

WITH LEONARD GILROY, DIRECTOR OF GOVERNMENT REFORM AT REASON FOUNDATION



**Leonard Gilroy** is the Director of Government Reform at Reason Foundation, a US-based non-profit think tank that advances free minds and free markets. Gilroy has a diversified background in policy research and implementation, with particular emphasis on Public Private Partnerships, competition, government efficiency, transparency, accountability, and government performance. He has worked closely with legislators and elected officials across the US in efforts to design and implement market-based policy approaches, improve government performance, enhance accountability in government programs, and reduce government spending. Prior to joining Reason, Gilroy was a Senior Planner at a Louisiana based urban planning consulting firm. He also worked as a Research Assistant at the Virginia Center for Coal and Energy Research at Virginia Tech. Gilroy earned a BA and MA in Urban and Regional Planning from Virginia Tech.

**Frontier Centre: Briefly can you describe the traditional procurement process?**

**Leonard Gilroy:** In a traditional procurement process for infrastructure, you tend to see a lot of bifurcation of the steps along the way. You have the designing part being separated from the construction part. You might have the government or government in partnership with private companies sort of teaming on one part of that, like say the design, and then coming back and then breaking that up into another contract for the construction. You tend to see a lot of different steps along the way, that in aggregate tend to increase the time it takes to get a project built and adds steps along the way that increase costs.

**FC: How do public-private partnerships differ from traditional procurement?**

**LG:** P3s differ from traditional procurement in a few different ways. First, you can streamline and consolidate some steps along the way in the procurement process such as design and construction. That can lower the cost and accelerate the projects faster.

P3 projects put the private sector into a situation where they are focused on minimizing the full life cycle costs of the operations and maintenance of an asset, which is over a period of decades. So what you're really doing is not only consolidating the design and construction elements and the up-front cost, but you're looking decades into the future and trying to figure out how to minimize the total operations cost over a 30, 40, 50 year period.

One of the huge benefits of P3s is that they put the focus on long-term value for money and at the same time transferring some important risks away from the public sector to the private sector. Some of those risks include construction costs overruns and the risks of going over schedule.

An infrequently discussed risk is that environmental regulations changeover time, which can add unforeseen costs. For instance, that might require meeting increased water quality standards in the case of a wastewater project. The risk of having to comply with future and unknown environmental regulations is one that is hard to quantify but passing that risk onto the private sector is an enormous benefit of P3s.

**FC: There are a number of different P3 arrangements. Can you describe some of the differences?**

**LG:** There are many different types of P3 arrangements but typically you can boil them down to just a handful of items. It's going to be some combination of designing, building, financing, operating and maintaining an asset. You may see a combination of some or all of the above of those five items but typically it's going to be something like either consolidating the design and build into and that would be called the design/build or maybe you're looking at the whole package which would be a design/build/finance/operate/maintain.

**FC: Is "public private partnership" just another name for privatization?**

**LG:** : I think that depends on your definition of privatization. If you think of privatization broadly speaking as just some kind of shift from public to private then, possibly. You could say that P3's might be some subset of privatization. But I think in the more traditional understanding of the word privatization, which is a full transfer of a service or asset from the government to the private sector, in that context I would say no, they are different things. A public private partnership by definition is a partnership between the public and private sectors. That's in the name.

The contractual relationship is between the government and a private entity and each side in the contract has roles and responsibilities that they have to fulfill. In a P3, governments are never signing the contract and walking away from it. There is always an ongoing responsibility there to protect the public interests and to fulfill other functions as the private sector is performing its end of the bargain. So, in the classic sense of privatization, no a P3 is not privatization.

**FC: Do public-private partnerships only work for major projects or is it a model that can work well for smaller projects?**

**LG:** P3s have a long track record of working for big ticket projects. What we started to see is the increasing application of P3s down to the more medium size project space. P3 can be an appropriate option anywhere there is enough scale to deliver significant value for money. That's not to say that there won't be some small scale P3s that could work, but those are probably going to be more niche opportunities. The sweet spot for P3s is going to be in that mid to large size projects. Using P3 for large and medium sized projects allows governments to then focus their

traditional resources and their traditional approaches on those smaller where P3 is not an option.

**FC: P3s are fairly new in North America but they are not very new in the rest of the world, correct?**

**LG:** That's correct. There's a long track record in Europe and South America. Many parts of the world have been using P3s for decades to deliver infrastructure assets along a broad range of asset classes, including, highways, airports, schools, higher educational facilities, water, wastewater and other types of public facilities.

P3s really started to emerge in the post WWII era in Europe and so a lot of the lessons and best practices that came out of those experiences are what has informed the world for the decades since then. The U.S. and Canada really started to get into the P3s in the 90s and early 2000s.

While it may seem new to people that aren't familiar with how infrastructure is financed around the world, there's nothing new about P3. In fact we're catching up with the rest of the world.

**FC: Can you name a few successes and why they worked?**

**LG:** The US has a long track record with water and wastewater projects. The city of Phoenix, for instance, did a design/build/finance water plant at its Lake Pleasant facility that received an award from the U.S. Conference of Mayors for its innovations and environmental design. That's on top of the cost savings and delivery benefits.

Transportation is a newer area in North American P3s, but there a number of emerging successes there. We've recently seen the first expansion of the capital beltway in the D.C. area in the decades since it was built. The new high occupancy toll-way on the Virginia portion of the beltway was originally going to be a public sector project that was going to cost about 3 billion dollars and require expropriating something like 300 homes from people. Virginia has a P3 law that allowed the private sector to make an unsolicited offer and a private venture came in and said: "We've got a better idea. We can engineer this differently so you would only have to take 8 private homes and businesses as opposed to 300. We can value engineer this thing down from a 3 billion dollar to about a 1.5 billion dollar project and it would use toll financing to better sort of regulate the congestion and the traffic flow." Ultimately, that is a project that is open and up and running now and seems to be very successful.

You also have projects like the Port of Miami tunnel underway, which is a truck tunnel that will divert traffic and ease the congestion around the port. That is a billion dollar privately financed project.

Texas right now has about 7 billion dollars or so in privately financed infrastructure projects. Texas is growing rapidly and has had a difficult time in the keeping up with its infrastructure through the traditional procurement approach. They were basically looking at P3s or continued increasing congestion. Some of the biggest congestion points in Texas are being rebuilt and reengineered through P3s that the state would have never otherwise been able to do.

**FC: Is there a high rate of failures with P3 projects? Is there a typical misstep or series of missteps that governments make when they don't go so well?**

**LG:** Failures are not a typical scenario. That's not to say they don't happen but they're rare with P3s. A couple of projects in California are instructive. Their first two P3 projects both ran into some issues. When they built their first privately financed highway project they took the advice of the environmental movement in building some restrictions around that contract that would prevent the roadway from ever being expanded. When growth started to materialize later they needed to build some new capacity to reduce traffic congestion, which the contract prevented the state from doing that. While that was at the behest of the environmental movement, the private sector got the blame for it. Public perception was that it was part of the contract so therefore it was the private sector's fault. That was back in the late 90's and that is one that a lot of communities have learned from since then and have changed the approach those types of capacity restrictions as part of contracts.

Another thing that can go wrong is changing economic conditions. This was the case with two P3s in Virginia and one in the San Diego area. In both cases the recession led to reduced traffic volumes. This caused revenue to come in lower than projected before construction.

In those cases you would say that the original intention failed. However, from the public sector standpoint it didn't fail. They were able to acquire these roadways at pennies on the dollar compared to what it would have cost them to do it traditionally procurement. The private sector took a risk and had to eat some losses. That's part of the virtue of these deals. The private sector bears a lot of those risks. There are failure scenarios in which the public sector is significantly impacted.

**FC: Analysts claim that governments are learning, and getting better at designing P3 contracts. Are governments tweaking their approach to take advantage of best practices?**

**LG:** P3s are among the more evolutionary processes that you see in procurement. Governments are learning by observing previous projects . Each project tends to have unique challenges so the bigger the base of experience there is to learn from, the more opportunities there are for governments to get it right and learn lessons from the past.

Not only do you see P3s evolving in terms of their structure but you've also seen the emergence particularly in places like B.C. and Ontario of dedicated centers of excellence whose job it is to help disseminate those best practices and lessons learned and to improve these projects over time. You have groups like Partnership B.C. or Infrastructure Ontario as well as others around the world such as Infrastructure UK and the Puerto Rico P3 authority.

The whole idea is to help accelerate that diffusion process and that learning process is to have a dedicated center of excellence that can be a partner alongside the governments sponsors of these projects to help them think through not only what types are projects are applicable for P3 and the project scoping early up front work, but also in the due

diligence process and in bringing model language that has worked in other places into contracts.

Rather than the governments having to learn these lessons themselves and everybody having to reinvent the wheel, all they have to do is tap the knowledge that's already out there. That's something that some Canadian provinces have done a very good job of and that other places around the world cite as a model. In fact some states in the U.S. are looking to a Partnerships B.C. as a model.

**FC: The City of Regina is holding a referendum on a proposed P3 wastewater project. Is this a fairly typical project?**

**LG:** Yes. The project that they are planning is of a privately financed new wastewater facility. There have been dozens throughout Canada and if you zoom up around the world, probably up to hundreds and potentially up to a thousand of similar projects. There is nothing unique here. There is no rocket science involved in this.

However, because it is new for Regina, it seems exotic. It takes a while for people to learn about the experience around the world. When you have people out there on both sides of the argument making different competing claims, it can be very confusing.

The advice I would offer to folks in Regina and other places that are getting familiar with this concept, is that you need to understand that this is nothing new. There are decades of experience around the world. You've got models and experience of many jurisdictions around the world and a wide variety of consultants and people out there who can help your governments navigate this process well.

**FC: P3 opponents take issue with firms profiting from public services. People are concerned that big companies are out there to profit off of water. The flip side of that the traditional procurement process often leads to cost overruns that are absorbed by the public. Is there anything wrong with the private sector making a profit if they are saving taxpayers money?**

**LG:** There are a few different elements to that. First, yes, the governments are finding that the P3 model can add significant value for money relative to a traditional procurement. That can come through cost and schedule predictability. Being able to keep a cap on the construction cost of the project is something that you rarely get in the public sector. It's very common with traditional procurement to see costs spiral from the initial estimates.

With P3s you have a contractual cap that reduces a lot of those cost risks. The private sector is well known for bringing cost efficiencies to bear on the long-term operations and maintenance of infrastructure assets. Decades of experience around the world has shown that the private sector can do operations and maintenance better, faster, and cheaper in the long run.

At the end of the day you also have to remember the incentives at play. There is no guarantee of profit to anyone in a P3. Sure the private sector is not here for altruistic reasons. They are not here to do something benevolent for the public sector. They would like to earn a profit.

What I would argue is that we should have no problem with that as long as they are delivering on all of the expectations

that are in the contracts. I don't see any problem or conflict in putting the private sector to work in the business of serving the public interests. If they make a profit, so be it. That's great. That will encourage more and more people, more and more companies to come out and provide better high quality services for taxpayers.

**FC: What kinds of safeguards are built into P3 agreements to make sure that people aren't getting substandard services?**

**LG:** If the government builds its contract properly it's going to put in all of the performance expectations that it requires and it can even exceed the standards that they currently are delivering today as a government run enterprise. So what you want to look at is, what are our benchmarks today? What are those various standards and parameters associated with this service? Do we want the company to exceed them? If so, you build that into the contract, ultimately with the power of revoking the contract in the event that the private sector is unable to deliver. Quality should not be a concern if you do this process properly.

The common practice today is putting the private sector on the hook for meeting the environmental regulations not only today but into the future, which is a huge cost and risk transfer to the private sector because there is always the unknown of what is the next storm-water regulation or what's the next water quality regulation that we're going to have to comply with 10, 20, 30 years from now. Putting the risk onto the private sector of having to comply with those regulations is a huge benefit to taxpayers.

**FC: Some people argue that the risk transfer argument is over-rated. What are your thoughts on that?**

**LG:** Risk transfer is one of the least understood but one of the most important aspects of the P3 model. In normal day-to-day operations governments absorb tons of risks in lots of different ways they never have to quantify because government and accounting systems don't make them.

Getting a fixed cost bid from a private entity is a vastly different scenario with a lot lower risk than the alternative in the traditional procurement which is government comes out with an estimate and says the project is going to cost 'X' and then a few years later those cost estimates go up. Traditional procurement tends to result in a ratcheting up over time of costs and schedules slips. So not only are the costs directly going up but time is money so project delays are costly over time as well.

Being able to transfer that very real kind of risk of cost inflation and schedule slips to a private entity is an enormous benefit here that should be quantified. What happens when governments don't quantify it is ultimately taxpayers eat that cost. The P3 model is designed to avoid that.

I would argue, not only is the cost-risk not some mirage, but it's also probably one of the most critical aspects of this because not only are you looking at up front delivery risk but you are also looking at risks of cost inflation over time. For the average user that translates into a better ability to control rates and what they pay than you might see compared to a traditional government scenario.

**FC: One of the arguments against using private contractors is the idea that private companies are short sighted and they are just looking at their profits today. What's your response to that?**

**LG:** A P3 is inherently a long-term document and is a long-term partnership where if the private company is lucky and does its job well it stands to maybe make a return by the end of a multi-decade deal, especially when you're talking about bringing financing to bear. The way these models work is that the private sector doesn't even start to recoup its' upfront costs until maybe year 20 or 30 of the contract, a long way down the road.

The contract builds in a long term expectation from start to finish. It stipulates the quality we expect from the start all the way through to the very end including the condition that that asset has to be in by the end of the arrangement – which is usually brand new. You have to essentially turn over a brand new asset to the government authority decades later. What that does is it puts the private sector into a long-term mindset and gets their incentives aligned with the governments over the life of that deal. So I would argue that that is not shortsighted, in fact it's quite the opposite. It's very long-sighted because that's the way these deals are structured.

**FC: Great, thank you.**