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Annual Privatization Report 2010: State Government Privatization

By Leonard Gilroy, Harris Kenny, Lisa Snell, Shirley Ybarra and Tyler Millhouse
Edited by Leonard Gilroy

Reason Foundation

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Part 1

State Budget Outlook

The widespread fiscal crisis faced by states in 2008 and 2009 may have reached its peak, according to the National Conference of State Legislatures' (NCSL) *State Budget Update: July 2010*, but policymakers can expect ongoing fiscal challenges amid a sluggish economic recovery.

While state revenues are projected to rise in FY 2011, ending a multi-year decline, many states do not expect revenues to make sufficient gains to offset losses from prior years. Combined with the terminus of federal stimulus dollars, state policymakers nationwide can still expect to face significant deficits in current and future budgets.

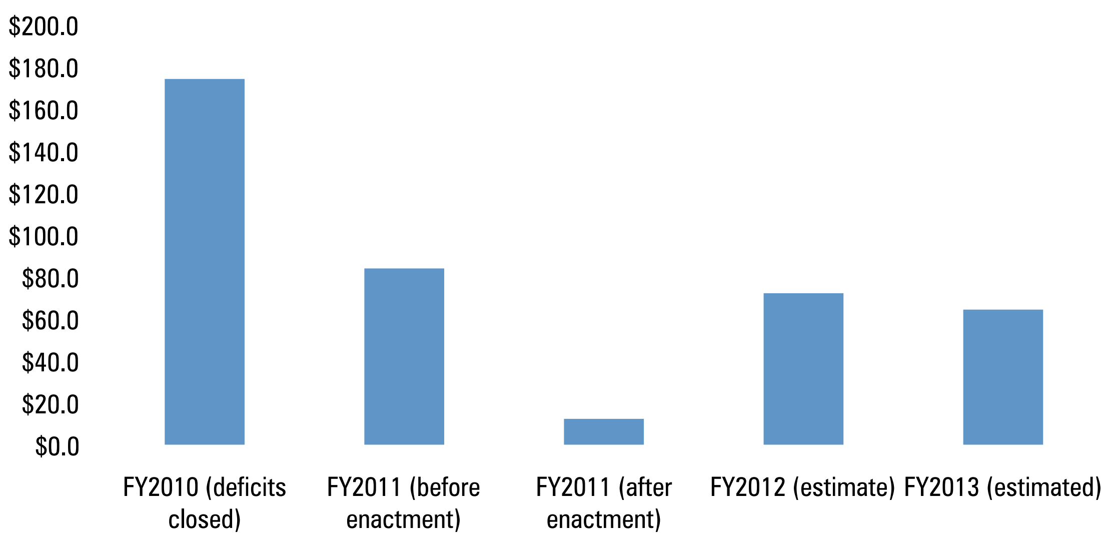
Figure 1 illustrates historical and projected state budget deficits from FY 2010 through FY 2013. According to the NCSL report, states still face $148.7 billion in deficits for the remainder of FY 2010 through to FY 2013. The NCSL report finds that:

- The steep revenue declines that began in FY 2008 and continued through FY 2010 are now beginning to abate, with numerous state budget officials reporting either a slowing in the rate of revenue decline or even a slight uptick in state revenues. Further, most states expect FY 2011 tax revenues to exceed FY 2010 collections.
- States closed a cumulative $174.1 billion budget deficit in their FY 2010 budgets. State FY 2010 general fund spending dropped 4.6% below FY 2009 expenditures, and 34 states reported year-over-year declines in FY 2010 spending. Eight states reported year-over-year spending declines exceeding 10%, with the largest in Louisiana (-16.8%), Illinois (-15.5%) and Alabama (-14.9%).
- Entering FY 2011, 41 states confronted aggregate deficits of at least $83.9 billion during the enactment of their FY 2011 budgets, the majority of which were closed as budgets were adopted. A total of 24 states reported FY 2011 deficits exceeding 10% of their general fund budgets, with the highest found in Nevada (45%), New Jersey (28%), Arizona (27.2%), Maine (26%) and North Carolina (25%). Only eight states reported no budget deficits for FY 2011.
- Though it is somewhat unusual for states to report new budget deficits between the time of budget enactment and the beginning of the new fiscal year, at least 29 states anticipate new FY 2011 budget deficits totaling $12.3 billion, largely the result of having budgeted for an assumed extension of enhanced Federal Medical Assistance Percentages (FMAP)—used to

determine the federal share of state Medicaid program funding—through the second half of FY 2011, which now seems increasingly unlikely in the current Congress.

- Over 30 states are already projecting deficits for FY 2012, with early estimates of a total cumulative deficit of $72.1 billion. Eighteen states are expecting deficits totaling over 10% of their general fund budgets.
- A total of 23 states are already projecting deficits for FY 2013 totaling at least $64.3 billion. These deficits can be partially attributed to the end of Recovery Act funds. Ten of these states are expecting deficits exceeding 10% of their general fund budgets.

Figure 1: Cumulative State Budget Deficits, FY2010-FY2013 ($ billion)



Source: National Conference of State Legislatures, *State Budget Update: July 2010 (Preliminary Report*), July 2010. National Conference of State Legislatures, State Budget Update: March 2010, April 2010 (updated May 27, 2010).

The NCSL report concludes that, "States budgets are in transition, apparently improving as state revenues stabilize and begin their slow march to pre-recession levels. But many uncertainties lurk, with their impact poised to hit state budgets next year. FY 2011 may turn out to be the calm before the next fiscal tempest."

The National Association of State Budget Officers (NASBO) and the National Governors Association (NGA) released a survey of state fiscal conditions in June 2010 offering a similar fiscal outlook. The report finds that, "Fiscal 2010 presented the most difficult challenge for states' financial management since the Great Depression and fiscal 2011 is expected to present states with similar challenges."

Among the findings in the NASBO/NGA survey:

- FY 2010 general fund expenditures ($612.9 billion) were estimated to decline 6.8% from FY 2009 ($657.9 billion), and governors' recommended FY 2011 budgets included a 3.6% increase in general fund expenditures from FY 2010. FY 2009 and FY 2010 represent the largest declines in the history of the NASBO/NGA report, as well as the first time state general fund expenditures declined in two consecutive years.
- For FY 2011, governors in only 13 states recommended lower general fund expenditures than in FY 2010. However, 44 still estimate lower expenditures in FY 2010 than in FY 2008. In FY 2009 and FY 2010, over 40 states made mid-year budget cuts of $31.3 billion and $22.0 billion, respectively. By contrast, FY 2002 and FY 2003 saw 37 states make mid-year reductions of $14 billion and $12 billion, respectively, after the last national economic downturn in the early 2000s.
- Many states continue to experience revenue shortfalls. States estimate that sales, personal income and corporate income tax revenues in FY 2010 will be $477.4 billion compared to $541.4 billion in FY 2008, a decline of 11.8%. For FY 2010, tax revenues exceeded expectations in only two states, were on target in two states and were below expectations in 46 states.
- Estimated FY 2010 sales, personal income and corporate income tax collections are 2.3% lower than actual FY 2009 collections; states had projected an average 1.7% growth in tax collections for FY 2010. For FY 2011, states are projecting a rise of 3.9% in tax collections.
- Tax and fee increases proposed in governors' FY 2011 recommended budgets would generate an additional $3.1 billion in revenue, down sharply from the $23.9 billion enacted the previous fiscal year. A total of 18 states are recommending net tax and fee increases while nine are recommending net decreases.
- Total balances—ending balances and the amounts in budget stabilization (e.g., "rainy day") funds— remain far short of their FY 2006 peak of 11.5% of expenditures. Balances dropped to 9.1% of expenditures in FY 2008 and 4.8% in FY 2009. In FY 2010, balances rose to 6.2% of expenditures, but are expected to fall slightly to 5.8% in FY 2011. However these estimates may be overstated, as two states (Texas and Alaska) made up 66% of total state balance levels in fiscal 2010, and balances in the remaining 48 states account for only 2.2% of general fund expenditures.

Despite economic growth in the fourth quarter of 2009 and the first two quarters of 2010, the financial crisis and weak recovery continues to dampen state tax revenues, according to research from the Nelson A. Rockefeller Institute of Government at the State University of New York. The Rockefeller Institute found that revenue had declined over all four quarters of 2009, though there was modest revenue growth in the first and second quarters of 2010. An August 2010 Rockefeller Institute report found that state tax collections increased 2.2% in nominal terms compared to the second quarter of 2009 and was 17.2% below the same period in 2008.

Part 2

Governor Christie Advancing Privatization in New Jersey

Gov. Chris Christie is embracing privatization as part of his larger efforts to streamline state government in New Jersey. Less than three months into his first term, Christie issued an executive order in March 2010 creating the New Jersey Privatization Task Force, a short-lived advisory body established to identify a comprehensive set of privatization tools and strategies the state could apply to save at least $50 million in fiscal year 2010–2011.

The Task Force conducted a statewide review to identify realistic, pragmatic and actionable privatization opportunities across state government, releasing a final report in May that identified dozens of privatization opportunities that, if fully implemented, would realize cost savings and/or other benefits totaling over $210 million on an ongoing, annualized basis. It is likely that this figure may be understated, as the Task Force was unable to quantify potential savings for a number of the individual privatization recommendations, and it did not attempt to estimate the potential revenues from proposed asset divestitures, which likely total in the tens of millions.

Beyond individual privatization opportunities, the Task Force clearly recognized the value of a sound privatization process—given several troubled privatization initiatives in the state's recent past that suffered from poor contract design and oversight—and outlined a series of institutionalization strategies designed to make smart privatization a routine part of public management in Trenton. Notably, it recommends that Governor Christie announce as an administration priority that achieving efficiency through private sector competition become standard policy for all state agencies. One of the key recommendations for doing so involves the establishment of a centralized privatization entity for the state that would fulfill functions similar to Florida's Council on Efficient Government, a privatization "center of excellence" established in 2004 during former Gov. Jeb Bush's tenure and a key component of a strategy that ultimately helped his administration realize over $550 million in cost savings through over 130 privatization and competition initiatives.

Additional Task Force recommendations on institutionalization include applying a set of best practices in project selection and contracting, creating a process for unsolicited privatization proposals, and ensuring that privatization initiatives reflect the state's environmental policy priorities.

The 40 individual privatization recommendations in the report ranged from broad to narrow, but some of the major highlights include:

- State parks management;
- State psychiatric hospitals;
- Vehicle fleet maintenance and management;
- Public-private partnerships (PPPs) to finance the construction and maintenance of new or expanded state infrastructure;
- Performance-based highway maintenance (e.g., bundled "fence-to-fence" maintenance contracts);
- Surplus asset divestiture;
- Emergency service patrols on state highways and interstates;
- State parking facilities;
- Water;
- Printing services;
- Workers compensation claims processing;
- State rest areas;
- NJ Turnpike toll collection;
- NJ Transit bus routes and vehicle maintenance;
- Statewide vehicle emission inspections;
- Motor vehicle titling and registration;
- Higher education facility maintenance;
- Child support services;
- Correctional inmate medical services;
- Correctional food services;
- Hospital debt collection;
- Golf course management; and
- Housing and construction code enforcement.

The Christie administration is already moving ahead on some of these recommendations. Current privatization initiatives being advanced in New Jersey include:

- ***New Jersey Transit parking***: In October 2010, the New Jersey Transit Corporation (NJ Transit) issued a request for qualifications (RFQ) for a 30- to 50- year concession for some or all of its commuter parking facilities throughout the state. The proposed concession program—known as System Parking Amenity and Capacity Enhancement Strategy (SPACES)—aims to expand parking capacity and enhance services at some or all of the approximately 48,000 spaces controlled by NJ Transit statewide. The RFQ specifically lists approximately 80 parking lots as part of the bid, and a mix of revenue-generating and unpriced lots (that would likely be converted to paid spots as part of the concession).

NJ Transit received statements of qualification from 10 bidder teams in mid-November, and the following month the agency narrowed the list down to seven qualified concessionaires eligible to bid when the agency issues a formal request for proposals, expected in March 2011. The teams include KKR/ECI Investment Advisors/Ampco Parking Systems, Morgan Stanley/Central Parking System, Carlyle Infrastructure Partners/Nexus Parking Systems, Macquarie Capital/Standard Parking/TimHaahs, JP Morgan/LAZ Parking, Cintra and Edison.

- ***Toll collection***: In December 2010, the New Jersey Turnpike Authority announced that it plans to solicit private sector proposals to potentially take over toll collection on the New Jersey Turnpike and Garden State Parkway, a function currently handled by 475 state employees. The agency expects to issue an RFP in January 2011 seeking bids on a five-year contract for toll collection on both roads. Current union agreements have been costly for the state, according to New Jersey Transportation Commissioner Jim Simpson. Simpson told *The Record* in January 2011 that "[t]he cost of toll collection in New Jersey is among the highest in the nation and it's gotten way out of hand—between work rules, salaries and benefits." Further, the Task Force report noted that manual toll collection is increasingly passé; 70% of Turnpike and Parkway tolls are collected electronically today through the E-ZPass system, while only 30% are collected manually. According to TollRoadsNews.com, the agency's 475 full-time toll collectors currently cost the state an average of approximately $100,000 each in salary plus benefits, and private toll collection services "tend to have overall costs about half to two-thirds the $100k/person/year that has become typical for public toll authorities," suggesting a potential cost savings of between $16 million to $24 million annually. Elsewhere in New Jersey, the South Jersey Transportation Authority explored the privatization of part-time Atlantic City Expressway toll collectors in 2010 but ultimately reached a tentative agreement with current part-time workers to reduce their hourly pay rates.

- ***New Jersey Network***: In December 2010, Governor Christie signed the New Jersey Public Broadcasting System Transfer Act, initiating a transition to private, independent management for New Jersey Network, the state-run public broadcasting network. The legislation was a compromise between the state legislature and the Christie administration, which had planned to defund the agency by the end of 2010 and had begun the process of laying off the network's 130 employees in November. The law grants a reprieve to the affected employees during the transition to private operation, anticipated to occur in 2011. It also authorizes the state treasurer to solicit and approve privatization proposals while requiring legislative approval of any negotiated agreement.

- ***Trenton War Memorial***: In October 2010, the state issued a request for information to gauge private sector interest in taking over operations and maintenance of the Trenton War Memorial facility in an attempt to lower or eliminate the facility's $800,000 annual subsidy. The facility—which stands adjacent to the statehouse and includes a theater and conference rooms—is underutilized, according to the Task Force, which found that it "has the potential to generate increased revenues if managed in conformity with theater and conference industry standards."

- ***State-owned racetracks***: A state advisory commission appointed by Governor Christie released a report in November 2010 recommending discontinuing horseracing at the Meadowlands Racetrack, consolidating racetrack operations at Monmouth Park and privatizing both state-owned racetracks. Annual operating losses at both facilities currently total over $17 million. An August 2010 poll conducted by Fairleigh Dickinson University found public support for the idea, with a 56% majority of state residents supporting privatization of the Meadowlands and Monmouth Park racetracks. Though Governor Christie remains committed to privatizing both facilities, it appears unlikely that the consolidation plan will materialize. In late December, Governor Christie announced an agreement that will keep the Meadowlands racetrack open through March 2011 and authorize the New Jersey Sports and Exposition Authority to negotiate a lease of the racetrack to a private operator. At press time, the state was negotiating a potential lease to a private sector partnership between the Standardbred Breeders and Owners Association of New Jersey (SBOANJ) and Jeffrey Gural, owner of the Tioga Downs and Vernon Downs racetracks in New York.

- ***Contaminated site cleanup***: As reported in Reason Foundation's *Annual Privatization Report 2009*, state policymakers enacted a law in 2009 to overhaul the state Department of Environmental Protection's (DEP) site-remediation program by authorizing property owners to hire licensed, private consultants to clean up a backlog of approximately 20,000 contaminated properties and certify their safety. The program got underway in November 2009, and responsibilities for program oversight are transitioning from the DEP to a new Licensed Site Remediation Professional Board created under the law to set standards and issue licenses to private contractors. The administration aims to have the majority of contaminated properties in the program by the summer of 2012. In November 2010, DEP Commissioner Bob Martin told *The Star-Ledger* that, "Cleaning up these sites is a number one priority for myself and Governor Christie. This program has to be a success. There are already large companies, large oil companies, stepping forward to bring hundreds of sites into the program."

- ***Roadside assistance***: The Associated Press reported in July 2010 that the New Jersey Department of Transportation was exploring the possibility of privatizing the state's free roadside assistance program to free up funds for road maintenance and other priorities. According to Transportation Commissioner Jim Simpson, privatization could make up to $12 million in federal funds available for other uses. "I can take that $12 million and use it for more asphalt," Simpson told the Associated Press.

Part 3

Louisiana, Governor Jindal Leading the Way on State Privatization

Amid the state's ongoing fiscal crisis, **Louisiana** Gov. Bobby Jindal has emerged as a privatization leader, with his administration aggressively advancing a broad government reform agenda since taking office in 2008 that incorporates a variety of privatization initiatives across a broad swath of state services.

To get ahead of a looming fiscal crisis, Governor Jindal and the state legislature established the Commission on Streamlining Government (CSG) in the spring of 2009 to recommend reforms to reduce the cost of government through downsizing, streamlining and privatization. In December 2009, the CSG issued a report to the governor and legislature outlining 238 recommendations estimated to save over $1 billion through privatization, streamlining, consolidation and elimination of government activities. Recommendations include a number of large-scale government overhauls, including adopting a statewide spending limit, shifting all of the state's retirement funds to 401-k style defined contribution plans for all new hires, and revamping state education finance to promote a student-based budgeting approach where education dollars directly follow children into the classroom.

On the privatization front, the CSG recommended over a dozen privatization initiatives estimated to save the state at least $88 million, including recommendations to create a statewide privatization program, privatize state inpatient psychiatric services and outsource the administration of state employee group medical benefits, correctional food and pharmaceutical services, road maintenance and most highway design engineering.

A number of the CSG privatization recommendations are already being implemented, with the Louisiana Division of Administration (LDOA)—the state's general services agency—leading the way. For example:

- In 2009, LDOA established an internal team to help the agency identify and implement appropriate privatization and outsourcing initiatives and prepare business cases on the feasibility and desirability of individual privatization initiatives.

- In March 2010, LDOA announced the privatization of property and casualty claims management and loss prevention services within its Office of Risk Management, a move expected to result in estimated savings of at least $20 million over five years, instant access to technology improvements and greater program flexibility. The state will partner with the Louisiana-based F.A. Richard & Associates, Inc. in a $68 million contract that will provide instant access to state-of-the-art technology improvements unavailable in-house, offer a high probability for reduced claims costs and reduction in overall program costs, and provide for additional flexibility in program management. The contract allows the state to focus on enterprise risk management, as opposed to the day-to-day business of running a large claims and loss prevention enterprise. The move will result in a reduction of approximately 85 state employees, but the state will require the firm to offer employment to those displaced by the privatization, at a salary based on the company's pay scales for their existing employees.

- As part of its efforts to reduce the state vehicle fleet by 10% per year over the next three years, LDOA expanded an existing rental car contract to facilitate the divestiture of portions of its vehicle fleet. The agency placed a moratorium on new state vehicle purchases in August 2009, so vehicles sold at regular state auctions since then have represented a net reduction in the overall fleet.

- In 2009, LDOA issued a request for proposals seeking bidders for a contract covering the operation and maintenance services across dozens of state buildings, functions currently provided by LDOA's Office of State Buildings. At press time, the agency was still evaluating the bids received and had not made a final decision on moving forward with the project.

- LDOA is undertaking an inventory and analysis of all state-owned buildings and lands to find underused property to return to private commerce.

- LDOA is exploring the possibility of contracting for a third-party administrator for the Office of Group Benefits' PPO plan for state employees and retirees. The Office currently uses third-party administration for its EPO and the HMO plans.

Louisiana's Department of Health and Hospitals (DHH) was also noteworthy for making bold shifts on privatization in 2010:

- The Louisiana State University-run Charity Hospital System—the only statewide public hospital system in the U.S.—is in the process of being transformed through privatization as part of a transition from a "direct provider" model to a "purchaser" model. For example, the aging, state-run Earl K. Long Medical Center in Baton Rouge will be closed in 2014 and replaced with a public-private partnership with Our Lady of the Lake Regional Medical Center. Similarly, the Interim LSU Public Hospital in New Orleans will be replaced by a new teaching hospital run by a private board.

- The DHH's Office for Citizens with Developmental Disabilities privatized two state-operated community homes in 2010 and has also been transitioning some residents of state-run homes to privately run providers for an estimated overall savings of $7.1 million. Further, DHH plans to privatize an additional 31 state-run community homes in the near-term. According to a DHH report submitted to the CSG, "[t]hese efforts are part of the department's goal of getting out of the business of competing with private providers and decreasing the size of government."

- DHH is discharging 118 people from state-operated psychiatric hospitals to privately operated community homes, while transferring another 138 institutional beds to a private operator.

- DHH is also privatizing six state-run substance abuse treatment centers.

Altogether, the privatization initiatives in developmental disabilities, mental health and substance abuse treatment are expected to cut costs by over $52 million in 2010, according to agency estimates.

The Jindal administration's multi-faceted privatization push encountered some legislative resistance in the 2010 session. Most notably, Governor Jindal vetoed a bill in July 2010 that would have required legislative approval before any procurement or contracting for state-provided health-care services. The bill—House Bill 1443, sponsored by Rep. John Bel Edwards (D-Amite)—originally focused only on long-term contracts for the private operation of state psychiatric hospitals, but the scope expanded under amendments offered during legislative deliberations. According to Jindal, the bill would have prevented the implementation of needed cost reductions and would have increased the risks faced by potential private vendors. A separate bill that would have created a permanent legislative subcommittee to review and approve state contracts was introduced, but was ultimately withdrawn by the sponsor.

In other privatization news from the Pelican State:

- In December 2010, the Jindal administration announced plans to privatize the bulk of Louisiana's Medicaid system and plans to issue an RFP in 2011 to private health insurance companies interested in providing state-subsidized policies to over 800,000 state Medicaid patients. Under the plan, the state will transition Medicaid recipients into "coordinated care networks," where the state would pay private insurance companies to cover Medicaid patients, and the insurers would manage patient benefits and reimburse providers for services rendered. The administration considered—and solicited interest from over a dozen bidders for—an alternate approach in which the state would let Medicaid recipients choose from a pool of private insurers pre-approved by the state to deliver services, but officials ultimately opted against it due to concerns that it would be unwieldy for providers and that recipients would be confused by choices over which insurance option to select. Though one of the least-healthy states, Louisiana ranks sixth in the nation for public health spending, according to state officials.

- In February 2010, a private contractor took over responsibility for providing medical care and pharmacy delivery services at the five veterans' homes operated by the Department of Veterans Affairs. Prior to privatization, each veterans' home had a full-time pharmacist on-site, and most also had an on-site doctor and nurse practitioner. Under the new contract, pharmacy services are provided through a centralized mail-order operation, and medical care is provided by private doctors contracted by the state. The privatization is expected to save approximately $2 million per year.

- In early 2010, the Louisiana Department of Corrections received approval from the Civil Service Commission for its plan to privatize correctional pharmacy services at all state-run adult prisons. Corrections officials expect the move to reduce costs by more than 50%, from $2.5 million to $1.2 million annually, according to *The Daily Advertiser*.

- The Louisiana Department of Revenue is considering the potential privatization of call center services as a way to improve services for state taxpayers. Currently, the department is unable to answer 15,000 of the 42,000 monthly calls it receives, prompting agency officials to consider outsourcing the work to a private service vendor.

- In the summer of 2010, the state's Civil Service Commission heard a report from Louisiana State University officials on their intention to outsource mail and printing services for its main Baton Rouge campus.

Though fiscal challenges remain into the foreseeable future, the Pelican State's government downsizing efforts are already benefitting the state. Notably, all three major credit rating agencies upgraded Louisiana's bond rating since 2009—at a time when other states have seen downgrades given their shaky fiscal health—and the agencies specifically cited the state's focus on spending control and streamlining as influencing factors. A higher credit rating will save taxpayers millions in avoided interest costs over time.

Part 4

Divesting the State's Liquid Assets: States Explore Privatization of Alcohol Monopolies

Amid widespread budget deficits and fiscal crises, many states are seeking novel ways to streamline government, boost income and eliminate unnecessary expenditures. One such reform that has caught the attention of policymakers in several states—including Virginia, Washington State, North Carolina and Pennsylvania—is the privatization of state-run monopolies in the distribution and/or sale of distilled spirits.

A vestige of post-Prohibition policies, every state maintains a three-tiered system of alcohol distribution—manufacturing, wholesale/distribution and retail. Over 30 states opted to pursue a "regulate-and-tax" approach to alcoholic beverage control (ABC) in the wake of Prohibition, whereby wholesale and retail activity is undertaken by private businesses subject to regulation, licensure and taxation by the state. However, 18 so-called "control" states opted to create a state-owned monopoly on the wholesale distribution of spirits after Prohibition, with eight also maintaining a state monopoly on retail operations (through government-owned and operated liquor stores). The eight control states with a total monopoly on both wholesale and retail operations include Alabama, Idaho, New Hampshire, North Carolina, Pennsylvania, Utah, Virginia and Washington State. Of all 18 control states with a wholesale monopoly, only two—Iowa and West Virginia—have transitioned to an entirely privatized retail model since Prohibition.

Proponents of privatized liquor sales argue that distributing and selling liquor is not a core function of government and that government's role should be to regulate spirits sales, not serve as both regulator and operator. They also cite improved consumer choice, better selection and convenience, and more competitive product pricing as predictable results of creating a competitive market in spirits sales.

Opponents of ABC privatization—which often include public employee unions, public health advocates and religious organizations—counter that the state's role in wholesale and retail prevents social harms from alcohol consumption, provides a steady revenue stream to the state and keeps the number of outlets in check. However, two separate studies released in 2010—one from the Mercatus Center at George Mason University and the other from the Pennsylvania-based

Commonwealth Foundation—found no significant differences between control states and license states in terms of their ability to control social harms, including per-capital alcohol consumption, underage alcohol abuse and drunk driving.

In the past year, lawmakers have considered large-scale ABC privatization initiatives in Virginia and Washington State, while a policy dialogue is underway Pennsylvania, North Carolina and other jurisdictions.

A. Virginia

Privatization of the Commonwealth's liquor retail and wholesale operations—and investing the upfront proceeds from privatization into new and expanded transportation infrastructure—was a central pillar of Governor McDonnell's larger fiscal agenda upon entering office in January 2010. In a February 2010 interview with Reason.tv, the governor articulated his support for ABC privatization:

> *Nothing that I glean from the Constitution […] would have me think that it is better or required in some way to have the government controlling distilled spirits. So from a fiscal and economic and philosophical perspective, it's the right thing to do.*

Toward this end, the McDonnell administration began crafting a proposal to privatize the wholesale and retail functions of the Virginia ABC, which was presented in September 2010 to the Governor's Commission on Government Reform and Restructuring, an advisory body on government streamlining created by McDonnell that subsequently endorsed ABC privatization. The key goals of McDonnell's initial ABC proposal were to: (1) privatize wholesale and retail ABC operations while retaining the "three-tier" system, and (2) invest the upfront proceeds from privatization (estimated at $400–500 million) into statewide transportation infrastructure, and (3) maintain ongoing annual revenues to the state.

The retail privatization component of the proposal involved issuing 1,000 new retail licenses in three tiers, allocated in the following manner based on store square footage and shelf space:

- 600 licenses at Level 1 (grocery stores, big-box stores)
- 150 licenses at Level 2 (smaller package and specialty stores)
- 250 licenses at Level 3 (convenience stores, retail pharmacies)

Under the proposal, no company would have been granted more than a 25% share of licenses at any level. Minimum bids for licenses at each level would have been based on population and other factors, and licenses would be sold in perpetuity (and could have been sold, transferred or leased by the licensee). Based on a review of current license bid prices in other states, administration officials projected that the state could raise a minimum of $265 million from the one-time auction of retail licenses.

Administration officials also projected that the sale of wholesale licenses—to be sold at a cost of 2.5 times the gross profit of the spirit line being distributed—would have generated at least $160 million in one-time revenue. Additional divestiture of the state's central ABC warehouse and 19 state-owned retail outlets would have raised an additional $33 million. The $458 million or more in total upfront proceeds from ABC privatization would have been used to establish a new state transportation infrastructure bank that could provide seed money for a range of privately financed transportation projects, effectively leveraging hundreds of millions in ABC proceeds into billions of new funds for transportation projects.

However, a more central focus for many state policymakers—and ultimately a key source of opposition that stalled the proposal—was the component of the plan dealing with ongoing revenues to the state. Under the proposal, the state's current markup and excise taxes would have been replaced with a $17.50 per gallon excise tax and a 2.5% surcharge for on-premise spirits sales for establishments that choose to purchase their products directly from wholesalers. Combined with existing excise and sales taxes on alcohol products—and enhanced revenues under privatization expected from corporate income taxes and repatriated sales currently lost to other states and Washington D.C.—administration officials projected that the state would continue to receive over $303 million annually in alcohol-related revenues under privatization.

This fell short of the $324 million generated under the current state system—largely due to the difficulty of trying to replace revenues from the Commonwealth's high 69%–79% markup on spirits today—drawing skepticism and opposition by a range of state legislators concerned with revenue neutrality under privatization. Subsequent changes to the original proposal by the McDonnell administration eliminated some of the proposed taxes to make the deal more palatable to industry and retail stakeholders, but this had the effect of extending the revenue gap even further and reducing legislative support.

Lacking a critical mass of legislative support, McDonnell abandoned plans to call a special legislative session to address ABC privatization in the fall of 2010 and hired a consultant to help the state develop an alternate privatization proposal. The administration is reportedly working on a new, more limited proposal involving retail operations only that it plans to unveil in January 2011 and introduce as legislation in the ensuing General Assembly session.

Though the initial privatization proposal failed to gain traction politically, Virginians appear to be ready to abandon their state's spirits monopoly. An October 2010 poll conducted by a retail coalition found that a solid majority (57%) of Virginians support ABC privatization, with only 35% opposed. Similarly, a December 2010 survey conducted by Christopher Newport University found that 52% of residents supported privatization regardless of how much money would be generated for the state; 38% of respondents opposed privatization. Further, endorsements from former Democrat Gov. Doug Wilder, former Republican Governor and Senator George Allen, Jerry Falwell Jr., the Virginia Fraternal Order of Police and the Virginia Chamber of Commerce confirm that support for the concept of ABC privatization falls along a broad and bipartisan spectrum.

B. Washington State

Washington State voters rejected two separate initiatives on the November 2010 ballot that would have each privatized the state's liquor monopoly. Initiative 1100 (I-1100)—which would have privatized the Washington State Liquor Control board's retail and wholesale operations, ended the state's 51.9% alcohol markup, repealed a ban against volume discounts for alcohol and eliminated the mandatory use of wholesalers/distributors (one of the “three tiers”)—was defeated by a narrow 52%–48% margin after being outspent by an alliance of major brewers, various national beer and wine wholesaler associations and public employee unions formed to defeat the measure. I-1100 was commonly referred to as the “Costco initiative,” since the large retailer was the primary supporter of the initiative and even led the petition drive—with petitioners stationed at the entry to Costco stores statewide—to gather sufficient signatures to qualify I-1100 for the ballot.

Wholesaler interests also placed another measure, Initiative 1105 (I-1105), on the same ballot that would have privatized the state's spirits monopoly while preserving a mandatory wholesale tier. Though defeated by a 63%–37% margin, it's reasonable to expect that at least some of the 37% of supporters voted for I-1105 over I-1100, siphoning off votes that potentially could have reversed the outcome of I-1100.

Despite the defeat of the competing privatization initiatives, there appears to be significant interest in continuing to explore ABC privatization. A December 2009 report by State Auditor Brian Sonntag explored ABC privatization options and found that the state could increase revenue from liquor sales and distribution by up to $350 million over five years beginning in fiscal year 2012 if it sold the state distribution center and auctioned liquor licenses to private retailers.

According to media reports, at least two lawmakers—Rep. Gary Alexander (R-Olympia) and Sen. Tim Sheldon (D-Potlatch)—plan to introduce legislation in the 2011 session on ABC privatization. Sheldon introduced a bill to privatize the state’s retail and wholesale ABC operations in the 2010 session that failed to pass, which he plans on revisiting in 2011. Alexander plans to reintroduce a prior bill that would turn existing state-owned liquor stores over to private operators contracted by the state.

Further, Gov. Chris Gregoire—who actively opposed the two November ballot measures—told the *Seattle Post-Intelligencer* in December 2010 that she would consider ABC privatization if there were demonstrable public support for the idea:

> *I'm not clear what the voters said in November about this […] So I told the liquor board, I wanted them to do a poll for me and bring me the results. Try and figure out, what were voters saying? ... Did they say, 'I don't want a liquor store on every corner of the state of Washington, but I'd really like more convenience at my local Safeway store?' I don't know the answer.*

That same month, the state’s Senate Labor, Commerce & Consumer Protection Committee began discussing potential changes the legislature could make on ABC operations—including privatization—in advance of the legislative session beginning in January 2011.

C. North Carolina

After a series of pay, abuse and corruption scandals, North Carolina's liquor control system is facing a critical review, opening the door to discussions on privatization. In 2010, Democrat Gov. Bev Perdue's administration hired the Chicago-based Valuation Research Corporation to conduct a market valuation of the state's 415 liquor stores and wholesale operation. After presenting the administration with preliminary findings in the fall, the state extended its contract to explore additional ABC privatization assumptions and scenarios.

The consultant's findings will be critical to Perdue's decision on whether or not to recommend privatization. "I have believed for a long time there has to be a real examination of privatization," Perdue told the *News & Record* in December 2010. "I'm not quite there yet…I need to know what it's worth. I need to know what it's worth to the taxpayers, I need to know what kind of damage it would do to local governments and how you protect them."

Separately, Governor Perdue signed into law an ABC reform bill aimed to keep excessive pay in check, increase operational efficiency and adopt certain ethics reforms. Composed of over 167 ABC boards in 100 counties, North Carolina's approach to liquor control and regulation is uniquely local and decentralized. The state's ABC Commission operates a central warehouse that distributes spirits to each of the local ABC boards, consisting of members appointed by counties and cities. Each ABC board is an independent unit of local government and oversees retail operations in its jurisdiction.

D. Pennsylvania

Facing a $4 billion deficit in the state's 2011 budget, Pennsylvania policymakers are exploring the potential privatization of the Pennsylvania Liquor Control Board (PLCB), an idea originally proposed by former Gov. Dick Thornburgh during his tenure in the 1980s, but which has lacked political support—at least until now.

Incoming Republican House Majority Leader Mike Turzai of Allegheny has introduced House Bill 2350 aimed at the privatization of the PLCB's wholesale and retail monopolies. Turzai's plan would auction off the state's distribution centers and 621 liquor stores along with licenses for 129 additional stores, bringing the total to 750 statewide. The state would also auction 100 licenses for spirits distribution.

In addition to expanding competition and getting the state out of the liquor business, Turzai's proposal would simplify Pennsylvania's liquor taxes. Most notably, the plan would eliminate the 18% "Johnstown Flood Tax," originally levied in 1936 as an emergency measure to offset flood-related expenses. Turzai's bill would replace existing taxes with a $2–$6 excise tax and a 6% retail sales tax, generating a revenue-neutral $500 million annually for the state, according to the representative's estimates.

Further, Turzai contends that his plan could result in a $2 billion windfall from the auction of licenses and sales of real property, and it may gain a more receptive audience in Harrisburg than his similar attempts in recent years, with the Republican takeover of the governor's office and both legislative chambers in November 2010. During his campaign, Governor-elect Tom Corbett made privatization of the Pennsylvania Liquor Control Board's (PLCB) spirits monopoly an explicit plank in his campaign platform, stating that:

> *Given the current economic climate in Pennsylvania, state government can no longer be in the liquor store business. We need to move our state out of the 19th century and refocus state government on its core functions and services for our residents.*

A December 2010 poll conducted by Quinnipiac University found that a 66% majority of Pennsylvania voters support PLCB privatization as a way to close the state budget deficit. Only 26 percent of respondents opposed privatization.

E. Other ABC Privatization Activity

In addition to those discussed above, other states and Canadian provinces have begun to consider the privatization of their liquor wholesale and/or retail operations:

- Incoming **Ohio** Gov. John Kasich is reportedly considering adding the state's Division of Liquor Control to the list of possible assets for privatization under his new administration. Kasich told reporters in January 2011 that he had received estimates that privatizing the state's spirits monopoly could potentially net $1 billion for the state, which faces an $8 billion deficit in 2011.

- The Canadian province of **Ontario** is currently considering partially privatizing a range of state-owned corporations, including its liquor, lottery and power companies. As part of this privatization initiative, the province could sell its 610 liquor stores. Elsewhere in Canada, Officials at NB Liquor—**New Brunswick**'s government-run spirits monopoly—are currently reviewing a variety of forms to cut costs and increase revenues to the provincial government, which include privatization.

- **Utah** policymakers are at the beginning stages of exploring potential ABC privatization after the Utah Privatization Policy Board—which advises the legislature on privatization opportunities—began to study the possibility of ending the state Department of Alcoholic Beverages' monopoly on spirits and wine sales.

- **Vermont** State Senator Claire Ayer's (D) 2010 bill to disband the state's Department of Liquor Control and allow second class licensees to sell liquor failed to pass. Under the proposed bill, the Department of Public Safety would incorporate the remaining liquor control functions.

Part 5

Puerto Rico Launches Major Privatization Program

Puerto Rico Gov. Luis Fortuño is embracing privatization as part of a larger package of government reforms put into effect in the first two years of his administration. Since taking office in January 2009, Governor Fortuño's administration has taken bold actions to address the U.S. Commonwealth's chronic deficits and unsustainable debt, including eliminating approximately 22,000 government jobs, dramatically cutting expenditures and passing a broad-ranging new law in 2009 inviting private investors to modernize or develop new roads, ports, water systems, electric plants and more.

The 2009 law (Act No. 29) authorizes any government agency to enter into public-private partnerships (PPPs) with private firms for the design, construction, financing, maintenance or operation of public facilities. In return for upfront payments, the Commonwealth would grant investors long-term leases during which they could recoup user fees. Under the law, most PPP contracts are limited to 50-year leases, though legislators can approve an extension up to 25 additional years. The law also established a new Public Private Partnership Authority (PPPA), a unit within the Government Development Bank responsible for identifying, evaluating and selecting PPP projects and for monitoring and enforcing the terms of PPP contracts.

It is likely that PPPs developed under the new law will cover a broad spectrum, as PPPA has outlined a set of priority projects that include toll roads, transit, energy, water/wastewater facilities, solid waste management and ports. Initiatives advanced by the PPPA thus far include:

- In November 2010, the PPPA issued a request for proposals to four qualified firms for a long-term lease covering operations and improvements to toll PR-22 and PR-5, two existing toll roads currently owned and operated by the public sector. Bids are due in March 2011.

- Puerto Rico is laying the groundwork to transfer the management of San Juan's Luis Muñoz Marin Airport to a private operator in 2011 in order to modernize the airport without public funds and generate up to $1 billion in upfront proceeds for public coffers. Officials have received preliminary approval from the Federal Aviation Administration for a long-term lease of the airport, and negotiations are under way to obtain consent for privatization from the airlines currently serving the airport.

- According to the PPPA, public schools in Puerto Rico face approximately $1.4 billion in renovation and facility modernization needs across their system of approximately 1,500 schools. To help modernize facilities and improve academic performance, the Fortuño administration and PPPA have launched the “Schools for a 21st Century” PPP program, under which Puerto Rico will enter into concessions with private operators to design, build and maintain approximately 100 schools across Puerto Rico. All municipalities will have at least one school included in the PPP program. Over two-thirds of Puerto Rico’s public schools operating today were built before 1970, some dating as far back as the 1930s.

- In August, the PPPA and the Puerto Rico Aqueduct and Sewer Authority (PRASA) announced that they had received 13 statements of qualifications from consortia interested in bidding on a PPP to automate water meter reading. The project involves the design, development, financing and operation of advanced technology for automated water meter reading, the implementation of a geographic information registry of PRASA customers and the reduction of non-revenue water.

- The Puerto Rico Electric Power Authority intends to launch PPPs to convert certain turbines fueled by crude oil combustion into turbines that run on natural gas, as well as to develop and operate a natural gas distribution system serving certain power plants along the Puerto Rico coast.

In August 2010, PPPA announced four new potential priority PPP projects for which it has begun preparing feasibility studies:

- a PPP project for the financing, design, construction, operation and maintenance of a new minimum custody correctional facility;
- ferry service between the municipalities of Fajardo,Vieques and Culebra;
- the development of a technology project for traffic control automation and traffic violation control; and
- rail transit station redevelopment.

Part 6

Arizona Blazing Trail on State Parks Privatization

The recent economic downturn has affected public service delivery for all levels of government across the country, and state parks are no exception. In 2010 states were forced to grapple with decreasing tax revenue and increasing costs. When budgets are tight, state parks often see funds diverted to other higher priorities, such as public safety and education, in the competition for scarce state funds. According to a 2010 study by the National Trust for Preservation entitled *America's State Parks & State-Owned Historic Sites*, at least 26 state parks systems are at-risk and face major budget cuts.

No state reflects both this crisis, and a possible solution, better than **Arizona**. In recent years, the Arizona state legislature has been forced to cut funding for the parks system and temporarily close parks, all while facing tens of millions of dollars in deferred maintenance in the system. However, a recent proposal in Arizona to lease state parks to private concessionaires offers a restructuring model other states can consider as they contemplate solutions to ensure the long-term fiscal sustainability of state parks.

In 2009, Phoenix-based Recreation Resource Management (RRM)—one of the largest private recreation management companies operating in over 100 public sector parks in the United States—submitted an unsolicited privatization proposal to the state offering to lease several Arizona state parks targeted for closure amid recent budget cuts. The company proposed to collect the same visitor fees the state charges today, while taking the operations and maintenance costs of these parks off the state's books entirely. Further, the concessionaire would pay the state an annual lease payment based on a percentage of the fees collected. The state would retain full ownership of the land, and the company would be subject to strict state controls on operations, visitor fees, maintenance and other key issues.

RRM's proposal reflects an innovative method of public-private partnership (PPP) being discussed with increasing regularity in state capitols around the country. Under a PPP, parks would not be sold. Rather, the state would enter into a lease (concession) authorizing the operation of one or more parks by a private recreation company (concessionaire) under a performance-based contract.

The term "concession" can have various meanings and needs clarification. A ubiquitous type of parks-related concession might involve having a private company run a retail store, food or equipment rental operation within a government park. For example, private concessionaires currently operate the commercial activities (e.g., lodging, retail, food) in the “crown jewels” of the national parks, including the Grand Canyon, Yosemite and Yellowstone. However, this is a more limited type of concession than discussed above.

In the "whole park" context, a concession would essentially be a long-term (10–20 year) lease of the entire operation of a park (or group of parks) under a performance-based contract with a private recreation management company. Agencies such as the U.S. Forest Service (USFS), Tennessee Valley Authority and the Lower Colorado River Authority have made extensive use of concessionaires to operate and maintain complete parks and campgrounds. In fact, the USFS—what might be considered the largest parks agency in the world, in many respects—has been consistently and successfully applying this model for over 25 years throughout many parts of its system after Reagan-era budget cuts forced the agency to seek alternate means of keeping its recreation areas open. During the famous federal government shutdown during the Clinton administration, the only federal recreation facilities that remained open were those run by concessionaires under leases.

Whole park concessions are usually structured as commercial leases in which the concessionaire collects the gate fees to fund its operations and maintenance costs, including labor. No public subsidies are required—in fact, the concessionaire pays a set percentage of the gate revenues to the public agency as an annual lease payment. This offers the opportunity to minimize, or potentially eliminate, public subsidies to the parks, while keeping them open for public enjoyment. Concessionaires can simultaneously increase the net revenue to the government and realize their own profits, given that they can tap a lower cost, more flexible labor force and realize significant economies of scale in procurement.

The public sector does not lose control of parks in these arrangements. Concessionaires are only allowed to do what the public sector allows them to under the contract, and they cannot change fees, facilities and operating policies and procedures without approval from the parks organization. The public authority sets the recreation or preservation mission for the park, and the contract requires concessionaires to manage the park to that mission. If that means “disturb nothing, build nothing, just run clean facilities,” so be it. And fears of concessionaires “cherrypicking” the profitable parks are unfounded, as it is common practice for authorities like the USFS to bundle together money-losing parks alongside break-even or revenue-positive parks in concession agreements.

In Arizona, RRM’s proposal was not ultimately accepted, but it prompted state legislators to include language in the 2010 budget requiring Arizona State Parks (ASP) to issue a request for proposals (RFP) for the private operation of one or more state parks. In response to this directive, parks officials released an RFP for the operation of Oracle State Park, but vendors demonstrated little interest in the small, revenue-losing park as a standalone opportunity. Warren Meyer, president of RRM, told the *Associated Press* in September 2010 that, "The Oracle RFP is pretty thin gruel… the state brings in about $20–$30K a year at Oracle and spends about $280,000 to operate the park."

However, in December 2010, ASP changed course and issued a request for information (RFI) to private vendors to "solicit feedback and recommendations regarding the feasibility of transitioning or enhancing various operations at ASP with the private sector." The RFI is open-ended in terms of scope—offering vendors the opportunity to present creative ideas and concepts for the agency to consider for further procurement—and can serve as a model for other states.

Arizona's situation unwittingly sparked a larger national conversation about the potential to rescue parks from closure as local and state governments face unprecedented budget deficits. Philip McKnelly, executive director of the National Association of State Park Directors, told *USA Today* in March 2010 that lawmakers in at least a dozen states were considering closing up to 400 state parks that year.

The potential benefits of parks management PPPs extend beyond cost savings and keeping parks open. They can also provide private capital to solve the common problem of deferred maintenance for park facilities, trails, water and wastewater systems, campgrounds and the like. A 2007 study by the American Society of Civil Engineers calculated that there is as much as $15 billion in deferred maintenance costs for state parks, and gave state-level parks and infrastructure a grade of "C-". As one example of parks PPPs in action, California State Parks tapped the private sector to finance, build and operate over $1 million in new cabins in McArthur-Burney Falls Memorial State Park, facilities the state could not afford on its own.

In 2010, several independent state commissions around the country have recommended studying PPPs in parks, which reflects increasing interest in this policy approach:

- Amid the ongoing discussion of parks funding and operations in **Arizona**, the state's Commission on Privatization and Efficiency issued a report in September 2010 recommending the expanded use of parks management PPPs in the state system to ensure that parks remain open and properly maintained, as well as take significant costs off the state's books.
- **New Jersey** Gov. Chris Christie's Privatization Task Force recommended that the state should enter into one or more long-term concession agreements with private recreation firms for the operation and management of all state parks. Department of Environmental Protection Commissioner Bob Martin told *The Star Ledger* in May 2010 that "[New Jersey is] barely getting by this year with enough funding to run the parks, so [the state is] looking for ways to ensure that [its] parks stay open and all residents have an opportunity to be able to use parks and recreation sites." Privatization of the 58 state parks could save the state anywhere from $6 million to $8 million annually, according to the Task Force's estimates.

- **Utah** is another state currently exploring parks PPPs. In August 2009, the Utah Advisory Commission to Optimize State Government issued a set of over 50 cost-cutting recommendations to Gov. Gary Herbert that included a call to study the potential privatization of state parks. Later that fall, Utah's Privatization Policy Board—which advises the legislature on potential privatization initiatives—began undertaking a review of the potential opportunities available through private management of state parks.

Other developments on the parks and recreation front include:

- **California** policymakers may need to begin exploring private management and other options in the wake of the defeat of Proposition 21, which would have increased vehicle registration in the state by an additional $18 per vehicle. Voters decisively rejected Prop. 21 by a 58–42 margin this past November. According to proponents, the ballot measure would have generated over $500 million for California's poorly maintained parks, while redirecting the current $130 million in spending back toward the general fund. In 2010, California was forced to partially close or reduce services in nearly 150 out of 278 parks, and the California Legislative Analyst Office recommended Governor Schwarzenegger cut the parks budget by $22 million.
- During the summer of 2010 **California** Governor Schwarzenegger signed an agreement with Viktor Vekselberg, head of the Russian nonprofit Renova Group of Companies, to keep Fort Ross State Historic Park open. Renova will support the park through the newly established Renova Fort Ross Foundation. According to a June 2010 *San Francisco Chronicle* article, Fort Ross was the only Russian colonial settlement in California, established in the early 19th century to promote trade. According to California State Parks director Ruth Coleman, "This is the first time a foreign nonprofit has come forward to preserve the history of another country."
- In 2009, the **Georgia** Department of Natural Resources (DNR) solicited bids for private companies to take over operations at the state's eight remaining public golf courses located within state parks. The agency ultimately received—and rejected—four bids. As DNR Parks Director Becky Kelly told the *Atlanta Business Chronicle*, one of the rejected bids was late, two failed to answer mandatory questions and another was unresponsive to follow ups.
- The **Kentucky** state parks system—the third largest in the nation with 51 parks generating $53 million in annual revenues—is facing significant fiscal pressures, with revenues only covering two-thirds of operating expenses. In 2010 the state issued an RFI to solicit private sector interest in leasing and operating 18 state-run golf courses. Kentucky's conventional parks are also facing changes that will save about $6 million a year, including hiring seasonal workers through temporary employment agencies, reducing winter operations and requiring full-time employees to work 37.5 hours per week instead of 40. The state is also allowing alcohol sales in resort parks and private facilities in a move expected to generate $1 million a year.

Part 7

Illinois Breaks Ground in Lottery Privatization

A groundbreaking contract for the private management of the **Illinois** Lottery may usher in a new wave of interest in lottery privatization among cash-strapped states. In September 2010, Illinois Gov. Pat Quinn announced the winning bidder for a first-of-its-kind contract to take over the management of the state lottery. According to Revenue Director Brian A. Hamer, the landmark deal will generate $4.8 billion for the state over the next five years, a $1.1 billion increase over the revenues projected under state management.

Under the terms of the 10-year contract, the winning bidder—Northstar Lottery Group, a partnership between GTECH and Scientific Games—will take over responsibility for lottery operations, management and marketing functions in exchange for a portion of revenues. The state of Illinois will continue to exercise control and oversight over all significant business decisions, including the state approval of annual business plans and ability to access all vendor information regarding lottery operations.

The deal also ties the operator's compensation to its performance at enhancing lottery revenues. Through a combination of an annual base management fee and incentives for extra profits, Northstar stands to earn over $330 million over five years if it reaches state-determined revenue targets. However, the contract includes a 5% total net income cap on the potential profits for the contractor, as well as penalties paid to the state if the company fails to hit revenue targets. The contractor will retain all 170 current lottery employees and has announced its intention to hire an additional 100 private sector employees.

Governor Quinn praised the initiative, saying in a press release, "Hiring a private manager to run the day-to-day operations of the Illinois Lottery is a creative way to generate revenues for critical programs that will aide Illinois' economic recovery." Under the privatization initiative, enhanced lottery revenues will be earmarked for capital projects and education funding.

According to a press release by Senate President John Cullerton, "The lottery's own statements acknowledge that the private sector can [manage the lottery] better." Northstar plans to increase revenue through enhanced marketing, an expansion in the number of retail establishments selling lottery tickets, and the introduction—subject to state approval—of new and more appealing games designed to appeal to a wider and younger swath of the population.

The Illinois deal may come as a surprise to industry observers that had nearly written off the idea of state lottery privatization just a year ago. Just last year the prospects appeared dim for state lottery privatization, as reported in Reason Foundation's *Annual Privatization Report 2009*, in the wake of a Bush administration Department of Justice (DOJ) opinion asserting that private firms may receive no more than "a de minimus interest in the profits and losses of the [lottery] business" under federal law. According to the opinion, the exemption state lotteries currently have from criminal prosecution under federal lottery laws would no longer apply if those lotteries were managed by private firms rather than states.

In order to stay within the bounds of the DOJ opinion, Illinois will not sell or lease the lottery operation outright. Rather, the state is contracting out operations and management duties while retaining a strong role in decisions affecting the lottery and public access to all lottery operations. The partnership will be governed by a private management agreement (PMA) requiring the private manager to submit a business plan each year for official state approval, allowing the state to maintain public control of operations while affording the private manager flexibility in game offerings. In a September 2010 article for GamblingCompliance.com, former New York Lottery CEO, Director and General Counsel Robert McLaughlin wrote that the PMA allows the state to circumvent the "de minimus interest" issue in several ways:

- It allows for the recovery of the private manager's operating expenses, a current industry practice where operators are paid from administrative expense retention.
- It allows for the private manager to receive an "incentive fee" based on projected net revenue thresholds established by the state.
- It requires the private manager to submit an upfront security deposit and allows for a revenue shortfall payment to be made to the state—a significant transfer of risk. If the operator fails to meet the state's revenue targets, it will be ineligible for incentive payments and will be responsible for covering any shortfall.

It remains to be seen if Illinois's model of lottery privatization will rekindle broader national interest among other states, though there are already early signs that this may be underway. For example, lawmakers in **Maine** are exploring this innovative policy approach. Senator Debra Plowman heralded the effort saying to the Capitol News Service that, "[Maine is] doing way too much with the lottery staff that drives up the operational costs." Maine Lottery Director Dan Gwadosky told Maine Public Broadcasting Network that though similar proposals have been rejected in the past, it's worth another look.

Similarly, policymakers in **Ohio** have begun discussions of privatization after a report released by state Auditor Mary Taylor revealed over $2 million could be saved by closing unnecessary offices alone. Taylor has advocated for further exploration of privatization during her bid for lieutenant governor. State Senator Kevin J. Coughlin is advocating to have revenues directed toward a higher education scholarship fund, which would benefit 70,000 students by providing up to $7,000 a year. Coughlin argues that the value added by improving the state's higher education system is too compelling to ignore.

Part 8

California Advances Nation's First Privately Financed Courthouse

Ongoing fiscal woes and a backlog of facility needs have prompted California policymakers to launch a groundbreaking, privately financed courthouse project that could serve as a template for the private delivery of other social infrastructure assets, both in California and around the nation.

In June 2010, the Administrative Office of Courts (AOC) of the Judicial Council of California selected a private consortium to finance, design, build, operate and maintain a new, $492 million courthouse to replace an aging facility in Long Beach. Under the 35-year agreement, Long Beach Judicial Partners (LBJP) will finance and develop the project over the first three years and will be responsible for operations and maintenance of the facility over the remaining 32 years. In return, the consortium will recoup its upfront investment through an annual fee paid by the state over the life of the agreement. The state will maintain ownership of the building and land throughout, and the state's annual payments to LBJP will be contingent upon achieving performance targets in the building's operations and maintenance.

Meridiam Infrastructure—the lead partner in the LBJP—will raise all project financing. Other members of the consortium include AECOM (architect/engineer), Clark Construction Group, LLC (construction management), Edgemoor Real Estate Services (commercial real estate services) and Johnson Controls Inc. (facilities management, operation and maintenance). Two other consortia also bid on the project.

The new facility will house the Los Angeles County Superior Court and will replace Long Beach's current half-century old courthouse—which suffers from functional and design flaws, according to state officials—with a new facility in excess of 500,000 square feet that can accommodate 31 courtrooms, office space for county justice agencies and, potentially, additional commercial office and retail space compatible with court uses. According to AOC Chief Deputy Director Ronald Overholt, "The Long Beach [PPP] will serve as a model that can effectively be used in state government projects, and be replicated throughout other areas of the state."

Though similar agreements have been used to develop courthouse facilities in Canada and Europe, the Long Beach courthouse PPP is a first for the United States and may provide a template for similar social infrastructure PPPs, both in California and other states. In California alone, state officials estimate a need for over 100 courthouse projects totaling approximately $3 billion, and the

Long Beach courthouse will be the first new courthouse built in California in 40 years, according to *Public Works Financing*.

At press time, the agreement was awaiting final approval from the California Department of Finance, which is reviewing a value-for-money analysis prepared on the project. If the transaction proceeds to commercial and financial close, the new building would be built and opened in 2013. Press reports indicate that Meridiam plans to use a $440 million bank loan to finance the project.

Part 9

States Move to Privatize Workers Compensation Programs

Ongoing fiscal pressures are prompting policymakers to pursue a wide variety of government streamlining strategies to cut costs. One of the less visible subcurrents of this streamlining trend involves moves in several states to privatize state-run workers compensation systems and get the state out of the insurance business.

In the latest privatization move, **Arizona** Gov. Jan Brewer signed Senate Bill 1045 into law in May 2010, which set in motion the privatization of SCF Arizona, the state's workers compensation fund. The bill requires SCF Arizona to become a mutual insurance company, regulated by state insurance officials, by January 2013. SCF Arizona is the largest workers compensation insurance carrier in the state, covering 40,000 state businesses and receiving $191.8 million in direct premiums written last year. SB 1045 passed with strong, bipartisan majorities in each legislative chamber.

A May 2010 *Insurance Journal* article notes that after its establishment in 1925, SCF Arizona has increasingly evolved over the decades into a "hybrid" enterprise that in most ways operates like a private insurance company, yet still has a politically appointed governing board and statutory restrictions on its activities and products.

Leading the charge for privatization was SCF Arizona management itself, which expects to broaden its services (previously restricted under state law), stabilize insurance rates and facilitate more responsiveness to its policyholders. As SCF Arizona Senior Vice President of Sales and Business Development Rick Jones told *Insurance Journal*, "SCF Arizona policyholders will not notice anything different in their day-to-day dealings with the company," adding that, "over time, what they will experience is a more diversified company that can better serve their needs in Arizona and elsewhere."

Similar arguments were echoed in Colorado, Oklahoma and Washington State in 2010 as well. In **Colorado**, a 2009 legislative proposal to raid over $500 million from the state-owned workers compensation insurer Pinnacol to keep the state budget afloat prompted the company's management to offer legislators an alternate solution: a $330 million payment to the state by Pinnacol in return for turning it into a private mutual insurance company. Legislators ultimately failed to act this session, but the issue is almost certain to return in 2011. Similarly, **Oklahoma** legislators have considered a variety of bills that would have fully or partially privatized CompSource Oklahoma, the state-owned workers comp insurer, though none has yet to pass. In **Washington State**, a building industry-led ballot measure (Initiative 1082) would have allowed private sector competition to provide an alternative to the workers compensation program run by the state's Department of Labor and Industries; the measure failed by a 59% to 41% margin.

For some policymakers, the rationale for privatization revolves around unfair government competition with the private sector. In all three of the aforementioned states, the state-owned insurers account for over 30% of total workers compensation policies and compete directly against private insurers that operate under different rules.

For others—including the insurers themselves—the primary arguments for privatizing state workers compensation systems are that it would allow the new companies to offer stabilized rates, diversify product lines and even expand into other states. Notably, these arguments are all borne out by the evidence from the most recent state workers compensation fund privatization in **West Virginia**.

West Virginia Gov. Joseph Manchin signed a law in 2005 fully privatizing the state's Workers Compensation Commission, transforming it into a private insurance carrier, BrickStreet Insurance. Since the completion of the process in 2008, workers compensation premiums have declined an average of 30% statewide, translating to over $150 million in annual employer savings. The initiative also dramatically reduced the outstanding unfunded liabilities of the old state-run system (from $3.2 billion to $1.9 billion in the first two years), the number of protested claims (down 80%) and the amount of time required for a ruling on protested claims. Instead of one, state-run monopoly insurance provider, there are now over 170 competitors operating in the state, and BrickStreet—the former state monopoly—is now competing for business in other states.

Unlike West Virginia, the state-owned workers compensation insurers in Arizona, Colorado and Oklahoma are not monopoly insurers in those states. Rather, these have operated as quasi-public companies with politically appointed governing boards and different rules than their private-sector competitors, despite being the largest workers compensation insurers in those states.

Successful privatization case studies like that of West Virginia—as well as the forthcoming implementation of SCF Arizona's privatization—may prompt more states to consider getting government out of the insurance business, both to right-size state government through eliminating non-core activities, as well as to remove unnecessary public-sector competition with the private sector in challenging economic times.

[*Editor's Note*: An earlier version of this article was published on *Governing* magazine's *Better, Faster, Cheaper* blog in June 2010 (http://tinyurl.com/25kaql7).]

Part 10

Arizona, Other States Privatizing Economic Development Agencies

Ongoing state fiscal challenges have hampered the public sector's ability to retain and attract economic development, and as a result an increasing number of states are seeking public-private partnerships (PPPs) to take over economic development activities currently performed by state agencies.

Arizona took the first step in early 2010 when Gov. Jan Brewer signed Executive Order 2010-12, which privatized the state's Department of Commerce and will replace it with the newly created, public-private Arizona Commerce Authority (ACA). The ACA—the result of a recommendation from an advisory council reviewing the state's economic development efforts—will feature a board of directors comprised of public and private sector leaders. The board will hire a professional economic development manager to run the ACA. Brewer's plan calls for a major reduction in staff, overhead and duties relative to current structure; the ACA will employ flexible staff focused solely on attracting and retaining business and will be compensated based on performance.

Arizona's privatization did not go unnoticed by several gubernatorial candidates in 2010 who proposed similar privatizations as key elements of their economic development agendas. For example, **Ohio** Governor-elect John Kasich plans to replace the Ohio Department of Development with JobsOhio, a private nonprofit corporation that would be governed by a 12-member board of active and former corporate executives reporting to the governor. Kasich calls Ohio's approach representative of national best practices, and the plan was a key plank of Kasich's successful election bid, and one that he argues will get Ohio back on the road to economic recovery. Kasich has called the state's current Department of Development—with 400 employees and a $1.15 billion annual budget—"calcified" and wants to restructure it to feature a flexible staff that would be compensated based on its ability to attract and retain businesses.

In **Iowa,** Governor-elect Terry Branstad intends to privatize the Iowa Department of Economic Development (IDED) and replace it with a new PPP, the Iowa Partnership for Economic Progress. Branstad elaborated on the campaign promise saying, "By converting IDED into a PPP, the customer service mentality will permeate the system and we can offer prospective investors with a simple and efficient system," according to KCCI.com. In January 2011, Branstad's new economic development chief—Sioux City executive Debi Durham—will lead the new partnership and has prepared a draft legislative bill creating and outlining the responsibilities of the new partnership. The new structure—expected to be operational by July 2011—will consist of a quasi-governmental authority and a separate, nonprofit fundraising arm that will work in tandem to attract new jobs and investment. Durham told *The Courier*, "It's nothing for people to fear […] I think when they see it they're going to say, oh, this makes sense and this will work."

In late December 2010, **Wisconsin** Governor-elect Scott Walker announced plans to replace the state's Department of Commerce with a new Wisconsin Economic Development Corporation (WEDC), a PPP to handle the state's economic development activities. "For too long the Department of Commerce has spent more time regulating business than promoting it," Walker said in announcing the proposal, according to *The Business Journal*. "[Though] a lot of work goes into completely eliminating an agency and creating a new entity from scratch, I believe it will be worthwhile because a [PPP] approach to the promotion of commerce will help businesses put Wisconsinites back to work."

The proposed Economic Development Corporation will be structured as an authority led by a chief executive officer who reports to a 12-member board of directors, with Walker serving as chairman. After its economic development activities are transferred to the new Corporation, the department's current regulatory activities will be shifted to another agency, and Walker plans to evaluate whether some current regulations should be eliminated as part of the transformation. The Walker administration is currently developing legislation to put the new corporation in place by July 2011—possibly for inclusion in a special legislative session on jobs upon taking office—and additional details will be incorporated into the next state budget bill, to be introduced in February.

Part 11

Indiana Changes Course on Welfare Modernization

Indiana's troubled welfare modernization project has changed dramatically since it was last covered in Reason Foundation's *Annual Privatization Report 2009*. In October 2009, Indiana cancelled its 10-year, $1.34 billion welfare modernization contract with IBM after determining that the company had not made sufficient progress in meeting the terms of a corrective action plan outlined earlier in the year in response to ongoing implementation difficulties. The company was in the third year of a contract with the Indiana Family and Social Services Administration (FSSA) to automate eligibility determinations for food stamps, Medicaid and other welfare benefits. At the time of cancellation the new system had been rolled out in 59 of Indiana's 92 counties.

The privatization initiative—designed to automate case management and significantly reduce face-to-face meeting requirements via more computerized processes—was launched in 2007 but was quickly beset with complaints from people who lost their food stamps or Medicaid coverage or who had difficulty utilizing new call centers or the new, Web-based application for welfare benefits. Indiana Gov. Mitch Daniels concluded that the new system would ultimately not work because welfare requires more substantive face-to-face conversation with case managers.

"The IBM method had the best of intentions, but it was very flawed in concept. The system wasn't working and it wasn't getting better despite best efforts," Daniels asserted at a press conference announcing the cancellation. "It looked good on paper, but did not work in practice."

However, the state is not abandoning privatization. Rather, the FSSA plans to implement a "hybrid" system that relies more on face-to-face contact while maintaining some of the technological improvements made by IBM, and the state plans to retain the services of Affiliated Computer Services (ACS)—IBM's primary subcontractor on the original privatization—to steer the project. FSSA also renegotiated contracts with other private firms that were working with IBM. In partnering directly with former IBM subcontractors, FSSA spokesman Marcus Barlow told the *Indianapolis Star* that, "we're cutting out the middle man."

The early results are encouraging. In December 2010, FSSA Secretary Michael Gargano testified before the State Budget Committee and said the new system is "absolutely [succeeding]." According to Gargano, the hybrid system has been introduced in 37 counties across the state so far.

Since introduction, welfare application backlogs have declined statewide, and the food stamp error rate fell to 2.5% in May 2010 (versus 14.5% a year earlier). FSSA is seeking federal approval to expand the rollout to the remaining counties in 2010.

Critics argued the contract cancellation pointed to a failure of privatization, a claim rejected by Governor Daniels. Daniels has referred to the state's old system as the "worst welfare system in the country," because it was paper-based, unresponsive, and riddled with fraud and abuse. In announcing the IBM contract cancellation, Daniels acknowledged that while Indiana had already spent over $360 million on the IBM contract, the state still benefitted from cost savings totaling approximately $40 million annually, relative to state operation.

"We're still on track to save taxpayers hundreds of millions of dollars, but the intended service improvements have not been delivered, and that's not acceptable," according to Daniels. "We'll now take the best parts of the old and new and move ahead with a hybrid system in what amounts to a major mid-course correction." Daniels also cited headway made on welfare fraud under the privatized system, noting that over $100 million had been lost through fraud the year before the initiative began. He also defended the program's ability to minimize personnel overhead.

Still, there were costs as well. For example, in May 2010 the state of Indiana and IBM initiated a legal battle over the cancelled contract, filing lawsuits against each other. The FSSA's suit seeks over $1.3 billion from IBM for breach of contract, and it claims that IBM gave the agency false and misleading information and denied benefits to certain clients to improve its performance metrics. IBM is seeking nearly $53 million from the state in deferred payments and costs for equipment ranging from computer servers to furniture the company claims the state is still using.

Further, the federal government fined FSSA $1.2 million in June 2010 as a penalty for miscalculating food stamp benefits at a rate more than 1.5 times the national average in 2009, the year prior to the rollout of the hybrid plan. FSSA is seeking to recover this penalty in its lawsuit against IBM, and it can reduce the penalty amount by improving its food stamp processing error rate in fiscal year 2010–2011.

Indiana's experience is reminiscent of **Texas**, another state incurring financial penalties for poor food stamp processing performance—its nearly $4 million fine was roughly triple that levied on Indiana—in the wake of a troubled modernization/privatization initiative that was subsequently scaled back. In 2005 policymakers in Texas privatized eligibility determination for food stamps, Medicaid and other assistance programs in a five-year, $900 million modernization contract with Accenture. However, the state fired nearly 3,000 agency workers before the privatization launched—leaving a major gap in service delivery at the same time as a major business process overhaul began—and the project was quickly plagued by cost overruns and customer service and performance issues, prompting the state to cancel the contract in March 2007 and bring many of the outsourced functions back in-house. Since 2007, the state has been steadily rebuilding its internal staff after the 2005 firings left the agency with a talent and experience vacuum.

In January 2010, U.S. Department of Agriculture Undersecretary Kevin Concannon told state officials that the 2005 privatization resulted in "a five-year slide" in how quickly and accurately the state processes food stamp applications, leaving Texas with the worst-performing food-stamp program in the nation, according to the *Dallas Morning News*. The federal agency found that Texas either overpaid or underpaid food stamp benefits 6.9% of the time in fiscal 2009, with rates close to 10% in some areas of the state. Concannon criticized the state's food stamp application processes and called for the state to increase the number of eligible residents receiving coverage.

Texas Health and Human Services Commission spokesperson Stephanie Goodman countered that the focus on privatization was overstated, citing larger issues affecting the performance of the system, including a swelling of welfare applicants in the wake of Hurricane Ike and the national recession, ongoing hiring and staff retention challenges and antiquated service delivery processes. Goodman cited ongoing improvements to the system in a June 2010 *Dallas Morning News* interview, noting that the agency has added hundreds of new eligibility workers and dramatically reduced the backlog of overdue cases. As one example, the newspaper reported that in October 2009, the state had a backlog of 42,000 households awaiting eligibility determinations, but by May 2010 the state had reduced the backlog of overdue cases to approximately 1,500. According to Goodman, "[t]he system has sort of buckled under a host of issues that weren't caused by call centers or privatization […] They weren't fixed by it, either."

Part 12

Florida State Outsourcing Continues Apace

In 2010, the Florida Council on Efficient Government's (CEG) released its *2009 Annual Report*, detailing the state's continued reliance on outsourcing across a broad swath of state services during fiscal year (FY) 2008–09. The report finds that there were over 553 projects outsourced by state agencies that year, totaling a lifetime value of over $7.5 billion. This is comparable to the previous fiscal year, in which CEG reported 551 projects with a lifetime value of over $8 billion (see discussion in Reason Foundation's *Annual Privatization Report 2009*).

As shown in Table 1, five agencies (Department of Elder Affairs, Department of Children and Families, Department of Juvenile Justice, Department of Management Services and Department of Corrections) accounted for 90% of all outsourced projects. Of all the agencies, the Department of Elder Affairs accounted for the most outsourced projects (332) valued at the highest annual contract amount (over $1 billion); The Department of Children and Families accounted for the third highest number of contracts (35), but the second highest total annual contract amount ($839 million).

Table 1: State Agencies' Status of Outsourcing for FY 2008–09

Departments	Outsourced Projects	Total Annual Contract Amount	Total Contract Amount
Department of Elder Affairs	331	$1,099,641,437	$1,099,641,437
Department of Juvenile Justice	66	$181,112,015	$828,831,338
Department of Children and Families	35	$839,223,802	$2,988,542,369
Agency for Persons with Disabilities	26	$11,630,582	$26,909,231
Department of Corrections	25	$252,331,923	$1,122,412,902
Department of Management Services	19	$262,020,755	$1,120,262,172
Department of Business and Professional Regulation	11	$6,105,369	$11,343,463
Department of Military Affairs	10	$13,037,179	$59,768,136
Agency for Workforce Innovation	7	$25,942,047	$73,071,867
Department of Highway Safety and Motor Vehicles	6	$1,021,500	$3,983,000
Department of Environmental Protection	5	$14,438,570	$93,213,658
Florida Department of Veterans' Affairs	3	$5,157,865	$30,455,807
Fish and Wildlife Conservation Commission	3	$2,229,680	$1,588,012
Department of Financial Services	2	$430,427	$11,792,098

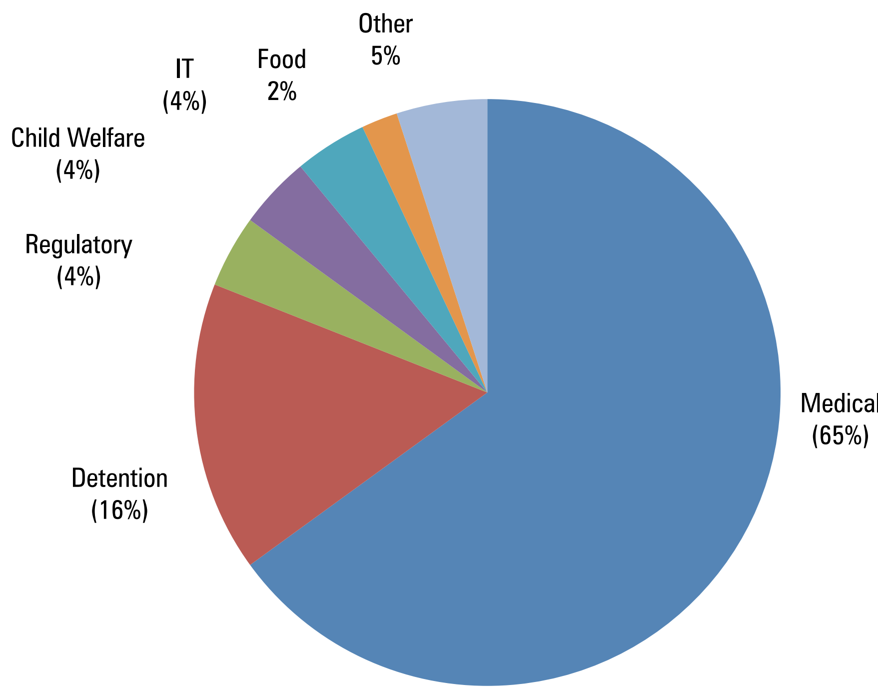
Table 1: State Agencies' Status of Outsourcing for FY 2008–09			
Departments	Outsourced Projects	Total Annual Contract Amount	Total Contract Amount
Agency for Health Care Administration	1	$8,800,000	$44,000,000
Department of Health	1	$1,600,000	$6,400,000
Department of State	1	$1,875,000	$9,375,000
Public Service Commission	1	$63,100	$63,100
Total	553	$2,726,598,153	$7,531,590,493

Note: The Department of Elder Affairs' projects have a one-year procurement life and are renewed by the agency on an annual basis.

Source: State of Florida, Council on Efficient Government, *2009 Annual Report*, p.8.

CEG also analyzed outsourced projects by service area, as shown in Figure 2. Medical services represented a majority (65%) of the state's outsourced projects for FY 2008–09, followed by adult and juvenile detention services (16%), child welfare services (4%), and information technology contracts (4%).

Figure 2: FY 2008–09 Outsourced Projects by Service



Note: The "Other" category includes training, security, administrative, custodial and landscaping services.

Source: State of Florida, Council on Efficient Government, *2009 Annual Report*, p. 10.

The CEG found that 95% of outsourced projects were for the delivery of core agency services, versus agency support services. According to the report:

> *Businesses and governments traditionally used outsourcing as a means to carry out activities and functions ancillary to the delivery of "core" customer services. Changes in the service marketplace, however, coupled with technological advances now offer organizations a range of options from which to select the most effective and efficient means of providing core services.*

Last, CEG reviewed 23 business cases in FY 2008–9 with a total value of approximately $225 million and potential cost savings (or cost avoidance) of over $31 million. Twenty-two of these business cases involved proposals to continue outsourcing an agency project or service, while one business case proposed bringing a previously outsourced activity back in-house.

Part 13

Higher Education Update

State universities invest a tremendous amount of capital into new and expanded facilities—academic buildings, administrative complexes, dormitories and the like—but ongoing fiscal pressures are making it increasingly difficult to do so. State university systems across the country are beginning to look beyond traditional tax-exempt financing (e.g., bonds, etc.) toward more innovative procurement models that bring private sector capital and expertise to bear on the financing of university facilities through public-private partnerships (PPPs).

At first glance, it may seem that tax-exempt financing would always present a more compelling option for public universities, as compared to taxable, private sector financing models that incur a higher cost of capital. However a June 2010 report by the Bay Area Council Economic Institute analyzing PPP opportunities in the University of California system found that this analysis ignores some important points. First, financing costs usually account for only about 25% of total project costs, and a 1% to 2% differential in tax-exempt versus private costs of capital will only translate to 5% of total project cost, leaving 95% of the remaining project costs as presenting opportunities for cost savings and other efficiencies brought by PPPs, according to the report. Further, PPPs can deliver 15% to 30% lifecycle cost savings for operations and maintenance and can be used to deliver projects significantly faster than under typical public procurement methods.

A recent sampling of innovative PPP arrangements in higher education include:

- The University of California-Davis is using a PPP to deliver its West Village project, a 130-acre project that will provide 343 housing units, 1,980 student beds in apartment housing and 42,500 square feet of retail in a mixed-use development. The university will receive income from both the lease payments for apartments and retail uses and payments by resident faculty in the housing units. Using a PPP allowed the university to leverage its small, direct investment of $11 million into a viable $280 million project.

- In March 2010, Florida Atlantic University (FAU) announced a PPP for a new $123 million, on-campus student housing community on its Boca Raton campus. Under the PPP, Balfour Beatty Campus Solutions and Capstone Development Corporation will oversee the development and management of the 1,216-bed student residential project, Innovation Village Apartments, which will also include mixed retail and office uses. Though this project is being financed through a combination of tax-exempt and Build America Bonds issued by the FAU Finance Corporation, partner Balfour Beatty Capital has invested in the project by purchasing $3.4 million of tax-exempt bonds.

- Northern Illinois University's board of trustees approved a plan in early 2010 to develop a new, state-of-the art on-campus housing complex to attract more students and have agreed to pursue a PPP model to deliver it. Under the plan, a private concessionaire would finance and construct the complex, which would then be managed by the university.

- Last summer New York Gov. David Paterson proposed the Public Higher Education Empowerment and Innovation Act to overhaul the State University of New York (SUNY) and City University of New York (CUNY) schools. SUNY and CUNY are among the most highly regulated of the country's large systems of public higher education. Everything from supply purchases to tuition rates are managed through the state's budgeting process. The act, which was not approved by the legislature, would have eliminated burdensome regulations on contracting, procurement and land use; allowed campuses to set different tuition levels that reflect their unique cost structures; and required semi-annual reports on revenues and expenditures at each campus.

- In January 2013, Illinois State University plans to raze two existing dormitories that are too old to be renovated. Officials issued a request for proposals from private builders for complexes to house up to 1,500 students. According to the university's master plan, it seeks to house 6,000 students in on-campus facilities augmented by new student housing provided through a PPP.

- East Carolina University is exploring PPPs as a way to preserve its "residential campus" distinction, whereby at least 25% of undergraduates must live on campus. There are currently 4,656 beds available for 21,424 undergraduate students at the university, or 22%. David Redwine, a trustee and chair of the facilities and resources committed told the *Greenville Daily Reflector*, "PPPs have been around for a while... [And] it is something that the university needs to continue to look at and get a handle on [to expand student housing]."

In other privatization-related news from higher education:

- In July 2010, the final report of the New Jersey Privatization Task Force estimated that colleges and universities in the Garden State could save approximately $27.4 million annually through the outsourcing of a variety of facility maintenance functions.

- The University of Alaska-Fairbanks announced plans in 2010 to contract out the management of its bookstore to Follett Bookstores, the largest national college bookstore operator, citing high operating costs and Internet book downloads as impediments to a sustainable in-house operation. The privatization will return textbooks to the bookstore, improve the online store, and provide new services and a wider array of merchandise.

- In 2010, officials at the University of Missouri engaged in talks regarding the potential privatization of the university's animal research laboratory. The Research Animal Diagnostic Laboratory (RADIL) has been at the university for more than 40 years and serves companies that care for and use animals in biomedical research, also providing biological and genetic testing services. RADIL researcher Leia Riley told the *Columbia Daily Tribune* that she believes "it would be a win-win situation… The university would win by acquiring money from the sale of RADIL at a time when finances are tight. It would be a win for RADIL in terms of the ability to expand and grow. And perhaps, most importantly, it would be a win for the community in maintaining and growing a business that would stimulate economic development for the city and state."

- According to the *Oakland Tribune*, Ohlone College—a community college serving cities in the East Bay area of San Francisco—is privatizing its bookstore through a five-year contract with Chicago-based Follett Higher Education Group. Ohlone lost $76,000 operating the bookstore last year, with total sales down by more than 25%. Follett guarantees payments of at least $225,000 to the college, with additional payments depending on sales. Further, it will donate $10,000 to student government; $5,000 for textbook scholarships, $25,000 in store improvements and a bonus $75,000 for the district. According to the *Tribune*, 45% of all college bookstores are managed by outside companies.

Part 14

Contracting for Performance in Child Welfare Privatization

In the United States government child welfare agencies have a long history of subcontracting for specific child-welfare functions from adoption to residential treatment. The Casey Family Foundation provides the most recent literature review of child welfare privatization in its April 2010 analysis of the Kansas and Florida Privatization initiatives. The foundation finds that the trend in recent years has been to move away from traditional models of contracting toward performance-based contracting. Performance-based contracting shifts the focus away from system processes and inputs and toward improved outcomes for children.

This new strategy of purchasing for results, rather than for service delivery, reflects a general trend in the child welfare field toward greater accountability. Rather than simply contracting for a subset of specific child welfare services, the trend has also favored transferring case management to the private providers, thus giving them primary decision-making authority over day-to-day case decisions. Child welfare privatization is increasingly defined as the degree to which these essential functions are managed by the private provider versus the public agency.

There has been limited research regarding the status of privatized child welfare service across the nation. The U.S. Department of Health and Human Services, Administration for Children and Families conducted a survey in 2001 that provides one of the few estimates on the scope of privatization in the states. The assessment found that all 46 states that participated in the survey used contracts to deliver a range of direct services to children and families and/or to support administrative functions. In 2000, the Child Welfare League of America identified 39 privatization initiatives in 25 states through its national survey of states. Additionally, in 2006, the National Quality Improvement Center on the Privatization of Child Welfare Services conducted an analysis to gather information about the current status of the privatization of case management where contractors have decision-making authority on a national level. It found 13 states with some level of case management privatization (see Table 2).

Table 2: Continuum of Privatized Case Management Services			
Level of Privatization	Definition	# of States	% of States
Not currently privatizing case management	Stay public agency worker retains case management function	32	71%
Small scale privatization	Providing case management services for a subset of children in a limited geographic location (AZ, CO, MI, MO, OH, SD, TN, WI)	8	18%
Large scale case management efforts	Large scale privatization of case management services (DC, IL, NY)	3	7%
System wide privatization	Statewide privatization of all case management services (KS, FL)	2	4%

Source: Adapted from National Quality Improvement Center on Child Welfare Privatization, University of Kentucky, *Needs Assessment and Knowledge Gap Analysis Findings*, 2006.

Since the National Quality Improvement Center analysis, Nebraska and Washington have also moved toward privatizing their child welfare case management.

- The **Washington State** legislature approved a pilot project in performance-based contracting for foster care that the governor signed into law May 18. Under the plan, the first pilot programs will be launched statewide in July 2012. After two and a half years, the Washington State Institute for Public Policy will evaluate the pilot program for the governor, who will then decide whether to expand or terminate it.

- **Nebraska** also began implementing a plan to privatize child welfare services. The state's Department of Health and Human Services is proposing to contract with a few large agencies for the more than 4,300 children who are wards of the state and don't live with their parents or other custodial relative. State workers would assess the children's needs, and then the contracted agencies or companies would provide foster or group homes and coordinate services. The state will require providers to acquire foster homes and facilities and coordinate and deliver services. Children's safety and well-being, and the preservation of families or timely adoption, will be achieved with financial incentives and disincentives to contractors.

Leading the nation in child welfare privatization are Kansas and Florida, the only two states that have privatized all child welfare services—other than investigations—statewide. Therefore, the outcomes in these states offer a comprehensive look at how privatization has the potential to improve outcomes for children in the child-welfare system.

A. Child Welfare Privatization in Kansas

In 1996 Kansas became the first state to privatize its child welfare system. The Kansas privatization effort was implemented very rapidly, which resulted in confusion concerning roles and responsibilities, and a shortage of services during the initial transition. In addition, since there was a lack of baseline data about the cost of serving each child in care, the state and the contractors severely underestimated that cost in the first round of child welfare cost management in Kansas. Therefore, while Kansas initially had a rocky start to its child welfare privatization initiative, today the state has more data, cost information and accountability than most child welfare systems in the nation.

The April 2010 Casey Family Foundation report, "An Analysis of the Kansas and Florida Privatization Initiatives," sums up the progress that Kansas has made since 1996 based on interviews with many different child welfare stakeholders.

Those interviewed in the Casey report claimed that the system in Kansas is a "far, far better system than it was before privatization." They have seen "improvements in the quality of services, data systems, and the range of service available along with a better system of care" for children and families. One staff member commented that "we have created a system that is far superior to what we had before or even envisioned we would have."

The Casey Foundation report found several benefits to the privatization effort:

- **Increased data collection and accountability:** Kansas now collects data on safety and permanency, as well as other indicators of good practice, including family connections, educational needs and timeliness of permanency hearings. It also has increased the level of accountability for providers through the use of performance-based measurements in its contracts.
- **Focus on permanency:** The emphasis is now on achieving permanency and keeping children with their families when possible. When that is not possible, the focus is on placing children in the most family-like placements close to their birth families, rather than in residential treatment centers or other restrictive placements. As a result, there are now more children exiting the system into permanency.
- **Better outcomes:** Kansas has seen the number of children in residential placement decrease from 1,064 to 421 since 1997 and the number of adoptions has more than doubled in the same time period. In addition, the average length of stay in care has decreased from 23 months to 16 months (See Table 3).

Table 3: Kansas Child Welfare Privatization Outcome Trends (1997–2009)					
Indicator	1997	1999	2003	2006	2009
The number of children entering care	N/A	3,342	2,642	3,048	3040
Number of children in residential placement	1,064	606	535	421	421
Percentage of children in residential placement	17%	N/A	12%	9%	8%
Number of adoptions	352	418	486	501	812
Average length of stay (in months)	N/A	23	26	19	16

Source: Kansas Department of Social and Rehabilitation Services, Child and Family Services. (12/19/09) *Kansas Child Welfare*.

The data below illustrate how the Kansas child protection system has strengthened since the privatization initiative was implemented.

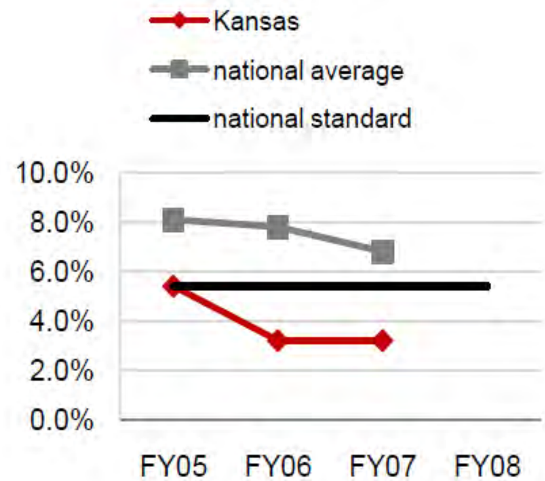
- Since 2003, Kansas has met national safety standards (94.6% of children are safe from recurrent abuse) for assuring children are safe from recurrent abuse.
- For nearly 10 years, Kansas has met the national standard for safety in foster care placement (99.68% of children are safe from maltreatment in foster care).
- To date in FY 2010, 98% of Child in Need of Care (CINC) reports are reviewed timely by a social worker (within one-half work day) to determine if further action is needed by the agency.
- Thus far in FY 2010, 97% of assigned CINC reports have timely contact initiated by a CPS social worker with a child or family.

In addition, while the lower number of children in out-of-home care shows that the community-based programs are helping troubled families to keep custody of their children, the cases of repeat maltreatment have not increased while Kansas is leaving more children in their own homes. In fact, Figure 3 shows that the rate of repeat maltreatment in Kansas has fallen below both the national standard and the national average.

Indeed, a federal study found that Kansas's foster care system scores consistently above the average of 32 states surveyed when it comes to foster child safety, family preservation and child well-being. The federal government's national benchmark for child welfare outcomes, the Children and Family Services Review (CFSR) 2010, finds that with 36 states completing the CFSR:

- Kansas ranks in the Top 5 performers for 4 of 7 national CFSR outcomes.
- Kansas ranks first in preserving family connections and in enhancing families' capacity to meet their needs.
- Kansas is in the Top 10 for six of seven outcomes and ranks 11th in the seventh.

Figure 3: Percent of Kansas Children Experiencing Repeat Maltreatment (within six months)



Source: An Analysis of the Kansas and Florida Privatization Initiatives, Casey Family Programs, April 2010.

Finally, Kansas is the only state that has been able to terminate a lawsuit filed by The Children's Rights Project (CRP) of the American Civil Liberties Union that had 153 improvement requirements for Kansas child welfare program to adhere to by a certain deadline. Kansas and Children's Rights Project agreed in 2002 to terminate the 1993 settlement agreement as successfully completed. No other state had been able to achieve a mutually satisfactory conclusion to CRP's efforts to improve child welfare.

B. Child Welfare Privatization in Florida

As recently as five years ago, Florida's child welfare system was criticized for being one of the worst in the nation. Florida had more than 500 children that had disappeared from the state's foster care system, with state officials unable to account for their whereabouts. Today, Florida has some of the best child welfare outcomes in the nation for adoptions, safety in and out of the foster care system and number of children in out-of-home care.

A 1996 state statute mandated that the Florida Department of Children and Families (DCF) privatize foster care and all related services throughout the state by 2003. It was decided that services would be contracted out to private agencies while child protection investigations would remain in the public sector to be managed either by the DCF or a county sheriff's office.

The original legislation in 1996 mandated that DCF establish five pilot programs to privatize case management functions as they moved toward statewide privatization. This mandate allowed these pilot sites significant freedom in determining the scope and focus of their programs. The state also required an external evaluation of the pilot programs. Evaluations revealed that four of the five initiatives were not successful: two of the contracts were terminated, one contractor dropped out of the pilot, and the fourth contract was never implemented. The fifth program was successful, however, and considered to be the model for replication.

The legislature decided to move forward with the statewide privatization initiative. It was a phased-in process, with one region at a time privatized over a five-year period. As of March 2005, the statewide transition to privatization was complete, with 20 lead agencies providing child welfare services in specific geographic areas in the state's 67 counties. Lead agencies now manage 500 subcontracts with community providers and serve an estimated 20,000 children in foster care in Florida.

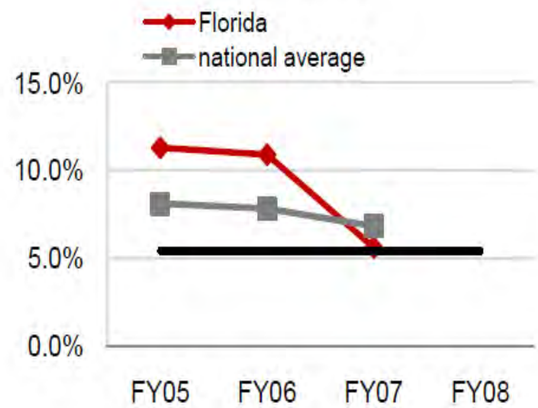
In addition, Florida was the only state to take full advantage of an experimental foster care waiver offered by the Bush administration in 2006. Ordinarily, federal aid is determined by how many children are in custody. In this way the federal funding gives states a financial incentive to keep children in foster care. Florida asked to receive a flat fee that it could spend on counseling and other aid instead of foster care when it wished. The shift was seen as fiscally risky—an increase in foster children would not bring more money—but it has paid off. Florida has now saved millions of dollars in foster care costs and invested that money in front-end services that keep more children with their own families.

The April 2010 Casey Family Foundation report, "An Analysis of the Kansas and Florida Privatization Initiatives," has found the most consistent message echoed among the Florida lead agency directors was that the first few years of the Florida transition to privatization was extremely challenging, with some informants stating that it was the most trying period of their careers. However, the lead agency agreed that, once the transition issues were addressed, the system as a whole stabilized and both quality of services and outcomes for children and families improved. In fact, all of those interviewed in the Casey report acknowledged that even with the challenges in the early years, the child welfare system has dramatically improved since the transition to privatization.

Overall, between 2003 and 2009 the number of children in out-of-home care in Florida has decreased significantly. The numbers of entries declined approximately 38% between FY 2005 and 2009. Some Florida counties have reduced their foster care populations by 50% to 60% since the waiver was implemented. It is apparent that Florida's lead agencies have developed a new paradigm of child protection based on strengthening in-home services to children and families. It is extremely encouraging that during the timeframe that entries decreased, maltreatment recurrence also declined significantly and is currently consistent with the national average.

Repeat maltreatment is an indicator of safety. During a time when the number of children in care declined, the percent of children experiencing repeat maltreatment also decreased and fell below the national average (see Figure 4). According to this measure, safety was not compromised to achieve the reduction of kids in foster care.

Figure 4: Percent of Florida Children Experiencing Repeat Maltreatment (within 6 months)



Source: An Analysis of the Kansas and Florida Privatization Initiatives, Casey Family Programs, April 2010.

In the 2010 Casey report there was consensus among those interviewed that the Federal IV-E Waiver has been one of the most crucial components of the success of privatization. The waiver allows federal foster care funds to be used for any child welfare purpose rather than being restricted to out-of-home care as generally required under federal law. This allows the lead agency to flexibly move the money in the way that it determines is best for the children; simply put, the money serves the child who needs it and not the foster care placement specifically.

In addition to the waiver, Florida participants also identified a paradigm shift in Florida toward family-centered, permanency-driven practice as essential to the improvements in outcomes. They acknowledge that the three-fold combination of family-centered practice, flexible funding through the waiver and the innovative practices through privatization as the driver behind Florida's reduction of children in out-of-home care.

The privatization of Florida's foster care system has allowed local communities to design and manage their own unique systems of care. Miami is the case in point. Miami's child welfare system has a public-private partnership (PPP) between Our Kids and the state Department of Children and Families (DCF). Our Kids began providing services in mid-2005. Miami's foster care system has been transformed into one of the state's best performers. This turnaround can be evidenced by reviewing any metric: number of adoptions, time to adopt, reduction in the number of children in foster care and other measures of safety, well-being and permanency. One innovation that has grown out of the Miami privatization effort is that Florida is now known for the most modern and accurate child-tracking system in the nation. In fact, Miami has created a technological solution for tracking children in foster care that could transform child welfare practice in the rest of the nation.

In 2007, through a partnership with AT&T, the Miami partnership launched OK Connect, a project that puts readily available technology and business solutions—such as digitally imaged case files, rugged laptops, Internet connectivity, smart phones equipped with cameras and GPS—into the hands of 270 case workers and staff that work directly with children and families.

Every time a case worker visits a child in his or her home, the case worker uses the smart phone to take the child's photo and, through GPS, records his location. Compliance with mandatory 30-day home visits has grown to almost 100% in Miami since the project began. In this case the technology helps with the compliance because the caseworkers know that their home visits are verified by technology. Case managers say that the new tools have made them feel like they could get their job done for the first time.

Copying Miami's example, in 2010, Florida's Department of Children and Families (DCF) procured and distributed smartphones and laptops equipped with built-in cameras and a software program that was developed in-house by the DCF. The solution, Remote Data Capture, allows the state's more than 2,300 caseworkers to take digital images—stamped with the date, time and GPS-marked location—and immediately upload the information to the state's child welfare data system.

Florida is the only state in which caseworkers can upload in real time information from their site visits directly into the DCF database from the field. GPS-stamped photos taken onsite add an additional layer of integrity by ensuring every child is visited and his condition accurately documented.

Finally, in addition to reducing children taken from home in the first place, Florida also has the best numbers in the nation for completed adoptions. In Florida more than 12,000 children in foster care have been adopted since 2007, including 3,368 children adopted so far in 2010.
In 2010, Florida was awarded a $9.7 million federal bonus for outpacing all other states in the number of adoptions of children from foster care. Florida set adoption records in fiscal year 2007–08 with 3,674, and in fiscal year 2008–09, with 3,777.

"Our bottom line in Florida is that no child should grow up in foster care," said DCF Secretary George Sheldon in a press release about the adoption award. "We have not yet fully achieved that goal, but we are making extraordinary progress through increased adoptions, safe reduction of the number of children in foster care, and more family reunifications and permanent guardianships with relatives."

C. Performance-Based Contracting Improves Outcome for Children and Families

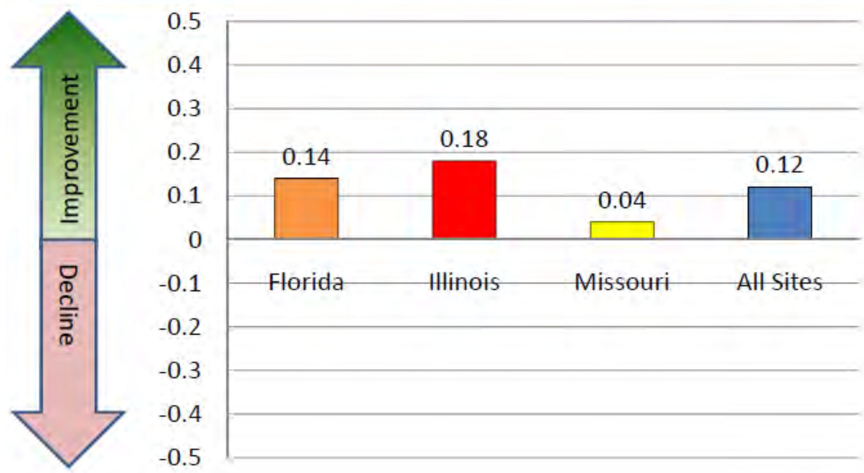
One way to encourage quality services and promote improved outcomes for children is to implement performance-based contracts. In 2010 the Quality Improvement Center on the Privatization of Child Welfare Services (QIC-PCW), sponsored by the United States Department of Health and Human Services, completed a demonstration project evaluating three privatized child welfare programs (Florida, Missouri and Illinois) that employed a collaborative approach to planning and implementing performance-based contracts (PBCs) in foster care case management or residential youth services.

The cross-site evaluation conducted as a part of the QIC project: 1) documented how each site approached the collaboration process between public and private child welfare agencies, 2) identified common organizational or agency changes made to support the PBC, and 3) evaluated the impact of PBCs on performance and improving outcomes for children and agencies.

Each site collected monthly or annual data on the performance of private agency contractors or consortia in achieving the outcomes specified in their performance based contracts. In Florida the four outcomes chosen were practice-level in nature and included: 1) the percent of frontline workers who entered case data within two days of case opening by front-line staff, 2) the percent of frontline workers who received a supervisory review within four days of case opening, 3) the percent of workers who received the review again at 30–45 days, and 4) the percent of quality contacts with biological parents. In Illinois, the two outcomes chosen focused on residential services for older youth and included: 1) the number of days youth remained in care (i.e., treatment opportunity days), and 2) the percent of youth who remained in a less restricted placement setting for 90 days post-discharge (i.e., sustained favorable discharge). In Missouri, the three outcomes chosen were based on federal child and family service review (CFSR) outcomes and included: 1) the percent of children who remained safe while in foster care, 2) the percent of children achieving reunification, adoption, or guardianship, and 3) the percent of children who do not re-enter foster care after discharge.

Results showed that outcome performance increased over time in all sites from year one to year two with Florida improving outcomes by 13.4%, Missouri by 18.1%, and Illinois by 29.1% (see Figure 5). Thus, outcomes improved in all sites under performance-based contracting from year one to year two as agencies were able to increase their performance on the outcomes specified in their contracts.

Figure 5: Relative Change to Performance (Standardized) From Project Year 1 to Project Year 2



Source: National Quality Improvement Center on Child Welfare Privatization, University of Kentucky, Cross-Site Evaluation Finding, August 2010.

Raw data from each site show that for most outcomes, agencies improved their ability to meet outcome targets from year one to year two under performance-based contracting. Standardized data across sites and outcomes show that the relative change or difference in target achievement performance from Y1 to Y2 was positive (+.12) (see Figure 5 above). This represents a 12% improvement in overall agency performance in fulfilling contractual outcome specifications. Taken together, data show that as agencies improved their ability to meet targets specified in their performance-based contract, outcomes also improved. In **Florida**, this meant that front-line workers improved practice by receiving quality supervision and increasing the number and quality of contacts with birth parents of children in care. In **Illinois**, this meant that more youth remained in the care of residential agencies receiving the appropriate level of care and were less likely to be hospitalized or on the run. In **Missouri**, this meant that more children achieved the permanency goal established in their case plans.

D. Case Study: Illinois Improves Outcomes in Children's Residential Treatment

The Illinois pilot project is significant because it uses performance-based contracting to improve outcomes for one of the most challenging populations in child welfare: children who need residential care. Illinois led the nation in the implementation of performance-based contracting and quality assurance (PBC/QA) initiatives for foster care case management. This initiative extends performance-based contracting to over 60 residential, independent and transitional living programs serving approximately 2,500 children and youth in the Illinois child welfare system, many of whom have increasingly severe and complex treatment needs. The *Striving for Excellence* project is a partnership between the Illinois Department of Children and Family Services (public child welfare agency), the Child Care Association of Illinois (private child welfare agency association) and the Children and Family Research Center of the University of Illinois (project evaluator).

The overarching goals of the *Striving for Excellence* project are to:

- Improve outcomes for children and youth;
- Build on success in foster care and kinship care case management;
- Enhance the existing PPP in the delivery of child welfare services;
- Address Child and Family Services Review (CFSR) deficiencies in permanency and well-being; and
- Inform the field through rigorous evaluation and documentation of the project.

The Project Steering Committee and CWAC Workgroups set the following goals for residential treatment:

- To improve the safety and stability of children during residential treatment;
- To effectively and efficiently reduce symptoms and improve the functional skills of children through residential treatment; and
- To improve outcomes for children at and following discharge from residential treatment.

Two performance indicators were derived from these goals and incorporated into residential contracts: Treatment Opportunity Days Rate and Sustained Favorable Discharge Rate. Agencies are given performance benchmarks for each performance indicator that are adjusted for risk using a risk adjustment model including historic child-specific characteristics (e.g. history of running away), demographic characteristics, and residential placement characteristics (e.g. geographic location). Since Illinois adopted a "no decline" policy to discourage agencies from taking only those children most likely to succeed, a risk adjustment model that takes into consideration an agency's case mix was critical for providers.

"Treatment Opportunity Days Rate" is a percentage of the total number of days in a fiscal year that residents are not on the run, psychiatrically hospitalized or incarcerated. Agencies are guaranteed payment for 100% of DCFS client beds, but if their performance is below the agency's performance benchmark, the agency will be penalized at the rate of 25% of the per diem cost for each bed day represented by the difference between their performance benchmark and actual performance.

Figure 6: Treatment Opportunity Days Rate

FY 2008	FY 2009
71 Contracts (40 Agencies)	69 Contracts (39 Agencies)
32 Contracts met or exceeded benchmarks	38 Contracts met or exceeded benchmarks
45%	55%
	Net gain of 2,587 bed days

Source: Illinois Department of Children and Family Services, Striving for Excellence: Performance Based Contracting for Residential, Independent Living, and Transitional Living Programs in Illinois, August 2010.

In FY 2009, 24 residential agencies were penalized for failing to meeting performance benchmarks for a total of $712,033 assessed. Penalties ranged from $1,602 to over $108,000 with a median amount at the agency level of $23,915. Penalties are deducted from the current year's rate paid to that provider. A formal reconciliation process was developed to ensure the accuracy of the data and resolve conflicts.

Agencies can earn bonuses if they exceed their established "Sustained Favorable Discharge Rate" performance benchmark. This performance indicator is based upon the percentage of all treatment spells (time in treatment) from which youth that were favorably discharged were able to sustain their discharge placement for 180 days. Each agency is given a benchmark, adjusted for risk, which sets expectations for the number of youth to be discharged and remain stable post-discharge for a minimum of six months. Favorable discharges are defined as step-downs to less restrictive settings or placements in chronic mental health settings. Unfavorable discharges are step-ups to more restrictive settings, lateral moves between agencies, running away, psychiatric hospitalization or detention. Bonuses are calculated based upon the difference between the statewide weighted average of residential per diems and the statewide weighted average per diems for less restrictive settings. Bonuses in excess of $3 million were awarded to 21 providers for exceeding their Sustained Favorable Discharge benchmark at the end of FY 2009, with an average award of $44,449.

Systemic changes which have occurred as a result of this project include:

- Standardization of provider rates and performance expectations;
- Centralization and automation of the admissions process through a new Centralized Matching Team to ensure appropriate and timely placement of youth in residential care;
- Monthly performance reports available through the Residential Treatment Outcomes System (RTOS) to keep providers apprised of their performance and allow for reconciliation of data issues;
- Use of a Discharge and Transition Protocol designed to facilitate step-downs to less restrictive settings and clarify roles and responsibilities of the various provider agencies;

- Development of pilot programs to address specific issues affecting treatment opportunity days rate such as the Runaway Assessment and Treatment Process pilot and the Residential-Hospital Networks pilot; and
- Shared strategies to engage youth in treatment developed through informal provider networking and best practices forums.

The bottom line is that this partnership resulted in kids receiving more undisrupted days of treatment enabling them to step down from residential care to a less restrictive setting and stay there. This happened because the partnership allowed the public and private agencies to use data about their performance and make decisions about how to care for kids based on that data.
One participant in the Illinois partnership summed up the value of performance-based contracting to residential service providers:

> *In the past we didn't have the data available, and contracting decisions were subjective. There was tremendous disagreement on whether facilities were good or bad. We were controlled by anecdotes. Now, we have data to support decisions. It's hard to argue with data, particularly when peers are doing better. Even people who didn't value data much are really beginning to come along.*

E. Privatization Presents Ongoing Challenges in 2011

Despite positive performance outcomes for children, **Kansas's** privatized system has come under recent criticism by some legislators and families for the way in which children are removed from their families. According to a March 2010 article in the *Wichita Eagle*, "parents and grandparents testified during four days of hearings in the Kansas House that the state and its contracted social workers ignored their appeals and took children away without full explanations." The state agency and its five foster care contractors defended the system with statistics that show dramatic improvement since privatization began.

"Privatization brought more accountability," said Dusty Buell, director of public policy for Youthville, one of the state's foster care contractors, according to the *Eagle.* "That's why many other states look at Kansas as the model they want to follow. They see the data. We should be really proud that we have this in Kansas." Since privatization, the number of children removed from homes has dropped. That's proof, contractors argued, that programs to help troubled families keep custody of their children are working.

The state's five contractors all contend they've improved the system since taking it over. They dismissed allegations that they remove children from homes simply to drum up profits. They noted that their state contracts provide financial incentives for moving children into permanent homes. "Our goal is not to make money," said the Rev. Edward Fellhauer, president of St. Francis Community Services, which has the foster care contract for western Kansas. "Our goal is to reintegrate families," he told the *Eagle*. Despite the controversy, in 2010 there were no legislative changes made around how children are removed from Kansas families and child welfare providers contend that they will continue to try to reduce removal rates in a safe manner.

In **Nebraska** on January 9, 2011 lawmakers called for an investigation of the implementation of child welfare privatization. State Sen. Kathy Campbell of Lincoln, chairwoman of the Health and Human Services Committee, cited continuing problems with the efforts to privatize foster care in Nebraska. Campbell is not planning to terminate privatization but has said the legislature needs assurance that the effort will be affordable, sustainable and in the best interests of children.

Three of five private agencies selected in July 2009 to oversee services to children and families had withdrawn from the effort by November of 2010. The privatization implementation in Nebraska faced similar problems that were encountered early on in Florida and Kansas. The private contractors and the state agencies underestimated the cost of foster care and the private providers assumed too much risk.

Despite these challenges, the Department of Administrative Services is moving forward with the privatization effort. The department submitted a new proposal to move more case management duties to the private providers. The proposal states that the overlapping duties of case managers and the agencies' service coordinators has caused a problem with efficient delivery of foster care services. Transferring case management to contracted agencies would more clearly define roles and responsibilities and result in better delivery of services to children and families, they said.

The state projects a net savings of $3.9 million for one year and $19.5 million for five years for the southeast and part of Omaha service areas if the case management transfer is implemented.
For the one-third of the Omaha area served by Nebraska Families Collaborative, the one-year savings would be $611,600 and the five-year savings $3 million. Total savings for the two remaining contractors is projected to be $4.5 million for one year and $22.5 million over five years. Much of this savings would be reinvested in front-end services to reduce foster care populations.

Oklahoma legislators discussed various child welfare privatization models in September 2010 and plan to more thoroughly investigate these models in 2011. State Rep. Ron Peters said that today's legislative study showed that moving to the privatization of child welfare services is a complicated undertaking.

Current reforms in Oklahoma have yielded positive results, but they have yet to be completed. There will always be ways to improve the system, Peters, R-Tulsa, said. "I think that all options must be examined, including privatization. At the end of the day, we have to have a system that serves our children."

Part 15

Port Privatization Update

The recession took its toll on the ports as traffic slumped virtually everywhere. However, as Christopher Lee, managing partner of the private infrastructure investment firm Highstar Capital, told Ship-Technology.com over a year ago, "Ports are going to be one of the first lines of the economy to turn when the environment improves." Virtually all of the ports have recorded substantial upswings in cargo traffic in the late spring and summer of 2010.

Public-private partnerships (PPPs) are a natural extension of the business model for ports because, unlike traditional highway transportation departments, port authorities operate as self-supporting businesses and have always had to face serious competition with other ports for their customer bases. Port authorities that capitalize on the port's natural ability to operate in a business climate by seeking capital in PPPs will be well positioned when the Panama Canal completes its nearly $6 billion expansion project in 2014 or early 2015. The Panama Canal Authority is adding a third lane to the ocean-spanning waterway that will double its capacity and allow access to the world's largest cargo-carrying vessels.

Today, cargo from Asia, for example, can reach U.S. markets either via the Canal (if the ship fits) or by docking at a West Coast port and riding rail lines or going by truck to inland destinations. With the expansion of the Canal, the larger ships (called post-panamax) will be able to efficiently travel directly to the East and Gulf Coast Ports perhaps saving travel time and certain costs of rail or truck. Roughly 65% of the goods sailing through the Canal go to or from U.S. shores. Investors and Port Authorities believe the East and Gulf Coast ports have significant upsides. This has driven the ports and the private sector to develop plans for expanding existing terminals and to look at creative ways of financing the needed improvements on the landside for the larger ships.

The types of deals pushing forward over the last year include:

Port Authority of New York and New Jersey: In late June of 2010 the Port Authority acquired additional prime waterfront property: the 98-acre Global Terminal on the Port Jersey peninsula in Jersey City and Bayonne. Under the Global agreement, the Port Authority takes over ownership of the Global property and, in turn, reaches a 37-year lease agreement with Global under which the terminal operator will develop the former Northeast Auto Terminal property into one new container terminal known as the Global Container Terminal as part of the Port Jersey-Port Authority Marine Terminal facility. Global, which is owned by the Ontario Teachers Pension

Plan, will then handle the day-to-day cargo operation on the much larger footprint. Coupled with the Port Authority's previous transaction in 2007 to change the use of the adjacent Northeast Auto Terminal, the agreement will lead to the expansion of the Global Container Terminal to 170 acres to accommodate future cargo growth. The expanded Global Container Terminal will become part of the Port Jersey-Port Authority Marine Terminal facility.

The lease agreement includes revenue-sharing on containers handled by Global on the 170-acre combined facility and staged rental payments as the terminal is developed over the years. In addition, the Port Authority will provide Global with up to $150 million to develop and construct new container terminal space. The Port Authority also has agreed to develop a rail facility on the adjacent Greenville property that could handle up to 250,000 containers per year, and the New Jersey Turnpike is redesigning the 14A interchange to handle projected port traffic as the Global terminal expands over time.

The Global acquisition and development will relieve the state of New Jersey of a $150 million financial obligation to the federal government to cover the cost of the 50-foot channel-deepening project in the Port Jersey Channel.

Virginia Port Authority: On July 1, 2010, the Virginia Port Authority (VPA) signed a 20-year lease agreement that effectively gives the agency control over all operations at the APMT Container Terminal located in Portsmouth, Virginia, the most technologically advanced port facility in the world. APMT was a privately owned and developed terminal—built by APM Terminals, an independent division of the A.P. Moller-Maersk Group—and VPA owns and operates Norfolk International Terminals, Portsmouth Marine Terminal, Newport News Marine Terminal and the Virginia Inland Port, an intermodal operation in Front Royal.

The lease agreement unifies all the marine cargo container terminals in the Hampton Roads harbor under the VPA flag for the next two decades. The VPA's private non-stock operating company, Virginia International Terminals Inc. (VIT), is responsible for the day-to-day management and oversight of all VPA facilities and it will have that same responsibility for the APMT Terminal.

Last year VPA received an unsolicited public-private partnership proposal from CenterPoint Properties to operate the ports of Virginia. Competing proposals were also received and all remained under review until September 2010. With the new agreement and changes at VPA and VIT, the proposals were rejected in September 2010.

VPA is also negotiating to take over the Port of Richmond which would provide a facility up the James River near Interstate 95. This facility would be served by barge service and is a natural extension for VPA.

Port of Baltimore: In April of 2009, the Maryland Port Authority (MPA) issued a request for a private investor to lease and operate the Port of Baltimore's Seagirt Marine Terminal. The MPA was searching for a private investor partner to fund a new 50-foot berth and increase the capacity of Seagirt Marine terminal to handle containers. The agreement was announced in November 2009 and signed in January 2010. (Baltimore port officials hope having 50-foot depth at the new berth will help the port attract calls by the larger ships that will transit the expanded Panama Canal.)

Under the Seagirt deal, Ports America will provide the Maryland Transportation Authority with an immediate payment of more than $100 million for use on roads, tunnels and bridges. Also Ports America will provide an annual lease payment. The 200-acre site will continue to be owned by Maryland, which will also maintain control of port security. Further, under the deal, the state will begin to receive a $15 fee for every container above 500,000 moved through the port annually. (Last year, according to state statistics, more than 600,000 containers were offloaded or loaded at Seagirt.)

The deal gives Ports America full control over operations, the obligation to design and build the new berth to MPA standards, and the right to consolidate all current container business in the port at Seagirt. Ports America will develop the new berth at Seagirt by 2014, the year the Panama Canal is scheduled to open its new set of locks that will accommodate larger container ships. The cost of the berth and four cranes is estimated at $105.5 million.

Part 16

Other State Privatization News

- The state of **Connecticut** has entered a 35-year public-private partnership (PPP) with the Carlyle Group to refurbish and operate the state's 23 highway service plazas in return for a state share of revenues raised. Under the deal, the Carlyle Group will invest $178 million in the state's rest areas and will attract new restaurants and businesses to the facilities. Mounting budget concerns and rest area closures in other states have prompted officials to seek similar programs, though most are stymied by current federal law. Transportation officials in **Arizona**, **New Jersey**, **Virginia** and several other states have requested that their state legislative delegations seek the elimination of federal statutory prohibitions on the privatization of rest areas on highways built with federal funds. According to a 2010 Arizona Department of Transportation press release, only states with rest areas built before the 1956 Interstate Highway Act are "eligible to privatize, outsource or engage in [PPPs]" for the operation of highway rest areas. The federal law was originally intended to protect mom-and-pop restaurants and other local businesses from competition as new Interstate highways diverted traffic away from downtowns. A 2010 survey by the American Association of State Highway and Transportation Officials found that transportation department officials in over 25 states agree with Arizona's call for greater flexibility in funding and operating rest areas. Meanwhile, the **Georgia** Department of Transportation is soliciting private sector interest in funding and sponsoring the maintenance of rest areas in exchange for advertising rights and other indirect revenue generation methods.

- In April 2010, **Colorado** Gov. Bill Ritter signed into law House Bill 10-1010, which grants nonprofit organizations the ability to submit unsolicited proposals to state executive agencies, boards or commissions to propose potential PPPs in the delivery of state services or projects. The bill also outlines criteria that state agencies will use in evaluating and accepting unsolicited nonprofit partnership proposals, and it mandates certain agency reporting requirements for any partnerships implemented. The state's Fiscal Stability Commission endorsed the bill in late 2009 as part of a package of recommendations intended to help solve the state's fiscal crisis.

- **Connecticut**'s new Contracting Standards Board is evaluating the state Department of Transportation's use of private contractors to provide certain bridge inspections in the wake of complaints from the Connecticut State Employees Association that the privatized inspections cost more than in-house work and compromise public safety. An August 2010 report from the transportation agency found that the state spent roughly $50 million on bridge inspection consultants between 2007 and 2010, compared to the $24 million spent on in-house inspections during the same time period. Agency representatives told the *Hartford Courant* in November 2010 that 4,000 of Connecticut's 5,300 highway bridges are currently inspected by in-house staff, but it uses private contractors to inspect the remaining 1,600 highway and railroad bridges due to a need for specialized engineers or equipment not available in-house. The transportation agency is currently preparing a series of additional reports on the cost-effectiveness of privatized inspections, which it expects to deliver to the contracting board by March 2011.

- Both houses of the **Florida** legislature advanced competing plans to expand the privatization of state Medicaid services by letting health maintenance organizations (HMOs) and other private health care providers oversee the care of more beneficiaries, but neither proposal ultimately passed both chambers. Former Gov. Jeb Bush initiated Medicaid privatization pilot programs in five counties earlier in the decade, and a University of Florida analysis found a reduction in the monthly per-member Medicaid costs by as much as $95 for those enrolled in a provider service network and a $26 per person reduction on average. Proponents of the measure argued that putting Florida's entire Medicaid program into a type of managed care system would be necessary to keep the system solvent in the wake of the national health care reform passed in 2010. According to state officials Florida spent $18.81 billion on Medicaid for fiscal year 2009–10 (28.3% of the state's total budget), and if current spending trends continue, the state expects costs to swell to $28 billion—accounting for a third of the total state's budget—by fiscal year 2014–15. Any further expansion of privatized Medicaid services would require a federal waiver.

- Earlier this year a proposed Office of Public-Private Partnerships (House Bill 1134) was defeated 103–57 in the **Georgia** House of Representatives. Under the bill, the proposed office would have identified state and local government programs and services suitable for privatization. The bill was sponsored by Rep. Wendell Willard and successfully passed out of the House's State Planning and Community Affairs Committee. The bill eventually died after disagreements over how to fund the office, given the cash-strapped state's ongoing budget trouble. The new office was to be run by one public administrator in conjunction with an advisory council of unpaid business leaders.

- In the 2010 legislative session, lawmakers in the **Kansas** House of Representatives considered House Bill 2403, sponsored by Rep. Marvin Kleeb, which would have created a state privatization commission modeled after Florida's Council on Efficient Government. However, the bill was sent back to committee for further consideration after state legislators created a government streamlining commission under separate legislation. In other state news, after initially receiving no bids for the potential privatization of health care services at the Kansas Veterans Home in Winfield and the Kansas Soldiers Home in

Fort Dodge early in 2010, the state reissued an RFP and is reviewing the single bid it received. As of press time, officials had not issued a final decision on whether to proceed with the privatization.

- Officials in **Indiana** announced a new PPP providing bus transportation to several Indiana communities. The Indiana DOT unveiled the Hoosier Ride intercity bus service, a partnership with Miller Trailways and Greyhound Lines Inc. that is funded in part by a $2 million federal rural transit grant.

- Recent legislation in **Massachusetts** allows local insurance agencies to offer many of the same services as a Registry of Motor Vehicles (RMV) satellite office. The state closed eight RMV offices in the last year, despite over 1 million new registration transactions and 2.5 million registration renewals. AAA, the national automobile club, signed a deal last year with the RMV to provide vehicle registration services in three state offices. At this point it is uncertain whether individual local insurers will apply to perform RMV services, or if the Massachusetts Association of Insurance Agents—which represents nearly 1,500 brokers statewide—would apply on behalf of all of its members.

- In late 2009, the **Mississippi** Department of Information Technology Services (ITS) awarded a three-year contract to Infinite Group, Inc. to provide virtualization services to state agencies. The move reflects a larger effort by the state to streamline operations through "cloud computing" and is expected to reduce both the physical footprint and the energy costs associated with operating state IT functions. ("Cloud computing" involves software or applications that are stored on the Internet, rather than on a PC hard drive or office server.) In other IT news, **Michigan** Gov. Jennifer Granholm signed Executive Order 2009-55 in 2009, consolidating the Department of Management and Budget and Department of Information Technology into a new Department of Technology, Management and Budget. In an early move, the revamped agency solicited private sector interest in building and operating a new state data center to provide cloud computing services to state agencies, cities, counties and school systems. Elsewhere, in late 2009, **New York**'s Office of the Chief Information Officer/Office for Technology (CIO/OFT) announced a contract with PAETEC Holdings Corp. to deliver core voice services to state agencies. The deal will cover over six million minutes in monthly voice services, and the agency expects to save nearly $370,000 per year under the contract.

- In June 2010, the **New Hampshire** legislature established an eight-member Commission Exploring Monetizing Certain State Assets, Enterprises and Resources, which will inventory state properties for possible asset divestiture, a move intended to generate $60 million to help state lawmakers close a $295 million budget gap. The Commission released a 58-page report that found the state owns 9% of land in the state. As of the Commission's final meeting in December 2010, it only identified three properties that can be sold quickly at a total value of $400,000. According to *The Keene Sentinel*, "The sheer magnitude of the state's property holdings revealed the need to create a Real Property Asset Manager position within the Department of Administrative Services… which should lead to a more accurate and effective accounting and allocation of real property assets.” Meanwhile, the Commission chose to not explore privatization of the state’s Lottery Commission, Liquor Commission or Cannon Mountain Ski Area.

- **North Carolina** faces a daunting $3.7 billion budget deficit, and in late 2010 Gov. Beverly Perdue announced a comprehensive, four-part reform plan to restructure, consolidate, eliminate and privatize parts of her administration. Specifically, she plans to consolidate fourteen departments and offices to eight cabinet-level divisions. Last summer the state hired a consulting firm to analyze its IT services. Perdue also announced a major IT privatization initiative that would close 100 computer service units and centralize IT services, which would be managed by a private firm. She also identified evaluating and eliminating some of the state's 400 independent boards and commissions with more than 4,000 appointees to reduce spending. The state will hire a contractor to find savings through bulk purchasing and coordinate bid requests for purchasing functions. The Greensboro-based *News & Record* quoted Perdue at a December 2010 event in Pinehurst, NC saying, “State government must seize this opportunity to become a more streamlined, focused enterprise... These savings will result in duplicative program elimination and cuts to middle management. Those changes that will show up in my budget will document how [the state] can manage for the results we demand.”

- Officials at **North Carolina**’s Department of Health and Human Services announced plans in September 2010 to close most operations at Dorothea Dix Hospital—the state's oldest psychiatric hospital—and relocate the bulk of patients to other hospitals in a move expected to save the state approximately $17 million. Upon implementation, the only patients remaining at Dix will be in the minimum-security forensics unit housing criminal offenders with mental illnesses that are under a judicial order to undergo psychiatric treatment before proceeding to trial and sentencing. In December 2010, Gov. Beverly Perdue told Raleigh-Durham area broadcaster WRAL that she wants to see all of the state’s forensic mental health patients consolidated at Dix and expressed interest in privatizing management of the hospital. According to Perdue, “I want to privatize it because I believe, in some instances, it's more efficient for us to privatize a service like that […] The forensics psych unit would really save money [and it would be] a valuable way to use the core hospital.”

- Policymakers in **Oregon** approved a 2009 bill requiring agencies to prepare a detailed public-private cost comparison prior to issuing any contract worth more than $250,000 to determine whether it could be done as cheaply in-house. The bill was championed by the Service Employees International Union and was seen by opponents as an obstacle to government reform. Sen. Rick Metsger (D-Welches)—the only Democrat to vote against the bill—told *The Oregonian* in August 2010 that, “I saw this as entrenching government jobs […] It makes it harder to wheel back the government agency's size.” However, one significant privatization project advanced at the same time. In the same legislative session, policymakers adopted a jobs and transportation bill that included a pilot project on contracted highway maintenance. The bill authorized the Oregon Department of Transportation (ODOT) to implement a six-year pilot program to outsource the entire maintenance of a 26-mile section of Oregon Route 219 in a performance-based, "total asset maintenance" contract. In July 2010, ODOT selected the Sherwood-based firm Eagle-Elsnern in a competitive bidding process for this project, which will include road maintenance and repairs, landscaping, snow and ice removal and 24-hour accident response. ODOT will monitor the contractor's maintenance and evaluate it based on performance specifications, but the DOT will not direct specific work.

- A consultant report assessing the feasibility of privatizing certain units within the **Utah** State Hospital (USH) and the Utah State Developmental Center (USDC)—state-run facilities providing residential care for patients with severe mental illness and mental retardation, respectively—was prepared for the state legislature's Executive Appropriations Committee and released in September 2010. Despite finding that privatization would lower costs in any scenario and that savings could be redirected to increasing the quantity of services, the report ultimately recommended against privatization due to concerns that the quality of care for patients might be adversely affected. According to the report, a lower benefits-to-salary ratio in the private sector could result in staff turnover and retention issues that could ultimately affect the quality of care. However, a Reason Foundation analysis of the report found that the consultants did not adequately substantiate that risk and ignored examples of successful privatizations in other states where feared staff turnover issues did not materialize.

- In February 2010, **Virginia** Gov. Bob McDonnell announced the launch of a $2 million PPP between the state and the Virginia Health Care Foundation to provide mental health treatment to uninsured Virginians. The initiative was the result of a $1 million challenge grant McDonnell issued to the Foundation in 2009 while serving as the state's attorney general. The partnership will underwrite nine grants throughout the state to enable health providers to treat uninsured residents suffering from basic mental health conditions and provide primary health care for uninsured Virginians with serious mental illness.

- **Washington State** Senator Rodney Tom (D-Medina) introduced SB 6867 in the 2010 legislative session to abolish the state's public print shop. According to Tom, the state could rely on a combination of desktop printers and private print services vendors to lower costs and improve government efficiency. A recent state audit found that the state printer is currently losing approximately $120,000 each month, and State Auditor Brian Sonntag told local news outlet King5.com: "Certainly that's one of those kinds of functions that I think the state could privatize easily […] the state printer already contracts out for substantial part of that printing work." At press time, SB 6867 had not yet been heard in committee; meanwhile, a competing bill that would fold the state Department of Printing into its Department of Information Services passed the House and was awaiting a final vote in the Senate.

- Earlier this year an independent report released by the Passenger Vessel Association (PVA) found that despite its success **Washington State**'s ferry system has significant room for improvement. Gov. Chris Gregoire requested a second report be completed on the pros and cons of privatizing the ferry system, which is the largest in the nation and fourth largest in the world.

- In December 2010, a circuit court judge in **West Virginia** dismissed a lawsuit filed against the state's Office of Technology and chief information officer by a public employee union alleging that state officials intend to privatize technology-related state jobs. Public Workers Union Local 170 argued that the agency must first compile a four-year strategic plan and biannual reports to legislative leaders pursuant to a 2005 law that restructured state IT operations, as well as a cost-benefit analysis for any proposed major IT project. Office of Technology Director Kyle Schafer told lawmakers in the fall of 2010 that West Virginia has saved millions since 2005 by centralizing technology infrastructure, and the state is considering seeking bids on a project to consolidate the writing and modifying of computer programs, a function currently spread out among over 30 different government agencies.

- In 2010, **Wyoming** Gov. Dave Freudenthal vetoed Senate File 0027, a bill passed overwhelmingly in both legislative houses that would have established a process to allow citizens to lodge concerns with government unfairly competing with the private sector. The bill, sponsored by State Senator Cale Case, would have created a Web portal for citizen complaints and required the governor's office to review each concern lodged and file an annual report to the legislature summarizing action on all complaints received. In his veto message, Governor Freudenthal noted his support for the overall goal of the bill but did not believe it was necessary to create a new law to achieve it.

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