



# Public-Private Partnerships (P3s): How to Deliver Innovative, Local-Serving Projects

Friday, May 21, 2021

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**LEAGUE OF CALIFORNIA CITIES  
CITY ATTORNEY CONFERENCE  
SPRING 2021**

**PUBLIC-PRIVATE PARTNERSHIPS (P3S):  
LEGAL AND PRACTICAL ISSUES WITH THE PROCUREMENT AND DELIVERY  
OF INNOVATIVE, LOCAL-SERVING PROJECTS, INCLUDING CASE STUDIES**

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We offer this overview of the requirements of California law without regards for the specific regulations that vary in each local agency. We recommend that each local agency and each specific project be evaluated separately for their compliance with conditions, restrictions or requirements imposed by California law.

This memorandum is not intended to be and should not be relied upon as a legal opinion or guarantee regarding alternative procurement and local agencies. This memorandum is only intended to provide information regarding the generally available use of such alternative procurement for P3 arrangements. Neither you nor any other person should rely exclusively on this memorandum in deciding how a project should be procured or entered into under California law.

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## **1. INTRODUCTION**

This paper discusses how local-serving, small- to mid-size projects can be structured and procured as successful public-private partnership (P3), as opposed to larger regional-serving, typically infrastructure projects, such as toll roads, airports, and larger bridges. In short, a P3 approach should be tailored to local serving and community-based projects (e.g. \$5 million to \$500 million) in a manner more suitable to their size, budget, and complexity than simply adopting the means and methods applied to very large “MEGA projects” (\$500 million to \$1+ billion).

A P3 is not one deal structure; it is a continuum of private involvement in public projects and vice versa (spanning a variety of project delivery methods from Design Build/DB, Design Build Finance/DBF, Design Build Operate Maintain/DBM, Design Build Finance Operate Maintain/DBFOM, etc.), and also includes classic redevelopment and economic development projects of all shapes and sizes.

The case studies in this article explore innovations in hybrid real estate/social infrastructure P3 projects and review the utility of various procurement, project delivery, and financing structures that should be considered for small- to mid-sized projects and/or local governments. The focus will be on best practices and lessons learned for local servicing Public Officials.

## **2. COMMON MISCONCEPTIONS**

Misconceptions about P3s can hinder the appropriate assessment and use of the “model” or approach, particularly in jurisdictions where P3s remain untested. Common misconceptions include the following:

- “P3s are funding sources”, “The Developer pays for everything in a P3” – P3s are not funding sources. The user fees or tax dollars used to pay for a P3 exist (or don’t exist) regardless of whether a P3 is used.
- “All risks should be transferred to the private entity” – Some risks are generally better managed by the public owner, such as the use of eminent domain necessary to acquire the project right-of-way, securing most environmental approvals, and other major planning requirements. It is important to note that risk transfer is not without cost.
- “P3s are appropriate for every project” – P3s may provide best value for money for certain projects over the long term. However, in order to be efficient, the project must be of sufficient size. In other cases, delivery methods such as design build or construction manager-at-risk may be better suited to a project. P3 is only one option among several.
- “P3s involve transfer of public assets to the private sector” – The private sector partner does not obtain any real property interest in the asset under a concession or availability payment P3. Under a lease-based P3 structure, the public owner also ultimately owns the asset.

### 3. UNDERSTAND THE 4P'S BEFORE THE P3

**To get a P3 proposal to the starting line, public officials need to make sure that there is clarity and agreement on basic issues and priorities.**

Aging and inadequate infrastructure, required upgrades and scarce public financial resources to pay for construction of new facilities is fostering a new spirit of innovation — out of necessity, rather than desire. Public-private partnerships (P3) is a tool that is being considered and implemented in California and elsewhere for economic development, real estate asset monetization and regional- and local-serving infrastructure.

Professor Stephen Goldsmith, director of the Innovations in Government Program at the Harvard Kennedy School, wrote an informative “5-Part Test” to get a public-private partnership project to the finish line. However, in California and elsewhere, many excellent P3 opportunities are lost as local officials fail to get the potential P3 to the starting line.

P3's is not a financing mechanism! In a successful public-private partnership, the public agency and the private investor function as “partners” pursuant to a contractual relationship throughout project development, financing, construction and even operation and maintenance.

P3's utilize many different deal structures and financing techniques to deliver projects that each allow for a certain amount of “risk shifting” from the public to the private entity. The public agency can also benefit from the expertise of the private provider, receive a project quicker than the normal procurement methods (for example, using authority found in California Government Code section 5956 *et seq.* for a P3 project or the recently expanded design-build authority) and, in return, the private entity receives a steady cash flow from the improvement with user fees or other payments.

Before a public agency is prepared to discuss if a public-private partnership arrangement is appropriate, consideration must be paid to the major steps required prior to the start of any public-private partnership proposal, negotiation or implementation. In short, an agency should first considered and agree upon the 4P's: Problem, Project, Priorities and Politics.

#### A. What is the Problem to solve?

While it may seem obvious when an element of a local agency infrastructure is in need of repair or upgrade, it is not always apparent what is holding up the fix. Is it simply a lack of resources, insufficient taxing authority or a stifling regulatory environment? Or maybe it is a credit rating downgrade, debt or pension obligations? Maybe the agency seeks operating efficiencies, capital cost reductions or rate stability? Whatever the local issue is, it is best to get the problem well-defined (and any other internal issues in order) before trying to entice a P3 partner to assist.

#### B. What Project is needed to solve the problem?

Many opportunities may exist to solve an identified problem. But without arriving at a defined project, it can be difficult to efficiently identify and evaluate potential partners. It is critical for the public agency to take time to analyze the various alternatives, educate elected officials and

members of the public on the nature of the problem and the various approaches to fixing it, and then develop a vision for the desired project.

C. What are the Priorities of the community?

Where there can be clearly identified problems and projects, a community must also assess how this project and this problem compares with many other pressing needs. More than just prioritization of the project, agencies must look deeper and consider the various economic and risk factors for a given project. Finally, it is important to work with all parties to generate a common expectation and understanding of the process and timing of the negotiation and project delivery. Sometimes, agency staff or private parties can have expectations that do not match, which can lead to unnecessary challenges.

D. What is the Political environment for such a venture?

It is critical upfront to understand the political environment and various parties in and around a public-private partnership transaction — their goals, level of sophistication, risk tolerance, biases, etc. Some of the significant interested parties include: public agency-elected officials, public agency staff / legal counsel, investors/developers, members of the public, special interest groups and regulators at the regional, state and federal levels. Moreover, many public agencies need to confront and overcome institutional bias from various outside consultants (financial, engineering, etc.) that may not have worked in a P3 context.

Finally, as the public-private proposal is being structured before being made public, make sure to prepare for success and build in elements to maintain transparency, and keep open communication and regular interaction. This is a marriage and every healthy marriage is based on open communication! Moreover, prepare for the P3 by making sure that the public agency has clarity on all required regulatory processes required for project approval (e.g. CEQA, NEPA, etc.) and an identified and secure revenue stream. Addressing these issues prior to the announcement of a P3 can also increase the amount of interest from investors and potential partners.

These 4P items can help the public agency prepare for the private investor/developer to better work cooperatively on the public-private partnership. Understanding these 4P items can also assist in the evaluation of the potential opportunity, working through the structure of the deal and then to implementation. Without a grounding in all these issues, parties can waste time and inflict great frustration on one another. We can do better! Our communities are counting on it.

#### **4. P3 AUTHORIZING LEGISLATION FOR ALTERNATIVE PROCUREMENT**

Although the term “P3” can mean many things, for purposes of this memorandum, a P3 is any public project where the Local Agency uses an Alternative Procurement process and integrates private design, construction and financing.

Traditionally, Local Agencies have led public projects through the design, bid, build method, where Local Agencies contract with an architect for the design work, and then conduct a competitive bid under the Public Contract Code to award the construction contract to the lowest responsible bidder. (See e.g. Pub. Contract Code, §§ 20128, 20162.) Nonetheless, there is no public policy that requires Local Agencies to engage in competitive bidding, rather, the legislature

imposes such requirements. (See *San Diego Service Authority for Freeway Emergencies v. Superior Court* (1988) 198 Cal.App.3d 1466, 1469). It follows that competitive bidding statutes in the Public Contract Code cover a wide range of public entities, from cities to counties to school districts. However, the legislature has also adopted statutory alternatives to competitive bidding.

Pursuant to California Law, cities and counties (“Local Agencies”) have substantial authority to procure and enter into public-private partnership (“P3”) arrangements to promote projects with private development and financing through various statutory authority and specific charter provisions that are separate from the Public Contract Code (“Alternative Procurement”), such as the following in summary as are discussed in greater detail below:

A. Leasing of Public Property: Government Code Sections 25515, 25536, and 25371 authorize counties to set up certain leasing and lease-leaseback arrangements to partner with private entities to design, construct and finance public projects (also commonly described as a “design-build-finance” P3 method).

B. Design-Build: SB 785 adopted in 2014 provided new statutory authority for Local Agencies to award design-build contracts on projects that exceed \$1 million based on a “best value” selection. SB 785 does not prohibit private financing. Therefore, a Design-Build-Finance P3 method utilizing authority pursuant to SB 785 can be implemented by (1) the use of a “best value” selection process (i.e. criteria determined by a Local Agency on a project-by-project basis) and (2) in concert with additional authority a Local Agency has to avail itself of private financing.

C. Charter Cities: Charter Cities are not fully bound by state bidding requirements and may, subject to local regulation, contract for the design, construction and financing of public projects.

D. Infrastructure Financing Act: Government Code Section 5956 enables Local Agencies to utilize private sector investment capital to construct fee-producing infrastructure facilities based on a “competitive negotiation” process, expressly not requiring compliance with the Public Contract Code for procurement.

E. Other: Local Agency Alternative document states, as discussed below.

## **5. SPECIFIC ALTERNATIVE PROCUREMENT AND CONTRACTING AUTHORITY**

### **A. Leasing of Public Property**

Another commonly used mechanism is the “lease-leaseback.” Essentially, the leasehold estate granted by a Local Agency to a private entity through a ground lease provides a vehicle for the private entity to finance the construction of the public facility and then lease it back to the Local Agency. This is effectively a “design-build-finance” P3. Below is a summary of a variety of statutes available to Local Agencies for entering into lease-leaseback arrangements with a private entity.

#### *i. County Property*

Government Code section § 25515 et seq. allows for the lease of county property (up to 99 years) for purposes of cultural, residential, commercial, or industrial use or development, subject to a four-fifths vote of the Board of Supervisors, provides the procedure for a county to lease real property to a private party for purposes of cultural, residential, commercial, or industrial use or development or participate as a principal party in the development of property for said purposes. The utility of the statute will depend on the specifics of the project proposed.

Section 25515.2 requires a county considering such a structure to adopt the lease or contract by ordinance after a public hearing. The Board of Supervisors must use either competitive bidding or a request for proposals (“RFP”) process. If the competitive bid process is utilized, the lease or contract must be awarded based on “greatest economic return to the County.” (Govt. Code., 25515.1 (b).) If an RFP is used, the Board must give 60 days’ notice, open the proposal at the time fixed, and then incorporate the proposal into the lease or contract. An RFP process will require a four-fifths (4/5) approval of the Board of Supervisors. (Govt. Code § 25515.2(c)). Thus, the Board of Supervisors has discretion to select the best proposal without the formalities of the Public Contract Code.

Government Code Section § 25536 et seq. specifically allows for lease-leaseback transactions on a 4/5 vote of the Board of Supervisors, but only if the lease is devoted to or held for ultimate use for airport, vehicle parking, fairground, beach, park, amusement, recreation, or employee cafeteria purposes, or industrial or commercial development incidental thereto or not inconsistent therewith without compliance with this article. Additionally, a county may lease all or any part of county-owned property if the county repurchases or leases back the property as part of the same transaction; and the county may pledge specified revenues as security for the payment of obligations incurred in the repurchase or leaseback of the property. (See Govt. Code §§ 25536, 25536.5).

Government Code Section § 25371 et seq. only requires a majority vote of the Board of Supervisors to allow a county to lease, for a term of up to forty (40) years, any real property that will be put to use after construction that is consistent with the purpose the county envisioned when the county acquired the property. If the property has been owned for over ten (10) years and the purpose has been abandoned, the property may be used for any purpose. The lease must require that a building be constructed and that the building becomes the county’s at the end of the lease. (Govt. Code, § 25371).

## *ii. City Property*

Generally, a city may lease property it owns or controls for a term not to exceed fifty-five (55) years. (Civ. Code § 718; Gov. Code § 37380(a).) If certain conditions are met, including awarding the lease through competitive bidding (though not necessarily low bid), a city without a charter (also known as a “General Law City”), may lease its property for up to ninety-nine (99) years. However, Charter Cities are not subject to the majority of these conditions, including competitive bidding, but instead may utilize procedures in its charter or adopted by ordinance to lease property up to ninety-nine (99) years. (Civ. Code § 719; Gov. Code § 37380(b).) Of note, there are some lease purposes, like for off-street parking or stadiums, that are subject to limitations on the term of the lease. (See Govt. Code § 37380 *et seq.*)

## *iii. City or County Property*

Government Code section 50478 allows Local Agencies to lease or sublease property for airport purposes or purposes incidental to aircraft, including manufacture of aircraft and related equipment, construction and maintenance of hangars, mooring masts, flying fields, signal lights, service shops, and other air navigation, airport, and airplane facilities for up to fifty years.

iv. *Integrated Project- “No Competitive Advantage”*

Not statutory in nature but a case law exception, competitive bidding is not required if it would fail to produce a competitive advantage for the public entity or is otherwise impractical or impossible. (*Graydon v. Pasadena Redevelopment Agency* (1980) 104 Cal.App.3d 631, 645).

This “no competitive advantage” exception could apply in certain situations, including possibly the development of public property, where a Local Agency and the private sector team together with private financing. The proposed project could provide a unique end product for the greatest public benefit that would not be found from competitive bidding. Using this method of procurement would be limited in use and be very fact specific to the Local Agency and project.

For example, *Graydon* involved a public agency’s agreement with a developer for the development of a major retail shopping center, which was financed with public tax allocation bonds, and consisted of a publicly-owned subterranean garage beneath the privately-owned retail shopping center. It was eventually determined “that competitive bidding [for construction of the garage] was not required because of the integrated nature of the garage and the major retail center; that the purposes of competitive bidding would not be accomplished and because construction of the garage without competitive bidding would be advantageous and in the public interest.” (*Id.* at 635).

B. Design-Build

Senate Bill 785, approved by Governor Brown in 2014, created new statutory authority for Local Agencies to use design-build procurement on certain public works projects that exceed \$1 million. (See Pub. Contract Code § 22160 *et seq.*) The “project” is defined to include the construction or improvements to buildings, county sanitation wastewater treatment facilities, and park and recreation facilities, but does not, with limited exceptions, include infrastructure projects such as streets and highways. (Pub. Contract Code § 22161(g)(1).) The statute specifically excludes operations as part of the design-build contract. (Pub. Contract Code § 22164 (a)(2)). Procurement includes a two-step process, a request for qualifications to prequalify design-build entities, and then, a request for proposals issued to those prequalified entities, with award based upon low bid or best value. (Pub. Contract Code, §§ 22164(b), 22164(d), 22164(a)).

While design-build projects are often thought of as only publicly financed, the statute does not prohibit private financing. The Local Agency can consider private financing offers for project financing in its determination of the “best value” to the public and award of the lease or contract. (See Pub. Contract Code §22164(f)(4)). Furthermore, in concert with the authority provided under SB 785, additional Local Agency authority may be utilized to authorize the use of private financing.

C. Charter Cities and Counties



Generally, a city or county is bound by the Public Contract Code and general state law bidding requirements. However, cities may adopt a charter, giving them the right to make and enforce all ordinances and regulations with respect to their municipal affairs. (Cal. Const. art. XI, §5(a)).

“Charter Cities” may enact their own rules and regulations regarding public contracting and not rely on the Public Contract Code because, for the most part, public contracting has been held by the courts to be a municipal rather than a statewide affair. (See *e.g. Piledrivers’ Local Union v. City of Santa Monica* (1984) 151 Cal.App.3d 509). However, the Public Contract Code does apply to Charter Cities in the absence of an express exemption or a city charter provision or ordinance that conflicts with the Public Contract Code. (Pub. Contract Code § 1100.7). Of note, “Charter Counties” have a limited amount of “home rule” authority, primarily related to governance of the county but not public contracting. (See Cal. Const. art. XI, §§ 3,4).

Each city charter and ordinance regarding public project procurement varies but if adequate provisions exist, this authority can provide for Alternative Procurement, be it a P3 agreement, design-build, Construction Manager at Risk, or another project delivery method based on best value. Additionally, all of these delivery methods could be privately financed.

D. Infrastructure Financing Act (Government Code Section 5956)

Government Code section 5956 et seq. enables Local Agencies to utilize private sector investment capital to study, plan, design, construct, develop, finance, rebuild, improve, repair, or operate, or any combination thereof, “fee-producing infrastructure facilities.” Section 5956.4 specifically lists potential fee-producing infrastructure projects, which include, among other things, water projects, municipal improvements, airports, wastewater projects and buildings. This agreement can last up to thirty-five years. (Govt. Code § 5956.6(a)). Qualified fee-producing infrastructure facilities may be procured through a “competitive negotiation process” and “shall not require competitive bidding.” (Govt. Code § 5956.5).

E. Other Local Agency Alternative Procurement Statutes

There are more forms of Alternative Procurement that authorize Local Agencies to implement private financing, including the following:

i. *Best Value Construction Contracting for Counties Pilot Program*

Senate Bill 762, codified in Public Contract Code section 20155 *et seq.*, established a pilot program for the counties of Alameda, Los Angeles, Riverside, San Bernardino, San Diego, San Mateo, Solano, and Yuba on projects over \$1 million. The listed counties may use a best value procurement process to select a contractor, instead of the normal competitive, low bid process. Best value is determined by objective criteria that is a combination of price and qualifications. This pilot program sunseted on January 1, 2020.

ii. *Renewable Energy and Energy Efficient Projects*

Local Agencies may enter into contracts on terms in their best interest for renewable energy and energy efficiency projects where the cost of the project will be less than the projected cost of

energy had the project not been completed. (See Govt. Code §§ 4217.2, 4217.3). Such contracts can be procured through formal or informal request for proposals and are not subject to a competitive, low bid process. Many of these projects are privately financed, sometimes with a combination of public funding.

*iii. Construction Manager At-Risk (CMAR)*

Public Contract Code section 20146 permits counties to utilize CMAR on projects over \$1 million, either by lowest responsible bidder or best value method. This is yet another project delivery method that allows a county to construct a project without necessarily having to rely on a competitive, low bid process, enabling a Local Agency to choose a high value partner to work with in constructing the project.

*iv. Project Specific Legislation*

The legislature has passed project specific laws to authorize the use of P3s at the local level. Senate Bill 562, codified as Government Code section 5975 *et seq.*, is one such example, where the legislature authorized the City of Long Beach to revitalize and redevelop the Long Beach Civic Center through a P3 involving private financing.

## **6. EXAMPLE P3 PROJECT DELIVERY / CONTRACTING APPROACHES**

**A. Design-Build-Operate-Maintain (DBOM) or Design-Build-Operate (DBO)**

This type of P3 combines design-build with the transfer of operations and maintenance (O&M) responsibilities to a private sector partner, but does not involve private financing. Under this approach, the project components are typically procured in a single contract. Note that a number of transit DBOM projects were ultimately contracted through separate design-build and O&M contracts, despite being procured together.

**B. Design-Build-Finance (DBF)**

The DBF approach builds upon a conventional Design Build (DB) process. The DB approach is intended to bring all key design and construction disciplines into the pre-development process as early as possible and to fast-track construction, where demolition, site work, and grading can occur before construction documents have been completed on the vertical structures to be built. A DBF approach goes further, where the developer finances 100% of the total project costs and leads the DB process under a Guaranteed Maximum Price (GMP) in a collaborative, open book, fully transparent process subject to audit by the government agency. A DBF is structured with long-term lease agreements, fully under the legal authority of a local government to execute, for a set period of time, often approximately 30 to 40 years to coincide with the useful life of a public asset.

**C. Design-Build-Finance-Operate-Maintain (DBFOM)**

Under a DBFOM approach, design, construction, financing, operations and maintenance responsibilities are transferred to a single private sector partner. While there are variations within this approach, particularly with respect to the financing component, a common feature is the leveraging by the Concessionaire of revenue streams from the project, whether user fees or pre-

determined payments from the public owner, to secure private financing. Projects that rely on payments from the public owner (such as performance-based availability payments) may differ significantly from those projects for which the private sector partner directly receives project generated revenues such as customer charges or tolls. The benefits of transferring demand risk often increase the cost of private financing, and may impact how the P3 ultimately is structured.

Once you have reviewed the “4Ps”, Problem, Project, Priorities and Politics, then confirm local agency authority for the P3 project.

## 7. A P3 PROCUREMENT MODEL

Key issues that public agencies must consider in conducting a project procurement are structuring the agreement, conducting a fair and competitive procurement process, and negotiating a final agreement that is transparent and protects the public interest.

### **HOW TO P3: PROCUREMENT / PROJECT EXECUTION PHASES**



#### **Executing a P3 Project can be broken down into five stages:**

##### A. Feasibility & Preparation: “4Ps before P3”

Understanding the needs of the government agency, broader stakeholders and community and establishing clear goals and vision are critical. It is also critical to understand the political environment with clear project champions at both the elected (board, council) and administrative level (city manager, CFO, etc.). Here, a public agency is well served to hire advisors to perform project Feasibility Study (advisor); Request for Information (RFI); Regulatory Approvals Strategy; Conceptual/Basis of Design (sometimes); Scope of developer responsibilities in a P3; draft RFQ/RFP docs.

##### B. Issue RFQ / RFP

An RFQ is issued inviting teams to submit qualifications and credentials. Shortlist or prequalify teams from the RFQ selection criteria. RFP is released including project related agreements. Preferred Proposer chosen based on evaluation criteria in the RFP

##### C. Exclusive Negotiations

Negotiate final terms and conditions with preferred proposer often in a confidential manner until the negotiations complete.

##### D. Pre-Development Stage

Where the developer and agency work collaboratively to gain environmental approvals and advance design until a guaranteed maximum price (GMP) can be reached. This article assumes

that the asset to be developed is a public facility, and as such the developer does not own the building – the building is for public use. Because of this, predevelopment expenditures are best paid for by the public agency.

E. Development Stage

Completion of construction drawings and construction.

**8. THE ROLE OF THE REQUEST FOR PROPOSAL (RFP) IN PUBLIC-PRIVATE PARTNERSHIPS**

One of the key drivers for the successful development of a P3 project is a well-defined, properly structured procurement process that encourages private sector companies to bring forward their best people and ideas.

What Can the public sector do to ensure a successful procurement

- Engage the public taxpayers early on
- Create a positive community experience
- Project Readiness Checklist (See Section 12 below)
- Understand the 4P's Before the P3 (See Section 3 above)

Structuring a Request for Proposals (RFP) is a critical step for public agencies developing new facilities. Like many tools that occupy the interface between the public and private sectors, the standard public RFP has evolved to where its focus is more on process than on outcome. If it is to be an effective decision-making tool, an RFP needs to be more outcome-focused and present a clear framework to judge responses. Below are questions that have proven useful in RFPs for developing public facilities, whether they are delivered through the traditional public works process or a public-private partnership (P3). Including these elements in your RFP will help you zero in on the most important aspects each responding Development Team has to offer.

A. Team Qualifications

The most important thing a Development Team brings to a public project is a group of qualified individuals. Your RFP should ask for the names and resumes of the specific individuals who will be assigned to the project. Confirm they have experience with similar projects of a comparative scale and scope as your planned project.

Ask how much time each individual will commit to the project, in both the pre-development and development stages. Will they be concurrently working on other projects, or are they able to fully commit their efforts to the subject project? Are they local? If not, how will communication work, both with the public agency and other team members?

What experience does the Development Team have working under similar circumstances? Are there multiple stakeholders, difficult site constraints or other public concerns that might affect project delivery? Does team have experience in these situations?

B. Creating Value

A team creates value by ensuring that the facility they propose meets all of the objectives outlined by the public agency in an efficient and cost-effective manner. Value can be added through innovative building design or site planning; by leveraging relationships to achieve advantageous contracting; through special construction techniques and efficiencies; in scheduling and critical path planning; and techniques to mitigate risk to the public agency. Development teams should demonstrate and be evaluated on how they propose to maximize measurable public value.

C. Contracting

Include in the RFP your proposed predevelopment and development contracts that incentivize efficiency and penalize delay. Ask each respondent to comment on the proposed contracts and to propose alternative terms. The RFP process is the only time where teams are competing for the work and the only time that public agencies have the ability to secure fair contract terms. After a team is selected, the public agency will have little leverage in negotiation of contract terms.

D. Bidding

Assume a construction hard cost per square foot based on recent market comparables, then ask the teams to bid their fees, project contingencies and related soft costs. Their actual fees can be adjusted up or down if the final accepted price falls outside of a reasonable range. Bidding fees is a much more objective measure than bidding project at this stage.

E. Be Careful of Concept Drawings and Architectural Renderings

Too often selection committees are swayed by concept drawings and architectural renderings that have little bearing on the final design solution. A qualified Development Team should present their general concepts for the best site plan and building layout, then work in partnership with the public agency to make the project aesthetically pleasing while meeting the agency's programmatic and cost constraints.

F. Construction Risk and Financial Guarantees

In a well-designed RFP process, the selected Development Team designs and prices the project in pre-development, producing a desirable design at an acceptable price. Only if pre-development is successful will they move to development. In the development phase, they are expected to guarantee the price agreed upon in pre-development and deliver the project on schedule. The Development Team must be able to provide a guaranteed maximum price, a guaranteed completion date, and be willing to assume development risk and completion risk. The Development Agreement should reward them for success if they complete the project as designed but at a lower cost. Conversely, if the project is "out of balance" at any point, the Development Team must be willing to pay money into the project in order to achieve substantial completion and meet its contractual responsibilities. Members of the selection committee should review the financial statements of each Development Team to ensure that they have the financial capacity to meet those obligations.

**9. WHY UTILIZE A DESIGN BUILD FINANCE P3? – GOVERNMENT BENEFITS**

Design Build Finance, and public-private partnerships (P3s) in general, offer a menu of benefits – there is no one-size-fits-all reason to undertake this alternative delivery approach. The most common benefits include:

<b>1. Cost and Schedule Performance Guarantee</b>	<ul style="list-style-type: none"> <li>Many publicly led projects consistently experience cost overruns and schedule delays. Developer guarantees total project costs and schedule; takes responsibility (via liquidated damages) for cost increases or schedule delays within the agreed upon scope.</li> <li>Projects are fully transparent, competitively bid, and open book subject to audit, and cost savings are credited back to the government client.</li> </ul>
<b>2. Turnkey Delivery &amp; Pay for Performance (No Payment Until Occupancy)</b>	<ul style="list-style-type: none"> <li>Developer finances and delivers a turnkey project, where the city/county/client can accelerate their project investments and makes no payment on the project until occupancy. This frees up public-sector revenue for ongoing service requirements.</li> <li>The government partner makes no payment until project occupancy/substantial completion.</li> </ul>
<b>3. Budget Management and Staffing Resources</b>	<ul style="list-style-type: none"> <li>The long-term lease rate / contractual payment creates a predictable payment stream and budget profile – the turnkey project is available for what the city/county budgeted and planned for.</li> <li>Developer is a fee developer and provides developer expertise for a government agency that may lack staffing resources to undertake the project.</li> </ul>
<b>4. Streamlined/Expedited Procurement &amp; Early Project Financing</b>	<ul style="list-style-type: none"> <li>Design Build Finance (DBF) allows Developer to utilize flexible and creative forms of trades procurement (design assist, design build, hard bid, etc.) and self-perform, with different approaches for different trades to optimize project buy out.</li> <li>With an integrated trades procurement approach, Developer can buy out the building trades earlier in the design process (e.g., advanced schematics or Design Development (DD) level documentation) – no need to wait for full Construction Documents (CD) and permits.</li> <li>Developer issues its Guaranteed Maximum Price (GMP) and finances the project off of a similar level of documentation (e.g., advanced schematics to various stages of design development), with the flexibility to access the bond markets and lock in rates early (great in a rising interest rate environment).</li> </ul>
<b>5. Low-Cost Tax-Exempt (Privately Issued) Financing</b>	<ul style="list-style-type: none"> <li>No public bond issue required. The government partner executes its leasing authority to structure the project with Developer, avoiding a need to gain voter approval of a new bond issue.</li> <li>Utilizing 100% privately-issued tax-exempt financing – with the same or better cost of capital as a public financing – which has proven additionally attractive for bond investors even with AA+/AAA rated government credit.</li> </ul>

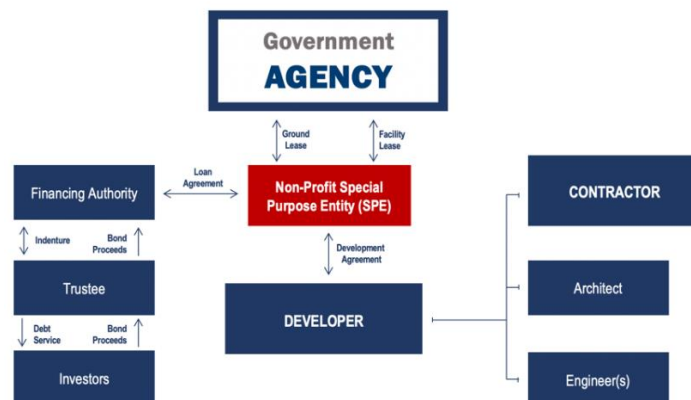
## **10. CASE STUDY #1 - DESIGN-BUILD-FINANCE (DBF) APPLIED TO THE ORANGE COUNTY CIVIC CENTER**

Under a DBF, the developer is responsible for financing and guaranteeing total project costs and schedule with substantial liquidated damages if timeframes are not met, which creates strong incentives for the developer to perform and to achieve schedule efficiencies and cost savings that are credited back to the government agency. In terms of bond pricing achieved on privately issued tax-exempt bonds, some example DBF transactions (e.g. Griffin|Swinerton's Orange County Civic Center Phases I and II) demonstrate that the nearly \$400 million of bonds were rated and priced on par with or better than other County-led tax-exempt bond financings. Bonds were privately issued through the California Municipal Finance Authority (CMFA). The public agency

collaborates and participates during the entire project delivery process, and after completion has the right to repay or refinance the privately issued debt at its sole discretion and receive, at no cost, the unencumbered fee title to the financed facility when it desires.

## How a DBF Approach Works

<b>Land Owner</b>	Government Agency
<b>Facility Owner</b>	Special Purpose Entity (SPE) <i>controlled by Gov't designees on SPE board</i>
<b>Developer</b>	Selected by Government Agency
<b>Financing Options</b>	1.) 100% privately issued tax-exempt securities 2.) 100% privately issued taxable securities 3.) Conventional debt & private equity investment 4.) Custom hybrid financing structures
<b>Gov't Control</b>	1.) Option to Purchase / Debt Prepayment 2.) Ownership reversion at the end of the lease 3.) All O&M decision-making during the lease
<b>O&amp;M</b>	By Gov't Agency or contracted out per Gov't discretion



The development team consisted of Griffin Structures (developer), Swinerton Builders (contractor), and LPA (architect). As summarized above in the DBF deal structure diagram, the Developer works with the Government Agency to create a not-for-profit project-specific company, or special purpose entity (SPE), to execute the project. The Government Agency enters into long-term lease agreements with the SPE for a set period of time, often approximately 30 to 40 years to coincide with the useful life of a public building asset. The Developer enters into a turnkey Development Agreement with the SPE to design, permit, finance, and build/construct the public asset and is compensated with a developer fixed-fee, and exits the deal after the project is completed, accepted, and occupied by the Government Agency.

This deal structure is sometimes also referred to as a “lease / leaseback” transaction, involving a ground lease (*i.e.*, a site lease from the Government Agency to the SPE) and co-

terminus facility/building lease (*i.e.*, the “leaseback” of the facility from the SPE to the Government Agency). The selected Developer executes a Development Agreement with the SPE to design, permit, finance, and build/construct the Project. The Government Agency’s rent payment under the facility lease is equal to the amount required by the SPE to make debt service payments on the tax-exempt bond financing (*i.e.*, the Developer and/or the SPE do not make a spread or profit between the lease payment and the debt service payment). The Government Agency would not be required to make any payments until substantial completion and occupancy of the project. Senior government staff or their designees may be appointed as officers of the SPE which permits the Government Agency to retain control of the public asset. At the end of the lease term or upon an earlier prepayment of the debt (*i.e.*, defeasance of the bonds), ownership of the facility reverts back to the Government Agency for one dollar (\$1).



## **11. CASE STUDY #2 - 63-20 PROGRESSIVE DESIGN-BUILD P3 APPLY TO LOS ANGELES COUNTY'S VERMONT CORRIDOR ADMINISTRATIVE OFFICES BUILDING**

LA County closed on their new \$350 Million Administrative Offices Building in 2018. The first phase of their multi-phased development is a 21-story administrative office building and parking structure delivered using a 63-20<sup>1</sup> Progressive Design-Build P3. Despite the challenges of Covid-19, the project is approximately 90% completed, ahead of schedule and under budget. At the time of publishing, the project has achieved a \$30 million reduction in the initial projected budget through Developer-led design improvements over the County's original specifications without reducing the desired level of quality. An additional \$30 Million in project savings have been achieved through delivery schedule efficiencies by shortening project delivery by 11 months. Currently at 90% complete, the expected project completion is 4 months ahead of schedule, with an anticipated \$15-\$20 million in project savings, which will be used to purchase additional furniture, fixtures and equipment (FF&E) for an increased employee count and to retire outstanding bonds.

In addition, the project has achieved or exceeded all of LA County's social impact objectives, including 1% for the arts, prevailing wage, local and targeted worker hiring requirements, and LEED Certification. The County of Los Angeles requires that at least 30% of work must be performed by qualified Local Workers and 10% Targeted Workers (low income, disabled, or other barriers to employment). To date, the project has achieved 42.71% of working hours performed by Local Workers and 28.57% performed by Targeted Workers. The project is expected to achieve LEED Gold certification despite being designed and contracted to meet LEED Silver certification.

The development team consisted of the County of Los Angeles (Public Partner), Public Facilities Group (Not-For-Profit Owner/Partner), Trammell Crow Company (Developer), Gensler (Architect), and Hathaway Dinwiddie & Bomel (GC). The question remains, what is it about the contracting and delivery model that made it possible for the project to be successful?

### **63-20 Progressive Design-Build P3**

63-20 PDB has been used to deliver over 30 P3 projects for state and local governments, colleges, and universities across the country. The key feature of a 63-20 PDB is the involvement of a not-for-profit partner to issue tax-exempt bonds on behalf of a developer-led P3 project. The model achieves the same benefits of developer-led project delivery seen in Traditional P3s: Faster delivery, lower construction cost, private operation and maintenance. These benefits are combined with tax-exempt bond financing and a more competitive and practical operation and maintenance approach. The result is dramatically lower capital and O&M costs. It achieves the P3 promise of

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<sup>1</sup> In general, the Internal Revenue Code and the Treasury regulations promulgated thereunder provide that interest on the obligations of any state, territory, or possession of the United States, or any of their political subdivisions, or of the District of Columbia (each, a "Governmental Unit") is not includible in the gross income (i.e., such obligations are "tax-exempt bonds") of the holder.

In Revenue Ruling 63-20 (from which the "63-20" financing gets its name), the IRS ruled that, in certain circumstances, bonds issued by a nonprofit corporation (the "Nonprofit") will be considered issued on behalf of a Governmental Unit – thus allowing the interest on such bonds to be eligible for tax-exempt treatment.

risk transfer, but with a focus on first eliminating or reducing risk. It has stronger public agency protections, more flexible operations, and competitive long-term maintenance. 63-20 PDB outperforms other forms of delivery in life-cycle cost efficiency, structural flexibility, transparency, client involvement, and protections.

### **Public Delivery vs P3 options**

Public delivery focuses on tax-exempt financing coupled with public works contracting. While tax-exempt financing is very cost-efficient, public works contracting is not. There are many forms of public delivery, all of which are slower than private delivery and are plagued with change orders and cost overruns.

Traditional public delivery commonly experiences cost and schedule overruns in the range of 15% or more. The average traditional P3 delivery experiences cost and schedule overruns of only 1% to 3%.<sup>2</sup> Comparatively, 63-20 PDB projects benefit from 5% to 10% project cost savings, commonly coming in ahead of schedule and under budget. The El Gabilan Library in Salinas, CA, completed in 2020, achieved a 6% project savings. The Riverside County Law Building (2015) achieved 9% project savings.

P3 delivery builds faster, with greater efficiency, and significantly fewer change orders, provided it is properly structured with effective cost guarantees and savings incentives. Such contracting structures are not readily available in public delivery but can be easily achieved in private or P3 delivery.

### **Why 63-20 PDB Uses Tax-Exempt Financing**

In a 63-20 PDB, the not-for-profit partner issues the bonds under IRS 63-20 regulations to finance the project's construction cost, hence the moniker 63-20 Progressive Design-Build.<sup>3</sup> A 63-20 PDB uses tax-exempt financing to finance 100% of the project costs. 63-20 PDB does allow for the use of companion taxable bonds that are issued to support increased private-use if the project exceeds the 10% private-use allowance in 63-20 bonds.

Ratings on the bonds are directly comparable to what the public institution would achieve when it issues its own bonds. In a 63-20 PDB, the capital charge to the public beneficiary is non-escalating and therefore the capital cost borne by the public institution is essentially equivalent to internal financing. In traditional P3, the capital charge normally escalates annually to produce a return on equity. Over the term of a traditional P3 structure this escalation can double or triple the overall project cost.

The term 63-20 refers to the 20th IRS revenue ruling in 1963. The revenue ruling gives a not-for-profit organization the ability to issue tax exempt bonds (*i.e.*, bonds the interest on which is not subject to federal income tax) to finance exempt facilities. The revenue ruling was further clarified in Revenue Procedure 82-26. The model has been widely used in the U. S. for funding Public-Private Partnerships. PFG has recently used this structure for the successful delivery of the

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<sup>2</sup> Bay Area Council Economic Institute, "Public-Private Partnerships in California, How Governments Can Innovate, Attract Investment, and Improve Infrastructure Performance," p. 7, August 2018.

<sup>3</sup> 501(c)(3) bonds may be used. They are considered less advantageous due to slightly more restrictive regulatory language, limiting their private-use allowance.

Salinas, California Police Service Headquarters, and the Salinas El Gabilan Library. Trammell Crow and PFG's staff jointly employed the model on the Riverside County Law Building in Indio, California, the Gateway at Alhambra project for the County of Los Angeles and most recently the Vermont Corridor project.

Because of certain restrictions on the use of general obligation bonds, most California jurisdictions look to lease revenue bonds to finance new facilities. While all lease revenue bond structures use a long-term lease with a governmental tenant as the principal source of security and repayment, they may differ greatly in how they employ and manage construction financing, risk transfer, incentives to achieve and capture cost savings for public agency lessees, long term repair and maintenance, and final transfer of ownership. The 63-20 Model offers an attractive set of public protections in each of these areas. The County of Los Angeles chose to use 63-20 bonds for the Vermont Corridor project because they offered certain safeguards not available in either lease revenue bonds or in conventional debt and equity structures commonly used in Privately-Led P3 delivery models.

The most important feature in 63-20 transactions is that the governmental entity "on whose behalf" the project is undertaken must have the right to repay the debt at its sole discretion, and by doing so, receive at no cost, the unencumbered fee title to the financed facility. This is an important safeguard that enables 63-20 transactions to avoid the unwind difficulties that some jurisdictions have experienced in other forms of P3 delivery.

Additionally, as seen in Alhambra, in Riverside County, in Salinas and most importantly in the Vermont Corridor financing, there are no negative impacts on bond pricing or bond ratings when comparing appropriately structured 63-20 bonds to traditional governmental lease revenue bonds. In all the above-mentioned projects, the 63-20 bonds were rated and priced on par with other City and County-Led lease revenue bond financings.

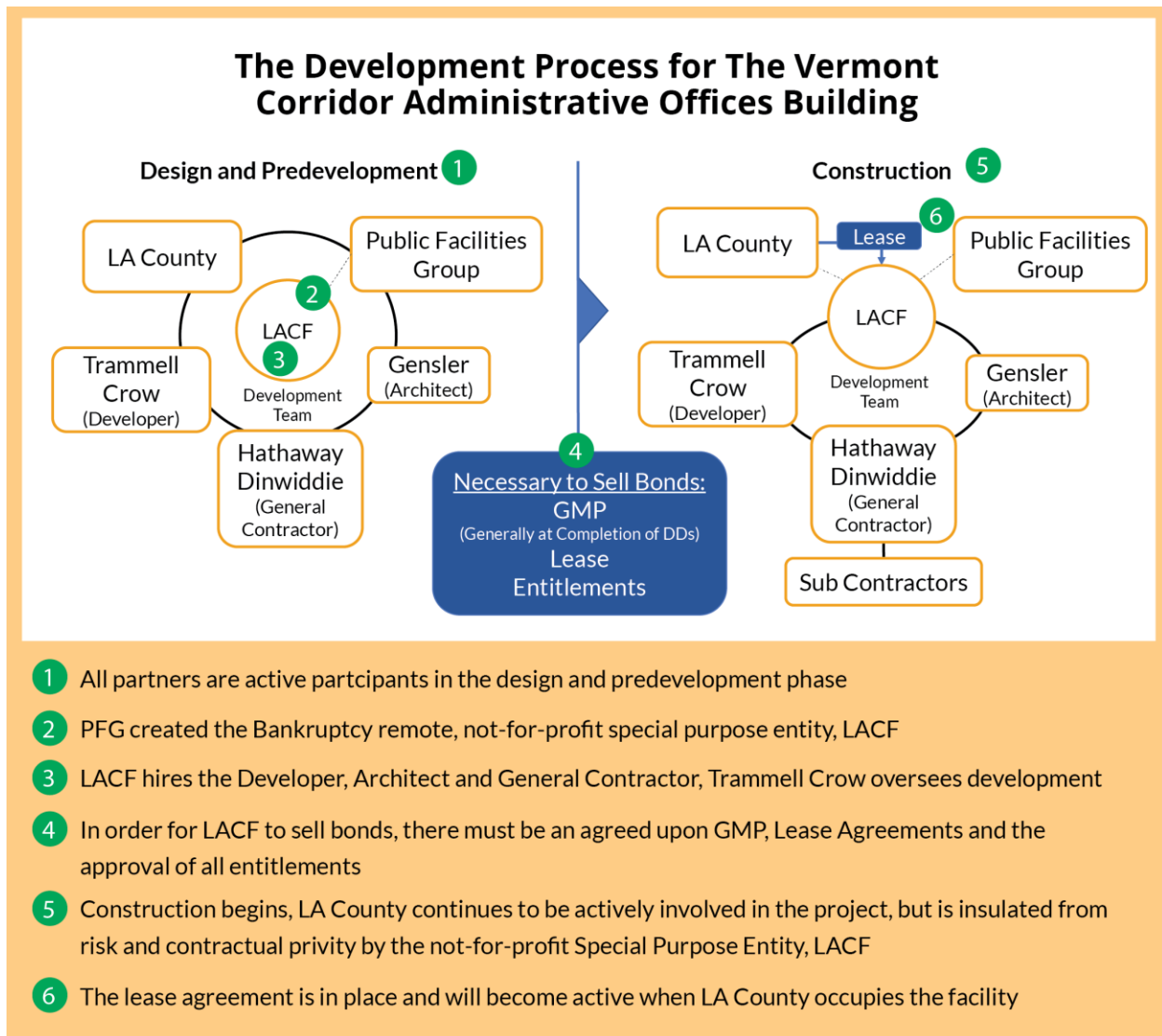
This dramatically differs from Privately-Led lease revenue bond financings and conventional debt and equity structures favored by many P3 models. These Privately-Led lease revenue bonds are normally viewed as project financings, as opposed to municipal financings. Project financings tend to be rated at the lowest investment grade by rating agencies, and if they have equity equivalent features, those "equity" tranches are commonly rated below investment grade. The Vermont Corridor project was rated equal to the County's own lease revenue bonds at AA with a positive outlook by S&P and as AA- by Fitch. The El Gabilan Branch Library and the Salinas Police Services Headquarters were also rated on par with the City of Salinas rating at A+ by S & P.

Unlike most governmental lease revenue bond financings, neither the Vermont Corridor project nor the Salinas projects required a debt service reserve. The absence of a debt service reserve did not negatively impact either the bond rating or the bond pricing. These issues achieved bond rates significantly below Privately-Led lease revenue bond financings and dramatically below rates achieved in blended debt and equity financed structures.

## **Incentives and Guarantees**

In all forms of contracting, key team members like the developer and the contractor are paid a fee for service. This fee is a small percentage of the total value of work performed. Since

neither Trammell Crow nor the contractor, Hathaway Dinwiddie, self-performs significant work, their fee is essentially structured as a percentage of the contract amount. In a typical publicly-led development approach, the process nearly always results in projects that fully exhaust their budgets, thus maximizing the fees paid to the key team members. Additionally, with the absence of an incentive structure, the typical public contracting process encourages change orders that result in increased costs and increased contractor fee revenue. By properly providing a development incentive to reduce costs and expedite delivery, this problem can be eliminated.



An important reason for 63-20 PDB's success is its Incentivized Guaranteed Maximum Price (GMP) contracting. The contracts allow for a percentage of achieved project savings to be awarded to the development team, provided they meet all conditions of the GMP and the delivery schedule. A common scenario is a 75%-25% split. The larger share accrues to the public client to retire outstanding project debt, to fund additional managed options, or both. The smaller portion is awarded to the private development team. Because the share of each dollar saved is larger than that dollar's contracting fee, each dollar saved becomes more valuable to the contracting team than a dollar spent.

Central to the Developer-Led Integrated Delivery approach are tightly-drawn contracts that include rewards for success, penalties for failure, and incentives for cost savings. In the Vermont Corridor project, the incentive was 33% of the first \$2,000,000 in savings and 25% of any savings in-excess of \$2,000,000. All savings after the incentive distribution were credited to the County of Los Angeles. The County's use of its share of project saving is limited by the tax code to project enhancements or retirement of the bonds. This incentive structure encourages the contracting teams to seek efficiencies by providing a mechanism that can increase their earnings beyond what they would achieve by simply building the project in accordance with the budget. At the same time, it benefits the tenant by lowering the overall project cost as reflected in their rental obligation. This approach is a win/win strategy that works by aligning both parties' self-interests.

In addition to employing an integrated delivery process to reward success, Vermont Corridor included a penalty for failure. The development team was tasked with a design and budget target. The design was advanced through Construction Drawings in the Predevelopment Phase of delivery at which time the GMP was established with appropriately sized contingencies and a completion date. The contract disallows an increase in price beyond the GMP and limits extensions of the completion date to events of force majeure with an outside limit of 90 days. The development team is required at all times to keep the project in "balance" and if it became "out of balance" to contribute from its fees sufficient funds to return the project to balance.

### **Operating and Maintenance Cost**

Municipalities want an approach that will achieve the lowest life cycle cost, specifically the overall cost of occupancy. This is the aggregate of capital charge, plus the costs of operations and maintenance over the life of the project. 63-20 PDB has the lowest capital charge because of its financing approach and lack of capital mark-up. Its O&M cost is also the lowest. A 63-20 PDB engages a property management vendor in 3-to-5-year increments, following market rates and competitiveness.

Traditional P3 locks in O&M with a single vendor for the term of the project, 30-50 years. The result is front end loading of inflationary charges to lower vendor risk. It is typical to see traditional availability payment P3 O&M charges that exceed comparable BOMA costs by a factor of 2 or 3<sup>4</sup>.

In 63-20 PDB O&M costs are further reduced because the not-for-profit "on-behalf-owner" is exempted from property tax. In addition, 63-20 PDB does not impose make whole agreements should the public agency desire to assume long-term project control. 63-20 rules mandate that the project revert to the public agency at no cost and without encumbrance whenever the debt is retired, granting the public agency the right to retire the debt at will.

### **Client Control and Protections in a P3 Approach**

In a 63-20 progressive design-build the public institution participates in both design and delivery, yet because of the contractual relationships through the not-for-profit partner, it is protected from risks inherent in contractual privity. In other words, a public agency can reap the

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<sup>4</sup> Matt Calcavecchia, Erin Birkenkopf, and John Finke "Understanding Public-Private Partnerships (P3) Through a Theoretical Cost Comparison," Illinois Municipal Policy Journal, 2017, Vol. 2, No. 1, 103-118.

benefits of project participation similar to public works delivery without the legal and financial risks.

The concept of transferring risk is being tested during the Covid-19 pandemic, more so than any other P3 selling point. Private partners are seeking to renegotiate O&M contracts and seek extensions of delivery dates. A number of public partners are in the uncomfortable position of stopping projects or firing their private partner. In doing so, they are likely obligated to pay sizeable make-whole fees. In a post-Covid-19 environment, a question arises: If the contract requires the private partner be made whole or granted the ability to renegotiate a project in adverse conditions, what risk is being transferred and do public controls and protections really exist?

In all concession and lease back P3 approaches, the public partner effectively pays for all aspects of the project through concession charges or lease payments, including all financing costs, O&M costs, and risk transfer fees. It is the willingness of the public agency to enter into a long-term agreement that makes these projects possible. Most municipalities can contract under public works delivery, they have the lowest cost of capital, they can self-manage or contract for private management. Considering this, a P3 approach must create a certainty of benefit that improves upon what institutions can already do themselves. P3 must result in lower cost, improved operations, more certain maintenance, greater flexibility, lower risk, full transparency, and balanced and fair contracting.

## 12. PROJECT READINESS CHECKLIST



### Public-Private Partnerships (P3S): Legal and Practical Issues with the Procurement and Delivery of Innovative, Local-Serving Projects, Including Case Studies

*League of California Cities City Attorney Conference Spring 2021*

#### Fundamental Evaluation - "The P4 Before the P3"

1. Problem (Opportunity)
2. Project
3. Politics
4. Priority

#### Top Ten Items to KNOW for Project Readiness

- |                            |   |
|----------------------------|---|
| 1. Know what you want      | - initial program, schematic design and cost estimate       |
| 2. Know your site          | - site control, due diligence, constraints, debt, etc.      |
| 3. Know what you can do    | - available revenues to commit and gaps you need to fill    |
| 4. Know approvals required | - local, state, and federal                                 |
| 5. Know your team          | - elected/staff champion, owner's rep, financial, legal     |
| 6. Know how to procure     | - internal evaluations of existing policies                 |
| 7. Know how to phase       | - design, build, finance, and O&M                           |
| 8. Know how to partner     | - review of alternative structures and approaches           |
| 9. Know how to negotiate   | - approaches to negotiation and risk, term sheets, remedies |
| 10. Know what to expect    | - negotiation, approval, financing, and implementation      |



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