

AGC White Paper on Public-Private Partnerships

The Risks and Opportunities

Executive Summary

As public-private partnerships (PPPs) garner more attention as a means of financing and addressing our nation's growing infrastructure deficit, the Associated General Contractors of America (AGC) developed this white paper to outline the issues that contractors will confront with PPPs. Former AGC President Harry Mashburn put forth a goal to "determine the best way for AGC to present the latest information and encourage an internal dialogue to determine the policies and practices that will best guide our interaction with PPPs," and a task force of AGC members focused on creating a document that succinctly and thoroughly describes the variables that must be contemplated as contractors participate in PPP projects.

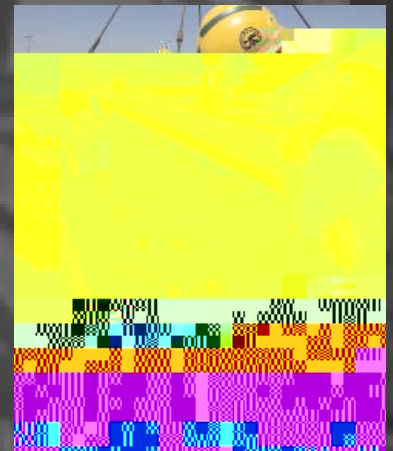
This white paper focuses on two primary areas: the legislative issues that arise when states and localities consider utilizing PPPs, and the issues that contractors confront when they consider participating in a PPP project. Before even addressing the specifics involved in PPPs, AGC makes clear that increasing public investment in our nation's infrastructure is essential. PPPs simply provide supplemental funding to traditional public financing. Furthermore, if PPPs yield an upfront payment to a public entity or a future revenue sharing agreement, the revenues derived from the transaction should be dedicated to investment in the type of infrastructure from which it originated. The revenue should not be diverted to other purposes.

As states explore utilizing PPPs, they need to approve enabling legislation. This first part of the white paper outlines the key issues that a state legislature will likely consider as part of such legislation. Many of these issues are important to contractors and they should be engaged in the debate.

The second part of the white paper addresses the new risks and opportunities that contractors encounter when they consider participating in PPPs. These projects take many forms to address the unique attributes of each project and each team. Many of the risks that are typically held in a design/bid/build project by the public entity are transferred to the private consortium in a PPP. This white paper highlights the risks that are unique to PPPs and the need to ensure that the risks are properly allocated so that contractors are not left with an inappropriate amount or type of risk. Since PPPs involve a team approach, we stress the importance of contracts and Memorandums of Understanding (MOUs) with the other team members, and the need for contractors to be at the table from the outset in any negotiations with the owner. Furthermore, we discuss how contractors must involve their insurer, bonding agent, and lender early in the process to assist in evaluating the risk potential in the projects.



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In short, contractors need to be involved in a PPP project from its inception in order to help shape the project and help define the roles and responsibilities of the team members and their relationship with the public owner. Successful PPPs can help deliver projects to the public faster than the traditional approach, but they must be done thoughtfully so that the public interest is protected.

Introduction

AGC of America developed this white paper in response to the increased interest of federal, state, and local governments to engage in public-private partnerships (PPPs) to fund a small portion of the growing gap between public funding for infrastructure and the increasing public demands. The paper outlines the issues that contractors will confront with PPPs. Our goal is to help educate AGC members about the opportunities and risks that PPPs present.

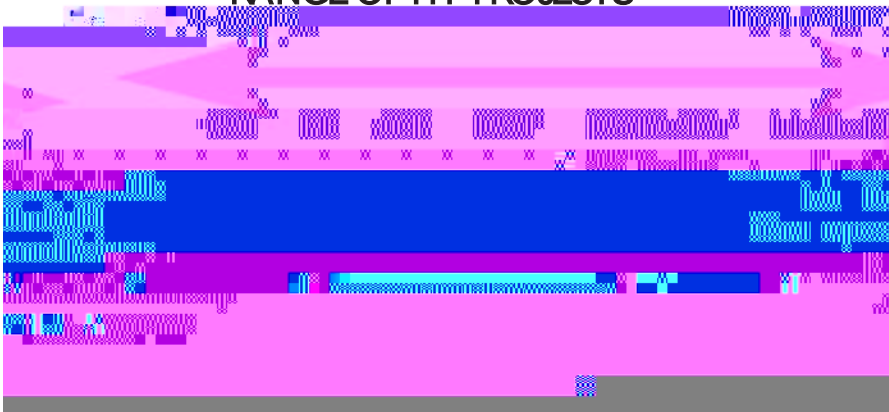
Defining Public-Private Partnerships (PPPs)

The first challenge is to define "public-private partnership." The Government Accountability Office (GAO) defines a public-private partnership as "a contractual agreement formed between public and private sector partners, which allows more private sector participation than is traditional. These agreements usually involve a government agency contracting with a private company to design, renovate, construct, operate, maintain, and/or manage a facility or system. While the public sector usually retains ownership in the facility or system, the private party will be given additional (often total) decision-making rights in determining how the project or task will be completed."¹

The National Council for Public-Private Partnerships (NCPPOP) defines a public-private partnership as "a contractual agreement between a public agency (federal, state, or local) and a private sector entity. Through this agreement, the skills and assets of each sector (public and private) are shared in delivering a service or facility for the use of the general public. In addition to the sharing of resources, each party shares in the risks and rewards potential in the delivery of the service and/or facility."²



RANGE OF PPP PROJECTS



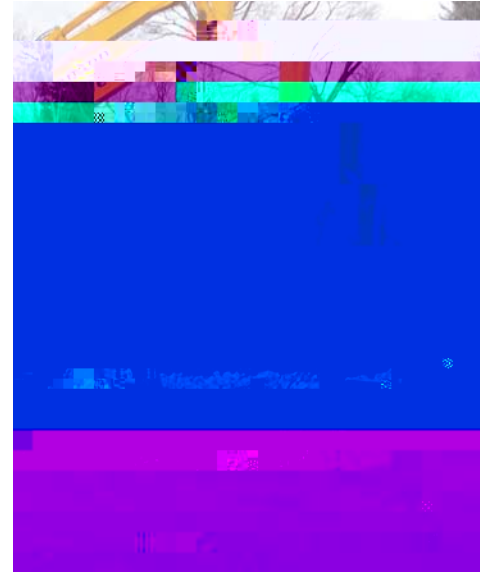
1. GAO testimony
 2. The National Council for Public-Private Partnerships
<http://ncppp.org/howpart/index.shtml#define>

Why PPPs Have Emerged

As governments from around the world struggle to address their infrastructure needs, many have turned to PPPs to help meet these needs. The United States is now facing an infrastructure crisis and is seeking ways to address this challenge. The American Society of Civil Engineers' "2005 Report Card for America's Infrastructure" gives the overall condition of the nation's infrastructure a grade of "D" and calls for an investment of \$1.6 trillion in infrastructure over the next five years. PPPs have emerged as one of the tools that may help states and other public entities address a portion of their infrastructure deficits.

The U.S. Department of Transportation (DOT) in its most recent Conditions and Performance report said we need to spend \$61 billion more annually to adequately address our highway and bridge needs. The report estimated that it would take an annual investment of \$31 billion just to fund Interstate preservation. Adjusting that "constant dollar" estimate to "year-of-expenditure dollars" the American Association of State Highway and Transportation Officials (AASHTO) estimates that it will take at least an annual investment of \$49 billion to preserve the Interstate System in

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Case Study 1: Using the PPP Model for School Construction

The Houston Independent School District (HISD) had a fast growing school district and a failed bond referendum. A solution was created when HISD entered into a lease/purchase transaction with Gilbane Development Co., whereby the private company assumed all the delivery risk for two 500,000 square foot high schools. The agreement called for Gilbane to take on the risk of financing and developing the facilities under a stipulated sum and specific schedule. Some of the advantages of this approach included the school district not incurring long-term debt and making school bond capital available for other purposes. HISD makes lease payments on the facilities from funds annually appropriated by the District.

3. American Society of Civil Engineers, "2005 Report Card for America's Infrastructure" http://www.asce.org/report_card/2005/index.cfm

4. U.S. Department of Transportation, "2004 Status of the Nation's Highways, Bridges, and Transit: Conditions and Performance" 2006

5. American Association of State Highway and Transportation Officials, "Transportation Invest in Our Future," 2007 http://www.transportation1.org/tif5_report/trans_network.html

6. U.S. Environmental Protection Agency, "The Clean Water and Drinking Water Infrastructure Gap Analysis" 2002

7. American Society of Civil Engineers, "2005 Report Card for America's Infrastructure" http://www.asce.org/report_card/2005/index.cfm

8. American Association of State Highway and Transportation Officials, "Transportation Invest in Our Future," 2007 http://www.transportation1.org/tif5_report/trans_network.html

Private Capital Investing in Our Infrastructure

The emergence of private capital wanting to invest in infrastructure projects is driving government's interest in PPPs. Over the past several years, a substantial amount of money has been invested in infrastructure projects by investment funds, private equity firms, institutional money managers looking to invest pension funds, insurance companies, and wealthy individual investors. New infrastructure funds are being established at home and abroad, and it has been widely reported that Goldman Sachs and the Carlyle Group have already established infrastructure investment funds that total \$7.5 billion. These two funds alone could leverage \$37.5 billion in total infrastructure improvements, and are just two U.S. companies that have recently targeted this market.

These infrastructure investment funds are looking to invest in toll roads, parking lots, water treatment facilities, power plants, airports, dormitories, hospitals, schools, prisons, and other infrastructure. The attraction of infrastructure project investments is that they are seen as long-term, secure, inflation-protected investments that fit well with the payout schedules of pensions and life insurance policies.

Major Infrastructure Areas Where PPPs Apply

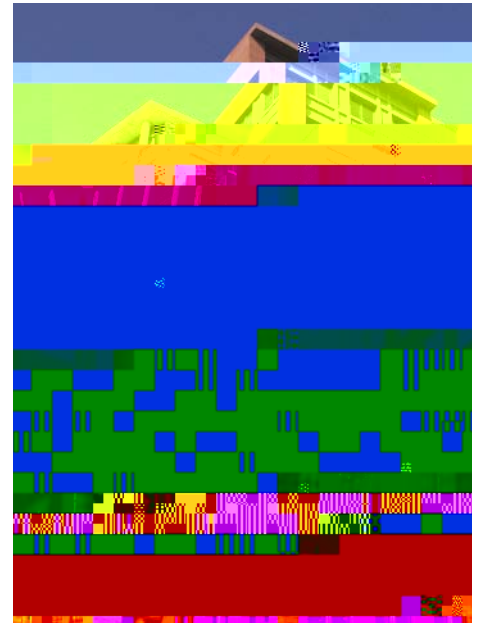
With the recent lease of the Chicago Skyway and the Indiana Toll Road, the media has focused on the role of PPPs in the highway and bridge sectors. While transportation is a significant focus of PPP activity, many other infrastructure areas are also ripe for PPPs. PPPs have been utilized as an infrastructure delivery mechanism to build drinking-water and wastewater treatment facilities, schools, hospitals, prisons, and military housing.

As noted above, we have tremendous needs that must be addressed in all these infrastructure areas. In school construction alone, the National Education Association (NEA) reported in 2000 that an investment of \$268 billion is needed to bring our nation's schools into overall good condition. In a typical PPP school construction project, the private sector would finance, design, build, and often maintain a school under a contract with a governmental entity for a certain number of years. At the end of the contract, ownership and responsibility for the school is transferred to the governmental entity. The key ingredient that entices the private sector to be interested in a PPP is a long-term revenue stream. All of these infrastructure sectors noted above have that essential element. In turn, the public sector is interested in pursuing a PPP because they believe a PPP will provide revenue to build, operate, and maintain the project and that the public will benefit by a faster completion time.

PPPs often allow for increased innovation. For example, a contractor/operator brought new efficiencies to a municipal water treatment facility by enhancing maintenance and operation of the facility. The contractor utilized the latest technologies to reduce energy consumption so the private contractor could save money and reduce the downtime for maintenance by accurately and aggressively planning critical maintenance activities. In another situation, contractors and developers collaborated at early stages in the construction of schools to design multi-use elements into the project that opened the facility up to rental income during after-school hours and during the summer months. In this instance, it was critical to get the authority to offer the facility for rent into both the concession agreement and the design. These protections assured the tenant that the additional activity could be carried out safely without compromising their use of the facility, or imposing risks upon them.

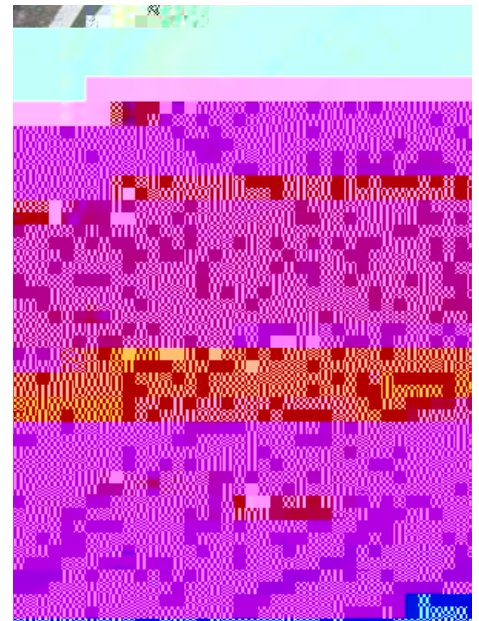
Legislative Issues and Contractor Issues

In an effort to address the major issues that contractors face when dealing with PPPs, the task force split the issues into two camps: legislative issues that arise when federal, state, or local governments attempt to utilize PPPs (Legislative Issues), and issues that contractors face when participating in a PPP project (Contractor Issues).

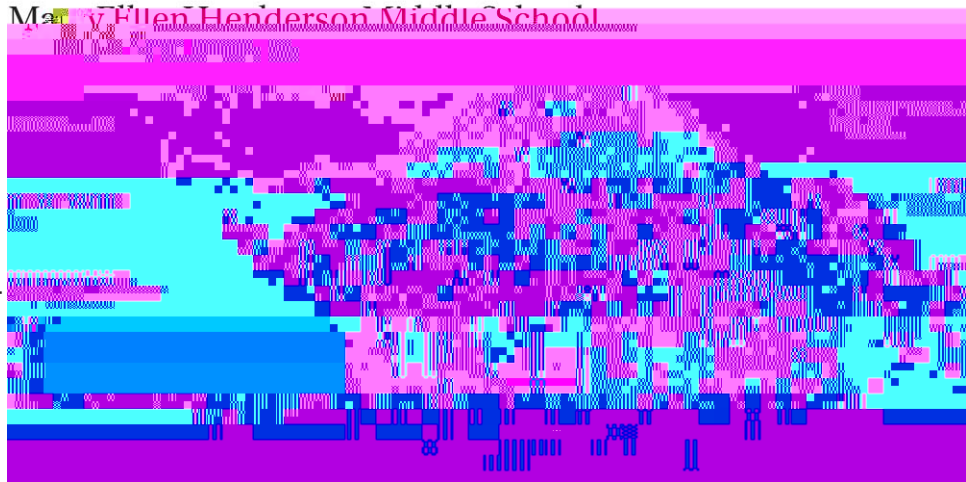


PPP Legislative Issues

The issue of PPPs has become controversial and contractors and AGC chapters should engage in this debate by lobbying for provisions that



It is imperative, however, that PPPs are utilized to supplement public funding, not supplant it. AGC strongly believes that PPPs should be used to bring additional revenue to address our infrastructure needs; it cannot replace the current revenue which needs to be maintained and increased just to continue our standard of living. We continue to aggressively advocate for significantly increasing public investment in our infrastructure and believe that PPPs can leverage additional private investment.



We recommend that AGC members and chapters make clear to public officials that they do not want PPPs to replace public investment.

Different Types of PPPs

PPPs come in many different shapes and sizes. They include both existing facilities, referred to as "brownfields," and new-capacity facilities known as "greenfield" projects. Although the brownfield projects have received the bulk of the attention thus far in the transportation area, the long-term PPP role will be in building new greenfield projects. The financial entities and concessionaires have gravitated to the leasing of existing facilities because it is easier to quantify the risk than building a new facility that involves all the construction risk as well as the uncertainty of how much the facility will be used, which determines the amount of revenue that will be derived.

One commonality among the different types of PPPs is a need for a dedicated revenue stream. Often the private entity will provide all or some of the upfront funding for the building or improving of a facility, but there must be a method of repayment over the duration of the partnership. The revenue stream can be derived from a number of different sources, including fees, tolls, shadow tolls, availability payments, and local taxation.

State Enabling Legislation - How They Impact PPPs

When a state or local government wants to utilize a PPP approach for a transportation project, or other types of infrastructure projects, they must first acquire legislative authority, referred to as state enabling legislation.

Case Study 5: Using the PPP Model for School Construction

To much fanfare, the Mary Ellen Henderson Middle School opened to students in September 2005. The first school built in the City of Falls Church, Virginia in over 50 years, this 130,000 square-foot, four-story facility accommodates up to 600 students for grades 5-7. Taking just 16 months to construct, Mary Ellen Henderson Middle School was the first school procured under Virginia's Public-Private Educational Facilities and Infrastructure Act of 2002 (PPEA).

Faced with building a new one to replace an older facility which could no longer adequately serve a growing population of students, the district solicited PPEA proposals. Under the entity, Public Private Alliances, LLC, Clark Ventures proposed a unique solution that did not require the purchase of additional land for the facility. By avoiding the cost and time associated with acquiring a new site, Clark Venture's plan saved the district several years on the schedule and between \$7 million to \$10 million in land costs. Additionally, by utilizing the expedited PPEA process to procure the facility, the client was able to avoid rapidly escalating construction prices and issue bonds at historically-low interest rates.

The building features, apart from traditional classrooms and hallways, a 10,400 SF gymnasium with 1,000 seats, media center/library, art lab, technical labs, media production rooms and a dual-purpose cafeteria - a combined cafeteria and auditorium complete with lighting and stage equipment. The facility also features Internet access in every classroom and in the labs.

The school board required that the building achieve numerous environmental goals, and the community wanted to substantiate the efforts of sustainability in the design and construction of the project. Clark Ventures assisted the school board in selecting feasible and cost-effective, environmentally-friendly materials throughout the facility.



Use of Proceeds from PPP Transactions

In some cases, PPP transactions yield an upfront payment to a public entity or a revenue sharing agreement whereby the public entity receives revenue from a private entity or consortium. In two recent high-profile examples, the lease of the Indiana Toll Road and the Chicago Skyway, a private consortium paid \$3.8 billion and \$1.83 billion, respectively, for 75- and 99-year leases of the facilities.¹³

In the Chicago transaction, little, if any, of the money was invested or dedicated to other transportation improvements. Conversely, in the Indiana lease, most, if not all of the money is dedicated to roads and bridges.

AGC strongly believes that the public entity that receives revenues from a PPP transaction should dedicate that revenue to the type infrastructure where it is derived (i.e., surface transportation reinvested in surface transportation, water systems reinvested in water systems). Some governors and other public officials will consider using the proceeds from a PPP to pay off public debt, pay for pensions, or pay for other types of unrelated infrastructure. AGC believes it is important to reinvest the revenue in related/like-kind infrastructure projects. With public infrastructure funds in such short supply, this revenue should not be considered fungible.

Challenges to Implementing PPPs

Once PPP legislation is approved, the focus shifts to approving and building a specific PPP project or projects. The main goal is to convince the public that your state's particular PPP approach is sound and has benefits such as delivering new capacity, incorporating new technologies, and meeting new federal, state or local standards. Since this is a new method of financing and delivering projects, the public is skeptical. Because the public will pay for it through user fees, they are fearful of the cost of future fee increases. In addition, all the interest groups that are devoted to stopping any infrastructure project from moving forward use the uneasiness about PPPs as another justification to stop the project. It is incumbent upon those who want to advance these projects to educate the public and local lawmakers about the benefits and risks that this innovative approach delivers and counter the misinformation that the opposition may put forth. As it is with anything new, the public needs to get comfortable with PPPs as a worthy approach, and, with success, more PPP projects will likely follow. Conversely, if the public is not convinced of their merits, and PPPs are unsuccessful, few, if any PPP projects will follow.

PPP Contractor Issues

Introduction

When contractors consider participating in a PPP, they face new risks and new opportunities. This section of the white paper is intended to outline the different challenges and issues that contractors might encounter with PPPs. Included in this section are the various roles contractors can play in a PPP and where, as well as when they can add value. The risks that are unique to PPPs are highlighted. The risks should be properly allocated so that contractors are not holding an inappropriate amount or type of risk. Since PPPs require a team effort, contracts and Memorandums of Understanding (MOUs) with other team members are very important and contractors need to be at the table from the beginning in any negotiations with the owner. Furthermore, it is essential that contractors involve experienced insurers, bonding agents, counsels and bankers to assist in understanding the risk potential in some PPPs. After examining these and other related factors, contractors can then determine if PPPs are a good opportunity.

13. The Washington Post, "Daley's Art of The Lease," Feb 8, 2007



Role of Equity Investments by Contractors

While not common, some project teams want contractors to provide equity up front. Putting your money at risk early in the process is a new element of risk for public works contractors, or even for contractors who work for private owners. In some cases contractors may be called upon to pay for design long before the public entity even considers a project. It is not unusual for bidding preparation to cost more than a million dollars. Stipends are offered on some projects, but they are often a pool of funds divided among all bidders. Understand up front if stipends will be paid and how the stipend pool will be allocated to bidders. In a project that involves a consortium that packages an unsolicited proposal, it may take years before your development or design investment bears fruit.

Contractors may be called upon to finance a portion of public projects where states or localities receive annual apportionments of project funds. The demand for the public improvement drives the public entity to accelerate the project ahead of the public funding being made available. In this case, the contractor must evaluate the ability of the public entity to make good on multiyear commitments.

No matter the structure of the deal, it is imperative to know who you are working for, how and when you will be paid, and the limitations and strengths of everyone on the team. The success of the project depends heavily on the strength of the team.

Private funding for projects frequently comes from financiers who will not need contractor equity. Major players in public-private transportation projects approach it differently - some have requested equity, while others do not require upfront equity but need the contractor's expertise and local knowledge. Almost always, however, the financier or concessionaire will require the contractor to take significant construction risk (see more detail below).

For the success of the project and contractors alike, it is important to go to developers and provide expertise early. In many situations, contractors have taken the lead in the construction processes, including early input on design, materials, quantities, scheduling, and maintenance that can make the difference between a successful or disastrous project.

Sizing Up the Risk

Fully understanding and anticipating risks will make the difference between success and failure for the contractor. Risk-shifting is complicated, and it varies depending on the strength and experience of the consortium, public owners, and the contractors.

When contractors work with developers and concessionaires, it is important to know how the enabling legislation, contracts, laws, and circumstances dictate the roles and responsibilities of the parties involved in the contract. Risk-shifting is further complicated by the levels of agreements, and, like any other type of construction project, shifting away risk is always preferable. Risks not shifted away must be accurately priced into the construction costs.

It is important to remember that many of the risks typically borne by the public entity in public works contracting are candidates for risk-shifting. Public entities are trying to get the public use of an asset with as little cost and responsibility as possible. If successful, they can focus their resources on other projects in the area.



Conclusion

While the role of PPPs in developing and improving our nation's infrastructure is still evolving, it is important that contractors help shape the outcome. As states continue to look to utilize PPPs as one of the tools to address our overwhelming infrastructure deficit, contractors should be a key contributor to that debate. It is also vital that the federal, state, and local governments look to PPPs as only a supplement to and not as a replacement for public investment in U.S. infrastructure.

Although PPPs present contractors with new opportunities, they also present significant new risks. Many of the risks that are typically held by the public entity are transferred to the private consortium in a PPP. By being involved early in the process, contractors can ensure that the risks are most efficiently allocated and that contractors do not take on too much risk. Not all risks in a PPP should be shifted to the private sector, some risks are better held by the public entity. Contractors also need to work closely with other team members from the outset to develop the necessary contracts and MOUs. Together with involving their insurer, bonding agent, and lender early in the process, contractors can evaluate the amount of risk they are taking on with a PPP project and determine if the project is a worthy opportunity.

Useful Links

For information on state PPP legislation see: The Nossaman, Guther, Knox & Elliott Web site Nossaman.com/showarticle.aspx?show=214