



Is risk transfer the P3 killer app?

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Managing volatility is the private sector's comparative advantage. Making it the main selling point of P3s should make them a popular choice among public authorities, explain Stanford's Julie Kim and Greengate's John Ryan.

Let's start with an analogy. The original and still most basic function of a cell phone is voice transmission. But with the meteoric rise of the internet in all aspects of communication, data transmission has become the product's most valuable feature and the basis of its dramatic market growth. This transformation required new and very clear ways to describe and evaluate the feature that were quite different than the original selling points for voice transmission. The catchy phrase 'smartphone', for example, makes it instantly clear that something different -- and valuable -- is being offered. These aren't marketing details. Without such new descriptions and measures of value, it would have been hard to make a compelling case using the old language of voice transmission about why anyone should pay more for data transmission. Consumers are understandably reluctant to buy anything that seems inexplicably expensive. And without consumers, there's no market for an innovative product-- even one backed by plenty of sophisticated and motivated investment capital.

Could there be a lesson here for a different product whose US market development seems slower to investors than it ought to be -- infrastructure P3s? Like cell phones, P3s have a basic original function, but their most powerful feature in a changing environment might be something quite different.

The original rationale for a partnership between the public and private sectors in an infrastructure project is very straightforward – to improve the cost-efficiency of the construction, operations and maintenance of the project by including private sector owners and investors. This has not changed and nor should it. Cost-efficiency will always be a fundamental part of the P3 approach, just like voice transmission is for cell phones.

But the P3 transaction framework is also capable of doing something that is not really related to direct project cost – the transfer of specific risks (especially funding risk) from the public sector to private investors. In the current economic environment, where the ‘new normal’ is at best characterised by stomach-churning uncertainty, risk transfer may be the real killer app of infrastructure P3s.

It is important to be precise about why risk transfer might be valuable to the public sector. US state and local governments are in general financially very strong. Most can easily withstand one-off shocks and adjust to secular trends. But even when otherwise well-managed, the public sector is intrinsically not very efficient at dealing with a persistently high level of revenue and cost volatility. There is pressure to spend surpluses. Deficits are politically taboo. The cash-based accounting systems that many governments use (and which are particularly reactive to annual volatility) can encourage ‘kicking the can’ on any number of issues, not the least of which is infrastructure maintenance. And, perhaps most importantly, they simply aren’t used to it.

In contrast, the private sector is exposed to volatility every day, and firms which aren’t good at managing it do not survive long. Private owners and investors in an infrastructure P3 almost invariably have (or can be incentivised to have) long-term objectives, and are guided by accrual accounting. Project surpluses are saved or re-invested, and deficits are generally an issue for liquidity management, not a political crisis.

In effect, the ability to efficiently manage volatility is (in economics jargon) a comparative advantage that the private sector has relative to the public sector. This is the substantive basis by which a risk-transferring P3 transaction can create value for both ‘seller’ (the P3 industry) and the ‘buyer’ (US state and local governments), quite apart from any improved cost-efficiency that’s also part of the deal. Risk transfer is not a budget gimmick, but its direct effect should be to improve public-sector budget management for infrastructure projects. In these terms, the pitch from the P3 industry can be very simple: “Let us help you manage volatility”.

Of course, risk transfer is never free, regardless of how much investment capital is lined up to take it on. That’s not a problem in itself. If the benefits exceed the cost, paying for risk transfer through a P3 transaction makes sense, no matter how expensive it might look in comparison to traditional approaches designed for an ‘old-normal’, less-volatile economy.

The problem is in describing and measuring the value of risk transfer to show why the benefits are worth

paying for. This is not trivial. The original cost-efficiency rationale for P3s is relatively easy to describe (what's not to like about lower cost?) and the standard P3 cost-efficiency evaluation methodology, Value for Money (VfM), does a good job of reducing its value to a single net present value metric.

In contrast, the value of risk transfer is intrinsically more difficult to demonstrate because it is based on the probabilities of things happening, not the expectation that they will, as with cost-efficiency savings. Risk transfer and probabilistic analysis do not easily fit into the current VfM methodology, which is unsurprising since VfM was developed to evaluate the original P3 function. New analytical methodologies, along with the language and metrics to describe their results, are needed, just as they were for the cell phone's transformation into the smartphone. But the basic concepts are not opaque by any means. Many are already prevalent in the private sector, developed by the financial industry (Value at Risk portfolio models, for example) when it faced its own volatility issues beginning in the 1980s. More importantly, in pursuit of value – and motivated by need – people absorb and adopt useful concepts quickly.

Still, the process of product transformation is not spontaneous. It's up to the P3 industry to kick-start the kind of interactive dialogue with public sector officials that leads to the organic development of new uses for P3s.

Here are some suggestions for topics that might get the ball rolling:

- Widespread misunderstanding about the public sector's 'cost of capital' and real risk position in public debt-financed infrastructure projects leads to unproductive conflict with stakeholders and ultimately to bad choices. What's the best way to surface – and communicate – the actual risks involved in a project?
- Federal policies that support infrastructure risk transfer would be consistent with a number of national macroeconomic objectives. What specific federal policies and programs would be most practical and effective at the local government level?
- The value of transferring funding risk to a P3 really only becomes clear in the context of the public sector's overall fiscal situation, something that is beyond the scope of the more project-specific VfM framework. Another analytical framework is needed to provide this context. To be most useful, the framework will need to be focused mainly on estimating the probabilities of various long-term fiscal scenarios. That's not so simple, but now powerful software can make even the most complex risk analytics accessible to non-technical policymakers and stakeholders. What are the hot buttons in a fiscally focused framework? Budget deficits? Or something else?

There are doubtless other topics. It is too early to say what exactly might light the fire. But one thing seems certain: given the vast scale of US infrastructure needs, and the huge amount of motivated investment capital interested in these assets, there is enormous scope for US P3 market development. All that's needed is the killer app.

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