ESSAYS ON ISSUES

THE FEDERAL RESERVE BANK OF CHICAGO

JUNE 2012
NUMBER 299a

Chicago Fed Letter

Beyond parking meters: The future of public–private partnerships

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On March 14, 2012, the Federal Reserve Bank of Chicago and the Civic Federation co-sponsored a conference examining the benefits and pitfalls of various types of public–private partnerships (P3s), including infrastructure sales or leases and "managed competition," where public and private entities compete for contracts to deliver services traditionally delivered by government.

Some materials presented at the conference are available at www.chicagofed.org/webpages/events/2012/public_private_partnerships.cfm.

Even during the current economic recovery, state and local governments are finding their usual sources of revenue pinched. In response, many are turning to alternative forms of financing involving P3s.

Infrastructure sales or leases

Charles Wheelan, senior lecturer, Harris School of Public Policy Studies at the University of Chicago, discussed infrastructure asset sales or leases as a means to help balance state and local government budgets. He stated that there are three primary factors that make these types of deals attractive for both government and private entities. First, a lot of public infrastructure is in need of repair or upgrading, and investments in new types of infrastructure, such as high-speed train systems, continue to lag those of international competitors. Second, infrastructure presents an attractive investment option for the private sector. Assets such as toll roads can produce steady revenues and often are less susceptible to economic swings. Finally, updated infrastructure often takes advantage of new technology that improves the efficiency with which the asset is used while reducing the cost of collecting user fees. For example, toll pricing differentiated by the time of day (with higher tolls during peak traffic times) can be used to reduce road congestion, and the variable price charged for using the roads can be collected via a vehicle's transponder.

Wheelan explained common arguments made by critics and proponents of infrastructure sales or leases. Critics of such deals contend that privatizing infrastructure might create fairness problems. For example, a private entity might introduce a pricing structure for toll road access that makes it unaffordable for lower-income populations. Wheelan stated that these types of problems should not arise if the contract to sell or lease an asset is designed to account for all population segments or protects against runaway future pricing. Many proponents of such deals argue that the private sector will be more innovative with the infrastructure. Wheelan warned that this is true only to a point. Private firms might have different incentives than governments to provide a service with the infrastructure. For example, a privatized prison might actually have an incentive to increase the prison population (to maximize revenues) rather than to actively work to reduce inmate recidivism. In all cases, Wheelan said, the quality of the contract is essential. In particular, contract provisions for regularly monitoring the performance of the privatized asset are critical so that private entities have to make adjustments if certain benchmarks are not met.

Privatizing requires more than just identifying the right infrastructure that can be sold or leased, Wheelan argued. Equally important is calculating the right price that reflects both the present and future value of the asset. Also, a clear plan must be established for how the proceeds from the sale or lease will be used. Privatization is not a substitute for bad government, Wheelan emphasized.

Finally, the public needs to have a clear picture of what the goal of privatizing is, said Wheelan. Often the public is suspicious of the relationship between the privatization of infrastructure and the revenue produced by the asset for the private entity, even when that asset was clearly in need of upgrading. Wheelan noted that the City of Chicago's lease of its parking meter system in late 2008 is a good example of this issue.[1] The city had little incentive to invest in new parking meter technology that allows for more-convenient payment methods, such as credit card, and had meter rates that were significantly below what the actual value of parking spaces should have been. So, the city leased the parking meter system to a private consortium, which upgraded the meters and raised the parking rates. While most residents did not approve of the significantly higher rates, the new rates reflected the present-day value of street parking and supported meter modernization while possibly reducing congestion (by discouraging some traffic).

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Managed competition

William Abolt—Chicago district manager, Shaw Environmental & Infrastructure Group Inc., and former budget director, City of Chicago—presented issues that need to be addressed when evaluating whether to use managed competition. First, there is the issue of better service. Abolt said this often means different things to different people. In the case of the City of Chicago's parking meter deal, the city got new infrastructure from a private entity, but thus far the public has seen this as a bad deal because of the higher parking rates. Second, governments must consider how to manage the performance of assets that are sold or leased and how to best measure the outcomes of such arrangements. The implementation of a managed competition strategy requires calculating the full cost of a service (including employee benefits and administrative overhead); creating performance benchmarks; and evaluating regularly the performance of outsourced, privatized services. Without these measures, it is difficult to determine what a government is trying to achieve through managed competition. Finally, state and local government officials have to consider what happens to public employees if they lose a managed competition bid. Public employees are often saddled with disadvantages, such as poor technology and legacy costs (for pensions and other benefits), that may hurt them in the bidding process. Having a strategy that allows public workers to have a fair opportunity to bid, as well as a plan for redeploying public workers if they lose, is important.

Abolt mentioned some situations where managed competition could be used—such as cases where a service is expanding, allowing a portion of it to be bid out without affecting the existing public provider, and cases where a service can be easily benchmarked, allowing for easier administration and greater transparency. Abolt also noted cases where the service need is clear but where existing revenues are insufficient. Such cases often involve a service with structural deficits (those that will not necessarily improve even if the economy gets better), so a lack of political will may exist to continue supporting such a service even if it is valuable to the public (e.g., a recycling program).

The City of Chicago is continuing to rely on alternative methods of financing—in line with those described by Wheelan and Abolt—to help achieve its fiscal goals. Alexandra Holt, budget director, City of Chicago, described Mayor Rahm Emanuel's Chicago Infrastructure Trust—a proposed public–private trust that would allow the city to leverage private financing to build and repair its infrastructure.[2] Holt explained that the first project would be to retrofit public buildings to improve their energy efficiency.

In addition to this nontraditional approach, Mayor Emanuel has made managed competition a key part of his budget strategy, said Holt. A goal of his administration is to reduce costs without cutting services. Several areas—including sanitation, street marking, towing, tree trimming, and curb and gutter repair—have been targeted. Holt said there are three elements to the city's managed competition strategy. First, the administration is making sure that private vendors and city workers compete based on both cost and performance criteria. Simply being the lowest bidder will not be enough, Holt emphasized. Second, the costs of a service are carefully identified—e.g., by measuring the full cost of an employee (including all benefits) and through careful identification of indirect costs (such as administrative overhead). Finally, a process that identifies the frequency of evaluation, as well as standards for performance, is put into place.

Expanding on Holt's comments, Thomas Byrne, commissioner of streets and sanitation, City of Chicago, described Chicago's use of managed competition in its recycling program, which was revived in late 2011. Before using this approach, the city had abandoned its recycling program in mid-2008 because of cost pressures. The reinstated recycling service was based on achieving lower costs and higher efficiency, through competitive bids, by city geography (four of six service areas were privatized, while the other two remained with the city's union workers). Chicago's program was designed to work with union employees to reduce costs while maintaining the quality of service and allowing the savings generated to expand the recycling service even further. In service areas where city crews lost to private contractors, union employees were reassigned to other services. Byrne explained that the program utilizes regular performance reports that are given to workers in the field. Under the new recycling service implemented in 2011, operating costs are down 31% and city crew costs are down 21% relative to the costs associated with the previous service. After six months of competition, cost–benefit analyses of both private and city crews will be completed to see how they fared.[3]

Edward Hogan, partner, Hogan Marren Ltd., said that organized labor has no opposition to the concept of managed competition and that in the case of Chicago, labor protections have tended to work well. He also stated that public workers, particularly in skilled trades (such as electricians and carpenters), are often cheaper than their private sector counterparts. Hogan raised important policy considerations surrounding privatization and labor. First, a service traditionally delivered by government needs to be able to adjust to emergencies and contingencies. For example, if there is a flood or a snowstorm, can capital and manpower be redeployed immediately when a vital service has been privatized? If the service is already stretched, it may not be able to meet these special circumstances. Second, Hogan said that a formal labor–management cooperation committee would be very useful: Regular committee meetings would provide a forum in which to discuss possible service adjustments and performance evaluations while building trust between the two parties.

P3s done right

The sale and lease of government assets are not the only forms of infrastructure P3s available to governments. John Schmidt, partner, Mayer Brown LLP, emphasized this fact, telling attendees that P3s can also involve the building and operation of new infrastructure and the rebuilding of old infrastructure. They can even involve infrastructure that does not generate revenue.

Phillip Washington, general manager, Denver Regional Transportation District (RTD), gave a detailed overview of the nation's first P3 involving a major transit line, the Eagle P3, which will deliver rail service to Denver International Airport by 2016. This project is part of the larger FasTracks venture involving new rail lines, bus rapid transit, park-and-ride developments, and the redevelopment of Union Station in Denver. He discussed the variety of financing structures the project is using. For the Eagle P3, the RTD is employing federal funding, private equity, local funds, and a Transportation Infrastructure Finance and Innovation Act (TIFIA) loan. The bidding process to deliver the Eagle P3 resulted in a winning bid that was $300 million under budget.

Washington then described the lessons the RTD has learned from its experience with the Eagle P3, including key insights about adhering to a construction schedule and getting the community involved in planning and in work force development. Starting in 2008, the entire Eagle P3 process took three years from the request for qualifications to construction. The RTD's experience ought to be replicable in other cities, including Chicago, where the Chicago Transit Authority (CTA) is exploring using P3s to expand its Red Line (a key subway line) south. However, Washington highlighted two factors central to the RTD's success with its transit infrastructure program: hiring a project director with extensive experience and focusing on performance standards rather than detailed requirements to allow for creativity on the part of the private sector to achieve project goals.

Expanding the discussion beyond transportation infrastructure, Ted Hamer, director, KPMG, discussed how P3s can build and operate "social infrastructure." In the United States, P3 projects have tended to focus on transportation infrastructure because assets like toll roads generate user fees and toll revenue. In other countries around the world, the use of P3s to build social infrastructure, such as schools, universities, and hospitals, is common. Partnering with the private sector to make infrastructure investments allows governments to deliver assets more quickly and less expensively, Hamer argued. Outside of the defense and aerospace industries, P3s to develop nontransportation infrastructure are almost nonexistent in the U.S. The first social infrastructure deal in the U.S.—the Long Beach, California, courthouse—was awarded in 2010. In addition to cost savings, Hamer said governments should consider P3s in order to transfer risk to the private sector and achieve a measure of budget certainty, among other advantages. He concluded with a checklist for successful P3 projects and emphasized that especially small or extremely large and complex projects, as well as projects without strong executive support, have not tended to be successful.

Nathan Flynn, director, William Blair & Company LLC, gave a summary of how government assets are valued within the context of P3 transactions for constructing non-revenue-generating infrastructure. Social infrastructure projects generally use an "availability payment structure," in which a private entity builds and/or operates an asset and receives a rent-like payment stream from the government in return. The value to the government in social infrastructure P3s comes from the shift of some risk from the government to the private sector. To determine whether a P3

Chicago Fed Letter is published by the Economic Research Department of the Federal Reserve Bank of Chicago. The views expressed are the authors' and do not necessarily reflect the views of the Federal Reserve Bank of Chicago or the Federal Reserve System.

ISSN 0895-0164

would produce savings, an analyst compares the present value of project costs (operating costs plus capital costs) to the present value of a P3 procurement of the asset. For a P3 project to be viable, the P3 cost must produce savings to the public entity. One reason why the private sector's delivery of an asset often costs less is its focus on the lowest life-cycle cost of the asset, rather than the lowest delivery cost. That is, over the entire 30- to 40-year life span of an asset, the total costs will be lower for a project completed by a private entity relative to one completed by a public entity, even though the upfront costs may be higher for the former, Flynn asserted.

Schmidt commented on the U.S. Commonwealth of Puerto Rico's creation of a government authority that oversees P3 deals involving infrastructure ranging from airports to shipping ports. The cumulative skills, such as technical and intellectual capacity, that the authority developed as it implemented different P3 projects are crucial to a robust P3 program. The Puerto Rican government's success in P3 deals has been made possible by strong political support from both the executive and legislative branches.

Keynote address

Robert Rivkin, general counsel, U.S. Department of Transportation, discussed global trends in transportation infrastructure and provided an overview of federal transportation policy and its local and regional implications. He gave a summary of congressional negotiations over a new transportation bill and emphasized how important the Obama administration considers infrastructure to be to the economy, employment prospects, and the nation's future economic competitiveness with China and other world powers.

With regard to private investment in public infrastructure, Rivkin noted that the U.S. Department of Transportation is a strong supporter of P3s, with many of its programs designed to catalyze infrastructure investments. However, a local government's ability to pull together many streams of funding at different stages of a project is critical to how effective federal funding will be. He said the Denver RTD is the best example of leveraging different federal and local revenue streams throughout the term of a project.

Conclusion

Cash-strapped states and cities are likely to continue investigating the use of public–private partnerships to balance budgets and enhance service delivery. As this conference suggested, the ultimate success of these often lies in the specific provisions covered in the project contracts.

[1] For details on this parking meter deal, see Dan Mihalopoulos and Hal Dardick, 2008, "It's official: Chicago parking meters will be private, pricier," *Chicago Tribune*, December 5, available at http://articles.chicagotribune.com/2008-12-05/news/0812040659_1_parking-meters-mayor-richard-daley-toni-preckwinkle.

[2] The proposal to establish the trust was approved by the Chicago City Council on April 24, 2012; see www.cityofchicago.org/content/city/en/depts/mayor/press_room/press_releases/2012/april_2012/city_council_passeschicagoinfrastructuretrust.html.

[3] For further details on the revived recycling program, see Fran Spielman, 2011, "Emanuel: Curbside recycling to be expanded to more households," *Chicago Sun-Times*, July 18 (updated on October 25), available at www.suntimes.com/6575091-417/emanuel-curbside-recycling-to-be-expanded.html.