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Alternative Project Financing and Delivery Methods for Developing New Oahu Community Correctional Center

The State of Hawaii will require substantial investments to its correctional facilities to accommodate current and future inmate populations and to meet state and national standards. Therefore, it is appropriate that the state evaluate various project financing and delivery methods available for developing a new Oahu Community Correctional Center; these include both conventional public financing and alternative bond and revenue generation options. A brief overview of these options is as follows:

“Pay As You Go”

The “pay as you go” form of financing involves the appropriation of public funds necessary to complete the proposed project within a single fiscal year. If the project’s construction spans multiple years, then additional funds must be appropriated for each year construction continues.

Bonds

A bond is a security instrument which acknowledges that the issuer has borrowed money and must repay it to the bondholder at a specified rate of interest at periodic intervals. A bondholder also receives the amount lent (the principal) when the bond reaches its maturity. Bonds are known as debt securities and are different from loans because as a security they can be publicly traded and have values that can fluctuate. Debt securities with a maturity of 13 months or less are known as notes; however, bond maturity can extend up to 30 years.

General Obligation Bonds

Until the 1980s, General Obligation Bonds (GOs) were the most frequently used form of public financing for correctional facility construction. However, the use of GOs has declined as states and counties faced higher budget deficits and fiscal challenges, including limits on accrued debt as well as competing priorities for the use of bond financing.

Revenue Bonds

Revenue bonds differ from GOs in that repayment is not directly secured through the taxing power of the government jurisdiction but rather through a pledge of a specific stream of revenues. Because of this difference, revenue bonds are referred to as “limited obligation” or “special obligation” bonds. The ultimate source of the funds to repay the debt could derive from a variety of sources, including fees, tolls, special district taxes, or general tax revenue that must be re-appropriated on an annual basis.

Sale of State Assets

Another approach for potentially generating significant funds, although on a one-time basis, would be to designate selected state property and assets as surplus and put them up for sale. Before such property or an asset can be sold, however, the state must declare it to be surplus.

Certificates of Participation

In recent years, governments have begun using a specialized type of revenue bonds to finance capital projects, referred to as Certificates of Participation (CoPs). CoPs are lease financing agreements in the form of securities that can be issued and marketed to investors in a manner similar to tax-exempt debt.

Public Private Partnerships

Public Private Partnerships (PPPs) are collaborations between governments and private entities to provide public infrastructures, facilities, or services for long-term periods through the sharing of risks, responsibilities and rewards. These partnerships are formed to optimize the advantages that the private sector can offer in building and/or operating public facilities and infrastructure. Examples of these include Private-Finance-Build-Transfer, Design-Build-Finance, Performance Based Infrastructure, Developer Finance, and Lease/Purchase.

Given limitations on traditional funding methods, and recognizing that the investments needed now and in the future could have a major impact on future budgeting cycles, the Consultant Team has been working to educate decision makers on potential approaches. On November 28, 2016, Architects Hawaii Ltd and Louis Berger U.S. hosted a workshop devoted to alternative methods to deliver and finance construction and long-term operation and maintenance of large-scale public works projects. The workshop, led by Barney Allison and Evan Caplicki of Nossaman LLP, provided a learning experience about the options available to finance future correctional facility construction including the use of public and private debt and private equity and a performance-based approach to long-term operation and maintenance. The workshop presentation on Alternative Project Financing and Delivery Methods follows.



Alternative Project Financing and Delivery Methods

Oahu Community Correctional Center

Barney Allison and Evan Caplicki
Nossaman LLP
November 28, 2016

Workshop Overview

- 9:00 – 9:05 AM: Welcome
- 9:05 - 9:10 AM: Purpose of Workshop
- 9:10 –10:30 AM: Conventional Project Delivery and Why to Consider Alternative Financing and Delivery Method
- Types of P3s
- 10:30–10:45 AM: Break
- 10:45 – Noon: Delivery Method Selection Process/Value for Money Analysis
Alternative Financing Arrangements
- Noon – 1:00 PM: Lunch
- 1:00 – 2:00 PM: Overview of Interactive P3 Procurement Process
- Breakdown of Resource Requirements
- 2:00 – 2:10 PM: Break
- 2:10 – 3:00 PM: Legislative Issues and Options
- 3:00 – 3:15 PM: Closing/Wrap-up

Purpose of Workshop

- Substantial investments needed for Hawaii's infrastructure, including correctional facilities
- Among state's priorities: Oahu Community Correctional Center
- Limited availability of funds for capital improvements via traditional financing methods
- Growing pressure on operating budgets
- Purpose of Workshop:
 - Learning opportunity about options available to finance future capital improvement project
 - Broaden knowledge base on alternative methods to deliver and finance construction and long-term operation and maintenance of large-scale public works projects
 - See how other public agencies are using public and private capital to deliver large projects
 - Opportunity to ask questions of leading industry experts and discuss the pros and cons of different approaches

Conventional Project Delivery and Why Consider Alternative Financing and Delivery Methods

Conventional Project Delivery & When to Look For Alternatives

- In the United States, public construction projects historically rely upon the traditional Design-Bid-Build (“DBB”) model

Owner Responsibilities	Private Party Responsibilities
<ul style="list-style-type: none"> – Designs project to 100% PS&E, directly or through engineering consultants – Breaks project up into biddable scopes – Bidder submitting the lowest responsive bid is awarded the contract – Pays invoices out of available revenues, grants and/or bond proceeds – Operates and maintains project itself or through separate developer(s) – Keeps integration, traditional construction, long term performance and revenue risks – Allocates risks between parties conventionally 	<ul style="list-style-type: none"> – Perform construction under standard design and construction contracts / specifications – Have conventional rights to claims and change orders

Other conventional tools, such as CM-at-Risk and CMGC, are not dissimilar

For Certain Projects, P3s Can Better Achieve Public Owner's Goals

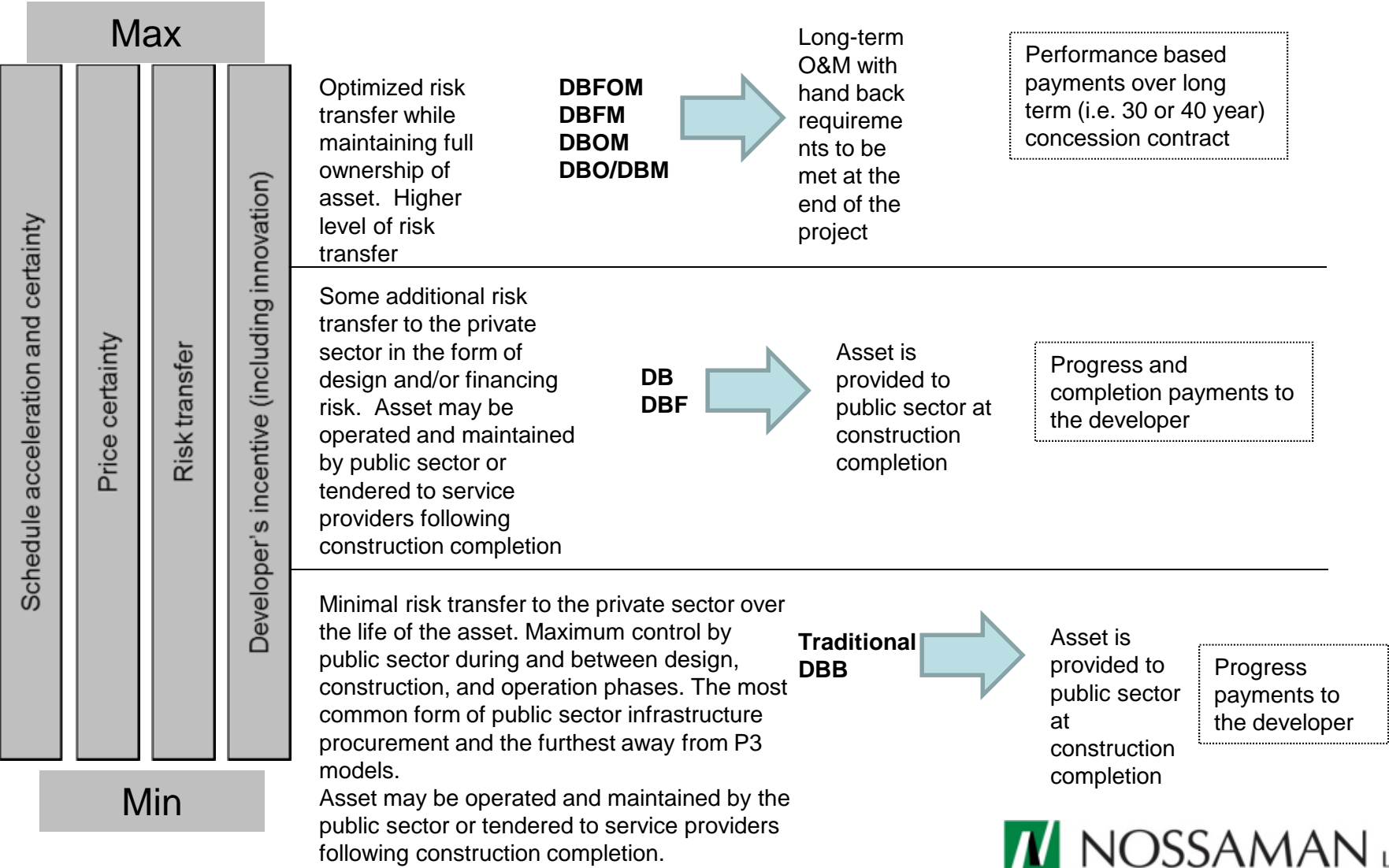
- Conventional delivery works well for many projects, but there are projects for which P3s can offer better outcomes, such as when one or more of the following are priorities:
 - Cost and/or schedule certainty at the preliminary design stage, with significantly reduced risks for claims and change orders
 - Accelerated completion
 - Lifecycle / whole life cost efficiencies
 - Incentives for quality facility performance
 - Private sector innovation to reach technical / financial feasibility and/or to lower capital and operating costs
 - While not creating new funding, achieving government financing flexibility not possible within traditional municipal markets
 - For certain kinds of P3 structures, reducing government exposure to lower-than- projected future project revenues

How Properly Structured P3 Can Better Achieve Public Owner Goals

- P3 delivery models can help realize such goals by:
 - Focusing technical specifications less on means and methods regulation and more on performance and outcomes
 - Allowing developers more control over how they deliver the project
 - Capturing economies of scale and lowered integration risk through aggregating contract scopes into single points of responsibility
 - Paying a higher cost of capital to secure financing flexibility, but more importantly to ensure lenders have a direct stake in achieving quality infrastructure outcomes
 - Creating a unique, highly demanding competitive environment that successfully attracts the biggest and most capable infrastructure developers in the world to invest

TYPES OF P3s

Types of P3s: Range of P3 Structures



Types of P3s

■ There is a spectrum of P3 delivery models, many hybrids and variations, but the following are the major types of P3 contracts:

- Design-Build-Maintain
- Design-Build-Finance
- Availability Payment
- Revenue Risk
- Pre-Development Agreement

Types of P3s: Design-Build-Maintain

- Design-build contract with a mandatory or optional maintenance scope
 - Routine and/or capital maintenance
- When appropriate:
 - Similar to design-build
 - Where some life cycle cost and maintenance risk shifting creates value
 - Where term/compensation structure work within IRS management contract rules
 - Where public funds are available for both construction as well as O&M term

Types of P3s: Design-Build-Maintain

- Attributes:
 - Same as design-build through construction
 - Continued maintenance acts like an extended warranty
 - Transfers some life-cycle costing risk to private sector
 - Typical term is 5-15 years after substantial completion
 - May allow for use of tax-exempt debt
 - Can be used for revenue producing and non-revenue producing projects (if non-revenue producing, may be able to extend the O&M term)

Types of P3s: Design-Build-Maintain

- Potential Drawbacks and Issues:
 - Same as design-build through construction
 - Less control over project maintenance by public agency
 - If revenue-producing facility, public sector retains revenue risk
 - Generally must comply with IRS management contract rules which constrain term and compensation structure
 - Marriage of design-build contractor and maintenance provider isn't always an easy one
 - Performance security and parent guaranties

Types of P3s: Design-Build-Finance

- When Appropriate
 - Sufficiently designed for developer to guarantee price/completion date
 - Not 100% designed, to permit developer innovation
 - A gap exists between total project capital costs and identified public funding sources
 - The timing of available funding is spread over time and does not allow for levels of upfront capital needed to do the project
 - Savings from accelerated project delivery outweigh cost of private sector financing
- Can combine with maintenance

Types of P3s: Design-Build-Finance

- Public Owner Responsibilities:
 - Performs conceptual / preliminary design
 - Achieves environmental clearance
 - May provide some, but not all, capital funding
 - Oversees design and construction
 - Operates and maintains the project
 - Keeps long term revenue risks

Types of P3s: Design-Build-Finance

- Developer Responsibilities:
 - Designs and builds the project
 - Assumes integration of design and construction and other development risks conventionally retained by public agencies
 - Finances the owner's shortfalls in cash flow
 - Provides debt financing via one or more mechanisms (i.e., deferred payment schedule, contractor loan, subordinated debt, private finance, tax exempt finance)
 - Assumes interest rate risk on its financing
 - Guarantees price / completion

Types of P3s: Design-Build-Finance

- Results in:
 - Greater price certainty with a lump sum price / guaranteed delivery date
 - Cost and time efficiencies
 - Owner cash flow financing, as needed

Types of P3s: Availability Payment

- Milestone and Final Acceptance Payments
- Unitary payment for capital expenditures, O&M expenditures and financing costs made periodically after substantial completion (e.g., monthly, quarterly)
- Fixed amount that may:
 - Be adjusted downward based on developer's performance with respect to quality, safety, performance, environmental provisions, etc.
 - Be adjusted by changes in an index (e.g., CPI)
- Structure encourages early completion of the construction phase and quality facility performance

Types of P3s: Availability Payment

- Suitable when:
 - Owner wishes to transfer life-cycle cost risk but retain certain operational functions
 - Project revenues are difficult to predict
 - Project is generally larger and/or more complex than standard capital improvement projects
 - Owner wants to incentive high quality operation and maintenance
- Generally procured using:
 - Best value selection process
 - Proposals include and are evaluated on a proposed “maximum availability payment”
 - “Hard bid,” fully committed financial proposals

Types of P3s: Availability Payment

Owner Responsibilities

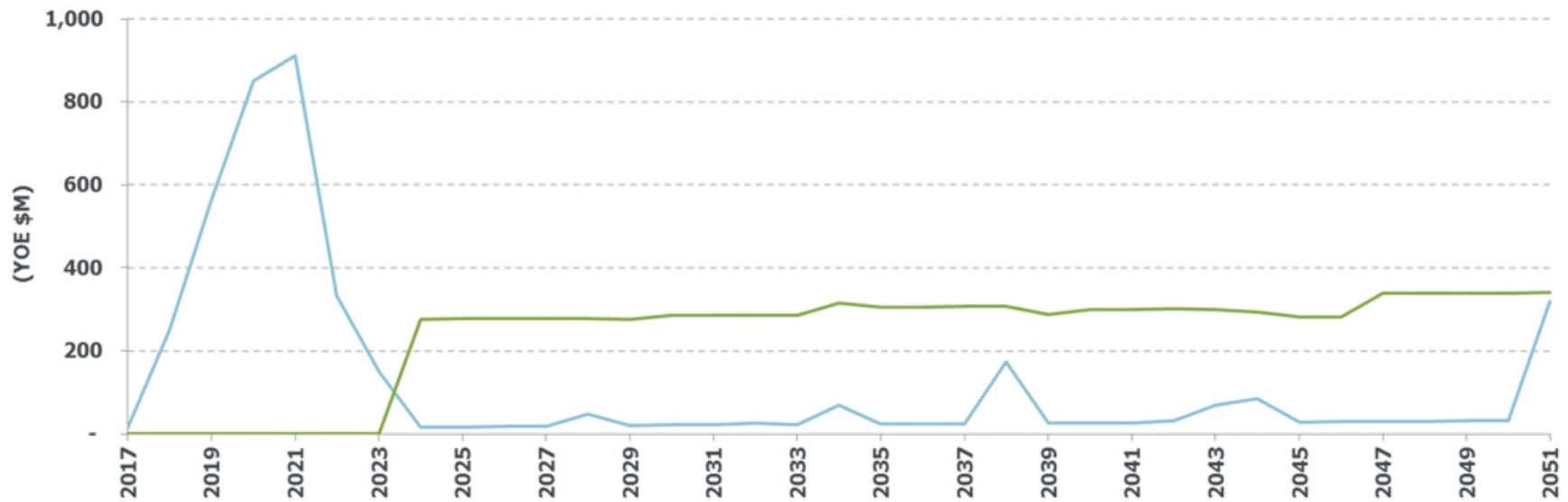
- Performs conceptual / preliminary design
- Achieves environmental clearance
- Determines performance specifications to which developer is to be held
- Oversees design, construction, operations and maintenance
- Keeps long-term revenue risk
- Pays private party based upon project availability and performance over extended period
- Liable for fewer claims and change orders than design-build and design-build-finance
- Depending on project economics, owner may “buy down” private investment required with up-front or structured payment

Developer Responsibilities

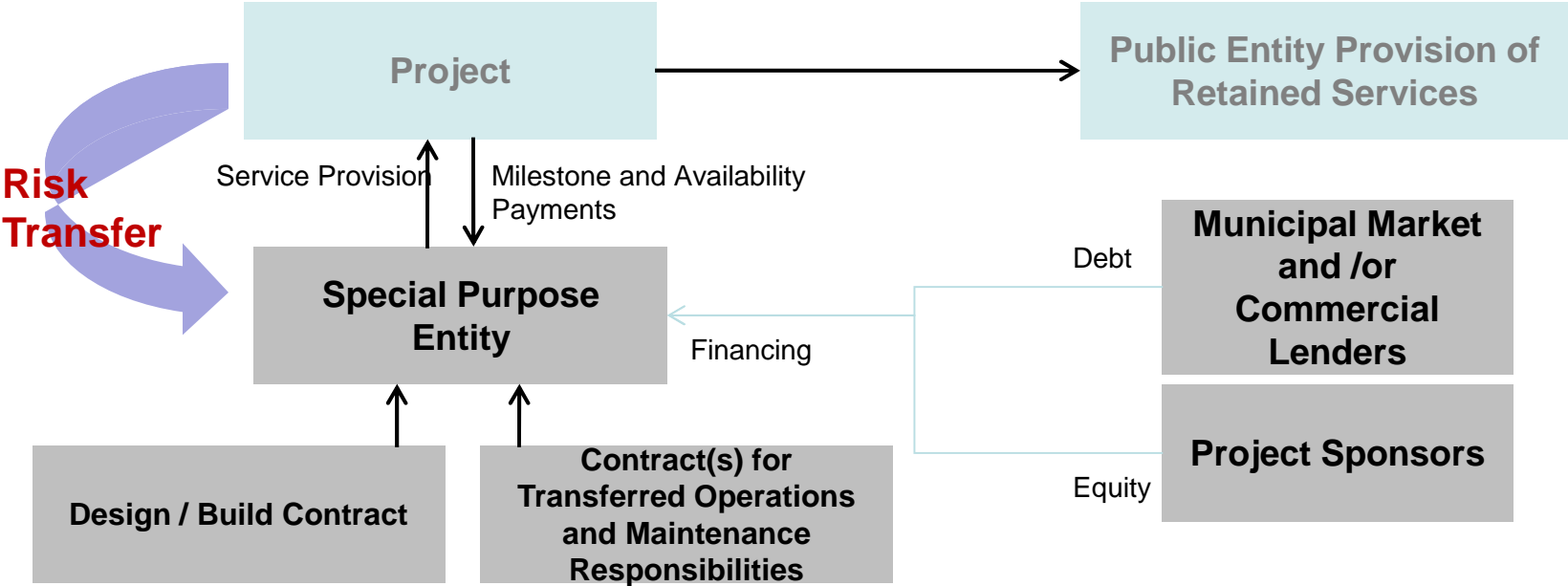
- Designs, builds, operates and maintains the project in accordance with owner’s technical specifications
- Assumes integration of design and construction and other development risks conventionally retained by owners
- Delivers private debt and equity sufficient to finance project completion, early operations and long-term performance, backed by owner’s availability payments (and milestone payments if used)
- Provides agreed O&M scope for services for contract term (typically 30-40 years) and assumes lifecycle performance risk
- Assumes responsibility for leaving project in specified “handback condition” at end of term

Types of P3s: Availability Payment

Availability Payment vs Conventional Delivery Cashflows



Types of P3s: Availability Payment



Types of P3s: Pre-Development Agreements

Contract contemplates two phases of activity:

- Pre-Feasibility Phase
 - Public and private partners “co-invest” in pre-development activities
 - Owner retains complete control over environmental clearance process, with developer performance of technical studies
 - Developer participates in project planning and design
 - Developer prepares master financial plan and master development plan
 - Developer may absorb some or all of its initial phase work – “sweat equity”

Types of P3s: Pre-Development Agreements

- Pre-Feasibility Phase (cont'd)
 - If project proves feasible, developer has limited right of first negotiation for the agreement(s) covering the implementation phase
 - If parties are unable to reach agreement, owner retains right to separately procure
- Implementation Phase:
 - Implementation phase agreements can take many forms, including:
 - Availability Payment
 - Revenue Risk

Types of P3s: Pre-Development Agreements

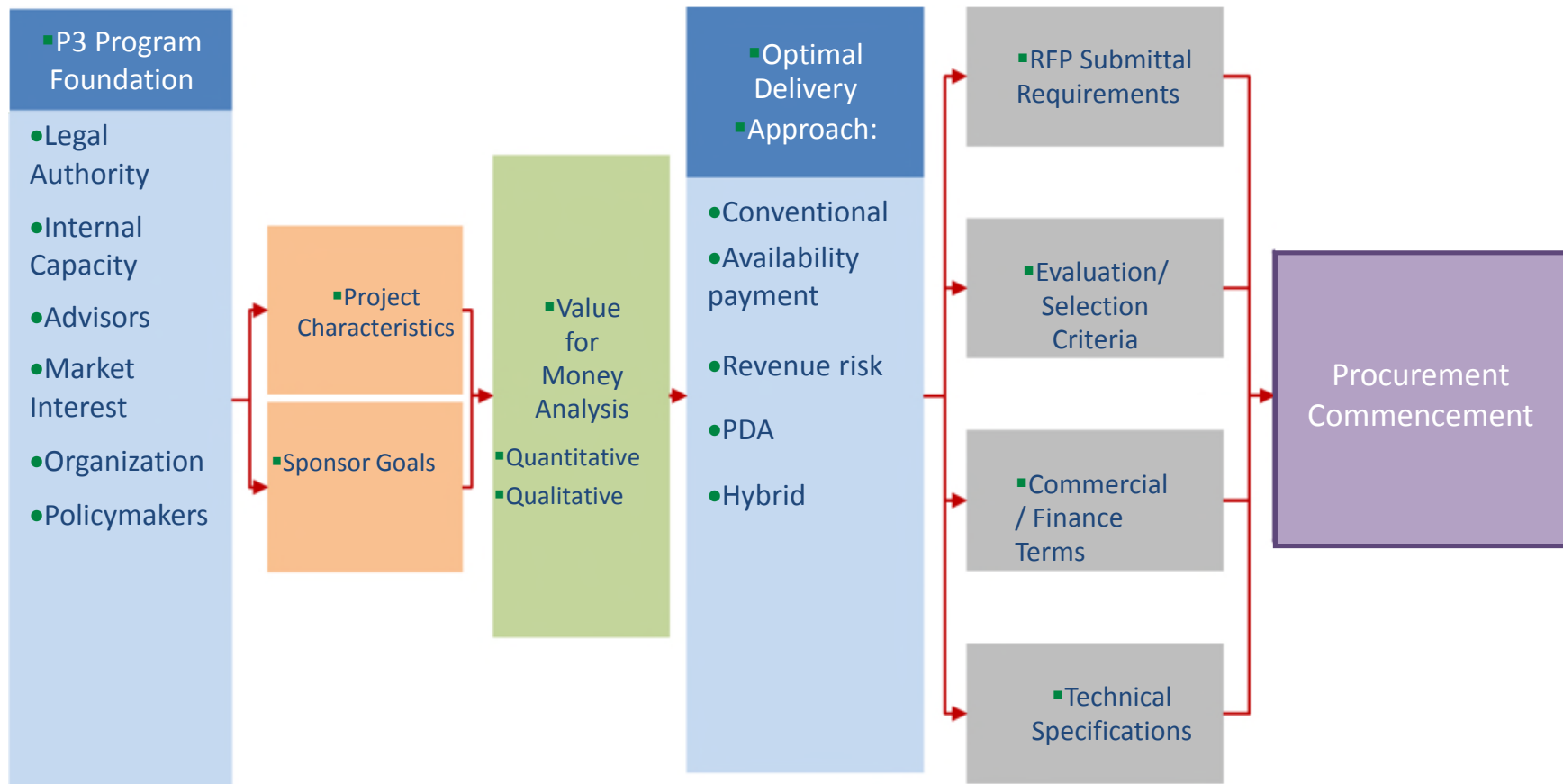
- Suitable when
 - Project not yet completely defined
 - Financial feasibility not yet determined, but preliminarily has good potential
 - Owner seeks private sector innovation in defining and accelerating an optimally feasible project
 - Environmental analysis is in the early stages
- Generally procured using:
 - Best value selection process
 - Selection mainly based on “best development and financial plans”
 - Rates (initial phase) and price (implementation phase) generally play little role in selection



Delivery Method Selection Process / Value for Money Analysis

Delivery Method Selection Process / Value for Money Analysis

Moving from Program Foundation to Procurement Commencement



Delivery Method Selection Process / Value for Money Analysis

Properly carried out, a process to select the optimal delivery method for a project should:

- Reflect a comparison among legal available options
- Document results in a manner that is objectively persuasive to public officials and stakeholders

Elements of Value for Money analysis include:

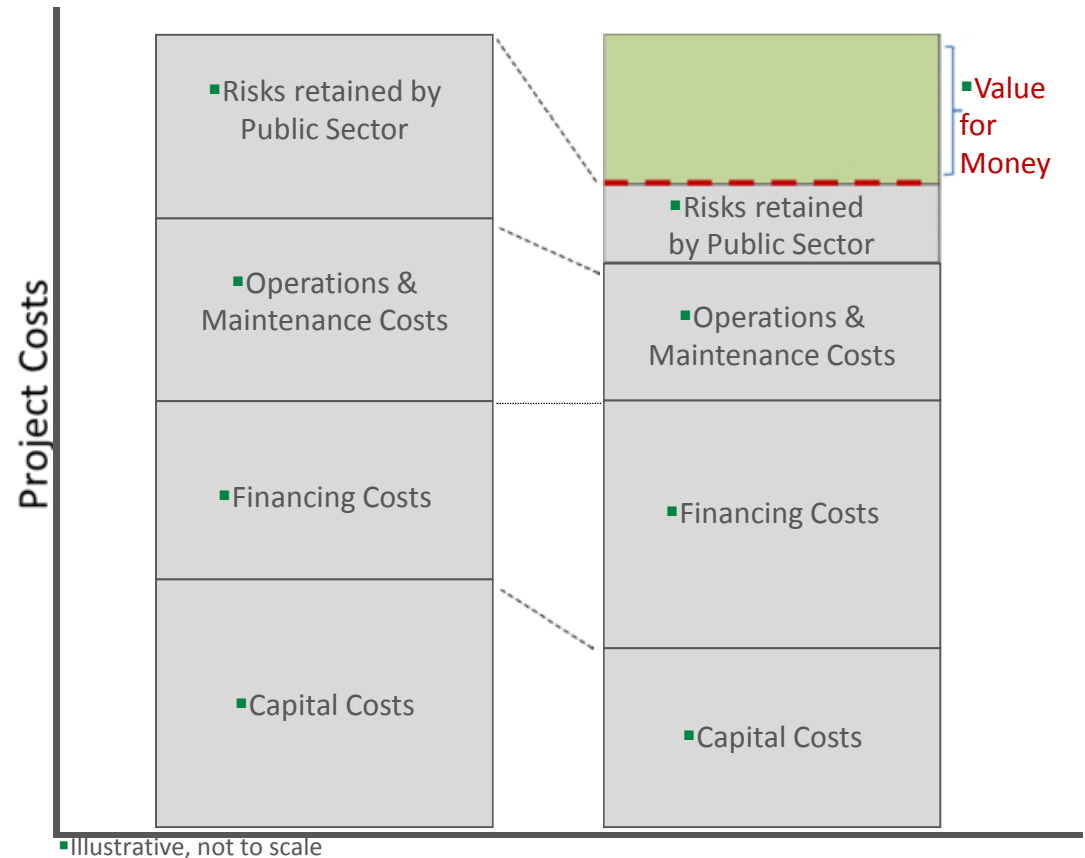
- Qualitative and/or quantitative analysis
- Establish goals / determine model's ability to meet goals
- Develop inputs (capex, opex, funding, discount rate, etc.)
- Initial risk identification / assessment
- Assess basic business / operational case for transaction

Delivery Method Selection Process / Value for Money Analysis

The financial model is a tool used to quantitatively evaluate various financing and delivery approaches over the project lifecycle

Two financial models are used in the Value for Money analysis:

- Public Sector Comparator
- Shadow Bid



VfM analysis compares the total risk-adjusted present value cost of delivery under and DBFOM versus a traditionally financed and delivered method



Alternative Financing Arrangements

Funding (“Equity”) vs. Financing (“Debt”)

- “Pay-Go” – A form of public equity funding
 - Grants
 - Annual Appropriations
 - Capital Improvement Fund
 - Budget and Finance Planning – Balancing expected construction and O&M costs and estimated revenue over the life of the project
- Traditional Financing – Public agency obligated to repay
 - G.O. Bonds – Voter Approval? Backed by the full faith and credit of the state
- Revenue Financing
 - Sales Taxes
 - Enterprise/User Fees
- Lease Financing – May be subject to appropriation or availability of project for its intended use
 - Requires granting a real estate interest in the project
 - The role of the “63-20” non-profit corporation

The Private Project Finance Structure – A Combination of Private Debt and Private Equity with Limited Recourse for Repayment of Private Debt

- The Special Purpose Vehicle (SPV)
- Equity Investors and the internal rate of return
 - Position in the revenue “waterfall”
 - Managed funds vs contractor sourced investment
 - Public Pension Fund Investors
- Private Debt Holders
 - Private Placements
 - Private Activity Bonds—Taxable vs Tax Exempt
 - Exempt Facilities
 - New management contract “safe harbor” rules (Rev Proc 2016-44)

The Role of the Financial Model

Preparation of the Financial Model

- Developing the key inputs and outputs
 - Capital and O&M cost assumptions
 - Revenue forecast
 - Project Risks
 - Project funding/financing sources and uses
 - Debt repayment
 - Funding O&M and Major Maintenance Reserves

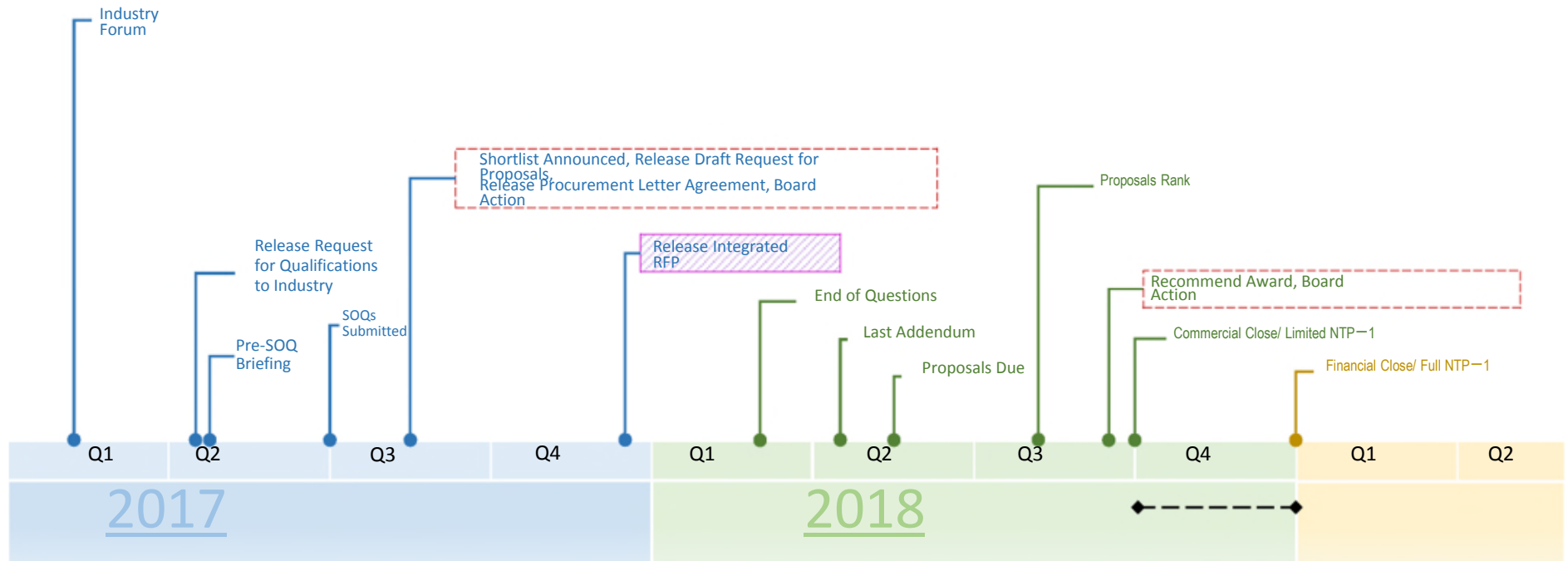
The Role of the Financial Model

- Developing the sensitivity analyses—“Stress Testing” the Model
 - Must be Flexible and Easy to Use
 - Able to accommodate multiple input and output assumptions regarding project costs and schedule
 - Capable of optimizing various capital and debt structuring approaches—Debt amortization, taxable vs tax exempt, debt to equity ratio
 - Used in developing commercial terms of the P3 contract
 - interest rate sharing, refinancing gain sharing, relief events, insurance requirements and contingency
- Due Diligence and Credit Input – the Role of the Rating Agencies
 - Coverage Ratios
 - Contractor financial capacity
 - The Investment Grade Rating



Overview of Interactive P3 Procurement Process

Overview of Interactive P3 Procurement Process



Process Overview

- Pre-Procurement
 - Request for Information
 - Industry Forum
- Two-Step Procurement Process (RFQ/RFP)
- Short Listing
- Vetting Draft RFP Documents with Shortlisted Proposers
- One-on-One Meetings
- Alternative Technical Concepts
- Payment for Work Product

Breakdown of Resource Requirements

Breakdown of Resource Requirements

- How responsibilities are optimally allocated among owner/staff and advisors/consultants depends on the project
- P3 projects generally involve more procurement costs, lower direct design costs and lower oversight costs than conventional projects
- Procurement documents require the owner to ensure technical specifications include O&M at the outset
- Types of services:
 - Program Management
 - Financial
 - Legal
 - Technical Support

Breakdown of Resource Requirements Program Management

- Advise owner in development of appropriate owner/consultant management team and resource requirements for P3 procurement
- Oversee and support the evaluation and determination of best project delivery method
- Assist in development of consensus by staff, board members, public and private stakeholders in support of selected delivery method
- Facilitate industry awareness and interest in the selected delivery method
- Oversee and manage the development of procurement documents

Breakdown of Resource Requirements Program Management

- **Oversee and manage the procurement process**
 - Industry Forum
 - Request for information and one-on-one meetings process
 - RFQ process
 - RFP process
 - Final negotiations and commercial close
 - Financial close and NTP

Breakdown of Resource Requirements Program Management Post-Award

- Manage owner and developer interface through final design and construction process
 - Design reviews and approvals
 - Maintenance of traffic and logistics requirements
 - Construction interface oversight
 - QA and design conformance oversight
 - Oversight of facility performance validation and final acceptance

Breakdown of Resource Requirements Program Management Post-Award

- Oversee and manage project control functions associated with the P3 development.
 - Contract administration
 - Change order process
 - Document control
 - Schedule and cost validation
 - Milestone payments verification (if any)
- Oversee development and implementation of facility management system for operational performance validation and payment administration