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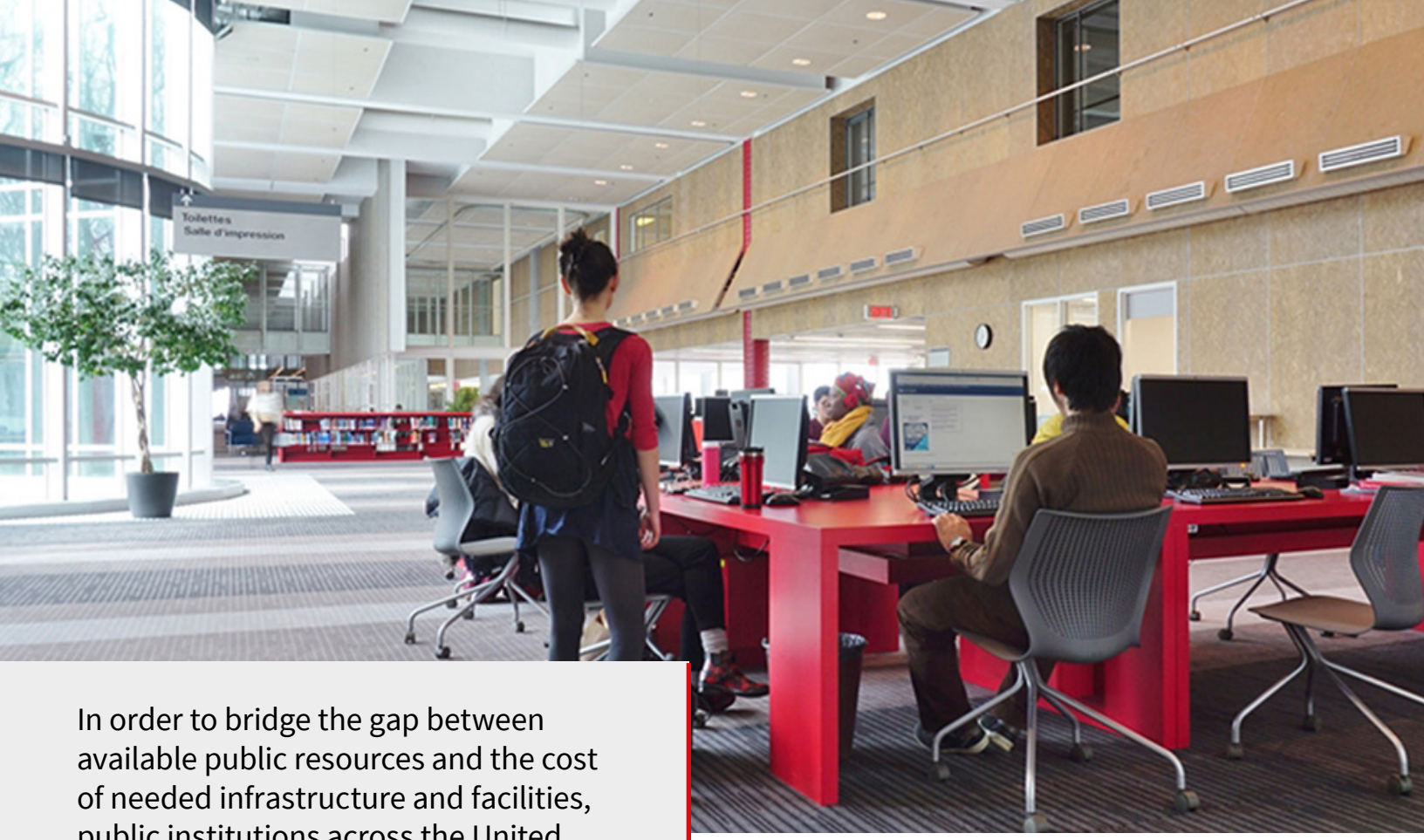
8 crucial factors

to consider before embarking on a public private partnership



In order to bridge the gap between available public resources and the cost of needed infrastructure and facilities, public institutions across the United States are turning to public private partnership (P3) transaction structures

Faced with funding challenges and aging or inadequate facilities and infrastructure, many institutions across the nation are struggling with how to repair, expand and modernize their core infrastructure and critical facilities. Many public institutions lack the financial resources required to meet their capital needs. In order to bridge the gap between available public resources and the cost of needed infrastructure and facilities, public institutions across the United States are turning to public private partnership (P3) transaction structures. Through an infusion of private capital and management, a P3 can ease fiscal restraints and boost efficiency in the provision of public infrastructure and facilities, and thereby services. Despite their potential, however, P3s are highly complex policy instruments. Indeed, significant political, regulatory and institutional challenges must be managed, mitigated and overcome in order to move from a traditional model of delivery to one where public and private sectors work together.

P3s come in many shapes and sizes and have been used in industry sectors as diverse as roads and airports, universities, hospitals and government facilities. Simply defined, a P3 involves leveraging the private sector, which partners with the public sector to provide the capital and expertise, to develop and/or operate and maintain infrastructure and facilities on publicly owned land. The key element of a P3 is the contractual arrangement between the public and private sector partners, which allows the private sector partner a greater level of participation in a public project than traditional structures. P3s are used to solve a variety of problems, utilizing a variety of structures. As such, it is often said that “if you’ve seen one P3, you’ve seen one P3.” This diversity notwithstanding, almost all P3s share the following fundamental characteristics:

- A medium- to long-term arrangement between the public and private
- A clear agreement of shared objectives and sharing of risks
- Capital investment is typically made by the private sector

Broadly speaking, in a P3 transaction the public sector partner benefits by transferring certain important risks to the private sector partner, thus giving the public partner the advantage of the efficiencies and innovations of the private sector. Moreover, the public sector partner may benefit by receiving substantial payments upfront and/or future revenue sharing from the private sector partner. P3s can provide the public sector partner with access to much needed funds to finance educational programs and public infrastructure projects, thereby freeing funds for core programs. However, if the public entity has sufficient financial resources, it is often more beneficial to have the public sector provide the financing through lower cost tax-exempt debt issuance. The pros and cons of different\financing alternatives should always be analyzed when considering the appropriate way to structure a P3.

P3s are designed to combine the strengths of both the public and private sectors. A P3 builds on the expertise of each partner to develop or improve facilities and services needed by the public, through the appropriate allocation of resources, risks, rewards and responsibilities. Accordingly, a P3 allows the public and private sectors to come together for the benefit of the public institution's stakeholders. Under the P3 structure, the relationship between the public and private partners extends far beyond the design/build period to include the costs of operating and maintaining the facility or asset (including maintenance and energy consumption) over a period corresponding to its useful life. This "life cycle cost" structure gives the private sector partner an added incentive to design, construct, operate and maintain the facility in the most efficient and costeffective manner during the term of the P3, while still complying with the technical performance standards established by the public sector partner.

Uses of P3s and typical structures

P3s differ from both traditional privatization (where an asset or facility is simply sold to the private sector with no public sector involvement going forward) and the "Design-Build" (DB) structure (where there is no equity investment by the private sector partner and no ongoing relationship after construction). The "Design-Build-Operate-Maintain"(DBOM) structure employed by various public authorities in recent years has allowed the public sector to tap into the innovation and efficiencies of the private sector more successfully than other, more traditional approaches. A well crafted P3 structure, with its added risk transfer and financing components, offers the possibility of maximizing these innovation and efficiency benefits.

P3s can be used to address many different types of issues, but the core reasons they are typically used involves one or more of the following elements:

- Leverage private sector expertise and capital to unlock value through the privatization of publicly owned assets to generate revenue, transfer risk and improve operations
- Development of new assets with a life cycle approach, whereby the risk for design, construction, operations, maintenance and capital renewal is contractually transferred to the private sector partner
- Access to private sector capital and minimizing the credit and debt capacity impact on the public partner
- An opportunity for the public sector to establish a joint venture in a revenue producing asset with the private partner, while transferring the development and market risk to the private partner
- Leverage private sector innovation through performance based design
- Provide resources and expertise that may be unavailable to the public sector under traditional project delivery methods and accelerate the speed of delivery
- Avoid legislative and policy encumbrances that add time and cost to public sector projects

There are two predominant categories of P3 structures, each of which can be hybridized in a number of ways.

A concession agreement whereby the public institution contracts with the private sector to design, finance, construct, maintain and/or operate the facility or asset for a specified period of time. Under a concession agreement structure the private partner usually makes a cash equity investment in its P3 project and may raise further funds from the capital markets, bank facilities or other traditional private funding sources. The possibility of losing its funds, and suffering reputational damage in the financing markets, provides the private sector partner with a powerful incentive to maximize innovation and efficiency in fulfilling its obligations under the P3 arrangement. Under these agreements the public agency always maintains ownership of the facilities, but the project is generally financed by the private partner using their equity and taxable debt.

A lease/ lease back structure whereby the public sector entity ground leases property to a 501c (3) and the 501c (3) contracts with a developer/builder to design, build, operate and maintain the facilities to the specifications and standards of the public entity. Under this structure, the 501 c(3) issues tax-exempt debt to finance the facilities while the public partner enters into a longterm lease with the 501 c (3) until the underlying debt is retired. Once the debt is retired (typically around 30 years) the facilities revert back to the ownership of the public entity. Under this structure the 501 c (3) is a passive owner of the facilities, which are built and operated for the benefit of the public sector partner who will ultimately retain ownership.

Planning for a successful P3

There is much industry debate as to which of the two P3 models outlined above offer the greatest benefits. However, each of these structures have pros and cons and determining the best structure should be derived through systematic and thoughtful analysis by the public sector,taking into account the project's specific goals, objectives, financing requirements and risk thresholds.

To ensure that the structure ultimately selected provides the maximum benefits, all public agencies should take the following steps to align their projects for success.

1. Define the need, goal to achieve and challenges to overcome

The well known phrase "if you don't know where you are going any road will get you there" too often characterizes public projects. Many public projects are undertaken with no clear objectives or metrics by which to measure success. At the outset of a major project, it is critical to think deeply about how success will be defined. This should begin with leadership developing an overall vision and strategy for the project. This vision should consider the many ways the proposed development and/or privatization will impact the organization. The result should be a document that articulates leadership's ideal state for the project. Once established, this vision and its supporting goals become the "conscience" of the project, forming the foundation by which all other actions are guided and evaluated.

The established vision should then be underpinned specific and measurable outcomes. One method of achieving this is to use a balanced scorecard model as the evaluative framework. The balanced scorecard considers project performance in the context of its impact on four major aspects of business: people, process, finance and the customer. The purpose of this perspective is to evaluate attainment of project objectives, not only in terms of their impact on each individual category, but also in relation to the overall equilibrium between categories. These perspectives address issues that pertain to:

People: impact of the proposed project on the human resources upon whose intellect, energy, motivation, and satisfaction the success of the organization depends

Process: ways in which the project will impact the work processes and productivity of the organization

Finance: degree to which the project optimizes the organization's financial health and viability, both in the short and long term

Customer: impact of the project on the performance and/or satisfaction of everyone who uses or wishes to use the services and/or products provided by the organization

After project goals and success criteria have been determined, the project team must develop a clear understanding of current conditions and future needs. This process focuses on defining the current condition and contrasting it against the desired future state. The process seeks to clearly identify the "gap" or variance between what is desired and what exists today. Once the goals, success metrics and gap have been defined, it enables the development of clear project targets, by which all subsequent actions can be compared and evaluated. If rigor is invested at this stage, the clarity established will continue to pay dividends throughout the life of the project.

2. Evaluate alternative approaches to solving the problem

There is never a single approach to implementing a project. The key challenge is determining the approach that best aligns with your project's unique goals, conditions,resources and constraints. The table above lists the typical development structures most often used on projects and includes both traditional owner-led development and P3 development. The table also provides a very high-level summary of each structure's key features and benefits.

There are a variety of methods that can be used to analyze various traditional owner-controlled and P3 project delivery methodologies, but in all cases each alternative should be evaluated based upon its ability to deliver on the project's specific goals, objectives, constraints and timing requirements.

A common practice is to build an initial business case that compares the merits of all structures contemplated against their ability to meet the project's overall goals on a risk-adjusted basis. This process considers each project structure on a life cycle cost basis that incorporates estimates of all project costs (e.g. design, construction, operations, maintenance, financing, etc.) and uses subject matter experts to value the various risks that are retained or transferred under each methodology. The goal is to objectively analyze the benefits and costs of each project delivery structure over the life of the investment prior to making a decision to move forward. It is also important as part of this process to evaluate any new delivery structure against what the public entity has done in the past and is the most familiar with.

3. Develop a clear program of requirements and performance standards

"Measure twice, cut once." This old carpenter's adage nicely encapsulates the role programming plays in development. Where architecture can be characterized as the art and science of designing a solution for the built environment, programming is the process by which the architectural problem to be solved is appropriately defined and articulated. A good program provides a clear and measurable map to an architectural outcome. Ideally, this map should convey the quantitative and qualitative characteristics desired by the architectural solution, including the key aspects of the work to be supported, the image and feel of the space, detailed building performance criteria for construction and operations and maintenance, space utilization requirements, space standards, key adjacency relationships, special space criteria, cost parameters and, most importantly, definitive ways to evaluate the architectural solution against measurable performance criteria.

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In addition to a clear program, a P3 requires the rigorous development of performance standards. Depending on the nature of the project, these standards will address some or all of the following categories: design, construction, operations, maintenance, and handback conditions. It is critically important that these standards be articulated in a manner that is measurable and contractually enforceable. Another key element of performance specifications for a P3 is to strive to make them outcome based, rather than prescriptive. For example, instead of specifying exactly what products and materials should be used to ensure that a room in a facility has adequate acoustic performance, a performance specification would simply state that the room has to perform within a certain range of decibel levels. With that standard set, the private sector partner has the freedom to determine how best to achieve the standard, rather than having it dictated by the public partner's specifications. This method of establishing standards provides the private sector with the flexibility to provide innovative solutions to achieve a prescribed level of performance, while still providing the public sector with the measurable assurance that their performance requirements will be achieved. Establishing specifications in this manner requires specialized expertise that most public agencies do not have and is a reason why it is critically important for the public entity to engage the right advisors to help them navigate through this process.

4. Determine the project timing/ critical path for delivery

Although well-designed P3s are can typically be implemented more quickly than traditional publicly controlled development, they often become delayed in the preparation and approval process if not properly planned. In a P3 it is very important to evaluate the time it will take for the public entity to define the project's requirements and to define the governance structure and all the approvals that will be needed to get the project off the ground. It is in the pre-planning and approval process that we most typically see schedule slippage on P3s. This is particularly the case when it is the first time that a public entity has ever been done by an agency.

To ensure success and adherence to schedule the public entity should be careful to address the following:

- Time required to develop Technical Requirements and the P3 Project Agreement
- Clearly define the governance structure from the public side
- Have a clear understanding, strategy and timeline to gain stakeholder approvals
- Establish a stakeholder communication plan to facilitate project support and approvals

5. Determine what staff and consultant resources are required

Most organizations do not have staff with expertise in the complicated finance, real estate and risk allocation strategies that must be addressed in a P3. Therefore, when considering the implementation of a complex P3 it is important for the public sector partner to honestly assess their staff's expertise and, where needed, retain the specialized real estate, finance and legal advisors who can support you through the process. The legal advisor will always be a specific entity. However, the real estate and financial advisory expertise you'll need could be contained within the same firm. Careful analysis of prior experience of the advisors is essential when assembling your advisory team. Factors to consider typically include:

- Do the advisors have experience with similar projects? For instance, if the development is a student housing project, a P3 advisor who has only done toll roads and bridges many not be an ideal candidate.
- Do the advisors have experience with a wide variety of P3 structures or are they specialized around one particular structure (DBFOM concession agreements vs. lease/lease back structures, for example)?
- Do the advisors have previous experience with your institution?
- Have the advisors demonstrated the ability to work well with multidisciplinary teams?
- Do they feel like a good "fit" with your institution's culture?
- Most importantly, how have they performed on prior P3s, as demonstrated through their qualifications, and further validated by reference checks?

6. Evaluate financing needs and resources

Financing is always a key consideration on every P3 project and establishing a supportable plan of finance that optimizes cost and effectively allocates risks and rewards between the parties is of paramount importance. There are many key considerations that must be addressed in determining the plan of finance and if your university does not have this expertise in house, you need to retain and advisor who does. Some typical financing considerations include:

- Do you have access to adequate funding to support the project or will you have to rely on the private partner to provide capital?
- What is the credit and debt capacity impact of various financing alternatives?
- Are there any restrictions on various types of funding and, if so, how do these restrictions impact the project?
- Are the assets revenue producing?
- Do you want the developer to have “at risk” equity in the transaction to incentivize their performance?
- Is there an opportunity for profit sharing between the public and private partners and, if so, how will this be structured?
- What are the financials implications of transferring various risks to the private sector?

7. Identify the key stakeholders and governance and approval process

We cannot emphasize strongly enough the need for a clear process and strategy to manage stakeholders and establish the governance and approval process on a P3. Failure to do so is probably the single biggest reason a P3 project fails. This is particularly the case in large systems where there is a governance and approval process required at multiple levels, both at the campus level and with the central system office. Key elements of this strategy should include:

- Identification of all internal and external stakeholders who can influence the project. For each stakeholder you should identify who they are, what their role is on the project (if any) and their influence and decision making authority.
- Clearly identify the governance structure for the project. Who makes the decisions? When are decisions made? What are the interests and concerns of each key decision making individual or body?
- What is the communication strategy for each key stakeholder and decision maker?
- What data and analysis must be provided to each decision maker to facilitate a positive outcome?
- What is the timing of decisions and how does this impact the overall. For example, if key board approvals only happen at certain times of the year, the P3 development schedule should be adjusted to work towards these milestones.

8. Identify the key risks and determine how they should be allocated between partners

A fundamental attribute of all P3s is the sharing of risk between the public and private sectors. These risks vary between projects, but generally fall into one of the following major categories, and within each of these categories will be a variety of subcategories:

- Design and construction
- Operation and maintenance
- Capital renewal
- Schedule
- Financing
- Cost
- Revenue risk
- Market risk

In traditional public projects the public entity (owner) retains most of the risk, while in P3s some or all of this risk is contractually transferred to the private partner. Understanding how to value risks factors and determine which risks are better held by the public or private partner is a core success factor for any P3, but not a skill that most staff in the public sector is trained in. Fortunately, there is an emerging center of expertise among a number of consulting firms that can help guide the process of identifying these risks and determining whether they are best retained by the public entity or transferred to the private partner. An important concept that all public entities must understand on P3s is that all risk carries cost and the goal of a P3 is to allocate these risks to the party that can most cost effectively own them.

Developing a P3 that balances flexibility and clarity, aspirations and reality, to meet the needs of both public clients and potential private partners requires hard work, hard thinking and hard choices. However, if clients have experienced consultants to guide them through a structured process that is designed to leverage the skills and wisdom of the private sector while adhering to the policy requirements and risk thresholds of the public entity, they are worth the effort. The public entity is able to deliver a project that is creative and well executed, maximizing return and minimizing exposure. The private partner is able to participate in a development that provides them with a well secured return on investment in what is often a high-visibility project serving the public interest, the classic definition of “doing well by doing good.”

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