

## PUBLIC-PRIVATE PARTNERSHIPS ARE A VALUABLE TOOL FOR GOVERNMENT, THOUGH NOT A PANACEA

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As tax revenues fall and stagnate, states, cities, and other municipalities are searching for ways to save money, deliver better service, and make investments in public infrastructure. Many are taking a fresh eye to public-private partnerships (PPP), which involve the private sector in traditional public-sector work. Once unusual in the United States, PPPs have increasingly become an option for governments here, particularly in the transportation and transit infrastructure arena.

Under a PPP, a government entity transfers some aspect or aspects of a responsibility traditionally performed by the public sector to a private-sector partner under a well-defined, long-term contract. Some such transactions involve an up-front payment from the private-sector partner to the public-sector entity. In return, the private-sector partner receives rights to a future revenue stream—such as monies from toll collection—over a defined time frame. Other PPP structures involve a private-sector pledge to provide a service, such as operating and maintaining a free road or a subset of bus lines, in return for a regular payment from the government entity. In general, the government retains ownership of any physical infrastructure asset.

PPPs differ from traditional government contracts in that the private-sector partner shoulders some uncertainty in return for an uncertain future reward. The private sector takes on significant long-term control, as well as the peril of failure, for some aspect of a project, such as running bus lines or toll roads, or rehabilitating a subway station, in exchange for a profit that depends on careful private-sector management of costs. In some cases, control includes the right to increase revenue through toll or other fee hikes. Under traditional contracts, by contrast, uncertainties such as cost and schedule overruns and control over fee structures generally remain with the public sector, while the private sector earns a reasonably certain profit, often a percentage of costs incurred.

PPPs originated in Europe and have been popular in Australia; they have come to the United States only over the past decade or so. Recent PPP transactions have included a ninety-nine-year agreement between Chicago and private operators to lease and operate a major toll road and a five-year agreement between

New Orleans and a private operator to run a bus and light-rail system.

The PPP model can be a valuable tool for the public sector, as long as government officials understand the complexities and risks involved. Allocating risk and responsibility to a private-sector partner is just as complex as directly running every aspect of a project. In many cases, it is more complex. Every PPP is different, as is every market environment; properly assessing the risks and getting each contract right matter.

Though each PPP is unique, broad principles can help guide the process. The discussion below uses examples largely from transportation and transit infrastructure to illustrate the principles; however, the principles apply to other PPP sectors.

***On each project, local and state governments must understand which risks the private-sector partner can reasonably take and which risks the public sector must retain.***

In general, a private-sector partner will not take on unlimited technological, engineering, or financial risk—at least, not for a price that is economical to the government. Government entities should be wary of a potential private-sector partner that says that it will take on unlimited risk.

For example, in 2003, the British government tried to offload the financial and technical risks of maintaining and improving its 100-year-old subway system to two private-sector consortia for a fixed price—that is, eliminating cost-overrun risks to the government—with fixed performance benchmarks. The private-sector groups, which included Bombardier Inc., nominally took on open-ended technical and financial risks. But as one group realized that it had underestimated the scope and cost of the project, the private-sector partners eventually decided that the risks were too much to bear and opted to cut their losses, a rational business decision. The soured venture will cost the British government hundreds of billions of pounds in guarantees offered to the private partners' lenders, a poor decision on the part of the government.

Even on projects that involve straightforward engineering and construction risks, private-sector partners may be unwilling to

take open-ended financial risks for a price that is reasonable to the government, including, for example, the risk that a new toll road won't generate enough traffic in its first years of operation to cover its debt-financing costs. For a project that represents many "firsts"—whether it's a state's first toll road in a rural area or its first use of a new construction technique—the government may have to continue to shoulder some of the costs of uncertainty to get the job done.

By contrast, the private sector can be well suited to take on tasks that are finite, easily defined, technologically straightforward, measurable, and comparable with other jobs. These tasks can include managing bus lines, taking construction cost and completion risks, or operating and maintaining a road within certain performance standards.

***Governments should encourage competition, often by starting small and keeping contracts short.*** A government entity should do its best to ensure that its private-sector partners are unable to use a lengthy or overly broad contract to gain a monopoly over certain functions.

Bus service lends itself well to the PPP model because governments can easily protect themselves and their citizens against monopoly, collusion, and poor work. As Baruch College professor E. S. Savas has noted: "Major cities in the United States and Europe—Los Angeles, San Diego, London, and Copenhagen, for example—introduced bus competition several decades ago and saw spectacular success in reducing costs," along the lines of 20 to 51 percent.<sup>1</sup> Even in a medium-size city with a dozen or more routes, government officials can bid out multiple contracts under which bidders usually compete for the lowest government subsidy required to provide services—to prevent any one private-sector partner from dominating. A well-designed bid can attract a deep pool of competitors because barriers to entry are low.<sup>2</sup>

With bus PPPs, it's easy for the public sector to assess whether it's getting a good deal for its subsidy, too, relative to the cost of doing the work in-house: citizens can tell whether bus service is better or worse than it once was, and can compare service across lines, while the government can tell whether it costs more or less, often through running its own cluster of lines.

So that the government can maintain consistent control over the quality of important public infrastructure and make it more likely that taxpayers and users get a good price, the length of a contract is important, as well. During the credit bubble that burst in 2007, two of the first-ever PPPs to be done in the United States—the Chicago Skyway and the Indiana Toll Road privatizations—offered unusually long terms. In 2005, Chicago leased its Skyway toll road to an international consortium led by Australia's Macquarie Group in exchange for a \$1.8 billion up-front payment. The transaction was completed after the city

had completed a \$250 million rehab program on the road. The consortium is responsible for running the road with no state subsidy, with toll revenues as its main source of revenue. A year later, the state of Indiana leased its own toll-road system to an international consortium, also led by Macquarie, for a \$3.9 billion up-front payment. Similarly, earlier this year, Chicago leased its parking meters and the rights to their revenues to a consortium led by Morgan Stanley. The consortium received a seventy-five-year lease, in return for an up-front payment of \$1.2 billion.

But the best PPPs have shorter terms, optimally thirty years at the longest, similar to the longest-dated bonds that commonly trade in the markets. Because investors' ability to estimate costs and risks diminishes with time, the money they offer to the government for an asset also diminishes, per year, with time. Thus, absent a credit bubble, the risk on a decades-long agreement is that the government is handing out free bonus years to a bidder for an asset that comes with its own valuable source of revenues. Furthermore, an overlong lease involves surrendering direct control of a public asset across several generations, raising issues of generational equity.

One example of a right-size contract: the city of New Orleans, still struggling after Hurricane Katrina hit in 2005, has recently decided to experiment with a public-private partnership to run its bus and light-rail service. The city awarded only one contract for the entire city, to France's Veolia Environnement SA, and was unable to attract a large bid pool. However, the contractor has pledged to save 20 percent of New Orleans's previous annual costs while improving service. The government and the public can easily measure the cost savings, while the five-year contract length means that the city hasn't locked itself into a decades-long bad deal. Veolia will save the public money partly by offering transit workers a 401(k) plan, rather than the guaranteed pension plan that most public-sector employees enjoy.<sup>3</sup>

***Market conditions for the private sector fluctuate while government must steadily plan infrastructure investments.***

Earlier in this decade, the high-profile "privatizations" that made headlines for offering governments a huge new pot of money with which to make badly needed infrastructure investments, including the Chicago and Indiana road privatizations, may have given governments a skewed view of the PPP world. In retrospect, the transactions were evidence of a global credit bubble that allowed the private-sector partners to think that they could borrow at abnormally low rates over the life of the lease. The Indiana project, in particular, looks increasingly uneconomical for Macquarie, as its interest costs may soon rise.<sup>4</sup> Such deals may not be repeated on the same lucrative terms for the public sector.

Government officials should, of course, take advantage of any great one-off opportunities that come their way (provided that

they don't contain hidden risks); but in this financial environment, they should not simply sit back and wait for them. In general, governments shouldn't rely on market cycles to provide money for critical infrastructure. States and cities should not depend on exuberant market conditions to find sources of infrastructure investment, but rather should budget reasonably for such investments.

Some state and local government planners, with continued federal support, may prove adept at dialing back expectations in a muted financial environment. In early 2009, Florida completed a transaction creating a private-public partnership that will rehabilitate and expand a 10.5-mile section of an urban interstate, I-595. Though the state is keeping traffic risk—that is, it will pay the private partnership a fixed payment that is not dependent on the road's toll revenue—the private partners, led by Spain's Grupo ACS, are responsible for design, construction, and maintenance costs over thirty-five years. The deal, the first in the nation, eventually could prove an optimal allocation of public and private risk. However, it would not have been possible without cheap federal financing; the private financing market showed itself less amenable in 2009 to taking creative risks than it may have been in 2005 or 2006.<sup>5</sup>

***Potential private-sector partners cannot act rationally unless government first creates a rational, consistent, predictable environment for infrastructure investment in which they can do business.*** If private-sector bidders are not confident that a state or local government fully understands or supports the benefits and limitations of the PPP structure or are worried that the support will erode after a change in administration, this political uncertainty will mean fewer quality bidders and higher costs for the government.

For example, infrastructure companies and their financiers learned a harsh lesson from Pennsylvania's effort to sign a long-term lease for the Pennsylvania Turnpike in 2007 and 2008. Potential bidders devoted money and other resources to submit bids only to see the government abandon the long process at a late stage as its political support eroded. In a bubble environment, potential private-sector partners might forgive political uncertainty, but it becomes a bigger factor, and a more expensive cost for governments, in more difficult market conditions.

***Private-sector involvement does not guarantee a good deal.*** Government entities must carefully assess whether their taxpayers are getting good value on a case-by-case basis, particularly on a complex, long-term contract. When a contract requires the private partner to borrow extensively, for example, the private partner may be at a disadvantage compared with what the government's direct cost of borrowing would be, because the government benefits from its taxing power and from an investor perception that municipalities generally do not go bankrupt as well as federal tax policy toward municipal debt.

The private sector could pass its higher cost down to taxpayers and users in the form of higher bids. It's a case-by-case empirical question as to whether higher borrowing costs can be outweighed by the efficiencies that private-sector partners bring to the table.

Though government likely got the better end of the deal in the Indiana toll-road case, there's no guarantee that it won't get the bad end of the deal in another, similar case. In the Chicago parking-meter transaction, for example, it's not entirely clear that the government will save any money. In some cases, it may be better for the government to focus directly on cutting its own labor and other costs to achieve savings, rather than enter into complex contracts whose successful outcome depends on intricate assumptions projected over decades.

Likewise, government officials should be wary of potential PPPs that do not attract wide bidding pools. If two or three major companies dominate worldwide in one particular function, it is difficult to ascertain if a fair market really exists. Again, bus service is optimal for contracting here, because the barriers to entry are low.

***The private sector can't save the public sector from itself.***

Government cannot use PPPs to avoid decisions on spending priorities, such as deciding whether to expend finite resources on social-services growth or infrastructure investment. Public infrastructure is, more often than not, a task that is not explicitly profitable, meaning that private partners require public subsidies to do the job even under PPP structures. The public sector can cut some costs by structuring effective PPPs, but it cannot eliminate them.

Similarly, PPPs are not a way for government to avoid decisions on issues like public-sector pension and other labor-cost reforms. PPPs are of no help to the government if, for example, the government simply requires private-sector bidders on a particular project to transfer unreformed public-sector labor to the new partnership, as New Jersey moved to do two years ago, and as New York State may do, as well. Government cannot avoid unpalatable conflicts with union labor and other special interests via the PPP model; in some states, including New York, public officials must enact legislation or agreements with unions before they can broadly employ the PPP model in the first place.

PPP structures will not change a government that has a habit and history of tolerating contractors with political ties or contracts assigned via kickbacks or collusion. Ethical bidders will simply stay away, and unethical bidders will do business as usual through the PPP structure. PPPs are no guarantee against corruption; only public-sector willpower and vigilance, as well as independent scrutiny on the part of the public and the press, can do that.

Government should not use the money extracted from PPPs as a way to avoid budget realities. Chicago, for example, has used some of the proceeds of its Skyway and other long-term asset leases to fill deficits in its operating budget. The state of Arizona is now looking to do the same, planning to sell its office buildings to a third party for a big up-front payment and then rent the office space back from the new owner. New York is looking at asset sales, as well. This strategy is no different from that of a government that borrows bonds long-term to spend money in the short term. Both strategies only allow government to avoid questions on spending levels versus resource levels. This is particularly dangerous in the current economic environment, in which it is unclear whether the tax slump is temporary or indefinite. Once a government leases off a valuable asset for an up-front payment by transferring that asset's future revenues to a private partner, as with the Chicago toll-road and parking-meter PPPs, the money that the government would have earned from that asset over time is gone forever.

***Finally, governments can never transfer their ultimate responsibility to plan, build, manage, and finance core government functions to the private sector.*** As governments consider PPPs, they can learn from an unlikely example: the recent attempt by aircraft giant Boeing—playing the role of a local or state government in this analogy—to pioneer an innovative way to design and build its next airplane, the 787 Dreamliner.

In an approach similar to that of the most ambitious PPP projects, Boeing abandoned its traditional role as the sole designer, financier, and manufacturer of its new planes, and instead adopted the role of project manager, outsourcing much of the actual design, construction, and financing work to new contractor “partners” around the world. Boeing’s experienced executives were confident that they could break the Dreamliner down into

a “portfolio” of measurable parts, assess the value of each part, and determine which of its partners could appropriately take on responsibility for that part and at what price.

Boeing’s strategy did not deliver as intended, as its management has forthrightly acknowledged.<sup>6</sup> The company has had to offer its supposedly autonomous smaller partners extra time and money, has had to purchase one major supplier outright to keep it afloat, and has had to take some major work back in-house to get the job—now years behind schedule and up to 100 percent over its initial \$8-\$10 billion development budget—completed.

Boeing has learned something valuable in salvaging the project, a lesson that the public sector should heed in pursuing PPPs. In the end, when it came to technical, financial, or scheduling difficulties, no matter how carefully Boeing tried to measure and allocate risk among third-party partners, much of the risk boomeranged right back to Boeing, the strongest party and the one with the most to lose in terms of its reputation and a new generation’s worth of profits.

With PPPs, if the government and the private-sector partner misjudge the private-sector partner’s capacity to do the job, the private-sector partner always has default or bankruptcy as a last resort; the government, on the other hand, just like Boeing, has no choice but to complete the critical job for which it is ultimately responsible. Further, if the government misjudges the value added by the private sector, it could be making a bad deal for taxpayers and infrastructure users.

Governments can use the private sector to help achieve public purposes. Though this evolution can transform the scope of a government’s responsibility, it will not—and should not—eliminate that responsibility.

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## NOTES

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