



## Regular Meeting

### Item Number 8 – Open Session

**Subject:** HQE Budget Approval

**Presenter(s):** Lisa Blatnick, Julie Underwood

**Item Type:** Action

**Date & Time:** January 28, 2022 – 30 minutes

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**Attachment(s):** Attachment 1 - HQE Budget History

Attachment 2 - Analytical Assumptions

**PowerPoint(s):** HQE Budget Update

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#### **PURPOSE**

The purpose of this item is to provide information to the board regarding the status of the Headquarters Expansion (HQE) Project budget and to recommend the board approve additional funding utilizing tax-exempt lease revenue bonds to complete the construction of 200 Waterfront Place.

#### **DISCUSSION/SUMMARY**

Due to extended project schedules, cost escalations associated with supply chain shortages, and safety measures associated with the prolonged Covid-19 Pandemic, the HQE project requires additional funding. Additional funding is necessary to ensure that the expansion facility meets all sustainability goals, adheres to code required changes, and maintains the functionality necessary to support CalSTRS operations now and into the future.

#### **Background**

In March 2018, the HQE General Contractor, DPR, and Architectural firm ZGF were onboarded to the project by CalSTRS and Ridge Capital, Inc., the Construction Manager, and began Design and Preconstruction budgeting activities. ZGF's team included a local architectural firm, Lionakis, who has extensive experience working on State projects with the Office of State Fire Marshal (OSFM). Over the course of the Preconstruction Design and Budgeting period, the team established, compiled, and refined the schedule regularly. The Guaranteed Maximum Price (GMP) was then established with a corresponding schedule. In November 2018, the board approved the

construction of an expansion structure at a cost not to exceed \$300 million utilizing tax-exempt lease revenue bond financing. The established budget and schedule were then developed into a complete design and documented in the GMP contract executed on November 6, 2019.

The project team developed the schedule and budget based upon industry experience, published permitting guidelines, and collaboration with Authorities Having Jurisdiction (AHJ) over permitting. The team elected to use a phased approval process that permitted portions of the construction along a planned timeline. Using published guidelines four permit phases were established: Phase I included a complete code analysis, Phase II included grading, offsite work, utility connections and structural foundations, Phase III included the above ground structural elements, and Phase IV is the balance of the work including the remaining such as architectural, electrical, plumbing, mechanical and fire protection systems. Once the Phase II permit was issued, construction was initiated. The GMP schedule, that identified the most cost-effective start date for construction, included 370 workdays for public agency review/permitting timeframes for the phased process. The schedule also contained a contingency of 22 workdays.

All initial permits were reviewed and approved as expected. The project team continued with confidence that the existing schedule was in line with experienced timelines. Unfortunately, the review duration for the final Phase IV permit was significantly longer than anticipated, and the team waited 5 months for comments on the proposed design. During this period there were forces beyond the control of either the project team or the AHJ's that prevented efficient progress of permitting: a record fire season that stretched all resources at the Office of the State Fire Marshall (the primary AHJ), the onset of the Covid-19 pandemic and associated business closures, and the subsequent supply chain impacts. The GMP schedule allowed for 18 months of permitting review, but the overall process to obtain permits necessary to progress with all major construction elements was a 30-month duration. The actual time spent in plan review was over 600 days.

As the project experienced delays with the permitting process, the project team remained committed to resequencing the schedule to remain within the original budget. However, it wasn't until the project team had the final permit in hand that they could confidently move forward with the remaining activities required in finalizing the budget impacts associated with the schedule delays. The team continues to experience issues in the field that require additional review and evaluation before construction of the identified element can continue. To date this has led to a realization of 10 additional schedule days. Increases to the project budget are directly associated with a prolonged construction schedule, market driven escalations of construction materials, and field conditions where additional life safety measures are identified as necessary once inspections are in progress.

### **Final Development Cost table**

Below is a summary table that reflects Hard Costs, Soft Costs and CalSTRS Contingency. Detailed cost categories are itemized further in Attachment A. Hard Costs include the direct construction expenses included in the DPR GMP agreement. Included in Soft Costs are consultant and permitting fees, as well as all owner furnished items including network equipment and furniture.

<b>HQE Development Costs</b>			
	<b>2018 Target Value Budget</b>	<b>Change</b>	<b>Final NTE Budget</b>
Hard Costs (Including Land Costs and Hard Cost Contingency)	\$234,335,390.00	\$26,941,031.00	\$261,276,421.00
Soft Costs	\$35,664,610.00	\$15,170,942.00	\$50,835,552.00
Project Contingency	\$30,000,000.00	(\$23,611,973.00)	\$6,388,027.00
<b>Total</b>	<b>\$300,000,000.00</b>	<b>\$18,500,000.00</b>	<b>\$318,500,000.00</b>

Prior to the final permit issuance and schedule completion, the Executive Steering Committee began exploring opportunities for cost savings. The project team was tasked with identifying any opportunity to use alternate interior finishes or simplify systems to achieve a budget reduction. Over \$1M in savings were realized through design simplifications.

Once the phase IV permit was issued, and it was determined that the project would require additional funding to maintain the existing scope, the Executive Steering Committee initiated an additional review of all uncommitted budget items to explore whether any additional savings were possible. The review analyzed the impact of material changes and scope deletion. The ESC determined that it was important to stay consistent with established project goals and exclude any changes that would affect sustainability certifications and green bond ratings. Anything that would initiate a plan review by an AHJ or impact an existing permit was also excluded. Lastly, anything that would affect continuity of design between the existing building and the expansion was not considered. With these constraints the team was able to identify the following savings:

- Over \$700K in A/V savings, through equipment reductions and simplifications
- Approximately \$800K in design savings through substitutions of lobby finishes and further A/V reductions

**Final Budget Assumptions**

To date the project has realized hard and soft cost contingency transfers necessary to cover increased project costs identified including:

- Over \$700K in general conditions added to the project scope to allow continued construction during COVID-19 pandemic and public health requirements

- Approximately \$7.6M in construction and material changes identified through the OSFM permitting processing
- Approximately \$250K in fees to properly dispose of Lead Contaminated Soil discovered on site once excavation began
- Approximately \$210K in owner operational enhancements to building equipment
- Nearly \$4.3M in customary hard cost contingency expenses to cover gaps in construction scope not developed in the architectural plans and bid process
- Nearly \$850K in additional professional services and consultant fees
- Over \$1.7M for additional permitting fees/added Inspector of Record (IOR)/OSFM inspections

These changes have exhausted the originally established \$300M total project budget and additional funding is necessary to complete construction. Funding is required to support the following:

- Over \$6.7M in additional hard costs for the DPR GMP agreement to extend the schedule by 143 days from an overall duration of 677 to 820 days and cover the extended general conditions and subcontractor expenses through January 2023. Additionally, funding is included to incorporate changes to construction required by site inspections. The hard cost figure also includes approximately \$4.8M in contractor contingency to cover any contractor scope gaps that may arise over the remainder of the project. Any remaining hard cost contingency at the close of the project will be returned to CalSTRS minus a percentage
- Over \$1M in increases to construction administration consultant expenses
- Nearly \$2M to fund an additional full-time IOR and support inspections required by OSFM.
- Nearly \$300,000 in added Builders Risk and General Liability Costs
- Nearly \$2.8M in additional IT Network integration and equipment due to rising costs from supply chain shortages, and an increase in the number of network devices in collaboration spaces that will support a blended work environment, and expanded services to augment staff installation demands.

The overall projected increase to the project budget is \$18,500,000, an increase of 6.17% beyond the original budget request. This reflects the final schedule, including 12 contingency weather days and 30 contingency final inspection days. The budget includes a combined hard cost and project contingency of approximately \$11.1M, with the majority held in the owner contingency. A portion of any unexpended hard cost contingency, which may not all be necessary under optimal

construction conditions, could be returned to CalSTRS at the close of the project. The owner project contingency of nearly \$6.4M includes considerations for future construction changes required through the inspection process, potential installation days that impact project substantial completion, and cost escalations for those owner purchases still in procurement such as furniture. The project team feels that the validation process to develop this funding request reflects a thorough evaluation of project challenges to date as well the appropriate levels of contingency to address any conditions that may arise in the field for the remaining duration of construction.

### **Bond Financing Analysis**

Since the November 5, 2021 board meeting, the project team has been working with our municipal advisor, Montague DeRose and Associates, LLC (MDA) to prepare financing models to assess the economic value of issuing a second series of tax-exempt lease revenue bonds (bonds) to finance the additional costs to complete the HQE, relative to the option of directly funding these additional costs from the State Teachers' Retirement Plan (STRP). In addition, the project team has consulted with bond/disclosure counsel, Stradling Yocca Carlson & Rauth (Stradling), to assess the various legal and disclosure requirements with moving forward with issuing additional bonds. The project team also met with the State Treasurer's Office (STO) to discuss the possibility of issuing a second series of bonds. Finally, the project team discussed with MDA, Stradling, and the STO considerations relating to the optimal timing of issuing a second series of bonds.

On the next page are examples of the financial analysis comparing the cost of direct STRP funding with the issuance of a second series of bonds under three different interest rate scenarios.<sup>1</sup> The analysis is followed by a discussion of the results and key considerations.

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<sup>1</sup> See Attachment B for assumptions used in the analysis.

	<b>Current Interest Rates<sup>2</sup></b>	<b>Current Interest Rates + 1.00%</b>	<b>Current Interest Rates + 1.50%</b>
Additional HQE Costs	\$18,500,000	\$18,500,000	\$18,500,000
Interest Earnings from 2019 Bonds <sup>3</sup>	(\$2,000,000)	(\$2,000,000)	(\$2,000,000)
NPV <sup>4</sup> of Net Cost of Direct STRP Funding	\$16,500,000	\$16,500,000	\$16,500,000
NPV Cost of Bond Financing	\$ 9,940,000	\$10,735,000	\$11,250,000
NPV Cost of STRP Interim Funding	\$ 195,000	\$ 195,000	\$ 195,000
NPV Total Cost of Bond Financing	\$10,135,000	\$10,930,000	\$11,445,000
Projected Savings from Bond Financing	\$ 6,365,000	\$ 5,570,000	\$ 5,055,000
Projected Bonds All-In Borrowing Cost <sup>5</sup>	2.65%	3.30%	3.75%

While the additional costs to complete the HQE are estimated to be \$18.5 million, the project team estimates there may be approximately \$2 million in interest earnings from the Series 2019 bonds that could be used to offset some of the additional HQE costs resulting in a net cost of \$16.5 million.

If interest rates were to remain at current levels, issuing bonds to finance the \$16.5 million in net costs is projected to result in an estimated economic savings of \$6.37 million, thus reducing the economic impact to the STRP from \$16.5 million to \$10.14 million. If interest rates increase by between 1.00% to 1.50%, the projected net benefit of bonds over direct STRP funding would be between \$5.57 million to \$5.06 million, respectively. Under these interest rate assumptions, the economic impact to the STRP would still be reduced from \$16.5 million to between \$10.9 million to \$11.44 million, respectively.

Based on the revised schedule and projected cash flows to complete the HQE, the project team determined the additional funding is not needed until the last few months of the project, which is expected to be around December 2022. Given the timing of the cash flows, the industry standard is to issue bonds around the time the funding is needed and additional costs are known with more certainty, or when the project is substantially complete and the final cost is known. Per the project team discussions with MDA, Stradling and the STO, since this would be a second bond offering

<sup>2</sup> Interest rate as of 12/15/21 was 2.45%.

<sup>3</sup> Projected investment earnings on the Series 2019 Bonds that can be used to reduce any additional project costs above the initial \$300 million.

<sup>4</sup> Net Present Value is a financial measure in which the value of all future cash flows (positive and negative) are discounted to the present.

<sup>5</sup> The all-in borrowing cost, which is the current interest rate plus fees, of the Series 2019 Lease Revenue Bonds was 3.25%.

for the HQE, waiting to issue the bonds until after the project is substantially complete, at which time the final cost of the HQE would be known, would reduce the complexities of bond disclosures and the overall transaction. Likewise, this approach would eliminate the risk of issuing more bonds than necessary, which will reduce costs. However, waiting until the project is substantially complete would require CalSTRS to provide interim funding of approximately \$16.5 million out of the STRP for a few months then reimburse the STRP once the bonds are issued. The estimated cost of this temporary funding from the STRP is a modest \$195,000.

Overall, issuing bonds to finance the net cost to complete the HQE will reduce the economic impact to the STRP. In the scenarios above the estimated savings are between \$5.06 million to \$6.37 million.

### **RECOMMENDATION**

The project team recommends the board approve the additional funding not to exceed **\$18,500,000**, utilizing tax-exempt lease revenue bonds, to complete the HQE project. In addition, the project team recommends CalSTRS issue the bonds after substantial completion of the HQE project, which will require interim funding from the STRP until the bonds are issued and the STRP will be reimbursed from bond proceeds.