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Memorandum

TO:	Renee Swanye, Chairperson, CBOC Measures A, B & J CBOC Committee Members Antwan Wilson, Superintendent Jacqueline Minor, General Counsel Lance Jackson, Interim Deputy Chief, Facilities	DATE:	April 1, 2015
FROM:	Cate Boskoff, Facilities Counsel		
RE:	• Bond Project Construction Delivery • Lease-Leaseback Agreements • OUSD Completed Project Results – Lessons Learned		

K-12 CONSTRUCTION DELIVERY OPTIONS

Under California law, there are 3 construction delivery methods available to public school districts – 1) Design-Bid-Build; 2) Design-Build; and 3) Lease-leaseback:

1. **Design-bid-build** -- school districts hire an architect/engineer through an RFP process to design a project and then following a proscribed advertisement process, award the contract to the lowest responsive, responsible bidder. (Prior to 2011, all OUSD capital projects were constructed via the design-bid-build delivery method.);

2. **Design-build** -- following an RFP process, school districts contract with one entity to both design and build the project. (The multi-site PV and Energy Savings Design Project with SunPower Corporation Systems was constructed using the design-build delivery method.);

3. **Lease-leaseback--** school districts "negotiate" directly with contractors pre-selected through and RFQ process, without adhering to formal bidding requirements. (Since 2011, OUSD has completed 8 major modernization and new construction projects, and 3 seismic retro-fit projects using the lease lease-back method.)

Lease-leaseback has emerged as OUSD's preferred option on its major capital projects because by the use of lease-leaseback, the District has insured that local business mandates are met, with the majority of projects exceeding 70% local participation.

STRUCTURE AND HISTORY OF LEASE LEASEBACK AGREEMENTS

A lease-leaseback agreement is comprised of two separate leases: a "Site Lease" and a "Facilities Lease." Through the Site Lease, the District leases a project site to a contractor/developer ("Developer" aka the General Contractor) for a minimum of one dollar ($1) per year. Through the Facilities Lease, the District subleases-back the project site from the Developer and, as "rent," pays the Developer for the construction of improvements (new construction or modernization) on the project site. At the conclusion of construction both leases terminate, and the "rent" paid for by the District equals the Developer's cost of construction of the improvements. Under this procedure, and subject to some limitations discussed later, the District has the benefit of selecting the Developer who will construct the improvements, rather than rely on the "low bid" process.

As a practical matter, the lease-leaseback transaction looks very similar to a typical construction project. An architect drafts plans that must be approved by the State, the project must have an inspector of record. The Facilities Lease looks very similar to a typical public construction contract, and performance and payment bonds are required as are compliance with prevailing wage regulations and other requirements of public construction. The only real differences are the selection process of the Developer (i.e., general contractor) to construct the improvements and the contracts required to create the appropriate relationships and obligations.

The lease-leaseback method dates back to the "baby-boom" following World War II. Recognizing the need to permit school districts to partner with private developers to accommodate the surge in students, the California Legislature enacted Education Code §17406 authorizing the lease of public property to private developers to construct school facilities and for payment to be in the form of rent paid by the schools to the Developer as compensation for the construction. The unique feature of lease-leaseback is that the Developer could be hand selected rather than requiring the school or District to contract with the lowest bidder.

DEVELOPER SELECTION PROCESS

Education Code §17406 authorizes Districts to select *any firm* to perform work under the lease-leaseback model. However, OUSD follows a competitive solicitation, comprised of a combined request for qualifications ("RFQ") and request for proposals ("RFP") process that is centered on maximization of small local contractor participation, and requires that non-local Prime contractors form bona fide joint ventures with certified small local construction firms.

PRECONSTRUCTION SERVICES

One clear advantage to Districts utilizing lease-leaseback delivery is the ability to enter into Preliminary or Preconstruction Services ("Pre-con") Agreements with the selected Developer before entering into a lease-leaseback agreement. In these circumstances the Developer participates in the design process of a project, during which the Developer reviews and analyzes the plans and specifications, provides comments, points out potential problems and potential cost savings. This process greatly increases the chances of an accurate schedule and budget and reduces the likelihood of change orders once the lease-leaseback contract has been issued. Unfortunately, OUSD has for the most part not had the benefit of true Developer / Contractor participation in the design process on lease-leasebacks entered into prior to the passing of Measure J. This is because the decision to use the lease-leaseback structure came late in the design process, often after Division of State Architect approval, affording little input from the General Contractor. With Measure J, Facilities staff has entered into a select number of Pre-con agreements very early in the design process, and expects that this will have a positive impact on both lease-leaseback *and* design-bid-build projects currently underway. Because there is no requirement under a Pre-con agreement to enter into a lease-leaseback once the project is through Division of State Architect, the peer/constructability review conducted prior to bid under Pre-con agreements is beneficial to both delivery models.

LEASE-LEASEBACK COST EFFECTIVENESS

There are varying schools of thought about the cost effectiveness of lease-leaseback agreements. Many argue that design-bid-build delivery, with the requirement that the lowest “responsive / responsible” bidder be selected, is the only way to ensure a project is built for the best value, and that lease-leaseback increases the cost of construction by removing any incentive to reduce fees, overhead and profit typically gained through formal bidding. However, this view fails to recognize an inherent flaw in design-bid-build delivery: in order to be the “low bidder”, the contractor in preparing its estimate is <u>actively</u> looking for design errors and omissions that will later become the basis for change-order work. In contrast, lease-leaseback (in conjunction with a Pre-con agreement) effectively eliminates design errors and omissions and, absent true “unforeseen conditions”, warrants that the project will be built for the maximum price “guaranteed” by the developer. In effect, a project that is less costly to begin with (design-bid-build) can be significantly more costly upon completion, whereas a project more costly at the start (lease-leaseback) should remain static. Thus, so long as the initial Guaranteed Maximum Price quoted by the developer is in line with the Architect’s estimate, negotiated lease-leaseback delivery should be comparable, or potentially less than formally bid design-bid-build projects.

Attached for general cost comparison analysis only, is a synopsis of recently completed projects, delivered by both design-bid-build and lease-leaseback. (Also included on the spreadsheet are examples of the cost of school construction performed by other California school districts, compiled from information gathered through online research.)

It should be noted that the listed projects vary greatly in complexity, are dissimilar in scope (modernization versus new construction or a combination of both) and often contain significant site/stabilization work, all of which can skew the ultimate cost per square foot (“sq/ft”) of the project. For example, Calvin Simmons a lease-leaseback, new construction project encountered a costly unforeseen condition when it was discovered that a live sanitary sewer-line ran directly under the existing campus buildings, a clear Division of State Architect and City Uniform Building Code violation. In order to tie the new building into the underground utilities, the Joint Venture Developer was required to completely re-route the line, causing significant delay and increase in the overall costs of construction, thus the cost per sq/ft noted on the spreadsheet is distorted. Conversely, Highland Elementary School, a lease-leaseback modernization and new construction project, was completed for the initial Guaranteed Maximum Price quoted by the Joint Venture developer, in-line with expectations for the Lease-leaseback delivery method. Other anomalies and constancies can be gleaned from projects formally bid under the design-bid-build process.

With respect to the overall sq/ft cost of construction on OUSD school projects in comparison with other school districts (in and out of California), I refer you to an informative dissertation entitled “THE COMPLEX AND MULTI-FACETED NATURE OF SCHOOL CONSTRUCTION COSTS: Factors Affecting California.”

According to the author, “it is extremely difficult to determine and compare school construction costs across districts and states, because costs are reported with varying scope and accuracy. This is in part due to the varied complexity of each project. . .. There is no universal standard format by which school construction costs are accounted. Not only is this true across states, but it appears to be true within most states, including California. There is no historical database for California school construction costs that compares like cost components. Comparing industry data is similarly difficult because they too differ in what costs are included. Some sources include only hard construction cost, some include land, others exclude land acquisition but include site development and others include hard and soft costs, but exclude “after-bid” (i.e., actual change order) costs. While these cost components differ widely, adjustments made to compare across projects or states also differ. Some sources utilize indices to adjust for bid date and/or regional geographic differences." The unsystematic way school construction expenditures and costs are reported limits any research ability to adequately determine the full range of factors driving school construction costs. (*Id. At page 37).*

This analysis is of particular relevance to OUSD, as the District is unique in its aggressive focus on local small business participation; achieving equity in the construction industry is not without attendant cost.

The link to this article is:
http://citiesandschools.berkeley.edu/reports/K-12_CA_Construction_Report.pdf.
A printed version is attached to this memorandum.

COMPLETED LEASE-LEASEBACK PROJECTS – LESSONS LEARNED

Below is a brief assessment and comparison of 5 major Lease-leaseback projects completed under Measure B, listed in order of Board approval. While it is impossible in this summary to capture every variable on these complicated public works projects, efforts to identify salient characteristics within the context of Lease-leaseback delivery and OUSD's Local Business Policy should be evident.

- **Highland ES – Modernization and New Construction** – The Highland ES Project was the first OUSD lease-leaseback and was constructed by the tri-venture partnership of ADCo, Turner Group and Alten Construction, Inc. As is demonstrated by the attached cost comparison spreadsheet, this Project was a "success" for the Lease-leaseback program and for the JV small business partners. Interestingly, the negotiated partnership relationship that Lease-leasebacks are intended to foster helped overcome a very concerning problem that occurred on the Project when it was discovered that the Architect had falsified records with respect to its licensing status and Division of State Architect filings. The JV worked with the District and Division of State Architect to correct the errors and OUSD successfully sued the fraudulent company, obtaining a Superior Court judgment in the amount of $361,311.00.

- **La Escuelita Educational Complex – Phase 1, Increment 2** – New Construction From a claims and overall quality standpoint, the LEEC Project ranks at or near the bottom of the recent Lease-leaseback projects. Weaknesses in project management and contributing problems with design triggered significant schedule slippage, causing construction acceleration during the 2012 summer leading to the start of school. Since there were absolutely no interim housing options for the students set to start school at LEEC that fall, crews worked round-the-clock to complete on time. It is recognized in the construction industry that acceleration efforts such as working overtime and additional shift work, performing out-of-sequence work, stacking trades, and overcrowding on a project site contribute to reduced labor productivity and loss of quality control. This Project was no exception. Although the Project "completed" on time, the District spent the next 18 months negotiating and settling claims with the JV and numerous subcontractors, including several instances where OUSD successfully back charged particular trades for defective work. Ultimately all claims raised by the District the JV were settled at mediation. The District has reserved its rights to pursue a claim against the Architect for its errors and omissions, and the JV has agreed to support any claim brought by OUSD. Outside facilities counsel and OUSD General Counsel are weighing legal options in this regard, and have until 2017 to formally file suit. Finally, it should be noted that

Turner Construction Company, the prime joint venture partner on the Project, is no longer solicited to participate in the selection of qualified Lease-leaseback contractors on future OUSD construction projects. However, ADCo, the Oakland local joint venture partner for the LEEC Project remains pre-selected for future OUSD Lease-leaseback projects.

- **Lowell MS – Modernization**
  Overall, the Lowell Modernization and Health Center lease-leaseback Project was a success, though like LEEC, it suffered from significant design errors and omissions. Again, because of the negotiated partnership with Arntz/Focon JV, OUSD was able to keep the overall cost of change orders at a minimum, while engaging a considerable small local business workforce. In addition, although problems with the plans and specifications substantially delayed the Project, OUSD was able to take beneficial occupancy in time for the start of school. Furthermore, unlike the contractors on the LEEC project, Arntz/Focon JV made no claims against the District and the quality of work met or exceeded industry standards.

- **Montclair ES – New Construction**
  The Montclair ES New Construction Project was a high-profile "hill school" project, complicated by the fact that the new buildings are located directly adjacent to the busy Montclair Village retail district. In addition, like LEEC, there were no interim housing options available to the school, and the Project was required to reach substantial completion before the start of school. Unfortunately for the District and the Local Business Program, the JV's small local business partner CAS, suffered a dissolution of its corporate structure mid-way through construction process, leaving the Project in chaos, many sub-tier contractors unpaid, and a significant portion of the work that was to be performed by CAS under a separate subcontract unfinished. To the credit of the Prime contractor and the District's experienced project management team, the Project completed on time. West Bay Builders, the prime joint venture partner, used extraordinary efforts to salvage the Project schedule and again, because of the partnership created by negotiated Lease-lease construction delivery, the exposure to OUSD was mitigated and no formal claims were made against the Project. In addition, the quality of work met or exceeded industry standards. CAS is no longer considered a qualified OUSD small business JV partner, and would not be considered for future District construction projects.

- **Calvin Simmons MS – Modernization and New Construction**
  The work was completed in two phases: new construction of a Career Tech Lab, a two-story building consisting of two life science laboratories, a biochemistry lab, a health lab, and support spaces (Phase 1) and modernization of existing classrooms and site improvements, including various upgrades to accommodate the middle school expansion for Life Academy (Phase 2). The JV selected for this project was Cahill Builders, Inc. a general contractor with over 100 years of experience building in the San Francisco Bay Area and Focon, Inc., an established Oakland small construction firm. As earlier stated, the Project encountered a costly unforeseen condition when it was discovered that a live sanitary sewer-line ran directly under the existing campus buildings. In a typical Design-bid-build project, this discovery would have precipitated extensive project delays and compensable extended general conditions in addition to the actual cost of re-routing, abandoning and constructing the new line. OUSD initially looked to the City's Department of Public Works as responsible for the error as the civil drawings indicated that the sewer line was

vacated. However, it was later learned that somehow OUSD obtained a permit in the 1950's to build the existing school over the live line, which ultimately came to serve dozens of new homes built in the area. It is unknown how the survey showing the line had been abandoned became part of the record. Cahill/Focon, JV sought no additional compensation for the significant delays associated with this unforeseen condition, completed the Project on time and the quality of construction exceeds industry standards.

CONCLUSION

While no guaranty of success, the lease-leaseback process provides the District with a unique opportunity to select the Developer whom the District believes has the greatest chance of constructing a project which meets the needs and goals of the District and community it serves. The process also reduces the likelihood of change orders, disputes over scope or design errors and ultimately litigation while increasing the likelihood of the project being brought in on budget and on schedule. Finally, an additional, well-tested benefit to OUSD is the opportunity to maximize small, local business participation on its bond projects.