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Legal Framework and Benefits of Public-Private Partnerships

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While traditional financing options still exist – including government bonds, federal grants, low-interest loans through state revolving fund programs, and emergency or disaster relief aid – partnering with a private entity provides an attractive alternative financing option.

Throughout the United States, governments and public agencies face the daunting task of upgrading or replacing their antiquated and deteriorating infrastructure, while grappling with fiscal pressures, such as declining tax revenues, increased expenses, rising pension costs, and state and federal mandates. As a result, municipalities and governmental agencies are seeking innovative financing and project delivery methods and increasingly turning to public-private partnerships (P3s) to carry out infrastructure projects in a cost-effective manner.

P3s are contractual arrangements between governmental bodies and private entities.[1] Through these agreements, the respective skills and assets of the public and private sectors are shared in delivering a service or facility for the use of the general public.[2] In addition to sharing resources, the parties also share in the risks and rewards associated with delivery of the service and/or facility.[3]

P3s are utilized for a variety of reasons, including monetization of the value of existing assets and the development or expansion of new and existing facilities, including water and sewer systems, solid waste facilities, toll roads, light rail, bridges, government buildings, and sports and entertainment complexes. Generally, P3s are structured such that the private sector takes on additional project risks, such as design, finance, and long-term operation and maintenance. Depending on the legal and regulatory framework in a particular jurisdiction, P3s will vary greatly and may be limited in many respects.

Legal Framework for P3s in Rhode Island

In many jurisdictions, P3s are precluded by laws that require public contracts to be awarded using traditional design-bid-build (DBB) methods. Under DBB procurements, a public entity must contract with an engineer to design a project and separately with a contractor to construct it.[4] Furthermore, each of these contracts must be awarded to the responsible bidder offering the lowest price.[5] Thus, P3s in which a private entity would take on responsibility for any combination of the design, construction, operation, and financing of a project, or which involve allocation of risk between the parties based on negotiated terms, would be prohibited in jurisdictions with these low-bid laws. However, where the laws permit alternative delivery methods, governmental entities may procure contracts based on the best value to the public, while considering many factors in addition to cost alone.

Although governmental entities in Rhode Island are generally subject to low-bid laws, exceptions exist permitting municipalities and state agencies to enter into P3s. R.I. Gen. Laws §§ 37-2-18 (governing state agency contracts) and 45-55-5 (governing municipal contracts) require that contracts exceeding certain threshold amounts "shall be awarded by competitive sealed bidding…to the responsive and responsible bidder whose bid is either" the "lowest bid price, or lowest evaluated or responsive bid price" based on "objective measurable criteria."[6] This second option to award contracts based on the lowest evaluated bid price using objective measurable criteria was interpreted by the Rhode Island Supreme Court to allow evaluation of factors that need not "be quantifiably reducible or digitized to a dollar amount,… 'which permits the awarding authority to exercise a reasonable, good-faith discretion, and does not commit it unqualifiedly to the lowest bid.'"[7] The Court blessed the use of evaluation factors such as "relative experience, expertise, qualifications, and quality of work" of bidders.[8] Thus, under §§ 37-2-18 and 45-55-5, state agencies and municipal governments need not award contracts based on cost alone.

Additionally, R.I. Gen. Laws §§ 37-2-19 and 45-55-6 permit state agencies and local governments, respectively, to enter into contracts through competitive negotiation when "the purchasing agent determines, in writing, that the use of competitive sealed bidding is not practicable," under regulations promulgated by the Director of the Rhode Island Department of Administration,[9] the executive director or chief operational officer of the agency, or the city or town council undertaking the project.[10] Under these statutes, state agencies and municipalities may enter into competitive negotiations with two or more proposers and may award contracts "to the responsible offeror whose proposal is determined, in writing, to be the most advantageous to the" state or the municipality, taking into consideration price, as well as other factors set forth in the solicitation documents distributed by the governmental entity.[11]

Furthermore, § 37-2-39 and the regulations promulgated pursuant thereto explicitly permit alternative delivery methods for state projects, provided that certain criteria, such as project cost, are met.[12] These delivery methods include Design-Build (DB) (where a single contractor designs and constructs a project), and Owner's Program Manager (OPM) (where a private entity provides preconstruction and construction project management services on behalf of a state agency).[13] Moreover, §§ 37-2-27 – 37-2-27.5 provide explicit authorization for state agencies to enter into Construction Manager At-Risk (CMAR) contracts, under which a firm provides preconstruction and construction management services at a guaranteed maximum price.[14] To enter into these contracts, however, certain requirements must be met, including a minimum estimated project cost of $5 million and the need to hire an OPM.[15]

In addition to the explicit statutory exemptions from low-bid laws, the Rhode Island Supreme Court has also recently interpreted § 45-55-5 such that it is inapplicable to concession agreements.[16] In **Kayak Ctr. at Wickford Cove, LLC v. Narragansett**, the Court held that § 45-55-5 (the low-bid statute governing municipal contracts) did not apply to the procurement of a concession agreement, under which a private entity would make payments to a town for the right to operate a business on town-owned land.[17] The Court reasoned that the statutory language requiring contracts to be awarded to the bidder offering the "lowest bid price" demonstrated the statute was meant to "regulate contracts that require the expenditure of public funds," not "contracts that produce revenue."[18] Thus, the low-bid law is inapplicable to this type of contract.[19]

Although state and local governmental bodies may utilize the statutory framework and applicable case law to enter into P3 arrangements, there currently is no comprehensive act governing P3s, as is the case in other states.[20] However, during the 2015 legislative session, a bill was introduced that would have created a comprehensive scheme granting state and local governments explicit authority to enter into P3s for a wide array of public projects.[21] The law would have permitted both solicited and unsolicited proposals from the private sector and broadened the ability for governmental entities to enter into P3s.[22] Although this bill did not become law, public entities are, nonetheless, able to enter into P3s under the existing legal framework.

Procurement of P3 Contracts

P3 contracts are awarded using an alternative procurement process, whereby the governmental entity issues one or more solicitation documents to request information or detailed proposals from private parties interested in entering into an agreement with the governmental body. Types of solicitation documents include Requests for Proposals (RFP), Requests for Qualifications (RFQ), and Requests for Information (RFI).

The most common of these documents is an RFP, which constitutes a formal solicitation of private entities to provide a full proposal for a particular project or service, including not only pricing, but technical specifications, firm information relating to personnel, finances, legal and regulatory compliance history, stock of equipment or other assets, and any other information, guarantees or commitments that the governmental body may choose to require as part of the P3.

In larger projects, governmental bodies may also choose to issue an RFQ prior to issuing an RFP. An RFQ will solicit a statement of qualifications from interested firms, but generally will not seek an actual proposal for a particular project or service. The purpose of an RFQ is to give the public entity a clearer idea of which firms may wish to participate in a certain type of project, to gather information about these firms and the qualities of the pool of potential proposers, while at the same time allowing the public entity to narrow the group of responding firms to a short list, prior to issuing an RFP.

Additionally, public entities may choose to begin the entire procurement process by issuing an RFI to gather information from the private sector on potential methods of achieving a particular goal and to help direct the public entity toward settling on the specific type of project that will be most beneficial to that public entity. RFI's are not invitations for bids and are generally not binding on the private firms that respond to them.

After proposals are received, public bodies evaluate them, along with the qualifications, and any other information contained in the responses to solicitation documents, to determine which proposal offers the best value to the governmental body. The public entity then initiates negotiations with one or more proposers to come to terms on the exact specifications of the project, allocation of costs and risk, as well as any other terms of the agreement. After this negotiation stage is complete, a contract is awarded and memorialized in an agreement, at which point the project commences.

Types of P3s

There are many different forms of P3s, and indeed, even within a particular category, no two P3s are exactly the same. Below is a general description of the most prevalent types of P3 arrangements in the United States today.

Contract Operation

Contract operations involve the transfer of responsibility for services from a public entity to a private entity to capitalize on the technical, management, and financial expertise of the private sector and to bring about cost savings to the governmental body. Such an arrangement can provide immediate savings by eliminating rising pension and healthcare costs associated with public employees. This type of P3 can range from a typical service contract, where only one particular service is provided, to an Operation and Maintenance (O&M) contract, under which a private entity provides complete operation of a publicly owned asset for a specified term. Under an O&M contract, ownership of the asset remains with the public entity.

Design-Build (DB)

Under a design-build (DB) contract, a single entity is responsible for designing and building an improvement or new facility and is accountable for all results through acceptance of the project by the governmental entity. The design-builder assumes the responsibility for the design work and all construction activities – together with the risks associated with providing these services – in exchange for a fee. The public entity will typically retain the responsibility for financing, operating, and maintaining the project in DB contracts. This delivery method provides a single source guarantor for both design and construction. Importantly, performance and business risks, such as cost overruns and construction delays, are transferred to the private entity.

Design-Build-Operate (DBO)

Under a design-build-operate (DBO) agreement, a single contract governs the design, construction, and operation of a capital improvement or public infrastructure asset. Title to the asset typically remains with the public entity; however, alternate forms of this P3 structure may vest title with the private party. The public sector secures the project's financing and generally pays the private entity a set fee for its services. Consequently, the public entity retains the risk, as well as any surpluses, associated with operating revenue fluctuations. While maintenance and repair responsibilities are shifted to the private sector, oftentimes, capital improvement obligations remain with the public entity. One major benefit of a DBO arrangement is the operational efficiencies realized when the design, construction and operation aspects of the project are brought under one contract. For instance, the project design can be tailored to the construction equipment and the materials used to operate the facility.

Design-Build-Finance-Operate (DBFO)

The design-build-finance-operate (DBFO) project delivery method combines the responsibility for the design, finance, construction, and operation components of a public project into a single contract and transfers that responsibility to a private entity. The private sector typically operates the infrastructure asset pursuant to a lease or operating agreement for a period of time that is sufficient to recoup its financial investment in the project. While there is great variety in DBFO arrangements, one commonality is that they are financed either partly or wholly by debt leveraged revenue streams derived from the project, such as roadway tolls or sewer system user fees. The capital and project development costs are often funded by the issuance of bonds or other debt that is leveraged against future revenues. In a DBFO, title to the assets also generally remains with the public entity.

Concession Agreements

Concession agreements involve a long-term lease arrangement for existing, publicly-financed assets to a private entity concessionaire for a certain period of time, in exchange for an upfront payment to the public entity. The public entity transfers the right to operate and maintain a facility or asset to the private party, which then operates the assets or becomes an exclusive provider for a designated service area. Frequently, the concessionaire is obligated to make improvements to the asset. The concessionaire recoups its investment over the term of the con-tract through fees assessed on the users of the asset and decreased operational costs stemming from the private entity's more efficient operation of the asset. Concession agreements provide a public entity with an immediate monetary infusion in exchange for the long-term operation of the public asset.[23]

Benefits of P3s

P3s provide an array of benefits to public entities. Most importantly, these arrangements offer governments the advantage of involving a private entity to deliver a project more efficiently, more cost-effectively, and with improved service. Frequently, the private entity is created solely to provide one particular service and, thus, has the expertise to improve the operational efficiency for that service. This expertise translates into lower overall project costs and faster project delivery when compared with traditional low-bid construction.

Under traditional design-bid-build contract procurements mandated by low-bid laws, governments may only award construction projects to the lowest bidder. However, P3s enable public entities to evaluate proposed projects based on the overall best value to the public. These project delivery methods allow the public entity to consider factors that optimizes quality, such as the experience and track record of a company on similar projects, while incorporating cost, efficiency, price, and performance criteria into the evaluation. Thus, governments that enter into P3s generally do not face many of the quality issues that stem from low-bid contract awards, such as contractors using inferior materials or otherwise cutting corners to undermine their competition to offer the lowest bid.

Furthermore, when a single firm provides design, construction and even operational components of a project, the public entity can shift greater responsibility and risk to the private sector to ensure projects are delivered to specification and are fully operational. This is the case because a private entity involved in a later stage of a project cannot blame those involved in the earlier stages if it fails to meet its obligations. Where a single entity manages all phases of a project, the operator cannot blame performance failures on design or construction flaws, and construction firms cannot blame performance failures on design flaws. Where one entity designs, constructs, and operates an infrastructure asset, it must – and generally is more willing to – take responsibility for all aspects of the project. Thus, P3s have the added benefit of decreased litigation, as there is less potential for finger pointing.

Finally, one of the most important reasons that public entities utilize P3s is that they provide increased access to capital needed to fund infrastructure projects. While traditional financing options still exist – including government bonds, federal grants, low-interest loans through state revolving fund programs, and emergency or disaster relief aid – partnering with a private entity provides an attractive alternative financing option. This type of funding can come from private equity firms and other private investors who invest in public projects in exchange for future payments from the public and/or private partner to the P3. Governments are relying more frequently on this type of funding to leverage the revenue-generating ability of public infrastructure assets in order to fund their construction or upgrades, rather than committing large amounts of public funds to finance the projects.

Important Contract Terms

P3s provide additional benefits to public entities through various contract terms that can be negotiated into a P3 agreement. These include contractual guarantees such as guaranteed costs, guaranteed schedules, and guaranteed performance. Cost overruns and delayed project completion dates often plague infrastructure projects. P3s, however, remedy this problem by providing for predictable future costs specified by contract.[24] Common cost guarantees include "fixed price guarantees," where a contractor is paid a certain price for the work, regardless of any delays or cost increases, and "guaranteed maximum" pricing, where the contractor is compensated for actual costs incurred plus a fixed fee, subject to a price ceiling. These mechanisms shift the risks of fluctuating input prices and delays to the private entities, encouraging them to complete the project on time and on budget. In Rhode Island, however, state agencies are unable to enter into cost plus a percentage of cost contracts, and they may only enter into guaranteed maximum pricing contracts that contain cost plus a fixed fee provisions (called "cost reimbursement contracts") upon a determination that the contract is likely to be the least costly to the state or that it is impracticable to utilize any other type of contract.[25]

P3s can also offer public entities guaranteed construction schedules that are negotiated into the agreements to ensure that projects are delivered on time. Construction schedules are easier to meet when the entity that is responsible for construction of a project is the same firm that designed it. With a single entity carrying out the design and construction, there is no lapse between those two phases of the project and no need for the construction firm to take time to familiarize itself with the design plans, thereby decreasing the likelihood of construction mistakes.

Moreover, P3s allow for guaranteed performance standards atypical of projects procured by traditional methods. Common performance guarantees include: 1) acceptance standards to delineate criteria for acceptance of the contractor's work by the public entity; 2) construction guarantees, including design requirements, review standards, and environmental guarantees; and 3) operational guarantees or delineated maintenance requirements. These guarantees can be negotiated into a P3 contract to ensure proper performance by the private entity.

Although guarantee provisions can protect governmental entities from cost overruns, delays, and substandard performance, there is still a risk that a private entity may breach the contract. However, there are several mechanisms often included in P3 agreements to add an additional layer of protection for the governmental entity and the public funds entrusted to it. These mechanisms include operations bonds, performance bonds, or payment bonds from third party bonding companies, letters of credit from financial institutions that can be drawn against in the event of a breach, and guarantees from parent companies that provide additional assets and capital for payment if a contractor defaults on its obligations. Additionally, P3 contracts often require private entities to maintain various insurance policies with specified minimum amounts of coverage to further protect the public entity.

Finally, P3 contracts can provide for liquidated damages in the event of a breach, along with concomitant performance incentives for early completion or heightened levels of performance, which may be negotiated to further encourage efficient service and project delivery that is on time or ahead of schedule.

Rhode Island Case Study: Cranston

In one of the first sewer P3s in the country, the City of Cranston entered into a 25-year lease and service agree-ment[26] that transferred operation, maintenance, and capital improvement responsibility for the City's sewer system to a private entity.[27] Under the terms of the agreement, the company made a $48 million upfront payment to the City, which was used to retire approximately$26 million in sewer bonds, pay back $8.6 million that the City's Sewer Enterprise Fund had borrowed from its General Fund, fill a $6.9 million General Fund deficit, and create an approximately $6 million surplus.[28] This upfront payment had the further benefit of eliminating the City's yearly debt service expenses on the retired bonds, increasing its long-term investment income, and raising its bond rating.[29] In addition to the upfront payment, the contractor was responsible for approximately $30 million dollars in necessary upgrades to the system.[30] In exchange for the contractor's payment and services, the City agreed to pay a monthly service fee that is derived from the charges collected from the system's users.[31] The agreement had the added benefit of stabilizing these sewer fees for the life of the contract, which are estimated to save ratepayers $35 million in comparison to the fees that would have been needed had a private entity not taken over operation of the system.[32]

Conclusion

As exemplified in Cranston, P3s can provide governmental entities with many benefits, including long-term savings, an upfront infusion of funds, and the ability to shift various responsibilities and risks to a private entity. Because of these benefits, P3s have increased in popularity in recent years, yet there still remains considerable opportunity for governmental entities in Rhode Island, and throughout the United States, to take advantage of these arrangements.[33]

ENDNOTES

1 *National Council for Public-Private Partnerships, 7 Keys to Success, http://www.ncppp.org/ppp-basics/7-keys/.*
2 ***Id.***
3 ***Id.***
4 ***See, e.g.,*** *New York General Municipal Law §§ 101, 103.*
5 ***See, e.g., Id.***
6 *R.I. Gen. Laws §§ 37-2-18, 45-55-5.*
7 ***H.V. Collins Co. v. Tarro,*** *696 A.2d 298, 303 (R.I. 1997) (quoting* ***Paul Goldman, Inc. v. Burns,*** *109 R.I. 236, 239, 283 A.2d 673, 675 (1971)).*
8 ***Id.***
9 *State of Rhode Island Procurement Regulations, § 6 (June 20, 2011).*
10 *R.I. Gen. Laws §§ 37-2-7, 37-2-19, 45-55-2, 45-55-6.*
11 ***Id.*** *§§ 37-2-19, 45-55-6;* ***see also*** *State of Rhode Island Procurement Regulations, § 6.1.1.2.1 (June 20, 2011).*
12 *State of Rhode Island Procurement Regulations, § 8.11.3 (December 2011).*
13 ***Id.***
14 *R.I. Gen. Laws § 37-2-7(30).*
15 ***Id.*** *§§ 37-2-27.1—27.2. These sections, however, do not apply to "highway or heavy construction projects."* ***Id.*** *§ 37-2-27.1.*
16 ***Kayak Ctr. at Wickford Cove, LLC v. Narragansett,*** *116 A.3d 250, 254 (R.I. 2015).*
17 ***Id.*** *at 251-252, 254.*
18 ***Id.*** *at 254. Although this case only applied to municipal contracts, given the almost identical language of the laws governing state contracts, it appears that the same result would be reached in concessions with state agencies. This conclusion is further bolstered by the Court's recognition that § 45-55-5 only applies to "procurements" and "purchases."* ***Id.*** *Concessions are clearly not "purchases," as nothing is bought under these arrangements, nor are they "procurements" under state regulations governing concessions and other contracts "which are not procurements." Section 10 of the State of Rhode Island Procurement Regulations. Under these regulations, "[i]n general" concessions, must be awarded to the proposer offering "the greatest cash benefit to the state"; this implies that there are situations when the highest bidder need not be awarded a concession contract.* ***Id.*** *(emphasis added).*
19 ***Kayak Ctr.,*** *116 A.3d at 254.*
20 ***See, e.g.,*** *Va. Code § 56-575.1 et seq.; Fl. Stat. §§ 287.05712, 334.30.*
21 *R.I. General Assembly, House Bill No. 6250 (2015).*

22 ***Id.***

23 *The term "concession" can refer to any grant of a right to use one's property. The more traditional examples include concession stands in theaters or the paddle sports business in the **Kayak Ctr.** case, where one entity is granted the right to operate a business on another's property in exchange for periodic payments or a percentage of the business's revenue. 116 A.3d at 251-52. However, in the more modern, P3 context, conces-sions generally involve upfront and/or periodic payments from a private entity to a public entity in exchange for the right to operate and collect revenues of an infrastructure asset.*

24 ***See** Allen Consulting Group, Performance of PPPs and Traditional Procurement in Australia (2007).*

25 *R.I. Gen. Laws §§ 37-2-29, 37-2-30.*

26 *The agreement was later extended to a term of 30 years. City of Cranston, Department of Finance,*

Comprehensive Annual Financial Report of the City of Cranston, Rhode Island for the Year Ended June 30, 2006 at 3.

27 *Public Works Financing, Cranston Opts for Private Finance for Wastewater Upgrade, (May 1996 to September 1997).*

28 *American City and County, The Pros and Cons of Long-Term Privatization (May 1, 1998). United States Conference of Mayors, Lease and Service Agreement Solves Financial and Environmental Problems for Cranston's Wastewater System.*

29 *Public Works Financing, Cranston Opts for Private Finance for Wastewater Upgrade, (May 1996 to September 1997); PR Newswire, Cranston RI $17.5M GOs Rated Underlying 'A-' by Fitch IBCA – Fitch IBCA Financial Wire.*

30 *American City and County, The Pros and Cons of Long-Term Privatization (May 1, 1998). United States Conference of Mayors, Lease and Service Agreement Solves Financial and Environmental Problems for Cranston's Wastewater System.*

31 *United States Conference of Mayors, Lease and Service Agreement Solves Financial and Environmental Problems for Cranston's Wastewater System.*

32 ***Id.***

33 *National Council for Public-Private Partnerships, Moody's Predicts Long-Term Increase in Cross-Sector US, International P3s, (September 24, 2015), http://www.ncppp.org/moodys-predicts-long-term-increase-in-cross-sector-us-international-p3s/.* ❖