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Public-Private Partnerships: Evolutions In The U.S. Public Procurement System And Lessons Learned From The UK And The EU

> "I want to be very clear on where the Bush Administration stands on public-private partnerships (PPP). We like them, we want to encourage them, and we support them."
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> ✦ *Federal Highway Administrator Mary Peters, Prepared Remarks Before the American Road and Transportation Builders Association (Dec. 9, 2004) (on file with authors).*

At the end of 2004, President Bush asked Congress to increase the use of PPPs for Federal highway projects. This request coincided with the U.S. Department of Transportation's release of "one of the most comprehensive studies of public-private partnerships ever written." See "Bush to Call for Public-Private Transportation Partnerships," Congressional Daily (Dec. 8, 2004). The DOT Report, entitled *Report to Congress on Public-Private Partnerships*, is available at *http://www.fhwa.dot.gov/reports/pppdec2004*.

While the U.S. Government has recently increased its focus on the use of PPPs, other governments around the world, as well as state and local governments in the U.S., have taken the lead in using these innovative procurement vehicles for over a decade. As a result, the U.S. Government has an opportunity to learn from these other countries in creating a legal framework for PPPs at the federal level.

This article attempts to define the broad term "Public-Private Partnership," and describes why governments are moving increasingly toward the use of PPPs. The United Kingdom's experiences with PPPs are explored to extrapolate lessons learned that may benefit the U.S. Finally, this article concludes by describing the European Commission's approach to furthering PPPs via common procurement rules, and explaining how the U.S. can benefit from that example. (A companion article at 2 IGC ¶ 16, this issue, addresses state and local government use of PPPs to show how this procurement method is taking hold at the state level in the U.S.)

What Are Public-Private Partnerships?—The term "Public-Private Partnership" describes a wide variety of contractual arrangements between government and the private sector. The common thread in all PPPs is the public sector's efforts to take advantage of private-sector management skills, expertise, innovations, efficiencies, and in some cases, financial resources.

The following elements typically characterize PPPs:

- Cooperation between the public and private partners on different aspects of the planned project;
- A relatively long-term relationship;
- Project funding that comes either partially or entirely from the private sector;
- The public partner concentrates primarily on defining the project's objectives in terms of public interest, quality of services, and pricing policy, while monitoring compliance with these objectives; the private partner serves as the project's economic operator, who participates in the work's design, completion, implementation, and funding; and
- The transfer of some risks traditionally placed on the public sector to the private partner, according to the respective abilities of the parties to assess, control and cope with the risks.

As the DOT Report from December 2004 observed, additional elements found in some PPPs include:

- Partnerships designed to accelerate the implementation of high priority projects by packaging and procuring services in new ways;
- Partnerships that turn to the private sector to provide specialized management capacity for large and complex programs;

- Partnerships focused on arrangements to facilitate the delivery of new technology developed by private entities;
- Partnerships drawing on private-sector expertise in accessing and organizing a wide range of financial resources; and
- Partnerships to allow and encourage private entrepreneurial development, ownership, and operation of infrastructure assets.

From a procurement perspective, PPPs typically involve a long-term contract for the design, construction, maintenance, and operation of a facility or other infrastructure project required by a public entity. The costs of providing the new facility are financed by the private sector in return for monthly income during the operating phase of the contract. The contracts might last 15 to 30 years or more.

A wide variety of contracting methods are available for PPPs, with the differences focusing largely on the extent and type of private-sector involvement in the project. Some examples include:

- *Design, Build, Finance, Operate* (DBFO): The private sector undertakes all or most of the financing, and designs, builds, operates and maintains the facility. As compensation, the private sector receives revenues from direct user charges, payments from the public sector, or both. In many situations, the public entity takes control of the facility at the end of the contract term.
- *Design, Build, Operate, Maintain*: This contracting method is akin to the DBFO approach, but the private sector is less responsible for the financing.
- *Design, Build, Warrant*: The private sector designs and constructs the facility and supplies a warrant for critical parts of the project.
- *Asset Management Contract*: The private sector maintains or operates a facility or group of facilities for a long period of time; the public sector pays the private sector for improvements to the facility.

PPPs often involve a range of funding sources, such as shareholder equity, public bonds, public guaranteed bank loans, and direct user charges, e.g., tolls. The goal is for private-sector investors to infuse capital with the expectation of receiving returns if the investment is a success. These financial arrangements often are structured through a new organization such as a nonprofit corporation or a special government agency created specifically for this task.

Why Governments Are Moving Toward PPPs—Governments around the globe are increasingly turning away from their traditional role in providing goods and services to the public and, instead, are relying more on private-sector organizations to meet these needs. As John Forrer and James Edwin Kee recently observed, "Worldwide, the new public management (NPM) movement has shifted the focus from improving bureaucratic management of government programs to eliminating the bureaucracy entirely—creating a more entrepreneurial-driven public management that utilizes the private and nonprofit sectors as partners in the delivery of government programs." "The Future of Competitive Sourcing: Public Servants as Contract Managers?," 33 Pub. Contract L. J. 361, 363 (2004). This trend is likely to continue, partly because of problems with the old bureaucracy, partly to take advantage of the benefits of PPPs.

Three significant issues facing the U.S. Government can be alleviated, to some degree, by the increased use of PPPs: the difficulties resulting from the shrinking procurement workforce the pressures of globalization on that workforce, and deficit spending resulting from procurement budgets.

First, it is well known that the number of public procurement officials in the Federal Government is dropping drastically, due to downsizing in the 1990s and the growing number of employees eligible for retirement. The result is a workforce that soon will be too small to meet the current demand for public goods and services. Partnering with the private sector will allow the Government to continue to meet the public's needs as the size of the procurement workforce declines.

Second, increased globalization demands that procurement personnel possess a greater level of information, understanding and sophistication on wide-ranging topics. These include domestic preferences, export controls, foreign corrupt practices, homeland security policies and programs, intellectual property rights and copyright laws, world trade regimes, anti-terrorism means, and countless other areas of immediate concern. Rather than requiring the shrinking number of public procurement officials to become experts on all procurement-related topics, PPPs allow the invisible hand of the private sector to develop expertise as needed.

Third, the December 2004 DOT Report found that PPPs typically result in cost savings of 20 percent to 25 percent for infrastructure projects in the

U.S. These savings result from the private sector's management, financing, and technical expertise, as well as its ability to obtain financing on better terms and with less delay than the Government. Additionally, using private-sector resources and personnel to complete public projects permits the Government to operate with a smaller workforce, thereby further reducing public-sector costs. Perhaps most importantly, the majority of PPPs involve little to no direct taxpayer dollars, because the private sector finances the projects and operates them with revenues generated from delivery of the facility or services, or both.

The U.S. Government has already begun using PPPs and realizing these benefits in a limited number of circumstances. For example, the *P*resident's Management Agenda for Fiscal Year 2002 introduced a military housing initiative focusing on the use of PPPs. The Department of Defense estimated that using traditional military construction funding to improve military housing would cost $16 billion and take more than twenty years. Instead, the Navy entered a PPP with GMH Military Housing of Newtown Square, Pa., in November 2004. See 46 GC ¶ 462(e). Over the next six years, the company will borrow and invest over $600 million to upgrade, replace, manage and maintain 5,000 military homes on seven naval installations. To compensate the company, the Navy requires military members to sign leases with the developer equal to the value of their basic housing allowances, providing the company with a reliable source of income for fifty years.

The U.S. Government has also established tax incentives to promote the use of PPPs by state and local public school systems. These incentives enable school districts to form a PPP wherein the private sector constructs a school facility, owns the building and leases it to the school system. The private sector finances the arrangement through tax-exempt bonds, a mechanism formerly available only for infrastructure projects undertaken by public entities. The result for the school system is lower annual costs than if the public sector had constructed the facility without using a PPP.

The Senate also is interested in expanding the use of PPPs. In September 2004, Senators George Allen (R-Va.) and Ben Nelson (D-Neb.) formed a caucus to focus on private-sector involvement in the development, operation, and maintenance of federal installations, transportation infrastructure, and water and wastewater facilities. The caucus is also exploring the expansion of enhanced-use leasing, a type of PPP, to take advantage of surplus real property assets within the Departments of Veterans Affairs and Defense.

The UK's Experiences with PPPs—The UK has been a world leader in developing PPPs that rely on private investment. The UK's Private Finance Initiative (PFI) is a procurement strategy using PPPs for the provision of key public services for the UK. The standard model for PPPs established under the PFI involves the creation of a "Special Purpose Vehicle" (SPV), a new company set up by the private-sector partner specifically for the purposes of the PPP. The SPV is responsible for performing the project by entering into contractual arrangements with commercial providers of goods and services. The public entity remains involved in overseeing the SPV's work to ensure that the contractual purposes are being met, but the SPV assumes the performance risks. Additionally, the SPV is funded predominantly by private debt and a limited percentage of private equity—usually a debt to equity ratio between 85/15 and 95/5. Therefore, because the performance risks effectively become financial risks for the SPV's investors, SPV participants have a strong incentive to perform properly. See Grahame Allen, "Economic & Policy Statistics Section," House of Commons Library, The Private Finance Initiative (2001).

The structure of the PFI and the government mechanisms to develop it have evolved during the decade following their introduction in the early 1990s. In the early years of the PFI, these mechanisms suffered from five drawbacks:

- A mandate for testing of all new projects to determine whether they were suitable for PFI placed demands on too many resources and delayed project completion;
- Public-sector employees did not possess the management skills required for overseeing a complex contracting process;
- Public-sector employees lacked knowledge about private businesses, particularly in terms of choosing appropriate advisors;
- Rigid input specifications limited the project's potential to provide better value for money through, for example, innovation and greater synergy between the design and operation of assets; and
- The investment projects were not properly prioritized.

See Her Majesty's (HM) Treasury, "Public-Private Partnerships: The Government's Approach 27 (2000)," (on file with authors).

The UK government attempted to overcome these issues by creating a PFI Taskforce in HM Treasury, designed to enhance the knowledge of PFI across the various agencies. It consisted of individuals with project management and financial expertise, and assisted agencies in determining which projects were well-suited for PPPs. These tests involved checking that the projects were affordable for the public sector, verifying that output requirements and schedules were realistic and appropriately specified, determining the likelihood of financial/revenue streams from the proposed venture, advising on draft contract terms and conditions, assisting in allocating the contract risks to the party best able to manage them, and then monitoring the progress of the projects.

The UK government eliminated the universal testing policy due to its overly broad, inefficient reach. It also endeavoured to create standard contract terms and conditions, significantly reducing legal fees during the contract formation phase and cutting the negotiation time between the parties. The government also established a project review group to assist agencies in prioritizing projects that would utilize PFI, such that subsequent projects could build on earlier ones. Information sharing among agencies was also a key component to promoting the use of the PFI.

In addition, the government has formed Partnerships UK, a permanent organization specializing in PFI projects that assists HM Treasury in the implementation and development of the PFI. Partnerships UK is comprised of board members from the public and private sectors and serves as a resource for both sectors in planning, negotiating and performing PFI contracts. In particular, Partnerships UK provides advice on the use of, and any necessary deviations from, the latest edition of HM Treasury's standard contract terms and conditions which is, in many cases, a mandatory requirement for use of the PFI.

Public perception was also recognized as an important factor in effectively delivering PPPs. During the early use of PFI, several private-sector companies received financial returns that seemed unreasonably high, due to their creative use of financing mechanisms. Although these mechanisms were legal and caused no harm to the government agencies, the adverse publicity damaged efforts to sell the idea of PFI to the British public. The government addressed this problem by imposing contractual provisions that required private-sector participants to share with the agency any financial windfalls that arise unexpectedly after entering into the contract.

Even as the international leader on PPPs, the UK is still striving to improve these procurement mechanisms. Costs remain relatively high, for example, as a result of the scope of advisor involvement and the extensive due diligence required to assess the long-term contract risks; such costs do not scale down proportionately to the size of the deal. Accordingly, HM Treasury estimates that the minimum project value to deliver value for money is around £20 million, though small projects can be "bundled" to make PFI cost effective.

The overarching principle of PPPs lies in ensuring that the project risks lie with the party best placed to manage them. The transfer of risk is a valuable tool in demonstrating value for money for the public sector, although bearing in mind that the acceptance of each risk will be priced by the private sector. Too aggressive a transfer and the price becomes inflated; too little and the costs of the project may outweigh the benefits. Ensuring the correct risk profile and an appropriate balance of costs against value, therefore, are essential to achieving an effective and cost-efficient PPP.

Relying on these experiences, the UK government has narrowed the types of projects for which it believes the PFI is appropriate. The projects best suited for PFI will involve (1) large value; (2) significant complexity; (3) the ability to focus on the outputs rather than the inputs; (4) a well-defined, optimal risk allocation; and (5) a clear differentiation between private-sector responsibilities and remaining public-sector accountability.

Despite early teething problems, the PFI is reported as a success in the UK. The National Audit Office issued a report in 2003, finding that 78 percent of PFI projects were delivered within budget, compared to 27 percent of construction projects using traditional procurement methods; 76 percent of PFI projects were delivered on time, compared to only 30 percent of traditionally procured construction projects. See Report by the Comptroller and Auditor General, *PFI: Construction Performance,* February 5, 2003, available at *www.nao.org.uk/publications*. These positive results have made PPPs an important tool in UK government procurement, accounting for over 10 percernt of Britain's total annual investment in public goods and services. This includes the use of the PFI and other developing forms of PPPs across a broad spectrum of public services, such as schools, hospitals, roads, military and non-military equipment, housing, and training.

Current PFI procurements include the £13 billion project for the supply of air-to-air refueling tankers to the UK Ministry of Defence. Figures published by HM Treasury reported a total of 677 PFI projects signed as of December 2004, with a cumulative capital value of approximately £42.7 billion. Other high-profile PPP arrangements in the UK (falling outside the PFI but using PPP principles) include the Channel Tunnel Rail Link between England and France and the £15.7 billion PPP for the maintenance and upgrade of the London Underground system.

Due to the success of the UK model, other countries have adopted it as a basis for procurement. See Frank Patalong, "UK's Innovative Approach to Defence Procurement," 1 IGC ¶ 28. More than fifty countries have requested assistance from HM Treasury regarding PFIs. The UK's model for PPPs is useful to other countries because the government has reworked it multiple times over the years, taking into account the lessons learned from past experiences. The UK's willingness to share information regarding its experience with PFI may save the U.S. from encountering the same stumbling blocks. The U.S. should seriously examine the UK's lessons learned with PFI in developing a legal framework to encourage the use of PPPs.

Establishing a Legal Framework to Foster the Use of PPPs in the U.S.—The U.S. currently lacks a comprehensive legal framework for the widespread use of PPPs in federal public procurements. To date, the legal reforms and efforts in this area have been piecemeal and sector-specific, largely because of the newness of PPPs in the U.S. system. As the interest in PPPs increases, however, the Administration and Congress would be wise to consider legislative reforms with Government-wide applicability, providing consistent guidance with flexibility for individual agencies to tailor PPPs to their particular procurement needs. Fortunately, the U.S. can look to Europe in formulating its legislative approach.

In 2004, the European Commission released its *Green Paper on Public-Private Partnerships and Community Law on Public Contracts and Concessions*, available at *http://europa.ed.int*. The Green Paper begins by describing the "public-private partnership phenomenon" that has occurred in various European Union countries, and observing that this proliferation of PPPs has occurred pursuant to national legislation of member countries. Seeking to build on this, the Green Paper's stated aim is to launch a wide-ranging debate to determine whether the E.C. should develop generally applicable rules to ensure consistency, transparency and competition in EU member countries' use of PPPs.

In furtherance of this aim, the Green Paper sets out various principles for using PPPs. For example, it describes topics that national or EU legislation on PPPs should address:

- Methods of identifying projects where PPPs are appropriate;
- Advertising the PPP procurement;
- Criteria for choosing a private partner;
- Award procedures that will best serve PPP formation;
- Methods for ensuring sufficient competition and fair treatment of all private firms competing for award;
- The allocation of risks between the public and private sectors;
- Contracting methods that go beyond the typical design-bid-build model of procurement and oversight; and
- Rules for using subcontractors in PPPs.

The Green Paper also describes specific provisions that might be included in PPP arrangements through national legislation. For example, for PPPs that will last for several decades, the legislation could require the public agency to include a price-indexing clause specifying conditions that would prompt changes to the compensation mechanism. Additionally, the Green Paper suggests that agencies should be obligated to incorporate "step-in" clauses into PPP contracts, which would allow the private-sector financial institutions to replace the project manager if revenue streams fall below expectations.

Additionally, the Green Paper asks a series of questions of the public and private sectors to find out more about how certain principles work in practice. For example—

- What types of purely contractual PPP set-ups do you know of? Are these set-ups subject to specific supervision (legislative or other) in your country?
- In contractual PPPs, what is your experience of the phase that follows the selection of the private partner?
- Do you think there is a need to clarify certain aspects of the contractual framework of PPPs at

the EC level? If so, which aspects should be clarified?

- In the context of PPPs, are you aware of specific problems encountered in relation to subcontracting? Please explain.

Thus, the Green Paper is not the end product of a study, but more a means of furthering the dialogue on the use of PPPs as a procurement mechanism. This on-going, transparent, lessons-learned approach is likely to serve both the public and private sectors very well, and the U.S. should follow this approach in developing its national legislation.

Finally, in creating a Federal framework for PPPs in the U.S., the Administration and Congress must take into account the tensions between public policy and market-driven interests. The private sector, of course, should play a significant role in formulating rules and standards for PPPs—after all, these procurement mechanisms are partnerships between the public and private sectors. But the public sector is ultimately responsible for determining the right balance between the competing interests. *See* Catherine Pedamon, "How Convergence is Best Achieved in International Project Finance?," 24 Fordham Int'l L. J. 1272, 1276, 1289 (2001).

Conclusion—Clearly, PPPs are not a panacea to fix the government's procurement and fiscal woes. Nor are they appropriate in many circumstances. A PPP will not always lead to cost and time savings. Further, PPPs can result in significant workload increases as procurement officials ramp up their understanding of PPP goals, methods, financial arrangements, and private business operations. Fortunately, the U.S. Government does not need to cut an entirely new path in this area. The UK's PFI model and the E.C.'s Green Paper provide a set of lessons learned that the U.S. Government can look to in developing its own legal framework for PPPs, thereby allowing the U.S. to maximize the benefits that these procurement mechanisms can offer: taking advantage of the innovations and commercial efficiencies that derive from private-sector experience whilst providing effective and "value for money" procurement of key public services.

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