

Public-private partnerships in the US: The state of the market and the road ahead

November 2016



The value of public-private partnerships (P3s, also known as PPPs) for infrastructure in the US is no longer in question, and we expect to see a rise in P3s in the years ahead.

While obstacles are real and likely to persist, the experience of the last five years has given us insight into how to navigate them.

Dedicated P3 offices, standardized project analyses and procurement procedures, an eye for the big picture, transparent communications, and the will to manage political interests are among the strategies that will raise the odds of success—and bring value to taxpayers and investors.

\$3.6 trillion needed

No dispute exists about the need for infrastructure investment in the US: The sector needs \$3.6 trillion by 2020.¹ The American Society of Civil Engineers' (ASCE) most recent report card gives the country's infrastructure a D+.²

City leaders continue to seek infrastructure upgrades,³ and the need for more infrastructure spending is one of the few issues that unites both major political parties in the US.⁴ At the same time, investors are looking for long-term investments.

Other countries continue to take advantage of this private capital and industry expertise. The UK's National Audit Office reports over £4 billion (\$5.8 billion) a year on average in capital investment from P3s, or PFIs as they're called in the UK, over the past fifteen years.⁵ In the US, where the economy is more than six times bigger, only five P3 deals worth a total of \$2.4 billion closed in 2015.

When suitable, high-quality projects are offered, investors are ready to snap them up. Infrastructure funds that focus on North American assets were sitting on \$75 billion in dry powder at the end of the first half of 2016.⁶ "Pension funds in the US have allocated money to infrastructure, but it has been very difficult for many of them to get that capital deployed in the US. Most of the investments that have been made in the sector have been by specialist infrastructure fund managers," says Julio Garcia, head of infrastructure in North America for IFM Investors.⁷

One problem has been a lack of bankable deals, but recent developments are promising. Moody's said in March 2016 that despite P3's slow start in the US, "the market remains positioned to become one of the world's largest."⁸

As of H1 2016, infrastructure funds that focus on North American assets were sitting on \$75 billion in dry powder—and they are ready to snap up suitable high-quality projects.

New kinds of deals are here

Approximately five years ago, P3s in the US were mostly represented by toll road concessions. However, the government and investors are now coming together on a much broader range of projects, including social infrastructure.

In another sign of maturity, a secondary market has emerged—mainly in toll road concessions at the moment. In May 2015, IFM investors bought the Indiana Toll Road out of bankruptcy for \$5.7 billion. IFM was then able to tap the bond market immediately to raise long-term investment grade financing to help pay for the transaction. The offering was oversubscribed. IFM has since sold down 10% of its equity to CalPERS and Allstate.

“The interest in the bonds showed that investors were confident in the underlying asset’s fundamental value and comfortable with investing in a P3,” says Peter Raymond, PwC’s global and US leader of capital projects and infrastructure. The sale of the Chicago Skyway for \$2.9 billion to a group of Canadian pension funds followed in December 2015.

Another long-held desire of P3 proponents also became a reality last year: The state of Pennsylvania became the first in the US to bundle small projects into a big package in order to attract global firms’ interest. The Rapid Bridge Replacement Project bundled 558 bridges to create a deal worth \$900 million. It was Pennsylvania’s first ever infrastructure P3 to reach financial close. It was successful enough that a county in the same state, Northampton, is using a P3 structure to replace and rehabilitate still more bridges.⁹

More than toll roads

For many years, a public-private partnership in the US mostly meant surface transportation. But other kinds of P3s are becoming more and more common.



For example, Kentucky closed in 2015 a \$275 million P3 to build a 3,000-mile statewide broadband network.



And Miami-Dade County in Florida is moving ahead with its P3 program for several major civic and waste and water projects.



Seth Miller Gabriel, director of the Office of Public-Private Partnerships for the District of Columbia, says government buildings, including schools are the main areas in which his city is looking at P3s.

“We see this area as offering very stable investments,” Miller Gabriel says. “People have to send their kids to school.”¹⁰



Other types of P3-sponsored government building projects are also on the rise. For example, the city of Long Beach, California closed on a \$530 million P3 to build a new civic center in 2016.



Public universities are also interested in P3s. Montclair State University in New Jersey began the trend with a P3 for housing facilities in 2011. Since then, universities in Georgia and Kentucky have done similar deals, while The Ohio State University closed on a P3 to develop parking facilities and is using a P3 to upgrade its energy system.

Purdue University and the city of West Lafayette closed in 2016 with the Plenary Group on a P3 to turn State Street into a pedestrian-friendly urban hub.

The University of California (UC) at Merced also closed in 2016 with Plenary on a \$1 billion P3 to build campus facilities. The UC Merced project’s size and ambition could pave the way for even more major university projects.

Source: InfraAmericas and PwC

The pipeline is growing . . .

PwC analysis shows an accelerated number of P3s have entered the pipeline since January 2014. The diversity is striking. While transport continues to be strong, power, waste and water, and social infrastructure projects are increasingly well represented. There's even a truck weighing station.

This P3 pipeline now stretches across more than 20 states, including many that have never closed a public-private partnership transaction before. And more and bigger deals are taking place. Nine P3s closed in the first three quarters of 2016¹¹ compared with five deals in all of 2015.¹² Several were giant: a \$3.9 billion deal to redevelop and operate Terminal B in New York's LaGuardia airport and Maryland's light rail Purple Line (\$2 billion).¹³

... but good ideas aren't always good enough

The remaining deals in the pipeline all have some merit, but a good idea isn't enough to ensure success. Several projects went through a laborious

preparation process but never saw the light of day. For example, the Indianapolis city council in 2015 canceled a \$400 million P3 to design, build, operate, and maintain a criminal justice facility.¹⁴ The city's preferred bidder had invested significant time and money in the failed deal.¹⁵

"A lot of investors have been burned in processes that went nowhere and cost a lot of money through broken deal expenses," Thomas Lefebvre, managing director at I Squared Capital, says. "At the end of the day you want to focus on where you think you're going to be successful."¹⁶

There's no shortage of either demand for better infrastructure in the US or private sector money interested in investing in it. The question is how investors, government agencies, and other stakeholders can increase the number—and the quality—of P3s in the pipeline, make the process more efficient, address the risks of getting involved, and achieve financial close and successful project completion.

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—David Spector, Director of Colorado Department of Transportation,
High Performance Transportation Enterprise

It’s not just about the financing

The first step is to make sure that the project really makes sense as a P3. The bar is high in the US where, thanks to the tax-exempt bond market, most cities and states can raise money inexpensively. That means if proponents are presenting a P3 merely as a financing mechanism, they may be playing a losing hand.

“You don’t do a P3 because you don’t have the money,” says David Spector, director of Colorado Department of Transportation, High Performance Transportation Enterprise. “You do it because you’ve looked at the lifecycle cost of the asset, and you’ve looked at benefits and costs that go beyond the financial side.”¹⁷

Project preparation and procurement costs are often higher in P3s, so an analysis that assesses how much a project will cost over its entire lifecycle can provide a more accurate picture. To do that, it’s not enough to predict regular operating expenses. Government agencies also have to estimate when and at what cost major

upgrades will be needed. This analysis should also look at how P3s can potentially generate cost and schedule efficiencies by including multiple project elements—such as design, construction, maintenance, and operations—in a single contract.

With the University of California at Merced’s recent P3, for example, construction costs were higher than estimated, but long-term maintenance and lifecycle costs and private financing costs were lower, so the overall project cost was affordable, according to the Plenary Group, the project’s lead developer.¹⁸

It’s also important to ensure that costs for the alternative are measured correctly. “In traditional public sector infrastructure projects, a standard analysis usually misses a lot of hidden costs,” says Dr. Julie Kim, program director of Stanford University’s Global Projects Center, which researches sustainable P3 business models in the US.¹⁹



Look at the big picture

Moving beyond finances, it's often in non-financial areas that P3s outshine traditional procurement processes. P3s almost always offer a chance to start and complete projects within shorter timespans. In Colorado, for example, an analysis of the P3 option for US Highway 36 illustrates that the rebuilding and expansion project will be completed two decades earlier than it would have been without the P3 component.²⁰

"You always have to remember that a P3 is an organizational structure that has a financial component, an operational component, and an assets component," says Alan Trager, director of the Public-Private Partnerships Initiative at the Johns Hopkins

University School of Advanced International Studies.²¹

Global infrastructure companies also have experience with innovative infrastructure technologies for everything from saving energy in buildings to managing highway traffic. Many local governments, which have neglected infrastructure for years, no longer have up-to-date expertise.

"With increasing demand and declining resources, governments need to redefine their role and leverage partnerships to efficiently meet demand," says Kylee Anastasi, director in PwC's capital projects and infrastructure practice.

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Centralize and standardize

To show that a P3 can deliver the job at the right cost, and then develop a project that will convince lawmakers and investors, isn't an easy task. Many government agencies lack experience with P3s. While 35 states, along with the District of Columbia and Puerto Rico, have legislation enabling P3s, only 18 states and Puerto Rico have ever reached financial close on a P3.²² And in some states, responsibilities are divided among multiple agencies, so one agency's experience may not be transferred to another.

"It's proven to be very valuable for states and local governments to create a dedicated, centralized P3 office," says Jacob Falk, counsel at the law firm Chadbourne & Park. "Without a dedicated team, it's harder to deliver projects effectively and quickly."²³

A dedicated P3 office not only centralizes expertise, responsibility, and decision-making capacity; it also makes it easier for governments to standardize every step of the process, including determining if a P3 makes sense, developing a comprehensive request for proposals, and deciding what proposal to accept.

"Standardizing project assessment and development helps inspire confidence in the market, and it lowers costs for governments,"



Michael Bennon, managing director of Stanford University's Global Projects Center, says.²⁴

If a project is cost effective and technically sound, and if it will clearly bring tangible benefits to taxpayers, its odds of success with the market, legislatures, and the public rise; however, P3 proponents still have work to do.

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Get the politics right

Even when objective studies argue in favor of P3s, partially privatizing public responsibilities can provoke political opposition. And if one party begins the project, then loses an election, the incoming party may not want to finish it.

Meanwhile, legislators and government officials don't always want to share authority or revenues with private partners. Voters worry that tolls or service fees might rise. Workers fear for their jobs, especially if those jobs are unionized. And a call against putting public assets in the hands of private companies, especially if they're foreign, can sway voters.

So a P3 needs a political champion, whether it's a governor, a mayor, or a high-level legislator. With the help of this champion, proponents have to offer voters thorough explanations of financing, environmental impacts, and the tangible benefits they'll receive. And the communications have to be constant.

Besides reaching out to local, state, and federal officials, Colorado's DOT "is literally knocking on doors to educate people," David Spector says.²⁵

Show that you're serious

Robust procedures cannot completely eliminate political risk, which might be daunting for investors. However, governments can take steps to attract

competitive proposals. Deals can be structured to ensure legislative approvals occur early in the process, before investors need to commit significant resources, time, and money. And the request for proposal (RFP) can include language around compensation if a deal doesn't close for political reasons.

"If a government offers a break fee, it shows a real commitment," Stuart Marks, senior vice president at the Plenary Group, says. "That gives us confidence that the public agency is taking care of its end, which helps greatly with our assessment of the political risk. When bidders see that, they're more likely to participate, so the public agency will receive more offers and more competitive ones."²⁶

Communicating early with potential bidders is another good move. For its P3 project to upgrade and operate its power systems, The Ohio State University sent out a request for information (RFI) to likely partners to get a sense of what they can do and at what cost. The university's P3 team also consulted continually with student and faculty representatives to make sure the project considers their needs.²⁷

"That kind of preparatory work can ensure a much stronger RFP," says Darin Siders, PwC's infrastructure deals leader, and mergers and acquisitions tax partner.

A P3 needs a political champion, whether it's a governor, a mayor, or a high-level legislator.

Recent administrations—Republican and Democratic—have overseen legislation and programs that supported P3s. This support will likely continue given ongoing fiscal constraints and the increasing need to repair and expand the country's infrastructure.

The federal government is getting on board

P3s have become an important part of the federal government's vision for infrastructure

Under the Obama administration, the Department of Transportation unveiled in 2015 the Build America Transportation Investment Center (BATIC). One of BATIC's main missions is to cultivate P3s by helping them access federal credit and navigate federal permitting and procedural requirements.

Also in 2015, Congress passed the Fixing America's Surface Transportation Act (FAST) with an overwhelming bipartisan majority. The FAST Act lets states use federal highway funds to create and operate dedicated P3 offices. It even lets federal funds be used, in certain circumstances, to pay compensation to unsuccessful P3 bidders. The FAST Act also has multiple measures to streamline and accelerate transportation projects, including P3s.

The FAST Act did cut the amount of funds available to the Transportation Infrastructure Finance and Innovation Act (TIFIA), which offers credit assistance to P3s. But PwC's Kylee Anastasi

says the cuts' impact probably won't be major. "There's still plenty of room for the market to leverage the funds that TIFIA offers," she says.

The potential for Federal credit assistance for water infrastructure P3s was realized at the end of 2014, when Congress passed the Water Infrastructure Finance and Innovation Act (WIFIA).

"Infrastructure investment is critically important, and for the right projects, P3s are valuable options," Monique Rollins, deputy assistant secretary for capital markets at the Department of Treasury, says.²⁸

Given the ongoing need for infrastructure and fiscal constraints, we expect that the government will likely continue to support P3 programs. "I'm optimistic that the P3 model will become more popular," Ankur Datta, senior policy advisor at the Department of the Treasury, says. "This sector is going to grow."²⁹

On the plus side: Benefits of P3s

Once an analysis confirms that a P3 is a viable option, the possible benefits are significant:



Cost

“A P3 can cost a government as much as 20% less than a traditional design-bid-build model,” DJ Gribbin, national director of strategic consulting at HDR, says.³⁰



Speed

Once P3 contracts close, they frequently deliver projects faster than traditional government procurement, in part because private parties pay stiff penalties if they fall behind schedule.



Risk-sharing

When the public sector builds and operates infrastructure, taxpayers bear responsibility when costs are higher or revenue is lower than expected. With a P3, depending on the contract, the private contractor may take on some or all of those risks.



Maintenance

While government budgets don’t always account for infrastructure maintenance, well-structured P3 contracts can require private partners to maintain and upgrade to meet the performance standards set in the contract, and to pay penalties if these standards are not met.

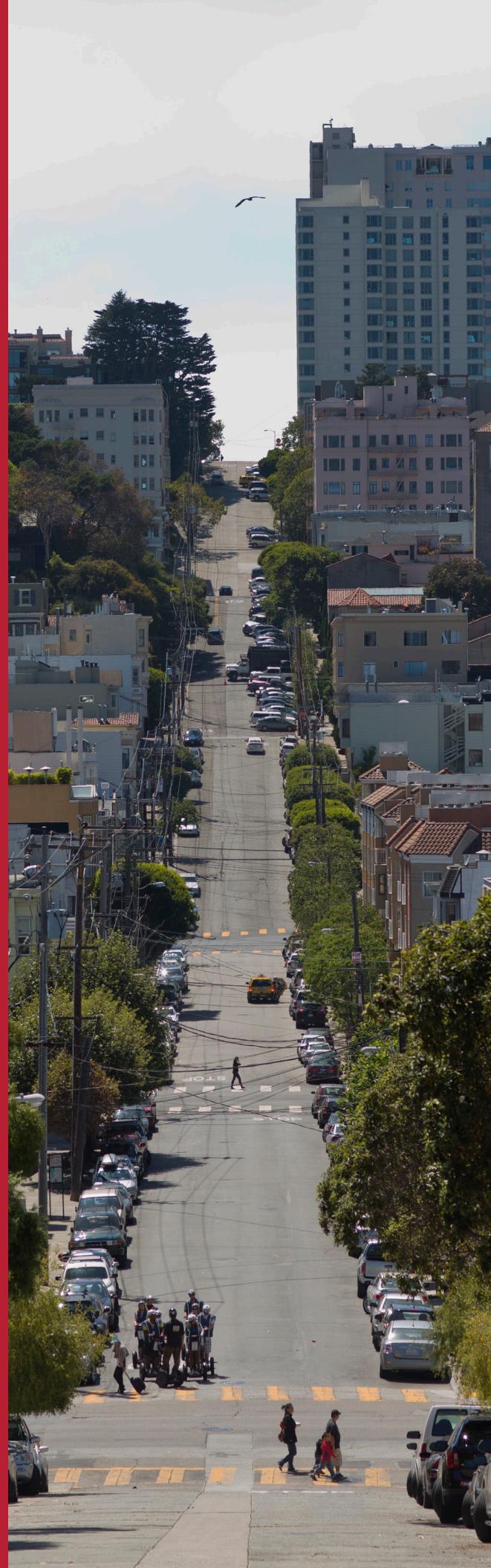
A look ahead at emerging practices

The market for P3s in the US is clearly gaining ground. Investors are interested, capital is plentiful, and governments are building capacity and passing enabling legislation. More projects are entering the pipeline and reaching financial close. It's noteworthy that these projects are spreading to new sectors and states.

We expect the positive trends to continue and to advance the P3 market, especially if proponents further embrace these emerging practices to address the challenges inherent in the P3 market:

1. When considering projects, view P3s as procurement mechanisms, not just as financing tools. Analyze lifecycle costs and non-financial benefits and challenges. This approach may articulate benefits that outweigh the potentially higher upfront costs.
2. Develop more offices or teams dedicated to P3s in states and cities. By centralizing responsibilities and experience, specialized teams can improve projects' speed, efficiency, and cost.
3. Design standardized procedures both to decide when P3s are appropriate and to make those P3s a reality. Standardization also improves speed, efficiency, and cost, and it increases transparency, which is important for political and popular support.
4. Execute communications strategies to build and sustain that political and popular support. Contracts can also be structured to reduce the risks of political shifts.

If these approaches become more widespread, as we expect, the US will likely see a growing flow of private capital and expertise to help deliver the infrastructure that it so urgently needs.



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