

PUBLIC-PRIVATE PARTNERSHIPS

On Sept. 29, 2016, the Society of American Military Engineers (SAME) hosted a CEO Round Table in Washington, D.C., to discuss industry and government perspectives on the viability of Public-Private Partnerships (P3s) as a tool to assist the federal government in funding infrastructure projects.

Given the unmet funding needs of military projects, the defense community and the private sector have discussed the use of P3s to reduce the backlog of neglected infrastructure requirements. Within the federal government, the Department of Defense (DOD) is often at the leading edge of executing new programs and implementing programmatic efficiencies. But a major question remains as to whether P3s will be viable to solve the infrastructure problems of both DOD and the country.

Recommendations for Infrastructure Investment

America's national security depends on an infrastructure that fuels our economy and assures the readiness of our military installations to protect Americans anywhere from any threat. The urgency to do something now requires a hard look at the barriers to fully leveraging P3s or any form of alternative financing. At the same time, we need to look forward and establish a long-term vision that assures the resilience of our infrastructure.

- Establish a broad vision for the nation that will set the course for more effective use of government and private resources. We need to build it better, not merely repair to old standards. For instance, is now the time to invest in high-speed rail to connect America's economic and population megaregions?
- Issue revised scoring guidance that encourages use of P3s while avoiding creating large, off-book obligations.
- Issue revised guidance on the federal laws, procurement clauses, and regulations that are required in P3s. The goal should be to minimize the number of restrictions in P3s.
- Develop training courses for the federal workforce in order to ensure that P3s are developed in a manner that will encourage private sector investment while ensuring the military obtains the facilities they require.
- DOD and national leadership must champion the use of P3s. Among other tasks, they must change the culture of the military that is accustomed to using traditional processes to purchase construction. Finally, in some cases, changes to statute are required.
- Identify projects across multiple categories (real property, inland waterways, lock and dam facilities) and require DOD and the Corps of Engineers to prioritize those projects based upon physical needs and national value and suitability for P3. Execute a set number of P3s across these categories and based upon the priorities identified.
- Adopt a portfolio approach for leveraging private capital. Mitigation Banks have been an especially useful tool for furthering environmental projects, many of which could not have met mitigation requirements without the banks. The spirit of this tool can be replicated in a creative approach to resourcing infrastructure improvements.

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Public-Private Partnerships for Military Projects: Barriers and Opportunities

I. Introduction

To launch our national rebuilding, I will be asking the Congress to approve legislation that produces a \$1 trillion investment in the infrastructure of the United States—financed through both public and private capital—creating millions of new jobs.

—President Donald Trump
Joint Address to Congress, February 28, 2017

It is no secret that one of President Trump's top federal spending priorities is investing in U.S. infrastructure. The President's statement that "we've spent trillions of dollars overseas, while our infrastructure at home has so badly crumbled" shows the President intends to prioritize domestic spending over international engagement and overseas spending.

The President has also made clear that he intends to leverage private financing to invest in American infrastructure. This will likely lead to an increase in the use of Public-Private Partnerships ("P3s") at the federal level. Whether the President's domestic infrastructure agenda will impact defense infrastructure and the Army's Civil Works projects, particularly P3s for military projects, remains to be seen. This white paper discusses the history of the use of P3s for military infrastructure projects, the barriers to federal and Department of Defense ("DOD") P3 projects, and opportunities for P3 investments in military projects during the Trump Administration.

Our nation's infrastructure is crumbling. This is not a political statement; it's a fact. The partial failure of the spillway at Oroville Dam in California is a sobering example of the danger of underinvesting in infrastructure. Oroville Dam is not an isolated event. The Lake Murray Dam flooded in 2015, an I-35W bridge fell into the Mississippi River in 2007, and an I-5N bridge fell into the Skagit River in 2013. There are many other examples of unfunded or underfunded critical national infrastructure needs in our country. In its 2017 Infrastructure Report Card, the American Society of Civil Engineers assigned a cumulative grade of D+ to the condition and performance of American infrastructure based on the physical conditions and needed investments for improvement in many categories of infrastructure, including rail, bridges, ports, aviation, dams, parks & recreation, drinking water, roads, energy, schools, hazardous waste, inland waterways, transit, levees, and wastewater.¹ The report calls for increased long-term investments, the use of lifecycle cost analysis, and increased incentives for the private sector to invest in maintenance, as well as "the identification of a pipeline of infrastructure projects attractive to private sector investment and public-private partnerships."²

In addition to the poor condition of our nation's transportation and public works infrastructure, the Government Accountability Office ("GAO") has consistently rated federal real property management as "high risk" due to excess and underutilized property, the deteriorating condition of many federally owned facilities, and the government's reliance on costly leased space that may not be fully used or occupied. The real property operated by DOD, including by the Army Corps of Engineers ("USACE" or the "Corps"), is not exempt from this assessment.

1. 2017 Infrastructure Report Card, AMERICAN SOCIETY OF CIVIL ENGINEERS (last accessed Mar. 10, 2017); <http://www.infrastructurereportcard.org/>.

2. *Id.*

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DOD has “taken risk” (Washington speak for underfunded) in its facility sustainment accounts, which has resulted in some facilities being poorly maintained. In recent years the Administration has requested and Congress funded less than 80% of the documented requirement for facilities sustainment. Chronic underfunding has resulted in DOD grading nearly a third of military facilities as “poor” or “failing.” The Corps’ Civil Works Program suffers from a similar lack of investment. The Corps estimates that maintaining the existing levels of unscheduled delays on inland waterways will require more than \$13 billion by 2020, but the current funding levels are expected to fall nearly 50% short at \$7 billion. While roughly 27% of these unfunded needs are for the construction of new lock and dam facilities, 73% are needed to rehabilitate current facilities. The Corps estimates that more than \$25 billion will be required to address dam deficiencies for Corps-owned dams.

Given the unmet funding needs of military projects, the defense community and the private sector have discussed the use of P3s to reduce the backlog of neglected infrastructure needs. Within the federal government, DOD is often at the leading edge of executing new programs and implementing programmatic efficiencies. But a major question remains as to whether P3s will be viable to solve DOD and the country’s infrastructure problems.

II. Definition of Public-Private Partnerships

P3s are a formal, legal, and primarily contractual relationship between a government agency and one or more private sector partners entered into for the purpose of delivering public services. These public services include designing, building, financing, operating, or maintaining a government project over a defined extended period of time.

P3s differ from traditional government procurement methods for infrastructure. Traditional government procurements involve the government entering into a contract with different contractors for different phases of a particular project. For instance, the government would procure a design from one contractor, contract with another to build the project, and then contract with a third to conduct operations and maintenance of the project throughout its lifecycle. In contrast, in a typical P3 arrangement, the government engages with a contractor or consortium to design, build, finance, and operate the asset over an extended period for a return on the private sector’s investment. A key benefit of P3s for the government is the transfer of risk to the private sector. The P3 contractor is required to service the asset over a long period of time based upon defined performance criteria. The public sector remains engaged in determining whether contractual performance requirements are being met in terms of quantity and/or quality. However, the private sector bears the risks associated with any design defects, schedule delays, instances of non-compliance with the government’s project requirements, and financing difficulties. This aspect of a P3 relationship incentivizes the private sector to ensure efficient operations while maintaining quality. P3s are also distinct from outright privatization because the public sector typically retains its status as an owner of the asset and often requires return of the asset at the end of the agreement in a pre-defined condition.

P3s are beneficial because traditional design-bid-build procurements have a history of exhibiting built-in potential for cost over-runs, schedule delays, and low construction costs but high maintenance costs, resulting in much higher life-cycle costs and shorter life-cycles. Some P3s have also freed the private sector from burdensome regulations and contract provisions, thus increasing the likelihood of private sector participation.

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III. Barriers to P3s for Military Projects

At the federal level, there are many cultural, political, fiscal, budgetary, and management barriers to generating and executing successful P3 projects.

A. P3 Financing Costs are Likely to be Greater

- The cost of financing in the private sector is higher than public sector financing, which may rely on tax revenues and tax advantaged-government bonds to fund projects. Private financing requires the private sector to raise money in private capital markets on behalf of a federal program and provide assurances to private financiers (bond holders) that they will be repaid. Typically this consists of some kind of long-term federal commitment. Obtaining this commitment can be difficult from an authorization standpoint. The

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reliability of a program's cash flows and assets and future risk to funding streams (in contrast to the backing of a project based on the full faith and credit of the U.S. government) increases private financing costs. In short, project revenue/repayment risks and other project risks such as construction risks and operating risks will result in a higher cost of money for P3s than a government-financed project. Consequently, all financial variables such as project cost, income or

revenue streams, expenses, debt and equity, interest rates, and repayment terms will make a more complex project structure over a traditional contractual relationship.

- Further, and as discussed more fully in the next section, the Congressional Budget Office ("CBO") policy is that relying on third-party financing generally is not in the best interest of the government from a budget perspective. In 2005, CBO described the problem in detail:

"Third-party financing arrangements have a number of negative consequences. In general, projects are more costly to the government when they use such financing. In addition, if agencies do not initially record the full cost of governmental activities, the budget understates the size of the federal government and its obligations at the time when those obligations are made. Third-party arrangements may also skew decisions about how to allocate budgetary resources by giving preferential treatment to investment projects on the basis of their method of financing rather than their relative merits. Finally, third-party financing allows agencies to raise capital in private markets without the full scrutiny of the Congressional appropriation process and without reference to the statutory limits on borrowing that exist for some agencies."³

3. Congressional Budget Office, *Third Party Financing of Federal Projects, ECONOMIC AND BUDGET ISSUE BRIEF (Jun. 1, 2005)*; <https://www.cbo.gov/sites/default/files/109th-congress-2005-2006/reports/06-01-thirdpartyfinancingbrief.pdf>.

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B. Budgetary Restraints and Scoring

- In a constrained national budget environment with strict accounting policies, federal agencies do not have many options to fund critical infrastructure deficiencies, maintain their facilities, budget for capital investments/repairs, or leverage underutilized assets (with some exceptions).
- The federal government is bound by certain rules for the commitment of funds and contracts that are

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intended to ensure adequate accountability of future obligations. These scoring rules implemented by both the Office of Management and Budget (“OMB”) and the CBO provide for an assessment of the extent of public sector fiduciary risk that, in most cases, assumes in the cases of P3s that the federal government will be liable for expenses in future years as a result of an agreement, transaction, or contract.

- “Scoring” is the process of measuring the budgetary effects of a project or venture, or any requested, pending, or enacted legislation to assess an impact to a budget plan. Scorekeepers start with the goal to control and measure federal spending by ensuring fiscal actions are fully accounted for at the time an obligation is undertaken by the government. This procedure provides accountability for decision makers about to lock into long-term agreements and commitments in future budgets.
- OMB and CBO maintain that the current budgetary methods of full disclosure of funding commitments are essential, and that Congress and the executive agencies should work inside the traditional budget process. OMB and CBO defend scoring rules on two grounds. One is cost: lease-purchases and public-private ventures are forms of third-party financing, and it is almost invariably more expensive for the federal government to use third-party financing than to purchase a capital asset directly as discussed above. The other justification is transparency. Like an installment plan, lease-purchases and public-private partnerships may “hide” the government’s real long-term cost commitment or fiscal risk, leading to suboptimal decision-making in the annual budget process. Current scoring rules promote transparency and fiscal control with regard to the funding of federal real property, and still provide agencies the flexibility to facilitate the acquisition, repair and alteration, and disposal of federal real property in support of federal missions.
- In short, the use of capital investment accounts has been limited to certain types of projects in specific conditions and the ability of federal agencies to use current alternative financing authorities has been curtailed or eliminated. While the backlog of critical facility and infrastructure requirements grows and the condition of existing assets deteriorates, there has been no real attempt to propose changes or updates to current OMB guidance. Yet there are ways to do so that would continue to promote transparency and fiscal control with regard to the funding of federal real property projects while providing agencies the flexibility to facilitate more timely acquisition, repair and alteration, and disposal of federal real property in support of federal missions by leveraging investments from the private sector and expanding contractual relationships over at least one life-cycle of a federal asset.

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C. Federal P3s Typically Funded by User Fees

- Another impediment to federal P3 projects is the limited view that payments for federal P3 projects should be made via user fees. In return for private sector financing, a dedicated revenue source to repay any underlying project debt and provide a return on equity is typically required. Direct user charges (for example, tolls for roads or a service member's Basic Allowance for Housing) are typical sources of debt repayment in P3 projects. Given the scope and nature of many federal infrastructure needs, the reliance on user fees or tolls will be severely limiting. Projects will have to be funded with traditional government resources committed via long-term contract, known generally as availability payments. Traditional government resources include tax revenues, bonds, or other borrowing, which all have political challenges and fiscal restraints.

D. Cultural Barriers

- In addition to budgetary and financing constraints, there are many other barriers to implementing P3s on federal infrastructure projects. First, there is the "business as usual" default that federal agencies revert to

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when executing federal projects. Since there is no established procurement process for large P3s, agencies are likely to rely on antiquated, legacy procurement systems and contract terms derived from the Federal Acquisition Regulation ("FAR") or Defense FAR Supplement ("DFARS"). This process can be time consuming and burdensome, particularly for large-scale infrastructure projects.

- Further, the ambiguity surrounding the applicability of certain federal laws such as labor laws (particularly the Davis-Bacon Act, Davis-Bacon Related Acts, or the Walsh-Healy Public Contracts Act), Buy American provisions, and environmental laws further impede efficient and implementation of federal P3 projects and drive up project costs. Many of the authorities do not address which federal laws are required for P3s. This has resulted in agencies adopting widely different interpretations with some agencies routinely including many of the typical FAR requirements and restrictions while other agencies and programs do not include similar restrictions.
- Finally, the engineering and construction industry that supports the federal government is mature. And the Executive Branch and Legislative Branch of government each have established roles in the planning, approval, funding, and execution of public construction projects. If P3s are going to be adopted for a greater number of projects, both industry and government will have to adapt to a new way of doing business.

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IV. Opportunities

In today's environment, projects that are considered for a P3 should be those that can have an associated income stream or quantifiable cost avoidance/savings over the life of the agreement—in other words, a positive return on investment. A model measurement mechanism supported by clear guidance and possibly statutory support could allow these projects to advance.

- **Energy Savings Performance Contracts and Utility Energy Service Contracts.** Both types of contracts are in widespread use in the federal government as well as in state governments. These types of contracts could be more useful if the government allowed the savings from reduced operation and maintenance (O&M) as well as personnel savings to be used in calculating the project's savings. DOD has also narrowed the authority for both arrangements in a series of interpretations of the underlying authorizations that limit the type of facilities that can be built and the types of savings that are counted in the project.
- **Utilities.** DOD has been a leader in utility privatization. These programs, which were started in the Clinton Administration, have resulted in a marked improvement in the infrastructure on military installations.
- **Energy.** DOD has not taken advantage of the radical change in the domestic energy market with many large energy users moving to decentralized generation. Unfortunately, much of the department has entered into long-term real estate leases to energy developers that do not provide energy security to the military. A better model is the biomass project at Fort Drum, N.Y. This privately funded plant provides the capability to for the installation to operate independent of the grid thus reducing risk in the event of a grid outage. Replicating this model requires DOD to value energy security and resiliency.
- **Housing.** The Military Housing Privatization Initiative is the military's largest P3. In this program, a private developer takes over an installation's housing, recapitalizes the housing, and then operates the housing under a long-term agreement. DOD has used the authority to harness the private sector to provide greatly improved family housing. The statutory limitation on the use of the authority overseas should be removed so that families outside of the United States can benefit from improved housing. The military should also consider following the path of many colleges and universities and use P3s to capitalize, operate, and maintain unaccompanied personnel housing.
- **Hydropower.** Federal hydropower projects are in need of an infusion of capital to bring the facilities up to current standards while increasing the reliability and efficiency of the plants. These would seem to be prime examples of where P3s should be used. There is an income stream from selling the power and a large unmet need for capital investment. The obstacles are both statutory and cultural, but with leadership from the current administration they can be overcome.
- **Installations.** The military should seek the authority to use P3s to capitalize, operate, and maintain other types of facilities. While there are obstacles to doing so, harnessing the private sector may be the only way to recapitalize the military's portfolio of deteriorating buildings.

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V. Recommendations

While the budgetary treatment of both Congressional legislation and initiatives by federal agencies to enter into third-party transactions, enhanced leases, or public/private ventures has resulted in much discussion and suggestions over the last 25 years, the only real change in policy has been the continual tightening of existing policies by OMB and CBO to restrict alternative financing arrangements. In order to tap into the private sector, the federal government should:

- Establish a broad vision for the nation that will set the course for more effective use of resources, both government and private. For example, in the spirit of President Eisenhower's national system of interstate and defense highways, is now the time to invest in high-speed rail to connect America's economic and population megaregions?
- Issue revised scoring guidance that encourages use of P3s while avoiding creating large, off-book, obligations.
- Issue revised guidance on the federal laws, procurement clauses, and regulations that are required in P3s. The goal should be to minimize the number of restrictions in P3s.
- Develop training courses for the federal workforce in order to ensure that P3s are developed in a manner that will encourage private sector investment while ensuring the military obtains the facilities they require.
- DOD and national leadership must champion the use of P3s. Among other tasks, they must change the culture of the military that is accustomed to using traditional processes to purchase construction. Finally, in some cases, changes to statute are required.
- Identify projects across multiple infrastructure categories (real property, inland waterways, lock and dam facilities), and require DOD and the Corps to prioritize those projects based upon physical needs and national value and suitability for P3. Execute a set number of P3s across these categories and based upon the priorities identified.
- Adopt a portfolio approach vice project approach for leveraging private capital. Mitigation Banks have been an especially useful tool for furthering environmental projects, many of which could not have met mitigation requirements within the confines of the project area. A portfolio approach simply aggregates the benefits to the government.

— Alexandria, Virginia • May 2017

Founded in 1920, SAME is the premier professional association uniting public and private sector individuals and organizations from across the architecture, engineering, construction, technology, environmental and facility management, and contracting and acquisition disciplines in support of national security. The Society's membership includes over 28,000 members and 1,500 Sustaining Member companies, public agencies and academic institutions. SAME and its more than 100 Posts around the world provide extensive opportunities for training, education, and professional development through a robust offering of conferences, workshops, forums, webinars, publications, STEM outreach, and leadership and mentoring programs. For more information, visit www.same.org.



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