

Alternative Development Strategies for Public Schools:  
The Financial Implications of Installment Purchase Contracts  
and Construct-Leaseback Transactions

A Piedmont Public Policy Institute Report

August, 2006

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The Charlotte, North Carolina, region is blessed with a vibrant, diversified and growing economy, as is the State of North Carolina as a whole. With this strong economic growth come both opportunities and challenges. Governments on the local, regional, state and federal levels are constantly seeking to address these issues through a wide variety of policies, programs, ordinances, rules and laws.

These government decision-makers must be fully informed if they are to craft effective and efficient solutions to these challenges. They must also take into account the economic and practical impacts of their actions. Too often, policy decisions have been made on the basis of limited analysis and without a rigorous examination of costs, innovative alternatives and market oriented solutions. In order to foster informed decision-making, the business community must help bring comprehensive, independent and authoritative research and analysis to the public policy debate.

Responding to this need, leaders in Charlotte's business community and real estate industry established the Piedmont Public Policy Institute (PPPI), a non-profit 501 (c)(3) research and education organization. The mission of the PPPI is to:

- Provide much-needed analysis and research on a range of important public policy issues, ensuring that economic and business aspects of these matters are considered
- Partner with universities, corporations, other organizations and individual experts to conduct these comprehensive and authoritative research projects
- Issue reports and policy papers digesting the research results
- Sponsor educational conferences.

Based in Charlotte, North Carolina, the PPPI will address issues of relevance to policy makers and the business community in Charlotte-Mecklenburg, the region, across the State of North Carolina and in other local communities and states around the nation.

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The Center for Real Estate at UNC Charlotte was endowed and established by the University and the Charlotte real estate and financial services community. The Center is part of the Belk College of Business and devotes its resources primarily to the educational and research activities of UNCC students, faculty, and regional real estate practitioners. The general objectives of the Center are as follows:

- Facilitate and fund practical and academic research on real estate topics of concern to the real estate community
- Facilitate MBA, professional and executive education in real estate
- Provide scholarships to students to encourage the professional study of real estate.

The Center's initial research agenda will focus on public policy issues that involve real estate and urban economic issues of concern to the academic, real estate practitioner and governmental communities. The major educational activity of the Center for Real Estate involves operation of the real estate finance and development concentration at the MBA level.

*Funding for this research was provided to the Center for Real Estate by the Piedmont Public Policy Institute*

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## Executive Summary

Financing the development of public school facilities is an ongoing challenge for many communities in North Carolina. General obligation bond revenues have proven insufficient to meet all of the infrastructure needs of school districts throughout the state and alternative financing methods are sought to accelerate the development process. The following research was funded by the Piedmont Public Policy Institute and completed by the Center for Real Estate at UNC Charlotte to explore the financial viability of two potential options: installment purchase financing and construct-leaseback transactions. The study involved an extensive review of existing literature, a series of interviews with professionals familiar with alternative development strategies, and the construction of a financial model comparing hypothetical lease purchase and construct-leaseback scenarios. The results provide guidance for North Carolina communities considering these techniques to finance the construction of public schools.

### ***Key Findings:***

- North Carolina legislation allows county governments to use installment purchase financing for school construction and the technique is widely used throughout the state.
  - Construct-leaseback transactions have not historically been used in North Carolina for the development of public school facilities, but the recently enacted Public-Private Partnerships for Schools Act provides school districts with clear legal authority to engage in build-to-suit capital lease arrangements with private sector developers.
  - While installment purchase financing is widely used throughout the United States to finance school construction, few school districts have engaged in construct-leaseback transactions. Unlike the public sector, private real estate developers have limited access to tax-exempt debt. Where they are permitted, this cost of capital disadvantage is the primary factor limiting the use of construct-leaseback arrangements. Significant savings must be generated by construction and management efficiencies to justify private sector ownership of public schools.
  - The use of installment purchase financing has increased because it provides a source of tax-exempt debt that is not subject to voter approval. Local governments can use the technique to accelerate the development process, while still benefiting from a cost of capital similar to general obligation bonds.
  - Avoiding the time and uncertainty involved in a bond referendum allows school construction to move forward much more quickly. Existing research and interview responses suggest this is the primary reason installment purchase contracts are used.
  - Private ownership of public schools is uncommon in the United States, but the private sector's role in school construction continues to grow. Design-build procurement and private sector management efficiencies have decreased construction costs between 5-25% and accelerated development timing by more than 25% in some cases.
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- School districts are successfully integrating the benefits of installment purchase financing and private sector construction management to reduce costs and accelerate development schedules.
  - Enabling legislation has been enacted in various states, including the recent North Carolina legislation, to encourage public-private partnerships for school construction. These statutes authorize various techniques, including: installment purchase financing, construct-leaseback transactions, unsolicited development proposals, design-build procurement, and authorization for competitive negotiation rather than competitive bidding.
  - Intensified use of school facilities is becoming more common to reduce occupancy costs. Public schools have entered into co-use agreements with community colleges, public libraries, and performing arts centers. Leasing school facilities to private sector tenants has been done extensively in other countries, but remains rare in the U.S.

## Table of Contents

I.	Introduction.....	1
II.	Financing Public School Facilities In North Carolina .....	3
	• General Obligation Bonds.....	3
	• Installment Purchase Contracts.....	3
	• Construct-Leaseback Transactions .....	4
III.	Financial Costs and Benefits.....	7
	• Financing Phase .....	7
	• Construction Costs .....	9
	• Ongoing Management.....	11
IV.	Qualitative Analysis.....	15
	• Motivating Factors .....	15
	• Financing Costs.....	16
	• Construction Cost Savings.....	17
	• Facilities Management and Intensified Use .....	18
V.	Financial Analysis.....	21
VI.	Enabling Legislation .....	27
VII.	Conclusions.....	29
	Glossary .....	31
	References.....	33
	Citations .....	35
	Appendix (S2009 N.C. Public-Private Partnership for Schools Act).....	41

## I. Introduction

The condition of public school facilities is one of the most salient issues facing communities in North Carolina. Enrollment continues to increase dramatically and school districts estimate nearly \$10 billion dollars are required over the next five years to fund construction and renovation projects.<sup>1</sup> The need for new facilities is pronounced in the state's largest urban areas. Guilford, Mecklenburg, and Wake Counties have increased enrollment by more than 20% over the last decade and the trend is anticipated to continue.<sup>2</sup> Mecklenburg County estimates 53,000 additional students will enter the system in the next ten years, while Wake County anticipates a staggering 72,000 new students.<sup>3</sup> Mecklenburg County alone requires 51 new schools and the expansion of 29 existing facilities to address overcrowding and projected growth.<sup>4</sup> The surge in enrollment has also affected surrounding suburban communities who struggle to provide classroom space for their expanding student populations. Cabarrus, Durham, Forsyth, Harnett, Johnston, and Union County each estimate the cost of new school construction in their counties will exceed, and in some cases substantially exceed, \$100 million dollars over the next five years.<sup>5</sup> Obtaining funding for these improvements poses an ongoing challenge for an increasing number of school districts.

General obligation bonds are commonly used to finance the development and renovation of school buildings. However, traditional public finance methods have proven insufficient to meet all the needs of public school systems in North Carolina. The time required to pass bond issues

and the difficulty of gaining voter approval have prevented delivery of new facilities as they are needed and forced a number of schools to operate well beyond capacity.<sup>6</sup> Charlotte Mecklenburg Schools (CMS) provides an excellent example of the problem. Mecklenburg County voters rejected a \$437 million bond referendum for school construction in November of 2005, leaving the district with overcrowded facilities and limited alternatives.<sup>7</sup> Prolonging the development process has also proven extremely expensive as construction costs continue to escalate.<sup>8</sup>

The limitations of general obligation bonds have stymied the development of public schools in many other communities as well. A growing number of school districts in the United States have turned to alternative finance methods to generate needed revenues. Lease-purchase financing has emerged as one of the most popular tools used in the construction of educational facilities.<sup>9</sup> The technique alleviates some of the obstacles associated with general obligation bonds, while allowing the public sector to construct schools in a timely manner. Lease-purchase financing is referred to as installment purchase financing in North Carolina and this term will be used throughout the study. Both urban and rural counties in North Carolina have utilized the technique.<sup>10</sup> Mecklenburg County has generated over \$222 million through installment purchase financing in the last seven years to fund construction of several new schools and multiple renovation projects.<sup>11</sup> However, the use of installment purchase financing appears to augment general obligation bond revenues rather than operate as an

ongoing program to finance and develop facilities.

Installment purchase financing has proven to be one viable alternative for school districts, but other options may be worthy of consideration. "Construct-leaseback" transactions also involve construction of school facilities by a private sector partner and a lease back to the school system for an extended period of time. However, these partnerships differ from installment purchase financing because residual ownership of the building may remain with the private sector after the lease expires. Few school districts in the United States have used the technique, but interest has increased as local governments seek to leverage the expertise of the private sector. North Carolina's newly enacted Public-Private Partnerships for Schools Act provides clear legal authority for local school boards to enter into construct-leaseback contracts. This legislation may stimulate private ownership of specific public school facilities.<sup>12</sup>

Installment purchase financing and construct-leaseback transactions potentially provide school districts in North Carolina with needed alternatives to general obligation bonds. Both offer unique costs and benefits over the life of a school development project that must be considered when comparing the techniques to traditional public finance methods. The following study is designed to analyze these financial implications.

The analysis begins by examining the legal constraints governing the use of each technique in North Carolina. A review of public finance literature is then completed to identify the potential costs and benefits created throughout the financing,

construction and ongoing management phases of a project. The study builds upon existing research by conducting a series of interviews with individuals involved in alternative school finance projects throughout the United States. These considerations are also incorporated into a financial model to compare the financial performance of general obligation bonds, installment purchase contracts, and construct-leaseback transactions. A brief discussion of legislation enacted in other jurisdictions is provided to demonstrate efforts made to maximize these benefits. Overall, the study hopes to provide a framework that can be used by school systems in North Carolina to evaluate alternative means of financing the development and renovation of public school facilities.

## II. Financing Public School Facilities in North Carolina

### *General Obligation Bonds*

Local boards of education and county governments each play a critical role in the provision of public school facilities in North Carolina. The local board of education is responsible for identifying infrastructure needs and estimating costs, while the county government is left with the task of providing necessary revenues.<sup>13</sup> County governments have traditionally financed the construction and renovation of public schools through the issuance of general obligation bonds.<sup>14</sup> These tax-exempt bonds are secured by the full faith and credit of the issuing government and provide an affordable source of debt.

North Carolina's General Statutes place a number of restrictions on the use of general obligation bonds to help preserve the credit ratings of local governments. The county must first receive approval from the Local Government Commission (LGC).<sup>15</sup> The Commission will not approve the general obligation bond issue if the county's net debt exceeds 8% of the assessed property value of all property subject to taxation within the county.<sup>16</sup>

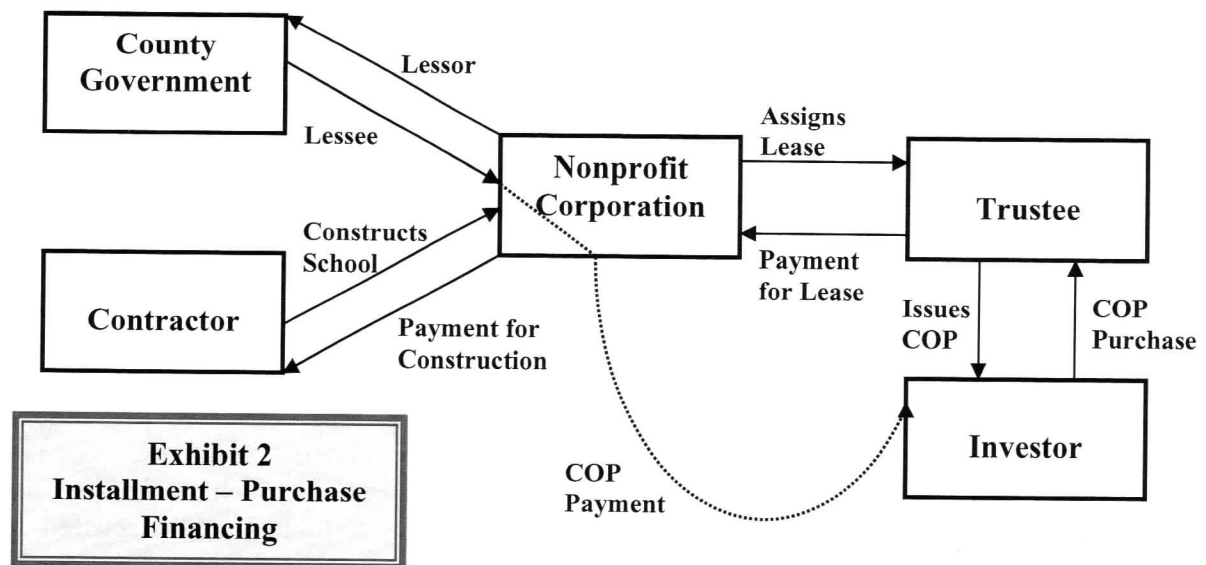
After receiving LGC approval, the bond issue must then be approved by county voters.<sup>17</sup> At times, the inability to gain voter approval has prevented jurisdictions from providing school facilities on an as needed basis. Installment purchase and construct-leaseback transactions are potential alternatives to general obligation bonds, in that they both allow a county government to fund school construction projects in the absence of general obligation bond revenues. The characteristics of each technique are outlined in Exhibit 1 and discussed in greater detail in the following sections of this report.

### *Installment Purchase Contracts*

Section 160A-20 of the North Carolina General Statutes provides county governments with authority to use installment purchase contracts to finance the development and renovation of school facilities.<sup>18</sup> In this model a county initiates an installment purchase contract by forming a nonprofit entity to facilitate the development or renovation of a school building.<sup>19</sup> A long-term lease is then executed for use of the space, usually ranging from 20-30 years. The lease is assigned to a trustee who

**Exhibit 1. Public School Finance Methods**

	Allowed by N.C. Statutes	Subject to Voter Approval	Subject to Debt Limit	Subject to LGC Approval	Ownership Retained by the School District
G.O. Bonds	<b>X</b>	<b>X</b>	<b>X</b>	<b>X</b>	<b>X</b>
Installment Purchase	<b>X</b>		<b>X</b>	<b>X</b>	<b>X</b>
Construct- Leaseback	<b>X</b>		<b>X</b>	<b>X</b>	<b>Subject to Contract</b>



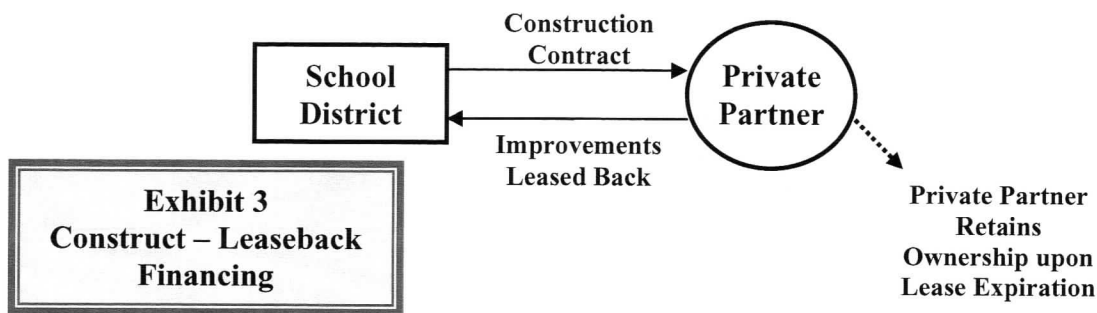
issues certificates of participation (COPs) to secure financing for the project.<sup>20</sup> COPs provide investors with the right to a pro-rata share of revenues generated by the county's lease payments. The lease payments are subject to annual appropriation by the board of county commissioners.<sup>21</sup> The interest portion of the COP is exempt from state and federal income tax, which significantly reduces the cost of debt.<sup>22</sup> Ownership of the school building is assumed by the local school district after the lease expires and all COP payments have been made. The process is outlined in Exhibit 2.<sup>23</sup>

Installment purchase financing is not subject to voter approval because the lease payments are subject to appropriation by the board of county commissioners each year and the county's taxing authority cannot be pledged to secure the payments.<sup>24</sup> The lenders are only provided with a security interest in the real property and cannot seek a deficiency judgment against the county if the lease is terminated.<sup>25</sup> Installment purchase agreements do require approval from the Local

Government Commission, which reviews the county's reasons for choosing a finance method other than general obligation bonds.<sup>26</sup>

### *Construct-Leaseback Transactions*

Construct-leaseback transactions are another means of providing facilities for public schools.<sup>27</sup> These public-private partnerships leverage the expertise of real estate professionals in the development, financing and ongoing management of educational facilities. The private sector partner acquires a site and enters into a contract with a local government entity to construct or renovate a school building. The facility is then leased back to the public sector partner on a long-term basis. Primary lease terms typically range from 20 to 30 years. The private developer may retain ownership of the school building after the lease expires in these arrangements or offer the public sector a market-value purchase option at various points throughout the lease. The construct-leaseback structure is outlined in Exhibit 3.



Until the recent enactment of the Public-Private Partnerships for Schools Act, school districts in North Carolina were extremely limited in their ability to lease school facilities from the private sector. Local boards of education were only provided with statutory authority to enter operating leases for the use of existing facilities and were prohibited from entering build-to-suit contracts for school construction unless the school board owned the underlying land in fee simple.<sup>28</sup> The new legislation (appended to this report), N.C. Gen. Stat. §115C-531, provides local boards of education with express authority to enter build-to-suit capital leases with private developers for the construction, renovation, or repair of school facilities.<sup>29</sup> The private sector may own the underlying land in these transactions.<sup>30</sup>

A lease of real property is considered a capital lease by the Financial Accounting Standards Board if it contains one of four provisions outlined in Exhibit 4.<sup>31</sup> A capital lease may transfer ownership to the lessee at the end of the lease term or include a bargain purchase option. Additionally, the lease term may extend for 75% or more of the estimated economic life of the property or the present value of the lease payments may equal or exceed 90% of the property's estimated fair market value. Leases meeting one of

these four criteria are considered capital leases for accounting purposes.

A capital lease operates as a financing agreement because the value of the building is amortized over the lease term. These types of obligations are generally included in a local government's capital budget and subject to voter approval. However, capital leases entered under §115C-531 do not require voter approval for several reasons. First, the lease payments are subject to annual appropriation by the board of county commissioners. Second, the lease cannot be secured by the full faith and credit of the local government or local taxing authority.<sup>32</sup>

#### **Exhibit 4. Capital Lease Criteria**

*A lease is considered a capital lease if it contains one or more of the following provisions:*

- Ownership Transfers to Lessee upon Lease Expiration
- Lease Contains a Bargain Purchase Option
- The Lease Term is Equal to or Exceeds 75% of the Estimated Economic Life of the Property
- The Present Value of the Lease Payments is Equal to or Exceeds 90% of the Property's Fair Market Value

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Third, the developer is only provided with a security interest in the real property and cannot seek a deficiency judgment against the county or school district if the lease is terminated.

Capital leases entered by local boards of education that extend for more than five years and obligate the unit of government to payments greater than or equal to \$500,000 are subject to approval by the Local Government Commission.<sup>33</sup> The school board must also provide public notice and opportunity for comment, specifying the circumstances justifying the use of a build-to-suit capital lease rather than traditional school finance techniques.<sup>34</sup>

North Carolina statutory law clearly provides authority to finance school construction through installment purchase contracts or construct-leaseback transactions. However, county commissioners may be reluctant to use either of these methods if the costs greatly exceed those of general obligation bonds. Alternative finance techniques must be analyzed to determine if they provide North Carolina counties with a financially competitive option.



### III. Financial Costs and Benefits

Installment purchase and construct-leaseback transactions offer different costs and benefits throughout the life of a project. A review of existing literature shows these factors can be examined in the three stages described in Exhibit 5: financing, construction, and ongoing management. Private sector expertise may provide a cost advantage in the construction process by effectively managing costs, implementing efficient design and reducing the time required to complete a project. Alternatively, the private sector may be at a cost disadvantage in the financing phase because of limited access to tax-exempt bonds and increased transaction costs. The allocation of risk between the public and private sectors may influence the financial performance of the project throughout the management phase. These costs are considered individually to evaluate the financial performance of each method.

#### *Financing Phase*

##### **Cost of Debt**

The cost of debt creates a significant disadvantage for private sector firms involved in the ownership of

public schools in the United States. Local governments have the ability to issue tax-exempt bonds, backed by the full faith and credit of the issuing government. This provides the public sector with access to debt financing well below the private sector's cost (Utt, 2001).<sup>35</sup> Private sector ownership has occurred more frequently in countries that do not provide this tax subsidy for municipal financing. In these instances, the private sector's cost of capital is much closer to that of the public sector and small efficiencies in construction and management may allow private developers to effectively compete. These efficiencies must be much larger in the United States to offset the private sector's cost of capital disadvantage.

Private activity bonds provide developers in the United States with one method to reduce financing costs. These bonds are issued on behalf of a local government to finance the development or rehabilitation of educational facilities. The interest portion of these bonds is exempt from state and federal taxation.<sup>36</sup> Unlike general obligation bonds, private activity bonds are secured by revenues generated by the educational facility itself and are not an ongoing obligation of the issuing government. The tax exemption allows the private partner to borrow funds for school construction

**Exhibit 5. Cost-Benefit Considerations**

<b>Financing:</b>	<b>Construction:</b>	<b>Ongoing Management:</b>
<ul style="list-style-type: none"><li>• Cost of Debt</li><li>• Transaction Costs</li><li>• Tax benefits</li></ul>	<ul style="list-style-type: none"><li>• Cost Reduction</li><li>• Development Time</li><li>• Design Efficiencies</li><li>• Transaction Costs</li></ul>	<ul style="list-style-type: none"><li>• Intensified Use</li><li>• Demographic Risk</li><li>• Technology Risk</li></ul>

closer to the cost of general obligation bonds.

Private activity bonds may not be a viable solution because their use is severely restricted. Ownership of the school facility must transfer to the school district upon expiration of the lease.<sup>37</sup> The lease is therefore treated as a capital lease and the private sector partner may be denied the tax benefits of depreciation. Additionally, each year a state may only issue private activity bonds for education in an amount equal to the greater of \$5 million or \$10 multiplied by the state's population.<sup>38</sup> For example, a state with a population of 8,000,000 may only issue \$80 million in private activity bonds for education facilities annually. Such an amount is insufficient to cover the infrastructure needs of many states. The use of private activity bonds has also been limited because they do not provide a school district with unique benefits that cannot be obtained through other alternative finance techniques, such as installment purchase financing.

Installment purchase agreements may provide a more attractive option in the financing phase because tax-exempt certificates of participation or lease revenue bonds are not subject to the strict limitations imposed upon private activity bonds.<sup>39</sup> COPs are generally used in North Carolina and may require an interest rate somewhat higher than general obligation bonds because they are not secured by the taxing authority of the issuing government and are subject to annual appropriation by the board of county commissioners. In the mid 1980s, Granof (1984) estimated the risk created by yearly appropriation required certificates of participation to offer interest rates 100-250 basis points higher than general obligation bonds.<sup>40</sup>

However, the interest rate spread between COPs and G.O. bonds appears to have decreased significantly over time. Empirical work conducted by Bunch and Smith (2002) found certificates of participation required only a 41 basis point premium.<sup>41</sup> Government officials in Chapel Hill, North Carolina estimated in 2005 that the premium required for certificates of participation exceeded general obligation bonds by only 15 to 18 basis points.<sup>42</sup> Mecklenburg County has also found a minimal risk premium when comparing COPs to G.O. bonds.<sup>43</sup>

### **Transaction Costs**

Installment purchase financing may offer a cost of debt closer to general obligation bonds, but transaction costs must also be considered. The spreads between general obligation bonds and certificates of participation are often reduced by insuring against non-appropriation. Insurance enhances the credit rating of the COP, but creates an additional transaction cost.<sup>44</sup> Limited experience with installment purchase contracts may also require the county government to incur increased attorney, consulting, and marketing fees when issuing debt. Bunch and Smith (2002) address this issue by comparing the issuance cost of voter approved bonds versus certificates of participation in Texas.<sup>45</sup> The regression analysis found issuance costs for certificates of participation more than doubled those of traditional bond financing. The estimated issuance cost for voter-approved bonds equaled \$18 per \$1,000 of principal, while financing through a lease-purchase/installment purchase agreement required transaction costs of \$37.20 per \$1,000 of capital.<sup>46</sup> However, practitioners involved in

installment purchase financing in Mecklenburg County and elsewhere suggest issuance costs for COPs have continued to fall and are becoming more competitive with those of general obligation bonds.<sup>47</sup>

Construct-leaseback and installment purchase contracts both appear to have higher financing costs than general obligation bonds. This has led some communities to dismiss alternative finance techniques as an overly expensive means of providing educational facilities. The conclusion may be premature, however, without first considering whether cost savings can be generated by private sector involvement in the construction and operation phases of a school development project.<sup>48</sup>

### ***Construction Costs***

Although school districts in the United States have traditionally relied upon the private sector in the construction of public schools, the structure of installment purchase and construct-leaseback agreements offers an opportunity to increase these efficiencies. Both techniques can reduce costs and improve quality through creative procurement methods, innovative design, and transfer of risk to the private sector. Existing literature suggests controlling contract negotiation and oversight costs is essential to reap these benefits throughout the construction phase.

### **Cost Reduction and Development Timing**

School construction is generally completed through a procurement process known as design-bid-build. The school district first enters into a contract

with a qualified architecture/engineering firm to design the new facility and then awards a separate contract for construction of the school through a competitive bidding process.<sup>49</sup> Many educational facilities delivered through construct-leaseback or installment purchase agreements utilize an alternative approach known as design-build. This procurement method utilizes a single contract for both the design and construction of a facility.<sup>50</sup> Consolidating these functions can reduce costs by eliminating overlapping functions and encouraging collaboration between the designer and general contractor.<sup>51</sup>

A design-build approach has reduced construction costs and accelerated the delivery of new school facilities in a number of cases. Utt (1999) identified a charter school in Pembroke Pines, Florida completed at a cost 22-34% below comparable schools in the area due to efficient design.<sup>52</sup> Brown (2001) found a design-build strategy used in British Columbia reduced construction costs of an elementary school by 10% and allowed the project to be completed in less than twelve months.<sup>53</sup> Dixon et al. also observed construction cost savings in a case study of public schools within the United Kingdom.<sup>54</sup> Similar experiences throughout the United States have encouraged a number of states to modify their procurement laws to expressly allow the use of design-build for public school facilities.<sup>55</sup> North Carolina allows design-build procurement of school facilities by submitting a request to the State Building Commission.<sup>56</sup>

### **Accelerating a Facilities Development Plan**

Alternative finance methods have not only allowed individual projects to be constructed more quickly. They have also proven to accelerate a school district's entire facilities development plan. Greenville County Schools in South Carolina implemented an extensive development plan in 2002 funded through a technique similar to installment purchase financing.<sup>57</sup> The plan included the construction or renovation of 70 public schools over a four year period at a cost exceeding \$800 million dollars.<sup>58</sup> A project management firm was engaged to oversee the design-bid-build procurement process and the construction phase. Fifty-five construction projects were completed as of June 2006 and 13 additional projects are currently in the planning or construction process.<sup>59</sup> School district officials report the facilities development plan would have required 23 years to

complete using general obligation bond financing due to debt limitations imposed by the state.<sup>60</sup> Accelerating the construction process is estimated to create over \$100 million in savings by avoiding inflation.<sup>61</sup> School district officials also note benefits derived from "standardization of school design, elimination of changes to scope of projects that increase costs, bulk purchase of building materials, and cost effective design that reduce maintenance costs."<sup>62</sup>

### **Design Efficiencies**

The examples above demonstrate design-build procurement and accelerated development timing create efficiencies in the construction of public schools. It is important to recognize, however, that these benefits can be derived without transferring ownership of school facilities to the private sector. Thus, any case for the financial benefits of construct-leaseback arrangements would need to identify additional cost savings. Design improvements and enhanced construction quality may provide the justification to support private ownership.

A construct-leaseback agreement can transfer the risk of functional obsolescence if the private sector retains ownership of the facility after the expiration of the lease.<sup>63</sup> This provides the developer with an incentive to design and construct a flexible, high-quality building that will remain attractive to tenants in the future. Studies completed by the Nova Scotia Department of Finance (1997) and Utt (1999) suggest this is accomplished by increasing investment in a facility's information technology and by including design specifications that allow classroom space to be easily converted to alternative uses

#### **Greenville County Schools:**

- *Over \$800 million raised for school construction and renovation*
- *55 projects completed in 4 years*
- *\$100 million estimated savings by accelerating development timing and avoiding inflation*
- *Benefits obtained from standardized design and bulk purchasing*

or expanded to accommodate future school district growth.<sup>64</sup> Some scholars acknowledge the potential for design efficiencies, but question whether they are the result of private sector innovation or more thorough design specifications completed by the public sector in anticipation of a public-private partnership.<sup>65</sup> Therefore, design and construction cost savings associated with private ownership must be considered carefully before inclusion in a cost/benefit analysis.

### Transaction Costs

The private sector has proven efficient in the delivery of educational facilities after a contractual agreement is in place. However, transaction costs required to reach the agreement must also be considered. Dixon et al. (2005) estimate legal fees and other transaction costs involved in construct-leaseback agreements may exceed the cost of traditional construction negotiations by 10-20%.<sup>66</sup> An empirical study conducted by Ahazdi and Bowles (2004) in the United Kingdom addresses the issue more thoroughly.<sup>67</sup> The study found time required for pre-contract negotiations exceeded the parties' expectations in 98% of the construct-leaseback transactions included in their sample.<sup>68</sup> Advisory and bidding costs exceeded expectations by 25-200%, primarily due to the retention of consultants throughout the extended negotiation process.<sup>69</sup>

Schools completed through installment purchase agreements may also experience increased transaction costs in the construction phase as school districts and private sector firms negotiate contractual terms for an expanded number of services.

### Ongoing Management

The role of the private sector in the development of educational facilities has traditionally ended after the construction phase. Ownership of the facility remains with the public sector and the school district is responsible for ongoing management. Most schools developed through installment purchase financing also leave management responsibility and ownership risk with the school district. These entities are typically formed and controlled by the school district and do not constitute a meaningful transfer of risk and responsibility to the private sector. Alternatively, construct-leaseback transactions can be structured to transfer significant amounts of risk to private firms. Providing private investors with an ownership interest in educational facilities may also reduce occupancy costs for the school district through intensified use. These financial benefits of ongoing ownership and management by the private sector could potentially be significant based upon a limited number of foreign examples, although there were too few U.S.

#### **Nova Scotia, Canada:**

- *Over forty public schools constructed using construct-leaseback method*
- *Occupancy costs reduced by 15% by leasing school facilities to third party users*
- *Demographic and technology risk shifted to the private sector*



examples to draw any meaningful conclusions in this regard.

### **Occupancy Cost Reductions through Intensified Use**

Public schools are generally unable to maximize the use of their facilities because school is in session for only a portion of the day and year. Classes are conducted during the morning and early afternoon, with classroom space remaining idle during the evening and on weekends. Special use facilities such as auditoriums and recreational facilities may also be underutilized. Private sector involvement can allow the school district to reduce its occupancy costs through intensified use in these situations (Utt and LaFaive, 2006).<sup>70</sup> Some partnerships allow private firms to bid for the right to construct and own public school facilities. The development and financing costs for the project are capitalized over a 20 to 30 year lease. The school district enters a long-term lease with the private firm, but only pays a portion of the capitalized lease payment. This allows the public school to occupy the building below the developer's cost. The developer makes up the difference by retaining the right to lease the educational facility to other approved users when school is not in session.

Over forty public schools were constructed in Nova Scotia, Canada using this form of public-private partnership (Utt, 1999).<sup>71</sup> The developer completed turn-key facilities in this case, including furniture, computers, and all fixtures. The cost of developing the facilities was converted into a 20 year lease, with the school district's lease payment set at 85% of the capitalized cost. The developer was allowed to

generate additional revenues by leasing the facility to qualified users before 8:30 am and after 3:30 pm. The school district was provided with two five-year renewal options, but ownership of the facilities was retained by the developer after lease expiration. Public schools in the United States have also reduced occupancy costs through intensified use, but these arrangements have generally relied on leases with other government entities such as universities, community colleges, and libraries.<sup>72</sup>

### **Technology and Demographic Risk**

Construct-leaseback transactions provide two unique benefits to the public sector in the ongoing management phase. The public sector can potentially transfer significant technology and demographic risks to the private sector.<sup>73</sup> Technology risk involves the possibility of a building becoming functionally obsolete as technology requirements change. It provides the owner with an incentive to initially construct a high quality building, but also encourages ongoing technological improvements that allow the owner to retain the school district as a tenant. This motivation may be very high because schools are often special purpose buildings, which may not be attractive for a large number of alternative uses. However, the special purpose nature of school buildings may also create uncertainty regarding the building's residual value and the private sector will require a higher rate of return to compensate for accepting the risk.<sup>74</sup>

Demographic risk occurs due to fluctuations in the student population that influence a school district's need for space. Many schools are currently experiencing large increases in enrollment, but demographic cycles may

reduce these levels in the future. Leasing space may increase a school's flexibility and allow it to respond to changing demand. On the other hand, some scholars contend 20-30 year leases greatly encumber a school district's flexibility and may prove financially burdensome over time. (Crump and Slee, 2005)<sup>75</sup>

It is difficult to generalize the financial costs and benefits created for a school district through intensified use of educational facilities, demographic risk, and technology risk. Cost savings associated with intensified use are ultimately a function of the underlying real estate's value and the developer's ability to lease the school to third party users. Steep discounts will presumably be available for some schools, while very minimal discounts may be available to others. In all cases, cost savings and risk transfer are products of negotiation between the school district and the private developer. The terms of the individual partnership agreement dictate the financial implications. These issues are explored in greater detail in a subsequent section of this report.





#### **IV. Qualitative Analysis**

Existing research shows school districts in the United States have limited experience with private ownership of public schools, but it also suggests real estate professionals have become increasingly involved in other aspects of the development process. The exploratory research completed in this section attempts to identify factors influencing the use of alternative development strategies and the benefits derived by local governments. Fifteen semi-structured interviews were completed with individuals involved in public school development and facilities management. Participants were selectively chosen from both the private and public sector based on their experience with alternative finance and management techniques. The sample includes project managers, contractors, consultants, finance officers, and facility managers.

Project managers and contractors were chosen from nationally recognized firms with experience developing public schools in multiple states. The interviewees were asked to provide generalized opinions on the effectiveness of alternative development techniques and examples from specific projects. Public sector facility managers, finance officers, and consultants were selected from school districts in California, Florida, Oregon, South Carolina and Virginia. These individuals represent school districts implementing unique methods in the development and management of public schools. The interview results were aggregated to maintain the confidentiality of the respondents and provide a balanced perspective of the benefits and costs

generated by private sector involvement in public school development.

#### ***Motivating Factors***

Interviewees from both the public and private sector were asked to identify factors influencing the use of installment purchase financing or other alternative techniques to fund school construction projects. Legislative debt limitations and failed bond referenda were noted in a limited number of cases, but nearly all respondents identified timing as a critical issue. The time required to pass a general obligation bond referendum often prevented school districts from providing facilities as they were needed. Local officials also found themselves continually playing catch-up as rapidly escalating construction costs stretched existing sources of revenue. Installment purchase contracts financed through certificates of participation or lease revenue bonds provided an effective alternative.

The use of installment purchase financing was often proposed by a private sector firm in conjunction with project management services. Many of these projects were later subjected to an open bidding process with multiple participants, but respondents from the public and private sector commented on the need for transparency in the process. The company initiating conversations with the local board of education was often awarded the project. These companies had an advantage over competitors because they more fully understood the school district's needs. Private firms and public officials recommended policies ensuring transparency to limit public objection to the process.

Despite transparency issues, interview respondents discussed very little public opposition to alternative development strategies. The demand for new facilities appeared to outweigh concerns about moderately higher financing costs or private sector profits. Some opposition was noted within the construction community itself. Many school districts found architecture firms resisted design-build strategies because their scope of services was reduced. Small construction firms in a few markets also resisted the combination of financing and construction management services because they felt it created an advantage for larger firms specializing in public sector projects. However, the expanding role of the private sector in school development was well received in the vast majority of cases discussed throughout the interview process.

### ***Financing Costs***

Respondents from both the public and private sector generally acknowledged installment purchase financing required higher debt service and transaction costs than traditional public finance methods. Only one respondent stated that alternative forms of tax-exempt financing could effectively be structured below the cost of general obligation bond debt. The majority of interviewees estimated certificates of participation required interest rates 10-25 basis points higher than general obligation bonds. Transaction costs were also anticipated

to increase, but these estimates were more disparate. One facility manager noted that the school district's experience with certificates of participation allowed it to reduce issuance costs well below \$5.00 per \$1,000 of capital raised. Other finance officials predicted issuance costs greatly exceeding those required for a general obligation bond issue. Despite higher debt service and transaction costs, all public officials involved in the interviews felt the costs were justified to accelerate the time required to deliver new facilities. The cost savings received from locking in construction prices were often perceived to offset any additional costs required in the financing phase. One respondent from the public sector justified the use of certificates of participation even though the school district planned to repay the debt within 2-3 years through general obligation bonds and other sources of revenue.

Public sector officials also offered differing opinions as to the benefit of contracting for financing services in conjunction with project management services. Some noted the convenience and cost savings of a single provider, while others were less satisfied. In the most extreme case, a school district's facilities manager cited a one million dollar decrease in

**“Despite higher debt service and transaction costs, all public officials involved in the interviews felt the costs were justified to accelerate the time required to deliver new facilities.”**

certificate of participation issuance costs by bidding financing and project management services separately. Facility managers from two different school districts also stated their staff needed to remain heavily involved in the development process

when one firm facilitated both financing and project management duties, but private sector respondents believed the school district's level of involvement was largely driven by their desire to remain active in the process.

### ***Construction Cost Savings***

The immediate need for new school facilities was noted as a key factor encouraging school districts' decisions to contract for financing and construction services at the same time. School district officials and private sector project managers estimated construction efficiencies were derived from design-build procurement and private sector management. Construction schedules were accelerated by at least 25% in a number of cases compared with design-bid-build procurement. Two school districts noted cases in which new elementary schools were delivered in approximately nine months.

Construction cost savings were not noted as a key factor influencing the school districts' use of design-build procurement, but significant efficiencies were acknowledged by public and private sector participants. Estimated construction cost savings ranged from 5-25% compared to other schools constructed in the region using design-bid-build procurement. Design-build

**"Estimated construction cost savings ranged from 5-25% compared to other schools constructed in the region using design-bid-build procurement."**

was found to limit costs associated with change orders and continued involvement by the school districts allowed informed tradeoffs between educational needs and budget constraints.

School districts developing multiple facilities concurrently, or working with large project management firms, experienced benefits through economies of scale in the procurement of sub-contractor labor and construction materials. System technicians offered lower contract rates and increased scheduling flexibility when negotiating for multiple projects. Bulk price agreements also reduced the cost of items such as carpet, ceiling tiles, vinyl floor coverings, and light fixtures. One

**"Construction schedules were accelerated by at least 25% in a number of cases compared with design-bid-build" procurement.**

project manager noted bulk purchasing proved more difficult for mechanical systems because many projects required different components due to site conditions and building specifications. However, installing similar systems across school buildings was anticipated to decrease maintenance costs and improve performance over the life of the facility.

Interview respondents also identified a number of design innovations introduced by the private sector to reduce construction costs. Infrastructure costs were reduced by incorporating school buildings into mixed-use projects including residential subdivisions and commercial facilities. This approach was reported to

significantly reduce site preparation expenses and allow delivery of new facilities at a cost 10% below regional averages. Major savings were also generated by adapting building plans previously used by the school district or designs previously completed by the contractor. Replicating existing facilities was estimated to reduce costs by more than 20% in some cases. Clearly defined specifications also greatly accelerated the development timing in many instances and allowed some school districts to negotiate construction contingencies as low as 2.5%. The use of pre-cast panels instead of unit masonry was found to accelerate construction timing and reduce costs, but the benefits were not quantified. Involving school district faculty early in the design process proved to be another cost effective way to adapt a facility to changing educational needs.

A number of school districts stated the negotiation of “turn-key” construction contracts allowed them to transfer substantial amounts of risk to the private sector in the construction phase. Competition among private sector firms for school construction projects provided the local board of education with sufficient leverage to negotiate guaranteed maximum prices in many projects. Some contracts also

included guaranteed delivery dates with firm liquidated damage clauses. Increased private sector responsibility in the construction phase allowed the delivery of schools more quickly and several school districts felt they received more for their money.

### ***Facilities Management and Intensified Use***

The private sector’s expansive role in the construction phase did not carry over to the management phase of school development projects. The construction management team helped develop ongoing maintenance plans in a limited number of cases, but execution of the plan remained the sole responsibility of the school district’s facility management department. The private sector’s role was generally limited to service contracts for HVAC and other mechanical systems. Several project management firms expressed interest in ongoing property management contracts for facilities they constructed. Little interest was expressed on the part of school district officials due to fear of displacing maintenance staff and questions as to whether the private sector could add value in the management phase.

The private sector was also inactive in the leasing of school buildings to third party users. Two school districts participating in the study utilized co-use agreements with other governmental entities to intensify the use of educational facilities. Another expressed interest in hiring a commercial real estate firm to dispose of excess facilities. However, none of the interview respondents discussed the possible use of private sector professionals to intensify use of school

**“Increased private sector responsibility in the construction phase allowed the delivery of schools more quickly and several school districts felt they received more for their money.”**

facilities through active leasing efforts. The school districts also remained exposed to technology and demographic risk in all cases because residual ownership of the school buildings did not remain with the private sector partners.

“Infrastructure costs were reduced by incorporating school buildings into mixed-use projects including residential subdivisions and commercial facilities. This approach was reported to significantly reduce site preparation expenses and allow delivery of new facilities at a cost 10% below regional averages.”

Overall, the interview responses correspond with the findings of previous studies and suggest many school districts in the United States are embracing the role of real estate professionals in the financing and construction of public school facilities. Nonetheless, none of the school districts surveyed were attempting to shift risk or outsource property management responsibilities by transferring ownership to the private sector. Section IV addresses this issue by examining the efficiencies that must be achieved by the private sector for local jurisdictions to consider private ownership of public school facilities.



## V. Financial Analysis

The analysis presented in this section incorporates the factors discussed earlier into a cost-benefit analysis comparing the financial costs and benefits of private *versus* public financing and ownership of public schools. There are three cases examined in the section: traditional public sector ownership and financing using general obligation bonds; installment-purchase programs with public financing using Certificates of Participation (COPs); and, fully private financing and ownership through a construct-leaseback transaction.

Due to the state and federal income tax exemptions on municipal bond interest, public financing is able to achieve a much lower borrowing rate (cost of capital) relative to financing by

the private sector.<sup>77</sup> The public's lower borrowing rate is the primary factor in favor of the traditional public financing.

One the other hand, the private sector is often thought to have advantages in ownership. For example, there is evidence the private sector can often lower overall building costs through design and construction efficiencies. Also, the private sector may be in a better position to effectively facilitate an intensified use of school buildings by leasing facilities to non-school sources. This additional income can lower (offset) the school district's occupancy costs.

It is important to point out that many installment purchase programs with public ownership are now being done with a design-build approach which has also greatly reduced construction costs. Also, some of the

<b>Exhibit 6 Base-Case Assumptions</b>			
<b>Assumptions</b>	<b>Private Sector</b>	<b>Public Sector G.O. Bonds</b>	<b>Public Sector COP's</b>
Cost of capital (financing)	7.25%	4.75%	5.00%
Construction cost per sq. ft.	\$120 80% of public G.O cost assumed	\$150	\$135 90% of public G.O cost assumed
Time to complete construction	18 Months	24 months	18 Months
Transaction cost percentage	2.5%	1.5%	2.5%
Useful life of building	35 Years	35 Years	35 Years
Square footage of building	125,000 sq. ft.	125,000 sq. ft.	125,000 sq. ft.
Land cost as a percentage of total costs <sup>76</sup>	15%	15%	15%
Land appreciation % per year	4%	4%	4%



best examples of intensified use of schools are for publicly-owned projects. Therefore, attributing all of these benefits to privately-owned projects may be inaccurate. Given the ongoing debate of public versus private ownership, the objective of the following analysis is to provide some guidelines as to what benefits the private sector must achieve, *over and above* the benefits that the public sector can also realize, in order to match or exceed the public sector's financing advantage.

The analysis begins by providing a base-case scenario for the construction of a "typical" public school. A typical public school is defined as a facility constructed through design-bid-build procurement, financed with general obligation bonds, and used 100% by the school district. Exhibit 6 presents assumptions used in this analysis as to current construction costs, financing costs, and other relevant inputs for both the public and private sectors.

Financing costs are significantly lower for the public sector because the interest on both general obligation bonds and COPs are not subject to state and federal income tax. An interest rate of 4.75% is assumed for G.O. bonds. A risk premium of 25 basis points is added to the G.O. bond rate for COPs to reflect the extra risk from lease payments not being backed by the county's taxing authority. The private sector's financing cost is estimated at 7.25% (weighted average cost of capital for private debt and equity). The low cost of private capital, relative to other *private* real estate investments, is due to the low risk of default on a lease to a government-backed entity such as a school district. The public sector's cost of construction using the traditional design-bid-build approach is estimated at \$150 per square

foot and an anticipated 24 months to complete a new facility. The assumptions are based on school construction cost estimates throughout North Carolina over the last 18 months.<sup>78</sup> The implementation of design-build procurement and other efficiency enhancing techniques is anticipated to reduce construction costs in the installment-purchase program by 10%. For comparison purposes, it is assumed that construction costs could be reduced 20% per square foot in the privately built construct-leaseback program. Construction efficiencies created by private ownership or private sector project management in an installment purchase transaction are both assumed to accelerate development timing by 6 months.

While private sector construction and ownership and installment-purchase programs are both expected to create efficiencies in construction, they are also anticipated to increase transaction costs required to negotiate financing and construction contracts. Transaction costs are assumed to be 1.5% of the total cost of a project for the traditional public sector project and 2.5% for the private sector construct-leaseback and installment-purchase projects. Land costs, building square footage, and useful life of the building are expected to be the same under each scenario. At the end of the school building's useful life, it is assumed the land can be sold for its residual value based on a 4% per year appreciation rate over the life of the school. The residual value of the school building is assumed to be zero.

Based on these assumptions, the total costs to build the school under each of the three scenarios are shown in Exhibit 7. The total costs are broken down into land, construction,



### Exhibit 7 Total Costs and the Lease Payment Requirements

Assumptions and Results	Private Sector	Public Sector G.O. Bonds	Public Sector COP's
Land cost	\$2,647,059	\$2,647,059	\$2,647,059
Building construction costs	15,000,000	18,750,000	16,875,000
Construction financing costs	1,098,844	1,141,075	816,867
Transaction costs	468,648	337,915	508,473
Total Costs	\$19,214,550	\$22,877,217	\$20,847,399
Land appreciation percentage	4.00%	4.00%	4.00%
Residual land value at end of 35 years	\$10,445,530	\$10,445,530	\$10,445,530
Annual lease payment required to provide investors or bondholders their required return	\$1,453,115	\$1,231,596	\$1,157,536

construction financing costs, and transaction costs.<sup>79</sup> The land value at the end of the building's useful life is based on the original land cost compounded at the 4% annual appreciation rate. The "bottom line" of the analysis is the annual lease payment that would be required under the public and private scenarios. This is computed as the lease payment necessary to provide either:

The public sector's required return to the bondholders (or holder of the COP's) over the useful life of the school, assuming the residual value of the land can be used to make the final bond (COP) principal payment.<sup>80</sup>

or,

The private sector's required return to investors (debt and equity investors combined) over the useful life of the school, assuming the land is sold at its residual value and the proceeds distributed to investors.

Despite the assumption of significant construction cost and time-to-build advantages for the private sector, the required annual lease payment over the 35 year life of the school is \$221,520 (17.99%) higher for private sector construct-leaseback financing and ownership. Relative to the installment-purchase scenario using COPs, the private sector annual lease payment required is \$295,579 (25.54%) higher. Based on these assumptions, the construction and design efficiencies are *not* large enough to offset the advantage of tax-exempt financing using G.O. bonds or COPs.

It is possible, however, to construct financial scenarios under which the private sector construct-leaseback model *could* compete effectively with the public sector in the construction and ownership of public schools. The variable parameters in this "break even" financial analysis include construction costs and the level of intensified use. These variable

parameters can be considered individually, or in various combinations, to achieve financial results comparable to the traditional method of financing and constructing public schools. Exhibit 8 illustrates a number of examples of how this could be achieved.

The analysis shows that the private sector can offset the public sector's cost of capital advantage through construction cost savings alone only if its' construction costs are 33.79% lower than the public sector (\$99.31 per sq. ft. versus \$150). If tax benefits of depreciation are assumed to be available under private sector ownership (an operating lease is necessary to allow tax benefits to private owners), then the private sector would need to lower

construction costs by 27.84% to 108.23 per square foot.<sup>81</sup>

Exhibit 8 also shows that if the private sector could lower construction costs 20% and increase the use of a school building 15.24% the required lease rate is then competitive with the traditional public financing scenarios. Alternatively, if the private sector could lower construction costs 10% and increase the use of a school building 23.68% (or 16.11% if tax benefits were available to private owners) the additional revenues would also lower the payments made by the school district to a competitive level.

The financial analysis shows that private ownership must offer *substantial* benefits in the construction and ongoing

<b>Exhibit 8: Break-Even Values</b>	
<b>Values to be achieved in order for the private sector construct-leaseback scenario to compete effectively with traditional public sector G.O. bond financing with construction costs of \$150 per sq. ft.</b>	
<b>VARIABLES</b>	<b>REQUIRED TO BREAK-EVEN WITH G.O. BOND FINANCING</b>
Construction costs	\$99.31 per sq. ft. (33.79% construction cost reduction)
Construction costs with tax benefits of depreciation included	\$108.23 per sq. ft. (27.84% construction cost reduction)
Construction costs and intensified use (option 1)	\$120.00 per sq. ft. (20% construction cost reduction ) and 15.24% intensified use
Construction costs and intensified use (option 2)	\$135.00 per sq. ft. (10% construction cost reduction) and 23.68% intensified use
Construction costs and intensified use with tax benefits of depreciation	\$135.00 per sq. ft. (10% construction cost reduction) and 16.11% intensified use

management of a school development in order to offset the public sector's ability to issue tax-exempt debt. Existing literature and the interview responses suggest these savings may not be insurmountable. Private sector construction efficiencies have reduced construction costs by 20-30% in some instances and private developers have shown the ability to reduce school occupancy costs by 15% in exchange for the right to lease facilities to third party users.<sup>82</sup> However, these savings are not unique to private ownership because many school districts already benefit from private sector expertise in the construction process and a growing number are reducing occupancy costs by entering co-use agreements with other government entities. These factors have encouraged jurisdictions to adopt legislation increasing the private sector's role in school financing and construction in a number of different ways.



## VI. Enabling Legislation

The success of alternative development strategies throughout the country has encouraged several states to enact legislation specifically designed to further their use in the development of school facilities. Virginia adopted the Public-Private Education Facilities and Infrastructure Act (PPEA) in 2002.<sup>83</sup> Maryland's Public School Facilities Act was enacted in 2004.<sup>84</sup> North Carolina recently adopted the Public-Private Partnerships for Schools Act. These three pieces of legislation provide guidance for states interested in increasing the use of alternative school finance techniques. Several key provisions of these acts are outlined in Exhibit 9.

### Virginia

The PPEA expressly acknowledges the inability of traditionally public finance techniques to provide all educational facilities needed by the state and calls for the use of public-private partnerships.<sup>85</sup> A local government may request bids from the private sector to construct and manage a school facility. Alternatively, the legislation allows a developer to submit a school development project for approval by the appropriate local government.<sup>86</sup> In addition to competitive bidding, the scope and terms of a development can be defined through competitive negotiation if the public entity determines negotiation advances the public interest.<sup>87</sup> The flexibility provided by the PPEA has reduced construction costs, encouraged innovative development projects and delivered needed schools to several communities throughout Virginia. For example, Stafford County Public

### **Exhibit 9. Public-Private Partnership Legislation**

- Design-Build Procurement
- Lease-Purchase Financing Provisions
- Construct-Leaseback Provisions
- Unsolicited Development Proposals Considered
- Competitive Contract Negotiation
- Authorization for Cooperative Use Agreements

Schools procured development of an elementary school through the PPEA. The school was incorporated into a mixed use project, including senior housing and a YMCA. The project was delivered at a cost \$17.47/sf less than the average elementary school construction cost in the state.<sup>88</sup>

### Maryland

Maryland's Public School Facilities Act identifies a number of alternative methods available to local governments to enhance the development of public schools throughout the state. Design-build procurement and lease-purchase financing are both authorized.<sup>89</sup> The legislation also expressly authorizes cooperative use agreements for school property, which allow a developer to reduce the school's lease payments by generating revenue from third party tenants.<sup>90</sup> Similar to Virginia's legislation, competitive negotiation and unsolicited proposals are also provided for if they create advantages for the public sector partner in the delivery of new infrastructure.<sup>91</sup>

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### **North Carolina**

North Carolina has built upon progressive legislation in other states to encourage the use of alternative development strategies. Many counties have already taken advantage of installment purchase financing to accelerate school development. The newly enacted Public-Private Partnerships for Schools Act provides another option for local boards of education by authorizing the use of build-to-suit capital lease transactions with private sector developers. This legislation also allows a school board engaging in a build-to-suit transaction to contract with a single developer for the provision of various services, including: site selection, facility planning and design, construction, financing, and facilities maintenance.<sup>92</sup> Integrating these functions may provide North Carolina school districts with cost savings similar to those experienced by other jurisdictions utilizing design-build procurement for public schools.

## VII. Conclusions

School districts throughout North Carolina will continue to face the challenge of providing adequate public school facilities to their expanding student bodies. General obligation bond financing may not provide a complete solution. The time required to pass a bond referendum, plus other financial constraints, prevents facilities from being delivered as they are needed and rapidly escalating construction prices make the cost of waiting substantial. Installment purchase financing and construct-leaseback transactions offer two alternatives. These techniques potentially allow school districts to circumvent restrictions placed on general obligation bonds and accelerate the development of new school buildings. North Carolina statutory law now authorizes use of both of these methods.

The financial model constructed in this report shows installment purchase financing may provide the better alternative because of the significant disadvantage private ownership creates in the financing of new facilities. Installment-purchase financing provides local governments with access to tax-exempt financing that generally cannot be obtained by the private sector. A private owner could potentially offset this disadvantage by introducing efficiencies in the construction and management of a public school facility, but many publicly financed projects are already leveraging the expertise of real estate professionals in these activities. The private sector would be required to dramatically decrease the school district's occupancy costs and risk exposure in order to compete effectively.

Installment-purchase financing overcomes many of the problems associated with the use of construct-leaseback transactions. Debt service and

transaction costs may be slightly higher than general obligation bonds, but installment purchase transactions provide a source of tax-exempt debt that greatly reduces the cost of borrowing compared to the private sector. The small increase in financing cost may be justified to accelerate the development process and avoid the risk of continually rising construction costs. Additionally, research shows many installment purchase transactions are completed in conjunction with private sector project management that creates cost savings through creative procurement methods and innovative design. School districts are also benefiting from intensified use by constructing facilities in a manner that allows co-use with other public sector entities such as community colleges, universities, and libraries.

The North Carolina General Assembly has recognized the potential benefits of public-private partnerships in the development of public school facilities by enacting legislation authorizing the use of installment purchase financing and construct-leaseback transactions. These techniques may provide two of the best opportunities for school districts to address inadequate school infrastructure in a timely and cost effective manner. Local boards of education must consider the unique advantages provided by each method and attempt to maximize the benefits provided by the private sector.





## Glossary

**Capital Lease-** A type of lease transaction transferring nearly all of the economic benefits and risks of property ownership to the leasee. Capital lease transactions must be included on a company's balance sheet as an asset and corresponding liability. Financial Accounting Standards Board guidelines consider a lease a capital lease if it meets at least one of four criteria: (1) ownership of the property is transferred to the lessee upon lease expiration; (2) the lease contains a bargain purchase option; (3) the lease term is equal to or exceeds 75% of the estimated useful life of the property; (4) the present value of the minimum lease payments equals or exceeds 90% of the leased asset's fair market value.

**Certificates of Participation (COPs)-** A method used by local governments to finance the construction of public school buildings and other capital facilities. The government entity enters into a long term lease agreement with a private sector partner (often a non-profit entity) for the development of the capital facility. Fractional shares of the municipal lease obligation are then sold to private investors who receive payments over the term of the lease. After all payments are made, ownership of the capital facility is retained by the government entity. Certificates of participation provide local government entities with an additional source of tax-exempt financing.

**Construct-Leaseback-** A public-private partnership in which a government entity engages a private sector partner to construct a needed public facility, such as a public school building. The government entity generally enters into a long term lease for use of the facility, but residual ownership of the land and facility are retained by the private sector partner upon lease expiration.

**Design-Bid-Build-** The traditional contracting method used by government entities for the construction of capital facilities. Design and construction phases of a project are bid and preformed separately.

**Design-Build-** An alternative to the design-bid-build project delivery method, in which design and construction responsibilities are bid and performed together.

**General Obligation Bonds** – Municipal bonds secured by the “full faith and credit”, and usually the taxing authority, of the issuing government entity.

**Installment Purchase Financing-** Financing technique commonly referred to as lease-purchase financing. The construction or renovation of a public facility is financed by entering into a long term lease with a private entity (generally a non-profit entity when used to finance public schools). The lease agreement takes the place of a mortgage obligation and ownership of the facility is acquired by the participating government entity by making lease payments over a specified period of time. Government entities often engage in installment purchase financing as an alternative to issue general obligation bonds.

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**Local Government Commission-** Commission created by the North Carolina General Assembly to oversee local government finance activities throughout the state.

**Operating Lease-** Include all leases that are not classified as capital leases. In these transactions the lessor retains nearly all of the economic benefits and risks of property ownership. Operating leases do not have to be shown on the lessee's balance sheet as an asset and corresponding liability.

**Private Activity Bonds-** Municipal bonds available to local governments entering public-private partnerships. They can be used for a variety of purposes, including the development of educational facilities, and provide privately owned projects with access to debt exempt from federal income taxation. Many states also exclude the interest portion of private activity bonds from state income taxation.

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- <sup>1</sup> North Carolina Public Schools Facility Needs Survey: Preliminary Report April 2006. North Carolina Public Schools. <[www.ncpublicschools.org](http://www.ncpublicschools.org)>. Enrollment throughout the state is anticipated to increase by 15.2% over the next ten years.
- <sup>2</sup> Stoops, Terry. "Building for the Future: The School Enrollment Boom in North Carolina." John Lock Foundation. September 2005. Between 1996 and 2001, enrollment growth in Guilford, Mecklenburg and Wake County was 10%, 16%, and 21% respectively. Enrollment growth continued to be substantial between 2001 and 2005, at growth rates of 8%, 12%, and 13%.
- <sup>3</sup> Id. at 4. Wagner, Michael. "Alternative Finance Stretches Dollars". *Triangle Business Journal*. February 20, 2006.
- <sup>4</sup> Charlotte Mecklenburg Schools Website. "Facilities Masterplan Draft 2005". June 13, 2006. <[www.cms.k12.nc.us/departments/facility/masterplan05](http://www.cms.k12.nc.us/departments/facility/masterplan05)>.
- <sup>5</sup> North Carolina Public Schools Facility Needs Survey (2006).
- <sup>6</sup> Charlotte Advocates for Education. "Community Guide to Understanding the School Budget". Charlotte, North Carolina. 2002. Ten public schools in Charlotte were estimated to begin the 2002-2003 school year with enrollment at 120% of capacity.
- <sup>7</sup> Hieb, Sam A. "Forsyth Has School Bonds Down" Carolina Journal Online. January 31, 2006. <[www.carolinajournal.com](http://www.carolinajournal.com)>.
- <sup>8</sup> Stoops (2005). School construction costs have increased more than 30% in the last three years.
- <sup>9</sup> The use of lease-purchase financing in the United States is widely discussed throughout the public finance literature. School districts in California, Florida, Texas and numerous other states have used the technique extensively. Several counties in North Carolina have also used lease-purchase arrangements (called "installment purchase").
- <sup>10</sup> A brief review of annual financial reports for counties across the state shows wide use of installment purchase financing for school construction and other capital improvement projects. Alamance, Carteret, Chatham, Cherokee, Cleveland, Durham, Guilford, Haywood, Henderson, Jackson, Johnston, Lee, Mecklenburg, Nash, Rockingham, and Sampson Counties are just a few which have utilized the technique.
- <sup>11</sup> Figures obtained from Mecklenburg Board of Education Budget Status Reports for 1999, 2004, and 2005.
- <sup>12</sup> The Public-Private Partnerships for Schools Act is formally titled "An Act to Allow Capital Lease Financing for Public Schools." SB 2009 and HB 2780 were approved by the North Carolina General Assembly in 2006. Mackinac Center for Public Policy. Winter 2006. Private ownership has been more widely used abroad. The United Kingdom's Private Finance Initiative has resulted in the development and financing of 256 school buildings by the private sector. The number will triple as 513 additional projects in the planning phase are completed. See also Utt, Ronald D. "How Public-Private Partnerships can Facilitate Public School Construction." The Heritage Foundation. Washington D.C. Domestic Policy Studies Department. 1999. Public-private partnerships used to construct forty-one schools in Nova Scotia.
- <sup>13</sup> Wagner (2006).
- <sup>14</sup> N.C. Gen. Stat. § 159-48 (2006). The statute provides counties with authority to issue general obligation bonds for the acquisition, construction or renovation of public school buildings. Many counties have also used certificates of participation, which are discussed in greater detail throughout the study.
- <sup>15</sup> N.C. Gen. Stat. § 159-51 (2006).
- <sup>16</sup> N.C. Gen. Stat. § 159-55 (2006). The statute provides a formula for calculating a local government's "net debt". N.C. Gen. Stat. § 159-52 (2006) presents other factors considered by the Local Government Commission when reviewing an application to issue general obligation bonds.
- <sup>17</sup> N.C. Gen. Stat. § 159-49 (2006) The statute allows issuance of general obligation bonds without voter approval in an amount equal to 2/3 of the reduction in the county's debt in the preceding fiscal year. However, this amount is generally insufficient to meet new infrastructure needs.
- <sup>18</sup> N.C. Gen. Stat. § 160A-20 (2006). The technique was upheld by the North Carolina Supreme Court in *Wayne County Citizens v. Wayne County Board of Commissioners*. 328 N.C. 24. (1991). School district's cannot directly use installment purchase financing and it must be facilitated through the county.

- <sup>19</sup> Johnson, Craig L. and John Mikesell. Certificates of Participation and Capital Markets: Lessons from Brevard County and Richmond Unified School District. *Public Budgeting and Finance*. Fall 2004. 41-54. School districts often form the non-profit entity to retain more control of the asset. However, independent non-profits may also be engaged to manage public school assets.
- <sup>20</sup> *Id.* at 46. Installment purchase financing in North Carolina is commonly completed using certificates of participation, while other jurisdictions rely on lease revenue bonds.
- <sup>21</sup> Municipal Securities Rulemaking Board. "Glossary of Municipal Security Terms." April 21, 2006. <[www.msrb.org](http://www.msrb.org)>.
- <sup>22</sup> IRC § 103(a). N.C. Gen. Stat. § 105-134.6(b).
- <sup>23</sup> California Debt Advisory Commission. "Guidelines for Leases and Certificates of Participation". Sacramento, California. November 1993. Diagram adapted from the report.
- <sup>24</sup> N.C. Gen. Stat. § 160A-20(f) (2006).
- <sup>25</sup> *Id.*
- <sup>26</sup> The LGC subjects COPs to the same debt limit test that would apply to general obligation bonds.
- <sup>27</sup> Task Force to Study Public School Facilities. "Alternative Funding and Financing Methodologies for Public School Construction". Maryland. 2003. The term "construct-leaseback" is sometimes used in conjunction with lease-purchase financing. However, this study defines construct-leasebacks as contracts in which ownership of the school building is retained by the private sector or the public sector is offered a market-value purchase option. Unlike installment purchase contracts, these arrangements are not purely financing agreements.
- <sup>28</sup> N.C. Gen. Stat. § 115C-530(a) and § 115C-521(d) (2006).
- <sup>29</sup> N.C. Gen. Stat. § 115C-531(b) (2006).
- <sup>30</sup> *Id.*
- <sup>31</sup> Financial Accounting Standards Board. FASB No. 13: Accounting for Leases. November 1976.
- <sup>32</sup> N.C. Gen. Stat. § 115C-531(e) and (f) (2006).
- <sup>33</sup> N.C. Gen. Stat. § 115C-531(g) and N.C. Gen. Stat. § 159-148(a) (2006).
- <sup>34</sup> N.C. Gen. Stat. § 115C-532 (c) (2006). The justification for using a capital lease to finance school construction can be based on "time, cost, and quality of design, engineering, and construction, including the time required to begin and the time required to complete a particular activity; energy costs; and any other factors the board deems relevant."
- <sup>35</sup> Utt, Ronald. "New Tax Law Boosts School Construction with Public-Private Partnerships". The Heritage Foundation. Washington D.C. 2001. Utt estimates tax exempt bonds provide the public sector with access to debt at a cost approximately one-third less than debt generally available to the private sector.
- <sup>36</sup> 26 USCS § 141-142 (2006). This creates a problem in North Carolina because school districts are not provided with authority to enter into capital leases.
- <sup>37</sup> 26 USCS § 142 (b) (2006).
- <sup>38</sup> 26 USCS § 142 (k) (2006). The limit on Private Activity Bonds is set at the greater of \$10 multiplied by the state population or \$5,000,000.
- <sup>39</sup> Bunch, and Smith (2002). IRC § 501(c)(3) identifies entities exclusively formed for educational purposes as a qualifying non-profit organization that can issue tax exempt debt. The amount of funds that can be raised through installment purchase financing in North Carolina is limited by the state's statutory debt limitation applied to local governments.
- <sup>40</sup> Granof, Michael H. Tax Exempt Leasing: A Framework for Analysis. *Public Administration Review*. May/June 1984. 232-240. The Financial Accounting Standards Board has determined lease-purchase agreements with non-appropriation clauses should be capitalized by both the lessee and lessor if the clause is unlikely to be exercised. Some states require lease-purchase agreements to be considered capitalized leases subject to the state's statutory debt limits. See Bunch, Beverly S. The Evolution of Lease-Purchase Guidelines in the State of Texas. *Public Budgeting and Finance*. Winter 1996. 114-124.
- <sup>41</sup> Bunch and Smith (2002) at 1057-1060.
- <sup>42</sup> In a memo to the mayor and town council members dated April 5, 2005, Chapel Hill's town manager estimated the cost of financing a new town operations center through certificates of participation would only require a premium of 15 to 18 basis points over general obligation bonds. See Johnson and Mikesell (1994) at 46. The authors note the peculiar situation created by installment purchase financing arrangements: "Government must convincingly argue that a [certificate of participation] is not a long-term



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obligation, legally, while assuring investors that, economically, the long-term obligation will be met.” Default on certificates of participation in Florida and California show risk is a factor.

<sup>43</sup> A conversation with the CMS finance department concurred with the findings in other jurisdictions, estimating the risk premium for COPs is generally less than 15 basis points when compared to general obligation bonds.

<sup>44</sup> Gamkhar, Shama and Mona Koerner. Capital Financing of Schools: A Comparison of Lease Purchase Revenue Bonds and General Obligation Bonds. *Public Budgeting and Finance*. Summer 2002. 21-40.

<sup>45</sup> Bunch and Smith (2002) at 1057.

<sup>46</sup> Id. at 1058. The authors state a portion of the increased cost may be offset by eliminating a bond election and reducing marketing costs through private placement of debt, but also note the danger of an increased interest rate on privately placed debt that is not widely marketed.

<sup>47</sup> A practitioner contacted during the literature review stated issuance costs for COPS rarely exceeded \$20 per \$1000 of capital. The cost of a voter referendum was also noted as a factor reducing the issuance cost spread between COPS and G.O. bonds.

<sup>48</sup> Dixon, Timothy, Gaye Pottinger and Alan Jordan. Lessons from the Private Finance Initiative in the UK. *Journal of Property Investment and Finance*. 2005. 23:5. 412-423. The authors note the lack of research examining the financial performance of PPP throughout the entire life of the partnership.

<sup>49</sup> Ling, Florence Yean Yng, Swee Lean Chan, Edwin Chong, and Lee Ping Ee. Predicting Performance of Design-Build and Design-Bid-Build Projects. *Journal of Construction Engineering and Management*. 2004. 130:1. 7-83. Design-bid-build is identified as the dominate procurement method in the United States, UK, Singapore, and several other countries.

<sup>50</sup> Id. at 75.

<sup>51</sup> Quatman, William. “More States Permit Design-Build for Schools”. The American Institute of Architects Homepage. March, 29 2006. <[www.aia.org/db\\_news\\_schools](http://www.aia.org/db_news_schools)>.

<sup>52</sup> Utt (1999) at 9.

<sup>53</sup> Brown, Daniel. The Public-Private Partnership that Build a “Traditional” School: A Case Study from British Columbia. *Society for the Advancement of Excellence in Education*. Kelowna, British Columbia. 2001.

<sup>54</sup> Dixon et al. (2005).

<sup>55</sup> Id. In April of 2005, legislation in eighteen states specifically allowed the use of design-build for the procurement of public schools.

<sup>56</sup> North Carolina State Construction Manual. § 404.5. January 30, 2006.

<sup>57</sup> Herlong, William. “Faced with Rapid Growth, A School District Embarks on an Ambitious-and Controversial-Construction Plan”. *Leadership Insider*. National School Boards Association. May 2004. Since installment purchase financing is not permitted by South Carolina law an alternative legal structure was developed using “63-20” bonds to finance the development plan. The financing method operates in a manner very similar to installment purchase financing and meets the statutory requirements imposed by the state.

<sup>58</sup> Greenville County Schools Online. “Facilities Plan”. Monday June 12, 2006. <[www.greenville.k12.sc.us](http://www.greenville.k12.sc.us)>.

<sup>59</sup> Id.

<sup>60</sup> Id.

<sup>61</sup> Herlong (2004) at 9. The author notes estimated cost savings from avoiding inflation ranging from \$100 million to \$600 million.

<sup>62</sup> Greenville County Schools Online (2006).

<sup>63</sup> Rawlings, Lisa. “Innovative Methods to Fund Public School Construction.” University of Maryland School of Public Affairs Working Paper. 2002.

<sup>64</sup> Utt (1999) and Nova Scotia Department of Finance. Discussion Paper. 1997.

<sup>65</sup> Hurst, Clair and Eoin Reeves. An Economic Analysis of Ireland’s First Public Private Partnership. *International Journal of Public Sector Management*. 2004. 17:5. 379-388. Dixon et al (2005) at 420

<sup>66</sup> Id. at 420. Dixon et al. explain that transaction costs may induce additional inefficiencies in the construction process if they preclude some contractors from bidding for the project. However, a study conducted in Ireland found robust competition in the private sector for public school construction regardless of transaction costs. See Hurst (2004) at 383.

<sup>67</sup> Ahazdi, Marcus and Graeme Bowles. Public-Private Partnerships and Contract Negotiations: An Empirical Study. *Construction Management and Economics*. November 2004. 22. 967-978.

<sup>68</sup> Id. at 968.

<sup>69</sup> Id. Interviews and questionnaires completed by parties to the negotiations found more complete design specifications, involvement by all stakeholders, and an understanding of risk by all parties would have improved the negotiations.

<sup>70</sup> Utt and LaFaive (2006).

<sup>71</sup> Utt (1999) at 4-6.

<sup>72</sup> See Utt (1999) at 9-10. Pembroke Pines, Florida financed the development of an "academic village" through a lease-purchase contract. The cost was reduced by including the local community college, a regional university and the public library in the project. See McLaughlin, John M. and G. William Bavin. "Private Capital for Public Schools: Districts Overcome Cultural Barriers to Find Non-Public Building Partners." *School Administrator*. August 2003. The Natomas Unified School District also reduced operating costs by incorporating a local community college and a branch of the public library in a high school development.

<sup>73</sup> Utt (1999).

<sup>74</sup> Nova Scotia Department of Finance. "Transferring Risk in Public/Private Partnerships". Discussion Paper. 1997.

<sup>75</sup> Crump, Stephen and Roger Slee. Robbing Public to Pay Private? Two Cases of Refinancing Education Infrastructure in Australia. *Journal of Education Policy*. 2005. 20:2. 243-258.

<sup>76</sup> Land costs are held constant across the three scenarios and are based on 15% of the total private-sector costs (land, hard and soft costs) excluding construction interest.

<sup>77</sup> IRC § 103(a) (2006). N.C. Gen. Stat. § 105-134.6(b).

<sup>78</sup> North Carolina Department of Public Instruction-School Planning. "Costs of Recent School Projects". March 17, 2006. <[www.schoolclearinghouse.org/costinfo/CostsByProject.pdf](http://www.schoolclearinghouse.org/costinfo/CostsByProject.pdf)>. The report included construction costs for three elementary schools completed in the first quarter of 2006. Construction costs averaged \$146.78 per square foot for these projects. The report also included 19 schools constructed in 2005 at an average cost of \$145.41 per square foot. The reported figures do not include design, survey or legal fees.

<sup>79</sup> Construction financing costs include only those incurred during the construction time.

<sup>80</sup> The assumption of selling the land and paying off the remaining bond principal is made only to facilitate the comparison with a private sector construct-leaseback transaction.

<sup>81</sup> These reductions in construction costs would have to be made on a building of equal quality to make an "apples to apples" comparison across financing scenarios.

<sup>82</sup> Utt (1999) at 9. Private sector efficiencies reduced the cost of constructing a charter school by 23-34% compared to other schools in the region, but the project was privately owned. Utt (1999) at 4-6. Nova Scotia, Canada provides one of the best examples of private sector intensified use reducing school occupancy costs.

<sup>83</sup> Va. Code Ann. § 56-575.1-16 (2006). § 56-575.8 of Virginia's PPEA provides a private entity with authority to (a) develop or operate the qualifying project and collect lease payments, impose user fees or enter into service contracts in connection with the use thereof. Section (c) states 'any financing of the qualifying project may be in such amounts and upon such terms and conditions as may be determined by the private entity.' § 56-575.16 additionally states a 'public entity shall not be required to select the proposal with the lowest price offer, but may consider price as one factor in evaluating the proposals received.' The public entity can also consider (i) proposed cost of the qualifying facility ; (ii) the general reputation, industry experience, and financial capacity of the private entity ; (iii) the proposed design of the qualifying project ; and several other factors.

<sup>84</sup> Md. Code Ann. § 4-126 (2006). § 4-126(a) of Maryland's Public School Facilities Act defines alternative financing methods covered by the statute, including : (1) Sale-leaseback, (2) Lease-leaseback, (3) Public private partnerships allowing cooperative use of school facilities, (4) Performance based contracting, and (5) Design-build procurement. § 4-126(b) authorizes county boards of education to use the following techniques in the development of public schools : (1) Use alternative financing methods, (2) Engage in competitive negotiation, rather than competitive bidding, in limited circumstances, (3) Accept uncollected

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proposals for the development of public schools in limited circumstances, and (4) Use quality-based selection to choose developers and builders for school projects.

<sup>85</sup> Va. Code Ann. § 56-575.2(3) (2006). The legislation states public-private partnerships are desired because of evidence suggesting they accelerate construction schedules and lower costs.

<sup>86</sup> Va. Code Ann. § 56-575.4 (2006).

<sup>87</sup> Va. Code Ann. § 56-575.16 (2006).

<sup>88</sup> McGuire Woods Consulting. "Stafford County Public Schools Project Summary". Richmond Virginia. 2006.

<sup>89</sup> Md. Code Ann. § 4-126(a) (2006).

<sup>90</sup> Md. Code Ann. § 4-126(a)(5) (2006).

<sup>91</sup> Md. Code Ann. § 4-126(b) (2006).

<sup>92</sup> N.C. Gen. Stat. § 115C-532(h) (2006).



GENERAL ASSEMBLY OF NORTH CAROLINA  
SESSION 2005

SENATE BILL 2009  
RATIFIED BILL

AN ACT TO ALLOW CAPITAL LEASE FINANCING FOR PUBLIC SCHOOLS.

The General Assembly of North Carolina enacts:

**SECTION 1.** Article 37 of Chapter 115C is amended by adding a new section to read:

**"§ 115C-531. Capital leases of school buildings and school facilities.**

(a) Definitions. – The following definitions apply in this section:

(1) Capital lease. – A capital lease as defined by generally accepted accounting principles, regardless of how the parties describe the agreement.

(2) Private developer. – The entity with which the school board enters into a capital lease or build-to-suit lease under the provisions of this section.

(b) Authorization. – Local boards of education may enter into capital leases of real or personal property for use as school buildings or school facilities. The capital lease may relate to an existing building or a new school building to be constructed. The term of any capital lease, including any renewal periods, shall not exceed 40 years from the expected date that the local board of education will take occupancy of the property that is the subject of a capital lease. Subdivisions (c) and (d) of G.S. 115C-521 do not apply to a capital lease entered into under this section.

(c) Construction, Repairs, and Renovation. – The provisions of G.S. 115C-530(b) apply to a capital lease under this section. A capital lease entered into under this section may provide that the private developer is responsible for providing, or contracting for, construction, repair, or renovation work. Construction, repair, or renovation work undertaken or contracted by a private developer is not subject to the requirements of Article 8 of Chapter 143 of the General Statutes. Construction, repair, or renovation work undertaken or contracted by the private developer involving the estimated expenditure of three hundred thousand dollars (\$300,000) or more is subject to the provisions of G.S. 115C-532.

(d) Nonsubstitution Clause. – A capital lease may not contain a nonsubstitution clause that restricts the right of a local board to continue to provide a service or activity or to replace or provide a substitute for any property financed or purchased by the capital lease.

(e) No Deficiency Judgment; No Pledge of Taxing Power. – No deficiency judgment may be rendered against any local board of education or any unit of local government, as defined in G.S. 160A-20(h), in any action for breach of a contractual obligation authorized by this section, and the taxing power of a unit is not and may not be pledged directly or indirectly to secure any moneys due under a contract authorized by this section. A capital lease shall state that it does not constitute a pledge of the taxing power or full faith and credit of the local board of education or board of county commissioners.

(f) Budgetary Accounting. – A capital lease entered into under this section shall be considered a continuing contract for capital outlay and is subject to G.S. 115C-441(c1); provided, however, notwithstanding any provision of G.S. 115C-441(c1) or G.S. 115C-426, in each fiscal year the appropriation of funds by

the county for the payment of amounts due under the capital lease shall be at the discretion of the board of county commissioners.

(g) Local Government Commission Approval. – Capital leases entered into under this section are subject to approval by the Local Government Commission under Article 8 of Chapter 159 of the General Statutes if they meet the standards set out in G.S. 159-148(a)(1), 159-148(a)(2), and 159-148(a)(3). For purposes of determining whether the standards set out in G.S. 159-148(a)(3) have been met, only the five-hundred-thousand-dollar (\$500,000) threshold applies.

(h) No Agreements on Student Assignment. – A capital lease may not contain any provision with respect to the assignment of specific students or students from a specific area to any specific school.

(i) Lien Laws Not Affected. – The provisions of Article 2 of Chapter 44A of the General Statutes apply to any real property, improvement to the real property, and rights that flow with the real property that is subject to a capital lease under this section. Real property that is subject to a capital lease under this section is subject to liens and foreclosure actions in the same manner and to the same extent as if the property were owned in fee simple by a private entity.

**"§ 115C-532. Additional provisions applicable to build-to-suit capital leases.**

(a) Definitions. – The definitions of G.S. 115C-531 apply in this section. In addition, for the purposes of this section, the following definitions apply:

- (1) Build-to-suit capital lease. – A capital lease that provides for the construction of new facilities or the renovation of existing facilities by the private developer, the cost of which is estimated to be greater than three hundred thousand dollars (\$300,000).
- (2) Prime contractor. – A contractor who contracts directly with the private developer or the private developer's construction manager at risk, if any, for construction, repair, or renovation work under this section.

(b) Contract Provisions. – A build-to-suit capital lease may include contractual provisions by the private developer regarding the provision of products, services, and guaranties related to a facility that is the subject of a capital lease. A local board of education may also enter into a separate agreement or series of related agreements regarding the provision of products, services, and guaranties related to a facility that is the subject of a capital lease; provided all agreements are approved by the board of county commissioners in connection with the approval of the build-to-suit capital lease.

(c) Approval by Local Board of Education. – Before entering into a build-to-suit capital lease pursuant to this section, the local board of education shall adopt a resolution as provided in this subsection. Before adopting the resolution required by this subsection, the local board of education shall publish a notice of its intent to enter into a build-to-suit capital lease at least 10 days in advance of the date of the meeting at which the action is contemplated and in a newspaper having general circulation within the geographic area served by the local board of education. The notice shall include, at a minimum, the date, time, and place of the meeting, a description in brief and general terms of the subject of the lease, the name of the other party to the lease, and an indication of the board's intent to take action to authorize the lease at the indicated meeting. The resolution shall provide the following:

- (1) That entering into the build-to-suit capital lease for one or more specified buildings or facilities is in the unit's best interests under all the circumstances. In making this evaluation, the local board of education may consider the time, cost, and quality of design, engineering, and construction, including the time required to begin and the time required to complete a particular activity; occupancy costs, including lease payments, life-cycle maintenance, repair, and energy costs; and any other factors the board deems relevant.



- (2) That the private developer is qualified to provide, either alone or in conjunction with other identified and associated persons, the products and services called for under the proposed capital lease and any related agreements. The local board of education shall make this determination taking into account any factors the local board deems relevant, including the knowledge, skill, and reputation of the provider and its associated persons, the goals and plans of providers for utilization of minority business enterprises, and the costs to be incurred by the local board of education.

(d) Additional Requirements Regarding Design Services. – Required design and engineering services shall be performed by an engineer, to the extent permitted under G.S. 83A-13(b), or a licensed architect. Specifications for any new school building shall be consistent with the requirements of G.S. 143-128(a). All applicable requirements for the review or approval of design and specifications for school buildings by the Department of Public Instruction and the Department of Insurance apply to school buildings constructed, repaired, or renovated under a capital lease authorized under this section.

(e) Additional Requirements Regarding Construction Services. – A private developer is required to seek competition and minority business participation in connection with all construction work under this section in accordance with the following provisions:

- (1) A private developer shall either (i) solicit bids from prime contractors for all construction work under this section or (ii) select a construction manager at risk through a qualification based process in which case the selected construction manager at risk shall solicit bids from all of its prime contractors for all construction work under this section.
- (2) The private developer or its construction manager at risk may prequalify contractors. The prequalification criteria, if any, shall be determined by the local board of education and the private developer to address quality, performance, the time specified in the bids for performance of the contract, the cost of construction oversight, time for completion, capacity to perform, and other factors deemed appropriate by the private developer and the local board of education.
- (3) A private developer and its construction manager at risk, if any, shall comply with the requirements applicable to a public entity pursuant to G.S. 143-128.2, and prime contractors shall comply with the provisions of G.S. 143-128.2 applicable to contractors, except the private developer and its construction manager shall adopt the local board of education's minority participation goal. The local board of education shall require the private developer to submit its plan for compliance with G.S. 143-128.2 for approval by the local board of education prior to the private developer soliciting bids under this subsection.
- (4) A private developer or its construction manager at risk shall publicly advertise at least 30 days in advance of the bid date in a newspaper having general circulation within the geographic areas served by the local board of education, shall open bids publicly, and shall award each contract to the lowest responsible, responsive, and prequalified bidder, taking into consideration quality, performance, the time specified in the bids for performance of the contract, the cost of construction oversight, time for completion, compliance with G.S. 143-128.2, and any other factors deemed appropriate by the private developer and the local board of education and included in the bid solicitation. A private developer or its construction manager at risk shall enter into the construction contracts directly with the successful



bidder. After the award of a contract or contracts, the private developer or its construction manager at risk and any contractor may negotiate and reach agreement with the successful bidder on modifications to all aspects of the contract, including the time for performance, the scope of the work, and the price to be paid.

- (5) The local board of education, in its discretion, may require the private developer to provide a performance and payment bond for construction work in accordance with the provisions of Article 3 of Chapter 44A of the General Statutes and may require the private developer to provide a bond or other appropriate guarantee to cover any other guarantees, products, or services to be provided by the private developer.

(f) Predevelopment Agreements with Private Developer Authorized. – Local boards of education may enter into predevelopment agreements with a private developer in advance of entering into a build-to-suit capital lease. Predevelopment agreements with private developers shall be approved by the board of county commissioners. Predevelopment agreements may include provisions for each of the following:

- (1) Site selection, land acquisition, and site preparation, including such services as wetlands delineation, archaeological review, and State and local government land-use permitting.
- (2) Building programming and design, including both architectural and engineering services pursuant to subsection (d) of this section.

(g) Real Estate Transfer Authorized. – Notwithstanding any contrary provisions of law, a city, county, or local board of education may, pursuant to the procedures in G.S. 160A-267, sell, lease, or otherwise transfer real or personal property to any private developer for construction, repair, or renovation of a school facility under a build-to-suit capital lease entered into pursuant to this section. The conveying unit may subject the property to any covenants, conditions, or restrictions as the unit deems to be necessary to carry out the purposes of this section. The disposition of property pursuant to this subsection is not subject to the requirements of G.S. 115C-518. No transfer by a local board of education under this subsection shall occur unless it is approved by the board of county commissioners.

(h) Additional Permitted Lease Terms. – In recognition of the potential economic and technical utility of build-to-suit capital leases, which include in their scope combinations of design, construction, operation, management, and maintenance responsibilities over prolonged periods of time, and the potential desirability of a single point of responsibility for these matters in connection with build-to-suit capital leases, any build-to-suit capital lease may include provisions imposing responsibility on the private developer or any identified affiliated entity for any of the following matters:

- (1) Site selection, land acquisition, and site preparation, including wetlands delineation, archaeological review, and State and local government land-use permitting.
- (2) Facility programming, planning, and design, including both architectural and engineering services.
- (3) Qualification and prequalification of contractors and subcontractors.
- (4) Construction and construction management.
- (5) Financing.
- (6) Facility maintenance and repairs.
- (7) Energy usage guarantees.
- (8) Transfer of ownership of the leased property to a local government entity at the end of the lease term.
- (9) Any other guaranties, products, and services as the local board of education may determine.

(i) Letter of Credit. – A private developer shall provide an irrevocable letter of credit for the benefit of laborers and materialmen in an amount not less than five percent (5%) of the total cost of the improvements which are the subject of the build-to-suit

capital lease and shall maintain the letter of credit throughout the construction of the project and for the succeeding six-month period."

**SECTION 2.** G.S. 143-129(e) is amended by adding a new subdivision to read:

"(e) Exceptions. – The requirements of this Article do not apply to:

(12) Build-to-suit capital leases with a private developer under G.S. 115C-532."

**SECTION 3.** This act is effective when it becomes law and is repealed effective July 1, 2011.

In the General Assembly read three times and ratified this the 18<sup>th</sup> day of July, 2006.

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Beverly E. Perdue  
President of the Senate

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James B. Black  
Speaker of the House of Representatives

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Michael F. Easley  
Governor

Approved \_\_\_\_\_ .m. this \_\_\_\_\_ day of \_\_\_\_\_, 2006

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