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TO: The Honorable Detroit City Council

FROM: David Whitaker, Director 
Legislative Policy Division Staff

DATE: April 5, 2024

RE: **REPORT ON PUBLIC-PRIVATE PARTNERSHIPS AND BENEFITS TO MUNICIPALITIES**

Council Member Coleman Young II requested that the Legislative Policy Division (LPD) provide a report on public-private partnerships and benefits to municipalities.

Defining Public Private Partnerships (PPPs) is a difficult task considering that the term is an expansive umbrella term that can encompass a wide range of agreements. The Government Accountability Office (GAO) broadly defined a PPP as a “contractual agreement formed between public and private sector partners, which allows more private sector participation than is traditional.”¹ This suggests that PPP agreements are contracts that go beyond normal government procurement of services in that they allow the private company to assume a responsibility that would typically be the responsibility of the government. Two defining characteristics of PPPs are that private partners often share some of the risk or liability, as well as a degree of autonomy associated with the infrastructure, and PPPs often bundle investment and service provision into a single long-term contract.²

¹ GAO, Public-Private Partnerships: Terms Related to Building and Facility Partnerships, GAO/GGD-99-71, April 1, 1999 (expanded version of glossary), <https://www.gao.gov/assets/ggd-99-71.pdf>

² Engel, Eduardo, Ronald D. Fischer, and Alexander Galetovic. “Public-Private Partnerships: When and How.” Working paper, Yale University (2008).

For example, it is common for the public sector to contract with private companies to build infrastructure using what are known as design-bid-build (DBB) contracts, where the public sector works with architects and engineers to design infrastructure and accepts construction bids to build the project while the government retains ownership and control. In the U.S., PPPs are mostly associated with large infrastructure projects, primarily toll roads or bridges. Instead of a governmental entity funding these infrastructure projects with tax revenue or bond issuances, the government will contract with a private company and set conditions whereby the private company will often fund all or a portion of the upfront costs of the project and later be reimbursed through a given revenue stream, often user fees (tolls) or taxes.

However, PPPs are not a funding mechanism, but rather a tool to finance. This is because the private partner still requires a revenue stream in order to provide and operate the infrastructure asset under a PPP. The revenue stream will be derived either from direct payments from the public partner or through user fees that the government would have otherwise collected. Conventional procurement relies on these same sources of funding.³ However, the primary rationale for utilizing PPPs is the theory that they will free up government resources by utilizing a private partner that can create efficiencies where the government otherwise would not. This theory is debatable and will be discussed further below.

PPP agreements can involve a government agency contracting with a private company to finance, renovate, construct, operate, maintain, and/or manage a facility or system that provides a public service. There is a great deal of variability with these agreements depending on how many of the previously stated activities the private company engages in, and the GAO Glossary on PPPs identified a non-exhaustive list of 18 general types of agreements.⁴ Typically, the public sector retains ownership of the facility or system while the private partner carries out its duties with certain discretion on how the task will be completed.

Some of the ambiguity regarding a definition of PPPs is because the U.S. Congress has not enacted general federal legislation on PPPs. Instead, Congress has passed various laws that are tailored to specific governmental departments, such as the Department of Transportation (DOT) and the Department of Defense (DOD).⁵ The DOT in particular began promoting the use of PPPs starting in the 1990s as an alternative financing mechanism while federal investment in infrastructure continued to decline. Statistics from the Congressional Budget Office analyzed federal infrastructure spending between 1956 and 2014 and found that federal spending on transportation and water infrastructure fell from a high of 3% of U.S. gross domestic product (GDP) in 1959 to 2.4% of GDP in 2014.^{6,7}

Because of the lack of federal legislation defining the terms and parameters of PPPs, there is also a wide variation among states with regard to statutes authorizing PPPs. Currently, 36 states have versions of PPP statutes, most of which limit their use to certain types of projects, commonly transportation infrastructure.

³ [U.S. Department of Treasury, Office of Economic Policy: An Economic Framework for Comparing Public-Private Partnerships and Conventional Procurement, 2016](#)

⁴ <https://www.gao.gov/assets/ggd-99-71.pdf>

⁵ For example, the National Highway System Designation Act of 1995 ([Pub. L. No. 104-59](#)) or the National Defense Authorization Act for Fiscal Year 1996 (Pub. L. No. 104-106) and the The Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users (SAFETEA-LU) of 2005 (Pub. L. No. 109-59) provide for PPPs with the Department of Transportation, and the National Defense Authorization Act allows the Department of Defense to enter into PPPs.

⁶ <https://www.cbo.gov/sites/default/files/114th-congress-2015-2016/reports/49910-infrastructure.pdf>

⁷ Additionally, the American Society of Civil Engineers stated in its 2021 report card that the U.S. received a grade of C- regarding the current state of infrastructure and that it would cost six trillion dollars to restore the national infrastructure to a state of good repair.

Michigan also does not have a general statute governing PPPs. PA 286 of 1964 provides for the organization, powers, and duties of the State Transportation Commission and the State Transportation Department. Under the statute, the Michigan Department of Transportation (MDOT) has limited authority to use PPP procurement methods, including design-build and design-build-finance agreements. PA 286 of 1964 does not allow for PPP contracts involving the creation of toll roads or bridges. The Michigan Metropolitan Transportation Authorities Act also allows for the creation of regional metropolitan transportation authorities with the power to contract with “private enterprise for service contracts, joint use contracts or contracts for the construction or operation of any part of the transportation facilities within the limits of the unit of government.”

While some states authorize local governments to enter into PPP agreements, Michigan does not. There is a limited exception provided under an amendment to the Home Rule Cities Act (HRCA). The Michigan legislature amended the HRCA to add Section 117.5k, which allows local governments to enter into certain PPP agreements for the construction, repair, and operation of movable bascule bridges. The amendment was primarily intended to specifically address two bascule bridges in Bay City and only six Michigan cities, not including Detroit, fell within the scope of the amendment when it was passed in 2020.

As a result, the City of Detroit does not directly enter into PPP agreements but may interact with PPPs utilized by state departments or statutorily created authorities. One major example is the QLINE, a 3.3-mile streetcar system that operates on Woodward Avenue in Detroit. The QLINE was funded by a variety of sources, including federal, state, and private investments. Since the inception of the QLINE, its operations have been overseen by M-1 Rail, a non-profit entity. The Regional Transit Authority of Southeast Michigan (RTA) has been assessing the feasibility of taking over the QLINE sometime in 2024.⁸ It remains to be seen whether the transfer will be financially viable. Although the QLINE operates within the City of Detroit, the RTA is a body consists of 2 members from each of the RTA counties: Macomb, Oakland, Washtenaw, and Wayne, as well as an appointee from the Mayor of Detroit and a non-voting chair appointed by the Governor of Michigan.

In addition to the complexity in defining PPPs, there is also a lack of scholarly research that comprehensively analyzes the effectiveness of PPPs by comparing projects. This is largely because it is difficult to compare different projects due to the variability in the scope of projects and the types of agreements. As a result, analysis of the effectiveness of PPPs often focuses on the conditions under which a PPP is likely to yield higher social welfare than other alternatives.

In many cases, the existing financing alternatives under the tax structure and municipal bonds are unfavorable to PPPs because “1) private debt generally has a higher default risk than bonds issued by governmental agencies, and 2) municipal bonds are exempt from federal income taxes, and generally exempt from state and local income taxes in the state where issues. PPPs also tend to result in higher transaction costs than conventional procurement because of the need to compensate additional external financial, legal, and technical advisors who plan and develop project specifications...”⁹

The success of a PPP agreement will ultimately depend on the terms of the agreement. The U.S. Department of Treasury stated the following with regard to whether PPPs provide a net benefit to society:

In short, a balance of elements – the project’s characteristics, the economic environment in which the project is being developed, and the ability of the project sponsor to take certain actions – jointly determines whether a PPP

⁸ <https://www.freep.com/story/news/local/michigan/detroit/2023/12/14/rta-weighs-qline-control/71924756007/>

⁹ U.S. Department of Treasury, *Supra* at 9-10.

can deliver and operate a project that yields higher social welfare than would have been the case under conventional procurement. In other words, no one single factor informs whether a project yields a higher net social benefit as a PPP than under conventional provision, while providing a competitive rate of return for the private partner.¹⁰

A report from the Economic Policy Institute (EPI) says the following with regard to the structuring of PPPs:

For P3s to be effective, two conditions must be met: the profit motive has to be consistent with the public good, and service quality must be contractible (Engel, Fischer, and Galetovic 2014).¹¹ That is, service quality should be easily specified in a contract, so that it can be observed and enforced. Maximizing profits by constraining costs may make sense for road maintenance, for example, but it could lead to disastrous consequences for schools or prisons, where cost minimization and the public interest may not align. Service quality can be measured for roads (potholes are obvious); it is more difficult to do so for school or prison maintenance. Without “contractible quality,” the monopoly provider will simply boost its profits by cutting costs and reducing service quality.¹²

It makes sense that service quality under a PPP agreement must be clearly defined and easily measurable for the agreement to be successful from a public perspective. This is because the agreement will provide clear benchmarks for oversight to ensure that the private partner is in compliance. If terms of compliance are unclear, the public partner will have to expend more resources on oversight, which will cost additional resources and is likely to reduce overall the cost-effectiveness of the project.

In other words, PPPs are preferred in situations where “quality is contractable” and where “the government can specify the desired service standards, letting the firm choose the optimal combination of inputs to achieve the standards.”¹³ In situations where quality is not contractable, the private partner may make cost-saving investments that lower service quality. Under these circumstances, conventional procurement is preferred.¹⁴

For instance, consider the issue of deferred maintenance in short-term contracts. If a private partner is only responsible for maintaining infrastructure for a short period of time, the private partner may determine that it is more profitable to defer maintenance as much as possible and wait until the agreement expires, ultimately saddling the public partner with the cost. This can be particularly concerning considering that, for the most part, maintenance tends to get more expensive the longer it is deferred. However, this problem often exists with governments in general, as building new projects is more politically attractive than investing in regular maintenance, resulting in underinvestment in maintenance.

With regard to long-term contracts, PPPs often contain non-compete clauses that are intended to provide the private partner with the opportunity to receive a return on investment. Because these contracts are intended to extend over a number of years, the public partner may be limited in its ability to address

¹⁰ U.S. Department of Treasury, *Supra* at 3.

¹¹ Engel, Eduardo, Ronald Fischer, and Alexander Galetovic. 2014. *The Economics of Public-Private Partnerships: A Basic Guide*. New York: Cambridge University Press.

¹² <https://www.epi.org/publication/no-free-bridge-why-public-private-partnerships-or-other-innovative-financing-of-infrastructure-will-not-save-taxpayers-money/>

¹³ See Engel, Eduardo, Fischer, and Galetovic. (2008) at 6, *Supra*.; See also U.S. Department of Treasury, *supra* at 8-9.

¹⁴ *Id.* at 7

unforeseen issues as time goes on. For example, if a private partner constructs a road that eventually becomes congested necessitating the need for the public partner to build an additional road to alleviate traffic, the public partner may be restricted from doing so based on a non-compete agreement.

The EPI cited a study that provided an illustrative example of a PPP with a poorly crafted agreement.¹⁵ California utilized a PPP to build express lanes on California State Route 91. While the agreement was initially beneficial because the private partner was able to reduce construction time, the contract ended up being extremely costly for the public partner. This is because the traffic eventually became heavier than expected, requiring additional lanes. However, the public partner was barred from building additional lanes due to a non-compete clause in the PPP agreement. After years of legal disputes, the public partner agreed to purchase the lanes, which initially cost \$130 million, from the private partner for \$207.5 million. Not only did the public partner have to pay for the lanes and the legal costs, but they were also delayed from building additional lanes to alleviate traffic until the legal dispute was resolved.

The EPI report goes on to state the obvious point that a private partner will only agree to projects that provide a return on investment. Therefore, PPPs are inherently limited to profitable projects and will not function as a mechanism to address socially beneficial projects that are not profitable. As the EPI report states, “(t)o put it bluntly, the fact that the citizens of Flint cannot afford to pay fees that are high enough to make the replacement of lead-infested water pipes profitable for a P3 does not mean that such investment is socially unnecessary.” On the other hand, PPPs can act as a filter to what are known as “white elephant” projects, which are projects where the cost outweighs the social benefit.¹⁶ Because a private partner will only participate on projects it believes will be profitable, there is an increased incentive to scrutinize projects that may be excessively costly.

A major selling point from proponents of PPPs is that they are an alternative procurement tool that provides relief to strained government budgets and frees up government resources that can be spend on other socially desirable projects. According to one analysis from Yale University, if we assume that a PPP is implemented as intended, there are not typically any government savings because any initial investment savings are offset by future income flows to the private partner.¹⁷ In other words, PPPs are essentially neutral in terms of savings. PPPs do not tend to offer any savings advantages over conventional procurement. The same holds true for allocation of risk, which remains substantially the same under both PPPs and conventional procurement.¹⁸

There is also an argument that PPPs can provide a way for governments to invest in socially desirable projects during periods of severe credit constraints. In these cases, conventional procurement is not possible, so depending on the circumstances a PPP may be favorable to deferring the project altogether until the government is in a more favorable financial position. Whether a PPP is beneficial in these circumstances will depend on the nature of the government’s credit constraints. If the government lacks credit because is likely to default on its debt, it may have difficulty locating a private partner to invest. However, if the government’s credit constraints will likely be short-term or it can offer upfront assurances to the private partner, a PPP may be beneficial. This will depend on weighing the cost of deferring a project until funds are available against going forward with the project with an increase in cost to compensate the private partner for the associated risk.

In circumstances where it is not possible to charge user fees that pay for a portion of the costs associated with infrastructure, PPPs are not favorable. For these types of PPPs, the public partner will often utilize “shadow tolls” whereby the public partner pays the private partner a user fee based on overall

¹⁵ Engel, Eduardo, Ronald Fischer, and Alexander Galetovic. (2014), *Supra*.

¹⁶ See Engel, Eduardo, Fischer, and Galetovic. (2008) at 12, *Supra*.

¹⁷ See Engel, Eduardo, Fischer, and Galetovic. (2008) at 7-8, *Supra*.

¹⁸ See Engel, Eduardo, Fischer, and Galetovic. (2008) at 27-28, *Supra*.

usage without directly collecting a toll from users. Because of the degree of government oversight necessary for this type of arrangement, any efficiencies created by contracting with a private partner essentially disappear.¹⁹

“Demand risk,” which is the risk that demand will be less than expected resulting in lower fees collected by the private partner, plays a major role in the outcome of PPPs. Demand risk is often difficult to assess due to the number of factors that can affect demand over time. Changes in demand often result in renegotiation over the term of the PPP. Private partners regularly attempt to renegotiate the terms of a PPP agreement when circumstances change, either in good or bad faith, often at the expense of the public partner.

PPPs typically compensate the private partner through a mix of user fees and subsidies. One suggested ideal form of a PPP agreement is a present-value-of-revenue (PVR) agreement. In circumstances where a PPP is for a high demand project that is essentially guaranteed to be financed with user fees, the public partner can utilize a PVR to bid the contract to a private partner that will agree to provide the service for a set amount of user fees. Since the demand risk is essentially non-existent, the public partner can agree that the term of the contract extends until the private partner collects the agreed upon amount in user fees without having to provide any additional subsidies to compensate for the risk, which is likely to reduce the overall cost.^{20, 21} Although the term of a PVR agreement may be shorter or longer than expected, it removes many of the potential variables in PPPs and likely reduces the ability of private partners to renegotiate in bad faith.

This general method can also be utilized for low-demand projects. If the public partner determines that a project will likely have low demand, but has a high social value, it can similarly bid the contract out to a private partner for a set rate. As long as the private partner continues to perform the service under the contract, the public partner will subsidize the difference between the agreed amount and the amount of fees collected. In either of these arrangements, it is once again essential that it is possible to clearly contract for quality of service.

On a related note, the Michigan legislature required MDOT to conduct feasibility and implementation studies regarding the implementation of toll roads under PA 140 of 2020.²² This study was an attempt to explore funding options to address the “needs gap” of over \$4 billion per year between 2020 and 2045, according to the Michigan Long-range Transportation Plan. The MDOT Statewide Tolling Strategic Implementation plan includes a discussion for utilizing PPPs to operate and maintain potential toll roads.²³ In the plan, MDOT advised against assigning the demand risk to the private partner because it believes that the risk is low if the tolls are implemented on existing highways, meaning that Michigan would retain any potential revenue that exceeded projections. However, it states that this analysis would be different for newly constructed toll roads.

While Michigan is exploring the implementation of toll roads with the potential use of PPPs, plans are still in the exploratory and preliminary stages. Actual implementation would require approval from the Michigan legislature to make the requisite changes in state law. Additionally, as the Citizens Research Council of Michigan stated in their analysis of the studies, states are largely restricted from converting

¹⁹ See Engel, Eduardo, Fischer, and Galetovic. (2008) at 21, *Supra*.

²⁰ See Engel, Eduardo, Fischer, and Galetovic. (2008) at 23, *Supra*.

²¹ Engel, “Least Present Value of Revenue Auctions and Highway Franchising,” *Journal of Political Economy* 109, 993-1020, 2001.

²² <https://www.bridgemi.com/michigan-government/highway-tolls-could-raise-1b-fix-michigan-roads-study-finds-it-time>

²³ [MDOT Statewide Tolling Strategic Implementation Plan](#)

interstate highways to toll roads.²⁴ Without a change in federal law, Michigan would be largely limited to implementing tolls on newly constructed roads and/or potentially adding toll lanes to existing highways.

Please contact our office if we can be of any further assistance.

²⁴ https://crcmich.org/dennis_michigan_tolling_2023; 23 USC 129