The Regents of the University of California

COMMITTEE ON GROUNDS AND BUILDINGS
COMMITTEE ON FINANCE
September 16, 2015

A meeting of the Committees on Grounds and Buildings and Finance was held on the above date at the Student Center, Irvine Campus.

Members Present: Representing the Committee on Grounds and Buildings: Regents Davis, Makarechian, Oved, Pérez, Ruiz, Sherman, and Zettel; Ex officio members Lozano, Napolitano, and Varner; Advisory members Hare and Schroeder; Staff Advisors Acker and Richmond

Representing the Committee on Finance: Regents Davis, Gould, Island, Kieffer, Makarechian, Newsom, Ortiz Oakley, Reiss, and Ruiz; Ex officio members Lozano, Napolitano, and Varner; Advisory members Hare and Ramirez; Staff Advisors Acker and Richmond

In attendance: Regents Blum, De La Peña, Gorman, and Pattiz, Regent-designate Brody, Faculty Representative Chalfant, Secretary and Chief of Staff Shaw, General Counsel Robinson, Chief Compliance and Audit Officer Vacca, Chief Investment Officer Bachher, Provost Dorr, Executive Vice President and Chief Financial Officer Brostrom, Executive Vice President and Chief Operating Officer Nava, Executive Vice President Stobo, Senior Vice Presidents Henderson and Peacock, Vice Presidents Budil, Duckett, Humiston, and Sakaki, Chancellors Block, Blumenthal, Gillman, Hawgood, Katehi, Leland, Wilcox, and Yang, and Recording Secretary McCarthy

The meeting convened at 9:30 a.m. with Committee on Grounds and Buildings Chair Makarechian presiding.

1. **APPROVAL OF MINUTES OF PREVIOUS MEETING**

Upon motion duly made and seconded, the minutes of the meeting of July 21, 2015 were approved.

2. **UPDATE ON THE 2020 PROJECT, MERCED CAMPUS**

[Background material was provided to Regents in advance of the meeting, and a copy is on file in the Office of the Secretary and Chief of Staff.]

Committee on Grounds and Buildings Chair Makarechian advised that the discussion would focus on those questions raised at the prior meeting such as whether the Merced

2020 Project (Project) should be divided into various separate contracts and the specifics of the Project's financing.

Chancellor Leland began by stating that this presentation would focus on the Project's risks and how they would be mitigated, with the goal of ensuring that the Regents were fully informed about the Project prior to consideration of an action item at a future meeting. Other questions posed by the Regents at the July meeting have been addressed. The objective of the 2020 Project was to enable UC Merced to increase its capacity to 10,000 students cost-effectively and rapidly. The advantages of using the proposed design-build-finance-operate-maintain (DBFOM) delivery method include faster delivery to meet both campus and University long-range enrollment targets, long-term financial predictability based on life-cycle financial plans for campus capital needs, efficient coordination, and avoidance of the significant interface risk of multiple simultaneous building projects. She acknowledged that no capital project was without risk, regardless of delivery method.

The two main categories of project risk were construction-delivery risk and financial risk. The campus had been able to gain insight from similar projects in Canada and Europe completed with the chosen delivery method. Responding to a request at the prior meeting, Chancellor Leland advised that representatives of Nossaman LLP, a firm that had advised similarly structured public agency projects, and Ernst and Young, advisors to public sector clients on financial structuring of infrastructure projects, were in attendance to answer questions. Both firms worked on the 2020 Project exclusively for UC Merced to develop a project structure.

Campus Counsel Elisabeth Gunther provided an overview of the legal structure of the 2020 Project and the Project Agreement (Agreement), focusing on risk allocation and contractual protections to manage and reduce risk to the University. The 2020 Project would face many of the same risks as all University projects. The delivery method chosen to reduce risk would be different from those used on previous University projects and presented significant advantages for the Merced campus in delivery time, quality of design and construction, elimination of deferred maintenance and renovation costs, and certainty of operating performance and maintenance costs. The campus was in the process of refining the terms of the draft Agreement, including meeting with short-listed development teams to understand the commercial and technical viability of the proposed terms. The Agreement would be finalized and the Request for Proposals (RFP), including the Instructions to Proposers and the commercial terms, would be presented to the Regents for consideration and approval before the RFP was finalized and released to the teams. Ms. Gunther anticipated that some terms would likely change before finalization and any changes would be highlighted to the Regents at a future meeting. If approved, the Agreement would be entered into with the winning developer and its equity partners. The developer would form a special-purpose entity for the transaction. The contractual obligations ensure that the equity investors backing the transaction have their equity at risk throughout the entire term of the agreement, providing significant performance incentive. The developer would contract with the design team, prime construction contractor, and operations and management (O&M) contractor. The developer would take the risk of coordinating design and construction and resolving disputes among the contractors, and would not get relief from delivery deadlines because of the failure of a contractor or design professional to perform.

The short-listed developers were chosen based on their financial strength and the qualifications of their equity partners, prime contractors, and key design firms, with restrictions on any substitutions of these entities during the construction and operating periods. Most importantly, any substitution of the prime construction contractor would be subject to approval of the University in its sole discretion. The firm proposed to be substituted must meet the minimum experience and qualification requirements set by the University for this procurement. The developer would be responsible for fulfilling all the contractual commitments to the University and the developer's investment would remain at risk for the duration of the 39-year contract.

Ms. Gunther described the fundamentals of the Project's financing. The developer would finance the Project construction. However, the financing would be structured as Project financing, meaning that the developer's lenders would not have a security interest in the buildings, land, or any other University asset; the lenders' recourse would be to the developer's milestone and availability payments. These payments would be set by contract and subject to reduction if the developer failed to perform. Reductions of the availability payments would be permanent and would not be reimbursed after the non-performance was cured, creating a significant incentive for the lenders to monitor performance throughout the contract term. For that reason, lenders would establish a robust system of monitoring performance and the University would have a right to monitor those documents on an ongoing basis.

The Project Agreement was based on an established form of contract used for similar projects that have proven successful, customized to UC Merced's facility types and performance needs. All terms had been analyzed to ensure they reflect campus needs, and to allocate risk and responsibility appropriately. Key terms included delivery dates, payment schedules, noncompliance points, availability payment deduction regimens, handback standards, and restrictions on assignment of the developer's interest and the substitution of prime contractors.

Ms. Gunther pointed out that the payment mechanism was the key to understanding the financial incentives for performance during the construction period. The University would not make progress payments as it would under a typical construction contract. Instead, it would make three milestone payments for amounts substantially less than the value of the work in progress, including materials procured but not yet integrated into the project (work "in the ground") at that time. The first payment of $50 million would be made when $100 million of work was in the ground; the second milestone payment would be made upon delivery of the first group of facilities to be completed in 2018. At that point, the University would have paid $300 million and would have approximately $600 million of work in the ground. At substantial completion, the University would have paid $600 million, with approximately $1 billion of work in the ground. Throughout the construction period, the University will have paid approximately 50 percent of value of the total work, creating a significant retainage in the event of default; at the time of substantial completion, the University would have paid 60 percent. The other 40 percent would remain at risk and incentivize the developer's performance throughout the life of the contract, which included the operating period.

Ms. Gunther addressed two key concerns that had been expressed by the Regents: the Agreement's allocation of specific risks and the University's protection in the event of problems during the design and construction or operating periods. Risk allocation between the University and the developer was carefully assessed and assigned in the Agreement on an issue-by-issue basis. The Agreement also addressed the risk to the University should problems occur during the construction or operating period, and provided contractual protection for the University to manage and reduce the risk. The risk of performance failure or breach was mitigated by the timing of the milestone payments, the liquidated damages for delayed delivery, reduction of availability payments, noncompliance points, step-in provisions, and default and termination provisions.

Ms. Gunther discussed risk allocation during design, construction, and normal operations. The University would not relinquish certain risks related to its core mission, including enrollment, State support, auxiliary revenues, delivery of academic program, and UC's reputational risk. The University would choose to retain certain other risks faced on all capital projects. Other risks common to all capital projects would be shifted to the development partner, resulting in financial and operational benefits to the campus. Under the Agreement, risk was allocated by determining which party was best able to control that factor and the relative cost of retaining the risk versus shifting it to the developer. Shifting a risk that the University could best control to the developer could result in a potentially significant contingency built into the contract price, a situation the campus sought to avoid. Some examples of risk that would be retained by the University included changes to the contract specifications during construction or operations, changes in law, force majeure events, and unknown environmental conditions. On the other hand, the developer would assume costs associated with known environmental conditions, technological changes during the operating period, and, most importantly, quality of construction, equipment and performance failure, long-term maintenance of building systems, and renewal work.

As to remedies and protections in case of a problem or dispute, the Agreement contained a robust scheme to manage and reduce risk by ensuring the Project would stay on track to avoid defaults and disputes. The contract administration structure would be key to managing performance issues. The campus was developing its workforce plan to manage the contract and had set up a structure designed to minimize owner changes to contract specifications, often a factor that increased delay and disputes. In this area, delivery of the Project under a single contract would benefit the campus by simplifying contract administration and shifting the interface risk to the developer. The complexity of the 2020 Project would be in its coordination and not in the construction itself. Ms. Gunther expressed the campus' view that the method of delivery and structure of the Agreement provide greater protection for the University and would result in fewer disputes than a more traditional delivery method would. Responsibility for resolving disputes with the prime construction contractor or its subcontractors would lie with the developer, not the University, and the University would not make its final milestone payment until work was successfully completed. Even then, the developer's equity investment would be at risk in the event of future nonperformance. Subcontractors would be paid by the developer on a progress-billing basis during construction as required by California's Prompt Payment statutes, a process the University could monitor through its audit rights. Thus the developer would be funding construction in the whole, and would be compensated for the work later through the milestone and availability payments. During the construction period, the University will have paid for only 50 percent of the work completed, creating significant retainage and much greater incentive for the developer to perform, protecting the University in the case of complete default, and reducing the University's need to rely solely on performance bonds as security for contract compliance during the construction period.

In the event of delay of delivery of key buildings such as student housing, the Agreement would provide for liquidated damages in an amount sufficient to cover the cost of mitigating the damage. During construction, the developer would be required to provide regular reports of progress against its master schedule, allowing the University to take early action to mitigate its damages, for example to secure alternative housing or classrooms. If a dispute should arise between the University and the developer, the Agreement would provide for dispute resolution during which work must continue. If a dispute should arise between the developer and its team members, the developer would assume all risk of any cost increases or delay.

Ms. Gunther discussed the University's several levels of protection during the operating period. First, the developer would have the risk of any design and construction defects by being held to a performance standard. If the buildings did not meet the standard, the developer must cure any defects at its own cost, while receiving noncompliance points and availability payment reductions for any inability of the University to use the facilities at the specified level. The accumulation of noncompliance points could eventually result in default under the Agreement. The developer and lender would both have significant financial stake in the Project and would be incentivized to step in to remedy a breach before the University would need to take action. For example, in the case of a failure to perform on the part of a construction or O&M contractor, both the developer and the lenders would be at risk of losing their investments and would have the right to ensure performance up to and including replacing the non-performing contractor. Lenders would have the right to step in should the developer fail to perform. In the unlikely event of a complete default, the lenders could take over the Project and replace the non-performing developer. In the event the lenders would not take such action, the University would have the right to step in and take over the Project. The Agreement would set forth a specific formula for a financial resolution in this event. Generally, the developer would lose its equity investment and the lenders would take a reduction on the repayment of their loan balance, providing a strong incentive for them to avoid this type of default. In this case, the University would need to refinance the Project, but would retain the buildings and would take over the long-term O&M. Because there would be no lease in this transaction and the lenders would have no security interest in the property, the University would have unfettered control over its facilities.

This single contract delivery method would provide greater performance incentives than would exist under multiple contracts. A breach or non-performance on a single building would put the developer's and lenders' entire investments at risk, increasing the likelihood of performance and prompt remedial action. Ms. Gunther stressed that at all times the University would own the land, work in progress, and completed facilities, and could ultimately remove the non-performing party from the site. Liquidated damages for missed delivery dates would supplement the step-in scheme to ensure that the University would be protected against costs resulting from delay. While these protections would not make up for reputational risk and inconvenience associated with the University's inability to open a new facility on time, they would cover the costs associated with temporary facilities.

Executive Vice President and Chief Financial Officer Brostrom further elaborated the unique financial aspects of the Project and their benefits. Rather than pay a contractor for design and construction services prior to completion of the buildings, the University would employ a payment structure in the DBFOM model using two types of payments. First, milestone payments would be made after specific construction milestones were achieved and would be substantially less than the value of the completed construction. In contrast to progress payments in typical financing, the developer would retain a significant financial liability, not only at the completion of construction, but also through the 39-year term of the contract that would include a 35-year operating period, enabling the University to hold the developer liable for the performance of the buildings after completion. The second kind of payment would be availability payments based upon the buildings' availability to the University and meeting the contract's performance standards. Should performance fall below those standards, payment to the developer would be reduced, enabling the University to maintain accountability of the developer and the quality of the Project.

Milestone payments, reducing the University's costs and maintaining accountability of the contractor, were modeled to be about 60 percent of the $1 billion total construction cost, or $600 million, to be issued in three different tranches. First, $50 million of Century Bonds would be used for a milestone payment once the developer had $100 million of demonstrated work in the ground. Two later milestone payments made upon completion of the first group of facilities to be delivered in 2018 and the entire Project in 2020 would be financed by general revenue bonds and limited project revenue bonds. Mr. Brostrom emphasized that under this delivery model the developer would retain significant exposure and financial liability throughout the construction period.

Mr. Brostrom explained how this finance strategy would balance the cost of capital to share performance risk. Using 100-percent University financing would gain the advantage of the University's low cost of capital, but would forfeit the accountability and shared risk of the DBFOM delivery model. Moving all financing to the developer would shift all risk, but at an increased cost of capital, estimated to be 150 to 200 basis points higher. Using a hybrid financing approach would both reduce the cost of capital and ensure that the developer would have significant financial liability through the term of the contract. This hybrid model would cost more than traditional financing, but that cost would be outweighed over the Project's lifetime by the advantages of speed of delivery and reduction in development and construction costs.

The upset limit of $105 million, the maximum Project annual cash flow for the campus, would include the principal and interest on debt paid by the campus to fund milestone payments, day-to-day related campus operations, and the availability payments made to the developer upon successful performance under the contract. To be responsive in the RFP process, developer teams must submit proposals with campus cash flow within the upset limit. Because of the importance of the upset limit to the success of the Project, Mr. Brostrom and Chancellor Leland recommended employing a third party to evaluate the assumptions underlying the upset limit to ensure that best value for the Regents and the campus would be ensured. The RFP would require a substantial amount of information from the bidders in their proposals, including finance plans, a detailed financial model with all assumptions about design, construction, operations, and maintenance, and stress testing under various circumstances. Evaluation teams from the Office of the President and subject matter experts would assess the financial health of each developer team.

Regent Ruiz asked for more information about other projects in which the DBFOM delivery model had been used successfully. Mr. Brostrom responded that the DBFOM model had been used extensively in Europe and Canada in development of many social infrastructure projects, and in the United States primarily for transportation projects.

Regent Ruiz observed that the Project's lifespan was 39 years and asked if other projects had such a long lifespan. Vice Chancellor Daniel Feitelberg said the length of similar projects developed with the DBFOM delivery method varied, with some as long as 99 years. The campus' analysis to determine the appropriate timeframe rested upon campus goals and objectives to transfer risk associated with the long-term maintenance of the facilities, requiring the developer to go through at least one full capital replacement cycle during which heating, ventilation, air conditioning, and other building systems would be required to be replaced.

Regent Ortiz Oakley asked if the Merced campus was currently at enrollment capacity, and how the campus would handle the risk of possible work stoppages on its enrollment capacity. Chancellor Leland responded that UC Merced's enrollment was currently over capacity. For example, at the beginning of the current semester its residence halls housed 300 more students than they were designed to hold; classrooms and office buildings were also over capacity. As to future trends, UC Merced has had either the highest or next-to-highest enrollment increase of any UC campus over the past few years. The vast majority of new students entering in the current year had applied directly to UC Merced, rather than through the referral pool. There was no other UC campus in the San Joaquin Valley. The Merced campus provides an opportunity for a college education to many students who cannot travel far from home because they contribute significantly to the welfare of their families. California demographics indicated that the populations served by UC Merced were growing. Ms. Gunther added that, from a practical standpoint, the timing of increasing enrollment and the development of the new facilities had been carefully planned so the campus could continue to grow during the four-year construction period. The Agreement would contain contractual protections such as strong incentives for on-time delivery and liquidated damages to cover the costs of alternatives in case of delays. The 2020 Project facilities were highly flexible spaces that would help accommodate increases in growth while new facilities were becoming available.

Regent Zettel asked about the composition of the Disputes Review Board and why its decisions would be non-binding. Ms. Gunther responded that the three-person Disputes Review Board would include a member appointed by the University, one appointed by the developer, and a third party, all to be mutually agreed upon, an arrangement she characterized as typical. The Disputes Review Board would have very tight time frames, so decisions would be made on an immediate basis during the construction period. A decision of the Board would be considered binding until it was resolved. Parties would have the opportunity to pursue litigation, but that would not slow down the Project. Ms. Gunther expressed her view that the University preferred non-binding arbitration in order to retain its right to litigate if necessary.

Regent Zettel asked who would analyze the financial models of the developers' proposals. Mr. Feitelberg responded that the campus would use its external financial and engineering consultants, as well as expertise at the campus and the Office of the President to evaluate proposals.

Regent Kieffer expressed support for the contractual provisions of the Agreement, including the management of risk and the University's maintenance of control of the property. He asked if the short-listed developers were comfortable with the Agreement provisions. Ms. Gunther responded that the draft Project Agreement had been circulated with proposed terms based on a precedent model that had been used successfully. The campus was currently in its third round of receiving detailed questions about both commercial and technical terms from the three short-listed developer teams, after having responded to developers' feedback in two earlier rounds.

Regent Sherman asked how the campus would monitor the developer's compliance during the course of the Project. Chancellor Leland responded that the campus was in the process of establishing a sophisticated construction management structure as part of its workforce planning, and would share those plans with the Regents for feedback and input.

Regent Gould commended Chancellor Leland for reminding the Regents that UC Merced serves students from the Central Valley and has accomplished great work particularly in the fields of science, technology, engineering, and mathematics. He expressed satisfaction that exit strategies and risk management in the Project Agreement had been clarified. Regent Gould asked Mr. Brostrom if he had received assurance of the State administration and Legislature's support for the Project. Mr. Brostrom noted that the

Project represented a commitment by the Regents of over $1 billion and pointed out that the State had contributed to the development of earlier UC campuses such as UC Irvine and UC Santa Cruz. The risk of this development would be shared between the Merced campus and the UC system. Over the upcoming eight years, one-third of all State appropriations to UC for capital development would support the Merced 2020 Project. The University had met with the Department of Finance a number of times. As part of the debt restructuring several years prior, the University gained the ability to commit a small portion of its State appropriation to capital development, since the State was no longer issuing lease revenue bonds. Regular briefings would be held with State officials to keep them apprised of the Project's progress. Mr. Brostrom expressed his view that, in general, the State's reaction had been quite favorable.

Committee Chair Makarechian asked about allocation of financial risk for the Project. He expressed his understanding that the University would be responsible to pay $600 million in milestone payments and asked who would be responsible for the other $400 million of financing. He pointed out that the developers' financing $400 million would not be an equity contribution. Mr. Feitelberg commented that the $400 million would be a combination of equity and debt. The developer would be required to contribute ten percent of the $400 million. Committee Chair Makarechian asked where the contract term that the developer would contribute $40 million appeared in writing. Mr. Brostrom responded that it would be a term of the Project Agreement. Committee Chair Makarechian asked if that $40 million equity contribution would be held throughout the 39-year term of the Agreement. Mr. Brostrom answered in the affirmative.

Committee Chair Makarechian asked for clarification of the collateral on which the developer's remaining $340 million would be financed. Mr. Feitelberg commented that the developer's financing would be against the pledged availability payments and subject to the adequate performance of the buildings. The lenders would take the risk of the developer's not delivering buildings and the commensurate reduction of the availability payments. Thus, the requirements to perform under the Agreement were built into the debt and the equity commitments. Mr. Brostrom reiterated that the developer would have no security interest in the buildings. The lenders would have an interest in ensuring that the developer delivered the buildings and that the performance standards were met during the operating term of the contract.

Committee Chair Makarechian expressed his view that a developer's $40 million equity commitment was not substantial for a $1 billion project. The University would be at risk for all the other funding. Given that relatively small developer equity contribution, it would be even more important to have a sufficient payment and performance bond, not just 25 percent of the Project as had been proposed at prior meetings. Ms. Gunther observed that other University construction projects have had payment and performance bonds of less than 100 percent. UCSF used a phased bond for development of its Mission Bay hospital, $250 million for each phase of construction. She added that the Office of the General Counsel had opined that it would be permissible to have less than a 100-percent payment performance bond. The campus' legal and financial consultants had advised that its proposed payment and performance bond would provide adequate protection for the Project, given the retainage and the fact that the University would not have paid for all the work in the ground. Committee Chair Makarechian reiterated his view that the proposed amount of insurance was minimal in relation to the value of the Project. He asked that the campus address this concern at a future meeting. The enormous scale of this Project required equally large guarantees, particularly from the single developer who would execute the work and who would presumably be both sophisticated and litigious. Mr. Brostrom reiterated that a third-party evaluation of the upset limit and of the adequacy of the payment and performance bond would be obtained. The proposed financing structure had not been finalized. Short-listed developers would submit their financing plans.

Committee Chair Makarechian also asked for some assurance that the State would contribute its portion. Mr. Brostrom said a very small portion of the University's State appropriation, about $15 million per year, would be reserved for capital projects.

Chairman Lozano expressed appreciation for the work of Chancellor Leland and her team in proposing a new model that would be sustainable over the long term for development of the Merced campus.

The meeting adjourned at 10:35 a.m.

Attest:

Secretary and Chief of Staff