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FINANCING DESIGN-BUILD CONSTRUCTION: One City's Experience - Part II - San Francisco's Experience

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Editor's note: Part one of this two-part series appeared in the August issue of *DEBT LINE* and discussed the design-build delivery method for construction projects.

Upon the recommendation of its Sheriff's Department, San Francisco first utilized the design-build delivery method in 1987 to construct County Jail No. 7. At the time, the City had been ordered by a federal court to reduce overcrowding in its existing jails. In the Sheriff's opinion, design-build presented the quickest opportunity for complying with the order. County Jail No. 7 opened in 1988, just 12 months from the date of execution of the design-build contract. Design and construction of County Jail No. 7 was funded with a combination of City general fund monies, State Proposition 16 monies, and an incentive payment from the U.S. Marshall. Based on the City's success with County Jail No. 7, the Sheriff again proposed the design-build method as the most expeditious means of complying with a 1997 judicial order to address health and safety issues at County Jail No. 3.

San Francisco's Experience

In 1997, the City's Sheriff and Director of the Department of Public Works elected to employ the design-build delivery method to construct a new jail facility to replace County Jail No. 3. Built in 1932, County Jail No. 3 is the oldest operating jail in California. In 1991, an inmate class action suit was filed against the City challenging the constitutionality of health and safety conditions at the facility. Subsequently, in 1997 the U.S. District Court of Northern California ordered the City to present a remedial plan for improving living conditions at the existing jail. In August 1999, the City settled the lawsuit by promising to rebuild the facility. The District Court judge gave the City until June 2000 to execute a binding contract guaranteeing construction of a replacement facility.

In March 1998, the City held a preliminary competition based solely on qualifications and selected 5 finalists. In an effort to refine the desired program, the City retained a preliminary architect to craft a general design of the replacement jail facility. On the basis of such design, the City drafted a comprehensive set of documentation that governed the bid and award process, the desired specifications of the facility, and the design-build agreement (the "DBA").[1]

The selection process culminated in January 1999 when the City selected the top-ranked respondent (a joint venture between a prominent architectural firm and a national contractor). Selection of this team was based on evaluation of qualifications, design-concepts (which elaborated on the City's initial designs), and the proposed price for a complete project. Negotiation of the DBA commenced immediately and ultimately concluded in June 2000. In the ensuing 18 months, the project was redesigned, costs were re-estimated and value engineered,[2] and the allocation of responsibilities and risks were negotiated. Both parties retained finance attorneys and consultants to ensure that the DBA would be financible. The joint venture fought hard to protect its guaranteed price levels and timelines while the City focused heavily on ensuring that the contractual guarantee was feasible and enforceable through a clearly articulated scope of work. In November 1999, the City's Board of Supervisors adopted an ordinance amending the City's administrative code to allow for a negotiated award under specified conditions[3].

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[1] Originally, the City intended that the project be designed, built and financed by a third-party and leased back to the San Francisco Sheriff's Department. The initial documents also contained a ground lease (on behalf of the third-party), a sublease (on behalf of the Sheriff's Department) and a standby operating agreement (in the event the Sheriff prematurely vacated the facility). In April 2000, the City decided to finance the facility itself with certificates of participation.

[2] The value engineering of the project and costs is not a typical step in the negotiation of a DBA. This could have been avoided (saving significant time) had the City performed cost estimates during our initial design and adjusted the design to adhere to the proposed budget. Had this occurred, the bidders could have based their bids on the City's documentation without further adjustment.

[3] Section 6.61 was added to the City's Administrative Code by Ordinance No. 286-99 on November 5, 1999 and subsequently amended by Ordinance No. 153-00 on June 30, 2000.

As the financing proceeded, the City began to comprehend the credit issues raised by the design-build approach. We received our first hint of these concerns when the managing underwriter brought its project finance professionals, rather than its municipal finance staff, to the table. In the underwriter's opinion, the extensive uncertainty posed by the design-build process transformed our standard municipal financing into a more speculative project financing.

While the City had negotiated a comfortable reliance on the joint venture's guarantee of a maximum delivery price and completion date, the underwriters had no such confidence. In particular, they were troubled by the fact that the majority of the work to be performed would not be bid by subcontractors for one year after the certificates of participation (COPs) were issued. Pursuant to the design-build process, each subcontract is bid upon completion of that segment of the design and engineering. The joint venture expected to have completed the requisite work within 10 months, at which time the sub-items (such as electrical systems, plumbing, etc.) would be bid and awarded and the prime contractor would actually break ground.[4] Understandably, the underwriters were concerned that construction market conditions, already exacerbated by costly shortages of labor and materials, would decline significantly in the ensuing months, rendering the joint venture incapable of delivering the project on time or on budget. The repayment schedule for the COPs was therefore considered speculative and a subsequent issuance of "completion bonds" could be considered possible.

Another credit issue pertained to the extraordinary length of time between issuance of the COPs and completion of the project. Under the DBA, the joint venture guaranteed to deliver the jail facility within 38 months from the date of the City's issuance of a notice to proceed. The underwriters again were troubled by the uncertainty of such a long timeline. To mitigate this concern, the underwriters strongly advised the City to fund capitalized interest for an additional 12 months beyond the guaranteed delivery date. The City roughly estimated that this "fix" would cost an additional $7.5 million in financing expense, adding another 6.5% to the cost of the project, with no corresponding increase in the value of the facility to either the Sheriff or its inmates. The City never calculated the added expense of a project financing versus a pure municipal transaction. However, we assumed that a transaction of speculative credit quality would attract fewer investors and thus require higher interest rates and sales commissions to stimulate sufficient demand to place the COPs.

The City received a second, more obvious hint of the severity of these credit issues when a potential bond insurer requested that the City redraft certain provisions of our DBA before it could even consider the transaction. After 18 long months of negotiation, the City could not afford to reopen the contract to accommodate this request, especially without any guarantee of receiving bond insurance. While the spread between single-A and triple-A rated COPs was not extremely wide, we believed that bond insurance would save the City considerably more than $100,000 per year in debt service. Ultimately, two other bond insurers were able to proceed on the basis of our existing agreement.

Fortunately, most of the credit issues were mitigated by the City's decision to encumber related assets as collateral during the long construction process. The City's initial decision to employ a partial asset transfer was motivated by a desire to reduce capitalized interest expense during project delivery. The City pledged its downtown jail facility and the entire 150-acre correctional campus until substantial completion of the replacement facility is achieved in October 2003. As a result, for the next 3 years, the City will use cash, rather than bond proceeds, to make interest-only payments to investors. This decision saved the City $18 million in additional proceeds or more than 13% of the value of the jail facility.

In addition to the asset transfer, the City took deliberate steps to ensure the efficacy of the project and the transaction. The terms of our DBA were tightly crafted to protect both the City's interest and that of our investors. Pursuant to the DBA, the jail will be designed, constructed, and delivered for an amount not to exceed a guaranteed maximum price. It will be designed and constructed in accordance with design criteria agreed upon prior to the COP issuance. The contractor, by warrant, promises to deliver a facility that is well-suited for its intended purpose as a maximum security jail. As collateral for these pledges, the contractor provided the City with a performance bond and a payment bond, each in an amount equal to the guaranteed maximum price.

In an effort to control costs and adequately fund the project, an $8 million contingency fund was established. Four million dollars is designated to cover instances where market costs are in excess of estimated costs; an additional $4 million is designated for costs arising from either design errors and omissions or from items overlooked between bid elements submitted by subcontractors. This $8 million contingency is in addition to a standard 10% price contingency contained in the guaranteed maximum price and an additional $6 million held in reserve by the City for change order flexibility. The aggregate amount of project reserves is $25.5 million or 19% of the facility's value. Contrary to traditional guarantee price contracts, the City structured its contract so as to recoup any unused funds. Traditionally, such funds are reserved for the benefit of the contractor as incentive payments.

[4] In actuality, the City's contractor expects to break ground in August 2001, prior to bidding many of these systems.

Finally, in an effort to ensure the timely repayment of the COPs, the DBA set a maximum of 36 months for the contractor to achieve substantial completion. In this case, substantial completion is defined as the point at which the facility can safely and securely house prisoners. In the event substantial completion is not achieved on time, the contractor will pay the City liquidated damages of $10,000 per day plus the City's actual financing costs up to a maximum of $45,000 per calendar day (or $16.4 million per year). The $10,000 penalty was crafted to fund the City's costs in completing the project in the event that the contractor is incapable or unwilling to do so. The additional penalty is specifically crafted to fund the City's daily rent such that lease payments can be made to the COP trustee and ultimately to our investors, even if the City does not have beneficial use and occupancy of the facility.

Ultimately, the City's COPs were issued through negotiated sale in August 2000. They are secured by lease payments from the City's sizeable general fund, hold underlying ratings of A1/AA-/A+ from Moody's, S&P, and Fitch, respectively, and carry bond insurance (including a surety policy) from MBIA. The surety policy (for part of its Debt Service Reserve Requirement) saved the City another $10 million in additional proceeds. The 33-year COPs were exceptionally well-priced with a true interest cost of 5.46%.

While public finance officials traditionally only participate in one aspect of the delivery process, the raising of funds, we valued our participation throughout the entire transaction, including negotiation of the DBA, at $35.5 million as illustrated above. Thanks to the cooperation between our public works and public finance offices, we did our job to raise the funds to deliver a critically needed jail facility.

So, Why Design-Build?

Bramble and West present several surveys which indicate extensive cost and time savings as a result of the design-build method. Specifically, they cite an average 14% cost savings and 18% time savings on projects owned by the U.S. Department of Defense.[5] They also note that "the time frame for Utah's I-15 Interstate highway design-build project [16 miles of roadway and 137 bridges was] … half the time that a similar project would require under the design-bid-build method."[6] For that and other reasons, Bramble and West conclude that "design-build will continue its growth among both private- and public-sector owners in the next decade and will be established as a viable, long-term project delivery method."[7]

As for the City's view, we believe the demand in California for public works projects is only going to rise as existing infrastructure ages, is rendered technologically obsolete or seismically unsafe, and fails to reach a significant percentage of the population it serves. Elected State and local government officials will continue to be pressured to address issues rapidly, such as today's problems of affordable housing, congestion management, and power generation and delivery. Public works personnel and public finance officials will necessarily strive for quicker, cheaper solutions and seek to utilize procedures such as design-build that are borrowed from the private and federal sectors. Clearly, proponents of design-build believe it to be a viable solution, particularly for projects with identical structures (roads, highways, pipelines, etc.). We believe municipal finance structures will evolve to accommodate the unique credit characteristics inherent in the design-build methodology. We expect to utilize design-build again when the opportunity presents itself. We have laid the ground work in this transaction; we expect our next transaction to net us greater time efficiencies and possibly greater cost

[5] *Design-Build Contracting Claims*, Barry B. Bramble and Joseph D. West, editors, Aspen Law & Business, a division of Aspen Publisher, Inc. Copyright 1999. Chapter 1.03, page 21.

[6] Ibid.

[7] Ibid. Chapter 13.07, page 391.

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