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Public-Private Partnerships: Bridging California's Infrastructure Gap

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Three experts explain how the enhanced efficiencies of "P3s" can save significant time and money on large public works projects.

>> See article on [Page 36](#)

Our Picks for Top Recent Real Property Cases

We do the work for you: Here are the significant recent real property cases, with expert commentary on the most important ones.

- **General contractor's filing of complaint for breach of contract constituted a refusal to arbitrate with subcontractor and satisfied requirements of CCP §1281.2.**
Hyundai Amco v S3H, Inc [Page 44](#)
- **Federal Telecommunications Act requires localities to provide reasons when denying application to build cell tower, but the reasons need not be in the denial letter.**
T-Mobile S., LLC v City of Roswell [Page 47](#)
- **Statutes authorized city and successor redevelopment agency to "reenter" into certain agreements entered into before dissolution of redevelopment agency.**
City of Emeryville v Cohen [Page 48](#)
- **After successfully defending class action lawsuit, residential developer's suit to enforce indemnity provision in its purchase and sale agreement was properly stricken under anti-SLAPP statute because indemnity provision was unconscionable.**
Lennar Homes, Inc. v Stephens [Page 49](#)
- **Shopping center won preliminary injunction against group soliciting donations in sidewalk area adjacent to entrances of stores within center because that area was not a "public forum."**
Donahue Schriber Realty Group, Inc. v Nu Creation Outreach [Page 53](#)

>> See more inside: [Table of Contents](#)

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BERNHARDT'S TAKE

Professor Roger Bernhardt offers his expert commentary on some of the most significant recent developments in real property law. In this issue, he comments on *California Bank v DelPonti* (guarantors) and *Stockton Mortgage v Tope* (title insurance).

>> See [Pages 46 and 51](#)



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FEATURED ARTICLES

Public-Private Partnerships: Bridging California's Infrastructure Gap

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Theodore K. Klaassen, Esq.

Introduction

Public-private partnerships (P3s) have become one of the hottest topics of interest among public entity facility managers in California and across the United States. In an era of budget cutbacks, the need for alternative, innovative construction delivery methods to repair and replace our aging public infrastructure has reached epic proportions. In November 2011, the California Transportation Commission issued its 10-year needs assessment report regarding California's "traditional infrastructure" needs (highways, roads, public transit, rail, ports, and airports) and concluded that, for that type of work alone, California would face a near \$300 billion funding shortfall over the next 10 years. See http://www.catc.ca.gov/reports/2012%20Reports/Trans_Needs_Assessment_corrected_01172012.pdf (table 3–9 at p 3–58). P3s can help bridge this infrastructure gap by infusing private capital to finance large infrastructure projects and leverage funding payments over the useful life of the new facilities. In fact, Moody's recently concluded that the United States is poised to become the world's biggest marketplace for public-private partnerships as infrastructure needs soar while traditional funding for roads, bridges, courthouses, and other projects wears thin. See https://www.moody.com/research/Moodys-US-is-poised-to-become-largest-public-private-partnership—PR_308002.

P3 is an innovative construction project delivery method that typically involves a long-term partnership between the public entity owner and a private developer (known as a concessionaire) for the concessionaire's design, build, financing, operation, and maintenance of a substantial public improvement work. Usually, a P3 project is built on public land and involves the construction and operation of public infrastructure with a projected revenue stream that is used to help secure and repay the project costs over time. Although P3 projects often involve financing by the private concessionaire, the facilities constructed and operated typically remain under public ownership. P3 projects have been successfully completed worldwide in both the "traditional" (*i.e.*, roads, highways, bridges, rail, ports, airports, water, and other utilities) and "social" (*i.e.*, healthcare, education, judiciary, corrections, and related public buildings) infrastructure sectors. As explained below, P3 is not a solution for all public infrastructure needs, but it is a growing and important

tool for public agencies to utilize for appropriate projects. As the California Legislature has recognized (Govt C §5956):

Local governmental agencies have experienced a significant decrease in available tax revenues to fund necessary infrastructure improvements. If local governmental agencies are going to maintain the quality of life that this infrastructure provides, they must find new funding sources. One source of new money is private sector investment capital utilized to design, construct, maintain, rebuild, repair, and operate infrastructure facilities. Unless private sector investment capital becomes available to study, plan, design, construct, develop, finance, maintain, rebuild, improve, repair, or operate, or any combination thereof, fee-producing infrastructure facilities, some local governmental agencies will be unable to replace deteriorating infrastructure. Further, some local governmental agencies will be unable to expand and build new infrastructure facilities to serve the increasing population.

This and other California P3 enabling statutes are discussed below.

P3 Versus the Traditional Public Works Project

Project Finance: Leveraging the Public Owner's Facilities Budget

A significant difference between traditional public works projects and P3 projects lies in project financing. A traditional, large public works project usually involves some form of public bond financing, often supplemented by federal grant money, to raise the funds necessary to pay the design and construction costs over the several-year-term of project design and construction. For such public bonds, the public owner repays the principal plus tax-exempt interest to the bondholders over an extended period.

In a P3 project, however, the private concessionaire typically obtains all or most of the financing and is paid either

- Directly from the project's revenue stream once construction is completed and operating; or
- By the public owner via milestone and other "availability" payments spread over time.

By utilizing private financing, or a hybrid of private and public financing, public agencies can leverage their infrastructure construction budgets over longer time periods covering more projects.

Every P3 project is unique and the project finance arrangements often vary. Typically, various project finance "tools" are used, including:

- Private equity investment by the concessionaire and/or investors;
- Private loans from commercial lenders;
- Government grants;
- Federal government loan and guaranty assistance programs (e.g., federal SAFETEA-LU/TIFIA); and
- Private activity bonds or other corporate bond financing.

The Transportation Infrastructure Finance and Innovation Act Program (TIFIA) provides federal credit assistance in

the form of direct loans, loan guaranties, and standby lines of credit to finance surface transportation projects of national and regional significance. TIFIA was originally authorized under the Transportation Equity Act for the 21st Century (TEA-21) and was reauthorized and amended in 2005 by the Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users (SAFETEA-LU). TIFIA credit assistance provides improved access to capital markets, flexible repayment terms, and potentially more favorable interest rates than can be found in private capital markets for similar instruments. See <http://www.fhwa.dot.gov/ipd/tifia/defined/>.

Private activity bonds are issued on behalf of a private entity and are generally restricted for use on projects that benefit the public. The obligor under the bond is the private entity, not the government. Other government programs, in addition to TIFIA, include public benefit corporations (used for public buildings, hospitals, courthouses, and schools) and Section 129 loans under 23 USC §129.

Even with multiple funding sources available, these projects have some limitations. Since P3 projects usually are built on public land, which is immune from security instruments, a common issue is finding adequate security to satisfy the private institutions providing project financing. Some government finance assistance programs, like TIFIA, exist to provide such security; currently, however, these are limited to traditional infrastructure projects. Other forms of security sometimes used include private company guaranties or letters of credit.

The Efficient Transfer of Long-Term Project Responsibilities and Risks

A second important difference between the P3 delivery method and the traditional public works project involves the efficient consideration and management of the project's responsibilities and risks. The P3 delivery method takes the efficiencies and risk transfer of the design-build delivery method and extends them throughout the life cycle of the asset. This is a powerful advantage of P3 and, in this respect, it can be seen as a form of "design-build on steroids." By forcing the coordination of the new facility's design and construction with the consideration (and risks) of its long-term performance (via operations and maintenance), the P3 project allows the public owner to ensure that both the construction period risks and long-term operations and maintenance risks for the facility are optimized, and transfers most of these risks to the private concessionaire, who is in the best position to control them.

The Green Building Revolution and P3's Building Performance Guaranties

P3 projects provide a particular advantage in the arena of green building requirements in the United States. New construction of government buildings in California and across the United States is undergoing a revolution in energy conservation. The United States government has ordered that all new federal buildings whose plans are submitted beginning

2020 must meet Zero Net Energy requirements (Executive Order 13514 (Oct. 5, 2009)). California's new CALGreen Code, effective July 1, 2014, includes a policy requiring all nonresidential buildings built in California to meet the same Zero Net Energy requirement by 2030 (24 Cal Code Regs., Building Standards Code, pt 11). Zero Net Energy requires that such new facilities produce at least as much energy as they consume—a stringent requirement currently met by only a handful of buildings in the United States.

By combining building performance risks and transferring them to a single entity for the construction period as well as the long-term operation and maintenance of the facility, P3 allows the public owner to obtain performance building guaranties from the private concessionaire covering not only the new facility's availability for use by guaranteed dates but also its energy performance, accreditation (*e.g.*, LEED, Uptime Institute for tier certifications of data centers, security, and lab facilities) and regulatory (*i.e.*, building codes) performance.

In the green building era, transferring such energy performance risks and responsibilities of the new construction and its long-term operations and maintenance to a single private concessionaire represents a huge advantage for the P3 method.

Design Responsibility and Risk

In a P3 project, the owner typically prepares a conceptual design sufficient to generate comparable proposals and to select a concessionaire. The project design is usually performance-based, rather than prescriptive, giving the concessionaire the freedom to maximize efficiencies and take advantage of its expertise in design and construction.

Perhaps most importantly, the focus on the long-term performance of the asset promotes a natural evolution of efficiencies in asset development—an evolution that began with the increased design/construction efficiencies of the design-build delivery method and now continues with the long-term "life cycle" cost considerations of the P3 delivery method. Design-build increased the efficient design and construction of assets by combining the responsibility of design and build in a single entity or team. This allows the contractors who will construct the building to contribute to the building's design. The result often allows construction to commence before the design is completed, decreasing the time to complete the project, reducing conflicts in the design, and generally increasing the efficiencies of the construction itself.

P3 not only takes advantage of these design-build method efficiencies, it extends them by integrating the long-term operations and maintenance providers into the concessionaire's "team" from the beginning of the design stage. Since the long-term operations and maintenance and refurbishment costs of most facilities dwarf the asset's design and construction costs, this consideration of the asset's "life cycle" costs from the outset results in greatly increased efficiencies and long-term cost savings that often are neglected under earlier delivery methods. See July 2010 Healthcare

BIM Consortium Meeting Slides, available online at projects.buildingsmartalliance.org/files/?artifact_id=4595. (The BIM Consortium consists of the Department of Defense Military Health System, Department of Veterans Affairs, Kaiser Permanente, and Sutter Health.)

Of course, to efficiently transfer design responsibilities and risks to the concessionaire and its team, the owner also must transfer much of the design control. Historically, construction design liability has been governed by the "*Spearin* doctrine," which has been applied in many jurisdictions, including California. In essence, this doctrine states "if the contractor is bound to build according to plans and specifications prepared by the owner, the contractor will not be responsible for the consequences of defects in the plans and specifications." See, *e.g.*, *U.S. v Spearin* (1918) 248 US 132, 136, 39 S Ct 59; *Los Angeles Unified Sch. Dist. v Great Am. Ins. Co.* (2010) 49 C4th 739, reported at 33 CEB RPLR 145 (Sept. 2010); *Souza & McCue Constr. Co. v Superior Court* (1962) 57 C2d 508, 510.

Construction Responsibility and Risk

A P3 project typically places the traditional responsibilities for construction of the project on the concessionaire and often enhances responsibility and risk for items such as testing and inspection of systems, obtaining government permits and approvals, testing and removal of hazardous materials, differing site conditions, indemnities, insurance, and extended warranties. These project agreement terms can carry substantial risks and costs that should be negotiated as between the public owner and concessionaire (and between the concessionaire and its design-build contractor) and reflected in the total contract price before project commencement.

Payment Responsibility and Risk

P3 projects also typically involve either "toll/revenue" or "availability payment" concession. The toll/revenue concession contemplates direct payment to the concessionaire from tolls, user fees, or other revenue produced by the constructed facility after the project is placed in service and during the term of the project's operations and maintenance agreement. However, the trend in the United States is toward the use of the availability payment concession, requiring the public owner to make payments to the concessionaire with substantial payments delayed until the project is operating and providing revenue to the public owner. Often, these availability payments are supplemented with milestone/subsistence payments made before the asset is available. Use of the availability payment model allows the public owner to use P3 to build new facilities even when there will be little (or no) projected revenues from the completed building.

In either case (toll/revenue concession or availability payment), a substantial portion of the payment for construction is made to the concessionaire *after* the facility is substantially complete and generating revenue. This financing structure can allow public owners to leverage their infrastructure construction budgets by spreading financing over longer

project terms and more projects, while shifting more liability and costs to the concessionaire.

Operations and Maintenance Responsibility and Risk

P3 projects generally include a lengthy period during which the concessionaire is responsible for the completed facility's operations and maintenance (O&M). The length of the O&M period varies, but often is 20 to 40 years following completion. The concessionaire typically will contract with a private company or companies having expertise in the particular areas necessary to operate and maintain the asset, and in most instances will involve the operations and maintenance expert in the design phase of the project. This results in considering the substantial long-term operations and maintenance and refurbishment costs of the asset in its original design. Additionally, because the concessionaire is generally responsible for maintenance and operation of the facility, the concessionaire/owner's prime contract typically includes an extended warranty of construction beyond the typical 1-year express warranty period for traditional public works projects. As a result, the concessionaire is obligated as to materials, workmanship, and repairs for a longer period of time.

For the concessionaire and contractor, although the P3 delivery method includes greater or extended risks, if the contract terms and price fairly reflect these risks, this delivery method typically enables larger projects, more control, higher returns on investment, fewer competitors, and often a qualitative element (*i.e.*, best value, rather than lowest bidder) to the bid selection process.

California's P3-Enabling Legislation

P3 projects require specific enabling legislation that typically

- Identifies the public agencies and types of projects to which it applies;
- Specifies the methodology for selecting the concessionaire and sometimes the design-build contractor (to guard against possible collusion);
- Establishes the term of the operations and maintenance agreement; and
- Often expressly mandates that the public improvement remain in the ownership of the government and not be privatized at the end of the project term.

California's most prominent P3 enabling statutes are as follows.

Transportation: Str & H C §143

This statute

- Allows CalTrans and regional transportation agencies, until January 1, 2017, to "solicit proposals, *accept unsolicited proposals*, negotiate, and enter into comprehensive development lease agreements with public or private entities, or consortia thereof, for transportation projects"

(italics added); before this amendment, Caltrans was limited to four P3 projects (that law expired on January 1, 2012); and

- Authorizes contracting entity to impose tolls or user fees.
- Selection is based on low bid or best value.

Local Government Public Works: Govt C §§5956–5956.10

This statute

- Enables local governments to use private investment capital to design, build, and operate "fee producing infrastructure" for the following categories of projects:
 - Irrigation;
 - Drainage;
 - Energy or power production;
 - Water supply, treatment, and distribution;
 - Flood control;
 - Inland waterways;
 - Harbors;
 - Municipal improvements;
 - Commuter and light rail;
 - Highways or bridges;
 - Tunnels;
 - Airports and runways;
 - Purification of water;
 - Sewage treatment, disposal, and water recycling;
 - Refuse disposal; and
 - Structures or buildings (except those to be utilized primarily for sporting or entertainment events).
- Requires payment and performance bonds, and competitive negotiation process, to demonstrate "competence and qualifications" at "fair and reasonable prices."
- Provides for a ground lease from the public owner to the private developer for up to 35 years (at unrestricted rental rates) to enable the design, construction, and long-term operation and maintenance of the facility before it reverts to the public owner.

Limitation: Does not apply to *state* agency projects or projects receiving state funding.

Court Facilities: Govt C §§70371.5 and 70391

This statute

- Establishes the Judicial Council as the policy-making body of the judicial branch.
- Establishes the Immediate and Critical Needs Account for state court facilities (the Account). The Account proceeds can be used for payment of court facilities' rent, leases, or service contracts, including those contracts in which one or more private sector participants share some

of the risks of financing, design, construction, or operation of the court facilities.

- Authorizes the Judicial Council to make recommendations to the State Public Works Board by considering any “economic opportunity”—*e.g.*, any viable financial partnerships with private parties that could result in lower project delivery costs.

High Speed Rail: Pub Util C §185036

This statute authorizes the California High Speed Rail Authority to

- Enter into contracts with public or private entities for design, construction, and operation of high speed trains;
- Acquire rights of way;
- Issue debt secured by pledges of state funds and federal grants; and
- Enter into joint development agreements with local governments and private entities.

University of California: Pub Cont C §10503 (b), (e)

Public Contract Code §10503(b) authorizes solicitation of bids by the Regents of the University of California on a design-build basis and requires the solicitation documents to set out the scope, size, type, and desired design character of the project, performance specifications, a maximum acceptance cost, and an evaluation system for grading contractor proposals. Section 10503(e) expands on this authority by allowing the Regents to solicit bids under such other contracting modes as the Regents determine to be in the best interest of the University, including a P3 delivery method, provided such bids or proposals are compared on a uniform basis and the award is made as specified by the published selection standards. As a result, a number of the UC campuses are utilizing P3 to expand their campus infrastructure in times of tight facilities budgets.

Airports/Local Agencies: Govt C §50478

This statute allows local agencies in California (*e.g.*, cities, counties) to lease or sublease property for airport purposes or incidental purposes, including manufacture of aircraft and related equipment, construction and maintenance of hangars, mooring masts, flying fields, signal lights, service shops, and other air navigation, airport, and airplane facilities. The term of the lease or sublease may not exceed 50 years.

Note: Despite the existing P3 enabling statutes in California, clearly more will be needed if P3 is to be used for a broader array of projects—particularly Social Infrastructure Availability Payment P3 projects.

Federal Legislation

A significant amount of P3 legislation at the federal level is being used for P3 federally financed transportation projects. In 1991, Congress passed the Intermodal Surface Transportation Efficiency Act, a federal pilot program for P3

projects on toll roads. See Pub L 102–240, 105 Stat 1914. That Act was followed by the Transportation Equity Act for the 21st Century in 1998. See Pub L 105–178, 112 Stat 107. In 2005, Congress extended the use of P3s by enacting the SAFETEA-LU and providing \$286.4 billion (including \$52.6 billion for transit) for various federal credit assistance programs through fiscal year 2009. See Pub L 109–59, 119 Stat 1144. In July 2012, Moving Ahead for Progress in the 21st Century (MAP-21) authorized \$105 billion for federal highways, transit, and safety programs for fiscal years 2013 and 2014. See Pub L 102–240, 105 Stat 1914.

President Obama recently announced the creation of a new type of public bond, called Qualified Public Infrastructure Bonds (QPIBs), in his proposed budget to increase opportunities for municipalities seeking to undertake P3s. If approved by Congress, QPIBs would further extend the benefits of municipal bonds to P3s, lowering the cost of borrowing and attracting new capital for these public benefit projects. Obama’s initiative is similar to the Private Activity Bonds Program, which has already supported over \$10 billion on road, tunnel, and bridge projects. However, as currently worded, the QPIBs would expand the limited scope of private activity bond availability only for P3 airport, port, mass transit, solid waste disposal, sewer, water, and transportation projects.

P3 Project Types

P3 projects tend to be appropriate for certain types of public works infrastructure projects, and typically include both “traditional infrastructure” involving transportation/transit projects or utilities (*e.g.*, water treatment facilities, alternative energy power plants) that generate revenue, and nontraditional “social infrastructure” projects such as healthcare, education, housing, hospitality, and even courthouses. Although not a panacea, P3 can be used to help fill the void left by the recent demise of redevelopment agencies in California, for appropriate infrastructure projects. Below are several case studies in California and other states illustrating P3 projects in different sectors.

Transportation/Transit Case Study: The Presidio Parkway Project

The Presidio Parkway P3 project involves Caltrans and the San Francisco County Transportation Authority and consists of replacing the existing Doyle Drive facilities on Route 101 in San Francisco (south access to the Golden Gate Bridge) with a new six-lane parkway-type road and a southbound auxiliary lane in two phases.

Phase I was a design/bid/build project. For Phase II, Caltrans switched to a P3 delivery method and required the concessionaire to design, build, finance, operate, and maintain the facilities. Phase II consists of work on the main Post Tunnels, Northbound Battery Tunnel, utility work, Girard Road undercrossing, northbound lanes, and landscaping. Caltrans selected Golden Link Concessionaire to develop Phase II. Under their original contract, milestone payments were set at \$185.43 million, to be paid at substantial completion, and an

additional payment of \$91 million to the concessionaire on completion of construction. Funding for this project totaled \$364.7 million, which was obtained by Golden Link Concessionaire from various sources.

Airport Case Study: La Guardia Airport Central Terminal

This is a new P3 project for the Port Authority of New York and New Jersey that is pending award to a private consortium/concessionaire. The project includes

- A design, build, finance, operate, and maintain P3 model to replace the La Guardia Airport Central Terminal, roadways, aircraft ramps, and ancillary facilities;
- New construction of the 35-gate/1 million-plus square-foot terminal building while operating the existing transfer tenants in the airport; and
- An “availability payment” scheme whereby the public entity’s significant payments to the concessionaire do not begin until the new asset is substantially complete and ready to generate revenue.

The approximate project value is \$3.6 billion.

“Social Infrastructure” Case Studies

Judiciary Case Study: Long Beach Courthouse

The new Long Beach Courthouse, successfully completed in August 2013, was the first true social infrastructure P3 project in the United States. In fiscal year 2007–2008, the legislature faced a \$2.4 billion deficit in the state’s general fund. The Administrative Office of the Courts (AOC) saw the limitation on the construction fund and worked with the legislature to plan a new courthouse using the P3 delivery method.

Before deciding on P3, the AOC evaluated the following options:

- Design/bid/build;
- Design/build for a court-only building with traditional state management and financing;
- A court building with space for justice partners, using design/build with traditional state management and financing; and
- A P3 delivery method.

AOC selected the P3 method because

- It was more cost-effective both for construction and over the life of the courthouse; and
- It did not obligate AOC to pay for the design and construction until the courthouse was ready for use.

AOC’s analysis indicated that, over the life cycle of the new facility, a P3 approach would cost the state up to \$52 million less than would a traditional state-financed construction project. AOC also estimated that the P3 method would allow AOC to use the facilities 30 months earlier than expected under the traditional design/bid/build process.

Under the P3 arrangement, the private concessionaire entered into a 35-year service agreement with the state. In exchange for the state’s payment of an annual service fee, the private entity designed, built, and financed construction and then will operate and maintain the facilities for 35 years. The state’s total payment to the private entity for design, construction, and financing is fixed, with the portion of the state’s payment representing the costs of ongoing operation and maintenance adjusted annually to reflect changes in an agreed-on index. Under this plan, the state was not obligated to make any service payments until the building was completed.

Financing for the project was obtained from equity contribution of approximately 10 percent of the construction cost and loans obtained by the concessionaire from private lenders for the remainder of the project costs. The concessionaire was Long Beach Judicial Partners LLC, comprised of Meridiam Infrastructure, Clark Design/Build of California, Edgemoor Real Estate Services, Johnson Controls, and an AECOM-led design team. A post-completion report by AOC (the project owner) validated its “value of money” analysis and decision to utilize the P3 delivery method, concluding that the project was completed on budget and that the P3 method enabled the courthouse construction to be completed nearly two years faster than a similar AOC courthouse construction project in San Bernardino. See http://www.courts.ca.gov/documents/lr_gov_deukmejian_courthouse-SB-75.pdf.

Education Case Study: UC Student Housing

The University of California (UC) has jumped to the vanguard of social infrastructure P3 use in California. UC has used P3 to deliver approximately 60 projects ranging from student apartments and hotels to medical office buildings and research facilities. See Schanck & Lamont, *Capital Resources Management, Private Public Partnerships at the University of California* (July 12, 2010), available online at http://www.ucop.edu/real-estate-services/_files/documents/ppp_at_uc.pdf. UC Merced currently is planning the largest social infrastructure P3 project in U.S. history—the “2020 Project”—which would allow the campus to nearly double its existing student body by 2020, adding almost 2 million square feet of academic, housing, recreation, and related campus facilities. The 2020 Project, valued in excess of \$1 billion, is in its pre-award/concessionaire selection stage.

Healthcare Case Study: UCSF Neuroscience Building

Although numerous large hospitals and other healthcare facilities have been built in the British Commonwealth and Europe using the P3 method, the only California P3 healthcare project to date known to the authors is the UCSF Neuroscience Building. This project involved a six-story research building with laboratories and clinical space at the UC San Francisco Mission Bay Campus. Financing was arranged through a hybrid tax-exempt bond finance model made available through a nonprofit entity and a conduit issuer. For more information about this project, see Schanck

& Lamont, *Capital Resources Management, Private Public Partnerships at the University of California* (July 12, 2010), p 8, available online at http://www.ucop.edu/real-estate-services/_files/documents/ppp_at_uc.pdf.

Hospitality Case Study: Omni Hotel, Dallas

Publicly owned hotels and convention centers that will generate revenue also are appropriate for P3 development consideration. A number of cities in the United States need more hotel space to attract business and tourism. For example, Dallas, Texas, developed a 23-story, 1000-guestroom hotel with 80,000 square feet of meeting space on city-owned land adjacent to its existing convention center. Using a P3 model, but with mostly public revenue bond financing, the city contracted with a private developer who, in turn, hired a design-build team to complete the project. The city entered into a separate long-term operating agreement with Omni Hotels to operate and maintain the hotel, which opened in early 2012 and has greatly enhanced the area's business climate. According to media reports, the hotel's construction came in under budget and the profitability of its first year of operations exceeded the city's own budget projections. See *Omni Plans to Build Underground Garage*, Dallas Morning News, July 26, 2012, Briefing, p 5; see also Bush, *Omni Raking In More Than Expected in First Year*, Dallas Morning News, Dec. 18, 2012, p A01.

Conclusion

Although P3 is not appropriate for all public works projects, it can be a very efficient and effective construction and maintenance delivery method for large public projects consisting of buildings or infrastructure that are expected to generate a revenue stream. By bundling the asset's design and construction with its long-term operation and maintenance from the outset of development, P3 represents an important evolution of the efficiencies realized in the design-build project delivery method. This, combined with P3's element of increasing budget leverage for public entities in the short term, has greatly increased public agencies' interest in P3 and promises to spark its use and growth in California and throughout the United States.

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