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Improving Upon P3

An Explanation of 63-20 Progressive Design-Build

UW Medicine's Biomedical Research Campus
All four phases of the University's state-of-the-art facilities were completed using a 63-20 Progressive Design-Build Approach

What is 63-20 Progressive Design-Build?

63-20 Progressive Design Build (63-20 PDB) is an alternative delivery approach that improves upon the development efficiencies and cost savings of traditional Progressive Design-Build (PDB) by pairing a PDB delivery with privately issued 63-20 tax-exempt bonds. The bonds are issued by a not-for-profit partner on-behalf of a public agency that is pursing the project. Using privately-issued tax-exempt debt instead of government-issued debt can decrease project delivery time and allow for greater operations and maintenance efficiency through the use of privately-delivered operations and maintenance services.

Is 63-20 PDB an Alternative Public Delivery or a P3?

63-20 PDB is often categorized as a niche form of Public Private Partnership (P3) when in fact, the use of 63-20 PDB is well established and has a longer and more successful track record in the United States than the more visible equity-based P3 models. In a 63-20 PDB, a not-for-profit partner is selected by the public agency to issue tax-exempt revenue bonds. This not-for-profit serves as the "on-behalf of" owner of the project during the term of the debt. The Internal Revenue Service Revenue Ruling 63-20, along with the subsequent Revenue Procedure 82-26, provide the basis by which not-for-profit entities can issue tax-exempt debt for the purpose of erecting or acquiring qualified governmental facilities. Because the approach is governed by Internal Revenue Service guidelines, 63-20 PDB is a regulated and transparent process.

63-20 delivery approaches have been referred to as alternative public delivery models, sharing that distinction with GCCM, Design-Build, and Progressive Design-Build approaches. This characterization ignores the significant benefits that the approach offers in construction efficiency and in long-term operations and maintenance. In the past 15 years, 63-20 PDB has evolved into the most cost effective and publicly beneficial approach for delivering public facilities. A 63-20 PDB takes advantage of more efficient project management and expedites decision making, thereby benefiting the project timeline and overall cost. It also employs an effective incentivized project delivery approach. The result is an outcome that consistently out performs project delivery objectives. 63-20 PDB projects are consistently delivered ahead of schedule and at or under budget.

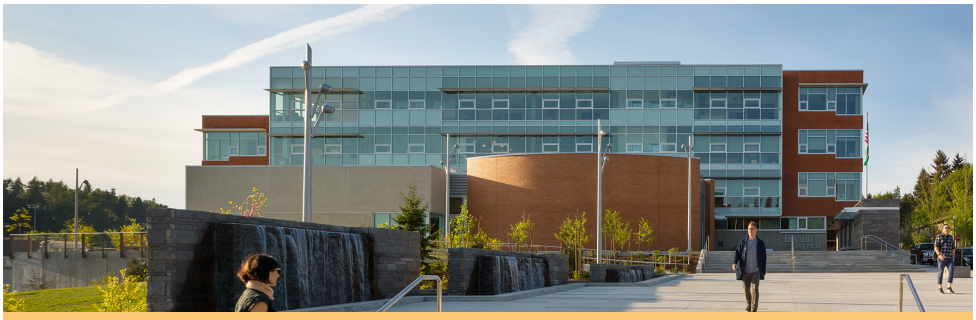
PFG's staff has used 63-20 PDB to deliver 30 Public Facitlies. All completed on-time or ahead-of-schedule and on or under-budget.

63-20 PDB emphasizes transparency, reduced debt service and low O&M costs. It is inclusive and cooperative, allowing for maximum public input in quality and design. Fees in 63-20 PDB projects are straight forward and transparent. There are no hidden charges and all fees are negotiated and agreed upon by the public agency during the procurement and pre-development phase, before project commitment. 63-20 PDB also provides cost transparency to operations and maintenance, which is publicly bid. Finally, 63-20 PDB involves much greater flexibility in unwinding should that be necessary. Unlike Equity or Availability Payment P3 structures, there are no unwind or make-whole fees in 63-20 PDB structures.

A Review of Progressive Design-Build as Defined by the DBIA

In the typical Design-Build process, public agencies often attempt to estimate the final project cost during the procurement phase of a project. This places an over emphasis on pricing at the expense of experience and quality as public agencies evaluate competing Design-Build teams. As a result, less capable teams are often selected based on lower cost proposals, which, too often, results in change orders and project delays.

Progressive Design-Build places emphasis on qualifications and best value over development cost. It accomplishes this by approaching a design-build delivery via a "progressive" process. The design-build team is selected based on their qualifications, expertise and the value they bring to the project. After team selection, project delivery progresses towards a design and a contract price with the team already in place (thus the term progressive).



Successful 63-20 PDB: City of Bothell's New City Hall

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The core features of a typical Progressive Design-Build as defined by the DBIA are:

- The design-builder is retained by the owner early in the life of the project and, in some cases, before the design has been developed at all.
- The design-builder is primarily selected on qualifications and the design-builder's final project cost/price. Schedule commitment is not established as part of the selection process.
- The design-builder delivers the project in two distinct phases with: (a) Phase One including budget level design development, preconstruction services and the negotiation of a firm contract price (either lump sum or guaranteed maximum price) for project delivery; and (b) Phase Two including final design, construction and commissioning.

For more information on Progressive Design Build please visit DBIA.org and look for "Progressive Design Build: A Design-Build done right Primer"

The 63-20 Progressive Design-Build Approach

The 63-20 PDB approach builds upon the principles of PDB to increase cost savings and flexibility. The first step of a 63-20 PDB is to procure a not-for-profit partner. This partner must be experienced in 63-20 PDB and have a qualifying public purpose, such as "lessening the burdens of government". The not-for-profit partner contracts with the public agency and the selected Design-Builder to complete the Phase One steps that are detailed above in Progressive Design-Build. The contract between the public agency and the not-for-profit gives the public agency full engagement in the design process and control over all design decisions.

When the design is complete and a guaranteed maximum price is agreed upon, the not-for-profit partner enters into a Guaranteed Maximum Price delivery contract with the Design-Builder and issues tax-exempt 63-20 lease revenue bonds to finance 100% of the project costs. Financing the project with 63-20 lease revenue bonds affords the public agency a variety of benefits:

COMPARISON OF PROJECT DELIVERY METHODS

METRIC	DESIGN-BUILD VS. DESIGN-BID-BUILD	DESIGN-BUILD vs. CM@R
UNIT COST	6.1% lower	4.5% lower
CONSTRUCTION SPEED	12% faster	7% faster
DELIVERY SPEED	33.5% faster	23.5% faster
COST GROWTH	5.2% less	12.6% less
SCHEDULE GROWTH	11.4% less	2.2% less

Source: Construction Industry Institute (CII)/Penn State research comprising 351 projects ranging from 5,000 to 2.5 million square feet. The study includes varied project types and sectors.

Design-Build delivery approaches outperform other traditional public delivery methods. Progressive Design-Build further improves on traditional Design-Build by streamlining the procurement process, reducing project delivery schedule, allowing for use of Guaranteed Maximum Price contracting, improving cost transparency, and allowing an off-ramp should the owner not accept the design-builder's price.

- The cost of capital equals that of publicly funded tax-exempt lease revenue bond projects. In other words, the privately issued tax-exempt bonds used in a 63-20 PDB achieve the same credit rating as a public financing option for the same project.
- 63-20 bonds are issued by a private not-for-profit entity, permitting the project to be delivered through a private delivery model and allowing for far greater efficiency and an accelerated schedule.
- All design and construction contracts are entered into by the private not-for-profit entity rather than the public agency, thus transferring construction risk away from the public agency and to the private contracting parties.
- The not-for-profit entity owns the facility during the term of the bonds allowing 63-20 PDB projects to be privately operated and maintained.
- Federal requirements governing 63-20 bonds require project savings and efficiencies accrue to the benefit of the public tenant.
- Fee title to 63-20 PDB projects must revert to public ownership at no cost whenever the debt is retired. There are no make-whole or breakup fees.

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How Private Tax-Exempt Financing Impacts PDB delivery

Assigning the responsibility of project financing to a qualified not-for-profit entity allows for more efficient project delivery. Because funding and "ownership" run through the not-for-profit, the delivery is typically exempt from the processes of public procurement and delivery. This allows for greater flexibility and emphasis on selecting more qualified partners and employing incentivized contracting. However, not-for-profit ownership does not mean that the public agency gives up control over the project's design. The public agency's contract through the not-for-profit allows the public agency to maintain the necessary control of design and quality and have an off-ramp should it be dissatisfied with either design quality or price. The use of 63-20 tax-exempt financing allows for faster delivery in three ways:

Construction

63-20 PDB has a positive impact on project construction schedule when compared to alternative forms of delivery, in which the public agency as owner undertakes the financing. As financer/owner in a traditional delivery model, the public agency has ultimate responsible for decisions. To mitigate this decision-making risk and to augment its sometimes lack of development experience, public agencies often rely heavily on outside consultants and on a consensus-driven decision-making process. The combination of these two factors result in significantly increased project costs and longer delivery schedules. By transferring the process to an experienced owner and housing the construction completion and price guarantees in an incentivized Design-Builder without recourse to the public tenant, these problems can be solved.

Financing

Because the financing resides with the not-for-profit partner, the project is not dependent on typically protracted governmental financing processes. Since the public entity is a tenant during the term of the 63-20 debt, the governmental entity's rights and obligations reside in a lease agreement subject to annual appropriation and abatement. Few jurisdictions consider such leases to be obligations requiring voter approval. Moving the financing out of the typical public process saves time and reduces public cost. By using 63-20 financing the public agency can positively impact the project schedule without increasing debt service.

Incentivizing

Since 63-20 PDB is legally a private work, it has the freedom to introduce truly effective incentivized construction techniques to motivate the private development team, improve project performance and reduce costs. The typical incentivized delivery structure offers a share of project savings to the development team, typically 25%. The remaining 75% of savings are returned to the project for project enhancements that reduce the public agency's rent obligation under the lease. Proper incentivizing means the private development team will be more focused in achieving project savings. Project savings are typically realized by strict adherence to schedule and creative approaches to project delivery that are challenging to achieve when using a traditional public delivery approach. The process succeeds because the development team's share of every dollar saved is larger than their share of every dollar spent. This resolves the common practice of exhausting the project budget or increasing the budget with change orders. There can be no reduction in quality because the project has been fully designed in Phase One of the process and the development team is contractually obligated to deliver the project to the design specifications under a Guaranteed Maximum Price contract.

An added benefit to private tax-exempt financing is the transfer of contractual privity from the public agency to the not-for-profit entity. This eliminates an owner's Spearin Doctrine liability risk and protects the public agency from potential lawsuits that could arise during project delivery.

The net result is that 63-20 PDB delivery achieves a 20% to 40% cost savings when compared to publicly-funded GCCM, DB and PDB, and far greater cost savings when compared to equity based P3 models.

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How Private Tax-exempt Financing Impacts Lifecycle and O&M

Among the more important features of a 63-20 PDB is the ability to employ private property management in operating and maintaining the facility. 63-20 PDB transfers operations and maintenance responsibility to the not-for-profit partner that issues the tax-exempt debt. The not-for-profit partner assumes the role of Owner and thereby is responsible for operations and maintenance of the building. Under the lease it must keep the building in like-new condition for its age. It carries out this obligation by hiring private property management on a series of 3 to 5 year competitively bid contracts. This arrangement allows for improved lifecycle costing and the transfer of O&M risk to the private sector, thereby eliminating the likelihood of deferred maintenance issues for the project. By keeping the O & M contracts short term and competitively bid, they become more cost effective than Availability Payment O & M contracts while effectively transferring O & M risk to the private partners.

63-20 PDB Lease Payments and Debt Characteristics

The public agency commits to the project through a long-term lease contract that exists between the not-for-profit partner and the public agency. The Lease Agreement is negotiated during Phase One of the 63-20 PDB and becomes active when the public agency occupies the building at the end of construction. The lease payment that the public agency agrees to is the sum of three major components: debt service, operations and maintenance costs, and a contribution to a repair and replacement reserve fund.

DEBT SERVICE - The bulk of the lease payment is made up of Debt Service. The bonds are privately issued by the not-for-profit partner on behalf of the project and generally are rated equivalent to the public agency's own tax-exempt lease revenue bond rating. The result is that bond pricing and the cost of debt is equivalent to a typical DB or PDB project. Therefore, debt service on the tax-exempt debt is the same as public agencies would expect when issuing their own lease revenue bonds. This contrasts markedly from equity based P3s, with their high cost of debt and annually exhalating equity returns. In the 63-20 PDB model there are no hidden costs or annually increasing returns on capital costs.

"63-20 PDB delivery achieves a 20% to 40% cost savings when compared to publicly-funded GCCM, DB and PDB, and far greater cost savings when compared to equity based P3 models."

OPERATIONS AND MAINTENANCE – O & M is the second component in the lease payment. It is billed to the public agency at cost. The Public Agency is involved in the selection and negotiation of the Property Management Contract. That contract is renegotiated on 3-year to 5-year intervals in order to keep property management costs competitive with the market. This provides the public agency with options to replace a Property Manager if it dislikes the quality or level of service. It is also possible to allow for public property management, should the public agency desire to self-manage

REPAIR AND REPLACEMENT RESERVE - The third component of the lease payment is a contribution to a repair and replacement reserve. The reserve is held by a trustee specifically for necessary repairs or replacements needed in the facility. This safely guards those funds from potential budget raiding and repurposing which is commonly the cause of deferred maintenance in publicly maintained facilities. The Repair and Replacement Fund is reevaluated regularly and if there are any excess funds they are returned to the public agency. The balance in the fund stays with the building when its ownership reverts to the governmental tenant.

Radford Court, a student housing project for University of Washingon

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Transfer of Ownership

In a 63-20 Progressive Design Build, the not-for-profit acts as the issuer for the tax-exempt bonds and thereby, as the on-behalf of owner of the project. Its ownership "on the behalf of" the public agency is governed by IRS regulations. As mentioned earlier, the project must be maintained in like-new condition for its age. This requirement assures that the project is well maintained and kept in good repair while the not-for-profit partner acts as the owner. Second, when bonds are retired, either before the term through early redemption or at full term, ownership of the building transfers unencumbered and with no additional cost to the public agency. When the debt is retired, the public agency assumes full rights of ownership and responsibility for the building.

Wood Center Dining Facility; a 63-20 PDB project delivered on behalf of the University of Alaska Fairbanks

For a project specific explanation on 63-20 Progressive Design Build see PFG's Document:
The Cutting Edge of P3: 63-20 Progressive Design Build The County of Los Angeles' Municipal P3 Project

P3 Webinars

For even more information, PFG hosts free webinars every Spring and Fall. To register or find out more, contact Matt Calcavecchia at mcalcavecchia@publicfacilitiesgroup.org

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