

## **OPPORTUNITIES AND CHALLENGES IN USING THE PUBLIC-PRIVATE EDUCATION FACILITIES AND INFRASTRUCTURE ACT OF 2002**

Are you or your clients looking for a new way to develop and finance a public facility for your community? Would you like a private developer to deal with the hassle of designing, building, financing, owning and maintaining a public facility? The Public-Private Education Facilities and Infrastructure Act of 2002 (the “PPEFIA”) may, or may not, be your answer. The PPEFIA was enacted in the 2002 Session of the Virginia General Assembly, and can be found at Section 56-575.1 *et seq.* of the Code of Virginia of 1950, as amended. It is similar to the Public-Private Transportation Act of 1995, known as the PPTA.

### **How Does it Work?**

Through the PPEFIA, a public entity will contract with a private operator for the operator to develop a qualifying project. Once the qualifying project has been developed, the operator will make the project available for use by the public entity pursuant to the terms of a comprehensive agreement between the operator and the public entity. The qualifying project may be made available by a lease, service contract or use agreement involving the operator and the public entity. For the right type of facility, in addition to serving the needs of the public entity, the operator may identify and take advantage of other streams of revenue to support the facility. As an example, a facility used on school days as a school athletic field might be leased by the operator at night and on weekends to a semi-pro soccer team, then might be leased during school vacations for sports camps. These multiple uses of the facility may reduce the cost of the use of the facility to the public entity, since costs are being shared with others, and may increase the profits to the operator.

In enacting the PPEFIA, the General Assembly found that authorizing private operators to develop qualifying projects may result in the availability of such qualifying projects to the public in a more timely or less costly fashion. The vision is to harness the resources and creativity of the private sector for the benefit of the public sector. (See Va. Code § 56-575.2).

Most governmental entities are authorized to take advantage of the PPEFIA, including the Commonwealth of Virginia; any agency or authority of the Commonwealth; any county, city or town; and any other political subdivision of the Commonwealth or regional entity that serves a public purpose. A local school board will be authorized to use the PPEFIA only with the approval of the local governing body. (See Va. Code §§ 56-575.1 and 56-575.16(5)).

A “qualifying project” under the PPEFIA includes (1) any education facility, including real and personal property, (2) any building or facility for *principal* use by any public entity, (3) any improvement or equipment necessary to enhance the public safety and security of a building used principally by a public entity, (4) utility and telecommunications infrastructure or (5) a recreational facility. (See Va. Code §56-575.1). Given this broad definition, almost any kind of capital project undertaken by a public entity may be developed under the PPEFIA. In this article, we will use the term “develop” as a short-hand reference to the acquisition, design,

construction, improvement, renovation, expansion, equipping, maintenance or operation of the qualifying project.

### **Getting Started**

A project may be started in one of two ways. First, a developer may bring to a public entity a proposal to develop a facility as a qualifying project under the PPEFIA. Second, the public entity may identify a need for a facility and request proposals from developers. In either event, it is expected (but not required) that the proposals will follow a two-phase process. In the initial conceptual phase, the developer will provide basic information regarding the facility. In the second phase, the developer will provide detailed information regarding the development and financing of the facility. The PPEFIA lists a few items that must accompany a developer's request for approval from the public entity, including a description of the qualifying project, a schedule for the initiation and completion of the qualifying project, a general statement of how the qualifying project will be financed, and a schedule showing the user fees, lease payments or other service payments related to the qualifying project and the method for changing those fees or payments over time. (See Va. Code § 56-575.4).

No public entity may consider a developer's request for approval of a qualifying project until the public entity has adopted procedures that are sufficient to enable the public entity to comply with the PPEFIA. At present, a working group is developing model procedures that public entities may adopt and expects to make those model procedures available to public entities by no later than September 30, 2002. (See Va. Code § 56-575.16).

Qualifying projects developed under the PPEFIA are **not** subject to the Virginia Public Procurement Act. Although the qualifying project itself may not be subject to the Virginia Public Procurement Act, a public entity may enter into a comprehensive agreement with an operator, as described below, only if it has entered into that comprehensive agreement in accordance with procedures adopted by it (1) that are consistent with procurement through competitive sealed bidding or (2) that are consistent with the procurement of "other than professional services" through competitive negotiation. The public entity need not select the developer with the lowest price, but may consider price as one factor in the decision process. The strong preference in the PPEFIA is for public entities to enter into comprehensive agreements in accordance with procedures similar to competitive sealed bidding, but public entities can choose procedures similar to competitive negotiation, if certain findings are made. If a state agency wishes to use procedures similar to competitive negotiation, it must first get the approval of the Governor or the applicable Governor's Secretary. (See Va. Code § 56-575.16).

The public entity may approve the request for the development of a qualifying project if it determines that the qualifying project serves the public purposes of the PPEFIA. Such a determination may be based upon findings that there is a public need for or benefit derived from the qualifying project, the estimated cost of the qualifying project is reasonable in relation to similar facilities, **and** the operator's plan will result in the timely development of the qualifying project. In evaluating any request for approval, the public entity may rely upon the expertise of its staff or may hire outside advisors or consultants. The public entity may charge the developer a reasonable fee to cover the costs of reviewing the request for approval, including

the costs of such outside advisors or consultants. The approval by the public entity will be subject to the negotiation of a comprehensive agreement between the public entity and the developer. (See Va. Code § 56-575.4).

### **Comprehensive Agreement**

The primary document between the public entity and the operator will be the comprehensive agreement. Among other things, the comprehensive agreement will provide for:

- Delivery of maintenance, performance and payment bonds or letters of credit in connection with the development of the qualifying project, in forms and amounts satisfactory to the public entity;
- Review of plans and specifications for the qualifying project by the public entity and approval by the public entity if the plans and specifications conform to standards acceptable to the public entity;
- Maintenance of a policy of public liability insurance or self-insurance, in form and amount reasonably sufficient to insure coverage of tort liability to the public and employees and to enable the continued operation of the qualifying project;
- Monitoring of the practices of the operator by the public entity to ensure that the qualifying project is properly maintained and the filing of periodic financial statements;
- Policies and procedures governing the rights and responsibilities of the public entity and the operator in the event the comprehensive agreement is terminated or there is a material default by the operator, including the assumption by the public entity of the duties and responsibilities of the operator and the transfer or purchase of property or other interests of the operator by the public entity;
- User fees, lease payments, and/or service payments as may be established from time to time by agreement of the parties, *provided* that payments or fees will be the same for persons using the qualifying project under like conditions and will not materially discourage use of the qualifying project; and
- A statement of the duties of the operator with respect to the qualifying project.

The comprehensive agreement may contain such other terms and conditions that the public entity determines will serve the public purpose of the PPEFIA. Further, the comprehensive agreement may contain provisions under which the public entity agrees to provide notice of default and cure rights for the benefit of the operator and the persons providing financing for the qualifying project. The comprehensive agreement may also contain provisions where the authority and duties of the operator under the PPEFIA will cease, and the qualifying project will be dedicated to the public entity or to some other appropriate local jurisdiction for public use.

When a public entity that is not an agency or authority of the Commonwealth enters into a comprehensive agreement, it must within thirty days thereafter submit a copy of the comprehensive agreement to the Auditor of Public Accounts. (See Va. Code § 56-575.9).

### **Defaults and Remedies**

The PPEFIA sets forth remedies that may be exercised by a public entity upon default by an operator. In the event of a material default by the operator, the public entity may elect to assume the responsibilities and duties of the operator, and in such case, it will succeed to all of the right, title and interest in the qualifying project, subject to any liens on revenues previously granted by the operator to any person providing financing. Further, any public entity having the power of condemnation under Virginia law may exercise such power of condemnation to acquire the qualifying project in the event of a material default by the operator. Any person who has provided financing for the qualifying project, and the operator, to the extent of its capital investment, may participate in the condemnation proceedings with the standing of a property owner.

The public entity may terminate, with cause, the comprehensive agreement and exercise any other rights and remedies that may be available to it at law or in equity. The public entity may make or cause to be made any appropriate claims under the maintenance, performance, or payment bonds or lines of credit required by the comprehensive agreement. In the event the public entity elects to take over a qualifying project, the public entity may develop the qualifying project, impose user fees, impose and collect lease payments for the use thereof and comply with any service contracts as if it were the operator. Any revenues that are subject to a lien will be collected for the benefit of and paid to secured parties, as their interests may appear, to the extent necessary to satisfy the operator's obligations to secured parties, including the maintenance of reserves. Such liens will be correspondingly reduced and, when paid off, released. Before any payments to, or for the benefit of, secured parties, the public entity may use revenues to pay current operation and maintenance costs of the qualifying project, including compensation to the public entity for its services in operating and maintaining the qualifying project. The right to receive such payment, if any, will be considered just compensation for the qualifying project. The full faith and credit of the public entity may not be pledged to secure any financing of the operator by the election to take over the qualifying project. Assumption of operation of the qualifying project will not obligate the public entity to pay any obligation of the operator from sources other than revenues.

### **Opportunities and Challenges for the Public Entity**

What's in it for the public entity?

- The PPEFIA gives a public entity a chance to use or take advantage of a desired public facility without all of the hassles of developing, financing, operating or maintaining that facility itself. The staff time and resources that would otherwise be spent on developing and operating a facility can be freed up for other uses.
- The comprehensive agreement may allow the public entity to begin using the qualifying project without the need for any up-front "down payments" by the public entity. Further, for a qualifying project with multiple revenue streams, the ability to share the cost of the qualifying project with other users should reduce the cost to the public entity.
- There are many qualified, competent developers in the Commonwealth that do not currently bid on public projects because the competitive bidding process is burdensome and does not recognize that some developers have more to offer than low price. The ability to develop a facility under the PPEFIA will expand the number and types of developers that will want to participate in the development of public projects.

Why should a public entity be wary?

- There is no such thing as a free lunch. The public entity will still need to pay for its use of the qualifying project, whether those payments are structured as lease payments, user fees or service fees.
- Although the operator will be managing the qualifying project in accordance with a comprehensive agreement negotiated with the public entity, the public entity will not have total control of the facility. If the operator is complying with the terms of the comprehensive agreement, but the citizens or staff of the public entity are unhappy about the management of the qualifying project, there may be little opportunity to force the operator to change its ways.
- Given the private ownership of the qualifying project, it may not be possible to finance the qualifying project with the proceeds of a tax-exempt financing. Since tax-exempt financing is almost always the cheapest way to finance a facility, the costs being passed through from the operator to the public entity will likely reflect this higher cost of capital.

### **Opportunities and Challenges for the Developer**

What's in it for the developer?

- The developer gets a chance to “be at the table” helping to develop a qualifying project that will meet the needs of the public entity while, presumably, also earning a profit for the operator.
- For the right type of qualifying project, the ability to create multiple revenue streams may increase the profitability of a qualifying project to a developer.
- The PPEFIA will reward developers who are creative and customer-focused.
- As an owner of a qualifying project, the operator should be able to take advantage of the full panoply of the tax benefits available to owners of facilities, such as depreciation deductions and historic tax credits.

Why should a developer be wary?

- As noted above, the PPEFIA sets forth several remedies that the public entity may use if the operator is in material default. The availability of these remedies to the public entity will hamper the ability of the operator to obtain financing for the qualifying project on advantageous terms. Lenders prefer to have a free hand to deal with a facility and its owner if there is a default and will not like having to deal with a public entity that has been given broad powers to act upon a default. At a minimum, the remedies provided to a public entity will increase the risk to the lender, thereby causing it to impose a higher interest rate. At worst, the remedies will provide a less-than-enthusiastic potential lender with the excuse to walk away from the financing opportunity.
- The PPEFIA is short on remedies available to the operator if the public entity defaults. In most cases, the obligation of the public entity to pay user fees, service charges or rent will be dependent upon appropriations being made for that purpose annually by the governing body of the public entity. If the public entity ceases to use the qualifying project or to

avail itself of the services provided at the qualifying project or to occupy the qualifying project, the governing body may refuse to make the appropriation. There are no effective remedies available to the operator for a failure to appropriate. Although there may be substantial unrelated “penalties” to the public entity for a failure to appropriate, there is never a binding or legally enforceable obligation to make the appropriation. The unrelated “penalties” will include bad publicity, close scrutiny (and a possible downgrading) by rating agencies and a reluctance of other capital market participants and businesses to enter into financial transactions or business dealings with the public entity.

### **Financing Opportunities and Challenges; Special Financing Provisions for Certain Educational Facilities**

The financing of a qualifying project will be in such amounts and upon such terms and conditions as may be determined by the operator. The operator may issue debt or equity, enter into sale and leaseback transactions, and may secure any financing with a pledge of the revenues of the qualifying project and lien or security interest in its interest in the qualifying project. The operator is expected to be the entity charged with arranging the financing for the qualifying project. Nevertheless, any lender will look to the public entity as a significant component of the creditworthiness of any qualifying project. The public entity should be prepared to provide its financial information to potential lenders and to be an active participant in the development of the financing structure and the terms and provisions of the financing documents.

It is expected that any lease payments, user fees or service fees due from the public entity will be subject to annual appropriation by the governing body of the public entity. If properly structured, this will avoid the characterization of the lease, user agreement or service contract as bonded “debt” under the Constitution of Virginia and avoid the need to comply with the Public Finance Act of 1991, Chapter 26, Title 15.2 of the Code of Virginia of 1950, as amended.

As a piece of the financing puzzle, in accordance with the PPEFIA, the public entity may provide grants of property or cash to the operator and provide loans to the operator, with funds provided from a variety of sources. (See Va. Code § § 56-575.9 and 56-575.10). These statutory provisions do not, however, trump the provisions of the Constitution of Virginia that constrain the ability of a public entity to provide credit to private entities for non-public purposes. (See § 10, Article 10 of the Constitution of Virginia and the Virginia Supreme Court cases interpreting this provision). It may be helpful to route property or cash through an industrial development authority or some other governmental entity to accomplish the transfer to the operator.

One of the challenges for the operator will be to arrange financing, in light of the significant remedies granted to the public entity should the operator be in material default under the comprehensive agreement. Lenders prefer to call the shots and will be reticent to get involved in a deal where another party (the public entity) has substantial rights that may be superior to the rights of the lender.

Generally, a tax-exempt financing is the least expensive way to finance a public capital project. Further, generally, a facility cannot be financed on a tax-exempt basis if it is owned or operated by a private entity. There are exceptions to this general rule for private activity bonds for manufacturing purposes, certain specified “exempt” purposes, charitable purposes, and for management contracts with private managers that meet certain specified criteria. Most of these exceptions will be inapplicable to a typical public facility. Accordingly, by having the qualifying project owned and operated by a private entity, it may be impossible to use tax-exempt financing for the qualifying project. This is true even though the qualifying project may be used for a significant public purpose. It is for this very reason that the experience of the PPTA, upon which the PPEFIA is based, has been that transportation projects are owned by a governmental entity (typically, the Commonwealth of Virginia). Those transportation projects were found not to be economically feasible, unless they could take advantage of tax-exempt financing. If preserving the ability to use tax-exempt financing is critical for the development of a qualifying project under the PPEFIA, it will likewise be critical for the operator and the public entity to work closely with bond counsel from the outset, to ensure that the facility can be financed on a tax-exempt basis.

One of the reasons for enacting the PPEFIA was to take advantage of a 2001 change in the federal tax laws governing the tax-exempt financing for public school facilities. As noted above, there are certain “exempt” facilities that will qualify for tax-exempt financing, even though the facilities are owned and operated by private entities. Now, “qualified public educational facilities” may be financed using tax-exempt private activity bonds. (See § § 142(a)(13) and 142(k) of the Internal Revenue Code of 1986, as amended). A qualified public educational facility is a school facility that is part of a public elementary school or a public secondary school that is owned by a private corporation pursuant to a public-private partnership agreement with a state or local educational agency. In Virginia, that public-private partnership agreement can be structured under the PPEFIA. The private corporation must agree to develop the school facility and, at the end of the term of the agreement, to transfer the school facility to the educational agency for no additional consideration. As with many types of private activity bonds, there is a cap on the amount of these types of bonds that can be issued in any state in any calendar year. In Virginia, that cap is approximately \$70 million, which is less than the cost of two modern high schools. The Virginia General Assembly has given the Secretary of Education the obligation of administering this cap and for providing guidelines for doing so by August 31, 2002. While this provision will allow the facility to be financed by the private owner on a tax-exempt basis, the requirement that the facility be turned over at the end of the agreement may impair other tax benefits that might otherwise be available to the private owner, such as historic tax credits and depreciation deductions.

### **Applicable Laws**

As noted above, the Virginia Public Procurement Act does **not** apply to the development of qualifying projects.

Nothing in the PPEFIA will serve as a waiver of the sovereign immunity of the public entity or its officers or employees. Any jurisdiction in which a qualifying project is located will possess sovereign immunity with respect to the design, construction and operation of

the qualifying project. All police officers of the Commonwealth will have the same powers with respect to qualifying projects in their jurisdictions as they would have for other facilities. (See Va. Code §§ 56-575.14 and 56-575.15).

Nothing in the PPEFIA expands or contracts the borrowing power of a public entity. If, for example, a county wishes to avoid holding a referendum or a city wishes to avoid tapping its debt limit with respect to its interest in a qualifying project, it will need to ensure that any financial arrangements that it may have with the operator do not constitute general obligation debt of the county or city. Although the PPEFIA expressly states that a public entity will have the power to make grants or loans to the operator, the public entity will still be subject to the provisions of the Constitution of Virginia that constrain the ability to provide funds directly to private entities for non-public purposes. (See Va. Code §§ 56-575.9 and 56-575.10).

Certain documents related to a PPEFIA solicitation are exempt from disclosure under the Virginia Freedom of Information Act, if the financial interest of the public entity or the private entity or the process of competition or bargaining would be adversely affected by disclosure. (See Va. Code § 2.2-3705 A. 56).

If a public entity finds that such action will serve the public purpose of the PPEFIA, the public entity may use its powers of condemnation and may dedicate public property for a qualifying project. In connection with such dedication, a public entity may convey any property interest that it has, subject to the conditions imposed by general law, to the operator for such consideration as such public entity may determine. The consideration may include the agreement of the operator to operate the qualifying project. (See Va. Code §§ 56-575.7 and 56-575.12).

## **Conclusion**

The PPEFIA can provide a time- and cost-effective method for developing a needed public facility. A public entity can take advantage of the facility, without the administrative burden of maintaining and operating it. Some of the provisions contained in the PPEFIA may, however, make the facility more expensive to the developer and its lender, thereby increasing the costs passed along to the public entity. A public entity will want to carefully assess each potential public facility in light of the benefits and challenges that may be presented by the PPEFIA.

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