scope of federal mechanisms that provide low-interest loans for projects that typically involve privatization. In addition, the number of states that have passed legislation to enable privatization is on the rise. Many people see P3s as a game-changer: the best, and possibly only, way to repair and replace the country's public works. "The only way we will be able to advance our system is with public-private partnerships," said Jeff Austin, a member of the Texas Transportation Commission, at a recent event in Washington.

Little, however, is said about the downside. The *Politico* column, for instance, did not point out that the airport deal was opposed by the governor and deemed so one-sided that critics have called it a "giveaway." (It also failed to mention that the authors' employer, Highstar Capital, was a partner in that very deal.)

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There's a growing cadre of academics, activists, and state and federal auditors who question these public-private deals, but their voices aren't always heard. At that Senate hearing, for instance, none of those dissenting views was represented on the panel. Nor did the hearing highlight what the governments' own accountants say about P3s—namely that they are unlikely to solve the country's infrastructure funding gap and, in some cases, may carry risks for state and local governments. "Whenever I see advocacy [for P3s], I look for real economic

analysis that justifies privatization," Cate Long, a municipal finance blogger for Reuters, recently wrote. "It's never there."

Increasingly, it seems the discussion of P3s isn't about whether it's wise for governments to enter the deals; it's about how governments can best facilitate them. Although former Congressman Jim Oberstar, who chaired the House Transportation Committee from 2007 to 2011, argued that P3 deals would trample the public's interest, today criticism from most lawmakers "has almost disappeared," says Robert Puentes, a P3 expert at the Brookings Institution. "It's not even political anymore."

To be sure, plenty of P3 projects are seen as successes. For example, Virginia's High Occupancy Toll lanes, which opened last year just outside Washington, D.C., were financed, designed and built by private firms, which will now operate them and collect tolls from drivers. Working with private partners allowed the state to complete the project far more quickly than it could have on its own, say advocates. Similarly, the $1 billion Port of Miami tunnel project, set to open next year, has been viewed as a largely successful public-private deal.

Still, there's a long list of P3s that turned out to be very bad for governments, cases in which public leaders failed to ask the right questions to ensure they were getting a good deal. These instances, in which governments ended up losing tens or hundreds of millions of dollars, provide a cautionary tale for anyone considering a P3. Given that history, and given the current enthusiasm for public-private partnerships, there's a basic question that states and localities ought to be asking: Are the deals accomplishing all they claim to?

When governments want to build a road, they typically use a process called design-bid-build: Engineers, working for the government or on a contract, design a project, and then construction firms bid for the right to build different pieces of it. Governments sell municipal bonds that allow them to borrow money cheaply to pay for the work. The system—at least theoretically—is intended to ensure that governments get the lowest price for building infrastructure.

With a P3, the design, financing, construction, operations and maintenance of a project can be rolled into one transaction. The deals are therefore incredibly complex. They are most common on major highway projects that cost hundreds of millions of dollars. Bidders are typically consortiums made up of major construction and financial firms.

Advocates for P3s say they make sense for four reasons. First, the contractors are involved in the engineering stage of a project, which means they can design features that will promote savings over a project's lifetime. Second, investors have their own money in the game, so they have a major incentive to come in on budget since every overrun eats into their profits. Third, because the deals include long-term maintenance components, they remove the temptation of governments to defer upkeep when times get tough. Fourth—and perhaps most important—governments can transfer risks to the private sector, such as the possibility that construction costs are higher or toll revenue is lower than expected.

The deals gained traction in Europe and Australia before they became prominent here, largely because their citizens are used to higher taxes in general and toll roads specifically. Moreover, the deals are easier to pursue in other parts of the world, where governments have more central authority. And finally, the U.S. is somewhat unique in that it allows municipalities to borrow money extremely cheaply on their own.

But the big firms involved in P3s abroad have been gaining a foothold in the United States. A few projects emerged here in the early 1990s. But the deals really got attention in the mid-2000s, when Indiana and Chicago took upfront payments in exchange for long-term concessions that gave private-sector firms the ability to collect tolls for decades. Today, those types of deals are less in vogue. It's now considered by many to be fiscally imprudent to sacrifice stable, long-term revenue for a one-time payment used to fund short-term needs. Instead P3s are typically used to build new roads or lanes, generally through arrangements where private companies pay for construction and maintenance, and in exchange collect toll revenue.

A slew of factors have made the deals all the buzz among transportation wonks and public officials. Warnings about the deplorable shape of America's roads and bridges have convinced the public of the need to build. But in the wake of the recession, state and local governments continue to struggle financially. Raising taxes is a nonstarter in many places, as is the notion of taking on additional debt through bonds. P3s have been portrayed in some cases as a solution to this dilemma, a source of "new money." "Politicians are at the point where people are crying out for enhancements to infrastructure, but they don't want to hear any proposals for new public revenues," says Phineas Baxandall, a senior budget policy analyst at the nonprofit U.S. PIRG. "So anything that makes it sound like the money's coming out of thin air is a win-win."

The Council for Public-Private Partnerships, which acts as a clearinghouse for P3 advocacy and counts as its members such P3 players as CH2M Hill, Deloitte and United Water, phrases it this way: "By establishing public-private partnerships, government authorities have achieved goals that would otherwise go unmet because of budget limitations." The language taps into a state or local official's greatest concern—that they lack the wherewithal to build infrastructure. "It's perceived as free money," says Puentes of the Brookings Institution. "That perception has to be dealt with," largely because, Puentes and others say, the capital often comes at a cost that can exceed the expense of typical municipal borrowing.

The most attractive aspect of a P3 for many lawmakers is that the borrowed money may not count as debt the same way a municipal bond does. The distinction is hard to grasp since the same citizens ultimately pay for the project, either through tax dollars or tolls. A recent report from New York state Comptroller Thomas DiNapoli says that the deals can be viewed as a form of "backdoor borrowing" that helps lawmakers get around laws requiring voter approval for issuing certain types of debt. They can also act as an end-run around a jurisdiction's debt limit, imposed by statute or simply by the political realities of their state.

"A lot of the time public officials say, 'We don't have any money, let's do a P3,'" says Joshua Schank, head of the Eno Center for Transportation, a think tank. That's a misperception, and one that is fueled by private-sector firms who want to pump up the concept, but also, Schank says, "by public officials who want to escape the reality that if they want better infrastructure, somebody's got to pay for it, and that somebody's got to be taxpayers."

Yet a recent report from the U.S. Department of Transportation's inspector general said unambiguously that P3s are unlikely to reduce the infrastructure funding gap, since they don't increase funding levels. The only way P3s could be seen as generating revenue for state and local governments, the report concluded, is through whatever savings they might achieve through lower construction costs. But even those aren't certain.

"There are people who say P3s create money. That is largely not true, but it's not entirely untrue," says Geoffrey Yarema, a partner at the law firm Nossaman, who has served as an adviser on some of the country's largest public-private partnerships. "They don't produce funding, but they can reduce costs significantly."

But reduced costs aren't a certainty, according to the Congressional Budget Office (CBO). In a 2012 report, the CBO found that P3s have built highways "slightly less expensively and slightly more quickly" than the traditional approach, but the relative scarcity of data and uncertainty of existing studies on the topic "make it difficult to apply [those studies'] conclusions definitively to other such projects."

William Reinhardt, editor of the *Public Works Financing* newsletter, generally believes in the promise of the deals, simply because the public sector has a poor record when it comes to on-time, on-budget construction of major projects. But even he says it's hard to prove which method is best for a given project. "All my life I've been looking for the perfect example to compare one to another," Reinhardt says, "and you can't."

The challenge lies in how governments analyze potential P3 deals. To do so, they estimate the cost of traditional procurement compared to a hypothetical P3 offer. But the analysis can include some factors that are subjective, and it may not consider factors that can't be easily quantified. A recent California Legislative Analyst's Office (LAO) study of two P3 deals—one for the Presidio Parkway in San Francisco and one for a new courthouse in

Long Beach—found that state officials were making assumptions that favored privatization. By the LAO's own estimates, traditional procurement would have saved $300 million on the two deals.

Julie Roin, a University of Chicago law professor, also questions whether the "risk transfer" argument carries any weight. Ostensibly, for the private sector to turn a profit, a deal only makes sense if the government overestimates its risk and underestimates the project's revenue potential. "It's not as if any investor is going to accept risk without demanding compensation," Roin says. "You're just paying for the risk in a different way."

Watchdogs note that in entering into the deals, governments actually may take on all kinds of new risk they didn't face before—like the implications of entering into long-term deals that can constrain lawmakers' policymaking options for decades. In a famous case, the California Department of Transportation used a P3 to build and operate express lanes that opened in the center of California State Route 91 in Orange County in 1995. When the government wanted to expand parts of the roadway to alleviate congestion, it was blocked by a "non-compete" clause in the 35-year contract. Following litigation, the government ultimately bought out the private partner. Just seven years after the express lanes opened, the county's transportation authority paid $207.5 million for the $130 million project. That's a worst-case scenario, of course. Those who study P3s say governments have learned their lesson about non-compete clauses. But "compensation" or "stabilization" clauses—in which governments owe the contractor money for taking actions that could reduce toll revenue—continue.

Chicago got $1.15 billion when it leased its parking meters for 75 years, but whenever it temporarily closes a street the city must compensate the private partner for the lost revenue. When Indiana faced flooding in 2008, tolls were waived to evacuate people quickly, but the state had to pay the Indiana Toll Road's private concessionaire $447,000 for the lost revenue. Carpooling is generally viewed as a good thing—it reduces pollution and congestion—but Virginia could owe millions of dollars to a contractor if too many carpoolers use its tolled high-occupancy express lanes. "These reimbursements make governments the contractor's insurer and guarantor," says Ellen Dannin, a law professor at Penn State University. Moreover, provisions like those may give states a strong monetary incentive to avoid actions that would ordinarily be considered smart public policy. If governments face fines for doing what they think is best, there could be serious implications for the way they govern.

Indeed, governments are not typically known as incredibly nimble actors. But skeptics say these deals have the potential to make them even less able to adapt to changing needs. When governments are locked into long-term deals, it's hard for them to adjust their priorities. "Sixty years from now, we may totally want to redesign cities," says Donald Cohen, executive director of In the Public Interest, an organization that questions privatization and is funded by foundations, unions and individuals who generally oppose privatization. "But we're contractually tied with some entity ... to consider their interests first in many ways."

The CBO notes that P3s "can end up costing the government more than it anticipates" if it has to renegotiate a deal due to disputes over control. The New York comptroller in a 2011 report said that the deals may even cause uncertainty about such basic questions as who's responsible for snow and ice removal or accident repair. "Projects that seem worthwhile initially," the report found, "may turn out to be less beneficial than thought."

But Reinhardt of *Public Works Financing* doesn't buy those claims. "None of these issues are hidden," he says. "The advisers on the public side are exactly as smart as the advisers on the private side. Believe me: Nobody is getting away with nothing." But others insist that even though governments employ consultants in the negotiations, the lawmakers themselves ultimately have to approve the deal. Legislators face a huge disadvantage since few of them have negotiated those type of deals in the course of their careers. And lawmakers focused on re-election may not be as concerned with the implications of a 50- or 75-year deal, since those implications may only be fully understood long after a lawmaker has left office.

Highway P3s are concentrated in certain regions and are relatively few in number. A 2012 Heritage Foundation paper says eight states accounted for 75 percent of the value of roadway P3s over the last 22 years. Since 2008,

the P3 market has represented only about 2 percent of all highway investment. That said, P3s represent some of the biggest and most expensive projects out there. Critics and advocates alike say the trend will continue.

Where does that leave a state or local official? Schank of the Eno Center warns that the public and private sector have widely different goals that often aren't aligned. The problem, he says, is that the private sector comes to the negotiating table with less to lose than the government, and it is also more willing to walk away. That needs to change, critics argue, and a healthy degree of skepticism is needed to ensure the best outcome for the public.

Chicago Mayor Rahm Emanuel's approach to the potential privatization of Midway Airport is a case worth studying. Operating under the cloud of Chicago's widely panned parking meter transaction, Emanuel took an approach that emphasized protections for taxpayers. He insisted on a shorter-term lease of 40 years. He helped develop a "Traveler's Bill of Rights" designed to ensure reasonable parking and food prices at Midway. And he required the private partner to share profits with the city. After initially receiving interest from 16 firms, the city was left with one bidder and opted against privatization, citing lack of competition.

"It's a tool that can be valuable but needs to be used very carefully and with a complete understanding," says Bob Ward, New York's deputy comptroller for budget and policy analysis. He notes that public-private partnerships aren't the only way to do big projects. "We went to the moon without a P3."

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