



PUBLIC-PRIVATE PARTNERSHIPS HELP UNIVERSITIES FUND CAPITAL PROJECTS

INTRODUCTION

Public-Private Partnerships, or P3s, have rapidly grown in popularity in the United States, becoming an increasingly common way for public owners to fund construction projects. While exact figures vary, P3 spending is expected to reach new heights in 2019 as public owners continue to search for creative ways to fund current and future infrastructure needs.

Initially used primarily in the transportation market, P3s now are being used in other market sectors, including higher education. Like the transportation market, the higher education market has endured recent decreases in public funding, and is spending less per student than a decade ago. According to the Center on Budget and Policy Priorities, nearly every state is spending less per student than prior to the Great Recession,¹ spending an average of \$1,600 less per student per year. Lack of public funding also has led universities to cut services and raise prices, as well as to admit larger numbers of out-of-state and foreign students, both of which have proved unpopular. Students are telling universities that they can no longer absorb higher tuition and housing fees, and continued increases are becoming less and less sustainable. As a result, without state funding and consistent revenue increases to fall back on, universities are turning to P3s to fund new projects.

University P3 projects initially focused on student housing, which provided a fairly simple and well-understood model. By leveraging a steady stream of student fees for housing and dining, universities have been able to successfully build student housing and support facilities. Later P3 projects expanded to incorporate facilities that are more central to the university experience, including academic and research spaces, and central-plant infrastructure.

The purpose of this paper is to provide an overview of the current status, key developments, and trends in the area of university P3 projects.

KEY P3 UNIVERSITY PROJECTS

UC MERCED

Perhaps the largest university P3 project in recent history has been the P3 initiative at the University of California, Merced (UC Merced). UC Merced opened its doors to students in 2005, and was the first new UC campus to open in 40 years. UC Merced is one of only two UC campuses in the Central Valley, and was established to help address the area's lack of higher education opportunities for lower-income residents.

¹ <https://www.cbpp.org/research/state-budget-and-tax/funding-down-tuition-up>

1

As the UC's newest campus, and as a campus focused on lower-income students, UC Merced faced a unique set of challenges. While the rest of the UC system was funded and built during the post-World War II era (UC Santa Cruz, UC Irvine), or were earlier existing colleges that were later incorporated into the UC system (UC Berkeley, UCLA), UC Merced was built in an era of tighter funding for higher education. As a new university, there was no alumni donor base to call upon, and the typical funding methodology of bond and state funding was not politically feasible. UC Merced determined that a P3 approach to building its infrastructure was necessary, and embarked upon a multi-billion-dollar program to construct its physical plant and establish itself as a university on par with the rest of the UC system.

UC Merced's master-planned capacity is 25,000 students. However, due to a lack of infrastructure, the campus currently has capacity for only about 7,000 students. In 2016, UC Merced launched a P3 program to build capacity for 10,000 students by 2020, and to ultimately fulfil its master-planned capacity of 25,000 students. UC Merced's P3 program includes the following:

1. UC and the developer will jointly finance design and construction,
2. The developer will take on maintenance of major building systems for a 35-year period, in exchange for predetermined payments consisting of availability payments calculated as a function of the capital investment and O&M amounts adjusted for inflation.² ³
3. At the end of the 35-year maintenance period, the developer will turn over maintenance to UC, and
4. Design and construction of the buildings are done on a performance-based framework, instead of prescriptive requirements for certain types of equipment and methods of construction.

2 Volume 1, Appendix 6, Section 1.2 details the calculation of availability payments. The formula for the yearly maximum availability payment is a function of the a) Initial AP Capital Amount, which is listed as approximately \$36.9M, and b) Initial AP O&M Amount, which is listed as approximately \$9.8M.

3 "During construction, the university will make predetermined progress payments to the developer. Once the buildings become available for use, the university will make performance-based "availability payments" that cover remaining capital costs, as well as the operations and maintenance of major building systems. From start to finish, the duration of the agreement is 39 years." <https://merced2020.ucmerced.edu/financesstructure>, accessed 8/23/19.

4 <https://www.universityofcalifornia.edu/news/first-merced-2020-project-buildings-open-students>

5 <https://smileypete.com/business/private-enterprise-for-public-benefit-legislative-changes-op/>

6 <https://ncppp.org/university-of-kentucky-s-housing-p3-continues-to-break-new-ground/>

7 <https://www.timhaahs.com/timhaahs-teaming-on-groundbreaking-mixed-use-p3-project-for-the-university-of-kentucky/>

8 <https://info.higheredfacilitiesforum.com/blog/6-things-to-know-about-kus-350m-p3-project>

9 <https://www.insidehighered.com/views/2019/01/28/advice-institutions-embarking-public-private-partnerships-opinion>

The first of the Merced 2020 projects opened in August 2018.⁴

UNIVERSITY OF KENTUCKY

In 2017, the University of Kentucky completed a \$450-million P3 project that added campus housing space for approximately 7,000 students, as well as a \$245-million P3 partnership for dining services that incorporated a large capital investment component.⁵ The housing component called for a 75-year lease by the developer, which included a profit-sharing plan with the university after certain thresholds were met.⁶ The University also recently announced plans for a smaller P3 project that will transform a former bookstore into mixed-use retail and parking space.⁷

UNIVERSITY OF KANSAS

The University of Kansas (KU) required additional student housing and science education facilities. However, according to press reports, the state of Kansas has funded only 10 percent of KU's major projects. Another 25 percent from private donors still leaves a 65-percent funding gap.⁸

KU initiated its P3 Central District Development Project in early 2016. The \$350-million project includes construction of a new science research/teaching space, residence halls, a student union, a central utility plant and parking garage to support the new facilities.

The P3 partnership required KU to lease the land to a specially created 501C3 affiliate corporation. This affiliate corporation contracted with a developer for building/design/maintenance, and was responsible for the development's bonding and funding. As with UC Merced, ownership of the land and facilities will remain with the state and KU. While not a "full" P3 in the sense that private money ultimately was not used, the KU project still relied upon a private developer to design, build, and maintain it.⁹

KEY ISSUES

As P3s continue to grow in popularity, several key issues have emerged that merit consideration. How the market has responded to each of these issues likely varies from project to project, and much of the information is concealed in private contracts that are inaccessible to the public. Fortunately, the contract utilized on the UC Merced 2020 project has been made publicly available, and relevant portions are discussed below.¹⁰

PROTECTION OF INTERESTS

One of the significant issues in any P3 project is the protection of the public interest. P3 projects are often perceived as “giveaways” to private enterprise. As such, public owners, including universities, are often sensitive to the idea that they are giving private owners property that rightfully belongs to the public. They also are under great pressure to create a perception of transparency and equitable risk-taking. For example, concerns around high costs and biased analysis that were exacerbated by a lack of publicly shared information eventually led to the rejection of the Marion County Justice Center project in central Indiana in 2015, despite the large amounts of time and money (over \$16 million) already invested by the parties to develop the project.^{11 12}

Delay claims are often the largest risk on any public infrastructure project. The daily cost of contractors' manpower, supervision and overhead comprises the highest price-tag on most construction projects. Delays in construction nearly always lead to higher costs that then can become the subject of intense negotiation and dispute proceedings. In addition to delay, disputes on P3 projects may also include more typical areas of conflict, such as cost growth due to extra work and unforeseen/changed conditions, as well as post-construction disputes such as shortfalls in post-construction revenue, O&M performance, and changes in standards during O&M. These disputes can be further complicated by the involvement of more players (i.e. lenders, investors, contractors and designers).

Public owners carry a unique risk in P3 situations. As they are often somewhat removed from the daily construction process, public owners need to ensure that any losses are distributed in an equitable manner and in proportion to the risk each party assumes. For instance, if a public owner of a P3 project has little involvement in the execution of construction and has ceded the management role to a private developer, it would be difficult to argue in the court of public opinion that the public should bear the burden of bad decisions that lead to cost overruns. Owners also face added scrutiny from the public, which often views fees it pays (including tuition) as subsidies for such overruns.

UC Merced's contract includes several clauses that attempt to address these risks:

- Articles 5 and 7, “First and Second Delivery Facilities...,” and “Noncompliance Points,” respectively, address developer breaches or failures in performance and their consequences to the developer. These include Deductions for late delivery of facilities. However, Article 10, “Relief Event Claims,” details provisions that allow the developer to seek additional money, time extensions, or other relief if certain events transpire, including owner-caused delays, delays resulting from third-party utilities, and weather delays.
- Article 12, “Payments to Developer,” contains several provisions that appear to be intended to limit the University's risk to cost overruns and/or prevent ill-advised disbursements. It includes a provision that states the owner will not be required to pay any monthly progress payments until at least \$150 million in work has been invoiced by the contractor.¹³ Article 12 also includes a provision that caps the total amount of monthly progress payments to the developer at \$585 million.¹⁴ Availability payments are also limited until achievement of certain milestones.

While these clauses are targeted toward mitigating risks and limiting exposure to cost overruns, the opinions of a fact-finder on these clauses have yet to be tested in any kind of dispute resolution setting. In addition, while many conflicts typically arise in the contractor-owner relationship (in this case contractor-developer), the addition of a university owner into the relationship can complicate the pursuit or defense of any disputes.

10 https://merced2020.ucmerced.edu/sites/merced2020.ucmerced.edu/files/documents/volume_i - project_agreement.pdf

11 <https://www.indystar.com/story/news/2015/11/06/city-owes-112-million-scraped-justice-center-plan/75315892/>

12 https://en.wikibooks.org/wiki/Public-Private_Partnership_Policy_Casebook/Indianapolis_Courthouse#Narrative

13 Article 12.1.5 states, “Monthly Progress Payments will not commence until at least \$150,000,000 in cumulative work has been invoiced by Developer's design-build contractor for work associated with the Project (the “Progress Payment Threshold”), as demonstrated by certified copies of Developer's draw requests and design-build contractor invoices approved by the LTA.”

14 Article 12.1.2.2 states, “The aggregate amount of Monthly Progress Payments payable by the Owner to Developer shall not exceed \$585,000,000.”

LONG-TERM NATURE OF RELATIONSHIP

Another aspect of P3 projects is the long-term nature of the relationship.

In a P3, relationships with the private partner will last significantly longer than those of a traditional construction project. Contracts spanning 50 years are not unlikely, as agreements can include significant periods of maintenance and operation.

According to a recent survey, a considerable number of projects since 2014 call for contractual relationships of up to 70 years.¹⁵ These lengthy time periods will likely outlast not only the original creators of the deal, but also several subsequent “generations” of university and private developer staff. Entering into multi-generational partnerships can be a huge unknown, and elevates the need for vetting of potential partners. Even if potential partners are deeply investigated, parties must consider the likely possibility that the private developer will transfer its interest in the project to other, currently unknown parties through any number of proceedings.

As a result, given the lengthy timeframes of the deals, having clear contractual language is imperative. When the original drafters and negotiators have long since retired, successive generations will be largely dependent upon the terms of the deal as described within the four corners of the documentation.

The UC Merced 2020 contract includes several provisions that allow for changes in ownership only if approved by the University. Volume 1, Article 14 allows the University to veto changes in the ownership structure or control of the developer (with exceptions), until two years after the date of substantial completion.¹⁶ After this two-year period, the owner is required to “not reasonably withhold its approval” of a transaction. The contract includes a series of clauses that would allow the owner to withhold approval in this post-substantial-completion period. Importantly, the owner may withhold approval if the developer cannot demonstrate that the sale would have no impact on its ability to meet its obligations.

While the UC Merced contract attempts to deal with changes in parties, the enforceability of these restrictions appears to have not been challenged. Furthermore, it is not unreasonable to foresee a leaner time, when either the University owner or private developer go bankrupt, attempt an unfavorable divestiture, or must otherwise seek an exit from the deal. It is unknown how the courts will view an agreement made decades ago in these or other situations.

MAKING ROOM FOR UNEXPECTED CHANGES

On the university administration side, there are several long-term issues that will need to be addressed.

First, planners need to ensure that a flexible set of building standards are in place, leaving room for future improvements that may be required by code changes or by elective decisions. There is an inherent difficulty in predicting future building standards over these long-life deals, and the ability of parties in a P3 relationship to adjust for unknown future developments will largely depend on the terms of the agreement negotiated.

Second, the use of the building itself may change over time. What was once an administrative space may need to be converted to student housing or academic research space, depending on how the needs of the university change. It is even possible that student enrollment is substantially smaller than projected, leading to some closures of space. The contract will need to have mechanisms to accommodate these types of changes, including changes that may be currently unimaginable.

One example, according to the Design Build Institute of America (DBIA), is the model used for hospitals in Canada and the United Kingdom, which requires design accommodations for future changes in medical equipment technology and results in the private developer designing with future equipment upgrades in mind from the beginning.¹⁷ It may make sense that similar design flexibility be incorporated into future University projects, which would allow space to be converted from its original use for new housing, academic or administrative use.

15 http://programmanagers.com/wp-content/uploads/2018/09/P3-State-of-the-Industry-Final_Small.pdf

16 These exceptions are discussed under Volume 1, Appendix 1, “Abbreviations and Definitions.” They include allowances for an initial public offering in the Developer, changes upstream of the Developer that do not cause changes in the ultimate directing entity of the Developer, or changes in ownership of parties with a direct interest in the Developer.

17 <https://dbia.org/wp-content/uploads/2018/05/DeeperDive-P3-Social-Infrastructure.pdf>

The UC Merced contract includes the following clauses:

- Article 6.2.1.1 requires the developer to perform its Operation & Maintenance (O&M) services in accordance with several provisions, which includes “Best Management Practice, as it evolves from time to time.” The contract allows this only after the owner issues a change order.
- Article 6.2.2, “Changes in Operation and Maintenance Standards” allows the owner the right to make changes to the technical volumes related to the O&M Services, subject to the issuance of a change order.

Although the UC Merced contract attempts to deal with future changes in building O&M standards, the practical medium- and long-term ramifications of these multi-decade deals are unknown. As the parties become accustomed to a certain rhythm of interaction in the long O&M phase of the agreement, important contractual requirements that were the subject of lengthy negotiations could simply end up being forgotten by parties who do not have any direct connection to the original negotiations, resulting in essential maintenance being ignored.

CONCLUSION

University P3 projects are showing signs of growth, driven by shrinking budgets, rising enrollments, and a limited ability to raise tuitions. Following an initial wave of easily monetizable assets such as parking and student dining—and pushed largely by the example of the UC Merced project—university owners are pursuing P3s to build spaces and infrastructure that more closely mirror their academic missions. Before universities pursue P3s, however, they should consider the issues outlined in this paper and decide how their own unique campuses will address those risks.

ABOUT THE AUTHOR

DANIEL KWON - DIRECTOR

Daniel W. Kwon is a Director with more than 15 years of construction industry experience, including contemporaneous scheduling, schedule reviews, and providing project controls monitoring and reporting services; preparation of claims and development of expert work product and reports; and presentations in support of settlement negotiations, mediation, deposition, arbitration, and trial. He has testified in deposition, mediation, and arbitration. Daniel has served as a construction cost and scheduling claims consultant, and as a general contractor. He has also served as a management consultant, with emphasis on construction programs, where he has provided technical support and consulting assistance on mega-projects valued at more than \$20B in the oil and gas, nuclear, hospitality, mining, pharmaceutical/ life sciences, and construction industries.

Daniel's specific claims-related expertise includes the identification, preparation, and defense of claims for a wide spectrum of industries. He has developed schedule delay claims, lost productivity studies, acceleration claims, and assessment of claims recoverability. He has prepared as-planned and baselines schedules, created extensive as-built schedules from historical data, served as a contemporaneous project scheduler, performed construction cost assessments and estimates for replacement construction.

Daniel's specific management consulting-related expertise includes authorship of playbooks, creation of Capital Authorization Request structures, and performance reviews of mega-projects. He has worked extensively with large owners by providing an independent viewpoint of how their policies compared against industry best practices and created detailed process improvement plans.