A Bond Buyer Executive Roundtable

Are P3's the Future of Infrastructure Financing?

Our panel of experts explores whether the U.S. is finally ready to use this uniquely flexible — and challenging — structure to renew its public assets.

MODERATOR

John Porzuczek
Managing Director,
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The potential of public-private partnerships (P3s) to develop into a major means of funding in the U.S. has been long-heralded but slow to materialize. On Oct. 5 in New York City, The Bond Buyer hosted an executive roundtable to discuss whether that may now be changing in the wake of several successful projects, what best practices industry participants could take from those experiences, and how they could support upgrades to the nation's infrastructure.

Moderated by John Porzuczek, Managing Director, BNY Mellon, four industry practitioners participated in the forum. They included: Doreen M. Frasca, principal at Frasca & Associates, LLC; Roderick Devlin, attorney, Squire Patton Boggs; Seth Crone, BNY Mellon; and Sandra Brinkert, Director, Municipal Banking and Markets, Bank of America Merrill Lynch.

What follows is an edited version of the engaging discussion that took place.

PARTICIPANTS

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Sandra Brinkert
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John Porzuczek: In its 2013 Report Card for America's Infrastructure, the American Society of Civil Engineers estimated that the U.S. would need to invest $3.6 trillion by 2020. Now, I believe that it's the same or higher. The stars should be aligning for P3 opportunities where public entities need infrastructure funding but are struggling with their tax revenues and their post-employment obligations such as pensions, and where private investors are looking for long-term, stable investments here in the U.S. But have P3s taken off? What are the reasons they haven't? What are the hurdles to seeing more P3s?

Doreen Frasca: I'm glad you brought up that ASCE report card — clearly we've got a problem. Assets are not being properly maintained and reinvestment for maintenance purposes doesn't occur on a regular basis. Some of it is a funding problem, although a wealth of tax-exempt financing is available. It's partially an issue of management and balancing competing needs of which there are plenty, and P3s are one way of addressing those needs.

Roderick Devlin: But if you're doing a P3 solely for financing reasons, you're probably doing it for the wrong reasons; a P3 is an infrastructure and service procurement mechanism. Why do a P3 when bond financing is almost always cheaper? The answer is simple: You have to look at the entire life cycle, not just the initial capital costs but the long-term maintenance and the life-cycle improvements. When you compare the traditional tax-exempt bond financed project using a design-build contact, coupled with 30-years of operation and maintenance by the public-sector, against a fixed priced 30 year P3 with significant risk transfer to the private party, that's when a P3 can shine. And if a P3 does not shine in that comparison, you shouldn't be doing a P3.

Seth Crone: With the private sector focusing on delivery and operations, the

public sector can focus on accountability measurements. With terms defined for the life cycle of the project, P3s bring discipline and expertise to maintenance, reinvestment and even exit plans.

Doreen Frasca: When we work on municipal bond transactions, the feasibility report looks out a certain number of years. Beyond that, you assume that cash flow is going to throw off sufficient funding to pay for operating and maintenance costs and debt service with coverage. But there aren't the obligatory structures in place to ensure that every discrete number of years you're renewing the asset. A P3 structure requires that investment and also obliges the private operator to turn the asset back over to private sector at the end of the lease term in good working condition.

Sandra Brinkert: When I first started in P3s, one of the contractors explained to me the beauty of a P3 by talking about a road project where they spent more on the road upfront and less on the maintenance overall, whereas in the government procurement, you would have spent less on the road and then each year would have budgetary pressures to reduce spending and defer the maintenance, and that ultimately, at the end of the life of that road, you've spent more by being frugal every year than you would have if you had done a long-term procurement that included the maintenance. Those annual budget pressures that encourage deferred maintenance are off the table with a P3. You enforce a discipline to the maintenance, and it can overall lower the cost.

John Porzuczek: P3s certainly present a more complex arrangement than traditional bond financing. What obstacles have you experienced —environmental, legislative, political —that can make a P3 not happen as fast a bond issue?

Sandra Brinkert: Successful P3s need political leadership and sponsorship.

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You are transferring activities that have historically been done by the government sector to the private sector, so there needs to be support for that all around. That’s where you see some of the hurdles in the marketplace, not to using P3s in the first place, but where procurements are canceled because of lack of political support or a change in administration. In Maryland, the Purple Line project was delayed when a new administration took office but ultimately went ahead with the support of the new administration.

Doreen Frasca: Robust discussion about whether a project should be done as a P3 or on an in-house basis is critical. I like it when there’s healthy disagreement about which way to go because, as an advisor, it makes me do a tremendous amount of work to examine the “value for money” proposition and what sort of benefits the municipal entity is accruing. I view that as healthy and very positive ultimately for the project because it strengthens people’s understanding of why they’re entering into a P3 in the first place.

Roderick Devlin: If you’re on the public sector side of the equation, robust preparation is key. A good P3 is one that has been gestating for a while and that has been run through the mill, and one that has wide political support. Ideally, you have a key political backer, a mayor, or a governor pushing for the project. But opposition to a P3 is not a bad thing, the opposition just has to be addressed, and if the opposition has a point, don’t do a P3. Why are you doing a P3 and not a traditional procurement? That always has to be the first question you ask. Interestingly, a lot of public sector owners can’t tell you what it will cost to operate and maintain an asset over a 30- to 35-year term, which are the P3 terms we are seeing now. They don’t budget out that far. If you look at the countries which have longer P3 histories, including Canada, there’s a lot more information available on public sector long-term operation and maintenance costs. If you ask those countries what a Design-Build contract will cost, followed by 30 years of public sector O&M, they can tell you, including the percentage of cost overruns and length of delay on the last 25 Design-Builds, and can factor this in when comparing that approach to a fixed price P3 with liquated damages for construction delays. Ideally we will get to the position in the US, so that the pros and cons of a P3 option vs. a traditional procurement can be debated more transparently.

John Porzuczek: Your comment about Canada’s track record is interesting, because it means that the analysis is more fact-based than leaps of faith. In the U.S. it can be hard on the front end to even get approval from some of these political subdivisions to even do the analysis; they don’t even want to expend funds to have the numbers crunched. So, when you get past the political and economic hurdles, once you’re into a P3 and have the deal team assembled, what are some of the hurdles during the structuring period? One that comes to mind is environmental.

Doreen Frasca: The environmental hurdles on the LaGuardia transaction were not as acute as they could be with an airport, where you’re always concerned about what might sit underground from the accumulation of jet fuels and de-icing fluids. At LaGuardia, since the aircraft are fueled by trucks versus an underground system, there wasn’t a tremendous expectation that we were going to find

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a lot of problems.. Nonetheless, it was a matter of great concern to the other side of the table. So, you do plenty of environmental homework; you take as many borings as you possibly can. And you set up protocols for what happens if you discover dirty soils when you're excavating and how all that gets handled. And we had a whole separate subgroup of lawyers that worked through the details until everyone was satisfied but, environmental is certainly one of the many points that has to get worked through in the in-market and negotiation period.

Roderick Devlin: One thing that differentiates a P3 from a traditional procurement is the risk transfer, the fact that the private sector takes on more than risks than they traditionally have. But, you can only transfer risk if you identify that risk beforehand so you're going through the project with a fine-tooth comb to identify all of the potential risks, and then you allocate them appropriately. In a P3, it's theoretically possible to pass all of the risks onto the private sector but you shouldn't. For one thing, it's expensive. The private sector has to put a value on every risk and they have to finance that risk so if the public sector is asking the private sector to take the risk, it's just going to push up the cost of the P3. To be frank, there are a lot of risks, the public sector's better at mitigating than the private sector, environmental for one example.

John Porzuczek: If we had an industry standard P3 Model, would that be a shot in the arm for P3s?

Roderick Devlin: A wise person once said, If you've done one P3 project, you've done one P3 project. Each of them is so different. If you're trying to work with a model form that assuming certain facts. and this could be more detrimental than helpful. There are not that many law firms and financial advisors that represent in the public sector on P3 matters, it's a relatively contained group. That in itself introduces some degree of standardization, in that they have a model they like and they have the approaches that they like. The U.S. isn't at the stage where it can commoditize P3 documentation in the way that the UK has. In the U.S. we're still at the bespoke stage, where every project is hand-crafted. And in the U.S. being the U.S., these projects will always be local. They'll always be in the mire of local politics. A successful P3 has to organically emergefrom the locality. I'm more for the bespoke approach. I think makes for a better project that is more attuned to local needs.

Doreen Frasca: Sometimes you don't want to hear “It's precedent doing it this way.” Other times you're happy to have precedent rule, but everything is just so individualized that it's very hard to have a one size fits all solution. I mean, an airport isn't a school building!

Sandra Brinkert: That's my least favorite form of negotiation, “Here's the precedent transaction, the market agreed to it last time.” But the projects are all different. What you agreed to last time is irrelevant to this. There are some models out there and I think the investors are getting accustomed to certain types of formats. You also have to consider that as banker, we start at the bid phase. A lot of the advisors and the attorneys have been working on a project from well before then. The investors have only 2 weeks and they have a big document to evaluate. to the big institutions have seen enough transactions they now understand the basic structure. From that point, the format, the language is very similar. It helps that we're starting to at least use common definitions, if not exactly the same forms.

Seth Crone: Sandy, I like your point about common definitions. P3s involve parties from various sectors, each of which have its own products, nomenclature and conventions. Even within the same firm, many professionals organize by client segment, for example---municipal, corporate, and financial institutions. Further each client segment has a typical product set with which it has great familiarity. While each segment may assume to understand how another area's products work, it is vital to have all participants on the same page. Not only do we have differences across client segments and related products, the P3 team faces a decentralized financing system in the US. We must tailor the transaction to work with regional preferences and local political sensibilities.

Sandra Brinkert: A decade ago when the European companies were coming into this country and wanting to do P3s and thinking that it was going to start immediately, I would remind them that we have 50 states — it's 50 different countries. This is not going to occur as quickly as it occurred, say in the U.K. or France or Spain. It's just not the same thing. I think they now all understand that, but there was also an attitude of "We know how to finance infrastructure in the U.K. and you don't so we're going to come in and tell you how to do it." We've gotten better partnership with importing concepts that actually work well but not necessarily importing the model wholesale from other parts of the globe. We do have this tax-exempt market and it works very well for financing infrastructure and it has for a long time and P3s are a new addition but are not always better.

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John Porzuczek: It sounds like our model is not cookie-cutter, it's really evolving and has evolved as we as a country have done more P3s. Could we touch on best practices that you have seen in the context of investor demand? Are there carrots that could be out there from an investor perspective that you could put in a deal?

Doreen Frasca: With the LaGuardia redevelopment there was already a tremendous amount of investor interest. The fact that it was being done as a P3 was an item of curiosity. Investors liked the belt-and-suspenders approach that came with having lenders' counsel looking over the consortium's shoulders. And for a long construction period like this, you want to make sure you've got the best and the brightest; with the Port Authority's knowledge of its assets paired with a construction giant like Skanska, it gave a tremendous amount of comfort to investors.

Sandra Brinkert: As rates start to rise, we'll have to see if the environment for P3s change. You will still see a strong market for P3 bonds, but the wide oversubscription may be a little bit tighter and spreads may be wider. Even so, a P3 may be the best option for all of these other reasons. What you get in a P3 transaction is end-to-end design competition from multiple firms who are optimizing everything they can. The sponsors are squeezing everybody in the transactions so that by the time the bid goes in, everyone should be a little uncomfortable. You've got competitive tension among multiple teams, even within teams, and they're doing that on the financing side, I'm sure they're doing that on the construction side and every other element of the design in the construction that they're doing. We know they're having hard discussions with their construction contractors. You just don't get that from any other procurement method.

Roderick Devlin: That's all to the benefit of the project and the public when you have a lot of tension among the private consortium partners and you're pushing that bottom line down and getting the best project you can. I'm a big fan of alternative technical concepts or ATCs, when the public comes out with broad design parameters and then the private sector goes through that with a fine-tooth comb and says "You've always done bridges this way, but there's new technology that can save on construction costs and time, or make O&M cheaper over the long term." Often you can directly link these ATCs to a particular price line in the budget and see what that saved you. Some of those are just genius if they're done properly. They're surprising to everyone, even the private sector. One of the great benefits of a P3 is to bring very smart and heavily motivated creative minds to the table for the public benefit.

Seth Crone: You want not only the best of breed on your team but also those that have a broad and deep bench. A global provider can bring to bear tools used successfully overseas to provide innovative solutions locally. Further, a firm with a broad product set can tailor its solution to the challenges at hand. Parties with a narrow range of abilities will tend to define problems and propose solutions within the confines of their limited range of options.

Roderick Devlin: We also often end up translating between the public and private sides. I've been in numerous meetings where there's been some major issue, often environmental or right-of-way, where the public sector just doesn't agree that it is an issue, and the private sector is getting frustrated because they don't understand why these guys aren't listening to them. It's just a different view of the world and a different risk analysis – neither side is right or wrong. Good advisors, on both the public and private sector side, can help "bridge the gap" by explaining issues and risks in a way that will resonate with both sides, so as to come up with the best solution for the project.

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Seth Crone: You need a referee for the life of the issue to interpret the documents. The care taken upfront in crafting definitions, mitigations, and their mechanics pay large dividends down the road. Projects have unknown trajectories. In corporate trust, we have learned that no matter how remote shortfalls or failures might be, it is prudent to anticipate them.

Doreen Frasca: Trustees, the unsung hero on all of these transactions. It's a big job, especially given the fact that the initial investors are usually not in it for the long term.

Roderick Devlin: One of the things we're hearing a lot here is that we need more trust on both the public sector and private sector side. That's still in relatively short supply. We're getting better, and there's a recognition that P3s, if done properly, work for everyone. They work for the private sector, they work for the public sector, and most importantly they work for the public, the end-user. And success breeds success: As more projects come through and as more states see their neighboring states getting new bridges, or new airport facilities, they'll say "I'd like some of that." And as more projects come along I think we'll see more momentum and more trust.