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U.S. Social Infrastructure P3 Roundup

A How-To Guide For Higher-Ed P3s

Recently, Joe Aiello, of Meridiam Infrastructure, and Eric Petersen, of Hawkins, Delafield and Wood, met with senior public officials in New Jersey to explain how a state P3 agency could procure higher education facilities under a DBFOM procurement model. Public Works Financing editor Bill Reinhardt, a resident of Westfield, N.J., initiated and facilitated the meetings. Legislation supporting P3s was introduced, and passed by the legislature in late June, and now awaits Gov. Chris Christie's signature (PWF 6/12, p. 12). This report consists of the briefing documents prepared for those discussions.

Introduction

As Ohio State University has discovered, monetizing revenue producing facilities through a long-term lease—a parking system in OSU's case—can free large amounts of captive capital locked up in existing assets.

OSU was paid $483 million this month by Australian fund QIC Global Infrastructure Fund and LAZ Parking Ltd. for a 50-year lease that caps increases at 5.5% for 10 years. The university in recent years has collected about $28 million a year in fees from 36,000 spaces, producing cash flow of $19 million.

Greenfield P3s for college dorms and other revenue-producing assets are being pursued by large home-builders and some commercial real estate developers. These are mostly lease-back deals that are 100% debt-financed, often backed by annual appropriations, and done through a tax-exempt state conduit. Private returns come through a large development fee—15% or so—and a long-term O&M fee.

There is also is a large need at colleges and universities for a way to finance, build and operate non-revenue producing assets. In that market, P3s can be an effective way to deliver "high tech"

buildings (sciences, medical research, etc), which must be built to exacting standards to support the work conducted inside. P3s often include equity finance for 15-20% or more of the cost at rates much higher (8-10%) than lease-back debt (3-5%) for 100% of the cost.

This report outlines a strategy for states and universities to pursue these large, complicated projects as P3s—and reasons why they should, despite the higher cost of capital.

I. The Big Picture

Program Objective

Expedited delivery in a concentrated timeframe of a significant number of long-planned, high quality New Jersey college buildings and dormitories with guaranteed performance and assured long-term maintenance to meet top-tier higher education standards.

Program Strategy

Plan a comprehensive program. Deliver dormitories and less complicated buildings using the traditional DBB (design bid-build) project delivery approach so as to address the interests of architects, engineers, and constructors normally involved in college building construction.

Deliver medical, research, high-tech and more complicated buildings using the innovative P3 (design-build-finance-operate) project delivery method in order to take full advantage of this new form of competitive project delivery. The College P3 program will build new assets and pay for their long-term cost with appropriated taxpayer funds.

P3 v. DBB

The comparative advantages and disadvantages of P3 and DBB procurement approaches are summarized in the third section of this report, entitled: "P3 vs. DBB Delivery"

Precedents

The State of California completed a highly successful P3 for a similar "social infrastructure" project, the new Long Beach Court Building. Construction will be completed next year. Travis County (Austin) Texas is actively considering a similar project. P3 has also been used successfully in the transportation, water and solid waste sectors.

Name

Give the program a defining name to help counter the "privatization" or "divestiture" critique. California used "performance-based infrastructure." Ontario calls its PPP program "Alternative Financing and Procurement" (AFP).

Business Case

It is becoming common for owners to conduct a "business case" analysis to determine the proper "project delivery method" for large projects. Legally available delivery methods are identified;

goals and objectives for the project are agreed upon; qualitative and quantitative analyses are conducted to determine how well each delivery method will achieve each goal and objective; and the "risk adjusted, net present value, life cycle cost" of delivering the project under each method is determined. A delivery method selection is then made.

This approach helps facilitate and validate the choice among methods, particularly for key stakeholders. P3 is ordinarily compared against the DBB traditional approach. A business case can be conducted for each project, or conceptually as the foundation of a multi-project program.

Private Financing

P3 involves "private financing for public infrastructure"; no public debt is incurred. A special purpose entity (a "project company") is formed solely for the project. It invests equity, incurs debt, subcontracts for design, construction and facilities management, and manages the subcontractors. The private debt is taxable.

Taxable v. Tax-Exempt Debt

P3s involve higher cost, taxable financing, when compared to traditional tax-exempt debt-financed projects using conventional DBB project delivery. Business cases typically show, however, that this cost advantage is generally erased (and even reversed) because of the degree of risk transferred to the project company in a P3. When the transferred risks are identified, assessed and "monetized," the monetary value to the government owner of the transferred risks typically exceeds the monetary advantage of the tax-exempt financing. This is particularly true when, as today, the "spreads" between taxable and tax-exempt interest rates are lower than the historical norm.

Supplemental State Tax-Exempt Financing

The State can supplement the private financing in a P3 by issuing public debt and paying a portion of the design-build costs with the public debt proceeds. The tax-exempt State debt would lower the blended cost of capital for the project.

Project Size

The cost of pursuit of a project to a proposing team runs in the millions. Therefore a sizable project (in the hundreds of millions) is often required to offer a bid stipend of $1-2 million to attract a fully committed proposer field of experienced firms.

Legislative Authority

General legislative authority exists in some states for P3s to be conducted by individual colleges for their own facilities.

State Direction

The State could form a centrally-directed working group for a coordinated and concentrated program of procurement, to be executed by individual colleges. Alternately, new legislation could empower the State to conduct centralized procurements for groups of facilities, groups of colleges,

or both. Evident issues of control, timing, facilitation, financing, funding and credit would have to be addressed in the context of the current system of college facilities contracting, financing and State funding support.

Stakeholders

As with any major new program, all significant stakeholders need to be appropriately engaged to assure the success of a P3. This includes particularly the relevant college administrators, faculty, and parent and student groups, as well as the State education, financial, legislative and executive officials responsible for higher education facilities.

Leadership

P3s require especially strong leadership. This is true particularly at the day-to-day project manager level. Project proposers carefully assess the governmental owner's commitment to using this new form of project delivery before deciding to pursue the opportunity.

Organized Labor

Construction unions tend to support P3, as it expedites construction work opportunities. Prevailing wage requirements are ordinarily included in project agreements in highly unionized states.

Operating unions are sometimes concerned about P3, based on potential worker displacement issues. Most successful P3 initiatives involve early, direct discussions with any involved operating unions to squarely address and resolve their issues. Workforce protection programs are well developed.

Procurement Advisors and Cost

P3s are highly specialized transactions. They normally require the assistance of experienced special counsel and outside consultants (financial, technical and procurement management), with substantial budgets. These budgets are a fraction of the budgets for architect and engineering firms that provide the complete plans, drawing and specifications before bid documents are issued in conventional DBB procurements (normally 6-10% of the projected construction costs).

II. The Developer Perspective

Launching a PPP Program and Implementing It

Communicate motivations and goals clearly to what will be a broad set of interested actors. Think through key implementation issues early, such as:

- What you'll need for a delivery infrastructure
- What's required to draw strong competition which induces innovation and drives down costs
- Be sure to address the needs of the current players in the public infrastructure market

Motivations/Goals

One major mistake some governments have made is to present P3s as a mechanism to access private capital markets. Private capital markets will almost always be more expensive than public debt. The outcomes that are possible that are of interest to taxpayers and facility users could be framed as using PPPs in an attempt to:

- Switch from a focus on lowest cost construction to lowest lifecycle cost
- Cause the private sector to finance the improvements as a mechanism to enable government to have greater leverage over long-term private sector performance
- Shift to a culture of maintaining public assets to drive down taxpayer financial exposure
- Group design /construction/ operations and maintenance in one bundle to transfer integration risk and to foster innovation

Implementation Issues

- Pick your project(s) carefully. You will likely have greater success presenting the need to develop and operate "high tech" buildings (sciences, medical research etc) at a higher standard to support the work conducted inside. Once you have that then:
- Properly staff and budget the initiative. You'll need very good project managers and outside financial, procurement and financial advisors. You'll also need to be sure technical (engineering) resources are available to develop operating specs and programmatic design requirements for the buildings.
- Bring the Financial Advisor on immediately to begin work on the business case, which would include the development of the Public Sector Comparator. Make sure the Public Sector Comparator is carefully prepared. This needs very senior policy oversight.
- Create strong competition through transparency and outreach, and award based on lowest Net Present Value of lifecycle costs.
- Try to reach at least $400 million of capex value. The State is a better credit risk than a local state university.
- Make sure the Public Sector Comparator and the draft project agreement are ready for release at time of shortlisting. Only shortlist 3 finalists.

Managing Constituencies

Everybody will have their antenna up. Lots of quiet outreach is needed prior to announcing the policy initiative, so:

- Have a union (public and private) strategy.
- Make sure the PPP initiative is part of a broader investment effort such that the long-term

players (architects, contractors, bond underwriters etc.) are not threatened.

- Pay special attention to the buildings' constituents—researchers, doctors etc. and the private sector companies that depend on this work. Controversy stirred up by opponents will scare away competition.

- States that have made this a "populist" issue ("I'm tired of flushing precious taxpayer money down the toilet when private companies build our infrastructure. I want performance. I want to hold a hammer over their head . . .) have seemed to enjoy success on selling the concept.

III. P3 vs. DBB delivery

A. P3 Project Delivery Method: DBFO

P3 Description

The terms "P3" (Public-Private Partnerships) and "DBFO" (Design-Build-Finance-Operate) are synonymous. In a P3, the project is owned by the government, just as it is in DBB.

P3 involves single contract with a "project company" for design, construction, financing and facilities management, typically 30 years. Best value, competitive selection of the project company (price plus qualifications; experience; proposed design; financial strength; financing proposal, and technical and business proposal). Facilities manager involved in design development. P3 "project agreement" is negotiated following best value selection. Concurrent performance of design and construction work.

P3 Advantages

Expedited Delivery Schedule. Shortens schedule for procurement and project delivery.

Guaranteed Performance. Design liability and performance risk are transferred to the design-builder and facilities manager through the project company. Comprehensive project agreement assures that the project will work as intended for 30 years.

Early Price Certainty. Construction price is known, and guaranteed, at 20% of design, when proposal is submitted.

Construction Quality. Major studies show improved construction quality.

Full Collaboration Between P3 Team Members. Builder, designer, facilities manager and infrastructure developer, all self-select. Their interests are completely aligned both in winning and executing the job.

Design and Construction Risks Transferred. Transfers to design-builder through the project company the risks of design; construction cost overruns; completion delay; project efficacy; and some permitting risks.

Best Value Selection. P3 project company (and entire project team) is selected on overall best

value, considering price; technical, financial and business terms; qualifications; and past performance.

No Change Orders. Typically there are no contractor-initiated change orders, because the contractor furnished the design. Disputes are rare.

Lower Transaction Costs. Procurement requires minimum design work. Cost to prepare RFP is relatively low, in comparison to cost to prepare a DBB bid package.

Lifecycle Focus. Maximizes life-cycle focus.

Single Point of Responsibility. Performance of the design, construction, operation and maintenance work is guaranteed by a single project company, creating one point of accountability. Comprehensive asset development and management under a single contract. Public owner is shielded from disputes between the designer, builder and facilities manager.

Lowest Cost. Trade-offs permitted between capital and operating investments and costs. Competition as to total life cycle project cost between teams, and collaboration within teams, produces lowest life cycle costs. Smaller contingency allowances. Broader technology access.

Promotes Innovation. Collaboration and competition also promotes innovation.

Guaranteed O&M Costs. Long-term operating and maintenance (including capital maintenance) costs guaranteed by the facilities manager through the project company, increased only for index-linked inflation.

Improved Capital Maintenance.

P3 project agreement assures long-term capital maintenance; less tendency to practice breakdown

maintenance. Transfers to the project company and facilities manager, the risks of O&M cost overruns; regulatory compliance; capital maintenance; technological obsolescence; and labor relations.

Risk Transfers. Extensive risk transfers to project company has substantial monetary value.

Equity Investment. At-risk equity investment (often 15-20%) by project company assures DBOM performance.

Project Finance Lenders. P3 project agreement is the only security for repayment of project financing, assuring careful due diligence by lenders as to feasibility, capability, cost and performance.

Enhanced Security for Performance. Service fee payments by owner do not start until project is complete and passes acceptance tests. Deductions imposed for non-performance during operations.

No Owner Debt. Debt is recourse to the project company; debt is not recourse to the public owner.

Owner Debt Flexibility. Allows use of owner's debt capacity for other projects; can delay onset of rate increases.

P3 Disadvantages

Less Familiarity. Learning curve involved.

Selection Complexity. Best value proposal evaluation and selection can be complex.

Pricing Contingencies. Contractor's lump sum design-build price includes contingencies because design is incomplete at the time of proposal.

Limited Control Over Design Details. Unless design requirements are heavily prescriptive, there is a limited ability to control the details of what will ultimately be proposed and built.

Limited Owner Collaboration. Limited opportunity for the public owner and design-builder to collaborate during the procurement process.

Owner Obligated to Determine Design Requirements Early. The public owner must determine the design and construction quality requirements, and performance standards, at the time the request for proposals is issued. Later change orders result in price adjustments.

Operating Staff. Transferring operating employees to private employment, if required, removes skilled staff from direct owner control, but lessens owner responsibilities for labor relations.

Contract Administration. Requires owner supervision of facilities manager performance.

Unwind Risk. Significant convenience termination fee is payable if service or relationship issues lead to termination.

Transactional Complexity. Adding "finance" to a contractor's responsibility increases the relative complexity of this form of procurement.

Debt Service Costs. Debt service on owner's tax-exempt municipal revenue bonds (with DBB) is lower than it would be on the project company's project debt to pay for the construction under a P3.

B. Traditional Project Delivery Methods: Design-Bid-Build

DBB Description

Two separate contracts / Qualifications-based selection of design professional only, no price competition / Lowest responsible bidder selection of construction contractor, with price as the sole criterion / Design is 100% complete before construction contract is executed/ No negotiation of construction contract/ Public sector responsible for facility management.

DBB Advantages

Familiarity. Well understood and proven over time.

Control. Full input and control on design details and means and methods.

DBB Disadvantages

Longer Delivery Schedule. Sequential, linear process takes time.

Little Collaboration. Designer and builder are separately contracted and perform with little collaboration. Limited involvement by facility manager.

Designer Driven. No design competition; extra expense can result from pronounced design conservatism.

Late Price Certainty. Relies on engineer's estimates of cost until the bid date.

Change Orders and Disputes. Prone to change orders and disputes adding extra cost resulting from design errors and omissions.

Vulnerable to Less Qualified Builder. Qualifications-based selection of builders not permitted.

Retention of Design Liability and Performance Risk. Builder not liable for design or constructability errors, or poor performance of the project. Project performance risk and budget risk are borne by the owner.

Retention of Lifecycle Risk. Owner retains risk and responsibility for lifecycle cost, facilities management, long-term capital maintenance, and long-term project performance. n

end

Social Infrastructure

NIH Build-To-Suit Lease at Johns Hopkins

by Patrick J. Keogh

I have previously presented my views on the principles that guide effective public-private partnering of development deals. Now I will try to show how those principles were applied to a successful deal: the $250-million leased build-to-suit home to the National Institutes of Health's National Institute on Aging (NIA) and the National Institute of Drug Abuse (NIDA). The project is located on the east Baltimore, MD campus of Johns Hopkins just west of I-95.

NIH is the federal government's primary medical research enterprise. NIH conducts research in-house that they call their "intramural" program. But the vast majority of their research funds go by way of grants to a wide variety of universities, hospitals and research institutes which collectively comprise NIH's "extramural" program. The largest single recipient of NIH grants is Johns Hopkins. Incidentally, after the government, Hopkins is the largest single employer in Maryland.

NIH is comprised of a number of individual institutes. Both NIA and the NIDA had a large presence on Hopkins' east Baltimore campus. In the early years of this century NIH wanted to replace their existing obsolete and rented facilities in Baltimore with a new research center. When NIH started down its public private partnering process it had no money for development nor any authority to develop a new center.

AMV had a long standing relationship with NIH in advising on development deals. That relationship had led NIH to partnering out the developer role on other major projects. NIH engaged AMV to advise on the acquisition strategy for what would become the NIH Bayview Research Center. AMV holds a schedule contract with the US General Services Administration that allows us to offer real estate, legal and financial advisory services. A schedule contract is like a catalogue with pre-negotiated rates and fees. The first step of the acquisition strategy was to partner out the developer role. NIH issued a Request for Qualifications for a private developer partner to work with NIH to create a business plan for the new facility.

The RFQ solicited developer partners based on experience, qualifications and compensation expectations. It took about two months from issuance to selection of the developer. Once selected, the developer issued RFQs for an architect and construction manager. The developer conducted the competitive procurements subject to NIH's oversight and those procurements took about six weeks or so. Remember, none of these solicitations are asking "what" the offeror will do but rather "who" they are and what they have done in the past to qualify them to work on this d evelopment planning effort. Also, remember NIH still has no authority to develop anything. There is no "box" that a solution must be fit in to.

With the team in place the business planning process started. The plan needed to address things like the program and architectural concept for the facility, the public value it would create, the location of the facility, development cost, and financing options. Because Hopkins operated a hospital on the Bayview campus, NIH and Hopkins needed to understand the synergies and business terms that would govern their future relationship. A Hopkins- provided hospital relationship obviated NIH's need for beds and testing facilities. Everyone was at the table to design the business plan; not only the NIDA and NIA tenants but the Hopkins site and hospital services provider as well as the full development team. At this point, NIH is paying some of the participants such as the lawyers in the preparation of the business plan. All governments have authority to do studies so it might be helpful to consider this the study period. But it is important to understand that every party has dibs on the relevant role if a real deal is eventually authorized.

After about six months a business plan was drafted. It is important to understand that the plan is a "draft." The plan is understood by everyone to be dynamic. The plan contains the program for NIDA and NIA occupancy, how the new "NIH Bayview Research Center" will operate, the public value that will be created by the Center, development and operations budgets, and business terms among the various development parties and financing options.

The latter point is particularly important. The business plan did not define a single way for financing the Center. Rather, it outlined various public appropriation and private financing options. A research center, in the end, is a tool of dynamic medical research science. It may become

functionally or economically obsolete with time. Ownership may not always be a positive. There is a risk and possibly a cost associated with ownership. The business plan outlined those risks and detailed various funding options. This was not a deal intended to fit into a preordained box. Rather, it was a deal the solution for which was tailor made for the situation. And tailor made by people who were at risk and incentivized to find ways to create the best deal they could.

Hopkins is a huge economic presence in Maryland. NIH, headquartered in Bethesda MD, is also an important citizen. Not much happens with either that its local and national elected leaders are not aware of. Needless to say, the elected officials took special interest in the NIDA and NIA business plan and encouraged the team to seek GSA sponsorship for the plan. When that took more time than the leadership was comfortable with the Maryland delegation to Congress sponsored special legislation to authorize implementation of the business plan, choosing the private financing option in the business plan.

The final steps in the business planning process involved negotiations with the Administration's Office of Management and Budget. They were not comfortable with the $60/sq-ft lease rate outlined in the plan and insisted on a $50 rate and strict conformance to the federal scoring rules. Those rules are very similar to FASB 13 requiring that the credit tenant not assume the risks of ownership of the completed facility.

That made sense for Bayview and the final financing structure involved amortization of 60% of the project cost over the 25-year lease term with a AAA insurer assuming the risk of the residual value and the 40% financing balloon after the initial term.

With the final reengineering of the financing to suit the OMB requirements the now authorized deal was executed. All the parties were in place and the business terms negotiated once authorization was achieved. There was no need to procure design and construction contractors. They were already in place and their business terms negotiated as part of the business plan process.

Federal and local government deals are much more alike than they are different. They usually presume a standard way of doing a development deal; a "box" that the development planning and implementation process must conform to. Times have changed. Money is not available. We who practice in the public sector need to embrace private development models. We need to think less in terms of money, costs, procurement, contracting, requirements, appropriations and authorities. We need to think more about leverage, value, relationships, and partners.

An empowered public-private partnering approach is the way to capture the most value for our citizens while expending the least amount of public funds. It's the way we would do deals for our own account. It's the way we should do deals for our citizens.

June 6/12

Social Infrastructure

NJ Schools P3 Bill Introduced

June 2012—Facing a contentious vote soon on whether to realign its higher-education assets, New Jersey's legislative leaders on June 15 proposed a large bond for traditional capital projects and a P3 program directed at developing revenue-producing facilities. All of the projects in both programs would have to be built and operated by NJ-registered contractors under project labor agreements at prevailing wages.

The proposed $750-million bond, the largest in state history, must pass a voter referendum in November and get the approval of Gov. Chris Christie. Both are uncertain, given the state's precarious fiscal situation.

The P3 leasing law would provide tax abatements and other incentives for private development of revenue-producing facilities on public land in order to generate funds for colleges to build research and academic buildings.

The bill, S. 2501, is sponsored by Democratic Senate President Stephen Sweeney, an organizer for the state ironworkers union, and Sen. Thomas H. Kean Jr., Republican leader. Both houses approved similar bills in late June. However, the Assembly version requires the legislature's Joint Budget Oversight Committee to approve leases negotiated by colleges before they can apply for conduit financing from the state.

The proposed bill expands and extends by one year an existing law sponsored by Sweeney and Sen. Ray Lesniak in 2009. Under that law, the New Jersey Economic Development Authority (NJEDA) has committed to finance four higher-ed projects so far totaling $417 million, according to Caren S. Franzini, Chief Executive Officer.

Projects fully negotiated at the college level, including a signed contract between a bonded developer and a state certified contractor, must be approved by NJ EDA to qualify for conduit financing using tax-exempt private activity bonds.

The first project under that program, which is directed by senior project manager Juan Burgos, is a $211-million student housing project done by a nonprofit developer to alleviate a housing shortage at Montclair State University. Others underway or planned, according to Lesniak, include:

· Montclair State University: Cogeneration heating, cooling and electricity plant, plus distribution system;

· The College of New Jersey: Campus Town project;

· New Jersey City University: 300-400 bed residence project;

· Ramapo College: Final paperwork on a 5-Mw solar installation, new roofs and a cogeneration heating, cooling and electricity facility;

· William Paterson University: 300-400 bed residence.

At Montclair State, a 568,000-sq-ft "state-of-the-art residential complex," called The Heights, was built in a student residence area on six acres of university land over 14 months by Terminal Construction, Woodbridge, NJ. Rents, collected by the university, are unregulated, and competing facilities at the university can only be built if a proven demand exists for new dorm capacity.

The university will receive all net revenue under a 40-year ground lease after debt service and a management/O&M fee of $555,600 paid annually to a nonprofit LLC called Provident Group-Montclair. The deal was put together by Capstone Development of Birmingham, Ala., and financial advisor Kenneth L. Becker, President of Becker Capital and Finance, Atlanta.

The EDA issued $211 million in BB rated, tax-exempt bonds for the nonprofit project company last June at 5.25%. The bonds mature in 2019, according to the offering statement.

The development fee is about 15%. About half of the management fee is in the form of subordinated debt. Capstone isn't happy about that, but is seeking similar opportunities.

In addition to Montclair State, Becker Capital has been the advisor for over $1 billion of debt offerings including project financings for over 3,000 beds of student housing for Montclair State, the University of Florida, Marshall University, and Kennesaw State University.

"I can't figure out why this isn't used on more student housing," says Becker, who was Director of Public Finance for Citigroup Global Markets, Inc. and head of its real estate group until 2008.

May 2012

Social Infrastructure

Public Comparator Report Positive on Travis County Courthouse P3

May 2012—Travis County, Texas, will put the decision whether to pursue a DBFM or design-build contract for its new courthouse in Austin to a stakeholders' group of local professionals who will make their recommendation by early July. This is the first time such a group has been convened by the county to decide on a procurement approach.

A public comparator study presented to the commissioners by Ernst & Young last month estimated the DB capital cost for the 510,500-sq-ft, free-standing courthouse and 188,300-sq-ft underground parking garage at $285 million vs. $269 million for the DBFM option. The analysis showed substantial risk-transfer benefits. Life-cycle savings over 30 years are estimated to be $27.5 million with private operations.

As proposed in the comparator, AAA-rated Travis County would buy down the private project's cost by financing half the capital expenditures with its own funds. The county recently sold 20-year bonds at 2.85%, tax-exempt.

Air rights fees from a new office tower proposed for the site, estimated at up to $23 million (net present cost over 30 years discounted at 7%), were excluded from the base-case analysis because of market timing and uncertainty, according to the report presented to court commissioners on April 17.

Excluding those fees resulted in a 3.7% value for money advantage for DBFM(O) delivery over a design-bid-build approach and 3.6% advantage for DB, Ernst & Young found. Without the tax-exempt financing cost advantage of public delivery, the P3 option would have been substantially greater than DBB on a life-cycle basis, says a close observer.

The legal analysis by Hawkins Delafield & Wood found that the private financing approach proposed for the courthouse would be legal under the state's new P3 enabling law, SB 1048.

Travis County paid $21.5 million for the site in December 2010. Twenty one firms responded to a request for information last year. With the value for money report done, the next step will be to convene a committee to select a procurement method. County Judge Samuel T. Biscoe is leading the study effort, which was managed by Belinda Powell strategic planning manager for the county commission.

Consultants will be hired within the next six months if a PPP is chosen, she says.

December 2010

Social Infrastructure

$492m Long Beach Courthouse Privately Financed

December 2010—Meridiam Infrastructure this month closed a $492-million debt-equity project financing for California's largest courthouse, leading an all-American development team that will design, build, operate and maintain the Long Beach facility under a 35-year lease-leaseback contract that's off the state's balance sheet.

The new 530,000-sq-ft building will be the first new courthouse built in California in 40 years.

Long Beach is the only Performance-Based Infrastructure (PBI) project financed during former Gov.

Arnold Schwarzenegger's administration. The more visible Presidio Parkway DBFO project in San Francisco reached commerial close on Jan. 3, hours before Democrat Jerry Brown was sworn in as governor. A financial close is is set for September (see p. 3).

For the Long Beach project, developer Meridiam Infrastructure paid in $49 million cash equity at the closing on Dec. 21. Seven-year floating-rate miniperm loans totaling $443 million were arranged with a bank consortium to cover the three-year construction period and allow Meridiam four years to refinance. The lenders are: lead bank BBVA, with RBC, Scotia Bank, BNP Paribas, Credit Agricole and Deutsche Bank.

At the financial close, a blended LIBOR swap was used to set the all-in interest rate, which determined the final cost of the service contract to the state. The payment for the first full year of occupancy, 2014-2015, is set at $53.65 million, assuming no deductions for poor performance.

(Meridiam worked with Barclays Capital last summer to look at 30-year-plus taxable bond financing with an appropriation-risk credit rating one step below the general obligation bonds of the state. The taxable bond market for California was highly volatile at the time, however, so the decision was made to go with short-term bank financing.)

The Business Deal

The Long Beach Court Building will house 31 courtrooms of the Superior Court of Los Angeles County, administrative space, offices of related county justice agencies, and about 50,000 sq ft of commercial office and retail space. A nearby existing parking structure will also be renovated and expanded to over 900 spaces.

The state owns the courthouse site and is leasing a six-acre parcel of land to the private sector for 50 years. If the project agreement expires as scheduled in 35 years and everyone has performed, the lease will terminate and control of the property will revert to the state. If the state doesn't pay its rent, the private sector has the right to evict it, convert the property to a profitable use, and operate it for the final 15 years of the agreement.

American Success

Long Beach is an American success, says Aiello. "We think this is the first all-U.S. team in the PPP space. It's a terrific message to the market."

"One of the things we've been trying to do at Meridiam is to make sure that as this PPP system evolves that it is viewed by U.S. professionals in the infrastructure space as something they can participate in," he says. "It's not a market that has to be dominated by companies from Europe, Australia and elsewhere."

The project was procured by the California Judicial Council through the Administrative Office of the Courts (AOC), which handles all construction for the judiciary. Its work was directed by Clifford Ham, Principal Architect of AOC, which was advised by Ernst & Young's Vancouver, B.C. office and attorneys from Hawkins Delafield & Wood.

The AOC has its own enabling legislation, adopted in 2007, which allowed it to bypass the legislature for approval of the final contract. The deal did require a sign-off by the executive branch Dept. of Finance, which accepted AOC's value-for-money analysis on Dec. 16.

The analysis showed a positive benefit—"a couple of percentage points," says Ham. The key benefits to the state, he says, are the assured funding of maintenance over 35 years and the ability of the state to expand into the 50,000 sq ft of commercial space as its need for courtrooms increases. Ham also believes that the opportunity to confer with the three finalists during the proposal process greatly improved the quality of their designs.

Speed of delivery, transfer of construction and operating risk, and other elements of the PPP value proposition are still hypothetical, says Ham: "The questions will be answered in due time."

Most other institutional building PPPs in the U.S. have been financed with tax-exempt debt issued by 63-20 nonprofit corporations. Though it brings a lower cost of capital, the IRS rules governing 63-20s prohibit use of private equity. "You don't have an entrenched developer/equity investor with long-term risk exposure," says Aiello.

Meridiam's project company, Long Beach Judicial Partners, LLC (LBJP), consists of AECOM Design; Clark Construction Group, LLC; Edgemoor Real Estate Services (owned by Clark); and Milwaukee-based Johnson Controls Inc. Clark Design/Build of California, Inc., bonded its performance under a $350-million, fixed-price, date-certain delivery contract. Johnson Controls guaranteed its facility management, operation, and maintenance performance and will manage the final hand-back to the State of California.

Consortium financial advisors include KPMG and BNP Paribas. Fulbright & Jaworski's legal team advising LBJP was led by Andrew Hart from its London office.

Canadian Model

After a number of visits by Canadian government PPP experts in 2008, AOC adopted the Canadian approach for assessing proposals and for negotiating the lease.

In the value-for-money "comparator" model, an expert panel is convened to evaluate the public and private options based on the panel's collective opinion about how each of about 70 separate types of risks might impact costs. This is the "industry standard" used in Canada, which adopted the structured risk assessment method used in the U.K.

During contract negotiations, all pieces of the selected developer's DBFO puzzle are incorporated into a financial model that's created by the project company and made available to the government and its advisors. The developer's desired return on equity is plugged into the model and that becomes the single point of focus for negotiations. KPMG ran the model for Meridiam, and Ernst & Young reviewed it for AOC.

At construction completion, an independent building expert has to certify that the building is properly commissioned to function as specified by AOC, according to a detailed set of design, construction and operations performance standards. The expert is paid by all parties to act, in

effect, as an arbiter in the commissioning process.

Among the banks, Toronto-based RBC took a leadership role, says Aiello, and that gave comfort to the European lenders: “It’s a very strong Canadian bank with a local presence [in California] and they were very excited about the project.”

Also, RBC has worked closely with Johnson Controls. It was a lender to two large hospital DBFO projects in Ontario, where Johnson Controls is the long-term operator and guarantor of performance.

California Risk

The bank transaction is a project financing so it’s the 10% equity invested by Meridiam that holds the various pieces together. Lenders have recourse only to the contracts, not to the state, Clark or Johnson Controls. The repayment of the bank loans is subject to annual appropriation by the legislature, so it is not considered a debt of the state.

In a default, the lenders only get the equity returns that would have been paid to the project company in order to cure problems and continue operations.

(A similar structure has been used for years in lease-purchase deals by the General Services Administration to build new federal office buildings.)

Meridiam’s challenge was to convince the banks that annual appropriations would be made by the legislature to pay the project company. “You have to put together all these pieces to demonstrate to the banks that there is a solid foundation of support for this project,” says Aiello.

There are a lot of pieces. The Schwarzenegger administration was a strong advocate of Performance-Based Infrastructure. The state has been trying to build this courthouse, the biggest in the California system, for 20 years. The City of Long Beach strongly favors the project. Democratic Senator Alan Lowenthal, a Long Beach resident who chairs the Senate Committee on Transportation and Housing, is a key supporter.

California’s state budget is put together in an intricate process that’s built on the previous year’s budget. It is not zero-based budgeting, so once an appropriation is embedded in the baseline budget the legislature has to affirmatively act to take it out.

AOC’s challenge will be to get Long Beach in the baseline budget starting in three years when the first service-fee payment comes due. After that, adjustments for uninsured losses and other uncovered risks would be funded through a budget-change proposal that does not include a review of the original appropriation.

Market Mover

It took about two years to compete and finance the courthouse, much longer than AOC expected. Now that it’s financed, Aiello says, “We’re hopeful that it will help move the market a bit.”

“There are a lot of courthouses that need to be built in California and around the country,” he says.

“Long Beach is getting a lot of attention. They’re going to look at this model and see if it fits their purposes.”

Government needs the PPP option, says AOC’s Ham. “We’re creating a new tool and we need all the tools we can get,” he says. n