

PUBLIC-PRIVATE PARTNERSHIPS: SUCCESSES, FAILURES AND PLANS FOR THE FUTURE



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As economic stressors around the world continue to plague the financial marketplace in general, and the construction industry in particular, the need for building, renovating and replacing critical infrastructure continues to grow in the United States, the United Kingdom and elsewhere. To address these needs, construction markets and industry participants must generate funds from all viable sources to build necessary infrastructure. In this climate, public entities will continue to explore and enhance programs for the financing and delivery of appropriate projects through public-private partnerships (PPPs).

Although limited forms of public-private collaborations have undoubtedly existed in various isolated forms for centuries, most commentators recognise and credit the UK as the modern birthplace of PPPs and related funding mechanisms. The most common form of PPP used in the UK, the Private Finance Initiative (PFI), was introduced in 1992 to involve the private sector in the design, construction, financing, operation and maintenance of public infrastructure, and to secure the delivery of well-constructed, well-maintained infrastructure at a good value for taxpayers. During the initiative's history, spanning more than 20 years, the UK has experienced many successes in the 700-plus PFI projects it has brought to financial close.

However, amid growing concerns that the public may not have received the best value for its money through the PFIs, the UK's economic and finance ministry in December 2011 launched a study on

the UK's PFI programme. Based on a large number of public and private-sector comments, Her Majesty's Treasury released its report on the study in December 2012. The report, discussed more fully below, provides important guidance to nations, states and local entities around the world – including California, the home state of this article's authors, where the use of PPP alternatives has met with less success. It also offers guidance to places like Australia and Canada, where PPP efforts have been more successful.

THE HISTORY AND PROMISE OF PPPS

Like the UK, Australia and Canada have long histories of using PPPs for public infrastructure projects, and that usage is likely to grow in the future. In both countries, the development of centralised PPP agencies to develop standardised agreements, and to shepherd and oversee the use and implementation of the PPP model for such projects, seems to be one of the key factors that has contributed to their success, or at least to have lessened the number of severe failures.

In California, while the use of PPPs has been embraced to some extent, successful deliveries of projects on a PPP basis have been few, and the performance of such projects has been mixed at best. California enacted its first PPP enabling legislation in 1989 for four "demonstration" transportation projects to be design-built, financed, operated and maintained by a private partner. Nearly 24 years later, only two of those contemplated projects have actually been built: SR-91 and SR-125.

The concession agreement for SR-91, a 10-mile long, four-lane toll road in Southern California which opened to traffic in 1995, and cost about \$130 million to develop, provided for a 35-year term. However, California's Department of Transportation (Caltrans) purchased SR-91 for about \$208 million in 2002, after a dispute arose between the concessionaire and Caltrans about a nearby roadway that Caltrans wanted to build that allegedly violated a non-compete clause in the concession agreement.

SR-125, another 10-mile long, four-lane toll road in Southern California, was opened to traffic in 2007. It cost more than \$450 million to develop, and the concessionaire filed for bankruptcy within several years of the roadway's opening. The project's design-builder had to write-off more than \$150 million in losses stemming from the project. Through the concessionaire's bankruptcy, an association of cities and the County of San Diego bought SR-125 for about \$342 million in 2011. The resolution of substantial disputes among the concessionaire, the project's design-builder and Caltrans, in conjunction with low ridership and less-than-expected user fees, resulted in the project becoming unprofitable.

Additional PPP enabling legislation passed in California in 2006 permitted the development of four more transportation projects, but none of the projects contemplated in that legislation was ever built. In 2009, broader PPP enabling legislation was enacted that allows for an unlimited number of transportation projects to be developed in California

through 2016, provided certain conditions are met. One such PPP project, the Presidio Parkway, is currently under way; it connects San Francisco to the Golden Gate Bridge. Unlike SR-91 and SR-125, which were based on user-fee payments to the concessionaire, Presidio Parkway is based on an availability payment scheme. The concession agreement calls for a 30-year term, and includes numerous performance-based standards that will reduce the amount payable to the private partner if not met during the concession term.

Why does the PPP model succeed in some cases, but not in others?

The use of the PPP approach on the Presidio Parkway, and on the Long Beach Courthouse project under other PPP legislation that allowed for the development of courthouses in California, has generated criticism from many venues; chief among the critics is California's Legislative Analyst Office (LAO), which concluded in a report that both projects should not have been undertaken on a PPP basis because, among other reasons, some of the assumptions underlying the value-for-money analyses for both projects were unrealistic and slanted toward pursuing the projects on a PPP basis. If more reasonable and accurate assumptions had been made, the report asserts, the life-cycle costs for the projects would have been less under a traditional approach (such as design-bid-build or design-build) than under the PPP approach. Additionally, with respect to the Presidio Parkway project, the LAO has charged that the decision to use a PPP model arose too late to fully take advantage of the PPP approach's benefits, after project

risks (such as design risks) usually borne by the private partner had already passed.

Outside the transportation context, California has broad PPP-enabling legislation that can be used by local public entities, such as cities, counties and districts, to build a variety of "fee-producing" infrastructure projects, including energy, water treatment, wastewater treatment, harbours, light rail, airports, garbage disposal and non-sports buildings. However, very few infrastructure projects have been developed in California under this statutory framework, even though this broad PPP legislation has been in existence for almost 20 years. Only one significant project known to the authors has been developed by a public utility as a PPP project under this legislation; that project reached financial close in December 2012, and calls for upgrading and expanding existing water and wastewater treatment facilities under a 30-year concession agreement valued at approximately \$175 million. The private developer on that project is to spend \$41 million to upgrade and expand the existing facilities over the first five years, and will operate and maintain the facilities for the entire 30-year term; the public utility is to receive an upfront \$30 million payment, plus additional sums to discharge about \$27 million in debt in exchange for payment of a monthly fee to the private concessionaire for water and wastewater treatment.

Why does the PPP model succeed in some cases, but not in others? What projects are most likely to benefit under a PPP model? The UK PFI report provides useful information that helps in answering these questions. The report was commissioned based on the widely perceived need for a fundamental reassessment of PFI in the UK. In 2011, after over 700 projects using PFI models had been completed, there was a perception that the model, while still viable, had been tarnished by what the report calls "waste, inflexibility and lack of transparency" which made "a compelling case for reform". As a result, the government undertook to gather evidence from a wide range of interested parties regarding the strengths and weaknesses of PFIs. The report first chronicled key weaknesses of PFIs, and then described

the adoption of a new approach, PF2. The weaknesses of the PFI projects cited in the report include:

- the process is often slow and expensive, leading to reduced value for the taxpayer;
- the PFI contracts are often inflexible, making alterations difficult during the operational period;
- the process has not been transparent enough in the areas of future liabilities and returns to the investor;
- the risks transferred to the private sector have resulted in higher risk premium charged to the public sector; and
- the perception of windfall gains to equity investors has led to concerns about the true value for money of the projects.

To address these concerns, the government's new PF2 initiative will include the following key components:

- include the government as a minority public equity co-investor;
- introduce funding competitions for a portion of equity to attract long-term investors;
- accelerate project delivery by, among other things, strengthening the mandate of Infrastructure UK and supporting departmental centralised procurement units, shortening the tender process, standardising procurement documentation and introducing additional Treasury oversight;
- improving transparency by publication of more information throughout the process; and
- returning more risk-management to the public sector.

A careful review of the 105-page UK PFI report and other literature written about PPP successes in Australia and Canada makes clear that greater centralised focus on these funding and project delivery systems, coupled with greater care in performing value for money analyses to support pursuit of a particular project on a PPP basis, are the key to project success. California and other states and nations using PPPs (or considering such use) would do well to internalise the lessons that have guided the UK experience and the recently instituted reforms.