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An Argument for Using Tax-Exempts in P3 Structures

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BRADENTON, Fla. - Tax-exempt bonds give municipal issuers a unique advantage in negotiating public-private partnerships, a factor that some municipal market and legal advocates say should not be overshadowed.

The fact that tax-exempt financing – the lowest cost of funding - is only available in the U.S. can be obscured as industry supporters encourage the broad use of public-private partnerships to fund large and small projects, they said.

"I've tried to make it clear that this is not a pot of gold at the end of a rainbow," said bond attorney Randall Clement of Bryant Miller Olive, who helped tweak Florida's P3 legislation earlier this year. "The private sector is in it to basically make a profit."

A governmental entity must look at the cost of financing and understand the benefits of what it is trying to achieve, while considering different approaches to accomplishing those goals, he said.

The tax-exempt bond market has adequately financed infrastructure projects for decades, Ben Watkins, director of Florida's Division of Bond Finance, said at the National Municipal Bond Summit last month.

Watkins said he finds fault with the growing use of P3s based on the European DBFOM design-build-finance-operate-maintain model, where a public entity uses a contractual agreement with the private sector to finance, design, construct, operate, and maintain a project.

"There is no rigorous analysis," he said, adding that feasibility assumptions of such P3s are embedded in paperwork done by industry insiders and supporters. "The recipient doesn't care about the cost of financing, they just want the project."

There are ways to deliver projects using P3s and tax-exempt financing that provide significant benefits to public agencies, according to Matt Calcavecchia, a vice president at the nonprofit Public Facilities Group in Seattle.

"We could not agree more that the industry insiders have been leading this conversation and focused primarily on the DBFOM model," Calcavecchia said after reading Watkins' comments.

"But you must be able to access tax-exempt bond financing in order to do so."

Public Facilities Group, a new muni shop that focuses on social infrastructure financing, combines tax-exempt bond financing with private development experience to significantly reduce the cost of a project, he said.

If the idea sounds familiar, it is.

The platform is similar to one created by the National Development Council called the "American model."

It uses the private sector's expertise to design and build a government project, while a private, nonprofit conduit issuer finances the project with tax-exempt bonds and fulfills operations and maintenance duties over the life of a multi-year contract.

"We can marry those two into a [public-private] delivery system," said PFG president John Finke, who helped pioneer the American model at NDC.

PFG, whose executives used to work at National Development, opened in January.

The model that Public Facilities Group uses allows the public entity to take over maintenance and operations at any time even as debt is still being paid off, Finke said.

Finke said DBFOM contracts that span 30 years and 40 years often are not in the public's interest.

"If you go to private financing and private equity, that's so much more expensive," he said. "From my point of view, tax-exempt bonds are the most efficient source of project financing. No expensive equity is required."

Companies in the P3 business want the profitability of a 40-year contract, and are paid back for their equity contribution, he said.

"I've never seen the private sector being fleeced in these deals." Finke said.

PFG typically structures its deals under the Internal Revenue Service's Rule 63-20, which allows a nonprofit public benefit corporation to issue tax-exempt debt to finance the private development of a public project through a lease-back arrangement.

PFG can also structure a deal using a 501(c)(3) charitable organization structure.

In its "New American Approach" platform, each project has a single asset and its own board.

"Local government has the right to replace that member with themselves or some other entity," Finke said. "Then they have total control of the entity."

Finke said his firm's platform works well for projects costing as little as $20 million.

PFG focuses on social infrastructure such as university housing, police stations and city hall, biomedical research facilities, and hospitals. At this time it is not delving into larger infrastructure projects such as roads, bridges, water and sewer projects, or broadband at this time.

So far, 34 states have adopted legislation allowing P3s to be used by state and local governments, schools and special districts.

The laws typically provide the legal and financial frameworks necessary to pursue the partnerships.

The enabling laws provide "more clarity and certainty" for the private sector to jump-start the use of P3s, said Clement, who helped develop Florida's enabling legislation in 2013.

Clement also advised Florida lawmakers earlier this year on tweaking the state's P3 laws, in part to clarify that the legislation is an alternative to the powers that counties, cities, and special districts already process under state law.

Senate Bill 126, signed by Gov. Rick Scott, revises a number of provisions in the P3 statute and addresses concerns of local governments that believed the P3 law limited their home rule powers, Clement said.

"One of the clarifications of the bill was that it's supplemental, in essence optional, and doesn't take away [local government's] ability or options to do projects," he said. "It was really intended to clarify that the statute was not intended to erode their home rule powers."

Florida's law was never intended to dictate the structure or the terms of a P3 transaction, Clement said, adding that it is designed to provide a consistent framework to process P3 proposals.

Scott also signed SB 124 into law March 30. It temporarily exempts unsolicited P3 proposals from public disclosure until a local government decides whether to pursue the project.

Both bills go into effect July 1.
