PFG
Public Facilities Group

Four Principles that Maximize Public Benefits in P3 Delivery of Social Infrastructure

Public Facilities Group (PFG) is a nationally recognized not-for-profit organization that works to maximize public sector benefits when using Public-Private Partnerships (P3). We encourage the use of the **New American Approach** of P3 delivery. This approach blends tax-exempt financing incurred by a single member not-for-profit special purpose entity (SPE) with private project development and delivery. It also encourages the use of private facility management and maintenance in order to maximize the public sector's benefit and minimize costs. It offers private guarantees of both cost and schedule and includes built in safeguards which allow the public to secure ultimate project control if desired.

The New American Approach

When contemplating P3 delivery of Social Infrastructure*, Public Agencies should consider four key principles:

1. **The Use of Tax-Exempt Debt**

   Tax-Exempt debt offers fixed-rate financing for longer terms than taxable debt. It has lower interest rates than private financing. For most public facilities, tax-exempt debt requires no more than a 1.0 debt coverage ratio. It commonly finances 100% of a project's costs and therefore requires no equity. Tax-exempt debt is also better suited to accommodate public agency leases that require "subject to appropriation" and "subject to abatement" structures.

   Taxable financing has shorter loan terms compared to tax-exempt financing. It requires interest rates that are more expensive, as well as interest rates that are fixed for significantly shorter periods of time. Taxable financing requires project equity. Equity is far more costly than either tax-exempt or taxable debt. In addition, taxable financing requires a 1.1 or higher debt coverage ratio and therefore requires increased public costs to satisfy this higher ratio.

2. **The Use of Private Development**

   Private Development is a competitive and profit driven business. Developers who build for themselves or for clients must work efficiently and know how to control costs. Private developers have in-house expertise and experience and therefore rely less on consultants.

   Public projects invariably can be characterized as having unreasonably long project schedules and therefore overly inflated project costs. Few local governments have in-house staff with the necessary expertise or experience to deliver complex social infrastructure projects. When undertaking such projects, they rely heavily on outside consultants. Too often the consultants' efforts are directed by oversight committees

comprised of members with little development experience and with outside demands for their time and attention. Often these committees do not meet at regular intervals and are imperfectly staffed. The result is a slow and inefficient decision making process with no direct project accountability. Additionally, most public agencies require public works bidding procedures. These procedures are not well designed to identify skill, efficiency or experience.

3. **The Careful Alignment of Risks and Rewards**

   A properly structured Public-Private Partnership should take great care in aligning risks and rewards. The partners must be paid fairly for what they bring to the project, but should not be rewarded for that which they do not.

   The private partners will contribute development expertise through their knowledge, skill, experience and management. They should be free to apply these strengths and incentivized to do so.

   In Social Infrastructure projects, the private partners are seldom responsible for project tenancy or ongoing rent-up. In a correctly structured project, the private developer does not deliver project financing since their sources of debt and equity are not the most efficient.

   Most social infrastructure projects benefit from private property management and a dedicated maintenance reserve to assure that the facility remains in like-new condition at any given age. Private property management and maintenance contracts should be short term (3 to 5 years) to ensure that they are competitive and will provide proper and measurable incentives for efficiency.

4. **Control**

   With Social Infrastructure projects, the Public Agency pays the bills through rent. Rent is sized to cover the sum total of debt service, operating costs and maintenance costs. At times rent will also include an "availability payment" to guarantee that the building and its components are always available for use. If the Public Agency pays all of the costs, it should have rights equivalent to ownership.

   Furthermore, the Public Agency should have the right to replace the board of the SPE or choose to become or replace the sole member of the SPE should it desire to do so.

   The Public Agency should have the ability to assume ownership without cost or delay if deemed necessary or desirable. There should be a right to secure fee title at no cost upon the retirement of the debt. This right should exist when the debt matures or whenever the public agency elects to prepay the debt. This is a required feature of 63-20** bonds and should be a contract feature in all 501(c)(3) bond structures.

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The **New American Approach** fully embraces these four principles and successfully combines private sector expertise with tax exempt debt. It offers the public the most efficient and the least costly option for developing and maintaining social infrastructure. It avoids the risks characteristic of public development and the inconsistencies typical of public maintenance.

Key to the structure is the involvement of an active SPE owner/bond issuer working on the public's behalf. The SPE is the obligated party for the debt. It works with the public agency to select and then hire the development team. This is most often accomplished through a public RFQ/RFP process.

The development team is composed of a private developer, an architect, and a general contractor. The private development team will ultimately guarantee the price and date of completion. This team should be allowed and incentivized to build efficiently and should be held to strict quality standards. The private development team earns a development fee commensurate with the development risk they have undertaken during construction. In addition, the team is eligible for a bonus if the project is completed under budget and on or ahead of schedule. Since the development team has not invested equity or taken operating risk, it should not receive ongoing cash flow or any proceeds from sale or refinance. Any savings, after incentives have been distributed to the development team, are returned to the project agency in the form of rent reduction or building enhancements.

Once completed, the building is leased by the SPE to the public agency for the term of the debt. Lease payments equal the sum of debt service on the bonds, together with operating costs and a dedicated repair and replacement reserve. When the debt is retired, the building, along with any operating and maintenance funds controlled by the SPE will be transferred to the public agency at no cost.

A well-structured public-private partnership can achieve cost savings between 20% and 40% when compared to conventionally delivered public projects.

Notes:

**Social Infrastructure refers to buildings build built for public occupancy. It is distinguished from traditional infrastructure such as roads and bridges.*

*** 63-20 Bonds are tax-exempt bonds issued by a not-for-profit organization on behalf of a local government to finance a public facility. The bonds are governed by the Internal Revenue Service's Revenue Ruling 82-26 and Letter Ruling 63-20.*

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