

# REBUILDING THE IVORY TOWERS

IN THE CONTINUING AFTERMATH OF THE GREAT RECESSION, UNIVERSITIES HAVE BECOME THE LATEST MARKET FOR INFRASTRUCTURE PUBLIC-PRIVATE PARTNERSHIPS (OR P3S) TO EMERGE IN THE US.

BY **JOHN D O'NEILL**, PARTNER AND HEAD OF HUNTON & WILLIAMS LLP'S P3 AND INFRASTRUCTURE PRACTICE, AND **DAVID HORNER**, PARTNER AT **HUNTON & WILLIAMS**.

Facing growing fiscal constraints, rising student debt, and ballooning maintenance backlogs, American institutions of higher education are under increasing pressure from policy makers and other stakeholders to do "more with less". In response, they are deploying P3s with increasing frequency to address the need for infrastructure renewal and to re-focus limited resources on their institutional core missions of teaching and research.

## What are P3s?

First developed to deliver infrastructure projects in Europe during the 1990s, P3s are contractual arrangements entered into by a public entity, such as a state university, with a private entity for the design, construction, financing, operation and maintenance of an asset that will be used by the public.

Unlike traditional methods of contracting for new construction or improvement of an asset, in which discrete functions are divided and procured through separate solicitations, P3 transactions contemplate a single private entity being responsible and financially liable for performing all or a significant number of the project functions, including design, construction, financing, operation and maintenance.

In exchange for the risks and responsibilities that the private entity assumes pursuant to a P3 agreement, the private entity receives the opportunity to earn a financial return commensurate with such risks and responsibilities – either through the collection of revenues generated by the asset (eg, user fees such as tolls) or availability payments made by the public entity to the private party. Such arrangements are only for a term of years as provided in the P3 agreement, with the public entity retaining a reversionary interest in the assets delivered or acquired by the private party in accordance with the P3 agreement. The public asset is never sold.

In the United States since the early 2000s, state governments have relied on P3s mainly for the delivery and operation of large-scale transportation facilities in order to obtain time savings, cost savings, and higher quality projects with reduced risks to the public sector.

Such projects have typically been enormous undertakings, such as the East End Crossing over

the Ohio River (US\$1.3bn), the Eagle P3 FasTracks Project in Colorado (US\$2bn), the Goethals Bridge Replacement Project in New York (US\$1.4bn), the Port of Miami Tunnel in Florida (US\$1.1bn), the I-495 HOT Lanes Project (US\$1.9bn) and the I-66 HOT Lanes Project in Virginia (US\$2.1bn) currently in procurement.

In contrast, the use of P3s by universities in the US is only a recent development (and has been for smaller projects), but the rate of adoption by universities of the P3 technique has been rapid. In 2015, P3 usage spiked dramatically with the announcement of 14 new projects, following only three in 2014, two in 2013, and one in 2012. So far in 2016, this trend has continued with six university P3 procurements launched to-date.

The potential size of the university market for P3 procurements is considerable. According to the National Center for Education Statistics, the entire capital stock of university campuses approximates US\$330bn (net of depreciation). The infrastructure of universities in the US must support approximately 21m students who comprise almost 5.7% of the total US population. The 10 largest public university campuses by enrolment resemble small cities, each having at least 46,000 students, in addition to thousands of non-student faculty, administrative personnel, service employees, and others.

## Three factors driving P3s at universities

Three factors are driving American universities to adopt P3s as a new means of developing, operating, maintaining and financing campus infrastructure.

- *Funding and financing challenges* – The first is that traditional sources of revenue such as state appropriations and tuition fees continue to be squeezed, even as the costs of labour, healthcare for employees, technology and interest on debt have generally increased – all heightening the need for smarter resource allocation and innovation in providing campus services.

From 2008 to 2013, for example, general-purpose appropriations by state governments for higher education fell by US\$14.1bn (or 21%), while the number of full-time students grew by 1.2m (or 8%). Tuition fee increases are no longer a tenable source of new funding, either, following

unprecedented growth in such fees by 225% over the last 30 years (adjusted for inflation) and corresponding increases in student indebtedness.

New borrowing by universities themselves has also become challenging as overall debt levels have more than doubled in recent years at the more than 500 institutions rated by Moody's (with the number of credit rating downgrades of universities exceeding the number of credit rating up-grades continuously during the last six years).

- *Deteriorating infrastructure* – A second reason for the growing use of P3s at universities is that the need for capital improvement of basic campus infrastructure has become acute. At the same time that fiscal pressure on universities has increased, many of the buildings constructed on college campuses during the 1960s and 1970s to educate and house the Baby Boomer generation are now over 50 years old.

These buildings today account for approximately 40% of university space in the US and now require major renovations or replacement. Compounding the challenge, other buildings constructed during the 1990s to educate and house university millennials – separately comprising an additional 30% of university space – are approaching the mid-point of their useful lives and require major maintenance. As a result, according to certain estimates, maintenance backlogs for such structures have grown by 22% since 2007. In total, approximately 70% of university space needs fixing.

- *Recycling capital* – A third reason that universities are undertaking P3 procurements is to recycle for a higher and better use the significant amount of capital invested in campus infrastructure over

prior decades. Known as asset monetisations, procurements launched for this purpose involve the granting of a long-term concession to a private partner with respect to an auxiliary enterprise owned by the university, such as a parking system, a utility system or student housing, in return for a large upfront payment from a private party and its contractual commitment to perform a programme of capital maintenance and operations during the term of the concession.

By means of asset monetisations, universities can command a higher amount of proceeds and a greater degree of risk transfer to the private partner than is possible in conventional financings. Such proceeds can be committed to reinvestment in an endowment or used for general purposes.

### **Contending with the new normal**

The combination of funding shortfalls and deteriorating infrastructure, together with the opportunity to recycle capital, has prompted policy makers and other stakeholders to press university leadership for reform in the procurement of campus infrastructure operations and services. In 2015, for example, Ohio Governor John Kasich and the Ohio General Assembly appointed a Task Force on Affordability & Efficiency that has produced recommendations regarding how universities can cut costs.

Former Indiana Governor Mitch Daniels, now president of Purdue University and a pioneer in P3 procurements, has recently led – through published editorials and articles, testimony before Congress, and high-profile initiatives at Purdue



Arkansas State University Dormitory, Jonesboro, Arkansas  
© Woody Pipatchaisiri | Dreamstime.com

– a national discussion about how to reduce the costs of higher education, improve efficiency in university operations and improve value for tuition. State lawmakers around the country have called similarly for reductions in university tuition fees and greater scrutiny of budgetary priorities at institutions of higher learning.

In the expectation that P3s will better manage lifecycle costs, clear maintenance backlogs and enable more efficient use of scarce resources, universities have launched a series of P3 procurements that generally fall into three categories – student housing, energy management and parking. They include:

**Student housing**

- *University System of Georgia Housing P3* – The University System of Georgia (USG) recently entered into a 65-year P3 agreement with a private entity to develop, construct, manage and maintain a multi-phase student housing project, to include 3,683 new beds and 6,195 existing beds totalling over 3ft<sup>2</sup> m across nine of USG’s 31 campuses.
- *Arkansas State University Housing P3* – Arkansas State University recently announced that a private developer will develop and maintain two apartment-style residence halls for 515 students under a 35-year lease.
- *Kent State University Facilities P3* – Kent State University recently issued a request for qualifications in connection with the development of student housing and a location for its Office of Global Education.
- *University of Texas at Dallas P3* – The University of Texas at Dallas recently signed a P3 agreement with a private developer to design, build, finance and operate certain campus facilities, including mixed-use housing and retail properties.
- *State Street Redevelopment P3* – The City of West Lafayette and the Purdue University Joint Board recently closed with a private developer the State Street Redevelopment P3, by which the developer will improve State Street – the road that runs through downtown West Lafayette and Purdue University – with a focus on residential, business and student needs in exchange for availability payments over a term of 20 years.

**Utilities and energy management**

- *University of Oklahoma Energy Management P3* – The University of Oklahoma entered into a 50-year concession with a private partner to improve, design, build, operate and maintain six utility systems serving 30,000 students at its campus in Norman, Oklahoma, in exchange for an upfront payment of US\$118m and the total capital investment by the private partner of over US\$600m.
- *Connecticut State Colleges & Universities Solar project* – Connecticut State Colleges & Universities (CSCU) are soliciting a private developer to finance, design, install, operate and maintain solar photovoltaic systems on building roofs and/or ground mount locations at two campuses and

to enter into a power purchase agreement with CSCU for a term of 20 years.

- *Ohio State University Comprehensive Energy Management project* – Ohio State University (OSU) is procuring a concession for the financing, improvement, operation, and maintenance of OSU’s electric, gas, steam, heating and cooling systems.

**Parking**

- *Ohio State University Parking P3* – In 2012, OSU entered into a 50-year concession and lease with a private partner for the financing, improvement, operation and maintenance of its 37,000-space parking system for an upfront payment of US\$483m.
- *Cleveland State University Parking P3* – Cleveland State University (CSU) has announced it will soon procure a master concession for its approximately 4,100-space parking system in downtown Cleveland.

**Diminished political risk**

In addition to recent growth in deal flow for university projects, another factor that supports a favourable outlook for the university market is the belief that university-sponsored P3s involve less political risk than is typical in other sectors of the US P3 market. In particular, because the boards of trustees and executive leadership of universities are not chosen by popular election – in contrast (for example) with city council members and state governors – university decision-makers are believed to be better insulated from the short-term political gyrations that have up-ended P3 procurements in other contexts.

Perhaps as important, university board members tend to possess a degree of commercial sophistication and familiarity with finance that is less common in other public sector settings – thus improving the quality of the decision-making in relation to P3 procurements. In addition, because universities are increasingly self-funding organisations that rely less on state support than other governmental units, they present less appropriations risk (if any) than that encountered by developers operating in other sectors of the US P3 market.

In the near term, the use of P3s on American campuses will almost certainly encounter challenges. Not least of these is the possibility that the credit standing of universities may continue to deteriorate. Also, some auxiliary enterprises maintained by universities – such as parking systems or utilities – that are otherwise ideal for monetisation may be encumbered by legacy financings that are prohibitively expensive to unwind.

Even so, the trend in P3 adoption is likely to continue: new fiscal constraints, growing capital needs and recognition that scarce resources must be better allocated in the future together are driving American higher education to rebuild the Ivory Towers by means of infrastructure P3s. ■