The ABC’s of PPP’s: 
The Basics Regarding 
Public-Private Partnerships

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I. INTRODUCTION

Overview

The term “public-private partnerships” or “PPP’s” is appearing with increasing frequency in discussions of ways to address the substantial deficit that exists in our nation’s public infrastructure. PPP’s are sometimes posited as a magic panacea for the financial and contracting challenges public agencies face when trying to build new infrastructure. It is important that public officials, and those who advise them, educate themselves about PPP’s in order be able to evaluate the usefulness of this approach, which can provide an effective alternative method of financing public infrastructure.

Background

The term PPP can potentially be applied to a wide variety of arrangements between government agencies and private parties, including concessions and franchises, as well as agreements for the development of public property. The Federal Highway Administration has defined PPP’s as follows: “A public-private partnership is a contractual agreement formed between public and private sector partners, which allow more private sector participation than is traditional.” (USDOT/FHWA Report to Congress on PPPs, 2004.) However, in this discussion, in addition to focusing on arrangements that allow for “more private sector participation than is traditional,” we will also primarily focus on methods that feature the utilization of private capital instead of tax or bond sale revenues to finance the construction of public projects.

There are a number of reasons for the recent focus on PPP’s. First, there is the undeniable need in our state and nation for new infrastructure in the form of roads, bridges, transit systems, and water facilities, not to mention new government buildings for schools, libraries, hospitals and correctional facilities. Second, governments in Europe and Canada, and, more recently, in the United States, have successfully delivered significant public projects using these methods. Third, a very appealing feature of these arrangements is the ability to secure private financing when public capital resources and bonding capabilities are limited or must be dedicated to other projects. Finally, but certainly not least, there are a host of consulting and financing firms that clearly see PPP’s as a way to profit in a new and potentially broad field. These firms are going to great lengths to promote the concept of PPP’s to government leaders, many of whom are eager to complete important public improvements during their tenures, particularly ones that would otherwise be unattainable.

In extolling the virtues of PPP’s, proponents can point to a host of projects, including ones in Europe and Canada, that have utilized private capital and expertise to develop important public facilities. In Vancouver, BC, construction is underway on the $2B “Canada Line” project, a light-rail system connecting downtown Vancouver and its airport. That nation’s clearinghouse for PPP information, the “Canadian Council for Public-Private Partnerships,” boasts of the successful completion of numerous toll roads, hospitals, water and waste-water plants, courthouses and correctional facilities. (See http://www.pppcouncil.ca/) Several provinces within Canada (British Columbia, Quebec and Ontario) have established their own centers to both promote the use of PPP’s and to assist local governments in undertaking
projects using the PPP model. PPP projects in the United States have included the Hudson-Bergen Light Rail project in New Jersey, as well as toll roads in Virginia, Texas and Southern California.

These projects have captured the attention of a number of federal and state officials, who have sought to promote PPP’s as a potential solution to the problem of financing infrastructure. Governor Schwarzenegger has proposed his own “Performance Based Infrastructure” or “PBI” program as part of his overall “Strategic Growth Plan,” which also included the $42 billion in bonds that the voters of California approved in November of 2007. As part of the recently-concluded budget negotiations, the Governor signed a bill, SB 4, that comprehensively revised the existing law on PPP’s in California. That action sparked this strong reaction from one union:

The 2009 budget package includes expanded PPP authority for state highways. The Legislature, Caltrans, and the oversight board created by the authorizing legislation must ensure public agency oversight and involvement in future PPP projects to prevent foreign, multi-national companies and Wall Street investment houses from taking huge profits out of our transportation system, preventing the improvement of public roads, and inflicting outrageous tolls on motorists. Public agency oversight is the only way to ensure that our history of failed PPP projects and public bailouts does not continue. (Professional Engineers in California Government, “PECG Objectives for 2009”)

Other groups have criticized PPP’s for increasing project costs and failing to deliver projects on the expedited schedule promised.¹ Despite these concerns regarding PPP’s, a number of agencies, including the Federal Highway Administration (FHWA), have strongly promoted PPP’s. The FHWA website features many useful resources for understanding and implementing PPP’s. (See http://www.fhwa.dot.gov/ppp/index.htm.)

However, while PPP’s certainly offer the prospect of facilitating the construction of needed public improvements, these arrangements are often quite complex and require the participation of a host of participants, including design professionals, contractors, financiers, and attorneys. This complexity provides a challenge to the municipal lawyer who must help his or her client sort through the competing proposals of project proponents, seeking to ensure that the arrangement provides the benefits that are promised without causing any unexpected risks.

Scope of this Paper

Given the complexity of these issues and the relative unfamiliarity of many municipal practitioners with this approach, this paper is intended to provide a basic overview of PPP’s and describe how this approach fits in with other methods of delivering projects. It will then describe the existing legal authority available to cities and also review the PPP provisions of the latest legislative foray into this field, SB 4. Finally, it will highlight some of the key issues that arise in negotiating and implementing these arrangements. In the course of this discussion, I have tried to note, where appropriate, the criticisms that some groups have raised regarding PPP’s. I have also included, in the bibliography, a list of resources to consult for additional information, so that practitioners can prepare themselves to address these issues should they arise for their clients.

II. PPP'S: A METHOD OF SHIFTING RISK

At its essence, the PPP approach is simply one of many different contracting methods that can be used to deliver public projects. It is useful to view PPP's as one step within a range of methods for constructing and delivering public projects. These methods, often termed “project delivery methods,” range from the traditional “design-bid-build” approach to a fully privatized model that nevertheless serves a public need. The chart below describes a range of potential delivery methods, showing the various stages of increasing private involvement and private assumption of risk. A key feature of the different project delivery methods is the ability to selectively shift different types of risk to the private sector, including risks involving price, schedule, financing, design or construction. While few arrangements shift all of these risks at once, their ability to selectively transfer risks to the private sector is a feature that offers a great potential to the public agency.

Given the legal requirements regarding public bidding for construction contracts and the procurement of professional services, many of these methods are not always available to every public agency. The chart attached at the end of this paper shows the range of authority available to various entities in California. In recent years there have been an increasing number of legislative changes that have allowed more agencies to engage in many of these approaches. With the trend of expanding the authority of cities and other agencies to use various project delivery methods, we think it is advisable to examine the full range of these methods before focusing on the legal limitations that may currently prevent cities from utilizing any particular method. That way, not only will the reader be apprised as to the range of options
that are possible, they will be prepared for any future changes in legislative authority.

**Project Delivery Methods**

The following are brief summaries of the most popular methods of project delivery.

**Design-Bid-Build**

Design-bid-build is the most conventional project delivery mechanism and has been used by public agencies for generations to deliver most public projects. Under this method, the public agency separately arranges with a design professional (either in-house or through a professional services contract) for the design of the project and the production of a set of plans and specifications to construct the project. The services of design professionals, under the “Little Brooks Act,” are procured through a process that focuses on qualifications, not price. (Cal. Gov’t Code § 4526.) Bids are then solicited from third party contractors and then construction contracts are awarded to the lowest responsible bidder (although public agencies may “pre-qualify” bidders on construction contracts to eliminate questionable performers). (Cal. Pub. Cont. Code § 20101.) With regard to such projects, it is said that “design risk” remains with the public agency, as it is held to warrant the completeness and accuracy of the plans and specifications. (See *Howard Contracting, Inc. v. G.A. MacDonald Construction Co.*, 71 Cal. App. 4th 38 (1998).)

While this process has successfully produced public projects for many decades, it is not perfect. There are delays due to the need to do two procurement processes (for the selection of the designer and the contractor) and there are often disputes among the designer, city and contractor, which can result in significant delays and expensive litigation. When plans are flawed, cities often find themselves in the uncomfortable situation of being trapped between asserting there was negligence on the part of the designer while trying to prove to the contractor that the design was not deficient. In addition, it can certainly be argued that the lowest bidder does not necessarily do the best quality work and may, through submitting contract claims, end up costing more than a competing bidder would have. Nevertheless, there is a perception that the sealed bid process helps to avoid favoritism and promote economy, even if the lowest bidder is not always the “best” contractor for the job.

**Design/Build**

The design/build approach has been utilized with success in the private sector and is now increasingly available to select public agencies (including cities for certain projects, pursuant to AB 642, Chapter 214, Stats. of 2008). This process is said to promote cooperation between the designer and contractor by putting them on the same team. The public entity typically designs the project through the preliminary design phase, then hands off the project to the design/build team to complete. This approach is seen as being more efficient, allowing for consultation between the party designing the project and the one that will actually build it. Proponents of design/build claim that projects are completed more expeditiously and at a lower overall cost. One primary benefit is that the public owner is not responsible for any designer/contractor disagreements. However, by combining the procurement of the designer and contractor into a single selection process, this approach requires legislative reconciliation of the inconsistent methods of awarding contracts to designers and contractors. This is normally accomplished by either specifying that contracts be awarded on the “best value” method which can balance several factors or can simply be awarded to the lowest responsible bidder, often after a prequalification process. In California, this process has met with determined opposition
by public employee labor groups, particularly the Professional Engineers in California Government (“PECG”), who have long opposed any efforts to “out-source” design work on highway projects to non-state employees.

**Design-Build-Operate-Maintain**

This approach extends the design-build contractor’s responsibilities beyond the delivery of the finished project by requiring the contractor to subsequently operate and maintain the facility. This arrangement provides a clear incentive for the contractor to provide a quality product that will not require substantial maintenance. These arrangements must contain clear performance standards in order to ensure that the public gets the quality of service it expects. Related arrangements are design-build-maintain and design-build-operate, where these selected functions are delegated to the contractor. Each approach has its particular advantages and is appropriate in different situations.

**Private Sector Project Methods**

At the far range of the spectrum are models in which the private sector, operating through a concession contract, essentially operates the public facility. A further and perhaps final step is where the facility is entirely developed and owned by a private firm, such as is the case with a public utility.

**Financing Projects through the Private Sector—the Essence of a PPP**

When one of the above arrangements also require the private partner to provide the capital financing for the project, the word “finance” is often added to the title, resulting in a “design-build-finance-operate” contract or similar project descriptor. It is this financing aspect that brings an arrangement within the definition of a PPP as used in this paper. This financing component is often the most crucial element motivating agencies to utilize PPP’s. Although some incorrectly view these arrangements simply as ways to undertake projects without having to either pay the capital costs out of general fund revenues or to sell bonds to raise funding, that analysis is perhaps a bit too facile. The PPP approach, when used for the right type of project, allows agencies to undertake projects they might not otherwise be able to afford with conventional funding approaches. Questions remain, of course, as to whether the overall cost will be lower and whether it is appropriate to shift such costs to the future through a contractual relationship that is not bond financing. In our remaining discussion, when we refer to PPP’s we will mean, at a minimum, projects that will include financing as well as design and construction.

A basic issue in considering use of a PPP is whether a privately-financed project can be delivered more cheaply than one that would be financed through tax-exempt bonds. While some might argue that the efficiencies available through a greater private role may overcome any additional financing costs, there are also a number of tax-free vehicles available to fund PPP’s that can be fairly competitive with bond financing costs. One type of financing, known as “63-20 bonds,” involves financing issued by a special-purpose non-profit corporation. Other programs, like the federal Transportation Infrastructure Finance and Innovation Act of 1998 (TIFIA), provide government funding to private partners for specific types of project.

**Other Non-traditional Approaches**

While the range of methods discussed above provides a framework for understanding the different methods of project delivery, no discussion of project delivery methods would be
complete without some mention of the lease-leaseback approach. In some ways this is the oldest of the non-traditional methods. At its essence, the lease/leaseback involves the transfer of public property to a private developer, who constructs the facility and returns it to the public via a leasehold. This process has been criticized for avoiding competitive bidding altogether, although proponents claim it produces a quality project at a lower cost.

Other non-traditional approaches include the “CM at risk” method, where a Construction Manager, or CM, is engaged through a professional services contract, who then hires the major trade contractors in a manner if its choosing (competitively bid or otherwise) and who is contractually obligated to complete the project for a fixed price. Given the requirements of competitive bidding, this process is difficult for public agencies to utilize. A modified approach, known as “multi-prime,” requires the public agency to bid and hold multiple trade contracts, which are then managed by a construction manager who provides management services only and is not at risk to deliver the project for a fixed price.

A more radical approach is termed “Integrated Project Delivery” or “IPD.” Under the IPD approach, all parties agree not to raise disputes and commit to work cooperatively to bring projects in on-time and under-budget. Early involvement of the trade contractors in the design process is vital under this approach. The application of IPD in a public setting is problematic, given incompatibility of the traditional low-bid contracting method with the need for the parties to be willing to work in a cooperative fashion with each other, which is normally the result of some prior experience working together. Such arrangements can also raise issues under conflict-of-interest laws, due to the mixing of the traditional contracting roles. However, these approaches (also called “Lean” contracting principles) are being increasingly explored in the private sector.

III. DESCRIPTION OF EXISTING CALIFORNIA PPP STATUTES

Now that we have reviewed the basic components of a PPP arrangement, it is appropriate to briefly review the existing statutory authority for PPP projects for several reasons. First, one of these statutes, (the California Infrastructure Financing Act, Cal. Gov’t Code §5956 et seq.) currently provides significant PPP authority to cities. Second, the terms of another statute, the recently-adopted SB 4 (2nd Ex. Session, Chapter 2, Stats. 2009), reflect the latest thinking on PPP’s and contains a number of protective provisions that are illustrative of terms that should be in most PPP agreements. Finally, given the many legislative changes in this area, it is very possible that terms contained in SB 4 or other statues could find their way into future legislation that is directly applicable to cities.

California Infrastructure Financing Act, Cal. Gov’t Code §5956 et seq.)

The California Infrastructure Financing Act (“IFA”), which dates back to 1996, is broadly applicable to California public agencies, including cities.² By its terms, the IFA applies only to “fee-producing infrastructure” which limits its utility for general governmental facilities. The permissible projects under Section 5956.4 include the following types of projects: 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

² Pursuant to Gov’t Code §5956.3, the IFA applies to “Government agencies, which 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.” Significantly, this authority is not available to the State.
water recycling; refuse disposal; or structures or buildings, except structures or buildings that are to be utilized primarily for sporting or entertainment events.

Although the IFA does explicitly authorize the PPP approach for fee-producing infrastructure projects, the statute contains several restrictive provisions that affect its usefulness and which may explain the scarce number of projects that have followed its model. For example, it limits the term of any transaction to 35 years. This may not provide sufficient time for private partner to recoup its investment. The statute also does not exempt the project from property taxes, meaning that possessory interest tax would apply to any leasehold interest the private partner takes in public property. It also appears to require 100% bonding, which may not be suitable for a large project in which significant value is not construction-related.

There are also some limitations on the use of the user fees received, including a prohibition on the transfer of surplus revenues for general fund. (§5956.6(b)(4).)³ Public hearings are also required before user fees can be imposed or raised. (§5956.5.) However, by making all fee increases subject to subsequent action of the public entity, this may raise concerns with private firms that their revenue stream may be uncertain, since even indexed increases would require hearings and approval.

The portions of the IFA that address procurement methods are somewhat unique. The statute apparently mandates the use of competitive negotiations. Section 5956.5 specifically exempts IFA deals from the normal competitive bidding laws, as well as the Little Brooks Act. There is also a broad exemption from many other standard contracting limitations in the Government and Public Contract Codes, including subcontractor listing requirements.⁴ It should be noted that the IFA may be utilized even if private funding is not utilized, thus providing a very flexible contracting method, provided the other requirements of the statute can be met.

Reflecting the ongoing political controversy over the use of design/build or similar methods on the state level, the IFA specifically prohibits the use of the act for “state projects,” which include “state-financed projects.” This provision may prohibit the use of any state grant funds for a project a local agency is developing under the IFA. It should be noted that a bill intended to address many of these concerns with the IFA, AB 1261 (Caballero), was defeated during the last legislative session, after receiving substantial opposition from public sector labor groups.

SB 4

As part of the budget negotiations earlier this year, one of the measures sought and obtained by the Governor was SB 4 (Second Ex. Session (Cogdill) (Chapter 2, Statutes of 2009), which modified the existing design-build legislation for toll roads and authorized additional state agencies (Department of General Services, Department of Corrections and

³ "User fee revenues shall be dedicated exclusively to payment of the private entity's direct and indirect capital outlay costs for the project, direct and indirect costs associated with operations, direct and indirect user fee collection costs, direct and indirect costs of administration of the facility, reimbursement for the direct and indirect costs of maintenance, and a negotiated reasonable return on investment to the private entity."

⁴ "Other than [the specific provisions stated in Gov't Code §5956.5] and applicable provisions related to providing security for the construction and completion of the facility, the governmental agency soliciting proposals is not subject to any other provisions of the Public Contract Code or this code that relates to public procurements." (Gov't Code §5956.5)
Rehabilitation and the Judicial Council), as well as redevelopment agencies, to utilize the design-build method for up to 15 projects statewide until 2014. This includes up to five projects (local street or road, bridge, tunnel, or public transit projects) for the local transportation agencies and up to ten projects (state highway, bridge, or tunnel projects) for Caltrans. SB 4 allows regional transportation agencies and Caltrans, until 2017, to enter into an unlimited number of PPP’s for transportation projects.

Although the PPP provisions of SB 4 are not directly applicable to cities, the legislation is worthy of note because it may serve as a model for future PPP legislation or may be amended to allow cities to undertake PPP’s, perhaps for a wider range of projects. The statute, which amends existing Cal. Street and Highways Code Section 143, creates a clearinghouse for PPP information, the Public Infrastructure Advisory Commission or “PIAC,” similar to those in the Canadian provinces. (§143(b)) It also posits the California Transportation Commission to supervise any PPP deals that are proposed and to seek comments from the PIAC and Legislature regarding any proposed transactions. (§143(c)) The statute does not restrict the types of deals to those involving leases, allowing easements and permits to be used, but specifies that the infrastructure must be owned by the public entity and must revert to the agency, at no cost, at the end of the term. (§143(d))

The law allows the use of either competitive bidding or competitive negotiation, but requires that the design-build method of project delivery be used. It is also fairly specific in listing how the procurement process is to proceed. In particular, in requires that at least one competing proposal be obtained before an unsolicited proposal is accepted. (§143(g)) The law contains extensive language regarding the required qualifications of any private partner, as well as language limiting the extent to which a contracting entity can promise not to construct competing facilities. (§143(h)) Unlike the IFA, however, the new statute allows for the agreement to contain a formula for the increase in user fees. (§143(j)) There are similar limitations on the use of user fees, although regional agencies, once other costs of the project are paid, may apply excess fees to other public transportation projects in the vicinity of the PPP project. (Id.) The new statute also contains language that would exempt the private interest in a project from possessory interest taxes. (§143(o)) Thus, SB 4 avoids some of the weaknesses of the IFA for the limited range of projects to which it applies, but unfortunately did nothing to revise the provisions of the IFA.

IV. THE PROS AND CONS OF THE PPP APPROACH

What types of projects have been successful as PPP’s?

Part of the impetus for California government to consider PPP’s is the demonstrated success such projects have enjoyed in other nations, and more recently, in other states within our own nation. While the United Kingdom and Canada have been at the forefront of the PPP movement, many nations around the world have had successful PPP projects. The range of such projects is quite wide, and includes transportation facilities (particularly roads and bridges, but also transit systems and airports) hospitals, schools, prisons and office buildings. The UK has had over 400 operational PPP projects, which comprise 10-15% of all annual infrastructure spending in that nation.5 In the US, most of the PPP projects have involved toll roads, with states such as Texas, Virginia, and Florida taking the lead. There have also been toll road projects developed via PPP’s in California, including SR125 and SR 91, with admittedly mixed

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5 "Investigating the performance of operational PFI contracts,” Ipsos MORI Social Research Institute, 2008.
What are the benefits and potential risks of PPP’s?

Before examining the details of PPP’s arrangements, it would be helpful to review the perceived benefits of PPP’s, as well as the potential problems with the approach. As noted, many proponents argue that PPP projects can be delivered more quickly and with less chance of cost overruns than traditional projects. Perhaps the most fundamental purpose cited for using the PPP project delivery method is to transfer the cost and timing risk to the private party. It is also felt that the more private nature of the process allows for greater efficiency, allowing projects to be delivered at a lower cost. Some of this savings may be attributable to the design-build approach that is often built into such arrangements. These arrangements can also ensure that a proper focus is given to the maintenance of facilities (and to the construction of easily-maintained facilities in the first place) by shifting this obligation to the private partner. The thought is that if the partner knows it will have to maintain a facility for 30 years it will have a greater incentive to design and construct the facility in a way that minimizes the long-term maintenance costs. It is felt that the financial incentives for the developers to complete projects and get them operating so that they can begin receiving revenues is an effective tool to encourage prompt completion.

While many of these perceived benefits may be attainable, critics of PPP’s point to a variety of difficulties that can arise with such projects. Perhaps the primary concern is that deals are often very complex, long-term arrangements, which may be a challenge for many agencies to undertake, particularly when dealing with sophisticated and experienced private partners. The negotiation of these transactions often requires the public agencies to obtain expert advice during negotiations which can be expensive and come with the risk that a final deal may never be consummated. Given their additional complexity, these transactions can take longer to negotiate, potentially undermining any scheduling benefits the process might otherwise provide.

Some of these criticisms may result from agencies having unrealistic expectations about what the PPP approach can attain. It is crucial that agencies considering the use of PPP’s have a clear idea as to what the traditional alternatives might cost, so as to better evaluate the potential cost savings from PPP’s. There can be misconceptions that PPP’s provide “magic money” to fund public needs and that the private partner can solve every challenge that a project involves. Unrealistic expectations can lead to more lengthy (and expensive) negotiations and result in frustration on both sides. It is important for the public agency to have a clear idea of what the business realities are with that particular project.

But perhaps the most significant criticism of the PPP approach involves the fundamental issue of cost. Proponents appear to reflect an organic belief that the private sector can routinely deliver projects at a lower cost than when there is less public involvement. Critics point to potential problems with unsupervised work and argue that the presence of a profit motive can only increase costs. These are difficult issues to resolve globally, and perhaps even more difficult to analyze for a single project. While there are some methods available to estimate the economics of PPP deals, there is no universally accepted method of comparison. And there is certainly an understandable concern on the part of critics that international design and construction firms, allied with major investment firms, might end up draining the municipal till as part of one of these deals. Yet the crying need for new infrastructure presses us to consider new approaches, even ones that will test our skills at protecting our clients from poor contracting decisions.
Finally, there are often concerns about, and sometimes direct opposition to, PPP projects from public sector labor groups. At best, these arrangements are viewed as limiting the number of potential new members for these organizations as new functions are controlled by private contractors. At worst, these deals are viewed as disguised “out-sourcing” arrangements under which current employees will either lose their jobs or find themselves with inferior working circumstances.

Public employee unions at times express concerns that the development of projects using PPP’s will result in either few jobs in the public sector or a reduction in existing jobs and have in the past challenged such projects. (See Professional Engineers in California Government et al. v. Department of Transportation (1993) 13 Cal.App.4th 585.) Unions may also raise questions regarding the propriety of arrangements that do not feature competitive bidding. While many of these concerns can be addressed by well-crafted PPP arrangements, sometimes the deal never gets to the negotiation stage due to political opposition. Nor is there any guarantee that the deal ultimately reached will adequately address these issues.

V. WHEN IS THE PPP APPROACH APPROPRIATE?

Choosing the right project

In considering a project for potential PPP treatment, an agency should consider a number of factors:

• Is there an urgent need for the project, such that an expedited schedule would provide a special benefit? *Assuming a transaction can be negotiated promptly, a PPP approach can result in the development of a project in an expedited fashion, which can provide additional benefits if the project is urgently needed. But, especially for an agency that has never entered into a PPP deal before, such an assumption may be unwarranted if staff and counsel must acquaint themselves with the PPP context.*

• Is this the type of project that can get completed more quickly using the PPP method? *Some projects lend themselves more easily to PPP treatment and provide efficiencies by combining design, construction and other functions in the same contract.*

• Is this the type of project that lends itself to PPP treatment as a result of particular technical or physical features? *Some highly technical projects can best be developed by parties with demonstrated experience on similar projects. The long-term operation and maintenance of a highly technical facility might best be left to the builder.*

• Has this type of project been successfully developed as a PPP in other places? *There is a great deal of information available about successful PPP projects, as well as a host of qualified consultants with experience developing such projects.*

• Based on the financial prospects for the project, is there a good chance that the project will attract private investment? *If a project can demonstrate a reliable, dedicated flow of funding (such as through toll revenues or user fees) then private sector funding will be more readily available. Such a project lends itself to development without reliance on public funds.*

• Does the city have the funding resources (general fund or bond revenues) to undertake the project and is it willing to commit them to the project or would it prefer to fund it via private capital? *Some PPP projects are attractive because they can be
funded privately, freeing other funds for projects that do not lend themselves to private funding.

- Are there likely to be multiple bidders for the project, such that competition will reduce the cost to the agency/public? Just as competitive bidding results in lower costs, having multiple parties compete for a PPP contract will likely provide more value to the public.

- Is the project significant enough to justify the transaction costs that will be required? A city needs to determine whether a project being considered for PPP treatment is of a size that will allow it to recoup the higher costs required to negotiate the deal.

- Will the PPP provide better value than developing the project conventionally (in other words, what is value of the project as a PPP compared to what it would cost normally over the lifetime of the deal)? This is a crucial factor in deciding whether to proceed with the PPP approach. While other factors may influence the decision to proceed with a project (such as the lack of other capital funding or a desire to avoid operating a complex facility) the overall cost analysis should be the primary consideration in deciding whether or not to proceed on the PPP path. There are consultants that can assist with this analysis, as well as publications that propose methods of analysis. However, there is no universally accepted method of determining when projects will work better under a PPP approach.

- Is the project the type that will provide benefits over a long term and not become quickly obsolete, such that it can obtain private investment for long term finance? Given the need to show potential investors that the facility will provide revenue long enough to justify the investment, facilities that are likely to become obsolete quickly do not lend themselves to PPP treatment.

- Is the desired outcome of the project capable of being captured in a contract? Given the need to receive services over an extended period of time, PPP arrangements that produce results that are easily capable of measurement are much more easy to enforce. For example, the output of a desalinization plant is readily measurable, while the proper operation of a conference center or office building may be more difficult to capture in contract language.

VI. ISSUES FACED IN NEGOTIATING PPP AGREEMENTS

Environmental Issues

The treatment and timing of environmental reviews can be a complicating factor for PPP’s. The desired timing of the turnover of the project to the private partner may not necessarily comport with the requirement under CEQA that environmental review occur at the earliest feasible stage, and certainly prior to a commitment to a project by a public agency. A very clear example of this challenge occurred in Save Tara v. City of West Hollywood (2008) 45 Cal.4th 116, where the city entered into a preliminary funding agreement with a non-profit developer to facilitate a project to construction housing on a property classified by the City as a cultural resource. Although the preliminary agreement stated that final transfer of the property would not occur until CEQA had been satisfied, when that agreement was challenged the court found enough evidence of the city having committed to the project to contravene CEQA (including making a half-million dollar loan to the developer). The court in Save Tara did attempt to reconcile its holding with two other decisions that approved a condition in preliminary
agreements providing for subsequent CEQA review. However, it made it clear that the mere insertion of language making an agreement contingent on subsequent CEQA compliance was not satisfactory:

A CEQA compliance condition can be a legitimate ingredient in a preliminary public-private agreement for exploration of a proposed project, but if the agreement, viewed in light of all the surrounding circumstances commits the public agency as a practical matter to the project, the simple insertion of a CEQA compliance condition will not save the agreement from being considered an approval requiring prior environmental review.

The holding in Save Tara has the potential to pose a significant obstacle for some public-private agreements, as a requirement that a full review be conducted before preliminary agreements can be entered into can limit the options of agencies with limited funding. Clearly, in order to craft an agreement that features sufficient clarity as to the business terms of the arrangement, much of the information about the project will need to be provided. At that stage, it would be difficult to assert that a meaningful CEQA review could not be conducted. Indeed it was on that basis that the Save Tara court distinguished the holding in Concerned McCloud Citizens v. McCloud Community Services District (2007) 147 Cal.App. 4th 181) in which many facts were not known at the time of contracting. At the same time, a fundamental principle of CEQA requires that an analysis of potential impacts be conducted prior to an agency committing to a project. Therefore, before entering into any public-private arrangement for which CEQA review has not been conducted, a city should carefully consider the holdings in Save Tara and -Concerned Citizens. While a grant-funded project can obtain funding for environmental review and preliminary engineering costs, thus allowing the proponent from expending general funds for a project, for a fiscally-constrained agency, the need to fund a full environmental review (as well as a full negotiation process) prior to obtaining any funding from the private partner can be a deal-killer.

Other issues arise once the public-private arrangement is approved and the project is turned over to the private partner, since the partner is likely to have to be responsible for the environmental mitigation for the project. While this might not differ significantly from private projects where mitigation obligations are placed upon the developer, the agreement needs to contemplate that this obligation will be borne by the private party.

Financial Issues

Given the variety of potential PPP projects and the different financial arrangements possible for them, it is hard to make universal statements about the financial structure of PPP transactions. Nevertheless, these deals can be grouped in a number of general categories in terms of their treatment of revenues. One group of transactions involves the transfer of existing facilities to a private operator, who will receive future toll or fee revenues. For such transactions, which often produce significant revenue payments to the public, the issues are generally whether the payment is received in a lump sum at the beginning or is paid over time and how those revenues are used. Some proposals, such as the proposed transfer of the Pennsylvania Turnpike, were criticized as proposing the sale of valuable public assets to raise short-term revenues. Other PPP’s have accepted lump sum payments, but dedicated the

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revenues to fund similar infrastructure projects, thereby stretching the limited funding to provide more benefits (which of course will be fully realized over time).

When the project involves the construction of new facilities, a key question is whether the facility will be able to produce sufficient revenues to pay for itself (and thereby repay any private capital invested to construct the facility). While this may work for roads or bridges due to the potential to produce toll revenues, some projects, such as transit facilities, will not turn a profit. In such cases, the transaction often requires a commitment by the public partner to make subsidy payments, termed “availability payments,” over the life of the project to ensure the continued availability of the facility. Of course, this means that such funds must be taken out of each year’s operating budget. This type of arrangement has been criticized as creating an off-balance sheet obligation disguising the long-term nature of the arrangement. In addition, cities must be cognizant of the Constitutional limitations on long-term financial obligations. (See Cal. Const. Art. XVI, § 18.)

When dealing with very large projects, the initial capital funding can derive from a wide variety of sources, including general fund revenues, private equity contributions, privately-raised debt, funds raised through tax-exempt bonds issued by a related non-profit corporation, as well as federal, state and local grant funding. Each of these sources may have their own legal constraints, particularly when a private party is involved in the transaction. If these requirements are inconsistent, or if other agencies must approve the transaction, this can add complexity to the transaction.

Even before funds are available from bonds or the private partner, the city may need to front substantial revenues to pay consultants and legal counsel, as well as preliminary engineering costs and the cost of any required environmental review. If the deal is never consummated, these funds may be lost.

Perhaps the most important issue, however, is how the private partner is compensated. After all, the private partner is in the transaction to make a profit, as well as to retire any debt it enters into to fund the project. Therefore, a return sufficient to provide the private party with a sufficient return on the capital it invests, to pay to retire any debt and to compensate the private partner for the risk it has taken, is crucial to concluding any such deal. However, although there are several parameters for measuring rates of return, it is not necessarily easy to determine what such a return might be. In addition, if such a return is to be obtained over time from toll or fee revenues, there may need to be terms that provide for a rate-setting procedure over a lengthy term. Some transfers of existing assets have been criticized for giving too much leeway to the private operator to set tolls, resulting in claims that the public agencies have “sold out” the interests of their constituents in order to get immediate revenues, forcing the users of the facility to face higher charges over the life of the deal.

A thorny financial issue is the potential exposure of the private interest the developer takes in the project to be subject to possessory interest tax under Cal. Revenue and Taxation Code Section 107. This is essentially a property tax that is imposed on the interest a private party holds in public property. As the tax is gauged to the capital value held by the partner and is subject to the 1% cap on property taxes, it can represent a significant expense to the developer.
Procurement Issues

Given the magnitude of the typical PPP transaction, the process for selecting the private partner takes on great significance. Some PPP transactions are the result of unsolicited offers from the private sector, which can be challenging to properly analyze and can also raise questions of propriety and favoritism. One approach a city can take in response to an unsolicited proposal would be to initiate a public process to invite proposals from other potential bidders. However, some agencies have proceeded to negotiate with the single proposer. A new statute permitting the State and transportation agencies to enter into PPP transactions requires that a second proposal be obtained before a transaction can proceed, reflecting these concerns about the propriety of accepting unsolicited offers. (Chapter 2, Stats. 2009) In order to encourage proposals from qualified firms, it is important to show a process that both transparent and fair, since, given the high cost of responding to such solicitations, potential competitors will decline to participate if they think their prospects are diminished by an existing “favorite” bidder.

Many agencies will begin by seeking “expressions of interest” or issue a request for qualifications, with the intent of obtaining a short-list of qualified parties from whom to receive more detailed proposals. However, the proposal process can be lengthy and quite costly for participants. Some agencies have provided stipends, cash payments to partially defer the cost of bidding, to encourage a larger group of proposers to participate in the selection process. If the proposals will potentially contain useful ideas that the agency may want to utilize, it is possible to condition the payment of a stipend on the transfer of the intellectual property rights in each party’s submittal. That way, if a meritorious idea is submitted by a proposer who is not ultimately selected for the award, the concept can still be utilized for the project.

Given the scope and complexity of many PPP deals, as well as the fact that details of the transaction may remain confidential until a final agreement is reached, the process to approve a PPP deal can raise legitimate concerns about transparency and equity among members of the public. It can be tempting, particularly after a long negotiating process, to seek quick approval of a governing body for a deal. However, it is advisable to consider ways in which to brief the public as to the details of the transaction in order to allow adequate public review of the deal.

The process to consider the transaction can also raise legal issues for cities. Under the terms of the Ralph M. Brown Public Meetings Act (Gov’t. Code Section 54950), legislative bodies are permitted to meet in closed session to consider the price and terms of payment for real estate transactions. (§54956.8). Although many PPP deals involve real estate assets and may therefore be appropriate for closed session consideration, some do not. (See Shapiro v. San Diego City Council (2002) 96 Cal. App.4th 904.) Complying with open meeting requirements may impact the negotiation process for those transactions. Even when deals do involve real estate issues, the decision in the Shapiro case indicates that counsel should carefully consider which aspects of a transaction involving real estate assets are appropriately discussed in closed session.

Contracting Issues

Once a private partner is selected, a host of other issues arise regarding the specific terms of the PPP agreement. Some of these points may have been addressed in the solicitation documents in order to focus the proposals on the parameters of the expected deal.
One key issue, which is often governed by the enabling legislation of the agency entering into the transaction, is the term of the agreement. Common lengths are 35, 50 and 99 years. Cities are permitted to enter into lease agreements for 55 years, but can, by making specific findings, enter into a term of up to 99 years. (See Cal. Municipal Law Handbook, §8.3.01, which notes that this limitation may not apply to charter cities.) There is no fixed limit on other sorts of (non-lease) agreements.

Another critical issue is how to ensure performance of the contract. In many deals, the private partner has a strong incentive to perform, since its compensation depends on the use of the facility or some other measurement that would be affected by good or bad performance. It is also possible to build incentives or penalties into a contract. Further protection can be obtained through performance bonds or through letters of credit or other forms of financial guarantees. Finally, the private partner can be required to deposit some revenues into an escrow account that can only be used to satisfy certain obligations under the contract. However, for long-term contracts, it may be difficult to obtain performance bonds for the full value of the contract and such bonds may unduly add to the cost of the undertaking. Some legislation has specifically authorized reduced bonding limits, sometimes tied to the value of the construction element of the arrangement.

Other maintenance issues involve the condition of the asset at the end of the term, which is often termed the “hand-back.” Without contractual protections, the private partner may be tempted to allow the condition of the asset to deteriorate in the final years of the deal, delivering a facility back to the public that is barely serviceable.

Another important issue, and one that was clearly highlighted in the SR 91 transaction, is the tricky question of how to address the potential for future public projects to “compete” with the PPP facilities. In the case of SR 91, the agency agreed to a “non-compete” clause promising not to build facilities that would compete with the toll road for drivers. When traffic conditions became so intolerable that such competing facilities needed to be built, the public was forced to buy out the toll road operator’s interest. However, since those providing financing to toll-type projects require sufficient assurance that they will be able to obtain the expected return on their investment, similar provisions will be needed to attract investors. Clearly the contractual arrangements for new projects can be better tailored so that sufficient protection is provided to investors, but necessary public facilities aren’t blocked.

Another related issue is the need to address future investments or expansions of the PPP facility. While the initial deal will customarily address how the cost of the initial improvements is to be borne, a more challenging issue arises when capital investments must be made after the initial transaction. Such capital requirements can arise through the need to replace initial improvements that wear out over time or the need to add additional capacity (such as additional lanes to a toll road) at some point during the contract terms. Particularly when the initial improvements are funded through grants or other outside funding sources, the issue of who will fund additional capital improvements can be a difficult issue to resolve between the public and private parties.

Other Issues

As most PPP projects involve high-profile, high-value undertakings, they are likely to catch the attention of interest groups with a stake in the ultimate project. These include labor unions and environmental groups. From the construction trade union perspective, most PPP projects are of a sufficient size to justify a project labor agreement or other arrangement that
goes beyond the standard prevailing wage requirement applicable to public projects. It should be noted that most legislation authorizing PPP projects contains a prevailing wage requirement.

Another tricky issue involves indemnity, due to the limitations on indemnity provisions affecting design professionals imposed by AB 573. One approach to this is to feature separate indemnity provisions with savings language that limits the interpretation of any indemnity to one that would not violate the statute.

VII. THE BOTTOM LINE

While PPP’s have proved a valuable tool in other countries and also in other states, we have few California models from which to judge their effectiveness. It is difficult to predict, in the current economic climate, exactly how future public improvements will be funded. But it seems clear that, based on successes in other states and nations, and as a result of the recent legislation, more PPP transactions will be undertaken in California. It is important that public officials, and those who advise them, become knowledgeable about PPP’s in order to more effectively carry out their responsibilities to provide the public infrastructure necessary to support our state in the coming decades.
## STATUTORY AUTHORITY FOR ALTERNATIVE PROJECT DELIVERY METHODS FOR PUBLIC WORKS PROJECTS IN CALIFORNIA

**By David Gehrig, Hanson Bridgett LLP**

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<th>Project Delivery Method</th>
<th>Public Agencies Covered</th>
<th>Statute</th>
<th>Notes</th>
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<tr>
<td>Design/Build</td>
<td>Transit Operators</td>
<td>Public Contract Code (hereinafter “P.C.C.”)</td>
<td>§20209.5 does not apply to highway projects</td>
</tr>
<tr>
<td>Design/Build</td>
<td>All cities</td>
<td>P.C.C.§20175.2</td>
<td>AB 642 applies to projects over $1 million</td>
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<tr>
<td>Design/Build</td>
<td>Sonoma County Health Care District</td>
<td>H&amp;S Code §32132.5</td>
<td></td>
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<tr>
<td>Design/Build</td>
<td>Calif. State University</td>
<td>P.C.C.§10708</td>
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<tr>
<td>Design/Build</td>
<td>School Districts</td>
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<td>Design/Build</td>
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<tr>
<td>Design/Build</td>
<td>Counties</td>
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<td></td>
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<tr>
<td>Design/Build</td>
<td>State of California Director of General Services</td>
<td>Gov. Code §14661</td>
<td></td>
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<tr>
<td>Design/Build</td>
<td>State of California Director of General Services</td>
<td>Gov. Code §8169.5</td>
<td>Applies to contracts for Capital Area Plan</td>
</tr>
<tr>
<td>Design/Build</td>
<td>Los Angeles County Metropolitan Transportation Authority</td>
<td>P.C.C. §20209.22-.44</td>
<td>for HOV lanes</td>
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<tr>
<td>Design/Build</td>
<td>“Qualified Entity” = cities, counties, city and counties, and special districts</td>
<td>P.C.C.§20193</td>
<td>limited to 20 projects in these categories:</td>
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<td></td>
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<td>1. regional and local wastewater treatment facilities</td>
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<td>2. regional and local solid waste facilities</td>
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<td>3. regional and local water recycling facilities</td>
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<tr>
<td>Design/Build</td>
<td>“Local transportation entity”; Department of Transportation</td>
<td>P.C.C.§6801</td>
<td>SBX2 4, Cogdill (effective Jan. 1, 2010)</td>
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<tr>
<td>Public Private</td>
<td>Administrative office of the Courts</td>
<td>Gov. Code § 70391.5</td>
<td></td>
</tr>
<tr>
<td>Partnership</td>
<td>“Public Agency” = the state, a county, city and county, city district, community college district, school district, joint powers authority etc.</td>
<td>Gov. Code §4217.10 - §4117.18</td>
<td>allows agencies to enter into ground lease with private contractor who constructs energy conservation facility and sells discounted energy to the agency for a period of years (20-30), before the agency takes possession of the facility.</td>
</tr>
<tr>
<td>Public Private Partnership</td>
<td>“Local Government Agencies” = 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.</td>
<td>Gov. Code §5956-§5956.10 “Infrastructure Financing Act”</td>
<td>authorizes any combination of: study, plan, design, construct, develop, finance, maintain, rebuild, improve, repair or operate - used by BART for Oakland Airport connector project - only applies to revenue generating projects</td>
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<tr>
<td>Public Private Partnership</td>
<td>“Regional transportation agency”</td>
<td>P.C.C. §143</td>
<td>SBX 2 4, Cogdill (effective Jan. 1, 2010)</td>
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<td>CM at Risk</td>
<td>University of California</td>
<td>P.C.C. §10503(c)</td>
<td>requires prequalification of bidders</td>
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<td>CM at Risk</td>
<td>Port of Oakland</td>
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<tr>
<td>CM at Risk</td>
<td>California State University</td>
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<tr>
<td>Job Order Contracting</td>
<td>Los Angeles Unified School District</td>
<td>P.C.C. §20919-§20919.15</td>
<td></td>
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<tr>
<td>Job Order Contracting</td>
<td>Cal. State University</td>
<td>PCC §10710</td>
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<td>Job Order Contracting</td>
<td>Counties</td>
<td>P.C.C. §20128.5</td>
<td>contract can’t exceed $3 million</td>
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<td>Lease Lease-back</td>
<td>Community College Districts</td>
<td>Education Code §81335</td>
<td></td>
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<tr>
<td>Lease Lease-back</td>
<td>School Districts K-12</td>
<td>Education Code §17406 can also be used as a revenue generating mechanism for existing assets</td>
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<tr>
<td>Best Value</td>
<td>UCSF</td>
<td>P.C.C. §10506.4</td>
<td>this is a pilot project</td>
</tr>
<tr>
<td>Infrastructure Privatization</td>
<td>“Local Agency” = city, county, city and county, special district or county service area</td>
<td>Gov. Code §54250-54256</td>
<td>Local Government Privatization Act; applies to wastewater and sewer projects</td>
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</table>
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