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An Explanation of The New American Approach

The purpose of this document is to create a framework of understanding around the New American Approach, which uses an Independent Not-for-Profit Owner employing 63-20 bonds as the financing mechanism together with a Developer-Led Delivery Approach (defined below). The New American Approach or American Model is the most frequently employed P3 delivery model in the United States for delivering public social infrastructure projects such as city halls, hospital buildings, administrative office buildings, courthouses and police stations. The model is flexible and can be employed to meet a variety of services requested by the public client, most frequently, Design Build Finance Operate and Maintain otherwise known as DBFOM.

Why 63-20 bonds?

The term 63-20 refers to the 20th IRS revenue ruling in 1963. The revenue ruling gives a not-for-profit organization the ability to issue tax-exempt bonds (i.e., bonds the interest on which is not subject to federal income tax) to finance an exempt facility. The revenue ruling was further clarified in Revenue Procedure 82-26. The model has been widely used in the U.S. for funding Public Private Partnerships and is generically a lease revenue bond structure.

While all lease revenue bonds use a long-term lease with a governmental tenant as the principal source of security and repayment, they may differ greatly in their approach to construction financing, risk transfer, incentives to achieve and capture cost savings for the public agency lessee, long term repair and maintenance, and final transfer of ownership. 63-20 Model offers an attractive set of public protections in each of these areas.

The New American Approach uses 63-20 bonds because they offer certain safeguards not available in 501(c)(3) and lease revenue bond structures commonly used in Private Owner-Led procurement models. The most important feature in 63-20 transactions is that the government, "on whose behalf" the project is undertaken, must have the right to repay the debt at its sole discretion, and by doing so receive, at no cost, the unencumbered fee title to the financed facility. This is an important safeguard that enables 63-20 transactions avoid the unwind difficulties that some jurisdictions have experienced in other forms of Private Owner-Led financings. Additionally, as experienced with appropriately structured 63-20 financed projects, there have been no negative impacts on bond pricing or bond ratings when comparing 63-20 bonds to traditional governmental lease revenue bonds.

Why an independent not-for-profit owner?

In the New American Approach, the Not-for-Profit Owner must be independent, have the correct public purpose (lessening the burdens of government), and be knowledgeable in real estate development and management. The Not-for-Profit Owner is the issuer of the 63-20 bonds and is responsible for preparation of the POS and other financing documents.

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After the bonds are sold, the proceeds are held by a trustee and used to build the facility. The Not-for-Profit Owner hires the development team: a developer, contractor, architect and all major sub-contractors. As the obligated party on the debt, the Not-for-Profit Owner is responsible for paying back the bonds. Since the lease does not obligate the tenant to pay rent until it has "beneficial occupancy" of the building, the owner must cause the building to be completed in accordance with the plans and specifications through its contracts. Without satisfactory completion of the building, there is no enforceable obligation for the tenant to pay rent. Therefore, the owner must secure contractual binding completion and price guarantees from its development team.

For the owner to sell bonds to build the facility, it must complete three key steps:

(1) Engage a strong development team willing to provide a Guaranteed Maximum Price (GMP) with a date specific completion guarantee;
(2) Obtain approval of all entitlements; and
(3) Negotiate a ground lease and facilities lease effective upon substantial completion.

Because the owner can borrow only funds sufficient to build the facility, and without recourse to the tenant, there is no means for the development team to exceed the limits of the Guaranteed Maximum Price. In addition, since no party to a contract can successfully complete its obligations without the other party fulfilling its counterparty obligations, the owner must understand its duties and have the capacity to perform them in a satisfactory and timely fashion. To facilitate timely performance, the development agreement and lease include specific time frames for all decisions. Without adherence to a schedule, the development team cannot complete the project on time and within budget.

Once the project is complete, the New American Approach allows for a series of short-term private property managements contracts. These contracts are between the Not-for-Profit owner and the property manager and are designed around the public tenant's needs. By using shorter term contracts, the process can introduce competitive bidding and more advantageous pricing into the property management process. It also allows for self-management, if the tenant desires.

There are other benefits of using a publicly motivated independent Not-for-Profit Owner. In many states, it is normal to size the bonds with an additional six months of capitalized interest to cover force majeure and other unforeseeable events that could delay project completion. Too often in Private Owner-Led lease revenue bond structures, this capitalized interest "cushion" is used or captured by the owner/developer. In a 63-20 transaction with an independent Not-for-Profit Owner, this unused cushion is returned to the tenant to fund building enhancements or to reduce rent.

Similarly, for many governmental lease revenue bond issuers, it is still standard to fund a debt service reserve. During periods with a positively sloped yield curve, this structure is of questionable benefit when developing essential governmental buildings. Transactions financed with 63-20 debt do not normally employ a debt service reserve fund and have not experienced negative impacts on either their bond ratings or pricings.

Finally, the structure is especially beneficial in insulating the public entity from cost overrun risk. Because only the owner and the development team members are obligated parties under the development contract, there is no contractual privity running to the public tenant. After a decision is made to use this means to develop, finance and build a facility, the public entity and the owner sign a lease, which is the only contract between the two. Without contractual privity between the public entity and the developer, the entity is not an obligated party for cost overruns, should they occur. In contractual disputes, the development team has no recourse to the governmental tenant.

Why a Developer-Led Delivery Approach?

The Developer-Led Delivery Approach used by PFG involves a form of Integrated Project Delivery designed to bring all key project disciplines into the pre-development process as early as possible. A developer-led approach is not to be confused with a construction manager or project manager approach – the developer's role creates critical value for the project. A skilled developer can bring an important track record of success in developing complex facilities on-time and within budget. The developer needs to be a recognized industry leader bringing experience, influence and clout into the design and construction process. It is this leadership that is at the heart of the Integrated Project Delivery process and is why it has developed as the most efficient form of project delivery. It allows for cross-discipline collaboration from the beginning of design and for selecting sub-contractors through the most qualified and advantageous selection processes. This approach has resulted in projects that on average are 15% to 20% less costly and are delivered 30% to 40% faster, with equal or higher quality when compared to typical publicly overseen projects. It is a fact in the industry that price is driven by who holds the contracts. With publicly-led projects, contractors always charge a premium when bidding. They price into their bids both a public learning curve and an expectation of time delays. By employing a Developer-Led integrated form of delivery with an experienced private not-for-profit owner/financer, this reality can be changed.

In all forms of contracting, key team members like the developer and the contractor are paid a fee for service. This fee is a small percentage of the total value of work performed. Since neither the developer nor the contractor self-perform significant work, their fee is essentially structured as a percentage of the contract amount. In a typical publicly-led development approach, the process nearly always results in projects that fully exhaust their budgets, thus maximizing the fees paid to the key team members. Additionally, with the absence of an incentive structure, the typical public contracting process encourages change orders that result in increased costs and increased contractor fee revenue. By properly providing a development incentive to reduce costs and expedite delivery, this problem can be eliminated.

Central to the Developer-Led Integrated Delivery approach practiced by PFG are tightly-drawn contracts that include rewards for success, penalties for failure, and incentives for cost savings. A typical reward structure allows for a stepped reward return where the development team is rewarded based on savings benchmarks. On a $50 million project, the incentive structure may be 33% of the first $500,000 in savings, 25% of any savings between $500,000 and $1,000,000, and 10% of any savings beyond $1,000,000. It is typical to tailor the incentive to the specifics of each

project. All savings after the incentive distribution are then credited to the public agency for use on additional building enhancements or to abate the principal portion of the public agency's rent, as required by the Indenture of Trust. This incentive structure encourages the contracting teams to seek efficiencies by providing a mechanism that can increase earnings beyond what they would achieve by simply building the project in accordance with the budget. At the same time, it benefits the tenant by lowering the overall project cost. This approach is a win/win strategy that works by aligning all parties' self-interests.

In addition to employing an integrated delivery process to reward success there also need to be disincentives for failure. The development team is tasked with a design and budget target. Under a predevelopment contract running from the public agency through the not-for-profit to the development team, design is advanced through design development to the point where a GMP can be established with appropriately sized contingencies and a completion date. The development contract then allows for no increase in price beyond the GMP and limits extensions to events of force majeure. To assure that the project remains in balance during the construction phase, the development team's fee is at risk.

Key Considerations on Cost and Budget

The American Approach addresses many risks associated with the public development process:

- By engaging a Developer-Led team of an architect, contractor and key subcontractors to advance the project design through Design Development before establishing price and schedule, it brings a broader range of expertise into the predevelopment process and gives certainty of price, schedule and quality.
- By removing the public agency/tenant as an obligated party in the construction contracts, it eliminates public exposure to cost overruns and as well as other construction related risks.
- By using the 63-20 lease revenue bond financing structure, it achieves competitive, tax-exempt bond rates with a federally mandated reversion to public ownership whenever the debt is retired. It also gives the public agency the right to prepay the bonds at its sole discretion at any time, and thereby receive unencumbered fee title.
- By introducing an Integrated Project Delivery mechanism, it rewards efficiency and creates the greatest opportunity to reduce public costs.
- By transferring development to the not-for-profit owner and the development team, it allows for significantly reduced public staffing and consultant costs.
- By employing short term private property management contracts, it fosters cost effective flexible tenant-oriented facility management and property maintenance.