

THE BOND BUYER

Commentary The new breed of public-private partnerships

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Robert Shiller, esteemed professor of economics at Yale University, once wrote that “financing an activity is creating the architecture for reaching a goal,” and that goals worth attaining “almost always require the cooperation of many people.”

This is especially true of public-private partnership (P3) projects, for as the name suggests, the notion of cooperation is central to P3 projects, bringing together two fundamentally different kinds of operations — public agencies and private enterprises — in pursuit of a common goal. Likewise, the financial models that hold these projects and their partners together are indeed a kind of architecture, a complex, elaborate and interlocking collection of economic and financial projections that weigh and balance each partner’s perceived risks and expected rewards.

For the better part of a generation, the dominant model for P3’s financial architecture depended upon a trade-off between the cost of money and risk transfers. Typically, public entities that opted for a P3 approach understood that the financing costs associated with these projects were going to be greater than a traditional procurement using tax-exempt bonds. The reason for this is simple: loans to private enterprises carry higher rates of interest. [According to a January 2019 report from the Government Finance Officers Association](#), over the past two decades there has been a 200-basis point difference in the cost of money between public and private borrowers, with much of the difference made up of the average spread between corporate and tax-exempt bonds. If public entities can borrow so much more cheaply, then why bother with the private financing elements of a P3?

To answer this question, it is helpful to bear in mind the full life-cycle risks and costs of infrastructure projects. By partnering with private enterprises, public entities offload risks associated with the construction, maintenance and operation

of the asset, thus bending the cost curve back in favor of the P3 model, assuming that P3 agreements properly balance the risks and rewards over their entire terms (some of which can last 30, 40 or even 70 years). Additionally, qualifying for relevant government-sponsored financing — such as Water Infrastructure Finance and Innovation Act (WIFIA) and Transportation Infrastructure Finance and Innovation Act (TIFIA) loans — is sometimes neither quick nor easy, which in turn can affect project timelines and complicate the subsequent financial models. While private financing does not eliminate these risks, experience demonstrates that it does materially reduce them.

In the traditional P3 model it has been common to have side-by-side private equity investments by concessionaires and developers in a project's capital stack, alongside the private debt financing. While such investments have the potential to make projects more “bankable” and lower the cost of money on the debt side of the equation, they haven't been entirely beneficial to the public sector. The return on investment demanded by private equity is meant to compensate for the higher risk profile, and those risks are considerable. If these private equity investors misstep with their financial or cash-flow models, key project partners can be financially impaired enough that the project's construction or operation would be imperiled, an outcome that public entities are rightly fearful of. Take, for example, [the I-69 debacle in Indiana](#), when in 2017 the state ultimately had to take control of a 21-mile highway project when the developer of the P3 project experienced financial distress and the project's private activity bonds hurtled toward default.

This example offered a valuable lesson to the P3 community on the importance of choosing project partners wisely, but it also contributed to a sentiment that had already been forming: is there a way for public entities to have their cake and eat it too?

In other words, rather than think of P3 in the traditional terms — as a trade-off between the higher cost of money and risk transfers — could public entities tap into a model that solves the cost-of-money problem by eschewing private financing, but still incorporate P3s' demonstrated advantages as a project delivery model?

[Husch Blackwell's latest Public-Private Partnership Report](#) presents evidence that more and more of these hybrid approaches to P3 projects are gaining favor. Part of the reason for this shift is that the very nature of P3 projects is changing. Where once upon a time U.S. P3s were dominated by transportation projects, a wide variety of infrastructure is now being built thanks to P3, including courthouses, student housing, prisons, and waterworks, among others.

Many of these new “vertical” project categories do not generate revenue in the traditional manner, if at all; therefore, the once predominant demand-risk concession model is useless. Instead, P3 partners are employing availability payments more frequently. Only one project in the Husch Blackwell report employs a pure demand-risk scheme. The remaining projects all feature availability payments or some hybrid model thereof, where the public partner pays a concessionaire directly according to a predetermined formula and schedule. Seven of the 13 projects in the report can be defined purely as availability based payment structures, and these projects make up both horizontal and vertical P3s.

Notably, the decade-long shift to availability payments has coincided with a significant decline in private equity participation. Equity commitments in the eight P3 projects reaching financial close in 2018 averaged just 5% of the total capital expenditure.

Time will tell if these data points, taken together, are more signal than noise, but given private equity’s higher cost of capital — and given that returns on that capital are typically paid out via a project’s availability payments — there is certain logic to the inverse relationship found in the recent data. As availability payments become the dominant concession model, public entities have a strong incentive to avoid what have been the most expensive components of the capital stack. It could be that, through trial and error, both public and private partners are striking a very workable balance through availability payments. Private enterprises enjoy the predictable cash flows associated with them, and by utilizing more hybrid financing structures that incorporate more public debt financing, public entities are finding a wider range of projects that can benefit from this new breed of P3.