



What's Good and Bad About Public-Private Partnerships

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Summary and Conclusions:

Public-Private Partnerships (P3's) are complex, controversial financial agreements, misunderstood by many. A P3 is not a partnership in the commonly used sense of the word. In a business partnership the partners share in making all the critical decisions involved in running a business. The partners share a common mission and share the rewards. It's much like a marriage. See: http://en.wikipedia.org/wiki/Public-Private_Partnership; http://en.wikipedia.org/wiki/Public-Private_Partnership#Controversy

Rather, a P3 is a business deal, defined in a build-to-suit leaseback contract negotiated between a landlord and a tenant, such as the Wake County Public Schools System (WCPSS). The big incentive for the tenant is that a P3 either: 1. converts assets into cash that could be better used elsewhere or; 2. Supplies new infrastructure when the cupboard is bare or insufficient to meet existing needs. The big incentive for the landlord is profit, derived from rent and tax credits.

Note that the rent in a P3, paid over several decades, is comparable to the interest on bonds issued for conventional infrastructure financing.

If WCPSS and the private "partner" (probably a developer) can agree on mission, goals and how to achieve those goals – then a P3 can be a positive force in digging all stakeholders out of the financial mess Wake's schools are in.

However, WakeUP Wake County can neither endorse nor argue against a contract that is not on the negotiating table and is a long

way from agreement by all stakeholders. Rather, WakeUP advises caution and suggests that implied cost savings are not a guarantee of same. WakeUP advocates for in-depth analysis and transparency to the public.

WakeUP Wake County will continue to lobby our State leaders for increased local empowerment. Namely, a menu of options for paying for school construction including impact fees and transfer taxes. For seventeen years the powerful development industry has effectively opposed impact fees and transfer taxes. Their position at this time of great need will be a measure of their motivation as a P3 “partner”.

Discussion:

First of all, let's define the term Public-Private Partnerships or P3's. There are many forms and variations of P3's. The most likely one to be used here in Wake County will be centered on a “Build to suit – leaseback”. This is part of a more general class of contracts known as sale-leasebacks. The lessee (tenant/WCPSS) specifies a building they need. A lessor (landlord/ developer) builds it for them and then the tenant pays rent over a period of years.

Under NC's recent legislation passed by the NC House and Senate and awaiting the Governors signature, the landlord/developer may select the location of the school and maintain the building over the life of the lease, typically 30-40 years.

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Rather, a P3 is a business deal, defined in a contract negotiated between two parties. The big incentive for the tenant is that a P3 either: 1. converts assets into cash that could be better used elsewhere or; 2. Supplies new infrastructure when the cupboard is bare or insufficient to meet existing needs. The big incentive for the landlord is profit, either in the form of rent or in tax credits.

Those who fear Wake County may take on too much debt and the impact on future taxes should note that the legal obligation to pay many years of rent is an equally onerous obligation.

The IRS allows private investors in a P3 (the landlord/developer) to take a tax credit not allowed public schools, i.e. depreciation. For every \$100 million in construction, about \$80 million in depreciation tax credits can be claimed over the period of the lease – everything but the land. And there are complex tax loopholes that allow still further tax credits. WCPSS cannot claim these tax credits since it doesn't pay taxes.

WakeUP has consulted with lawyers and the authors have a financial, banking and business background. However, an in-depth financial analysis is too complex without further, specialized professional assistance. Tax attorneys, real-estate attorneys and specialized financial consultants are needed.

In essence, a P3 is a way for the landlord/developer to get all NC and federal taxpayers to subsidize the cost of building his school which is then leased to the public. Since there are many instances where Wake and NC taxpayers subsidize infrastructure elsewhere, this is an advantage of P3's.

By borrowing most of the money from banks at low interest rates, the landlord/developer can leverage his profits.

The important points to remember are:

- The motivation of the landlord/developer is profits.
- Whether the developer's profit motivation is in the short-term or in the long-term is critical for a fair deal.
- Developers should realize that their long-term profitability relies on the health of the public schools.
- The motivation of WCPSS should be the long-term health of the school system. Primarily, by continually raising the bar of public education.

- However, the motivation of some among the public and the county commissioners is to keep spending and taxes down right now.
- From these conflicting motivations will emerge a lease agreement/contract.
- A P3 only exists in the form of a contract. Any claims as to the results of P3's are hollow until that contract is written.
- For the life of the lease the developer/landlord owns the school. (After the tax credits are used up it is common for landlords to give back the school to the tenant.)
- Since P3 contracts typically cover 30-40 years, they must anticipate what could change over that time, e.g. the landlord/developer wants to sell his building.
- The tenant/WCPSS cannot make changes to the landlord/developers building without his agreement. Assume that five years down the road WCPSS wants to convert an ordinary classroom into a science lab. WCPSS cannot do so without the landlord/developer's consent and under terms agreeable to the landlord/developer.
- If the contract says the landlord/developer is responsible for the maintenance (for additional rent) then the details of that maintenance agreement should be spelled out in the contract. For example how often do the floors get cleaned and waxed? Is the right non-slip wax being used? And if a third-grader slips and falls and breaks his leg who is responsible? If the landlord is doing the maintenance, rather than an employee, and you don't like the job being done, it's not easy to fire the landlord.
- One of the new powers allowed in the new state law is to allow the architect/designer to be employed by the builder/developer/landlord. This is known as "design-build" This speeds up the entire process by making the decision making process on a myriad of details more direct. Cost savings are claimed. However it is unclear if such cost savings is a trade-off of reduced durability. If the latter, then long-term costs will be driven up.
- The above is just a sample of the details involved in negotiating and managing the contract over its life. Based on other documented cases, a P3 contract can be hundreds of

pages long and cost a million dollars or more to prepare and negotiate. The contract inevitably involves complex decisions and huge amounts of time on the part of the superintendent of schools, the school board and county government.

- When the school construction is being done by competitive bidding and outsourcing to builders, WCPSS' position is far more flexible and simple.

What's Good About P3's

- **If** WCPSS and the developer can agree on mission, goals and maintain that agreement over a few decades – then a P3 can be a positive force in digging all stakeholders out of the financial mess Wake's schools are in.
- To use a theoretical example, if the "private partner" were the Gates Foundation, there would be little concern over long term compatibility. There are successful P3's structured in that manner.
- If the lessor/WCPSS is short of funds and its "banker" i.e. the county commissioners and the public can't agree on giving it more money, then P3's are a, last-resort, fall-back position.
- A sale-leaseback P3 allows WCPSS or the County to convert property into cash and still have the use of the property. Land prices have gone up by 250% over the last five years. For example, Wake County owns land, e.g. the 2,000 acres intended for the Little River Reservoir, (paid for by our tax dollars). Those 2,000 acres could be converted to cash now. Perhaps as much as \$100 million dollars that could be spent to build five added elementary schools and get 4,000 children out of trailers or give our ~7,000 teachers a real bonus. And we would still have the use of the Reservoir. Ditto for the County Office Building or the Poole Road Commons complex. Note that the legal complications regarding the above remain to be defined.
- Because furniture, fixtures and computers can generate more valuable tax credits than buildings, leasing of same may be attractive for both schools and county offices. This assumes the lessor will rebate a portion of the tax credits to WCPSS or the County .

What's Bad About P3's

- Normally, citizens get to vote on new debt and potential new taxes. P3's take away that right. The decisions are made by government alone. While government has the right to make such decisions under dire conditions, that right should be rarely used.
- Because of their complexity, P3's are not readily understood by the public, i.e. they are not readily "transparent". Add the lack of a vote, and the accountability of government is eroded.
- P3's, while relatively new, have been used all over the world for all sorts of infrastructure. P3's for public schools are more common overseas and have a longer history than in the U.S. There have been some successes but over time their defects have become more apparent.
- Because of their complexity there have been spectacular failures among P3's.
- Proponents claim that P3's can build schools faster and less expensively. But there is little hard proof from independent sources that P3's save money or can build schools faster in every case. Since the analyses require assumptions stretching over decades, they are a source of controversy.
- The recent law passed by our legislature makes it virtually impossible to test the cost advantage. Costly, bureaucratic regulations have been swept aside for P3's but not for schools built in the standard manner.
- The cost to WCPSS depends on its ability to negotiate for a portion of the developer's profits and tax credits. The school board is key. They answer to the public. If the public is misled or confused the school board can be pressured into poor decisions.
- The "blame game" will be intensified. Instead of just the school board and the commissioners negotiating over the construction budget, the landlord/developer is part of the negotiation. Whose side will he be on in a dispute?

- Landlord/developers may use their new found negotiating position to influence the location of schools, e.g. in their subdivisions. It would result in neighborhood schools for newcomers and increased busing for others. In the long term it would threaten economic diversity. That diversity has won national acclaim for WCPSS. It has resulted in new quality jobs and businesses locating in Wake County. The resultant new income and sales taxes is an asset throughout the state.
- The time consumed in negotiating and managing a P3 detracts from the #1 mission of the school board, superintendent and staff. That mission is to continue to raise the bar of quality education. That mission is to prepare the next generation for the enormous challenges that lie ahead for this nation.

Conclusions

The citizens of Wake County should be extremely cautious about putting the future of their schools into the hands of developers, (and their agents), lawyers, bankers, financial consultants without understanding their motivation. Consider that none of the private participants of P3's are accountable to the public.

There may be some cases where P3's are the method of choice in building schools or other infrastructure. There may be some cases where converting existing infrastructure into cash is attractive.

But P3's are not silver bullets. Like other complex financial instruments (e.g. an annuity) they should be approached with caution and evaluated with the advice of professionals. A knowledgeable citizens group is needed to insure that a P3 agreement is fair to all stakeholders.

Lastly, citizens should reject any claim that P3's are an alternative to new revenue sources such as transfer taxes and impact fees.

WakeUP Wake County will continue to lobby our State leaders for increased local empowerment and a menu of options including impact fees and transfer taxes. For nineteen years the powerful development industry has effectively opposed impact fees and

transfer taxes. Their position at this time of great need will be a measure of their motivation in a P3 negotiation.

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Commercial Leasing for Dummies – 300+ pages of simplified discussion. Highly recommended for lay readers.

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