

Public Works Financing

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\$492 Million Long Beach Courthouse P3 Opens The Door For Social Infrastructure

by William G. Reinhardt, PWF editor

December 2010—Meridiam Infrastructure closed a \$492-million P3 project financing for California's largest courthouse in December 2010, leading a 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 530,000-sq-ft building will be the first major new courthouse built in California in 40 years and one of the largest social infrastructure projects to be developed under an availability-based payment agreement in the U.S.

California has a backlog of 500 courthouse capital projects but is not likely to repeat the P3 approach until results of this first project are known, says Clifford Ham, Principal Architect of Administrative Office of the Courts (AOC), which directed the procurement.

Speed of delivery, transfer of construction and operating risk, and other elements of the P3 value proposition are still hypothetical, says Ham: "The questions will be answered in due time."

The project, which took over two years to bid and finance, was procured by the California Judicial Council through the AOC. Its work was directed by Ham, who was advised by Ernst & Young's Vancouver, B.C. office and attorneys from Hawkins Delafield & Wood.

Performance-Based Infrastructure

Long Beach is the only Performance-Based Infrastructure (PBI) project financed in California during former Gov. Arnold Schwarzenegger's administration. The more visible

Presidio Parkway DBFOM project in San Francisco reached commercial close on Jan. 3, hours before Democrat Jerry Brown was sworn in as governor.

Brown's administration has not challenged the Presidio Parkway project. A financial close using availability-based payments from the state is set for September by development partners Hochtief PPP Solutions and Meridiam Infrastructure. An appeals court challenge to the contract by the state public employee union, Professional Engineers in California Government, is still pending, however, and could delay the financing.

Bank Financing

For the Long Beach project, developer Meridiam Infrastructure paid in \$49 million cash equity at the financial close on Dec. 21, 2010. Seven-year floating-rate mini-perm 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 loans were priced at 275bp over Libor during construction. The lenders are: BBVA, RBC, Scotia Bank, BNP Paribas, Credit Agricole and Deutsche Bank.

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 also will be renovated and expanded to over 900 spaces. Both will be managed by the consortium as a private business.

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 Joseph Aiello, North American CEO of Meridiam Infrastructure. "We think this is the first all-U.S. team in the P3 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, 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.”

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.

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.

Most other institutional building P3s 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.

Value for Money Test

After a number of visits by Canadian government P3 experts in 2008, AOC adopted the Canadian approach for assessing proposals and for negotiating the lease.

In the Canadian 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 and modified 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. RBC 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 the Long Beach Courthouse appropriation 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 bid 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."

In fact, there are about 3,000 hospitals in the U.S., and many need retrofits or upgrading, which could be done using the Long Beach model. In education, there are 40,000 colleges, a and many are in need of innovative solutions to their capital needs.

Government needs the P3 option, says AOC's Ham: "We're creating a new tool and we need all the tools we can get."

Whether governments want the P3 option remains to be seen. The next big project may be with Travis County, Tex. Officials there recently met with about 20 companies, including Meridiam and Skanska, that are interested in P3 development of a \$300-million courthouse in Austin. The county recently paid \$22 million for an unencumbered site. RFIs are due June 30, 2011.

The county has been considering a municipal lease transaction that would be 100% debt-financed with tax-exempt municipal bonds. One P3 challenge will be to prove that a fixed-price design-build contract and private operations under a taxable debt-equity project financing delivers greater value than the municipal lease, which includes no equity. The county was interviewing financial advisors in mid-June 2011 to help it decide on a procurement approach.