ONE SOLUTION TO CAPITAL BUDGET SHORTFALLS:
A Primer for Public-Private Ventures
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Preface

This paper was prepared by the Logistics Management Institute (LMI) as an Independent Research and Development project. It addresses public-private ventures—a major component of privatization—from the perspectives of different levels of government. In doing so, it draws upon previous LMI study projects and analyses undertaken for the Department of the Army, the Department of the Navy, and the Department of the Interior.

From our experience, we offer Federal, state, and local government managers an in-depth discussion of public-private venture concepts. Those managers will be responsible for ensuring that their communities receive the maximum value for funds they expend. And knowledge of the advantages, disadvantages, risks, and opportunities of public-private ventures will help them decide on the use of ever-decreasing purchasing power.
EXECUTIVE SUMMARY
One Solution to Capital Budget Shortfalls: A Primer for Public-Private Ventures

Privatization of government facilities and services is seen variously as the solution to government's burgeoning budget shortfalls and as an expensive and dangerous intrusion of the private sector into the public domain. In either case, the concept of privatization demands the attention of government managers and they should become thoroughly versed in its opportunities and pitfalls.

In this report we address a major subset of privatization – public-private ventures (PPVs) – from the perspectives of the Federal, state, and local governments. We explore the issues, give examples, present alternative strategies, and look at developments that are likely to affect the future of PPVs. Finally, we present a primer for senior government managers for initiating a PPV program.

Formulating a PPV program forces some fundamental policy decisions on a government manager. Some of the issues that manager must deal with are policy and operational control, capital and operating costs, liability and risk, accountability, performance monitoring, disposition of assets, and the role of special interests.

A government manager must also determine the strategies to use in developing a PPV program and to do so must clearly understand the organization's goals and objectives. Some organizations need alternative sources of capital financing while others see economic potential in underused government assets. Examples of strategies available to meet the goals include restrictive captive markets, financial risk-sharing, and packaging PPV opportunities. For those organizations that have several PPV opportunities, we advocate a comprehensive or global strategy that incorporates PPVs into a total government "business" plan for the long term. For example, a local government can structure a PPV by packaging unprofitable public golf courses with those that produce high revenues. The private sector can make a profit and the public sector can keep more courses open.

Developments in the PPV arena are both encouraging and discouraging to government managers. Executive orders, legislative initiatives, growing fiscal pressures, new services, changes in the tax code, and weakening public employee unions are some examples of forces affecting PPV attractiveness and prospects.

After discussing the policy, strategy, and developments in the future of PPVs, we offer a step-by-step primer for those senior government managers who want to explore and possibly initiate the PPV option. Structuring a PPV is a complex and time-consuming undertaking. Merely obtaining the authorizing legislation may take several years. The manager must assess the corporate culture of his or her organization to see whether it is favorable to PPVs and how much education will be needed to gain their acceptance. Sometimes the public must also be educated on the PPV concept. The manager must also decide on who is to conduct the economic and operational analyses and whether to establish a full-time PPV organization. We offer advice born of experience on these and the other steps involved in the entire process.

Our goal in this report is to give the government manager a thorough grounding in PPV concepts. The future of government facilities and services may or may not belong to PPVs, but the future of more and more government managers may depend on their knowledge of PPVs.
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Public-private ventures (PPVs) are a subset of privatization of Government facilities and services. In this study, we define public-private venture as follows:

A public-private venture is an activity that provides public facilities and/or services, wherein both the public and private partners materially contribute capital assets, and both parties materially share in the risk of economic profit or loss from the activity.

This study summarizes procurement, operational, and financing strategies for participating in PPVs. Its corollary purposes are to clarify the legal, tax, financing, and administrative issues that must be addressed before instituting a successful PPV program, to project the future course of PPVs in the United States, and to suggest an approach for Government departments that wish to initiate a PPV program. These issues are important at this time for several reasons. First, in working with various Government departments and the private sector, we have noted a wide array of strategies and approaches. More often than not, those strategies and approaches are implicit rather than explicit and have little basis in rational, goal-seeking departmental policy grounds. Second, many Government departments are not aware of the successful and unsuccessful strategies and approaches attempted by others. Third, Government departments attempting to use PPVs to provide public facilities and services need to discuss the major obstacles confronting them.

BACKGROUND

Under PPVs the local, state, or Federal Government shares a significant economic interest in the ownership of facilities and land with the private sector. The private sector may also operate the facilities to provide Government services to the general public, charging fees that are primarily established by market forces rather than dictated by the Government department. In either case, some elements of equity ownership and entrepreneurial risk are shared by the public and private sectors; hence, the term public-private venture distinguishes that activity from the more general activity termed privatization. In Chapter 2, we give a more complete discussion of the definition of PPVs and privatization in general.

Privatization programs in general and PPV programs in particular have been developed for many reasons. According to one privatization observer, "The impetus for privatization has two sources: (1) opposition to further growth of the public sector, and (2) the belief that the private sector would be a more efficient producer." While those reasons are important, others have added to the impetus for PPVs. At the Federal level, the budget cuts spawned by continuing large budget deficits in the 1980s and early 1990s have severely curtailed the ability of Government departments to replace older, worn-out facilities, thus threatening the Government's ability to maintain its existing level of services. The Federal budget cutting has also affected state and local governments as the amount of Federal grants and loans to lower levels of government has shrunk. In addition, the current recession and spiraling employee costs have added to budget problems at all levels of Government. Partly in response to these budget pressures, Government departments at all levels have increasingly looked to PPVs as alternative means of providing long-term facilities and the services that go with those facilities. PPVs are seen by many as alternatives that are less susceptible to budget and business cycles.

Another impetus for PPVs has been the public's desire to increase the use of unused and underused

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public assets. In some particular areas, such as forests and offshore assets, that desire has caused concern over nature and the environment. In other areas, such as underused urban government real estate, PPVs have offered opportunities for social and economic development that, while they do not threaten the environment, may threaten neighborhoods or entail congestion.

In the early 1980s, significant tax advantages also accrued to private-sector equity owners involved in PPVs. Those tax advantages spurred the private sector to actively seek out innovative PPV arrangements. However, such tax advantages were all but eliminated under the Tax Reform Act of 1986 and are no longer an impetus for PPVs.

STRUCTURE OF THE REPORT

The remainder of this chapter provides examples of PPVs at the Federal, state, and local levels of Government, and it reviews recent events that have variously encouraged and discouraged PPVs.

Chapter 2 discusses the current issues related to PPVs. In particular, that chapter discusses the policy, legal, financing, tax and other critical issues that must be resolved to successfully implement individual PPV projects or comprehensive programs. The chapter also discusses options for resolving some of the problems surrounding those issues.

In Chapter 3, we review and categorize the strategies used by government departments at all levels to plan and implement PPV programs. Such strategies are discussed in the context of governments' goals and objectives for PPV programs.

The future prospects for PPVs are discussed in Chapter 4. In that chapter, we consider the current and projected desirability of PPVs.

In the last chapter, Chapter 5, we suggest an approach a Government department might take in attempting to initiate a PPV program for the first time. We also present useful information on such issues as planning, legislative authority, departmental culture, economic feasibility analysis, and procurement policies.

EXAMPLES OF PUBLIC-PRIVATE VENTURES

While hundreds of PPVs could be used as examples, we cite only a few at each level of Government. The examples cited here are representative of categories of PPVs and strategies that Government departments use to implement PPV programs. (PPV strategies are discussed in Chapter 3.)

Federal Government

The Federal Government has been using PPVs for decades although the 1980s witnessed a marked increase in their use. The Department of Defense has implemented more PPVs and more types of PPV than any other Federal department. One of the reasons for this is that the Congress passed legislation giving DoD special, temporary authority and incentives to enter into a wide variety of PPV contracts. Other Federal departments are learning from DoD's experience and are also implementing innovative PPV programs.

Department of Defense

Army

The U.S. Army Corps of Engineers (USACE), Civil Division, has been using PPVs for several decades, primarily at recreation areas that are collocated with civil public works facilities. In particular, marinas on lakes and rivers controlled by USACE (e.g., dams and other hydro facilities) are a good example of PPVs. The USACE leases water and land rights to private-sector entrepreneurs for extended periods as part of a concession agreement that allows the entrepreneurs to construct, own, and operate those facilities at the entrepreneurs' risk of profit or loss. (In some cases, a portion of the revenues is shared with the Government.) In this example, the Government does not own the facilities but only owns the land and/or water on which they are situated. These PPV facilities are open to the general public since they are not on military installations, which is not usually the case with DoD-controlled sites. USACE has some operational guidelines that must be followed by the private concessionaire and its patrons; however, the concessionaire is otherwise free to provide facilities and services.
Another example of an Army PPV is the new temporary living facility (TLF) at Fort Drum, N.Y. A TLF is similar to a motel; the Army owns and operates many TLFs on other installations. The TLF houses Army families transferred to Fort Drum while they are seeking permanent living quarters. It is located on the installation on real estate owned by the Federal Government. The Army entered into a long-term contract for the TLF with a private developer-operator. The contract includes a lease of Government land to the developer—an “out-lease.” The developer is totally responsible for financing, constructing, owning, and operating the TLF for the life of the contract and assumes total risk of profit or loss. The Army provided a guarantee of the developer-operator’s debt obligations for the first 3 years of the contract; otherwise, the Army has no liability or commitment to the developer-operator. At the end of the contract term, the facility becomes the property of the Federal Government. The TLF at Fort Drum is not open to DoD civilians or the general public.

**Navy**

The Navy began a PPV program in 1986. Since that time it has implemented PPV projects for an administrative office building, bachelor officers quarters (BOQ), and a moving picture theater. The administrative office building, located at the Memphis Naval Air Station, Tenn., entailed a long-term out-lease of Government land as part of a contract with a developer-operator to finance, construct and own the building. The Navy agreed to lease the facility for the period of the contract, at which time the building will become the property of the Government.

The BOQ is a unique example of a PPV project. A BOQ is essentially an on-base hotel for commissioned officers who are temporarily assigned to the installation (e.g., for education or training) for less than 6 months. The typical assignment is 2 to 4 weeks. The Navy entered into a long-term contract (plan, design, and construction, plus 32 years of operation) with a developer-operator for BOQs at the Naval Submarine Base, New London, Conn., and Naval Education and Training Center, Newport, R.I. As with most other DoD PPVs, the contractor is responsible for financing, constructing, owning, and operating the BOQs. This PPV has two unique features. First, the Navy guaranteed a minimum 70 percent annual occupancy rate; otherwise, the entrepreneur assumes all risks of profit or loss. The Navy assumed that risk on the basis of historical data that showed more than twice this number of room-nights were being paid for at off-base hotels, at much higher room rates, because of a severe shortage of BOQ rooms. This sharing of risk allowed the developer-operator to obtain more favorable financing for the project. The second unique feature is that the contractor is allowed to rent unoccupied rooms to retirees, reservists, active duty family members, and DoD civilians. That feature also made the project more attractive to the private sector because both installations are located near seasonal seashore vacation areas.

The moving picture theater is located just outside the gate of Naval Station, Norfolk, Va., on the parking lot of a shopping mall owned and operated by the Navy Exchange System for the benefit of active duty sailors, their dependents, and retirees. The “six-plex” theater was privately financed and constructed and is owned and operated by a private entrepreneur under a long-term lease and contract. The theater is a modern, state-of-the-art complex that shows first-run pictures the same as any private theater. Because the mall is outside the fenced area of the installation, the Navy decided to allow the contractor to open the theater to the general public. The contractor must charge market prices to the general public but may give customary discounts to active duty sailors and their dependents.

**Air Force**

Like the Navy, the Air Force has contracted for a PPV BOQ project. It is for a 350-room facility at Nellis Air Force Base, Nev., and, like the Navy’s, it is for officers temporarily assigned for military training. The Air Force will lease 15 acres of its land to the developer for 40 years for the sum of $1.00, and the developer will finance, construct, own, and operate the BOQ.

Unlike the Navy, the Air Force will not contractually guarantee the facility’s occupancy rate. Air Force contracting officers worked hard to convince the private sector that the risk of a high vacancy rate
is minimal. Nor will the developer have the option of building additional rooms to rent to a wider market to increase the developer's revenues. A long-term comparison of the approaches taken by the two Services would yield useful data on how risk-sharing affects the ultimate cost to the Government.

**Pentagon**

The Pentagon is the world's largest office building. Several years ago, DoD initiated a project to establish a child care center at the Pentagon for children of its employees. Although some Federal departments also have child care centers located on-site, those centers are owned and operated/managed by employee associations and are not PPVs. The Pentagon child care center is a PPV. A private contractor owns the equipment and furnishings used at the center, operates the center as a private enterprise, and assumes all risk of profit or loss.

**Department of Veterans Affairs**

The Department of Veterans Affairs (VA) initiated a PPV program in 1991. Congress recently gave the VA special legislative authority to enter into enhanced-use leases for PPVs. That legislation gives the VA wide latitude to enter into long-term (e.g., 32-year) out-leases to obtain facilities and services for it and its clients. The VA's first PPV project will be in Houston, Tex., on VA land. It intends to issue a request for proposals (RFP) for administrative office space to be financed, constructed, owned, and operated by a private developer-operator on the VA's land. However, since the proposed site is larger than that needed to accommodate VA's needs, the contractor will be allowed to build, own, and operate non-VA facilities on the excess area of the parcel, provided the non-VA facilities meet certain acceptable use guidelines stipulated by VA. Therefore, this VA Project will comprise mixed-use facilities in two senses—mixed functional use and mixed public-private use. For economic reasons, VA is considering a contract clause to purchase the VA portion of the facilities before the end of the lease term; the contractor would, however, continue to own and operate the non-VA facilities for the duration of the contract.

**Department of Transportation**

The Department of Transportation (DOT) has been actively promoting PPVs and many other forms of privatization for many years. Most DOT PPV activities focus on assisting state and local governments with the planning and financing of PPV projects, often as stipulated in congressional legislation. A good example is the Farragut North Metro Station in Washington, D.C. DOT provided assistance to the Washington Metropolitan Area Transit Authority in the development of a mixed-use facility above that station. In this example, air rights were leased to a private developer-operator who constructed and operates an office building and retail shop complex above one of Washington's busiest subway stations in the heart of the downtown office area. This type of PPV project fosters economic development of the local area.

**Environmental Protection Agency**

The primary mission of the Environmental Protection Agency (EPA) is to foster and ensure compliance with Federal environmental laws. As with DOT, most of EPA's PPV activities focus on assisting local governments to obtain facilities and services that bring those localities into environmental compliance. To date, EPA funding has been in the form of demonstration grants (about $50,000 each) to develop PPV project proposals. A major issue, currently under debate in the Administration and in Congress, is whether a private entrepreneur acquiring an interest in a facility would have to repay any Federal grant or loan money that had previously been used to construct a local government facility. A recent Executive Order, discussed below, is a major step in resolving that issue. Depending on the implementation of the Executive Order, PPVs may become more viable for wastewater treatment facilities.

**State Government**

States are finding innovative uses for PPV techniques. According to a recent survey, 80 percent of state governments are planning to use PPVs in such applications as corrections, health, and educational facilities among others. The State of Tennessee, for example, was one of the first to use PPVs to get the
private sector to finance, construct, and own state prison facilities under a long-term lease and contract. The state operates the prison with its own staff of state employees.

Examples of state PPVs similar to the VA's enhanced-use concept are university research and technology parks. Several state universities (e.g., the University of California at Irvine and the University of Maryland, Baltimore County) have used PPVs on university land to obtain additional research, conference, and office space for school use in exchange for nonschool development that may have some synergy with faculty research interests. The private developer leases the nonschool space to research- and technology-related companies at an entrepreneurial risk of profit or loss over the contract term.

Based on recent state activities, transportation should see growing use of PPVs, propelled by the enactment of the Intermodal Surface Transportation Efficiency Act (ISTEA) of 1991. Toll roads are an obvious example. One of the most written-about proposals is the planned 17-mile extension of the state-owned Dulles International Airport Toll Road from the airport to Leesburg, Va. The extension would be financed, constructed, owned, and operated by a group of private investors at their own risk of profit or loss. Given the large capital investment involved by the private sector and the required permits and other legal issues, many people and groups are analyzing the feasibility of PPV toll roads, especially in view of the latitude granted by the new ISTEA legislation.

Since the majority of non-Federal public facilities and services are provided by local governments, state governments can also play an active role in assisting local governments in developing PPV programs. A few states (e.g., Pennsylvania) have special comprehensive initiatives in which they have allocated state staff and funding to assist local governments in the planning of PPV programs and projects.

Local Government

Local governments across the country have implemented a wide variety of PPV projects, from golf courses and marinas to solid waste disposal services and recycling facilities. Some of these projects, particularly large mass-transportation projects, have been partially funded in conjunction with the Federal Government.

At one end of the spectrum are public recreational facilities such as golf courses and marinas. In the mid-1980s, the City of Philadelphia entered into a multiyear contract with a private company for operation and maintenance of its five city courses - courses that had been operating at an overall net loss. The contract included a capital improvements escrow account (a percentage of gross revenues), and the contractor ran the courses at its own risk of profit or loss. In addition, the contractor paid the city a percentage of gross revenues. Other local governments have similarly contracted with entrepreneurs to upgrade and operate one or more of their golf courses, with little or no financial risk to the community.

Marinas are another interesting example of very successful PPVs, often handled in very different ways. In one case, the City of Racine, Wis., leased the rights to develop and operate a marina along its harbor for a one-time, lump sum cash payment from the developer. Another case represents a more intensive long-term involvement between the public and private partners. The County of Los Angeles set up an independent department to handle a PPV marina in the City of Marina Del Rey. Over 4,000 boat slips have been developed to date under long-term contracts with several developer-operators. Ancillary development has also occurred on the site, including retail shops and restaurants. All of the facilities were developed and are operated by private entrepreneurs with private funds. The county receives a percentage of the annual gross revenues from all of these operations. The county's revenues from this marina have far exceeded the cost of contract administration and oversight and have helped to pay for other nonrevenue-generating county services.

At the other end of the local government PPV spectrum are basic public services such as drinking water facilities, solid waste disposal services, and airports. For example, the planned new Denver airport and perhaps a third Chicago airport at Lake
Calumet will have PPV elements such as maintenance facilities. Similarly, across the border in Canada, two of the main terminals at the Toronto International Airport may be modernized and operated under a lease. A number of PPV toll roads and bridges are being considered by localities. One example is a 16,000-vehicle-per-day toll bridge near the San Juan, P.R., airport; the bridge will be built, transferred, and operated under a 35-year concession. The private group and the Puerto Rico Highway and Transportation Authority will share any after-tax profits above 19 percent on a sliding scale, with most of those excess profits going to the government authority.

Other PPVs are found in the area of environmental facilities. Waste-to-energy projects have been especially important examples of joint ventures in which facilities are owned and operated by private parties under contract to government. While recent tax laws have reduced the financial advantages of private ownership, private firms continue to construct and operate the facilities. Likewise, components of systems for sewage treatment, sewage recycling, and wastewater treatment frequently involve mixtures of public and private ownership and operation. In the case of solid waste disposal, a jurisdiction that permits the waste facility (landfill or waste-to-energy plant) to locate in its boundaries may receive cash payments and free service. Several local governments, such as Mt. Vernon, Ill., have contracted for private ownership and operation of waste treatment plants. As in the case of Downingtown, Pa., enlargements of existing facilities that were partially Federally funded may be undertaken by private companies that partially own and operate the facilities.

THE ENVIRONMENT FOR PUBLIC-PRIVATE VENTURES HAS CHANGED

A number of factors have changed the PPV environment: tax law changes, the economic recession, real estate and banking industry problems, Executive Orders, and Government legislation. These changes have added to the difficulty and complexity of determining the feasibility of PPVs.

Tax Reform

The Tax Reform Act of 1986 dealt a significant blow to PPVs by eliminating most of the tax advantages associated with privatization projects. That act placed restrictions on tax-exemption of bonds, resulting in the issuance of taxable bonds instead of tax-exempt bonds for some projects, at interest rates that were 2 to 3 percentage points higher. In addition, changes in the depreciation schedule, investment tax credit, and "at risk" rules have lessened the attractiveness of private ownership of facilities used by governments or financed by tax-exempt bonds. Nonetheless, certain opportunities in economic development and housing still exist for those tax-exempt bonds.

FEDERAL GRANT PROGRAMS

Over the past 20 years, the Federal Government has provided approximately $300 billion in grants for capital facilities owned and operated by state and local governments. According to Federal grant policies established by Circular 104 of the Office of Management and Budget (OMB) and implemented by the Uniform Administrative Requirements for Grants and Cooperative Agreements, public-sector entities that received grants have had to hold title to the assisted property and could not sell it nor use it as collateral. Were such property to be disposed of, the Federal Government would have been entitled to receive a share of the proceeds from the asset sale at the current market value. That share would have been the proportion of the Federal grant to the project's original cost. This "grant repayment" requirement has discouraged many privatization efforts. Any upgrade or replacement of facilities involving acquisition by or mortgaging to the private sector faced the costs of improving the structures and operations and also the cost of paying the Federal share of the transaction.

On 30 April 1992, President Bush signed an Executive Order that limits the amount that Federal aid recipients must reimburse the Government to no more than the original grant received less the
accumulated depreciation. That change may encourage the use of PPVs or asset sales where the value of the facility has appreciated substantially. Toll roads and airports are popular examples, although sewers and other infrastructure items are also possibilities. The technical feasibility and financing implications of this change need to be further examined.

Scoring

Similarly, the OMB was successful in having its project "scoring" guidelines for certain Federal PPVs signed into law. OMB regards many PPVs as lease-purchases. For example, if the Federal Government, over a fixed number of years, paid for the use of a private-sector asset on Government land and after that time the asset reverted to Government ownership, OMB would define the PPV as a lease-purchase. It would then require the PPV to be scored, i.e., having any annual operating costs approved by the Congress as a line-item requirement in the Federal budget. Such scrutiny increases the perceived risk to the contractor and undoubtedly drives up cost estimates. Moreover, the law also requires a PPV to be fully funded with sufficient budget authority in its first year to cover the Federal Government's termination liability. For some PPVs, such as those for military leased housing, the Federal Government's termination liability amounts to the lifetime cost of the contract. Such an arrangement is now little different from obtaining those same funds for the Government to provide the asset. Those funds are rarely available, of course, which is why the Federal Government agencies resort to PPVs in the first place.

Other Factors

The combined effects of the current recession, the precipitous nationwide drop in real estate values, and the savings and loan crisis have resulted in a lukewarm climate for many PPV projects. For example, PPV projects that involve the construction of new administrative office space part of which is to be leased to the private sector may only be feasible in a small number of carefully defined markets. The short- and medium-term future of the commercial real estate market is very much in doubt, which means that PPVs predicated on property value growth will be more difficult to justify economically.

The recession has caused most state and local governments to cut back on many facilities and services—those governments are not in an expansion mode. However, the economic situation has caused more local governments to investigate PPVs as options for providing facilities and services when public funding is in critically short supply.
CHAPTER 2
Issues in Privatization

In this chapter, we first review the meaning of PPVs within the larger context of privatization and then review, in general, the major issues surrounding cooperative efforts between the public and private sectors. Because PPVs necessarily involve a close, active contractual relationship and risk-sharing between the two sectors, they typically place those issues in boldest relief and require a feasible solution to them in the negotiating process.

PUBLIC-PRIVATE VENTURES AND OTHER FORMS OF PRIVATIZATION

In the course of our study, we found a wide disparity in the usage of the term public-private venture (or public-private partnership). To understand PPVs, we must first understand the differences in the types of PPVs and then how they differ from the other forms of privatization.

In the broadest sense, privatization involves private-sector participation in some activity that has traditionally been reserved for the government. Such a definition does not fix the activities because what governments take responsibility for and do are very much matters of tradition and local choice. For example, either the government or the private parties may perform many activities such as collecting garbage, servicing motor fleets, supplying water, and constructing and maintaining streets.

On another, more analytical level, one might view the phases and component parts of a service that might be provided - its design, financing, and operating and the capital requirements - and the possible choices between the public or private sectors performing those services. Along those lines, privatization alternatives for a service requiring the use of facilities (which most do to some degree) can be classified by the division of responsibilities into the following phases:

- Design and construction of a facility
- Financing of a facility
- Ownership of a facility or land
- Operation of a facility or the performance of a service
- Ultimate transfer of a facility to public ownership and operation.

A venture is an enterprise that may experience a loss and has a chance for gain. Thus, the concept of public-private ventures has its most precise meaning when it is applied to the active participation of both the public and private sectors in an undertaking wherein each party experiences risks and has the opportunity to be rewarded. To meet the requirement for active participation, a public entity cannot simply go to the private capital markets to secure a loan or license a service to be provided by a private entity; along with its private-sector partner, it must play an active role in negotiating an agreement that defines the nature, scope, and costs of a facility or service. The nature of the rewards and risks is normally, if not necessarily, monetary for the private-sector participant. The public participant may or may not realize a monetary reward or may or may not reap a public benefit in the activity being performed. Thus, as an example, a government may sell (or simply give away) excess or abandoned property to a private developer simply to get it off its books or to encourage beneficial development. The government runs the risk that the property will not be developed as planned and that the asset could have been used more productively in an alternative way. If things work out according to plan, it realizes the reward of having useless or unsightly property attain an economic value or be put to a use that is beneficial to the public.

The concept of risks and rewards in an undertaking also conveys the fact that, in most cases, PPVs are multiyear activities and so are the terms of
calculating the gains and losses for both sectors. Therefore, the definition of a PPV given in Chapter 1 is appropriate.

"Design-build" or "turnkey" construction projects are a special case under our definition. Under such projects, one contractor designs, builds, and possibly installs equipment in a facility that is turned over to the public sector for operation. The concept of mutual benefit and risk is present in such an arrangement. However, in most cases, private design and construction is merely the provision of a service and more a matter of procurement policy than one of a multiyear sharing of rewards and risks. Therefore, under our definition, design-build and turnkey projects are not PPVs.

Our definition of PPV is illustrated in Figure 1. The vertical axis (the Y-axis) measures the proportion of the venture’s economic value of capital assets contributed by the private partner; the horizontal axis (the X-axis) measures the proportion of the venture’s operations handled by the private partner. It is not possible to indicate a specific point on either axis that shows where PPVs begin. However, our definition of a PPV clearly eliminates the four corners of this capital asset contribution square. As labeled in Figure 1, corner a is a function that is totally owned and operated by the government and does not involve the private sector. Corner b denotes a pure lease whereby the government operates a function in an asset leased from the private sector. Corner c is a function that is totally owned and operated by the private sector and does not involve the government. Finally, corner d denotes a commercial activities contract whereby the private sector operates a function at its own risk in a government asset and contributes no capital assets of its own. You have to move away from the four corners to get a mix of public-private risk sharing and capital ownership.

A REVIEW OF MAJOR PRIVATIZATION ISSUES

As a subset of privatization, PPVs share in many of the concerns raised about greater levels of involvement of the private sector in the delivery of services or the provision of facilities. The force of those issues depends on how “governmental” the nature the activity to be provided is and whether the activity is currently being provided by a government. The major issues are as follows:

- Responsibility and policy control
- Operational control
- Operating costs

![Figure 1. The Boundaries of Public-Private Ventures](image-url)
• Capital costs
• Liability and risk
• Accountability
• Contractual complexity and monitoring of performance
• Special interests
• Disposition of assets.

We discuss each of these major issues in the following subsections.

Responsibility and Policy Control

This issue entails the responsibility and ability of the public sector to establish priorities in the allocation of resources and the regulation of private activity for the public benefit. Activities have historically fallen to the public sector because of their economic characteristics of joint consumption, an inability of the market mechanism to operate effectively, their essentiality, or because they were viewed as socially meritorious. Governments are unique in that they define social objectives and then regulate private activities and raise and expend resources to attain those objectives. The prime example of the latter process is the annual budget, in which tradeoffs are exercised among various forms of raising revenues and approving expenditures. Privatization of major activities, while not inconsistent with regulation, may be seen in practice as inconsistent with maintaining public responsibility and retaining public decisions on production and pricing. This apparent inconsistency arises when the government under contract with a private company grants that company latitude for setting its own rates or following its own procedures; it may also arise when the government gives the private company certain guarantees that limit its (the government’s) discretion and flexibility. Examples are “take or pay” contracts in the area of solid waste whereby the government agrees to pay a private company for that service whether it is used or not. The competition between solid-waste-to-energy plants and recycling plants presents another example of potential conflict. On the one hand, the waste-to-energy plants seek abundant high-grade (energy-rich) waste; on the other, the recycling plants wish to reduce the supply of waste. These problems are not unique to PPVs, but the activities become a matter of contract and less susceptible to the political alteration they might face if public bodies performed them.

Operational Control

Operational control entails the day-to-day decision making on the level and price of a service or the operation of a facility. Private control, it may be argued, is influenced by a different set of criteria and motivations than those found in a public entity. In the private sector, emphasis is placed on financial results (efficiency and profit maximization), whereas in the public sector, emphasis is placed on political goals (equity and service satisfaction); thus, the array and cost of services will differ depending on who provides the service. Under private control, costlier inputs will be minimized and unprofitable services will be eliminated. Thus, unless contracts are tightly drawn and output regularly inspected, they will tend to drive down costs and skimp on services to maximize financial results. The counterargument is that this behavior by private providers is desirable in that it reflects the “true” market-determined costs of service provision which are needed to make rational decisions about the quantity and price of those services. Furthermore, it is argued that where benefits are to be conferred to particular factors of production or classes of users, that choice should be addressed through redistributive policies not through inefficient operational procedures that bury actual costs and lead to uneconomic choices. Examples of such redistributive policies are abatements of charges to the elderly and preferential hiring practices.

Under a PPV, customer satisfaction need not be sacrificed; in fact, it may increase if the contractor’s revenue is critically dependent on customer satisfaction. For this to happen, customers must have alternatives from which to choose or they must have an explicit way to penalize the contractor financially for poor customer service.

A special area of concern for PPV facilities is physical maintenance, especially towards the end of the contract period. Given a fixed-length contract, the private partner has an incentive to mini-
mize maintenance expenditures as long as the facility is minimally functional. That attitude is in direct contrast to the objective of the public partner if the facility is to be turned over to the government at the end of the contract term.

**Operating Costs**

Operating costs are the costs of maintaining and operating a service or a facility. One of the major advantages seen in privatization is the incentive to minimize operating costs, linking the price system closer to the provision of public services. Operating economies are driven by the desire of the private sector to minimize costs to maximize profits. An advantage frequently touted is that a business-like operation, free from the labor and procurement policies and restrictions frequently found in government, can produce the same or better services at lower costs. Examples of restrictive procurement policies are those that specify quotas for certain groups (minority and women-owned businesses, for example), specify prevailing wage rates (as does the Davis Bacon Act), or require certain types of labor or materials (as with "buy America" requirements or the use of union labor only). The counterargument is that costs that reflect socially desirable objectives are appropriate for governments and the services they provide.

Firms specializing in services and facilities also claim greater expertise and economies of scale. For example, certain forms of managerial and technical expertise are too costly to employ on a regular basis in individual governments but can be shared by several governments through a contract. Examples are sewer treatment operating contracts whereby professional chemists and engineers can oversee several installations.

**Capital Costs**

A major argument in favor of government ownership is that governments are able to provide services, especially those that are capital intensive, at lower costs because of their access to capital at lower costs. This argument arises from three sources. First, governments typically have stronger underlying credit capacity because of their ability to tap into a larger and much more diversified economic base than the private sector. Second, governments effectively have natural monopoly positions, regulatory controls, and taxing powers and thus can mandate payments to meet obligations. Last, and unique to the United States, state and local governments can borrow at preferential rates of interest because of the tax-exempt nature of their debt obligations. Private businesses, on the other hand, need to earn competitive rates on their equity and must pay higher rates of interest on their equity capital.

Counterarguments favoring privatization are that governments can conserve their borrowing capacity (and lower their borrowing costs) by shifting part of the load to private-sector capital providers and that the private sector will use more capital-efficient means of production. Special tax advantages have been available to private capital employed in public-sector activities in the past and may reappear. For example, the 1986 Tax Reform Act greatly reduced benefits to private firms undertaking privatization techniques to finance public works. However, groups such as the Anthony Commission have argued for restoration of tax preferences to encourage privatization. Another argument frequently encountered is that private ownership can often acquire and construct facilities more rapidly than governments and that this speedy construction not only brings the facility on line faster but in periods of inflation, means a lower cost.

**Liability and Risk**

A major argument advanced in favor of privatization has been the notion that PPVs give the two sectors the opportunity to share in the risks of new ventures as well as reap their rewards. New ventures, especially those employing innovative or complicated technologies, carry an assortment of risks, and a partitioning of liabilities may lower the overall risk to any one party. For example, the building of a waste-to-energy plant involves the risk of timely completion of construction, of attaining prescribed levels of operation, and of a major

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calamity. One common arrangement is for the private party builder to construct, test, and perhaps operate a facility for a limited time before turning it over to the government (a turnkey project with limited burn-in operating responsibility). Effectively, the government is protected against design and construction risk and only absorbs risk when the project is completed (and receives the required permits). By the same token, the private party is guaranteed payment (often with incentives) if it completes the project on time. The notion is to affix the liability and risk to that party that has control and can effectively protect against risks.

On the other hand, the equity component is usually small in relationship to the overall capitalization and in most cases, the government with its lower cost of capital is usually able to protect (insure) against most risks at a lower cost than the private entity.

Another aspect of risk is that of the financial stability of the private party and any underlying guarantees. Most private parties will limit their liability and will retain the right to sell off their interests in the facility. If they default, the facility will typically revert to the public entity.

Accountability

A common assertion is that accountability in the public sector ultimately rests with the voter-consumers, whereas in the private sector, it rests with the private owners. That assertion is overly simplistic. In the public sector, accountability may or may not reside with the elected officials in the services area. For example, the level and performance of many services is mandated by superior levels of government, with little latitude given to the actual operators of the services. In other cases, publicly owned facilities may be controlled by boards and commissions that are distant if not wholly removed from the elected officials. In the private sector, providers of financial capital (bond-holders) may essentially dictate the bond contract basis levels of the pricing, quality, and continuity of the service provided and the condition of the capital stock. For example, an independent public authority, financed by revenue bonds, may be established to own and operate the facilities, and its operations may be strictly controlled by the terms (covenants) of the bond contract. Similarly, in the private sector, accountability may be jointly shared with public entities through contracts with the host or partner government and/or regulation of its activities by regulatory bodies other than the host or partner jurisdiction. An example is wastewater utilities. Accountability to the sponsoring public body may be obtained through contractual provisions. However, such contract provisions may cause the loss of efficiencies or greater uncertainties of future operation and pricing policies due to the increased restrictions.

Contractual Complexity
and Monitoring of Performance

Public-private cooperative relationships involve the assignment of responsibilities to the private sector through contractual relationships. The length and complexity of a contract depends, of course, on the degree of control and accountability that the public sector wishes to exert, the nature and complexity of the service being provided, and the distribution of liabilities and risks. Contracts entail expense in their drafting and negotiation and also in their effective oversight and enforcement by each party. Governments in particular tend to be at a disadvantage in drafting and negotiating contracts because they have fewer in-house resources and skills and they hesitate to incur costs often needed for good representation. Examples of the consequences abound in the private negotiation of solid waste disposal agreements with local governments where large, private firms have been able to get major concessions from small, rural governments. Contracts also entail a cost for monitoring to ensure the private provider performs in accordance with the agreement. Monitoring can be difficult where the service has many dimensions and subjective factors are heavily weighted.

Special Interests

Privatization can meet with problems when it affects special interest groups, either public or private, significantly. A major inducement to privatize may be to circumvent governmental labor costs and work rules. In areas in which public employee unions or the civil service are strong, privatization
may be used as a way to employ lower-wage, less-restrictive, more-productive labor. While economizing on labor or other costs may lower the cost of a particular service, it may threaten the political interest groups both in this area and as a matter of public policy.

On the other side of the transaction, privatization may be seen as a way to acquire activities and markets that can be manipulated to benefit private interests. For example, private control of service levels and acquisition policies of a privatized service may be used to earn ancillary profits for the operating or other private parties. For example, a contract with a private provider who uses a proprietary technology may result in a monopoly market for subsequent supplies and replacement parts produced by that vendor. Of course, the problem of selection of a particular system or process may be technologically endemic, whether the provider is public or private. Satisfaction or preferences for particular groups is not unique to privatization but permits the decisions to be further removed from public review than would occur with public body oversight.

Disposition of Assets

Both the public and private partners contribute material capital assets to the venture. The assets contributed by the government generally remain the property of the government at the end of the contract term. However, the assets contributed by the private partner may be given or sold to the government, given or sold to another private partner, removed completely, or retained by the private partner, depending on the terms of the contract. The precise contract terms for disposition of assets are not always clear and may be influenced by statutes, regulations, or various goals of the department’s PPV program.
CHAPTER 3
Public-Private Venture Strategies

INTRODUCTION

This chapter describes the strategies that governments have used to plan and implement PPV programs. The strategies we review are based on our definition of PPVs presented in Chapter 1. In discussing PPV strategies, we note their advantages and disadvantages because PPVs are entrepreneurial joint ventures that necessarily involve some element of risk (or disadvantage) for both the public and private parties. The public partner has to weigh its benefits against the risks.

No PPV program should be implemented in the absence of a comprehensive plan – a strategy. Some government departments use more than one strategy, particularly when the department has several different types of projects or multiple objectives. The types of projects, the economics of those projects, department culture, and department goals and objectives for PPVs determine the strategy set. Of prime importance are the department’s goals and objectives for a PPV program.

MATCHING STRATEGIES WITH GOALS AND OBJECTIVES

The PPV strategy for a government department should be matched with the department’s goals and objectives, which are the ends that a department wants to achieve; the strategy is the means to those ends. We have found, both through our experience and that of others that PPV projects can be structured differently on the basis of different PPV program strategies. The right strategy or set of strategies is the one that maximizes the department’s probability of attaining its goals and objectives. That statement becomes clear as we discuss various strategies in this chapter. The pyramid in Figure 2 illustrates the relationship between PPV projects, strategies, and goals and objectives. PPV projects are put together (i.e., individually structured and packaged together) to support a PPV strategy, and the strategy, in turn, supports the goals and objectives of the PPV program. Without a strategy link, PPV projects are planned and implemented on a piecemeal, almost ad hoc basis, without a clear strategy link to the program’s goals and objectives. This type of uncoordinated, project-driven rather than a strategy-driven approach to a PPV program may not efficiently use a department’s scarce financial and personnel resources and may not achieve the department’s goals and objectives.

Figure 2. The Strategy Link in a Public-Private Venture Program

We have also found, through experience and interviews with others, that the strategy-driven approach may help in fostering institutional understanding and support for the PPV program throughout all levels of the department. The strategy-driven approach better enables employees to understand the direction of the program and the reasons for the department’s policies and procedures for implementing an individual project or group of projects.

A department will typically have more than one goal or objective for a PPV program. PPV program goals and objectives are usually driven by a larger program need of the department. For example, the department may have a pressing need to increase the quality or quantity of a service to either its constituents or its employees. As a result,
and usually influenced by the existence of seemingly insurmountable financial resource constraints, PPVs are considered as an option. Preferably, before embarking on an individual project-driven approach to PPVs, the department will realize that the situation is not an isolated incident and it will formulate PPV program goals and objectives. Typical goals and objectives are discussed below.

**Bring Capital Construction Projects On Line Faster**

This objective is difficult to separate from the previous one since earlier completion of projects usually translates into cost savings to the government. For example, the Navy Department found that a private developer could complete a BOQ (i.e., a hotel) at least 2 years quicker than it could be completed following the normal procedures of the military construction program. This translated into 2 years of cost savings of the differential between commercial off-base rentals and the PPV room rentals—a substantial sum in present value terms.

However, completing a project as soon as possible may have benefits other than cost savings. Early completion of a PPV hospital addition may alleviate suffering and that of a PPV road may alleviate intolerable traffic congestion. Most of the reduction in time by the private sector is accounted for by the absence of intradepartmental and interdepartmental coordination that must occur in governments, and by the fact that the private entrepreneur has strong economic incentives to complete the project as quickly and efficiently as possible.

**Realize Economic Benefits from Unused or Underused Government Assets**

Governments at all levels own significant real property assets (i.e., land, buildings, and equipment), and many departments underutilize some of those assets. More efficient utilization could be an economic or budgetary boon to the department and its clientele. Such increased utilization could also promote economic development in the local community. We refer specifically to partially or totally empty government buildings, underutilized real estate in communities in which it could contribute to economic development or raise revenue. (We do not include important natural and environmental assets such as protected coasts and forests.) For example, the VA has an outmoded and now unneeded hospital in a section of Baltimore in which...
the Baltimore Orioles' baseball stadium was recently closed. Rather than merely letting that real estate lie fallow, the VA is entering into a PPV for a private nursing home, from which the VA would rent a minority percentage of the beds—beds for which the VA already contracts in the Baltimore area. The objective of the VA in this instance is to realize economic benefits for both the community and itself.

**Establish Institutional Structure for Sustained Project Development**

An important objective for some departments is to institutionalize PPVs as a permanent program throughout the organization. If PPVs are to become part of a department's traditional repertoire of approaches to providing public facilities and services, the PPV program must become an integral part of the organization. Different strategies are available to achieve this goal, including a centrally controlled PPV organization versus decentralized PPV responsibility. However, both strategies have an institutional structure as their goal. When that structure is realized, units within the organization will routinely consider PPVs as options and will know the policies and procedures that are available to evaluate, plan, and implement those PPV options.

**TYPES OF STRATEGIES**

Given a set of goals and objectives, the government department should develop a set of strategies to achieve them. We describe individual strategies in this section. The department will typically select a set of strategies that links its project opportunities with its goals and objectives.

Many of the strategies involve "in-leases" of facilities whereby the government department leases an asset from the private sector. However, such leases do not have to be part of most of these strategies. Long-term in-leases are disdained by some people because they are seen as lease purchases that are economically inferior to outright purchase, that commit the department unnecessarily to long-term contracts, or that circumvent the normal legislative approval process for acquiring fixed assets.

**Enhanced Use of Assets**

This strategy consists of offering underused facilities or land in exchange for other needed facilities or services. It usually goes along with the objective of realizing economic benefits from underused assets. By employing this strategy, the department is leveraging its assets to obtain other assets or services that it needs. The advantage is that the department does not have to use scarce budget resources or bond indebtedness to finance the facilities or services that it receives in exchange. The disadvantage is that the department may be committing its real property assets to one use for a relatively long period of time (e.g., 20 to 30 years). An example is the VA’s concept of offering unused beds to other hospitals in exchange for laboratory or X-ray services, or offering building or land in exchange for nursing home beds. Excess university land can be used for private research and technology parks that will share research facilities with the university. Government real estate can be used in a PPV to provide public recreation services such as golf courses and marinas. Fairfax County, Va., and other local governments have minimized the costs of new facilities by bartering county-owned land in exchange for private financing and development of office complexes. Besides the land the developer acquires, the proximity of the county work force and activities (e.g., courts or engineers) can offer ready-made markets for private interests.

A variant of this strategy is to offer underused facilities or land to provide public services in exchange for a share of concession profits. Under such strategy, the department gains fixed assets or public services and it also generates revenue that can be used to subsidize other government facilities or services. An example is Marina Del Rey in Los Angeles County which generates revenues to subsidize county-wide lifeguard services.

**Construction of Excess Requirements**

Under this strategy, the PPV entrepreneur is permitted to construct facilities beyond the department's requirements so that the private partner can operate them for profit in exchange for meeting the department's requirements, sometimes with profit sharing. This strategy has many varia-
tions. For example, the Navy’s strategy for PPV
hotels is to let the developer build more rooms than
the Navy requires for housing its trainees at tempo-
dary duty stations. The developer is allowed to rent
the excess rooms to other authorized customers (e.g., DoD civilians, reservists, etc.), and part of the
profits from the rental of excess rooms subsidize the
room rates of the basic Navy requirement. Another
example would be to allow construction of separate
office or mixed-use buildings on government land,
one for the department’s office space requirement
and the other or others for private-sector office or
retail rentals, with a public-private sharing of rental
profits. The advantage of this strategy is that the
department is leveraging existing assets to gain
more assets, services, or revenues. The disadvantage
is that it commits fixed assets for an extended
period of time.

Financial Risk-Sharing to Lower Financing Costs
and Profit Margin Requirements

Under this strategy, the government depart-
ment shares some of the financial risk with its
private-sector partner. While this strategy is for-
egn to the procurement process thinking of most
government departments, it can create significant
savings. Two important cost factors in any PPV
project are the cost of financing it and the profit
margin required. Both of those factors are heavily
influenced by how the private sector perceives the
project’s risk. The higher the risk, the higher the
interest rate charged by financial intermediaries to
fund the project and the higher the profit margin
required by the entrepreneur to take the necessary
risks. If the government department is willing to
share some of that risk with the private sector, it will
lower the project’s per-unit costs. For example,
based on its knowledge of past and future sailor
training requirements, the Navy was able to share
the occupancy rate risk with hotel developers for
hotels at major training sites. The Navy guaranteed
a minimum level of occupancy. It is confident that
occupancy is unlikely to fall below that minimum
and it is therefore unlikely to have to pay for empty
rooms. However, the entrepreneur parlayed that
risk-sharing into lower, long-term financing rates
and a lower profit margin and was able to reduce
the costs of the room rental. The advantage is lower
unit costs to the department and lower actual bud-
getary costs to the government and taxpayers. The
disadvantage is the government’s assumption of a
share of the risk that the condition of the guarantee
is not met.

Limited Monopolies for Infrastructure

Governments, especially local governments,
have a unique opportunity to offer public-service
monopolies in exchange for provision of infrastruc-
ture facilities and services. Some local govern-
ments are taking new approaches to this relatively
old opportunity by entering into PPV arrangements
that maximize economic benefits to the commu-
nity. A good example is airports. In the United
States, Denver plans to replace its current interna-
tional airport (Stapleton) with a new PPV airport,
parts of which will be owned and operated by the
private partner. PPV airports in other countries
have been relatively successful; London’s Heathrow
Airport is a good example, and Hong Kong is also
planning a PPV airport. Bridges and tunnels offer
additional examples for this strategy in the United
States, and several such strategies are now being
implemented in the United Kingdom, The Nether-
lands, Malaysia, and several other countries. Toll
highways and light railways are other examples,
primarily tried to date in other countries although
proposed private toll roads in California, Colorado,
and Virginia are relevant U.S. examples. The ad-
vantages of this strategy include private financing
(usually with no government financial risks) and
faster construction and implementation. The dis-
advantages include the possibility of needing spe-
cial legislative authority, public-private coordina-
tion in obtaining real estate, the large amount of
private-sector funds that must be secured, ques-
tions of ownership of the assets in case of default on
bond payments, among others. A recently com-
pleted study for the Department of Transportation
of three light rail PPV initiatives extensively ana-
alyzed these problems. Although successful projects
have used this strategy, it has proved to be one of
the more difficult ones to implement to date. Public
and private interests are working hard to overcome
the problems.

Leases for Economic Development

Government departments can use PPVs to pro-
mote economic development. This strategy is usu-
ally a by-product of providing mass transit facilities
and services such as subways and light rail. Those
types of facilities tend to increase both commercial
and residential property values in the immediate
area. However, PPVs allow government depart-
ments to take a more active role in these situations,
explicitly promoting economic development and
simultaneously adding to the tax base. For ex-
ample, leasing air rights above subway stations is a
PPV strategy that promotes economic development
in the surrounding area. The leasing of air rights
above the Farragut North Metro station in down-
town Washington, D.C., is a good example. The
Seacaucus, N.J., rail transfer station, which has 28
adjacent acres, is another such example. The ad-

dvantages of this strategy are obvious. The disad-

vantages are few, but some may not be obvious.

One of the main disadvantages is the possible con-
troversy in the local community over commercial
use of the property, especially in residential areas.

Social Policy Implementation

Local governments can use PPVs to implement
social policy, although such use is not normally a
primary objective of a PPV program. One can argue
that using PPVs to promote economic development
in depressed areas has beneficial social implica-
tions. However, a more direct social policy strategy
is to use PPVs expressly to achieve social goals. A
prime example would be to increase the supply of
affordable housing. Some local governments (e.g.,
Montgomery County, Md.), require certain types of
residential real estate developments to include a
minimum number or percentage of affordable hous-
ing units that can be leased or sold to defined lower
income individuals and families. In those situa-
tions, the community is foregoing maximum eco-
nomic development of the real estate, and therefore
foregoing maximum increases to the tax base and
revenues, in favor of achieving social policy goals.
The local government may directly participate in,
or control, the leasing or sale of these units to ensure
the achievement of specific levels and types of
social policy goals. The advantages are real eco-
nomic leverage over developers, without expend-
ing local budget dollars, to achieve social goals. The
disadvantages are, primarily, lower economic val-
ues of certain real estate and lower property tax
revenues, compared to unconstrained development
of the properties and possible discouragement of
development in general.

Restricted Captive Markets

Governments sometimes have the unique op-
portunity of being able to offer a restricted captive
market to the private partner. That strategy is
similar to the ability to offer a limited monopoly;
the difference is that the market is restricted to less
than the general public and is captive in the sense
that the customers in the market have limited or no
opportunities for purchasing the services elsewhere.
A good example of such a captive market is Military
Service personnel. The Navy, for example, recently
implemented a PPV arrangement for a first-run
motion picture theater at Naval Station, Norfolk.
Sometimes the department is able to allow the
private operator of such a PPV to supplement that
captive market from the unrestricted private mar-
ket. Such is the case with the Norfolk theater since
the Navy Exchange shopping mall is located on
government property outside the security-fenced
area of the complex. The advantage of this strategy
is that facilities and services are provided without
public funds, and the captive market enjoys the use
of those facilities and services that it might not
otherwise have had at all. Among the disadvan-
tages are that the captive market patrons might
prefer to have the facilities to themselves, and other
providers of the services in the local economy may
resist increased competition for their own public
market.

Revolving Funds

A strategy that takes a relatively long-term
view is the revolving fund approach. That strategy
attempts to provide a financing pool that will allow
more projects to be implemented over a relatively
longer time period than if the department attempted
to finance each project independently. Under this
strategy, the department uses seed money to estab-
lish a loan fund for planning and implementing
projects. As implemented projects successfully
generate revenues, their repayments replenish the
fund and it can start additional projects. An ex-
ample of this strategy is the State Revolving Fund
(SRF) established by the U.S. EPA. Our discussions
with other Federal Government departments re-
vealed that more attempts to establish such revolv-
ing funds are under consideration. The advantage
of this strategy is that it leverages a relatively small
amount of seed money for a relatively large number
of PPV projects. The main disadvantage is the increase in time necessary to implement a number of projects because of the need to await repayments into the fund.

Institutionalized PPV Programs

Once a department has made the basic decision that PPVs should be a routine option for facilities and services, it usually seeks a strategy to ensure that PPVs are routinely considered and not merely considered as an exception or after special directives. Such a strategy seeks to institutionalize PPVs by creating a set of policies and procedures for implementing them within the department. That way, PPVs have a departmentally sanctioned set of normal planning and implementation procedures that are known and understood by all decision-making units. Obviously, such a strategy can be implemented in different ways. One way is to establish a central PPV organization responsible for planning and implementing such projects. However, if the department consists of many subunits, especially if those subunits are geographically dispersed, it may attempt to diffuse the knowledge and experience throughout the organization, closer to where the decisions and programs are normally carried out. The VA is pursuing such a strategy for its PPV program. The primary advantage is that decision-making units are more likely to consider and accept PPV options as a matter of course. The disadvantage is the removal of PPV decision making from central control, possible duplication of effort, and the risk of missing opportunities to package PPVs to create a more attractive venture.

ENHANCEMENTS TO BASIC STRATEGIES

Any of the strategies can be enhanced in several ways. Such enhancements increase the likelihood that the strategy will succeed and that individual projects that are part of a strategy will succeed.

Packaging

Packaging of individual PPV projects may be the most important enhancement. Government departments are usually required to put PPV projects up for competitive bid. Such competition is generally beneficial for the department because it forces potential PPV partners to offer their best proposal to win the contract. However, too often departments put up individual sites (e.g., one golf course in a city). Such individual PPVs are not as economically efficient, for either the PPV partner or the government department. Both the government and the private sector achieve economies of scale in management, purchasing, etc., when several sites are under central control. We have seen situations in which no bids were received RFPs for PPV projects; in those cases, private-sector companies indicated that they would only be interested in multiple sites for management and other economies of scale. In that example, the government department was testing a single site as a pilot test of PPVs. However, that approach is atypical in practice, in both the private sector and the government.

Packaging is also good for other reasons. For example, a department may have a number of sites, some of which are “profitable” individually and others of which are “unprofitable” individually. The private sector would probably not bid on any of the unprofitable sites as individual projects. However, packaging unprofitable and profitable sites together in one contract can avoid this problem and may be better economically for the government than keeping all or any of the projects in house.

It is possible to package PPVs in several ways. National or regional packages can be devised for similar functions. For example, a package could include all of the sewage treatment plants in a county or all of the fast-food hamburger restaurants in the Army. Packages that include different functions can be devised for a local area. A single PPV contract for office space, a child care center, and a cafeteria is an example. Finally, packages can be devised that include profitable and unprofitable functions. An example is a package of several golf courses, only some of which are profitable.

Contract Options

By definition, PPVs are an entrepreneurial risk for both parties to the contract. Sometimes, especially in the early stages of a PPV project, the government department may not be able to predict all of the best possibilities for a successful PPV project.
Instead of making the RFP overly restrictive, a department can provide for other good entrepreneurial ideas by having flexible bid options in the RFP. One example would be to extend a “right of first refusal” to the winning bidder on a defined set of future PPV RFPs at other sites. Another example would be to allow the contractor to include other facilities and services not specified in the RFP or originally executed contract, as long as such additions are not in conflict with the defined parameters of the RFP and contract. A potentially important option is a contract extension. It is not uncommon for non-PPV government contracts to contain options for contract renewal without a new RFP competition. Likewise, PPV contracts may benefit from this same option.

**PPV Formalization**

As long as PPVs are considered “special, prototypes, nonmainstream contracting options,” or are otherwise set far apart from other contracting approaches, employees and subunits within the department will be more skeptical of using them as options and will be less likely to pursue them than the more standard contracting approaches. This problem cannot be easily overcome. The department must somehow “formalize” PPVs as a standard contracting option. Whether it does so by creating a central PPV unit that promotes PPVs or by creating PPV procedures and processes that can be used in a decentralized manner by all subunits in the same way that other contracting options are carried out, depends on the department’s situation. The end objective and result should be the same – making PPVs an option for every new and expanded facility and service project considered by the department.
CHAPTER 4
Factors Affecting the Future of Public-Private Ventures

The future development of PPVs depends upon a variety of factors that either will encourage such partnership approaches or discourage movement in that direction. Bear in mind that decisions about PPVs are seldom made on economic grounds alone; a PPV may be more or less costly in particular application, but its selection depends upon the perception of the need to control, and of the strength of special interests that stand to gain or lose on a particular undertaking. Since such ventures involve governments as one of the players, it is also clear that the ascendency of competing political philosophies and associated interest groups is critical to political conditions that either favor or resist the intertwining of public and private interests.

In this chapter, we assess a number of key factors that influence the pace and direction of privatization in general and PPVs in particular.

FISCAL PRESSURE ON GOVERNMENTS

The financial condition of many levels of government in the United States is as tight as it has been at any time since the Great Depression (1930s). Among the many reasons for this problem, the most compelling is the current protracted recession and the systemic restructuring of much of the economy.

Governments, faced with declining revenues and accelerating costs because of unemployment and poverty, are seeking ways to reduce costs, cease providing less essential (or less politically defensible) services, and shift responsibilities to others who are willing or able to finance them. Privatization and joint ventures are methods of reducing the scope, size, and hence fiscal burdens on the public sector. Furthermore, improvident governments faced with the political impossibility of raising taxes or user charges are increasingly ready to experiment with using the private sector to deliver some services and provide some facilities.

WEAKENING OF PUBLIC EMPLOYEE RESISTANCE

A decrease in the political strength of public employees is the inevitable result of the fiscal pressure and general economic restructuring of governments. Governments' desire to lower salaries and benefits and to eliminate restrictive public-sector work rules has been a major stimulant to PPVs. As public employment declines in the context of generally soft labor markets and weakening unions, public employees are likely to be more susceptible to alternatives that involve private partnerships (even if they mean some loss of public employment) and, in any event, to become less able to resist shifting activities to private ownership. Offsetting this over the longer term will be the relative lowering of public wages and benefits and relaxation of work rules that will make public operation more competitive with conditions found in the private sector.

LEGISLATIVE INITIATIVES

Recent legislation, at all levels of government, has tended to be more favorable to privatization. As was discussed in Chapter 1 in the subsection on State Government, the recently passed Intermodal Surface Transportation Efficiency Act of 1991 offers incentives in the areas of mass transit, toll roads, and bridges that are designed to stimulate privatization efforts and attract private capital to meet facility needs. These incentives include permitting the use of Federal aid in programs that involve private ownership and operation of highways and bridges (excepting the interstate system). In the context of declining Federal assistance, the U.S. EPA has undertaken an educational and technical assistance program to encourage privatization by its state and local government constituents. Aside from transportation, however, few Federal programs appear to be actively funding such efforts.
Other Federal agencies, such as the VA, are examining privatization techniques, including PPVs, to help finance their facility needs or to supplement their budget appropriations. These programs usually involve the granting of concessions at Federal installations or the marketing of redundant facilities or vacant land.

As discussed in Chapter 1, unfavorable Federal legislation was recently enacted when the OMB's philosophy of "scoring" PPV projects for budget purposes became part of Federal law. On the other hand, the recent Executive Order relaxing the barriers to privatizing Federally assisted facilities should bolster consideration of PPVs.

Most states have enacted legislation that accommodates PPVs or that is at least neutral on the subject. In the area of highways and toll roads, according to the Federal Highway Administration seven states have legislation permitting private ownership and operation of highway systems. In other areas, such as prison construction and operation, states have moved in the direction of requiring cost comparisons between public and private provision. One fairly recent survey of privatization concluded that lack of legal authority was not a major handicap to greater privatization efforts.

With no sign that fiscal pressure will abate at any level of government, the trend should be toward greater liberalization of laws and intergovernmental aid programs to either permit or, indeed, foster use of PPVs.

INFRASTRUCTURE NEEDS

Infrastructure needs are seen as an especially important stimulus because they typically require heavy investments of capital and frequently sophisticated technologies (such as in the case of waste-to-energy technology). The attractiveness of PPVs (as opposed to having conventional government build/own/operate) is heavily conditioned, as has been pointed out, by tax considerations and the ability of the private sector to get adequate returns on capital at given levels of risk. The issue of tax law changes is considered in this chapter, but as tax law is now constituted, private ownership or operation of facilities has no advantage.

Generally, governments that borrow for what are considered by the Federal Tax Code to be governmental purposes, can raise capital at cheaper rates of interest than a private-sector borrower or equity provider. Under the limitations placed on the use of tax-exempt bonds, any material involvement of the private sector in the ownership or use of the facility means the added financing costs of selling taxable debt or, even where limited tax-exempt financing may be available, delays in project timing because of the system of caps placed on private-activity financings. Privatization therefore appears to have greatest advantage where the government is simply precluded from being the capital-raising partner or it is able to expend funds from sources other than borrowing. On the other hand, the generally low rates of interest on debt in the markets has lessened the role of debt service in the cost of facilities. They also have squeezed the absolute differential between taxable and tax-exempt interest rates and have made relatively more important benefits that will be experienced in future years, not forcing the rapid payback that is implicit in the high interest rates of a few years ago.

NEW DEVELOPMENT AND NEW SERVICES

While the fiscal pressure on governments as a result of recessionary conditions has encouraged interest in privatization, development and new-investment opportunities are at low ebb. They are particularly low in the case of commercial real estate where, because of previous overbuilding, an inventory of property is available that experts believe will take several years to absorb. However, even in a saturated market, pockets of opportunities exist for PPVs. For example, a primary motivation in private road building is that the value of land along the right-of-way will increase. The same is true of air rights and terminals in the case of mass transit joint ventures. Such prospects of increased property value in a generally flat market make the private sector more eager to participate in PPVs.

A similar situation is found in the implementation of new services. Public-private ventures are easiest to institute in new, growing areas and for new services in which governmental bureaucracies and other vested interests are not already embed-
ded. Slow economic growth and a cessation of development mean that in the near term, opportunities for PPVs springing from new services will be limited.

CHANGES IN THE TAX CODE

The current Federal Income Tax Code does not encourage PPVs. In fact, the Code has been progressively changed over the past decade to discourage such relationships when it comes to private-sector involvement in the ownership, use, and financing of facilities. The primary deterrent is found in the otherwise tax-exempt treatment that is accorded to debt sold by state and local governments for governmental purposes. That favorable treatment, which leads to lower interest rates on state and local government securities, is lost when private use or ownership of facilities financed with such debt (either directly or through loans from the debt proceeds) exceeds certain thresholds.

Between 1981 and 1983, the Tax Code included various inducements to such partnerships, but a procession of tax changes, culminating in the Tax Reform Act of 1986, whittled those inducements into extinction. Aside from a few special cases involving wastewater treatment, airports, nuclear waste, and recycling, few opportunities are available to secure a real venture relationship and retain access to tax exemption.

Several varieties of tax changes have been proposed by members of Congress and by study groups to soften the tax-exemption restrictions on private participation in projects for infrastructure purposes where there is a public benefit that outweighs the level of private involvement. At this time, however, we see little likelihood of any substantial loosening of the Federal Tax Code that will encourage greater use for these types of instruments as long as the “Budget Agreement” remains in place. Although less widely discussed, other once-favorable tax provision changes such as permitting accelerated depreciation and investment tax credits – which once were available to certain types of infrastructure facilities even when they were owned or used by private entities – appear even less likely to reappear.

EDUCATING GOVERNMENT DECISION MAKERS

As of today, PPVs are not yet a permanent part of government departments’ contracting options for facilities and services; they are still considered “special” alternatives. Part of this situation may be because government decision makers do not fully understand the advantages and disadvantages of PPVs compared to other options and are unsure of the situations in which PPVs may provide a feasible option. Decision makers must be continually educated on PPVs in order to increase their efficient use in providing public facilities and services. An important part of that education is to get the government to think more like its private-sector partners when considering PPVs. The private partner must be enticed to join the venture for economic reasons. The public partner needs to fully understand the economics of the venture from the private partner’s point of view. An understanding of both perspectives is necessary to attract willing partners and to protect the public assets from uneconomic ventures. An important implication is that the government department should be able to construct pro forma income statements for the private partner’s operations in the venture. By doing so, the government departments will better understand the true costs of owning and operating the facilities and services themselves. However, government departments are not used to thinking like the private sector and may need assistance to achieve this understanding.

SUMMARY

More and more serious consideration will be given to all forms of privatization, including PPVs, in the immediate future as current and foreseeable economic and fiscal conditions dictate a determined and, in many cases, desperate search for alternative ways of delivering services. Furthermore, Federal assistance programs, especially the new ISTEA, offer encouraging demonstrations of PPVs albeit at a subdued pace and with several institutional obstacles to hurdle.

However, the slow economic conditions and depressed real estate values will take part of the
private sector's vigor out of active participation in the short run. Currently, the Federal Tax Code does not promote these ventures on "tax-driven" grounds – the Tax Code is essentially neutral with respect to PPVs. That means projects will continue to depend on their intrinsic economic value, that is, their ability to be self-sustaining and to generate income. This is probably desirable for the long run because it will ensure that PPVs become a permanent part of contracting options based solely on their economic merit to society. In the case of capital-intensive infrastructure projects, public-private arrangements will tend to be more expensive than when they were exclusively financed by the public sector. This disadvantage, however, will be offset by projects for which the infrastructure is used in support of new or rehabilitated property development such as low- and moderate-income housing and business developments.

On balance, PPV methods will evidently receive a more intensive examination. Although the rate at which they are agreed upon may not increase greatly, a more widespread and systematic examination of that option will take place. A greater emphasis will be placed on the project-by-project examination of benefits and costs of alternatives and on the assumption that the public sector needs to own and operate simply because it is the cheapest source of financing will be subject to closer scrutiny. The new discipline of systematically examining the alternatives sets the stage for greater adoption of PPVs in the future as economic and fiscal conditions improve and as Federal policies perhaps once more encourage PPV alternatives.
CHAPTER 5
An Initial Approach to Public-Private Ventures

This chapter provides guidance to the senior government manager who wants to explore and possibly initiate the PPV option. The discussion assumes the definition of PPVs as stated in Chapter 1. The discussion also assumes that the government agency is large and you have many PPV opportunities. That scenario is the most complex one. However, if your government department is small and you have only one or two PPV options, most of the discussion still applies and you can easily identify and ignore those portions that do not. Figure 3 outlines the entire process of PPV implementation.

![Figure 3. The PPV Implementation Process](image)
The first caution for those of you entering the PPV arena for the first time is not to underestimate the length of the process. The time will be considerably longer if you do not yet have the legislative authority to use PPVs. For example, the VA needed 2 years to get congressional legislation to use PPVs. A Federal agency should expect a 1- to 3-year effort to obtain authorizing legislation. At the local level, although PPVs are prohibited in some states, recent surveys suggest that most officials find existing laws sufficient to authorize them. At both levels, however, if additional legislation is needed, the length of time to get it will be influenced by the type of PPV you are considering and the sensitivities of the legislating body at the time you apply for authorization.

Before such a major effort is undertaken, you should answer two questions: First, could the PPV concept help you to meet your agency’s goals and objectives? For example, is your construction backlog growing so much that normal appropriations or bonds can no longer satisfy it, or are appropriated operations and maintenance funds so scarce that they need supplementing from some other source? Chapter 3 discusses the reasons agencies initiate PPVs, but whatever your reason for choosing the concept, it must support your agency’s broader goals and objectives or it is unlikely to receive the enthusiastic support it will need. The second question to be answered is does your agency have an asset that the private sector might be willing to pay for either directly through a cash flow or indirectly through services provided or at least through lower costs on those services? Such an asset could be land, a good location, or simply a level of patronage that you can offer to or even guarantee a contractor. For example, locations in rest areas along major highways are of major interest to concessionaires. If the answer to both of these questions is yes, your legal staff should begin the process of preparing contract outlines or securing the legislation needed to authorize you to enter into PPVs.

EVALUATING THE ENVIRONMENT FOR PUBLIC-PRIVATE VENTURES

As your legal staff develops the needed PPV legislation or contract outlines, you should take stock of your corporate environment to see how supportive it is likely to be. The first place to look is in your department’s internal regulations and directives to see whether any self-imposed roadblocks to PPVs exist. Your department may have restrictions on contracting or what uses can be made of its assets. Rules may also be imposed by organizations outside of your agency. The U.S. OMB, for example, does not prohibit PPVs in the Federal Government but it does impose some budgeting rules that make them less economically attractive (see Chapter 1). Identify any internal policies that will inhibit PPVs and work with appropriate officials to change them or suspend them for PPV test projects.

In addition to the written rules and regulations that govern your agency, you must assess how its “corporate culture” will support the PPV concept. How open is your agency to new ideas? To be successful, you will need the support of the senior in-house staff, the contracting division, the legal department, field divisions, and probably the construction division. The staff of some of these functions may perceive PPVs as a threat and be reluctant to support the idea. For example, a construction division may see a PPV to construct office space as a major departure from its normal practice that will cause turmoil and extra work. It may also fear a loss of jobs in its design section, for instance, if the PPV approach is successful and results in a major reduction of conventional construction.

You will probably have to mount a major education and corporate relations campaign to sell the idea of trying PPVs to support your agency’s goals and objectives. The VA produced a pamphlet to publicize the PPV concept and help its staff understand it. The Navy conducted a series of on-site, educational briefings for all of those functions affected by its first PPV test projects. Do not forget to use the arguments of the indirect benefits that PPVs generate such as additional tax revenues, new jobs, and economic development. You cannot assume that the PPV concept is so good that it will sell itself. You will have to work hard to assure its acceptance or it will be summarily rejected or die a slow bureaucratic death.

Besides having to sell the idea of PPVs internally to your government agency, you may also have to sell the idea to the public. The public may
be distrustful of the idea of private-sector involvement in its public assets and services. Many of the arguments you use to sell the PPV concept internally will also be helpful in the public forum.

**STEPS TOWARD A FIRST-TIME PUBLIC-PRIVATE VENTURE**

**Initial Assessment**

Before you expend many resources exploring PPVs for your agency, you should conduct a cursory review of PPVs to see whether they are appropriate and have potential for your agency's requirements. With a few telephone calls you can check on the experience of other state or Federal agencies with similar requirements. A check on some of the PPV literature related to your agency's requirements will also be useful. For example, *Public Works Financing* is a quarterly supplement dedicated to the entire spectrum of PPVs. Finally, your membership in professional organizations such as the American Public Works Association and the Association of Physical Plant Administrators may give you access to your field's record of success with PPVs.

With the information you gain from your initial inquiries, you should perform some "back of the envelope" economic analyses. What assets do you have to offer that are likely to be profitable for the private sector? If you are hoping to build PPV parking garages on government land, for example, what is the going rate for parking fees and how many of your employees will be likely to pay it? Such cursory analyses cannot be used for any major decision making but they can steer you away from pursuing PPV solutions that simply will not work. In a market glutted with vacant commercial office space, for example, a PPV for administrative space is unlikely to succeed. You can use your cursory PPV inquiries and economic calculations to help sell your ideas within your agency and to the public.

**Organizational Steps**

When you are ready to start seriously exploring the feasibility of using PPVs in your agency, you will have to make some initial policy decisions. The first is whether to rely on your in-house resources or consultants to analyze the options and their feasibility and to initiate the PPVs. The decision depends on the following factors:

- The strength of your in-house analytical staff. The research and development will require detailed financial analyses of both in-house and alternative private-sector options and operational feasibility analyses.

- Your staff's familiarity with PPV concepts. Many agencies have hired people specifically for their PPV experience. Without such first-hand experience, examination and implementation of the PPV concept will be a slow process and may lead to a contract that is seriously flawed.

- Your staff's familiarity with the private sector. Structuring a PPV requires knowledge of how the private sector works, how it views risk, and what will attract it to a joint venture with a government agency. One of the greatest challenges in structuring PPVs is to educate government officials to think in terms of a business environment: profit and loss, return on investment, tax considerations, and the time value of money.

- The kinds and amount of resources you have available to support the PPV research and development. That effort will not be free whether the resources come from in-house staff moved off of other projects and workloads or from outside consultants paid for through a contract.

Most government agencies rely on consultants to examine the feasibility of PPVs and structure the PPV program. As the in-house staff gains experience in dealing with the PPVs, it often takes over more of the workload, especially if all of the potential PPV projects fall into the same category toll roads or child care centers, for example. If, on the other hand, your PPV opportunities span a number of industry segments, you will need consultant support for some time. It is difficult for an in-house staff to become expert in the nuances of every industry.
For very large government departments, the second decision required in this step is whether to set up a full-time PPV department or whether to rely on the assets spread around existing departments and make PPV an additional duty. That decision is needed regardless of whether the actual research and development will be handled by in-house staff or by consultants. Usually, an agency begins with an ad hoc team comprising representatives from the required functions. As the concept begins to appear desirable and feasible and the workload increases, a full-time PPV department is established. The factors affecting the decision are as follows:

- The potential size of the program. A department with a large number of requirements that could be satisfied through PPVs will find that establishing a full-time PPV department is more efficient.

- The complexity of the issues. For example, if gaining the legislation necessary to enter PPVs is going to be an uphill battle, a full-time attorney or legal assistance team may be needed fairly early on. Another consideration is the amount of education and “marketing” you will need to sell the concept in your corporate environment. A dedicated team may be required if the concept is to gain acceptance.

- The urgency of the requirements that might be satisfied by PPVs. If you are working to a tight deadline, you will need a full-time team to focus the effort needed to resolve the issues, come to a decision, and initiate the projects. Ad hoc committees of representatives are notoriously slow at meeting those objectives.

**Strategy Determination**

You should start to develop your PPV strategies early in the process. First, you should decide how comprehensive a PPV program you should aim for. If you are part of a large government function with many PPV opportunities, we advocate a PPV program in the context of your entire spectrum of requirements. This means that instead of selecting PPV projects on a piecemeal basis, you should make PPVs part of your long-term and business planning. For example, it may be far more cost effective to package your PPVs regionally or across functional lines to capitalize on the private sector’s economies of scale. Such a comprehensive or “global” PPV strategy is essential to reap the full benefits of PPVs and it may even be necessary for the PPVs to succeed.

Formulating a global PPV strategy is a major undertaking, however, and will be complex and time consuming. It requires complete financial and operational knowledge and understanding of your activities, the industry segment that would support the PPVs, current and projected availability of investment capital, and the markets that exist where your activities are located. The knowledge of the private sector must be combined with knowledge of your in-house operations to determine what combination of in-house and PPV activities would best meet your organization’s objectives. The complexity prompts many government agencies to seek outside help in developing their global strategies.
An outside look at your activity will not only help you in developing your PPV strategy, it can also provide some insight to your in-house operations that only an outside, impartial analysis team can bring.

Few government agencies are willing to implement a global PPV strategy on a grand scale without first testing the ideas on a smaller scale. Deciding how you will test the PPV concept is the other requirement of your strategy formulation. You must structure the test and decide on the criteria for its success. You may decide to test the concept on a few carefully selected PPV opportunities. However, if you are to know that the PPV is more cost effective than its conventional alternative, you must make arrangements to determine the price of the conventional alternative. If one of your criteria is public acceptance, you must make arrangements to measure the level of that acceptance.

If you have decided to use consultants to help support your PPV research and development, you will probably need them during this strategy determination phase. This is also the point at which an industry forum will be useful. At such a forum, industry representatives are invited to attend a briefing on the broad concepts of your PPV strategy and to comment on its feasibility and how much industry interest it is likely to attract. These forums can be lively and usually include discussions on degrees of risk and who should assume it. Your strategy will likely be modified based on what you learn from the industry. However, your chances of a good response to any future requests for contract proposals (RFPs) will be much improved.

Requirements Priorities

If you have many opportunities for PPVs, you should establish priorities for them according to the order you want to try them. This setting of priorities can get complicated if you have conflicting priorities from the field or a variety of PPVs dealing with different industries. You should choose your first PPV candidate carefully, however. In the eyes of your agency it will be the test case for the viability of the entire PPV concept. If it fails for any reason, the credibility of the PPV approach will be damaged and you may find it harder to sell the next attempt. Your selection of your agency’s first PPV should consider the following:

- How well it supports your agency’s goals and objectives
- Its complexity and probability of success
- Its projected economic payback
- The concerns of departmental and field managers
- How well it will serve as a successful test of PPVs and as a model for future PPVs.

Detailed Analysis

Until now your operational and economic analyses of the PPV options have been cursory to help you decide on the general feasibility of PPVs in your operations and to select the first project to try. Once you have selected your first candidate, however, you are ready to conduct a detailed, site-specific analysis.

You must decide how much time and effort you should spend on this detailed analysis. Some believe that the analysis does not have to be too rigorous and that the agency should prepare RFPs for several projects, issue them, and see which ones work the best. That approach certainly saves time and the cost of an in-depth analysis, but it has some drawbacks. The cost of drafting an RFP, releasing it, and evaluating the responses is quite high. If you have to issue several RFPs before you get it right, the cost could easily exceed the cost of a proper project analysis. Also, if you have many candidates in the same category, the major cost of the first analysis could be amortized over all of the PPVs. Moreover, without such an initial analysis, you can never be sure that the RFPs are structured to give you the best deal from industry on your PPV opportunities. More important, however, is the damage you may do to the credibility of the PPV concept by releasing a poorly structured RFP or an RFP on a poor PPV candidate. Your in-house credibility may be damaged, making it harder to try again, and your credibility with your industry counterparts may also be damaged. Responses to RFPs
are costly for the private-sector respondents and you do not want to waste their time and money. We have seen evidence that if the first RFP is ill-conceived, you may be ignored by the industry on subsequent attempts. For all of these reasons we advocate a full operational and economic analysis.

Your operational analysis should look at how well a PPV would fit into the operational requirements of the selected site, and it should be done in conjunction with the economic analysis. For example, two military installations wanted to enter PPVs for golf courses on their properties. However, the economic analyses showed that to be profitable, the courses would have to be open to the public. One installation then declined because of the sensitive nature of its military operations.

The economic analysis is much more involved than most government officials realize. You must construct and analyze pro forma income statements for the private-sector alternatives, and to do so, you will have to gather a lot of information from the private sector and understand how that sector operates. If the PPV alternative is to replace a function that you currently do in house, you will also have to construct similar pro forma income statements on your own operations in order to compare the alternatives. We have found that this often presents enormous problems in data gathering because government departments simply do not account for costs in the same manner or in the same detail as does the private sector. If this is the case in your department, you will have to do some cost measuring and estimation to support the internal income statements.

The economic analysis should project the net present value and cash flow of various options for the PPV. In the golf course example above, for instance, analyses were done for the course open and closed to the public and for various green fees that the contractor might charge. This sort of sensitivity analysis is useful not only to test the options but also to measure the degree of risk. If the revenues are highly sensitive to changes in a particular parameter, that parameter should be examined closely to ensure that the assumptions made for it are reasonable.

We advocate modeling the PPV on a computer spreadsheet to facilitate the analysis, especially the sensitivity analysis. A computer model is especially worthwhile if it can be used for more than one site. Moreover, it can also be used to help evaluate the proposals during the source selection process.

The modeling process will also help to identify the assumptions that must be made for the analysis. You may have to decide, for example, whether the industry you are dealing with is likely to finance any construction through conventional loans or with certificates of participation (COPs) or municipal bonds. The latter methods will lower the developer's debt burden and part of the resultant savings may be passed on to the government in the form of a more favorable proposal. In the past, this type of analysis has led us to encourage the use of COPs or municipal bonds in the RFP and at the preproposal meeting.

You should not view the operational and economic analyses as an independent phase. In reality they become an integral part of debates such as how much operational control to give to the contractor and how complex the contract will be to monitor. The decision makers will want projections and outcomes from every possible scenario as they develop the requirements and constraints for an RFP.

The Request for Contract Proposals

Requests for contract proposals for PPVs are invariably for negotiated contracts rather than firm-fixed-price contracts for a prescribed set of services or goods. You must decide how much flexibility to give to the proposers. For example, you may have land on which you want a contractor to build some office space in return for use of the remaining land for revenue-producing ventures. Are you going to place any restrictions on the use of that land? Flexibility in RFPs makes the proposal difficult to compare but enables you to capitalize on the private sector's expertise and imagination. Comparisons are usually made with the help of net-present-value analysis, and at that point, a computer model of the venture again proves useful. Such a model also allows sensitivity analysis of the proposers' assumptions.
We advocate making the RFP as short and as simple as possible. A PPV will often bring in proposers who do not usually contract with governments. We have seen instances in which the sheer size and complexity of a government RFP has discouraged desirable proposers. You should also appoint a single spokesperson to represent your government’s interests during the RFP and contract negotiation stages. Do not air differences within your organization in front of the private sector.

Also, during the RFP formulation and coordination stage, you will control decisions on how the PPV contract is to be managed. It is imperative to educate your department heads on the differences between a PPV contract and the conventional contracts they are used to dealing with. For example, we have seen cases where an agency’s construction division wants to impose all of the normal inspection and control on the contractor’s construction even though the contractor will pay for and own the facility. The result not only discourages the proposers but eliminates some of the factors that make PPVs more cost effective, such as faster construction. The RFP formulation and coordination stage, more than any other point in the process, is where you must encourage your agency’s staff to think more in terms of what drives the private sector. If the contract imposes so much bureaucracy that it becomes unattractive to the private sector, all of your work to this point will have been in vain. We are not advocating the abrogation of your responsibility to guard your constituents’ welfare. However, in many instances control of the PPV should be left to market forces rather than government regulation. Central control of a market economy has been shown to fail. In the construction example above, the contractor should be required to follow local building codes and generally be allowed to build the facility to maximize revenues.

Another common problem is the reluctance of government agencies to make the contract term long enough to enable the contractor enough time to amortize the start-up costs and enjoy a reasonable return on the investment. Throughout the RFP formulation you should look for ways to reduce the contractor’s risk without disproportionately increasing the risk to the government. When contractors respond to RFPs, they will invariably translate perceived risk into higher prices. Government guarantees can lower the respondents’ perceptions of that risk.

You and your legal staff must decide what is to become of any property provided by the contractor once the contract has expired. For example, at the end of the contract term does a building’s ownership revert to the government? If so, it may be argued that the contract is a lease-purchase and not a PPV construction contract. On the other hand, if the government even hints that its land must be returned to its original state, the cost of equipment removal and building demolition will be added to the proposals.

Many of these points will be brought out during a preproposal conference with prospective proposers. This conference is important since PPVs are new to you and may be new to the segment of the private sector you are hoping to attract. It may reduce some of the proposers’ perceptions of risk and will give you a clearer picture of what to expect in the proposals and how to evaluate them better.

Finally, be prepared for some tough negotiating. You will be in the private sector’s domain. If you are a soft touch, the private sector will eat you alive. If, on the other hand, your negotiating fails to acknowledge the private sector’s need to reduce risk and generate a reasonable profit, you will drive away the very entrepreneurs you are hoping to attract. Your best protection from either of these extremes is to become knowledgeable in the industry environment you are dealing with. Know what its operating ratios and usual contract terms are. You should also set a timetable for the negotiating process. Government organizations tend to spend a great deal of time on internal coordination and decision making. Minimize the number of decision makers involved and insist on rapid turnaround.

Evaluation

The final step is one often overlooked. Once the PPV contract is awarded and the concept is seen to work, do not succumb to the temptation to declare victory and move on. If the project is a test case, this
point is where some of your most important work begins. The criteria for success that you established at the beginning of this process should be dusted off and applied to your evaluation of the results. The costs and benefits must be compared with normal operations. Look at the total cost of the PPV, not just the contract cost. For example, contract administration costs should be factored in.

Finally, you should schedule a lessons-learned session with all of the relevant department heads. You should use the results from this session to improve the next PPV on your priority list.
Privatization of government facilities and services is seen variously as the solution to government's burgeoning budget shortfalls and as an expensive and dangerous intrusion of the private sector into the public domain. In either case, the concept of privatization demands the attention of government managers and they should become thoroughly versed in its opportunities and pitfalls.

In this report we address a major subset of privatization — public-private ventures (PPVs) — from the perspectives of the Federal, state, and local governments. We explore the issues, give examples, present alternative strategies, and look at developments that are likely to affect the future of PPVs. Finally, we present a primer for senior government managers for initiating a PPV program.

Our goal in this report is to give the government manager a thorough grounding in PPV concepts. The future of government facilities and services may or may not belong to PPVs, but the future of more and more government managers may depend on their knowledge of PPVs.