



Traditional Financing and P3s: Creating a Foundation for Success

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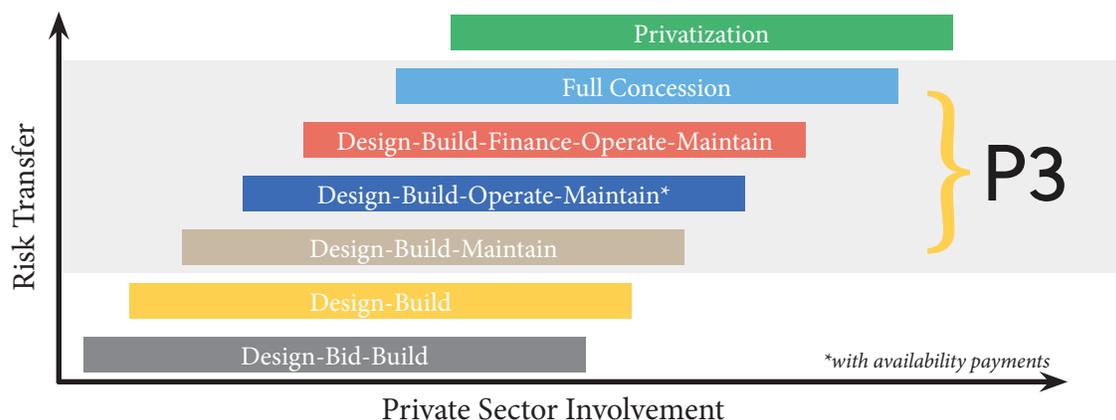
All Projects are Local

The use of private equity in rebuilding the nation's infrastructure has won advocates and critics among the highest levels of the U.S. government. The increased advocacy has brought new life to an old debate, but what is often lost in the tussle is the valuable, objective discussion of the myriad of project delivery vehicles that lie between full privatization and undiluted public finance and control. Understanding new ways to finance, construct and operate traditionally public services (regardless of whether private partnerships are ultimately pursued) is an illuminating activity if the analysis is informed and objective. That means ignoring the inevitable polarization in the national conversation and focusing on local priorities and needs.

Starting From the Very Beginning

The wide range of financing options is shown in the chart below. Given the varying elements of public and private financing and procurement, it is important to undertake some analysis and consideration of how best to undertake a project before determining where it sits on this spectrum of choices. Even before beginning this analysis, a project should have clear objectives: What is the end goal? Is it more important to reduce costs or reduce risks? How important is timing? How will upfront costs be managed? Answering those questions is the first step when seeking to build a financing plan that best achieves public objectives and effectively uses private incentives to achieve those objectives.

Sample Spectrum of Financing Arrangements





Process Makes Perfect

By definition the best approach is one that achieves the objectives initially set out, yet many planners do not perform set objectives explicitly or effectively at the start. Part of what makes this step critical is that each project is different, but there are some basic parameters to be discussed and set. While not a complete list of priorities to be defined, all public entities should have a concrete understanding of the following:

What is our risk tolerance?

To analyze or enter into any arrangement, public entities should thoroughly understand those risks, revenues and responsibilities of the project and the costs of not addressing the project. It is important to note that this is a useful step regardless of a traditional or P3 arrangement.

How critical is the timing?

The timing and complexity of the project should be considered carefully as well, prior to assessing financing options. In theory, traditional financing means that the contractors bear less of the timing risks, which can result in less incentive on the part of private companies to avoid cost or schedule overruns. A P3 often dictates that these risks are borne by the private partner, which directly incentivizes timely, efficient completion. However, if a private partner becomes too indebted or behind schedule such that it imperils the entire project, a public entity can find itself answering and paying for decisions it did not make.

What are our goals on maintenance and operation?

One of the more compelling rationales for P3s are that they can offer a better “whole-life” value by including operation and maintenance of the project. Most public projects are procured looking at only the upfront costs. However, a more expensive construction project may cost less to maintain and provide an overall “best value.” In addition, financial stress on a government can mean deferring maintenance costs even though the costs resulting from the deferrals can be exponential. Planners should look at the life-cycle costs and not just the upfront costs no matter what financing arrangement is being considered. Depending on local risk tolerances and expectations, P3s can offer a way to shift some of the risks while ensuring the project is maintained.

These basic considerations are the foundation for any type of project no matter what final arrangement is pursued. We have found those who don't perform these basic activities may approach the next crucial phase of opening negotiations with the market without a full understanding of the choices and how that works toward or against desired outcomes. In the case of P3s, public entities can find themselves on unsure footing hammering out the specifics with their private partners. Later disputes over contract obligations or claims of mismanagement can often be traced back to a lack of clarity or failure of the decision-making process used in deal negotiations.

In It to Win-Win It

In general, competition is a benefit no matter what type of deal. And fostering competition requires a solid platform market analysis as a basis for negotiations. In traditional publicly financed and managed projects, there is a robust universe of funders (the bond market) and project builders (contractors, engineers, architects, etc.) and many have experience navigating this market.

“There are some risks that the public authority will always retain at least to some extent, such as political risk.”

–U.S. Dept. of Transportation,
Guidebook on Financing of Highway Public-Private Partnership Projects



“For a public-private partnership to be successful, the public and private partners should both be better off having entered the partnership than they would have been if they had chosen an alternative approach or project.”

–Congressional Budget Office,
*Using Public-Private Partnerships to Carry Out
Highway Projects Transportation Enterprise*

In the P3 world, the competition in finance, project delivery and operations is well-established but not as fully developed. Any of the alternative delivery approaches that appear to offer the best outcome demand a diligent assessment of market interest and expectations. Different assets and services – schools vs airports, wastewater treatment systems vs bridge replacement (tolled or untolled), student housing vs landfill gas extraction – attract different investors, contractors and operators. Before confirming the preferred project delivery method, governments should consider engaging in market soundings to make certain a project has the attention and volume of interest from the market to ensure strong competition. This not only imposes discipline on transaction pricing, but provides assurance that contract terms that are reflective of the public sector’s interests will be accepted

by proposers competing to win the project. In the case of a P3, keep in mind that it is a partnership, and bankruptcy of a partner is one of the risks that can roll back on the public.

Financial Advisor or Financing Vehicle?

A final basic due diligence step is to consider how all actors in a deal approach planning. While the underlying analysis is very similar, not all financial advisory firms have an agnostic approach. Hiring a “P3 consultant” will likely result in advice to use a P3. If you use a traditional consultant, they may not have the capacity (or interest) to objectively analyze all the options that P3 offers. If all you have is a hammer, all the world is a nail.

To reiterate our initial point, define the needs of your community then approach the P3 versus traditional financing debate on your terms. The diversity of options provides opportunities, but can also result in public entities trapped on unfamiliar terrain in the midst of high impact and high visibility projects. It is not a strict binary argument, as is often portrayed in the press. The careful dovetailing of private and public sources can solve timing and cost problems in the delivery of public projects.

We believe that the results of the public debate will ultimately be helpful. A wider range of choices for public officials will allow us all to approach difficult challenges with creativity that has sustainable long-term positive impact. At the same time clear definition of the public sector’s objectives supported by rigorous and comparative analysis of financial and delivery alternatives remain essential ingredients to successful outcomes.

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PFM's financial advisors specialize in the needs of the public sector and have done so from the beginning. As the country's leading financial advisor to state and local government agencies for over 20 years, we focus on two goals: determining what our clients' goals are, and objectively identifying the best solution for each client, project and circumstance. Our vested interest (and responsibility) is to ensure that our clients have an objective analysis, a fair comparison of their choices, and feel empowered to make the choice that best meets their objectives. As a result, our track record in P3s or alternative delivery reflects a diversity of outcomes, ranging from full P3 concessions that transfer financing delivery and operating responsibility to the private sector to publicly financed and operated design/build delivery of projects. In between these two ends of the project delivery spectrum, PFM's financial advisors have led clients through privately contracted operations and maintenance and publicly funded capital, public-public partnerships where non-profit agencies teamed with private sector operators to invest in and deliver public services, and hybrid structures where public and private sector capital are combined to facilitate the most cost effective delivery of a project.

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