

How to become a player in the P3 market

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At a glance

More P3s will mean greater opportunities for US engineering and construction firms.

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Public-private partnerships (P3s) for infrastructure projects have had a fitful history in the US. Despite their success in Canada, Australia, the UK, and other countries, P3s have encountered numerous obstacles in the US, most notably public and political opposition to the notion of private involvement in owning or operating such vital assets as roads and mass transit.

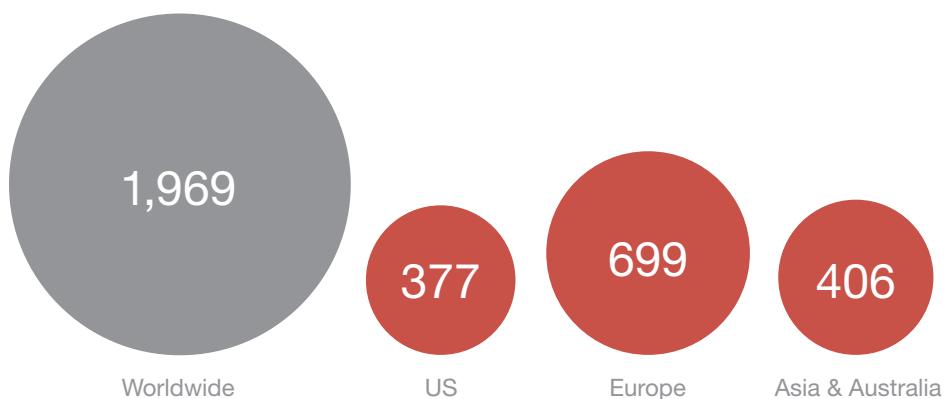
Between 1985 and 2011, 1,969 P3 projects were funded worldwide, but the US accounted for only 377, according to Public Works Financing's International Major Projects database. In contrast, 699 were funded in Europe, and 406 in Asia and Australia.

But financial realities are making P3s more attractive to government officials who face both deteriorating infrastructure and severe budget constraints. The World Economic Forum ranked the US 24th in the world for infrastructure quality¹, while the American Society of Civil Engineers gave the US a grade of "D" for infrastructure.²

While Congress and the Obama administration recently passed the federal transportation bill Moving Ahead for Progress in the 21st Century (MAP-21), which maintains current funding levels through September 2014, state and local governments are taking a hard look at partnerships with private industry to address the

24th
The World Economic Forum ranking of the US in the world for infrastructure quality

P3 projects funded between 1985 and 2011



increasing need to patch or replace crumbling roads, bridges, parking facilities, public buildings, and other infrastructure. Municipalities, in particular, “are the places that I think are seeing more financial stress and therefore may need to be doing [P3] transactions,” says Anthony Edwards, investment director at Industry Funds Management, an Australia-based manager of infrastructure funds. “Everything I read points to the states balancing their budgets by cutting funding for cities and towns, and therefore, the pain is being felt at the more local level. Increasing people’s property taxes materially or cutting local services and jobs isn’t politically acceptable for anybody, so that should help to move things along.”³

More P3s will mean greater opportunities for US engineering and construction firms E&C. Now is the time to prepare for such projects to get an edge on potential local competitors and catch up with more experienced international contractors and project managers.

Getting in the game

How can US E&C firms get into this competitive game dominated by foreign companies with extensive P3 experience abroad?

First, it’s necessary to understand the basics. A P3 is a contractual arrangement between a public agency and a private-sector entity that results in greater private participation in the project. Such agreements usually involve the creation of an entity called a “special purpose vehicle” (SPV) to design, build, maintain, and operate the asset for a contracted period. The SPV typically has several members, including design, engineering, and construction firms, as well as a bank lender and a company to operate and maintain the asset. These private parties invest in the project, receiving an equity interest, and take on substantial financial and operational risks.

P3s take a variety of forms. In many cases, the private-sector entity wins a contract to design, build, finance, operate, and maintain the infrastructure asset under a lease agreement. Depending on the nature of the asset and its revenue-generating capability, the private-sector entity may pay an upfront concession fee and collect and retain revenue generated from the asset. Increasingly, though, the US is adopting “availability payment” schemes in which the private-sector entity is paid by the public sector based on agreed-upon performance criteria for delivering, maintaining, and operating the infrastructure asset. The key to all P3s is how risks and benefits are allocated between the public and private partners.

Building confidence in US P3s

Some states “are attempting to create more uniform and predictable P3 pipelines. An important step in that direction has been the creation of standalone P3 project delivery agencies—the Innovative Delivery Division in Ohio, the Puerto Rico Public-Private Partnerships Authority (PPPA), and the Office of Transportation Public-Private Partnerships (OTP3) in Virginia. ...Steps like this help create confidence in the project pipeline, and they also mean that the US is moving towards becoming an established P3 market like Australia, Canada, and the UK. One estimate puts the value of the near-term US P3 project pipeline at USD40bn.”

Source: July 9, 2012, Peter Allison, Managing Director, Infra-Americas.com, article: “US P3 Forum 2012: A Step-by-Step Guide to What the Market Said about US P3s in New York”

For the private-sector participants, P3s offer potentially greater financial rewards than the typical construction project, as well as greater control and flexibility.

P3s are becoming more popular because they can produce a variety of benefits, including greater operational efficiencies gained from capitalizing on the private sector's know-how and more appropriate allocation of risks to the parties best able to manage them. For the private-sector participants, P3s offer potentially greater financial rewards than the typical construction project, as well as greater control and flexibility.

"You have more leeway in how you go about building and operating things because it's your dime, your financing; you are the captain of your own destiny," says Mitch Lester, project director for Fluor-Lane, the joint venture of Fluor Corp. and Lane Construction Corp. that is building 14 miles of express lanes on the Capital Beltway in northern Virginia. He and Fluor also were part of a consortium that built a high-speed rail line between Schiphol Airport in Amsterdam and the Belgian border.⁴

E&C firms that want to establish their credentials with government officials and members of the SPV must demonstrate a thorough understanding of P3s and articulate the role they want—and are qualified—to play.

Take the partnership route

Many engineering and construction firms are interested in participating in P3s, but it's worth learning the ropes before trying to take a leading role. Firms often assume a subordinate role at first and gradually expand their role and equity stake as they gain experience. It's best to develop a relationship with a large firm with P3 experience, either US-based or international. Local firms can offer to partner with the larger company, but they may find that some large global P3 players have acquired US construction firms and have less need for a local partner.

What can P3 newcomers bring to the game? Tony Caletka, principal in PwC's Capital Project and Infrastructure practice, says, "First and foremost, they must be able to boast an impressive track record for finishing major infrastructure projects on time. Beyond that, it's primarily about their reputation, local connections, and experiences. E&C firms need to position themselves as 'the local team of choice.' After all, they will have developed the major projects in their area, should be very familiar with key government officials,

pertinent codes, laws and regulations, labor unions, suppliers, and local subcontractors."⁸ Their expertise can actually save time and money by expediting the permitting process and acquisition of materials from suppliers.

"You want partners that have relationships with the local subcontractors, local workers, and unions to be able to get the requisite number of experienced people out there to perform the work in a timely fashion," Lester says. "They also can supplement you with their own owned equipment that may already be in the area." Such factors figured into Fluor's partnership with Lane for the P3 in Virginia. While Fluor is an international company, Lester notes that, "Lane has been in the highway business in Virginia and the Washington, D.C., metropolitan area for years."⁴

Those hometown connections are especially important with politically sensitive P3 projects. Companies with strong local roots understand political and community dynamics, which are critical to the acceptance and success of P3 projects. In addition, a firm's local status will appeal to the state and local governments that want to create jobs and boost income tax revenue.

US E&C firms are well advised to connect with bigger out-of-town players early in the process. For example, if there's a P3 in the works for a municipal building, construction firms should approach the procurement officials responsible for the project to see if there's a list of large out-of-town companies that have expressed interest. Companies also can learn about proposed P3 projects and follow their progress by reading industry publications and perusing the minutes of local planning board and city council meetings.

Online research can be valuable because government agencies tend to be quite transparent about P3 projects on their Internet sites. "How many contracts do you see published on websites?" says Ian Dickinson, director of alternative delivery water projects for the global engineering and construction management company AECOM. "It's commonly done with P3 contracts and not commonly done with other forms of procurements. Smaller firms can educate themselves by just pulling off those documents, reading them, and understanding what the risk transfer is in the contract."⁵

Measure your risk tolerance

No doubt, getting involved with P3s is risky business. It requires a bit of drive and entrepreneurial spirit to be willing to invest money upfront in hopes of reaping a healthy return on the tail end. Although it isn't a requirement for admission to a P3, contracting firms typically take an equity stake in the project, even if a nominal percentage initially, to get some "skin in the game." More experienced members of the SPV will take a local player more seriously if it has the ability and willingness to put up some of its own money, indicating a commitment to making the project as efficient and cost effective as possible. The return on that investment will be a share of income generated by a toll road, parking garage, or other asset when it becomes operational.

Making an equity investment may even be necessary for a company's qualifications to be considered in the pre-qualification stage of the bidding process. "Very often at the request-for-qualification stage, the clients will only evaluate the participants who are agreeing to participate in the

concession," Dickinson says. "And so I've seen in many instances where the smaller companies are asked or encouraged to take a stake just so that their qualifications can be counted."⁵

But before deciding to try a P3, construction firms must determine their risk tolerance and carefully evaluate the risks and rewards of specific projects. This analysis requires the know-how to develop a financial model to help determine some of the risks. Then, companies must gauge their own risk appetite and chart a plan to manage and minimize any risks. There's much to gain—and lose—with P3s. It's wise to look at some existing P3 projects in the US or abroad to gain an understanding of how they work. The websites for those projects will probably lay out the risks involved. Then, firms should ask themselves whether it makes sense to take on some or all of those types of risk.

"Companies need to go in eyes wide open, being aware that there will be some risk transfer because of the long-term nature of the deal, which perhaps they might not be used to seeing on traditional projects," Dickinson says. "Particularly in regard to the

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Director of alternative delivery water projects, AECOM

long-term operation and maintenance of the asset, those are risks the smaller companies may traditionally have shied away from and may even still be uncomfortable with in a P3. They need to understand that those risks are inherent to those deals, but that doesn't mean as a smaller company that they can or should take those risks. Those may be risks that have to stay with the larger partner.”⁵

There is no blueprint for P3s put in place by the federal government. Each state and local government has its own procedures and politics—and risks. For example, some states allow non-compete clauses in their P3 deals, while others do not. In the case of a toll road, a non-compete clause would prohibit construction of a competing roadway, reducing the risks to the private companies in the P3.

In addition, “bonding is a key concern for companies because there’s typically a financial guaranty involved, which is beyond what you might normally see in a project,” says Kent Goetjen, PwC US Engineering and Construction

industry leader. “You’re taking on a different kind of risk because it’s not the municipality that’s going to guarantee payment of your invoices.”⁶

Additionally, there is a different kind of collection risk because an SPV may have a lender putting restrictions on the payment cycle, Goetjen notes. “If so the contractor may need to consider its working capital needs. The contractor’s surety needs to understand the project, its cash flows, and the risks. The contractor needs to understand how the P3 will impact its overall capacity with the surety.”⁶

To deal with the various risks, it is important to develop an effective governance framework to oversee project execution and spot problems, such as increased costs and missed deadlines. Among the higher risks associated with P3s is the limited ability to recover costs related to overruns and delays. Often, P3s are toll roads, bridges, or other infrastructure assets that are expected to generate revenue once they’re completed. So, there’s a firm deadline at the back end and some significant financial risks if targets are missed.

The contractor needs to fully understand the project: how it will be designed, built, and inspected, as well as any key milestones, because each will affect the completion date and any potential liquidated damages. “While these risks may be similar to those seen on other projects, they take on a different level of significance in a P3,” Goetjen says. “Typically, there are some pretty significant liquidated damages if you don’t make those targets because interest is clicking off on a daily basis. That kind of a financial risk is much higher in these projects.”⁶ A contractual provision for liquidated damages calls for payment of a specified sum should one of the parties be found in breach of contract. In a P3, such damages typically provide compensation for lost revenue and added interest on debt attributable to a delay.

Some states have tied payments to completion of the project, as well as successful operation of the asset. In Florida, transportation department officials are holding the P3 consortium on a major highway improvement project in Broward County to a high performance standard by linking compensation to results.

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I-595 Express, LLC, the consortium created by ACS Infrastructure Development, was awarded the contract to serve as the concessionaire to design, build, finance, operate, and maintain the Florida project for 35 years. But the state says the consortium will receive no compensation until the highway improvements are fully operational, thereby providing powerful incentives for meeting the five-year design and construction plan. In addition, performance-based availability payments will be made monthly during the operating period of the project, but the payments can be reduced if quality and performance requirements in the contract are not met and roadways are not available to traffic.⁷

Assess and develop your skills

Companies will need to expand their portfolio of skills to include new risk management strategies, tax and financing expertise, an understanding of equity investment and return, governance and oversight capabilities, and screening techniques for choosing both projects and partners. To get up to speed, firms should study past P3s and consider consulting with expert advisors in the field.

Financial expertise is particularly critical if companies take an equity position in the project. “You have to have that know-how for the costing and financing of the project,” Lester says. “You have to know how the traffic studies work and put it in that

magic black box called a financial model. The financial model will show the riskiness of the project is X and determine the lenders’ willingness to stand behind the project.”⁴

In their initial P3s, small companies can sometimes rely on their larger partners’ experience and knowledge. “I’ve seen some smaller companies piggyback on the larger companies for their legal and other due diligence,” Dickinson says. “Maybe two large partners hold 45% each of the concession and a smaller regional partner is holding 10%. Instead of that small regional partner mirror imaging all of the due diligence that the bigger firms do, they tend actually to fly a little bit on the coattails of the bigger companies.”⁵

Choose your projects, partners, and position wisely

Settle on an appropriate role

Once a contractor has decided to get in the game, it must start making some choices. One of the first and most important questions: What role in the P3 would the company like to play? There are a variety of options:

- A provider to the P3, similar to contracting roles in other projects.
- A partial owner, taking on additional risk and reward through the life of the project.
- An initial partial owner with exit options after construction is complete and operations have begun.

- An initial partial owner with exit options post-bid phase (deal structure allowing).

The answers will depend on a firm's risk appetite, as well as its financial capabilities.

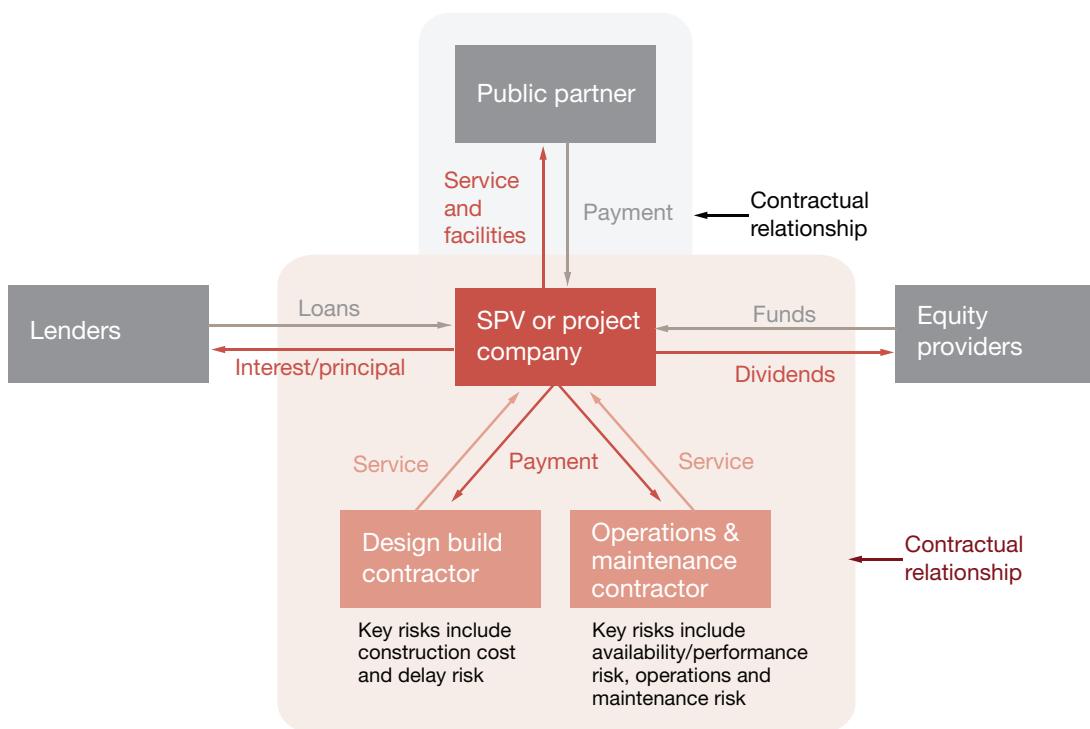
Establish project criteria

In weighing the benefits and risks of P3s, it's important to define project selection criteria and stick to them. That may even mean walking away when necessary. "It's usually best for pure design/build E&Cs to start small and work up to larger-scale projects," Caletka says. "E&C companies need to understand their own risk appetite and formulate a list of selection criteria to consider before throwing their hat in the ring, such as the size, duration, and

complexity of a proposed P3 project; the type of infrastructure; how realistic the government's proposals are; and other risk factors. It's also important to be alert to optimism bias, meaning overly positive revenue projections and budgets or overly ambitious design milestones and construction schedules."⁸

Lester, the project director of the Fluor-Lane joint-venture, advises construction firms to be well aware of the political factors that can unexpectedly doom a P3. He has been involved in several P3s that have fallen apart late in the process. "Politically, all of a sudden it can just—boom!—go away," he says. If things start looking precarious, he adds, companies might decide, "We're not going to continue to pour money down this rat hole and simply bow out."⁹

Risk distribution



To try to avoid such risks, it's wise to focus on states that have enacted P3 enabling legislation, which varies from place to place and covers different types of infrastructure and projects. In some states, an executive branch agency can approve a P3, but in others, the state legislature must agree to the project. Sometimes, even lower levels of government, such as counties and municipalities, get involved. Such additional layers of approval obviously increase the risk that a project might be delayed or canceled.

Companies also should assess the track record of states and other governmental units. Thus far, states in the South and West have pursued

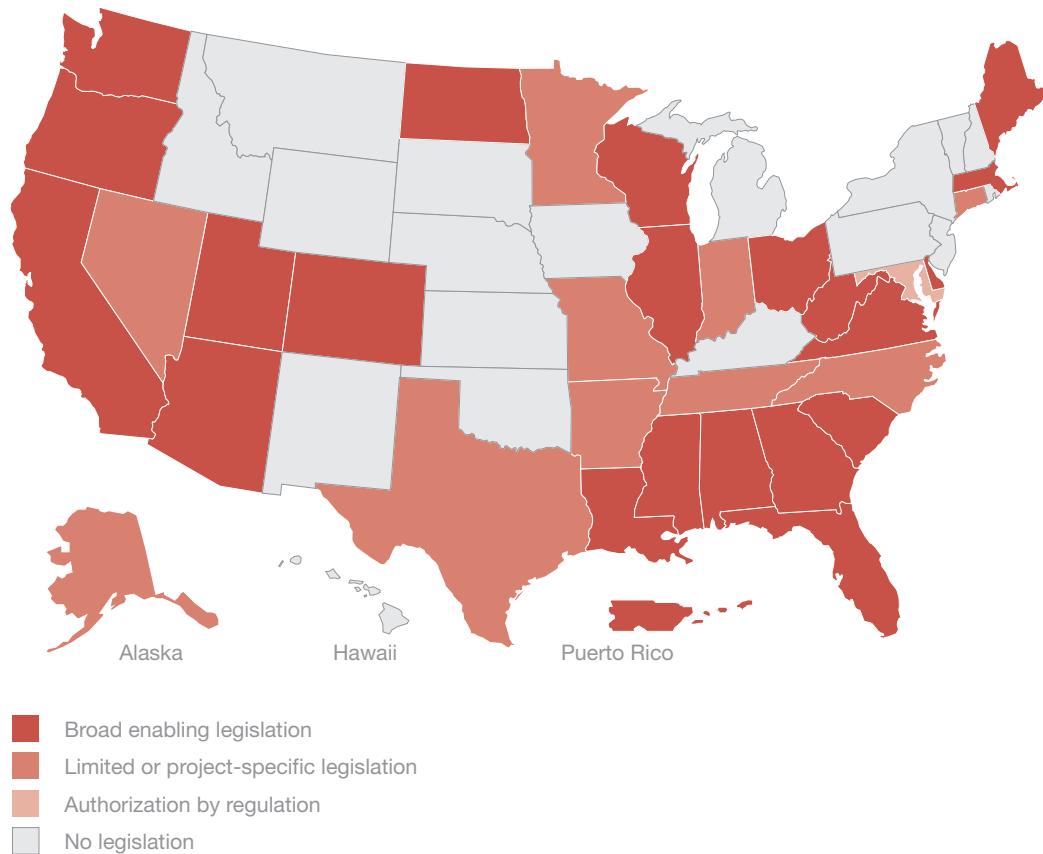
more P3 projects than those in the Midwest and Northeast, although such states as Ohio, New York, and New Jersey are expressing greater interest.

"If I'm advising an E&C contractor, and we see a state or local municipality advertising a prospective P3 project, I'm going to want to look at it carefully and ask a few simple questions to gauge the likelihood of the project going forward as advertised, such as 'Does the government have an advisor on board?'" Caletka says. "This could demonstrate they believe the project to be real and are actually investing in a team to help them through the PPP process. Secondly, we would ask, 'Has anyone prepared a formal business case

for the project?' This could demonstrate that it can go to market as packaged, structured in such a way that everyone takes on acceptable risk and is able to make an acceptable return on their investment. If that doesn't exist, then it may still be a pipe dream or will take a few iterations before it matures to the point where I would advise spending time or money positioning a team for the opportunity."⁸

Finally, firms should focus on projects that promise transparency to all of the partners and to the public. Such accountability increases the likelihood that the P3 will move forward and reduces some of the risks and uncertainties.

States with PPP enabling legislation as of March 12, 2012



It's critical to seek a good culture fit with prospective partners. After all, the partners will be working closely together for several years on a complicated, potentially high-risk, high-pressure project.

Evaluate potential partners

Companies should define their partner selection criteria before joining a P3. They need to look at the track record of other participants: What have they done before in P3s? Are they financially robust? How strong is their reputation in the marketplace? Are they known for doing appropriate deals, producing good returns, and being a flexible and understanding player?

The ultimate goal is to ensure that the overall team is a serious contender for the P3 project, bringing strengths across the board in design, engineering, construction, and facilities management. Given the steep legal, financial, advisory, and other costs of simply making the bid, some P3 experts believe companies shouldn't make the commitment unless they feel they are joining one of the best teams in contention and have at least a 50% chance of winning.

"It's important that companies not have stars in their eyes," says Dickinson of AECOM. "They may be approached by a bigger company that says, 'Oh, would you like to join my team?' and they may be flattered by that. But they

still need to sort of say, 'Well, you know, that sounds nice, but who else is on your team? Who's your operator and who's your financier and who's this and who's that?'" Because of the long-term nature of P3s, he adds, "the chance of the team's success depends just as much on the facilities manager doing his job and pricing his scope of work efficiently, as the design/builders."⁵

It's also critical to seek a good culture fit with prospective partners. After all, the partners will be working closely together for several years on a complicated, potentially high-risk, high-pressure project. "You really need to have a level of comfort that there's a good cultural fit between the companies and that you're really going to be able to work together when things get tough on these types of projects," Dickinson says. "Even putting the bid together can be pretty demanding, so I think it's really important that the smaller companies and larger companies that work together have a reasonably similar culture and can quickly form an effective team."⁵ Some large, lead partners might be more collaborative, for instance, while others take a more hierarchical approach and view smaller team members as subordinate players.

The key is to be diligent in evaluating partners. "There's a courtship, a mating ritual, that goes on when teams are being formed," says Lester. "You need to do your homework, whether you're being courted or doing the courting." In evaluating potential partners, he adds, "we look at their financial strength, their history, and their track record, and for those people we have experience with in the past, we ask how it was to work with them on other projects. A lot of it is personal relationships."⁴

Determine a comfortable equity position and exit strategy

When considering whether to take an equity stake and how large it should be, construction firms should keep in mind their risk tolerance and risk management plan. A graduated equity approach is usually the best way to avoid taking on too much financial risk too fast. For example, companies might start with 5% equity, then 10% on the next project, and then 20%, as experience grows. They also should analyze total return on the project, keeping in mind return on the construction work, as well as on the equity investment in the ongoing operation of the asset.

Equally important is determining an exit strategy upfront: when to exit, whom to sell the equity stake to, and what is the desired return. A clear exit strategy is especially important because a company could find itself in a financially tight situation. It needs to know how it can put its share of an asset up for sale and collect money for it quickly, perhaps from a pension fund looking for a relatively low-risk infrastructure investment.

Sometimes smaller companies negotiate an agreement for their larger partners to help them exit. “Very often, the smaller companies say that one year after acceptance or the substantial completion of the project the other bigger partners will buy out their share at a predetermined price,” Dickinson says. “That’s very common because very often the small companies don’t want to leave their money in.”⁵

Selling the equity stake effectively means selling future cash flow from the asset. “A buyer would look to the present value of the cash flow stream,” says Goetjen of PwC. “For example, if the related project was a toll bridge built by the P3. The value would be derived from an estimate of the number of cars that will travel over the bridge and pay the toll reduced by the debt service associated with the project, the estimated costs of maintaining the road and any other costs. The seller’s share of the residual cash flow stream would then form the basis of the value of the equity stake being sold.”⁶

Becoming a P3 player

Public-private partnerships may be ready to take off in the US. It’s time to get on board and find a positive risk-reward investment. Here’s how to get that boarding pass:

- Learn the ins and outs of P3s and assess whether it’s time to participate.
- Perform a risk assessment and determine what role to play in a P3.
- Develop a resume of sorts, highlighting strengths and experience.
- Determine if the firm has the resources and the risk tolerance to take an equity position in a P3.
- Investigate possible partnership opportunities.
- Decide whether to take an equity stake in the project and formulate an exit strategy—even before the P3 gets going.

Endnotes

1. World Economic Forum, *The Global Competitiveness Report, 2011-2012*.
2. American Society of Civil Engineers, *2009 Report Card for America’s Infrastructure*.
3. PwC, *Stability in volatile times*, February 2012.
4. Interview with Mitch Lester, project director for Fluor-Lane, the joint venture of Fluor Corp. and Lane Construction Corp., April 17, 2012.
5. Interview with Ian Dickinson, director of alternative delivery water projects for AECOM, May 23, 2012.
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7. PwC, *Public-private partnerships: The US perspective*, June 2010.
8. Interview with Anthony Caletka, Principal in PwC’s US Capital Projects & Infrastructure practice, August 8, 2012.

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