A Guide to Evaluating Public Asset Privatization

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A Guide to Asset Privatization Deals

In response to the fiscal crisis in cities and states across the country, governments are entering into long-term lease agreements with private investors and companies to operate, maintain and develop major public structures and facilities. The investors offer a large up-front payment to local and state governments starved for cash, in exchange for decades (from 20 to 75 years) of control and steady return on investments.

Local and state governments have signed contracts to "sell off" many types of facilities and infrastructure, including government office buildings, landfills, transit systems, roads, parking structures, zoos, convention centers, and other assets that could generate substantial capital. These new owners typically get to keep all or part of the associated revenue (such as advertising or concession revenue), increase fees or rents charged, and are responsible for maintaining the asset.

In many of these asset sale agreements, the public has been on the losing side – loss of control, increased user fees, loss of jobs, lower quality infrastructure, and future budget woes are just a few problems that communities have experienced following asset privatization.

In any proposed asset privatization deal, there are key questions that should be asked by those who want to ensure that the public interest is protected and advanced. This guide seeks to give some basic information about asset privatization deals, and provide examples of important questions that should be asked and explored when faced with a proposed privatization effort. While this is not a complete and exhaustive list, it provides a framework for examining these agreements.

ARIZONA GOVERNMENT BUILDINGS

Each of these different asset "sales" has unique characteristics depending on the project revenue stream. For example, Arizona leased the State Capitol and several other buildings for $735 million dollars in immediate income to fill the state budget shortfall. Of course, Arizona still needs a Capitol building and office space so they have committed to lease back the use of the buildings for time periods ranging from 3 to 20 years.

CHICAGO PARKING METERS

In 2009, Chicago "sold" the city's parking meters to a consortium of companies led by Morgan Stanley. Private investors gave the city an upfront payment of $1.15 billion in exchange for meter revenues for the next 75 years. Since private operators took over the parking meters, rates have significantly risen, while meter maintenance quality has declined. Recent analysis shows that Chicago undervalued the asset and should have received a billion additional dollars for the deal. These "fire sales" of assets are especially a problem in the current economic climate, where private companies are offering desperate governments amounts that are far below the asset's true market value.

Types of Asset Privatization Contracts

Asset privatization contracts can take many different forms. Below are a few of the most common models.

LONG-TERM LEASE AGREEMENT

This is an agreement where a private company (or consortium of companies) receives the right to collect revenues associated with an existing asset in exchange for an upfront fee to the governmental entity. Examples of this model include the long-term leases of the Chicago parking meters mentioned above and the Indiana Toll Road.

SALE/LEASEBACK

A sale-leaseback is a transaction in which the owner, in this case the government, sells public property and then leases it back from the private buyer. Examples of this model include the sale/leaseback of the Arizona capitol and state buildings and the recently proposed sale/leaseback of numerous California state office buildings.

DESIGN-BUILD-FINANCE-OPERATE-MAINTAIN

There are many variations of this model, such as Design-Build, Design-Build-Operate, etc., depending on the private entity's role. In this model, a private entity is involved in varying aspects of the financing, design, building, operation and maintenance of the asset, and is compensated for its investment by receiving the right to collect future revenues associated with asset, such as user fees. An example of this model is Georgia's new West by Northwest project, which bundles the state's Northwest Corridor and Western Corridor into one contract.

AVAILABILITY PAYMENT

In this model, the governmental entity provides regular payments, based on criteria such as project milestones or performance standards, to private investors, developers, and operators that design, build, finance, operate, and maintain the asset (or perform a subset of these activities). An example of this model is the I-595 Corridor improvement project in Florida. This project is similar to the design, build, finance, operate, and maintain-type contract described above, but uses an availability payment scheme to compensate the private companies.

Phases in the Process

This section provides a general overview of the phases involved in an asset privatization deal. It is important to note that not all deals will follow this exact process, and names of phases and documents associated with those phases may vary from one governmental entity to the next. In some cases, privatization deals may completely circumvent this process. For example, a private company may propose to build a structure for the governmental entity. The deal may actually start with a proposed contract, and then go straight to the negotiation phase to finalize details. Unfortunately, these types of deals bypass important opportunities for thoughtful analysis or meaningful public input. It is important that each deal goes through a competitive process with public interest standards, and be approved not only by government staff, but also by government agency decision makers (elected or appointed), to ensure that the government is getting the best deal.

PLANNING AND REQUEST FOR QUALIFICATIONS (RFQ)

The purpose of the RFQ is to identify potential “qualified” bidders who then can negotiate with the governmental entity regarding all the parameters of the contract, with the exception of the final price. While the information supplied in the RFQ is not binding (unlike the next step), it does provide important information about any likely bidders and their history and capabilities. Though they need not be, the negotiations have typically been considered confidential and can last a year or so. However, this phase establishes the basic contract parameters and language. The governmental entity usually contracts with attorneys and financial experts to analyze the contract issues, establish the potential value range of the asset (e.g., valuation), and review the management and financial capabilities of the potential bidders.

REQUEST FOR BIDS OR PROPOSALS (RFP)

After the basic contract has been worked out with the eligible bidders identified in the RFQ process, the governmental entity can issue a Request for Proposals based on the draft contract. The responses to the RFP will contain any proposed modifications to the contract and the “Bid” (amount of money offered for the lease).

NEGOTIATION PHASE

After the governmental entity receives bids and chooses a potential contractor for the project, the parties enter into the negotiation phase of the process to decide important contract terms. In many cases, there is an Exclusive Negotiating Agreement (ENA) between the contactor and the government entity that sets out the purpose and terms of the negotiation. If the contractor and governmental entity fail to reach an agreement within the allotted time period, the governmental entity can choose another contractor to begin negotiations. It is important that the governmental entity has the necessary staffing and expertise to adequately negotiate with the contractor.

FINAL CONTRACT

Once the governmental entity and contractor come to agreement regarding contract terms, the final written contract is drawn up. In many but not all cases, the contract needs some form of legislative or council approval. The process of legislative approval is useful in expanding review and oversight of the arrangement. However, the contracting parties often argue that any documents used in the entire process that list revenue, expenses, length of lease, needed improvements, potential value, or other issues related to negotiations should be considered confidential and preliminary, and therefore not open to the public or the legislative authority.

Key Issues

Below is a list of questions that identify key issues in proposed asset privatization deals that should be thoroughly explored. As mentioned above, this is not a complete and exhaustive list, but provides a framework for examining these agreements.

UNDERSTANDING THE ASSET

EXAMINING OPTIONS

- Has the governmental entity prepared an economic analysis describing potential revenues and expenses if the asset remained in public hands?
- Has the governmental entity identified alternatives that include rate or fee increases going directly to it rather than a private contractor?
- If the asset constitutes a net cost to the budget, has the governmental entity evaluated why costs exceed revenues and whether the costs could be eliminated without privatizing the asset through a long-term lease?
- Has the governmental entity performed or contracted for a valuation of the asset?
  - If so, how was the valuation determined and what was the methodology used? The methodology can dramatically increase or decrease the valuation range. It may be necessary to get outside expertise to review the valuation and methodology, including the assumptions used and the details of the calculations.
  - Does the valuation consider alternatives to leasing? Alternative options include the governmental entity improving its management of the asset, probably with increased fees or rates; shorter leases; revenue sharing; or some combination of those alternatives.

PUBLIC PURPOSE OF ASSET

- Is there a clear identification of the "public purpose" of the asset?
- Is there a competitive, transparent process with standards in place to protect the "public purpose?"

IMPACT ON CURRENT WORKFORCE

- What will be the potential impacts on the existing workforce?
- Are the workers currently unionized and does the Collective Bargaining Agreement or government policy contain clauses that require workforce retention, retraining, or labor peace?
- How will the wages and benefits and the number of jobs change once control is shifted to the private sector?

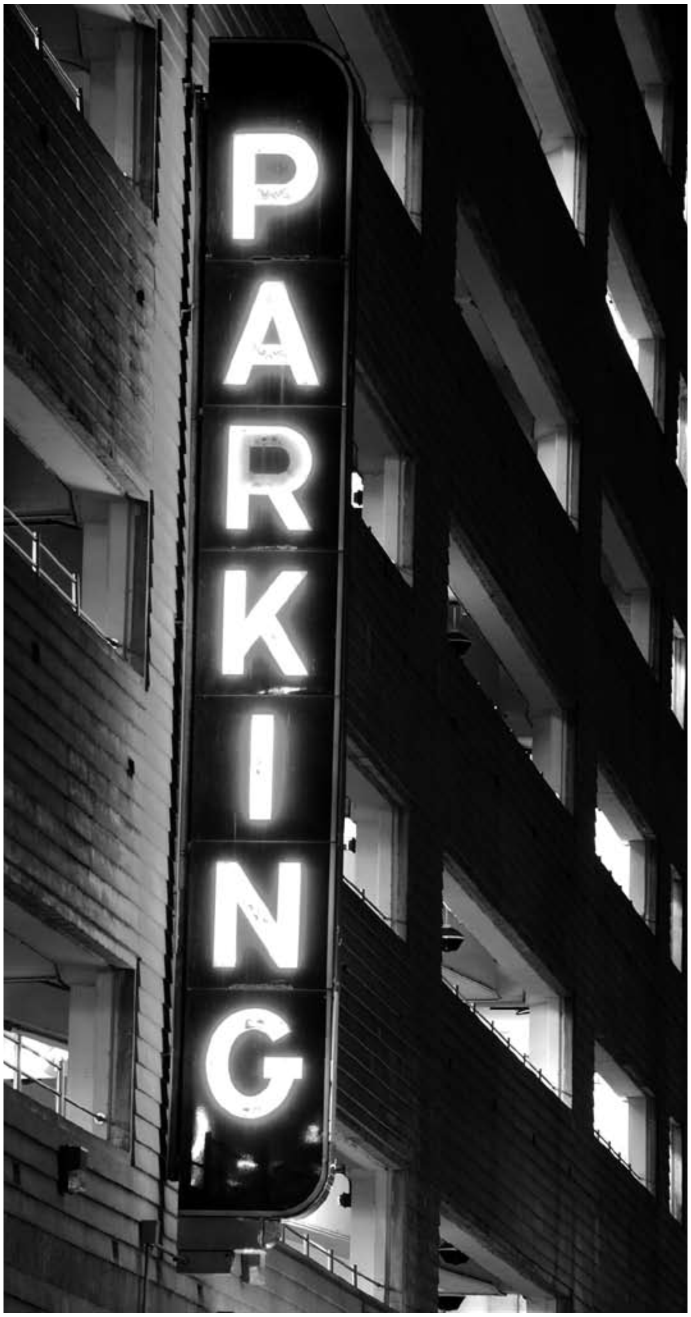
COSTS TO THE GOVERNMENT AND PUBLIC

IMPACT ON GOVERNMENTAL BUDGET

- An asset might provide revenue to the governmental entity, such as a building with a public parking garage, advertising, or cell phone towers. If the asset currently provides net revenue to the budget, how will that revenue be replaced?
- If the deal requires investors to make a large upfront payment to the governmental entity, are there budget restrictions that prevent the funds from being used too quickly?

COSTS TO THE PUBLIC

- Will the lease result in any hidden costs for the public? Private companies leasing government buildings often claim that they will reduce operating costs. But these cost-saving measures can impose hidden costs on the public. For instance, cuts to healthcare benefits can leave the state picking up more uninsured medical expenses. Likewise, measures such as reduced hiring of disabled employees, reduced purchases of recycled products, or reduced access to a facility for the general public can compromise other important public goals. Contracts should contain safeguards against hidden costs, such as a scheme where the company receives lower lease payments if it takes measures that shift unforeseen costs onto the public.
- Will the lease result in the loss of indirect benefits provided by the asset? For example, a public parking ga-



rage may provide support for a nearby retail and restaurant area, but access could diminish once the garage is no longer publicly controlled, hurting local businesses.

- Are there any specific requirements that the public asset serve the "public purpose?" For example, is the asset made available to local businesses or communities at agreed upon rates (e.g., an agreement with local businesses that parking rates will be low)? If a private operator can raise rates, who will pay for the original commitment?

IMPACT ON USER FEES

- What rights does the governmental entity have to restrict rate or fee increases?
- Does the private entity have unrestricted power to raise rates?
- What will be the impact on the public of significant or rapid rate increases? Do rate increases affect equity of access to the asset?

ENSURING A FAIR AND ACCOUNTABLE PROCESS

TRANPARENCY

- What rights does the public have to see documents related to the deal, especially through online disclosure?
- Are there adequate and meaningful forums for public input, such as public hearings or public comment periods?
- Do legislative or other oversight bodies have access to the information they need to evaluate the contract?

POTENTIAL CONFLICTS OF INTEREST

- How are contracts with consultants, lawyers, or their affiliates structured? Do they collect fees for services rendered or for successful completion of deals, regardless of the outcome for the agency?
- Do the consultants, lawyers, or their affiliates have any conflicts of interest? What is their track record and background with these types of contracts?
- Have the investors or consultants made campaign contributions to relevant decision makers?
- Are there regulations preventing the public evaluators from accepting high-paying jobs with the private investors after the deal?

GOVERNMENT CAPACITY AND EXPERTISE

- Does the governmental entity have the necessary experienced staff to negotiate a good deal for the public?
- Does the governmental entity hire consultants to value the asset or assist with other parts of the deal? Does the governmental entity have the necessary and experienced staff to ensure that outside analyses are fair and sound?
- Does the governmental entity have necessary in-house staffing and expertise to adequately monitor the contract for the entire life of the contract?

TERMS OF THE CONTRACT

UNFAVORABLE CONTRACT TERMS

- Does the contract contain non-compete language or contingent liability clauses? Such provisions could restrict a governmental entity from carrying out various policy or development responsibilities without paying a penalty to the private entity. For instance, does the contract restrict the ability of a governmental entity to build new roads, parking garages, or other assets that might "compete" with the privatized asset without approval by or compensation to the private entity?

- Does the governmental entity provide any guarantee for minimum revenue to the private entity? For example, the private entity may require that the governmental entity guarantee a minimum level of rental, advertising, or concession income related to the asset.

ASSET MAINTENANCE

- What are the maintenance requirements in the contract? What power does the governmental entity retain to require proper maintenance and staffing – especially in 10, 20 or 30 years?

- What requirements will the private operator have to fulfill, such as making improvements to the asset or complying with required changes in technology?

PUBLIC INTEREST PROTECTIONS

- If the private operators default on the lease, what guarantees will protect the governmental entity?

- If the proposed deal is a Sale/Lease-back, and a public office building is sold with an agreement to lease it or part of it back from the new owners, how long does that agreement last? If the governmental entity decides to find less expensive office space, can the agreement be canceled?

- Is the governmental entity indemnified if the private entity or their subcontractors are sued?

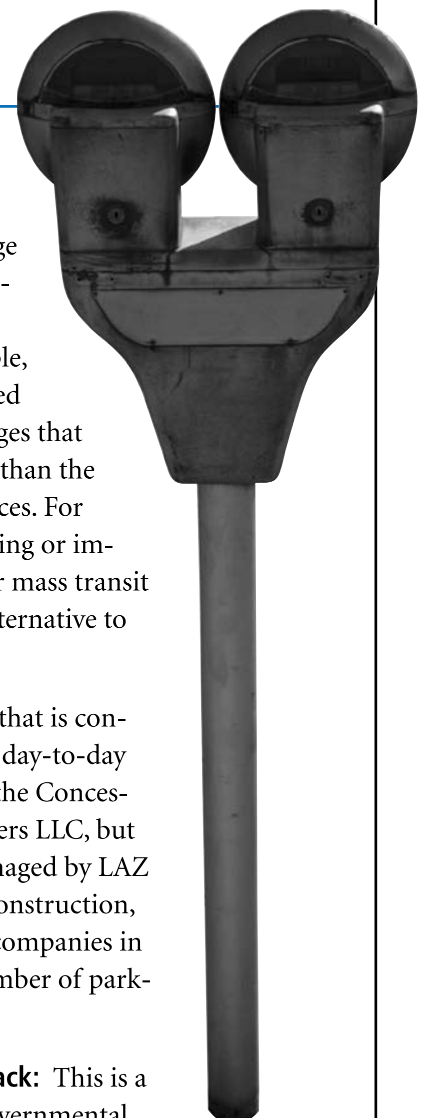
- Can the lease or contract be cancelled if problems arise in the operation or if public needs change? If so, what are the criteria for cancellation and what are the liabilities (e.g., cost) for canceling?

- Is there a mechanism, such as an escrow account, to insure that the public assets are returned in excellent condition? Over time a private leasing company, or successive investors, will have declining incentive to invest in maintenance and improvement of a building or other asset that eventually will revert to public control. For that reason, it is important that proposed lease arrangements include provisions requiring a private investor to independently secure financial resources that can be freed only if the asset, at the end of the lease, is in an excellent state of repair or that can be easily accessed to make any necessary repairs.

- What rights does the governmental entity have to review and restrict refinancing, or sale of interest, by the private entity? If the private entity refinances the contract to bring in new investors, that could affect the ability to properly maintain the asset. For example, the original operator of the Chicago Skyway refinanced its end of the deal to recover its equity stake in 12 years; after that, with no equity at risk, the company had less incentive to maintain the asset in excellent condition.

- Can the asset be securitized, re-packaged, and resold to other investors without the approval of the governmental entity?

Glossary



Concessionaire: This is the legal entity(ies) that signs the contract to lease the asset and supplies the money for the payment. In the long run, the Concessionaire is responsible for future investment (including maintenance and operating) decisions. For example, in the Chicago Parking Meter Concession, the contract was signed by "Chicago Parking Meters LLC" and three Morgan Stanley investment funds.

Equity Partners: These are the investors in the Investment Fund. The investors include other banks and pension funds in the US and other countries.

Contingent Liability (aka "Compensation for Adverse Actions" or "Make Whole Clause"): This is part of most contracts and requires the governmental entity to compensate the Concessionaire when the government takes an action affecting how much revenue is generated by the asset. For example, governments have to compensate for privatized parking meter revenues lost while street access is restricted for a street fair or permanently lost due to urban development, or for highway tolls limited when police, ambulances, and fire services block traffic as a result of an accident.

Governmental Entity: The city, county, state, school district or other governmental authority that owns the asset.

Investment Fund: This is the source of the money to provide the up-front lease payment. These funds are listed by their Manager's name such as Morgan Stanley, Macquarie, KKR, Carlyle, etc.

Managing Partners: These are the financial institution(s) that run the Investment Fund, and get fees for managing the investments. They may or may not be Equity Partners.

Non-compete Clauses: These clauses are commonly found in privatized highway contracts and may show up in other types of contracts. Depending on the contract language this can create significant restrictions on public planning and decision-making. In one example, the non-compete clause restricted the ability to build parking garages that would be more attractive to use than the privatized on-street parking spaces. For tollways, they often forbid building or improving a competing highway or mass transit system that would provide an alternative to the tollway.

Operator: This is the company that is contracted to operate the asset on a day-to-day basis. For example, in Chicago the Concessionaire is Chicago Parking Meters LLC, but the parking meter system is managed by LAZ Parking, a subsidiary of Vinci Construction, one of the largest construction companies in the world. Vinci also owns a number of parking garages in Chicago.

Sale-Leaseback/Lease-Lease Back: This is a financial transaction where a governmental entity sells or leases a public asset (such as a building or a rail line) for an upfront fee and then agrees to lease it back and pay monthly or annual lease payments to the private investors.

Securitization: Included in some asset lease deals, securitization involves pooling several revenue-producing assets, such as mortgages, into a "security" (e.g., a stock or a bond) that can be sold in pieces to other investors. For instance, an asset like a tollway or parking garage can be "securitized" and then sold to a broader array of investors so the original investors can recoup their investment early.

Additional Resources

For additional resources on asset privatization, please visit the In The Public Interest resource center at *www.inthepublicinterest.org.*

Specific reports that may be useful are listed below:

Infrastructure Privatization Contracts and Their Effect On Governance

Ellen Dannin, Pennsylvania State Dickinson School of Law, 2009

http://inthepublicinterest.org/article/infrastructure-privatization-contracts-and-their-effect-governance

Private Roads, Public Costs: The Facts About Toll Road Privatization and How to Protect the Public

US PIRG Education Fund & Frontier Group, 2009

http://inthepublicinterest.org/article/private-roads-public-costs-0

Privatization and the Public Interest

US PIRG Education Fund & Frontier Group, 2009

http://inthepublicinterest.org/article/privatization-and-public-interest-1

Road Privatization

US PIRG Education Fund, 2007

http://inthepublicinterest.org/article/road-privatization

The Political_Economics of Private Infrastructure Finance: The New Sub Prime

Elliott Sclar, Columbia University, 2009

http://inthepublicinterest.org/article/political%E2%80%90economics-private-infrastructure-finance-new-sub-prime

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In The Public Interest

1620 Eye Street, N.W., Suite 210
Washington, DC 20006
202-739-1160
www.InThePublicInterest.org

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