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Public-Private Partnerships in California

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Current funding levels for public infrastructure in the United States are inadequate. Existing infrastructure is crumbling due to long-deferred maintenance and new infrastructure needed by the public is not being built. Public-private partnerships (“P3s”) cannot completely bridge the wide gap between our increasing infrastructure needs and our limited public resources, but they should be part of the mix. P3s have been widely used for decades with success in Europe, Canada and Australia to develop public infrastructure projects.¹ They also have been available for use by California’s local government agencies for nearly twenty years, but they have not been embraced by such agencies as a tool for building needed infrastructure despite the benefits that P3s can deliver. This two-part article explores P3s and “best practices” for addressing California’s infrastructure needs through private funding. In Part I, the definition of P3s and various forms of P3s are initially examined. The focus then shifts to the enabling legislation for the use of P3s by California’s local government agencies. Part II of this article, which will appear in the next edition of the Journal, will drill down further on P3s, examining the pros and cons of developing infrastructure projects on a P3 basis, a recent P3 success story, and the “best practices” for establishing and implementing P3 programs.

Demand for Public Infrastructure and Supply of Private Funds

There is, to be sure, very high demand for public infrastructure projects generally in the United States and in California. A recent report card issued by the American Society of Civil Engineers (the “ASCE”) gave the nation’s overall infrastructure a “D+” grade and estimates that an additional \$3.6 trillion beyond existing funding is needed by 2020 to address the “significant backlog of overdue

maintenance” and the “pressing need for modernization” of existing infrastructure.² Although California’s existing infrastructure fares somewhat better, earning an overall grade of “C” from the ASCE in 2012, it is estimated that an additional \$65 billion is required annually to address the State’s infrastructure needs.³ According to the ASCE, “California’s infrastructure investment has not kept up with the state’s population demands and is continuing to delay much-needed renewal and maintenance.”⁴

Additionally, while the supply of public funds for such infrastructure projects is low given strained public budgets and challenging economic times, the supply of private funds is relatively high and is expected to get higher. The amount of private funds available for investment in P3s is difficult to pinpoint, but some estimate that over \$250 billion is currently available and that as much as \$2.5 trillion may become available globally by 2030 to support well-implemented P3 programs as investor appetite for infrastructure investment increases.⁵ The number of investment funds dedicated to infrastructure has doubled between 2006 and 2009, and capital in those funds has increased threefold over the same period.⁶ Further, many large pension funds and institutional investors, including insurance companies, are interested in P3s to tap into long-term revenue streams and to diversify their holdings, thereby increasing the amount of private capital potentially available for P3 projects by another \$38 billion.⁷ Infrastructure assets are attractive to such private investors because they tend to be counter-cyclical, they generate quality cash-flows backed by long-term revenue contracts, and they have reasonably stable regulatory environments.

However, there is a disconnect between this supply and demand, and very few of the needed public projects are being developed in California under a P3 approach. This needs to change. California's crumbling infrastructure and the lack of new infrastructure projects is negatively impacting the quality of life in the State, and hindering economic development and job growth that could be realized if needed projects were designed and built.

P3s Defined and Common P3 Forms

There is no universally-accepted definition of a public-private partnership, but a P3 can be generally defined as follows:

A contractual agreement between a public agency 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 sharing in the resources, each partner shares in the risks-and-rewards potential in the delivery of the services and/or facility.⁸

P3s are very broadly defined and can encompass many different forms and payment models. Each P3 agreement (also called a concession agreement) between a private partner (also called a concessionaire) and a public partner is therefore unique. However, there are some common forms and payment models that P3 agreements generally share. At one end of the spectrum, the private partner may be contractually required to only design and build ("DB") a public infrastructure project, though some would say that a DB project would not qualify as a P3 because there is no financing component for which the private party is responsible and no sharing of the risk/reward beyond the construction phase. At the other end, and a more common P3 form, is an agreement calling for the private partner to design, build, finance, operate and maintain ("DBFOM") an infrastructure project. Under a DBFOM P3 approach, the private partner is incentivized to design and construct a better-performing and a longer-lasting facility that will cost less to

operate and maintain over the facility's entire life-cycle. There are, of course, many variants between these two P3 forms on the P3 continuum, but the private financing component is the real driver that allows public infrastructure projects to be built that otherwise would not be built (or would be delayed) due to strained public budgets and revenue-raising constraints.⁹

P3 agreements typically range in duration from 25 years to 50 years, depending on the specific enabling legislation. P3s can be used for existing infrastructure (sometimes called a brownfield concession) or new infrastructure projects to be built (sometimes called a greenfield concession). In the context of an existing facility, a DBFOM P3 agreement may call for the lease of a public facility, such as a wastewater treatment plant, to the private entity for 35 years. The private partner then may be required to make capital improvements to the facility in the short term to address such things as deferred maintenance, expansion to accommodate population growth since the facility's original construction, and modernization. Similarly, in the context of a new facility to be built, a DBFOM P3 agreement may call for the lease of public lands upon which a wastewater treatment plant, for example, is to be built. In either context, a P3 agreement may require that the private partner make an upfront payment to the public entity that can be used to retire the public entity's existing debt, if any, or that can be used for other public purposes.

Detailed designs for construction work to be undertaken by the private partner are not typically specified in P3 agreements for existing or new facilities. Instead, P3 agreements usually establish performance criteria and standards that the upgraded or new facility are to meet, thereby allowing the private partner (usually through engineers and contractors, or a design-builder, hired by the private partner) to devise the means and methods for an overall design-and-construction plan, which may also include operation-and-maintenance methodologies, to meet the required performance standards. For example, in the context of a wastewater treatment plant, the P3 agreement may require

the plant to treat a certain quantity and quality of influent to a certain level. Additionally, it may also require that the plant maintain certain odor controls, meet certain energy efficiencies, and be capable of future expansion. In the longer term, and while the short-term improvements are being designed and built in the case of an existing facility, the private partner would operate and maintain the facility (usually through a private O&M provider hired by the private partner) for the term of the P3 agreement. During a facility's operation phase, the private partner typically assumes the risk of operating and maintaining the facility, which in the context of a wastewater treatment plant would include the risk that fines could be levied for the unauthorized release of untreated or undertreated wastewater. At the end of a P3 agreement, the infrastructure facility is returned to the public entity in a contractually pre-determined condition, and the public entity can then operate and/or maintain the facility itself or outsource this work to the private sector.

Whether a P3 project involves an existing public facility to be upgraded or a new public facility to be designed and built, there are two primary payment models that can be used to provide the private partner with a reasonable return on investment. The first is called a "user fee" payment model. Under this model, like its name suggests, the private partner is paid a return on investment through fees paid by users of the particular public infrastructure project. Usually, a rate-setting mechanism or formula is contractually set to establish a rate ceiling to ensure that the private partner does not receive a windfall. Sometimes, the rate-setting mechanism also ensures that the private partner makes a threshold rate of return, but where no floor is established for rates, the private partner assumes the risk that there will be an adequate number of users and that user fees generated by the facility will be sufficient to cover the cost to operate and maintain the facility, the service of debt, and a reasonable return on investment. This risk is less for facilities that have "captive" users, such as wastewater treatment plants, but this risk can be significant for facilities that are not necessarily needed for use by the public,

such as toll roads where drivers can instead use alternate roads that are not tolled.¹⁰

The other payment model is called an "availability" payment scheme. Under this second model, the public entity pays contractually pre-determined amounts to the private partner during the term of the P3 agreement. These payments are similar to lease payments, but are subject to performance-driven deductions if the facility, in whole or in part, is underperforming. For example, if the infrastructure project is not "available" for use or if the facility fails to meet certain performance standards during the P3 agreement's term, the "availability" payments to the private partner will be reduced. Unlike the "user fee" payment model, the private partner under an "availability" payment model generally assumes no risk that there will be an inadequate number of users to generate a reasonable rate of return.

Significantly, under either the "user fee" or "availability" payment models, P3 agreements generally do not call for the private partner to receive significant payments until the construction work called for under the particular P3 agreement has been satisfactorily completed and the infrastructure facility has become operational.

California's P3 Enabling Legislation

Although California has had P3 enabling statutes for transportation infrastructure since 1989, only two transportation projects have been built to date, though a third project – the Presidio Parkway project, which is based on an availability payment model – is currently being built in San Francisco. The two projects already built – SR-91 and SR-125, both toll-roads in Southern California based on a user-fee payment model – would not be considered by many to be success stories, and the difficulty that private partners have historically had in working with the California Department of Transportation does not bode well for a robust P3 program for the development of transportation infrastructure in the short term in California.¹¹

There are also P3 statutes enabling the development of courthouses and the high speed rail system in California. However, California's Administrative Office of the Courts recently stated that it does not intend to pursue the development of courthouses under a P3 approach after it was criticized for building the Long Beach Courthouse – the first and only courthouse P3 project in California, which is still under construction – on a P3 basis.¹² Additionally, although the high speed rail system holds great promise, assuming it weathers current political storms and gets built, the legislation enabling this one system's development on a P3 basis is not broad enough to address California's many other public infrastructure needs.

There are, however, broad P3 enabling statutes in California that are available to "local government agencies" to develop a variety of public infrastructure projects using a P3 approach.¹³ Specifically, since 1996, local government agencies have been able to pursue the following types of "fee-producing" infrastructure projects on a P3 basis: irrigation; drainage; energy or power production; water supply treatment, and distribution; flood control; inland waterways; harbors; municipal improvements; commuter and light rail; highways or bridges; tunnels; airports and runways; purification of water; sewage treatment, disposal, and water recycling; refuse disposal; and structures or buildings, except those that are to be utilized primarily for sporting or entertainment events.¹⁴

Additionally, these enabling statutes for local government agencies are flexible and allow for many forms of P3s that can last for as long as thirty-five years.¹⁵ They even allow local government agencies to transfer ownership of constructed facilities to private partners, though ownership must revert back to the local government agency at the conclusion of the P3 agreement.¹⁶ As explained in the enabling statutes: "It is the intent of the Legislature that local governmental agencies have the authority and flexibility to utilize private investment capital to study, plan, design, construct, develop, finance, maintain, rebuild, improve, repair, or

operate, or any combination thereof, fee-producing infrastructure facilities."¹⁷

Despite these broadly worded enabling statutes for local government agencies, there are some possible limitations on the use of P3s stemming from ambiguities in the statutes.¹⁸ For instance, the enabling statutes provide that only "fee-producing infrastructure projects" and "fee-producing infrastructure facilities" can be pursued on a P3 basis.¹⁹ The statutes define "fee-producing" as meaning that the "operation of the infrastructure project or facility will be paid for by the persons or entities benefited by or utilizing the project or facility."²⁰ Does this mean that P3s must be based only on a user-fee payment model, and that the use of an availability payment model is prohibited for P3s? For example, can a local government agency enter into a P3 agreement by which the private partner will design, build, finance and maintain a new firehouse needed in a community? The general definition of a P3 project contemplates use of the facility by the general public, as opposed to a specific government entity, such as a fire department. However, the firehouse would be "utilized" by a government entity, and the enabling statutes allow for payment to the private partner for the project "by the persons or entities benefited by or utilizing the project or facility." Until this ambiguity is resolved, social infrastructure projects, which typically do not produce a fee, may be difficult to develop in California.

Another ambiguity involves Proposition 218, and whether a P3 project that entails the raising of user fees (as would nearly always be the case) requires a Proposition 218 vote. Proposition 218, which was passed in 1996 (the same year as the P3 enabling statutes for local government agencies), generally prohibits local governments from raising property-related taxes, fees, assessments or other charges without voter approval "[n]otwithstanding any other provision of law."²¹ However, Proposition 218's limitations do not apply to "private fees," and user fees paid to a private partner under a P3 agreement could be considered a private fee, the increase to which would not necessarily require a Proposition 218 vote.²² Additionally, the P3

enabling statutes for local government agencies do not specifically require a Proposition 218 vote before a P3 agreement is entered into by a local government agency. All that is required under the P3 statutes is that a local government agency “conduct at least one public hearing at which public testimony will be received regarding a proposed user fee revenue or increase in user fee revenues.”²³ After the public hearing, the local government agency can “levy a new fee or service charge or approve an increase in an existing fee or service charge,” provided it does so through an ordinance or resolution.²⁴

Thus, it would seem that a Proposition 218 vote would not be required before a local government agency decided to pursue a P3 project if the user fees to be produced through the p3 project were considered “private” fees. Under this approach, user fees could be established or raised pursuant to the procedures called for under the P3 enabling statutes. Nevertheless, the acceptability of this approach is not entirely settled in all contexts. User fees for some P3 projects could be considered a property-related tax or assessment, which could be subject to proposition 218’s voter-approval requirement.²⁵ More specifically, user fees for some types of P3 projects, such as wastewater treatment plants, are typically tied to a parcel of property, whereas user fees for other types of P3 projects, such as bridges or tunnels, are not tied to a particular parcel, but instead tied to actual usage of the P3

facility. In the former context, where fees are tied to a parcel, there is a higher likelihood that a proposition 218 vote would be required, whereas in the latter context, where fees are tied to actual usage, there is a lower likelihood that a proposition 218 vote would be required. Again, though, this is not entirely certain, and for this reason, there remains a risk that a disgruntled property owner will challenge an increase in the user fees that a P3 project would normally entail when such fees are tied to parcels of property.

Conclusion

Local government agencies have a powerful tool to address their infrastructure needs. That little-used tool is the P3 project delivery method that can be used to develop projects through private funding. P3s can help bridge the gap between the State’s public infrastructure demands with the supply of private capital available to invest in P3 projects. In Part II of this article, the focus will shift to the pros and cons of developing infrastructure projects under a P3 approach. Although not every infrastructure project is appropriately pursued on a P3 basis, many larger, technically-complex projects could benefit from the private sector’s involvement. The benefits P3s offer extend beyond the particular P3 project to be built and can be wide ranging, and there is a recent P3 success story that will be examined. Finally, Part II will explore the “best practices” for establishing and implementing P3 programs.

¹ In the United Kingdom, 700 projects have been pursued on a P3 basis since 1992, and over £55 billion in private funds have been invested in the UK’s P3s. HM Treasury, *A new Approach to Public Private Partnerships* 16 (Dec. 2011). These projects have included schools, hospitals, roads, prisons, housing, and waste facilities. *Id.* In Canada, over 100 projects have been built under a P3 approach since the early-1990s. The Conference Board of Canada, *Dispelling the Myths: A Pan-Canada Assessment of Public-Private Partnerships for Infrastructure Investments* 1 (Jan. 2010). Additionally, over the past 8 years, Canada has used P3s to deliver 34 operational hospitals and 20 are currently under construction. Canadian Council for Public-Private Partnerships Database, available at <http://projects.pppcouncil.ca/ccppp/src/public/search-project?pageid=3d067bedfe2f4677470dd6ccf64d05ed>. By using P3s to design, build, finance and maintain eighteen schools in Calgary and Edmonton, the Alberta government saved \$97 million over thirty-two years compared to a traditional approach (\$634 million instead of \$731 million, a 13% savings). *Id.* The use of P3s also delivered the schools two years earlier than they would have been delivered under traditional delivery methods. *Id.*

² American Society of Civil Engineers, *America's Infrastructure Report Card 2013*, available at www.asce.org/reportcard.

³ American Society of Civil Engineers, *California Infrastructure Report Card 2012*, available at www.ascecareportcard.org.

⁴ *Id.*

⁵ K. Jones, *Rebuilding Failing Infrastructure through Public-Private Partnerships*, CDC News (March 11, 2013) (citing Sphere Consulting 2011 study); R. Dobbs, J. Manyika et al., *Infrastructure Productivity: How to Save \$1 Trillion a Year*, McKinsey Global Institute, McKinsey Infrastructure Practice (Jan. 2013).

⁶ Sphere Consulting, *The Benefits of Private Investment in Infrastructure*, available at www.constructiondatacompany.com/rebuilding-failing-infrastructure-through-public-private-partnerships/.

⁷ *Id.*

⁸ National Council for Public-Private Partnerships, available at <http://www.ncppp.org/ppp-basics/7-keys/>.

⁹ A variant that does not neatly fall within this P3 continuum is being used by some government entities outside California. For instance, in New York, some government entities are entering into lease or sale agreements with private developers whereby the private partner tears down an existing public facility, such as a dilapidated library or school, and builds a tower of apartments or commercial space. In exchange, the private partner builds a library or school on the lower floors of the tower and pays the government lease payments. See J. Berger and A. Baker, *Saving Schools and Libraries by Giving Up the Land They Sit On*, N.Y. Times, March 17, 2013.

¹⁰ Security for private partner's financing of a P3 project usually takes the form of a lien or security interest in the user fees that are payable to the private partner, rather than a security interest in any of the government-owned assets of the subject facility.

¹¹ SR-91 is a 10-mile long, four-lane toll road in Southern California that opened to traffic in 1995, and cost about \$130 million to develop. The concession agreement for SR-91 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-down 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.

¹² C. Miller, *Capital Accounts: Long Beach Lands AOC in Woodshed*, The Recorder, March 15, 2013. The California Legislative Analyst's Office recently issued a controversial report in which it concluded that the decision to pursue the Long Beach Courthouse project under a P3 approach was not based on "clear P3 processes" and that the project was not well-suited for a P3 approach.

¹³ The phrase "local government agencies" is broadly defined under the P3 enabling statutes and includes: "a city, county, city and county, including a chartered city or county, school district, community college district, public district, county board of education, joint powers authority, transportation commission or authority, or any other public or municipal corporation." California Gov't Code § 5956.3(a).

¹⁴ *Id.* at § 5956.4.

¹⁵ *Id.* at § 5956.6(a). The P3 enabling statutes are seen by the Legislature as a valuable tool, the use of which is to be encouraged. As the Legislature explained: "Local governmental agencies have experienced a significant decrease in available tax revenues to fund necessary infrastructure improvements. If local governmental agencies are going to maintain the quality of life that this infrastructure provides, they must find new funding sources. One source of new money is private sector

investment capital utilized to design, construct, maintain, rebuild, repair, and operate infrastructure facilities. Unless private sector investment capital becomes available . . . some local governmental agencies will be unable to replace deteriorating infrastructure. Further, some local governmental agencies will be unable to expand and build new infrastructure facilities to serve the increasing population.” Id. at § 5956. As the Legislature further explained: “It is the intent of the Legislature that local governmental agencies have the authority and flexibility to utilize private investment capital to study, plan, design, construct, develop, finance, maintain, rebuild, improve, repair, or operate, or any combination thereof, fee-producing infrastructure facilities.” Id. at § 5956.1.

¹⁶ Id. at § 5956.6(a).

¹⁷ Id. at § 5956.1.

¹⁸ In 2011, a Senate Bill was introduced to, in part, address several ambiguities in the P3 enabling statutes for local government agencies, but the original intent of that bill was undermined through the legislative process such that when it was ultimately enacted, it had nothing to do with P3s. See SB 475.

¹⁹ Id. at § 5956.4.

²⁰ Id. at § 5956.3(c).

²¹ California Legislative Analyst’s Office, *Understanding Proposition 218*, Dec. 1996.

²² Id.

²³ California Gov’t Code § 5956.6(b)(5).

²⁴ Id. at § 5956.6(b)(6).

²⁵ Although the P3 enabling statutes allow local government agencies to establish or raise user fees for P3 projects after a public hearing and the passage of an ordinance or resolution, this lower threshold would be trumped by proposition 218’s more onerous voter-approval requirement given proposition 218’s status as an amendment to California’s constitution. *But see Citizens Ass’n of Sunset Beach v. Orange Cnty. Local Agency Formation Comm’n*, 209 Cal. App. 4th 1182 (2012)(certain property-related taxes imposed pursuant to Cortese-Knox-Hertzberg Act not subject to Proposition 218 voting requirements).