

Advisory | Public-Private Partnerships (P3)



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When Is a Public/Private Partnership the Right Choice?

Between 2016 and 2025, state and local governments are projected to spend an estimated \$1.88 trillion on building and rebuilding public infrastructure. But the American Society of Civil Engineers (ASCE) estimates that in addition to this significant amount of infrastructure spending, a \$1.4 trillion gap in needed infrastructure will remain. The ASCE estimates that the aggregate economic impact of the failure to fund this gap would add up to a loss of nearly \$4 trillion in gross domestic product (GDP) by 2025. Many pundits have hailed access to private capital through public/private partnerships (PPPs) as the Holy Grail with the power to unlock private sector infrastructure delivery efficiencies, which will provide the impetus for state and local governments to fill the gap.

Given this momentum toward considering PPPs, our research team at the Harvard Kennedy School of Government has created an interactive web-based Decision Tree application to help state and local government officials and administrators determine when to use traditional infrastructure delivery methods and municipal financing, or when to access private capital and PPP delivery methods, with guidance on which PPP delivery method should be used. The Decision Tree can be accessed at www.P3Guide.com.

The Decision Tree is based on practical experiential input and interviews with government procurement officials, financial market professionals, engineering experts, and infrastructure purveyors in both the traditional and PPP infrastructure delivery arenas. Team members also surveyed the literature on PPPs and analyzed major projects from the United States and abroad. While many people have begun promoting the expanded use of PPPs, others counter that municipal bond market finance and traditional

infrastructure delivery vehicles, such as design/bid/build, and traditional sources of public sector capital, including taxes, federal grants, and user fees, have done a credible job in delivering trillions of dollars' worth of public infrastructure, so why change what works? They argue that only more federal dollars funneled to state and local governments will work to close the infrastructure delivery gap, positing that the problem lies not with the method of procurement, but with the identification of additional federal sources of revenue to pay for nationally important infrastructure projects.

Still other industry players, such as purveyors of public infrastructure (e.g., engineers, contractors, construction companies, and equipment vendors) and providers of private capital (e.g., private equity funds, pension funds, and infrastructure banks), respond that the infrastructure delivery gap demonstrates a structural failure in traditional delivery methods and that the unique characteristics of PPPs—while not a panacea for all public infrastructure woes—can begin to fill the gap not being addressed by traditional delivery methods. They see PPPs less as supplanting traditional infrastructure delivery methods and more as being additive to and thriving alongside them. They argue that if PPPs can effectively draw down a meaningful portion of gap projects, traditional delivery vehicles will remain sufficient to handle the lion's share of infrastructure projects that they currently implement.

Veteran political policy experts add their skepticism, arguing that waiting for Congress and the president to authorize meaningful additional federal funding for public infrastructure construction may not be a successful short-term strategy for state and local governments. They raise understandable concerns that the passage of H.R. 1—the Tax Cuts and Jobs Act, which was signed into law on December 22, 2017—has drastically limited the future availability of unallocated federal monies for infrastructure funding. While the Consolidated Appropriations Act, 2018, provided an approximate \$21 billion one-year infusion of infrastructure funding in a trade-off for approval of increased military spending, that funding makes only a small dent in the infrastructure spending gap and provided no long-term structural solutions to the challenge of funding infrastructure.

In early 2018, President Donald J. Trump unveiled his ten-year, \$1.5 trillion infrastructure project vision and proposed infrastructure plan to much fanfare from his base and significant dismay from state and local officials. If Congress were to approve the Trump plan (which veteran policy experts predict has a low probability), federal funding of state and local infrastructure would be reduced significantly due to a lowering of federal matching funds—traditionally a 50/50 split—to 20 percent of project costs, with state and local governments picking up 80 percent of the trillion-dollar funding lift sustained by redesignation of existing federal financing dollars (which some skeptics compare to rearranging the deck chairs on the *Titanic*). As noted in *The Bond Buyer*, quoting Chris Hamel, former head of municipal finance at RBC Capital Markets, “President Trump’s infrastructure plan is less important for the funding it may provide, but rather is significant because of its bold and sweeping proposals to move federal policy toward the involvement of the private sector in the provision of public infrastructure.”

Where does this leave state and local governments facing the real conundrum of how to protect public health, safety, and welfare with the seemingly intractable dilemma of finding the funds needed to fix the nation's public infrastructure deficit? As noted by S&P Global, “[t]he problem for U.S. infrastructure has never been a shortage of private capital, but rather how it is paid for.” State and local governments are left having to find a new mix of traditional existing infrastructure funding and delivery tools with which private capital and PPPs must play a significant role alongside traditional public infrastructure delivery. This may include challenging the traditional infrastructure paradigm that essential public services, such as roads, should be free or affordable, as is the case with drinking water.

Given this dialogue on the use of PPPs, we have structured the Decision Tree around three principal infrastructure project goals (complete project within budget, complete project on time, and project works as designed) and four principal analytic considerations (legislative, financial, technical, and political). The three project goals need no explanation. The Decision Tree defines the various PPP procurement structures and then allows the viewer to access decision tools that lead the viewer through a series of questions related to the four principal analytic considerations identified above and, depending on the answers to the questions, suggests an appropriate procurement methodology. For example, under “technical considerations,” the user is asked: “Does this project have technical complexity beyond your governmental entity’s competencies?”

Continuing within the technical considerations box, users will find other questions related to their particular infrastructure project, including the degree of technical complexity, the use of new technology, and the level of experience/manpower/competency of the staff and management team to manage the public infrastructure construction and its subsequent operation and maintenance. Within the legislative considerations box, users will find and apply the particular constitutional, statutory, and local government charter and procurement framework under which they operate.

Within the financial considerations box, users will find questions related to their government’s access to capital markets, limitations on borrowing capacity, bond ratings, bond market capacity, demand risks, and differential costs of capital. Financial considerations responses are given the greatest weight in the PPP decision recommendations. In some instances, a governmental entity does not have ready access to financial capital for a project (for example, the government may have structural debt issuance limitations, debt capacity limitations, or low credit ratings), which makes accessing private sector finance through a design/build/finance PPP procurement more attractive. In other instances, a governmental entity does not need to resort to private financing, but due to the technical risk or user-demand risk profile of the project may nonetheless desire to shift the potential financial burden of these risks to the private sector through an appropriate PPP structure. Weighing project risks and the potential to shift them to the private sector against the additional risk allocation and financial return requirements that the private sector will impose will play the most significant role in deciding whether to use a PPP structure.

Finally, within the political considerations box, users will find questions specific to the political arena in which their infrastructure project will be built, including whether the project spans multiple political jurisdictions; whether it includes or affects multiple politically active stakeholders; the anticipated degree of constituent pressure against new or increased taxes, rate increases, and new user fees and charges; the likelihood of constituent dissatisfaction from project completion delays; the ability of the jurisdiction to absorb material project cost overruns; and the likelihood of constituent fallout if the project fails to work as designed or constructed or from a technology failure.

Depending on the answers to those questions, the Decision Tree will guide users to a point where all those involved can make a more informed decision on the optimal method to implement an infrastructure project. The interactive nature of the Decision Tree allows users to move backward and forward through the questions so they can experiment with different scenarios. We also have included pop-up information boxes that users can click on for definitions and more in-depth discussion of specific topics.

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