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Slimming down: Why small projects are driving innovation in US P3s

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The US is known for some of the world's largest P3 projects. Whether it's LaGuardia Airport in New York, Maryland's Purple Line or the Sepulveda Transit Corridor currently in procurement in California, there has always been a smattering of projects across the country that offer investors the chance to put a large amount of cash behind a deal.

And with the signing of the Infrastructure Investment & Jobs Act (IIJA) a year ago, many in the industry could have been forgiven for expecting more multi-million and even billion-dollar deals to come down the track, as states got busy funnelling the legislation's $1trn of federal investment.

However, the market is increasingly looking at how it can enable and develop smaller scale projects. Time and energy is being spent working out new ways to develop P3 models so that deals of less than $100m can be delivered.

So why all the attention in this area now? Is it reasonable to believe there is an opportunity here - and if there is, what will this mean for P3s in the future?

Part of the reason for the focus on smaller deals may, of course, have something to do with the current economic climate: it is simply less risky for the big investors to place small amounts of cash into a number of deals than large sums into big projects that may be hit with delays, cost inflation and even cancelation as a result of challenging economic conditions. Wavering political commitment will also be a concern on larger deals, as politicians may struggle to convince electorates of the importance of a billion-dollar transportation project when the cost of living crisis is biting into pay packets.

Another reason may simply be that getting smaller deals done is easier. "Smaller projects are necessary because the US public sector is extremely fragmented down to the local level," points out Sean Agid, chief business officer at advisory firm Community Infrastructure Partners. "For example, you have the federal level, passing money down to 50 states, with hundreds of municipalities in each state.

"When you're working with mega-cities and large authorities, the

bureaucracy means it can take years to get deals done. Mid-sized authorities are able to move a lot faster due to having a smaller number of decision-makers."

Grenville Riley, managing director at Graham Capital in Canada, explains that the lack of activity in the sub-$100m market to date is something that creates an opportunity in itself. "Only a handful of P3s have been done at the municipal level, and they have tended to be larger municipalities, although we have seen some of the smaller municipalities show an interest in pursuing project finance to meet their infrastructure gap," he says. Riley recently spearheaded the innovative Wetaskiwin P3 project in Canada, which saw Graham sign a deal with the local authority for a C$53m wastewater treatment plant P3 project.

There are, however, plenty of difficulties that come with smaller scale deals. P3 arrangements are notoriously complex (indeed, some will argue this is why they should only be used for the larger, more complex schemes), and finding the right way to deliver projects without seeing their benefits swallowed up in fees and other setup costs is always a risk.

"Transaction costs for P3s are high: so much work has to be done up front," says Suhrita Sen, principal at Infrastructure Advisors. "That is sometimes disproportionate to the cost of the project itself if it is quite a small project."

She and others agree that there should be ways to streamline some of the extra costs that exist around P3s so that smaller schemes can be made more viable.

One argument is to reduce the role of advisors in projects - however many in the market agree that this could backfire significantly for authorities. "Public authorities need independent advice, and advisors are the only unbiased third party in a transaction," argues Sen. "Otherwise, authorities have to be informed enough to make a decision on their own on complex matters that are not their core expertise. That is even more important for smaller authorities, because you need to be close to the industry to understand all the options, and more often than not, they do not have prior experience of a P3 transaction. So advice has an important role to play."

It is also acknowledged that advisor fees are the thin end of the wedge when compared to the overall costs of a project and the amount that a contractor will be paid.

One source therefore suggests that equity might be taken out of some of these smaller P3 projects. "Equity is the most expensive part of the capital stack, so something has to give," they explain.

This won't work in all circumstances - and certainly won't attract many of the larger equity players. However, it could help smaller construction companies to enter into the P3 space.

"For every project there is a requirement to include local players," says Sen. "One way that the local companies can develop their

expertise is to get involved in these projects: they are often fully capable of doing P3s, they just need the experience and it is better to start small."

Finding solutions

Bundling of projects could also provide a solution to getting more small projects off the ground. This approach allows authorities to create economies of scale by only procuring one set of advisors for a series of projects - not to mention the savings achieved through only having one procurement process covering a series of schemes.

Agid goes further, arguing that an authority may not even need to have a series of defined projects lined up - but instead it could procure at a program level. "[The authority] could procure a partner to deliver a variety of different assets, such as stormwater schemes, septic to sewer conversions, etc.

"When procuring programmatically, at the time of procurement you don't have the exact project scope but you have goals - for example, to replace a certain number of lead pipes within 10 years."

Perhaps a more thorny issue is where a smaller municipality that may be looking to do a project doesn't have an investment grade credit rating. That would often put investors off, particularly in volatile economic times.

Agid, though, argues that a P3 could still be achieved. "It could potentially use public capital, but with risk still transferred to the private partner. P3s are more than just about the cost: they are also about the transfer of risk."

In that vein, the recent enthusiasm across North America for early contractor engagement models - often referred to as progressive P3s - could come into play.

"Smaller projects may lend themselves to progressive P3s," says Jim Ziglar, principal at consultancy Rebel Group. "A progressive approach means the upfront costs are lower and end up being shared by the parties."

Riley agrees. "In a typical bid, a project team is only able to progress to about 30% of the design because of time, bid of cost risk and the need to focus on responding to all of the mandatory bid deliverables which are not typically very onerous. As a result, bidders have much less ability and time to fully design out risk to the extent they would want to. Because of the rigid nature of traditional P3 procurements, and the protection that seems to exist around using precedent contractual documents, it is often difficult to have reasonable conversations with the client about how risk can be mitigated or avoided, which adds further problems when approaching traditional P3 bids.

"By using an early contractor involvement approach, once the private partner is selected the parties can collaborate to take the design forward to a much more advanced stage as all energy and effort is focused on a single design solution rather than multiple

bids. This allows the parties to mitigate or design out risk in a much more efficient manner. This can also have a healthy impact on the cost of the project as the client is not paying large honorariums to losing bidders and contingency can be focused to cover specific risks rather than general allocations for risk to hopefully cover unknowns."

Lower bid costs also helps to reduce the threat of inflated bids as a result of firms needing to recoup the expense of previous lost bids.

The common concern with a progressive approach, of course, is the reduced competition involved. Experts in both the public and private sectors remain uneasy with the loss of competitive tension where a contractor is brought into the project at an early stage - not least because competition is meant to be at the heart of what P3 brings to the table.

Ziglar, however, suggests that there are circumstances in which a progressive model may be more appropriate than in others. He contrasts two projects on which he has recently worked. One, in Florida, saw the public authority have a host of questions about the best format for delivery of a transit scheme, and so used an early contractor engagement model to help work up and formalize its plans.

The other is the recently signed Clackamas Courthouse scheme, where Ziglar says the procuring authority "knew what it wanted in terms of the number of courtrooms and other spaces on the site. So in those situations, the competitive tension of a standard P3 is better for the authority."

It has long been said that the US is the sleeping giant of P3s. With the IIJA momentum behind it, a new era may be dawning. If the market is to truly take off, it may be that finding routes into smaller scale projects will be at least as important as any big flagship, billion-dollar scheme.