
Overview of Alternative Funding

Presentation to
Task Force to Study Public School Facilities

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Task Force to Study Public School Facilities Alternative Funding and Financing Methodologies for Public School Construction

Outline of Alternative Methodologies

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A. Alternative Funding

General: Conventional project delivery, but using alternative sources of funds to support local project expenses through conventional financing (bond payments or pay-go).

Impact fees: A fee is imposed on the developer for each new unit of housing that is constructed. Impact fees must be used in the area of impact, however that is defined (i.e., must be used to build capacity for the school or schools that will be impacted by the students that are brought into the system by the new housing development).

- Pros: Places burden for funding school capacity on the parties that generate the need (the developer and the home buyer).
- Provides certainty for the developer, who generally will pass the costs on to the home purchaser.
- Cons: Difficulty of defining at what point in the development process the fee should be assessed: Preliminary platting? Final permits?
- Difficulty of defining the "area of impact".
 - Since housing construction and sales occur much faster than a school can be planned, designed, and built, the funds assessed cannot be used to build school capacity quickly enough to provide for the children who come out of the housing developments.

Excise Tax: A tax is imposed on the home buyer when they purchase a new home, and is passed on to subsequent buyers until the debt is extinguished (for example, in ten years).

- Pros: Places burden for funding school capacity on the parties that generate the need.
- Provides certainty in defining the point in the development process when the fee will be assessed.
 - Provides certainty for both the developer (who must disclose the tax in selling the home) and the homebuyer.
- Cons: Funds are assessed with purchase of the home, therefore presumably when the children are already present; construction of school space based on the funds will come several years after it is needed.

Sales Tax: There are several options:

1. A State sales tax increment will be added to the existing sales tax, which will be dedicated to public school construction. The funds will be placed in a general account and added to the anticipated allocation for each fiscal year.
2. A local sales tax is authorized by the Assembly (e.g. LISTOS, Local Incremental Sales Tax Option for Schools). Under one proposal, LEAs would be allowed to levy

½ to 1 cent in incremental sales tax dedicated for public school construction. 2/3 of the revenue raised would be used by the LEA for their public school construction, and the remaining 1/3 would be placed in a general statewide fund, which would be distributed by need.¹

- Pros: Reliable source of funds, with relatively little hardship to the consumer.
- Likely to gain a relatively high level of public support, if the funds are clearly dedicated to public school construction.
 - Distributes burden of funding to entire citizenry, under the argument that all benefit from good public schools, whether or not they have children in the public school system.
- Cons: Constitutes a new tax that may face political resistance.
- LISTOS: Raises issue of equity, since the LEAs with busy retail markets will benefit more than those without. If the formula were adjusted to provide greater redistribution of funds, there would likely be resistance from the wealthier LEAs.

Proffers: Housing developer is required to offer either sites or a funding contribution as part of negotiations with local planning authority.

- Pros: Sites offered will be in the area of likely impact.
- Additional conditions can be negotiated, e.g. developer must provide access road, storm drainage, or a level building pad.
- Cons: Sites offered by the developer may not meet the size, configuration and access requirements of the LEA; developers will be reluctant to offer up good sites that can be profitably developed for additional housing.

Grants and Donations: Voluntary contributions from businesses, developers, non-profit organizations, or individuals.

- Pros: Promotes community and business involvement in schools
- Lessens public debt obligation, or maintains level of debt obligation but provides enhancements for schools not typically provided or not affordable under debt limitations.
- Cons: Raises issue of equity: schools in affluent, well-organized communities benefit, those in poorer, socially disorganized communities do not.
- Raises question of ownership and control: Can the LEA transfer the improvement (e.g. window A/C units) to another school without the donor's approval?
 - May raise issue of quality: If materials or equipment are installed by private individuals or groups, do they meet the LEA and local standards for workmanship, safety, and durability?

B. Alternative Financing

General: Conventional project delivery, but using alternatives to bonds or pay-go to wholly or partially finance the project.¹

¹ Lisa Rawlings, "Innovative Methods to Fund Public School Construction" (report to Task Force to Study Public School Facilities," _____, 2002.

Lease-leaseback: LEA leases a school property (buildings and land or land only) to a private entity (the lessor), which renovates or builds the school and then leases it back to the LEA. The LEA's lease is paid out of its operating budget, rather than through sale of public bonds. This procedure can be used with a school design that is provided by the LEA, or under a design-build arrangement in which the lessor provides both design and construction services. It can be extended to include equipment, and in one instance in Florida the lessor provided the educational equipment, hired the teachers, and delivered the educational program (based on a design that was already completed).

Private activity bonds provide one possible source of revenue for the lessor. These bonds are issued by or on behalf of the local government to provide debt financing for projects, but are most often used by a private user. The finance cost is generally less than the market rate because private activity bonds are typically tax exempt. The local government does not pledge its credit to pay on the bond, but rather the bond is supported by the private user of the property that is financed. As one example, the Federal government has created Qualified Public School Facilities Bonds, which are available to all of the States. These bonds are tax-exempt and are provided solely to assist in financing school construction.

- Pros: Lease-leaseback removes payment for the school facility from the local fiscal authority's indebtedness, transferring it to the operating budget. (However, under local tax and accounting laws, the lease may be construed as a capital rather than an operating lease, in which case the indebtedness of the fiscal authority may not be reduced (ref. Nova Scotia case)).
- The lessor is usually at risk for the cost of the improvements (lease payment will not increase if construction costs are higher than agreed-upon value).
 - Various other aspects of risk can be transferred to the lessor. All transfers of risk are likely to increase the cost of the lease:
 - Occupancy risk: If school occupancy falls below a certain level, the lessor is responsible for some part of the lease payment (since the school's funding may be tied to the number of students it has)
 - Lease risk: Lessor may be responsible for some portion of the lease payment, which they will make up through rental of the facility to outside groups that are compatible with school functions (Nova Scotia model). (Note: this raises the "bad money" question, i.e. use of public facility to generate private profits.)
 - Ownership risk: Lease may allow LEA to exercise option to extend the lease arrangement at the end of the lease term, or to acquire the facility; in either case, the LEA can opt out of the arrangement if enrollments decline or shift location.
- Cons: The risks transferred to the lessor, as well as the need to provide profit to the private entities involved, will generally lead to costs that are higher than those involved in public borrowing through bond sales. These costs make this approach attractive when no other funding sources are available, or when the urgency of the facility need outweighs the cost consideration.
- Increase in operating budget must be approved by the fiscal authority.

- Hidden costs may be added to hard and soft construction costs, e.g. fees, pre-payment penalties, and conditions requiring re-negotiation of the lease after a set period (based on then-current interest rates).
- Maryland procurement laws require competitive bidding for public school construction, irrespective of the source of the funds (exception: an LEA can ride a contract established with a constructor through competitive bidding in another jurisdiction). This signifies that the lessor must be selected through competitive solicitation. LEA must develop a thorough performance specification, requiring counsel review and possibly engagement of a consultant to guide the process. These expenses, and the additional staff time involved, must be added to other expenses.
- The risks assumed by the lessor may create an incentive to reduce the costs of construction by cutting back on quality.

Sale-leaseback and Construct-leaseback: Similar to lease-leaseback, except that the LEA sells the property to the developer, who then makes the improvements and leases the facility back to the LEA. Ownership is retained by the lessor. “Construct-leaseback” specifically refers to the arrangement when the building is not reverted to the LEA at the end of the lease term.

- Pros: Revenues generated from the sale of the property can be used by LEA for school construction or modernization, at subject site or elsewhere, or for other school purposes, e.g. purchase of instructional materials.
- Sale of land (by County) reduces County’s asset base, and can have positive impacts on County’s bond rating.
 - Lease agreement can be written to allow LEA to purchase property at end of lease period; to opt out of lease at some point in the term; or to continue the lease arrangement after expiration of the lease term.
 - Other pros are similar to lease-leaseback.
- Cons: If title to land is transferred to lessor, State procurement law prevents the PSCP from providing funds to a school construction project.
- State law requires that sites be transferred to the County government (or City of Baltimore) before they can be sold.
 - Other cons are similar to lease-leaseback.

Performance Based Contracting: Private energy management firm or construction company replaces or upgrades the energy components of a school facility. Cost of construction is paid through the energy savings that are generated by the improvements. Typically an intermediary financing entity is involved, which pays the constructor in a lump sum payment and then is reimbursed by the LEA through monthly payments from the operating budget (conceptually, the operating funds previously spent on energy costs are now spent on payments). The energy savings are guaranteed by the energy management firm, based on anticipated fuel costs.

As a variant, the energy management company may retain ownership of the mechanical system or other components of the building, and the periodic payment by the LEA may be considered a lease payment consisting of energy savings and some increment. This will reduce the time required for payoff, but will also increase the operating budget. As in other lease arrangements, ownership of the system may revert to the LEA after a set period.

- Pros: Improvements in building performance and human comfort are achieved at no additional cost to the operating budget.
- If the lease arrangement is established, the lessor will carry risks such as maintenance, operations, and warranty.
- Cons: Renovations and upgrades are limited: if educational enhancements are combined with the energy upgrades, it becomes more difficult to measure the anticipated energy savings and establish a calculated rate of return. Also, if the energy upgrades are occurring simultaneously with the other improvements, culpability for contractor non-performance becomes clouded.
- Even upgrades that are apparently energy-related may not be considered eligible expenses by the energy management firm; e.g., window replacement is almost always an essential component of an energy upgrade, but at least one industry participant considers them to be outside of the energy management scope.
 - Contractual difficulties may emerge if school-based personnel work on the system, or on parts of the building that are outside the lease area but affect it (e.g. electrical system).
 - Typically these projects are executed through a design-build methodology, with the energy management firm providing design services and construction under a single contract. State requirements for competitive procurement still apply, requiring the LEA to engage an independent consultant for complex projects to ensure that specifications are complete and whole and to oversee construction of a highly technical nature.

Public-Public Partnership: Another public agency uses the facility, participating in the costs of construction and operation. Several arrangements are possible:

1. Campus Organization: LEA and the other public agency have separate structures on a common piece of land, and share in the cost and maintenance of outdoor areas (e.g., Parks and Recreation has a community center adjacent to the school, shares responsibility for ball fields and parking)
2. Shared Building: LEA and other public agency each control a part of the building, with a firm separation between the two portions. Occupants of each section use the other section as would any other member of the public, subject to the same restrictions (e.g., recreation center adjacent to school, but with separate entrance and separated by fire wall).
3. Joint-Use Agreement: LEA and other public agency share at least some common space in the building, generally on the basis of a pre-determined schedule (e.g. recreation center and school under one roof, with some portions of each off-limits to the other, other portions used in common at different times of day or week).

The public agencies that may be eligible for this type of arrangement in a school include, at a minimum, medical (community wellness center), police (koban concept), itinerant social services, day care, library, recreation, and community college (adult extension courses).

- Pros: Distributes costs of construction, operations and maintenance onto other public entities, which may have revenue sources not subject to the county's bond restrictions.

- Enhances the offerings of both entities: School benefits from expanded recreation or athletic facilities and presence of community members as volunteers and mentors, while the other agency benefits from use of specialized school facilities (e.g. distance learning lab, science lab, computer rooms, art room, high school weight room, pool, etc.)
 - Increases daily use of the facility, extending the benefits obtained from public monies.
 - Increases the value of the school as a community facility, with positive impacts on community spirit and identity.
- Cons: Joint-use arrangements defining responsibilities for maintenance, security, janitorial services, etc. are very difficult and time-consuming to work out.
- Presence of adult members of the public at a school facility during school hours is a source of concern for the safety of the students.
 - Design has to account for the required separation between the entities, while still ensuring that code requirements for fire egress are maintained.
 - Design also has to ensure that the instructional arrangements of teachers are not disturbed by the public that uses certain spaces in non-school hours, e.g. by providing separate storage spaces for art materials and projects in an art classroom. These additional arrangements offset some of the savings achieved through the joint-use structures.

Public-Private Partnership (P3): A private entity shares a facility with the school (campus arrangement, shared building, or joint-use). Revenues generated by the private entity's activities are used to reduce the debt service or lease payments of the LEA. Private uses must be compatible with school activities. The most prominent example is the James F. Oyster School in Washington, D.C., in which a portion of the school property was sold to a private developer to construct a high-rise residential tower, proceeds from which were used to replace and expand the existing school. More ambitious projects are now being developed in Virginia under new legislation that allows for "competitive negotiation."

- Pros: Engages profitable private sector activities in addressing a social issue.
- May provide educational enhancements for students, e.g. opportunities for business education, after-school jobs, mentoring in the classroom by business people, etc.
- Cons: Opportunities similar to the Oyster situation are not readily apparent in Maryland (Oyster is located in one of Washington's most desirable residential areas, adjacent to Connecticut Avenue and Rock Creek Park). Hence private sector interest may not be strong.
- The stability of the private sector entity must be assured: if the private partner defaults, considerable cost and risk revert to the LEA.

Commercial Development Schools: This is a variant on P3 in which a private sector entity, e.g. a coalition of businesses, provides a school facility in a non-traditional setting, largely to serve the needs of its own employees. The school is administered and staffed by the LEA, but with input of funds and expertise from the private sector. Examples have included a school in a downtown skybridge, in a shopping mall, and in an airport. It is claimed that these small schools achieve high academic standards, high levels of parental involvement, and increasing support from the private group that sponsors them.

- Pros: Engages profitable private sector activities in addressing a social issue.
- Removes the facility costs entirely from the LEA's capital or operating budgets.
 - Allows working parents to be near their children, facilitating their daily movements and logistics, and reportedly also increasing their involvement in school activities and satisfaction with their jobs.
 - May provide educational enhancements for students, e.g. opportunities for business education, after-school jobs, mentoring in the classroom by business people, etc.
- Cons: Stability of both the private sector sponsors and of the employees is essential: What happens to the school if the private group's finances change and they can no longer support the facility, or no longer are willing to support it? Can a child continue in the school if the parent decides to seek employment elsewhere?
- In addition, the responsibilities of each party must be made clear, and the independence of the school system must be protected. How does the public school system guarantee freedom of education if it chooses to include material in the instructional program that may be contrary to the orientation or beliefs of the private entity?

Alternative Project Delivery

General: May use conventional or alternative project financing.

With conventional financing:

Construction Management Agency (CMA): Owner engages Construction Manager as a professional agent both to provide pre-construction services and to manage multiple prime contracts, which are held by the Owner. The Owner in effect becomes a general contractor.

- Pros: The Owner has a professional constructor involved at the early stage of design, providing value engineering, constructibility review, and cost estimating at the time that it is most needed.
- The Owner has direct control of the trade contractors, providing greater freedom to re-bid a package or default a contractor if needed.
 - The project can be broken down into packages small enough to make it accessible to small businesses and minority businesses, who frequently have lower bonding capacity than majority firms.
 - Costs are generally similar to those of conventional Design-Bid-Build methodology; advantage lies in closer control.
 - Particularly applicable to projects that entail difficult site conditions, compressed schedules, or intricate community relation issues.
- Cons: The quality of the CMA services provided is of crucial importance; the selection process must be thorough and have integrity.
- Although the CMA serves as the Owner's agent, the management of multiple contracts frequently exceeds the Owner's staff capabilities.

Construction Management At-Risk (CMR): The Owner engages the Construction Manager for professional services in the pre-construction phase, and then contracts with

the CMR on the basis of a Guaranteed Maximum Price (GMP) to carry out the construction phase. Typically, the CMR's trade contractors operate on an "open-book" basis so that the Owner can see all costs. Often this is accompanied by a cost-savings incentive, so that the CMR shares in the savings if the project is ultimately completed below the GMP.

- Pros: The Owner has the input of a professional constructor in the critical pre-construction phase, but also knows the actual cost of the project (the GMP) well in advance of construction activities, allowing for revisions to scope to bring the project into line with the budget.
- Cons: This approach works best if the Owner can negotiate the scope of the project with the same CM that was engaged for pre-construction services, in order to obtain the best value for the project. Under current public school construction procurement rules, this is not possible: at the point that the Owner seeks a GMP, they are required to publicly solicit competitive prices based on a fixed scope. The CM engaged for the pre-GMP phase may not be the same CM that eventually builds the project.

Design-Build (DB): The Owner engages a single entity to provide both design services and construction of the project. The arrangement can be extended to include equipment and even maintenance of the project.

- Pros: The Owner benefits from having a single entity responsible for delivery of the project.
- The adversarial relationship between the designer and the constructor is eliminated, improving the efficiency of the process.
- Cons: Like Construction Management at-Risk (CMR), Design Build works best when fee and scope can be negotiated with a project team that is selected through a qualifications process. Under current State law, the project cost must be provided through a competitive sealed bid arrangement. This requires the Owner to have an exceptionally well-developed performance specification that unambiguously outlines the educational standards and performance standards of the future building, as well as the responsibilities of the DB team. The Owner must have exceptional staff time that can be devoted to this process and must either be thoroughly knowledgeable about the DB process or must engage a consultant who is.
- Since the DB is at risk for delivering the project within a fixed price before the design is known, there are built-in incentives to either reduce the scope of the project by altering the educational specification, or to reduce the quality of the built work by modifying the performance specification. To counter this, the integrity of the DB team is essential, combined with an air-tight specification and the diligence of the Owner's staff.
 - The absence of an adversarial relation between designer and builder eliminates one of the checks and balances that in a typical Design-Bid-Build scenario helps to control quality and schedule.
 - Reports from the industry indicate that while the DB approach can provide substantial schedule benefits for a project, it does not deliver projects at a cost lower than conventional Design-Bid-Build.

Job-Order Contracting (JOC): The Owner engages a contractor for an indefinite set of projects based on a detailed fixed-price index of construction items, as well as a competitively bid mark-up for the contractor's overhead and profit. Typically the contractor is engaged for a maximum yearly amount and is guaranteed some minimum amount of work. The contract expires after a set period, requiring a new solicitation and bid. New projects are assigned to the contractor through purchase orders, without competitive bidding between contractors. This methodology has been successfully used by the military for base improvements.

- Pros: This process is normally used for smaller, maintenance-level projects. It allows the projects to be assigned to a contractor and quickly carried out, since the contractor selection process is eliminated for the specific project. Larger projects, however, are feasible. The efficiency of project delivery under this methodology is impressive.
- The Owner can refuse to give the contractor additional work if their performance is not satisfactory.
 - Since prices for building components are defined in advance and the contractor's mark-up is known, the Owner has great control over the cost of projects.
 - The generally small size of the projects makes them accessible to smaller contractors.
- Cons: Since many small JOC projects are defined by simple scope descriptions rather than by architectural/engineering documents, great trust resides in the integrity of the JOC contractor to provide a price that is in line with the scope (the Owner can, however, scrutinize the proposed cost in detail, assuming that staff is available for this time-consuming task).
- The absence of an architect on many of the smaller projects removes one level of quality control that Owners normally depend on.

With alternative project financing:

Finance-Design-Build (FDB): This represents an extension of the Design-Build methodology, in which the DB entity also provides financing for the project, normally under a lease-leaseback arrangement. As in lease-leaseback, the Owner's costs are paid as an item in the operating budget. Other financing arrangements are possible and should be investigated. Since the scope of work required of the FDB entity can be adjusted, "turnkey" variants on the basic theme include Finance-Design-Build-Equip, in which the FDB entity also provides furniture and equipment for the project, and Finance-Design-Build-Equip-Operate, in which the FDB continues after construction as the building operator. The costs for each of these arrangements will be reflected in the lease payment.

- Pros: Transfers almost all responsibility and risk for the project from the Owner to the FDB entity.
- Allows the Owner to proceed with a project when conventional financing is not available (e.g., in Houston, two major high school projects that were rejected in bond referendums were completed using a FDB structure, averting a capacity crisis).
- Cons: Total cost of the project is likely to be substantially higher than a project delivered through conventional financing, even using a Design-Build methodology.

- This methodology works best when the FDB can be selected through a Quality Based Selection process: Since the Owner is seeking innovative financing solutions from outside expertise, the quality of ideas should be a component of the selection criteria. If the Owner has to narrowly define the financing option in advance in order to provide a truly competitive solicitation, the advantage of pursuing a FDB strategy is virtually eliminated.
- The pressure to develop a complete, air-tight solicitation package is even greater than with Design-Build, since differences in the financing arrangement can substantially impact the Owner's budgets for many years. Vulnerabilities with respect to project scope and quality are similar to those in Design-Build.

Further Questions to Consider:

Are the alternatives outlined here available to the State, or only to the LEAs and Counties?

Where have the methodologies been used, and what are the outcomes?

What are the real costs of using each of these methodologies?

Which of these methodologies has application in the Maryland situation?

What barriers in State procurement law or federal tax law stand in the way of each of the above alternatives?

What recommendations can we make regarding alternative project funding or financing?

¹ *Local Funding Strategies for School Construction: An Analysis of Six Maryland Counties.* Report presented to Task Force on Public School Construction _____, 2003.