



ISSUE BRIEF

PRIVATIZATION VS. PUBLIC-PRIVATE
PARTNERSHIPS:
A COMPARATIVE ANALYSIS



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INTRODUCTION

Since the sale of the Chicago Skyway Bridge that provided the City of Chicago \$1.8 billion in exchange for a 99-year operating lease of the toll bridge, the discussion of the use of privatization and public-private partnerships (otherwise known as “PPPs”, “joint-ventures” or “P3s”) to solve public agency infrastructure needs has reached new levels.¹ Privatization and P3s are not new concepts; rather both have been in existence for many years. In the 1980’s, British Prime Minister, Margaret Thatcher, popularized privatization by divesting her government’s ownership of the coal, steel, oil and electricity industries in Britain, which helped to invigorate the British economy.² In the late 1980’s, California was on the cutting edge of P3s, with the passage of Assembly Bill 680, which authorized four pilot public-private partnerships for transportation projects, leading to the construction of SR-91, a toll-road in Orange County and SR-125, a toll road in San Diego County. Public-private partnerships, including design-build concepts, also were included in the 2007 California Five-Year Infrastructure Plan as a way to leverage limited public resources to help address the state’s growing infrastructure needs, which were valued at approximately \$500 billion for the next twenty years.³



The principles behind privatization and P3s are similar—private sector involvement with the delivery of public projects or services. While these terms are often used interchangeably, they have distinct differences that public agencies should weigh when considering them. This issue brief provides basic information on privatization and P3s and identifies shared characteristics and key operational differences. This analysis is intended to assist public agencies in better understanding and evaluating options to deliver public infrastructure projects and related services.

WHAT IS PRIVATIZATION?

The basic goal of privatization is the introduction and use of market-based competition by government for the delivery of public services or goods by the private sector. The term “privatization” is most commonly used to refer to any shift of government activities or functions from a public agency to the private sector. It is an umbrella term used to account for greater private sector participation in the delivery of public services. Privatization has also been characterized as “sometimes leaving very little government involvement, and other times creating partnerships between government and private service providers where government is still the dominant player.”⁴

Specifically, privatization is defined as the economic process of transferring property, such as a building, road, or enterprise system that delivers services from public ownership to private ownership.⁵ Supporting this definition is the Office of Management Budget’s (OMB) Circular A-76, the policy of competition of commercial activities for federal agencies. In this document, privatization accounts for the process of a public agency transferring a government-owned or government-operated commercial enterprise activity to private sector control and ownership. With privatization, according to the OMB policy, there is no government ownership and control and there is no service contract or fee-for-service agreement between the agency and the private sector after a commercial activity or enterprise has been privatized.⁶ Further supporting this definition, the California’s Legislative Analyst’s Office has described privatization as the involvement of the private sector in providing goods and services that otherwise might directly be provided by governments.⁷ Thus, privatization occurs when the government sells public assets to the private sector or when the government stops providing a service directly and relies on the private sector to deliver the service. Ownership is the key distinction of privatization according to this focused definition of privatization.

Privatization has been used as a procurement and service delivery method for public agencies including but not limited to contracting, grants, vouchers, volunteerism, public-private partnerships, private donation, franchise, service shedding, deregulation, and asset sales.⁸ It has been frequently associated with industrial or service-oriented enterprises, including power generation, health, sanitation, and education, but it can also apply to any publicly owned asset, such as land, roads, or even water rights.

Successfully implemented, privatization can provide many public benefits including efficiency, innovation, and high quality services, which can yield cost savings as well as streamline government operations. A common form of privatization is an asset sale where the public agency sells or transfers ownership of public assets to the private sector, with the government having no role in the financial support, management or oversight of a sold asset. A possible result of this form of privatization is that a public agency may become a regulatory body over a former public asset or enterprise system if new ownership results in a potential monopoly.

Privatization Example: In 1995, the state of Virginia, sold the \$300 million loan portfolio and building facilities of the Virginia Education Loan Authority to Sallie Mae, a private loan servicing firm. The state realized \$59.3 million from the sale and was able to eliminate a program that was not considered a government function.⁹

The potential drawbacks of privatization focus on the loss of public control once the asset or enterprise is no longer under the auspices of the public agency:

- After the sale of a public asset or enterprise, the public agency no longer has responsibility for the asset or enterprise; ownership and control is now shifted to the private sector purchaser. By giving up ownership, the public agency will no longer have control over the fee structure or rate setting process associated with the privatized asset or enterprise.
- After privatization, there is the potential for the loss of public employment. While the privatization may address the issue of public employees, there is the potential that a public sector employee will be redirected to another public job or can become an employee of the private sector.

Most public agencies already have incorporated some form of privatization within their normal course of operations, whether it is procuring office supplies from private vendors, contracting for waste management services or selling a water utility system to a private water company. Public agencies, however, may still need assistance in identifying potential privatization opportunities. Merrill Lynch, for example, has composed a list of characteristics to use when assessing the possible use of privatization for toll roads and transit projects.¹⁰ While the characteristics were specifically targeted toward transportation-related projects, they could potentially be used to evaluate privatization opportunities in other public operations. They include assessing the following:

- The asset or enterprise is not a core government function.
- The public agency is in serious financial trouble or has an urgent need for capital.
- The asset or enterprise is producing poor financial results under the current ownership structure.
- The asset or enterprise has an established operating history of five or more years and has reasonable flexibility for revenue increases.

Privatization Example: In 1998, the largest privatization of federal property in the history of the U.S. government occurred when the federal government sold Elk Hills Naval Petroleum Reserve in Kern County, California to Occidental Oil & Gas for \$3.65 billion. As the oil supply source for the U.S. Navy, Elk Hills was once considered an essential government asset, but with the availability of refined petroleum products and nuclear energy meeting the military's fuel needs, Elk Hills was no longer needed. With the divestment, the federal government was out of the oil and gas producing business.¹¹

While the above example is not a transportation-related project, it does meet two of the characteristics described by Merrill Lynch; Elk Hills was no longer considered a core federal government function and it had an established operating history of oil production.

WHAT ARE P3s?

By definition a partnership, involves two or more parties committed to a common goal, sharing risk and yielding a reward to all the partners. This is a defining characteristic of P3s. A P3 is a project in which there is cooperation between the public and private sectors in one or more areas of the design, development, construction, operation, ownership or financing of infrastructure assets, or in the provision of services.¹² Compared to traditional procurement methods, the private sector assumes a greater role in the planning, financing, design, construction, operation and maintenance of public facilities or service delivery.¹³ Ideally, a P3 is based on the strengths of both the public agency and the private partner, which are directed toward the achievement of goals that optimize public needs, funds and services.

The contractual agreements creating the P3 between a public agency and private partner should outline the roles, responsibilities and expectations of each partner, thereby providing incentives for delivering projects on time and on budget.¹⁴ Under this agreement, the skills and assets of each sector (public and private) are shared in delivering a service or facility for the use by the general public.¹⁵ Traditionally P3s typically involve some combination of design, build, finance, operate or transfer of an asset between the public and private sectors. The project delivery model varies, as each public agency will have its own specific need for considering a P3, ranging from contracting for operations and maintenance of a public facility to the design, construction, financing and operation of a public facility.



Successfully implemented, P3s define the scope of business; specify priorities, targets, and outputs; and set the performance expectations of the partnership resulting in tangible benefits to the public agency, including:

- Public agencies can use P3s to optimize public benefits derived from cost savings, administrative expedience, and management efficiency. P3s may encourage a focus on value for money over the lifetime of the asset and, under the right circumstances, can be well suited for many large infrastructure projects, enabling the partners to spread the cost of the investment over the term of the partnership.¹⁶
- Public agencies can optimize a private partner's operational and management expertise and efficiency to improve service quality as well as realize cost savings.
- Public agencies can reduce their role from engaging in day-to-day operations to contract management, which enables limited public personnel to fulfill other responsibilities.

As with any project financing or procurement method, there are also some potential issues of concern related to P3s that public agencies should consider when contemplating such agreements, including:

- Regardless of the division of public-private responsibilities, the public agency will be held accountable by the public.
- P3s are complex transactions that require more preparation, planning, oversight and coordination than traditional forms of procurement, which may equate to additional costs. In a typical transaction, an agency would need to assemble a team consisting of financial advisors, consultants, and legal counsel that specialize in P3s.¹⁷ In addition; public agencies should plan for long-term contract management and oversight of the P3 for the duration of the term of the partnership.

- P3s may result in the transfer of public sector employees to the private sector. This may or may not result in actual job loss, depending on the terms of the agreement.

While the public sector has the potential to realize cost savings, utilize expertise, achieve efficiencies in construction and operation, access private capital, and improve the quality of services with a P3, there are numerous factors for a public agency to consider in determining whether such a partnership may be viable. As an example, the Water Partnership Council has composed a checklist to help public water agencies determine if a P3 is appropriate for their operational or capital needs.¹⁸ The questions cover rate issues including capital budgetary issues, regulatory compliance concerns, staffing, and operational and system deficiencies.

Among the infrastructure sectors in the United States where P3s have been applied are transportation, water, wastewater, schools, prisons and defense. Since each sector is different, P3 policies, approaches and political strategies must be tailored to the unique circumstances of each sector and project.

P3 Example: In response to changing water regulations, Seattle Public Utilities (SPU) had to address their water filtration methods. The result was a P3 with CH2M HILL to construct a state-of-the-art water treatment facility. The P3 consisted of a design-build-operation (DBO) contract between SPU and its private partner. The private partner was responsible for the design, permits, material and equipment procurement, construction, onsite inspection, start-up, and operations (for up to 25 years) of the facility. In addition to the timely delivery of the \$200 million new facility, SPU calculated that use of the DBO saved the utility \$50 million when compared to the cost of using the conventional design-bid-build process.¹⁹

WHAT ARE THE DIFFERENCES BETWEEN PRIVATIZATION AND P3s?

Privatization and P3s are similar concepts, both rooted in the philosophy that private sector involvement in the delivery of public projects or services can result in operational and fiscal benefits for a public agency. While these terms often are used broadly and interchangeably, there are key differences between them. These differences occur in three primary areas: ownership, structure, and risk. Ownership refers to the party that has and controls the rights or interests in an asset or service enterprise. Structure refers to the resulting contractual arrangements that are used to facilitate privatization or P3s. Risk refers to the responsibilities, financial or legal, that are undertaken by the appropriate party—public, private or shared as conditions of a contract. The details and examples of these differences are discussed below.

OWNERSHIP

A primary distinction between privatization and P3s is ownership of the asset (existing or new) or enterprise system that is the subject of the transaction. When a publicly owned asset or enterprise system is privatized, ownership and responsibility for the asset or enterprise are fully transferred or sold to the private sector.

Ownership Example: The Department of Defense's (DoD) Military Utilities Privatization Initiative (MUPI), directed the privatization of all military installation utility systems, unless uneconomical or exempt for security reasons, by 2003. This act of privatization involved the transfer of ownership of the physical distribution system; it did not include the supply of electric power, natural gas or water.¹⁹ The government would be charged user fees by the new service provider. Privatization enabled the DoD to meet its objective of removing itself from the business of owning, managing and operating utility systems, thus allowing the military to focus on its core mission of national defense.²⁰

In a P3, the public agency retains ownership of the asset or enterprise, oversight of the operations and management of the asset, and controls the amount of private involvement. Through a P3, the public sector sets the parameters and expectations for the partnership and the private sector uses access to capital markets to address the public agency's needs. If the P3 does not live up to the contractual expectations of the partnership, the public agency can regain complete control of the asset or enterprise system.

P3 Example: In 2002 the City of Indianapolis acquired the assets of the Indianapolis Water Company from NiSource, a privately owned water company. Once publicly owned, the city contracted with Veolia Water North America, for the management of all operations, maintenance and customer service facets of the water-works system. The 20-year P3 contract is based on performance incentives and contains over 40 performance criteria in customer service, water quality, capital improvements, operations and maintenance practices, and community involvement. The partnership also addresses over \$400 million in capital improvement projects. The City maintains local control of the water system, while utilizing the private sector expertise for achieving rate stability, water-quality improvements, and capital improvements.²¹

STRUCTURE

Another difference between privatization and P3s is the structure of the contract that formalizes the involvement of the public and private partner after privatization or the creation of a P3. With privatization, once an asset or enterprise is sold, the public agency's involvement is limited to non-existent except possibly in a regulatory role. In a P3, there is flexibility with the structure of the agreement, allowing the public and private partners to determine the level of participation of both partners to specifically address the needs of the public agency, while maintaining public agency ownership.

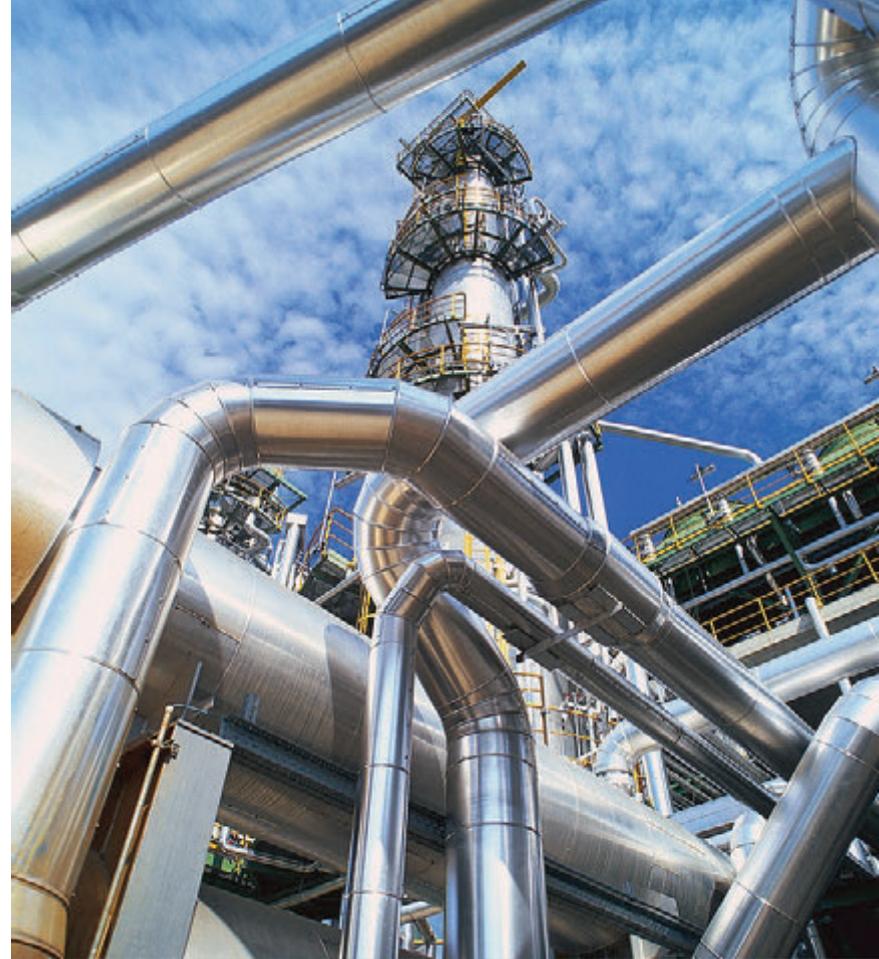
While there are many methods for a public agency to transfer ownership of public assets or services to the private sector, the results are the same: public ownership is transferred to the private sector and the public sector is no longer involved in owning or managing the public asset or providing the once-public service. The following privatization models, as defined by the U.S. General Accounting Office and the Reason Foundation reflect additional methods that a public agency can transfer ownership of public assets or services to the private sector:

- **Divestiture** The public agency sells government-owned assets or commercial-type functions or enterprises. After divestiture, the public agency will generally have no role in the financial support, management, regulation, or oversight of the divested activity.²²

Example: In 1993, as a result of the Energy Policy Act of 1992, the federal government created the (<http://www.usec.com>) United States Enrichment Corporation (USEC) as a Government corporation, to initiate the transfer of the federal government's uranium enrichment operation to the private sector. USEC completed privatization on July 28, 1998 through an initial public offering of stock and USEC officially changed its name to USEC Inc.²³ Included in the sale was the U.S. Department of Energy uranium enrichment enterprise and the Paducah and Portsmouth Gaseous Diffusion Plant (GDP) sites. The U.S. government received about 1.8 billion dollars from the divestment of USEC.²⁴

- **Self-Help** (also known as “transfer to non-profit organization”) The public agency enables a community group or neighborhood organization to take over providing a public service or asset such as a local park which results in a cost savings for the public agency, as well as eliminates non-core government functions.²⁵

Example: Public agencies turn non-core government services, such as zoos, museums, fairs, parks and some recreational programs to community groups of neighborhood organizations.



- **Vouchers** Vouchers are public agency financial subsidies given to individuals for the purchase of specific goods or services from the private or public sector. Redeemable certificates are issued by the public agency for the purchase of services in the open market. Under this approach, the public agency relies on market competition for cost control and on the individual to seek out quality goods or services. The public agency's financial obligation is limited to the amount of the voucher.²⁶

Example: In 1990, the Milwaukee Parental Choice Program, the nation's first publicly funded voucher program, was created in Milwaukee, Wisconsin. Under this voucher program, state funds are used to pay for the cost of students from low-income families that reside within the City of Milwaukee to attend private schools located in the city at no charge so long as program criteria are met. A goal of this voucher system is to localize accountability as opposed to relying on government standards.²⁷

Each P3s is unique; therefore, there is no "cookie-cutter" approach to assembling a P3. The following P3 models, as defined by the National Council for Public-Private Partnerships, highlight the possibilities and scope of private involvement where the public agency retains ownership of the public facility or system:²⁸

- **Contract Services—Operations and Maintenance (and Management)** A public agency contracts with a private partner to provide and/or maintain a specific service. Management of the system can also be included in the contract.

Example: Since 1972, the City of Burlingame, California has contracted with Veolia Water North America (formerly USFilter Operating Services, Inc. and then Envirotech Operating Services, Inc.) to operate, maintain, and manage the city's wastewater treatment facility.²⁹

- **Design-Build (DB)** A public agency contracts with a private partner to provide both design and construction of a public project.

Example: Utah's Department of Transportation used design-build procurement for the Interstate 15 reconstruction to minimize the period of traffic congestion resulting from project construction and to complete the project before the 2002 Olympic Games in Salt Lake City.³⁰

- **Design-Build-Operate (DBO)** A public agency awards a single contract for the design, construction and operation of a public facility.

Example: Tampa Bay Water (TBW), Florida's largest public wholesale water supplier, selected Veolia Water North America to build a new surface water treatment plant, using the DBO option, enabling TBW to sign a single contract with one private-sector partner that would be responsible for the design, construction and operation of the facility under a long-term agreement.³¹

- **Lease Purchase** A lease purchase is an installment-purchase contract, under which the private partner finances and builds a new facility, which is then leased to a public agency. The public agency accrues ownership to the facility over time. At the end of the lease term, the public agency owns the facility or purchases it at the cost of any remaining unpaid balance in the lease.

Example: The Natomas Unified School District in Sacramento, California employed a P3 to address overcrowding in its high school facilities. Using a lease-leaseback model, the district leased part of its land to a private developer that financed and built a new school on the land. The school district makes lease payments to the developer until the end of the lease period, at which time ownership of the school will be transferred to the school district.³²

- **Turnkey** A public agency contracts with a private partner to design and build a complete facility in accordance with specified performance standards and criteria for a fixed price, where the private partner commits to absorb the construction risk and cost of meeting the agreed upon price.

Example: In 2005, the Fairfax County Public Schools used the turnkey approach to develop, design, finance, and construct South County High School, a state-of-the-art 386,000 square-foot educational facility in Lorton, Virginia.³³

RISK

Accompanying the asset or enterprise system that is the subject of privatization or a P3 is the risk associated with the ownership, operation and maintenance of the asset or enterprise for either the remaining useful life (of the asset or system) or the contract term.

Risk is not limited to just liability but includes the assumption of responsibility for uncertainties conceptual, operational and financial that could threaten the goals of privatization or a P3, including design and construction costs, regulatory compliance environmental clearance, performance, and customer satisfaction. An infrastructure project owned and operated by a public agency subjects the agency to 100 percent of the risks associated with the facility. When an asset or enterprise is privatized, the private owner assumes all risk associated with the asset or enterprise. With a P3, which has public ownership and private operation, many (but not all) of these risks can be transferred to the private partner. Risk is typically shared based on the principle that risk should be assigned to the partner that is better equipped to manage or prevent that risk from occurring or that is in a better position to recover the costs associated with the risk. Typically in the development of capital improvement projects, the private partner may prefer to assume risk of a commercial

nature that can be appraised and controlled, leaving the residual risks to the public agency. As an example, the Water Partnership Council developed a list of typical risk elements for water projects, which are generally described below.³⁴

Examples of risk typically assumed by the private partner include:

- The risk that the design and existing condition of the asset or enterprise are adequate for meeting contractual obligations.
- The risk of operating and maintaining the asset or facility within its design capacity and capability as well as in accordance with established performance criteria for service quality, safety, employee and community satisfaction, and community relations.
- Preventive maintenance risks (and any associated costs) over the contract term. The private partner is expected to return the asset, at the end of the contract, in good operating condition except for normal wear and tear.
- The financial risk for exceeding the contractual budget. Except for adjustments for inflation, system inputs and other variables specified in the contract, a private partner assumes the risk that project costs may exceed the proposed budget.
- The risk for conducting operations in compliance with applicable laws and regulations. The private partner also assumes responsibility for any fines or penalties imposed for non-compliance, provided that the violation is attributable to negligence by the private partner.

Examples of risk typically assumed by the public agency:

- Risks/responsibilities for any change orders it requires of the private partner. Due to unforeseen changes in regulatory requirements or community concerns, the public partner may want to amend the contract after it has been finalized to address these issues. The public agency generally would be responsible for any increases in cost associated with implementing the amendment.

- Risks/responsibilities for any variation in inputs to the system (e.g., for water and wastewater projects, the quantity and quality of water or wastewater that enters a treatment plant operated by a private partner).

Other risks typically shared between public agency and private partner:

- Shared risk associated with planned system repairs and replacement by having the public partner assume responsibility for financing major capital projects because of its access to low-cost (tax-exempt) financing, while the private partner assumes responsibility for the performance and reliability of capital projects while under its control and management.
- Shared risk associated with catastrophic events such as loss of power, floods, storm damage, and earthquakes. While this risk is not under the control of either partner, these events are usually covered by the contract's force majeure clause that can excuse a private partner from responsibility so long as the failure to perform is not attributed to its lack of due diligence.
- Shared responsibility in proportion to their respective negligence or fault for a loss resulting from the other partner's actions or omissions.

Because P3 contracting arrangements vary based on the amount of risk shared between the partners, the above are only an example of possible risk allocations.

Each project is unique and will have its own allocation of risk factors agreed upon by the partners.

SUMMARY OF DIFFERENCES BETWEEN PRIVATIZATION AND P3s

The following chart summarizes the differences discussed earlier between privatization and P3s after the transaction occurs between the public and private partner.

SUMMARY OF DIFFERENCES BETWEEN PRIVATIZATION AND P3s

| | PRIVATIZATION | P3 |
|---------------------------|---|--|
| Definition | Any process aimed at shifting functions and responsibilities, in whole or in part, from the government to the private sector, almost always involving the irrevocable transfer of public sector assets. | A contractual agreement between the public and private sectors for the financing, developing, operation or managing of a public facility or service. |
| Ownership | Private | Public |
| Contract Structure | Contract methods that result in private ownership. | Contract methods that result in varying levels of private participation. |
| Risk | Private sector has sole responsibility in general.* | Shared responsibility between partners. |

* Except as retained in a regulatory role.



CONCLUSION

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The high level of interest in utilizing privatization and P3s for the delivery of public services and projects can be attributed to recent high profile concession deals involving the City of Chicago and the State of Indiana. As a result, privatization and P3s have been increasingly promoted as possible financing tools for the delivery of public services and projects. Because of the potential long-term impacts of these agreements, it is important for public agencies to have a basic understanding about the differences between privatization and P3s and the corresponding positives and negatives of each procurement method. The examples provided above demonstrate that privatization and P3s are not limited and can be applied to many areas including education, defense, water/wastewater treatment, and transportation.

There are advantages and disadvantages to using both procurement methods to address infrastructure needs or improve public agency efficiency in the delivery of public services and projects. Local agencies should carefully consider these factors in light of their particular project needs and resources.

While neither privatization nor P3s is likely to fully replace conventional financing, when used judiciously, they can be a useful financing option for public agencies to consider.

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On-line resources

National Council for Public-Private Partnerships

www.ncppp.org

Privatization.org (a program of the Reason Foundation)

www.privatization.org

Federal Highway Administration

www.fhwa.dot.gov/ppp/

U.S. Environmental Protection Agency

www.osti.gov/privatization/report

www.eren.doe.gov/brightfields

Water Partnership Council

www.waterpartnership.org

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