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10 August 2020

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Do US universities need further education in P3?



Thomas Hopkins in Social infrastructure

well-priced risk allocation still possible?

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The budgetary pressures that have pushed US public universities into using P3 concessions have not abated. Private sector capital is still plentiful. But is



Over the last decade, US university public-private partnerships (PPPs, or P3s, as is more common in North America) have surged in popularity. Although versions of P3 concessions did the rounds before the P3 label even existed, universities view them as an increasingly viable and mainstream option for university infrastructure investment. But are P3s the answer to cash-strapped universities' prayers? Developers believe that their specialist expertise and potential off-balance sheet treatment will be part of that answer.

P3s involve the public sector, in this instance a public university, engaging a private sector developer and operator in a to build and/or maintain an asset under a fixedterm concession. This can take the form of a full design-build-finance-operatemaintain (DBFOM) contract, or it can include only some of those responsibilities. Projects can involve anything from student housing to car parks to utility systems, the last of which a concessionaire serves the university's energy needs and, in some cases, manages other utilities such as water.

Typically, university-owned property is leased to the private sector partner, which then develops, operates, and maintains infrastructure on the property and sub-leases this infrastructure back to the university. Contracts vary, but this work is done either in exchange for fees paid by the university to the concessionaire such as availability payments or by giving the concessionaire the right to levy charges for parking or accommodation, for instance. For assets where the concession includes user charges, but even on some availability deals, sponsors may have to provide an upfront payment made by the concessionaire to the university.

Budgetary pressures bite

Before 2008, P3s were less widely used by US universities. The recession of 2008/2009 seriously eroded state funding for US public universities. The Center on Budget and Policy Priorities estimates that, adjusting for inflation, funding for public

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universities in 2017 was around \$9 billion lower than 2008 levels. The 2008 recession forced state governments to curb spending, including higher education. It is ultimately this funding shortfall that has given P3s their hour upon the stage.

Uniquely among OECD countries, the US has many private universities, both non-profit and for-profit, including its most prestigious institutions. These universities tend to enjoy large endowments and can charge high tuition fees, and their finances have generally held up better than their public peers, though private universities can and do outsource infrastructure and accommodation operations. Augustana University, a private liberal arts college in Sioux Falls, South Dakota, recently issued a request for proposals for a roughly \$50 million monetisation and redevelopment of its student housing stock. But public universities are the more motivated sellers.

As Lee Weintraub, a shareholder at law firm Becker & Poliakoff, explains: "The Great Recession caused funding for public universities to take a dive and they did not have the money to build new facilities, let alone maintain the facilities they had anymore. And so it became almost a financial crisis at the university level. A lot of developers, mostly from Europe and Australia and Canada, who had been doing these P3s for a while, came to America with ideas about how they could help. The success of some of these early P3 projects increased the popularity of P3s as a model for universities."

P3s could be a source of revenue for universities in the short term, while giving them a clear budgetary picture of their infrastructure spending commitments in the long term. Demand, at least until very recently, has been growing strongly. The National Center for Education Statistics predicts a 14% rise in university enrolment by 2022, although this estimate might be affected by the Covid-19 pandemic.

Housing and utilities dominate

Since December 2019, Capstone has reached financial close on a \$23.5 million housing project at San Diego State University as well as a \$118 million housing community project at Arizona State University. Similarly, Balfour Beatty Campus Solutions closed a P3 deal for a 557-bed housing and entrepreneur centre at Bowie State University.

Demand for utility P3 concessions has also been strong over the last few years. Young Lee, a partner at Orrick, points out that "energy providers have made a very good case for themselves that they can provide everything from procurement services to major maintenance to future proofing assets in such a way that they can incorporate new technology instead of having to replace the whole asset to generate savings and efficiencies as the world moves away from carbon-based production."

In March, Meridiam and Engie North America reached financial close on the University of Iowa's Utility System Project. The concession includes upgrading, operating, and maintaining the university's utility infrastructure with the goal of making the university coal-free by 2025. The deal includes a \$1.165 billion upfront payment to the university, which was placed directly into an endowment to be grown over the length of the concession, generating estimated annual returns of \$15 million. The returns on the endowment will help to finance the utility upgrades. Fees to the concessionaires stand at \$35 million for the first five years, after which they will rise by 1.5% per year for the remainder of the 50-year concession. Meridiam and Engie face a penalty fee if the coal-free target is not met.

Engie closed on a similar deal in 2017 for Ohio State University (OSU) in a joint venture with Axium Infrastructure known as Ohio State Energy Partners (OSEP). That 50-year concession includes operating, maintaining, and improving the university's utility systems, including electricity, steam and condensate, chilled water, natural gas, and geothermal energy. The deal included a \$1.015 billion upfront payment to the university, as well as a \$150 million commitment to aid academic development. OSU pays a fee indexed annually for OSEP to manage the assets, a fee for improvements that OSEP makes to the infrastructure, a capital recovery payment based on a 20-year amortisation schedule, and a recovery fee for operation and maintenance expenses.

The acquisition of management expertise through P3 concessions may be useful. But the examples above show that upfront cash proceeds can be a key driver. Lee notes that "typically, universities fall into one of two categories, the first being those with a desire to use an upfront payment to increase their endowments or divert funding otherwise not available in their capital budgets to build new facilities or technologies, and the second being those who are looking to upgrading aging equipment with greener and more sustainable forms of energy production, which is increasingly what prospective students demand."

The private sector also offers protection against life-cycle risk, in theory handing back good quality assets, and can dedicate more management expertise to infrastructure management than is typically on-hand at the university, where teaching and research are the main priorities.



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Universities have worked hard to ensure that their P3 decision-making and oversight are robust and transparent. The OSU concession established an Energy Advisory Committee, which acts as a liaison between OSU and OSEP. The committee has representatives from both sides and approves and advises on changes to university infrastructure, significantly reducing the threat of disagreement or litigation.

Variants of these committees are common to university P3s. Discussing them, Weintraub says: "I think the oversight on these committees is generally good. It is very healthy to have a committee that is representative of both parties that is tasked with deciding on issues such as how much maintenance needs to be done on the asset."

These university P3 concessions also tend to put sustainability at the centre of the process. This prepares university infrastructure for a decarbonised future, and establishes universities as public sector leaders in addressing climate change. As Lee notes, green energy policies can also be key to attracting students, many of whom feel strongly about environmental issues.

Discussing private sector demand for university P3s, Jeffrey Gans, a partner at Pillsbury Winthrop Shaw Pittman, indicates that "the feeling in the market on the private side is that there are many opportunities to make projects available that are able to be executed that may not be possible under traditional models and so there is a deep pool of liquidity available and that brings competition."

The Proximo perspective

The P3 structure is not entirely free from blemishes. The financial modelling of a P3 contract includes assumptions ranging from tax law to environmental conditions on the building site to the ratings assigned to any project bonds that might be used to finance work. If any of these assumptions change after a contract has already been signed, a contract's carefully calibrated risk-reward allocation can be knocked out of kilter, or progress on the project can grind to a halt.

Other problems include the slow pace of negotiating a P3 contract, which can take as long as two years, and the need to keep both managers and on-the-ground staff onside and engaged during the process. Political opposition can be intense. The Louisiana state legislature once threatened to shut Louisiana State University (LSU) permanently rather than consent to a \$400 million P3 concession, although that P3 was eventually successful, and the state has gradually become more welcoming.

Asked about the disadvantages of P3s, Weintraub says, notably, that "In my mind, just about any disadvantage of a P3 can be solved by taking the time to identify it and prepare to deal with it effectively." Detailed penalty provisions and contingency plans, both financial and administrative, can be included in P3 contracts and relevant university staff can be incentivised to work alongside their private sector partners. State legislatures can be consulted and brought onside from the outset of P3 negotiations, though P3s always run the risk that a newly elected body will try and reject the work of its predecessor.

With the IMF expecting US GDP to fall by 8% in the aftermath of Covid-19, it is unlikely that state funding for US universities is going to increase any time soon. Universities are also facing tough long-term questions about whether Covid will lead to a shift in teaching and learning models and a greater reliance on distance learning. But the capital available for investment is still plentiful, and public universities will continue to find the private sector's offer of up-front payments and outsourced expertise compelling.

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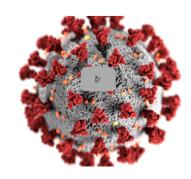








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