How-To Guide No.10
September 1993

TECHNIQUES FOR MINING THE PUBLIC BALANCE SHEET

by

Roger D. Feldman and Thomas M. Ingoldsby

EXECUTIVE SUMMARY

State and local governments are increasingly searching for innovative solutions to balancing budgets without raising taxes. "Mining the public balance sheet," a systematic process of identifying and divesting government assets through sale, lease, or other techniques, offers one way to increase nontax revenues. Moreover, if done carefully, mining the balance sheet can result in upgrading of the asset, new tax revenues, and preserved or improved service quality. Effective mining the balance sheet thus has the potential to do far more for a government than merely balance its budget for a single year.

Diverse types of facilities may be monetized in this fashion, including: government buildings; data processing centers; recreation facilities; wastewater treatment facilities; bridges; and publicly owned utilities. Legal development rights for undivided land and air rights may also be divested.

Several different types of transactions may be utilized in the divestitures, such as, asset sales; long-term leases; sale and leasebacks; sale and service agreements; asset swaps; and value capture arrangements.

The form of transaction employed depends on several legal and tax considerations. For example, public assistance to private development is frequently subject to a body of state law; the availability of tax-exempt finance will be affected by the extent of private benefits realized and the terms of operating agreements with private parties; and the availability of tax benefits to private purchasers will be determined by the terms of service agreements and leases.

Approached in a systematic way of matching objectives, assets, financing techniques and available incentives, mining the balance sheet can jump start a public entity's ability to meet current financial difficulties.

I.INTRODUCTION

"Mining the balance sheet" is a process of systematically scrutinizing what assets and rights a government owns, determining which selected public assets it makes sense to transfer to private control, and structuring the transfer in a manner which meets public objectives.

At a time when state and local governments are facing both near term deficits and the long term inability to provide key services, "mining the balance sheet" offers governments at all levels a workable strategy to deal with these problems without further allocation of federal funds or tax increases. States, cities, counties, as well as the federal government possess billions of dollars worth of assets. They can selectively transfer some of these assets to the private sector and still control their use. By doing so, they can turn physical capital into financial capital and thus take control of their future infrastructure planning.

II.OBJECTIVES

Governments should only undertake an asset transfer activity when the particular asset in question, and the form of the transfer, meet several of the following objectives.

- ☑ 1Government realization of a significant part of the cash value of the asset in a relatively short period of time.

- ☑ 2Improvement of the governmental asset by the purchaser so as to meet health, safety or environmental standards.

- ☑ 3The continued dedication of the asset to providing a public service or the substitution by the purchaser of an asset in lieu of the transferred asset, which has equal or superior capability.

- ☑ 4Delivery of the service in a manner which assures protection of the public interest.

- ☑ 5Establishment of a foundation for needed innovation by the private purchaser, whether through system expansion or upgrade, or through introduction of new technologies.

- ☑ 6 Creation of a new tax base resulting from private ownership of facilities previously exempt from tax because of its public ownership.

All of these objectives cannot be met in any single transaction but if a significant number of these objectives are met, mining the balance sheet will generally be welcomed by the public.

III.OPPORTUNITIES FOR MINING THE BALANCE SHEET

The areas for consideration for mining of the balance sheet fall into five basic categories:

- **Transportation:** bridges, tunnels, roads and approaches, airports, maintenance facilities, mass transit assets and ports. Federal support for these types of transactions is specifically provided for in highway projects in the Intermodal Surface Transportation Efficiency Act (ISTEA) of 1991.

- **Environment:** wastewater treatment, drinking water; integrated solid waste disposal (waste-to-energy recycling and landfills); and sludge processing.

- **Utilities:** electrical generation and distribution; gas distribution; data transmission; telecommunications.

- **Government buildings:** parking garages; office facilities; data processing centers; hospitals; prisons; recreation facilities.

- **Property rights:** undeveloped land; air rights; license and permitting type rights; exercise of government condemnation rights.

Not all assets in these categories are always suitable for government divestiture. Basic criteria to take into account in targeting particular assets are the following:

- Choose assets whose sale will trigger larger improvement of government or private operations, as in transportation or environment; or that are already frequently in the private sector, such as recreation facilities.

- Choose assets whose sale will have a meaningful fiscal impact on budgetary problems. There is no sense using up the significant political capital that will have to be expended for anything less than a major pay-off.

- Choose assets whose acquisition likely will have significant revenue-generating potential for the private-sector purchaser. This ensures that private purchasers will bid on the sale and that public user rate shock can be eliminated or minimized.

IV.FORMS OF TRANSACTION

Transactions must always be structured to provide enough flexibility to allow the parties to meet their particular financial and operational objectives. Six basic types of transactions may be utilized (see Figure 1).

A. Asset Sale

An asset sale is a direct and complete divestiture by a government of a particular asset. Typically, such a divestiture will be subject to state and local government restrictions designed to assure that any property being sold is sold for a minimum fair price and there is sufficient competition for its purchase. In many instances, special purpose legislation authorizing the transaction may need to be enacted. The special purpose legislation may exempt the divestiture from the normal restrictions on disposing of public property.

Figure 1

Types of Mining the Balance Sheet Transactions

_Asset Sale
_Long-Term lease
_Sale-Leaseback or Lease-Leaseback
_Sale-Service Contract or Lease-Service Contract
_Asset Exchange Arrangements
_Value Capture Transactions

The private asset purchaser may request terms to assure that it is acquiring the project on a basis that it can be successfully developed. These may include stipulations with respect to the asset's zoning and permitting. The scope of government's legal flexibility to agree to such provisions must be examined. For example, a local government's ability to sell a wastewater treatment facility which it owns will not be accompanied by its ability to convey entirely the regulatory status which that facility enjoyed when it was publicly owned.

B.Long-Term Lease

Instead of transferring an asset's title to a private party via a sale, a government may lease or “rent” the facility to a private party for a specified number of years. Payment, maintenance, and operation of the facility are all spelled out in the lease agreement. At the expiration of the lease, the government has the right to resume full control of the facility. The parties will have the same concerns about the rights to asset operation in a lease as in a sale; in addition, the parties will be concerned about the rights of the government to resume control of the asset during the term of the lease and upon its termination. Leasing may be useful where transfer of ownership may be construed to be contrary to applicable regulatory requirements, as in the airport privatization field, where grant repayment and loss of federal assistance considerations have been present.

C.Sale-Leaseback or Lease-Leaseback

In a sale-leaseback transaction, the private party purchases the asset from the government and then enters into a multi-year lease with government for the asset which it has acquired.

For the private party to be treated as the owner of the asset for tax purposes, the terms of the lease must meet rigidly prescribed Internal Revenue Service requirements. Leases that meet these requirements are referred to as "true" leases to distinguish them from arrangements that are really conditional or installment sales contracts. These latter types of arrangements are frequently referred to as "lease-purchases." In a lease-purchase, the government, not the private party, is deemed to be owner of the asset. In a true lease transaction, on the other hand, the private party is entitled to the tax benefits associated with ownership of the asset. These benefits are not available to a private party in a lease- purchase transaction.

If the lease is a true lease, the government cannot become the owner of the asset at the end of the lease term without exercising its option to purchase the asset at its then *fair market* value. This effectively requires the government to pay for the asset twice, once during the financing and again on exercising its purchase option at lease term's end.

Case Study: Illinois Beach Lodge

Illinois Beach State Park is the busiest Park in the state system. It stretches from the Wisconsin border to Waukegan, about 7 miles of waterfront property on Lake Michigan. The northern part of the Park contains North Point Marina, the largest fresh-water marina in the Country. At the south end of the Park is Illinois Beach Lodge, a building owned by the state.

In an effort to privatize the operations as well as decrease the anticipated $13 million required to upgrade the entire structure, the state of Illinois put out an RFP and reached an agreement with the private sector to lease the project from the state, operate it for the term of the lease (25 yrs. with an additional 25 yr. renewal), and then walk away.

For financing, the developer will "borrow" Lake County's bond rating and fund the project privately through the Whitehall Group/Chicago Corp., a private financier. The county will participate in the cash flow in addition to re-acquiring lost jobs and recapturing tax revenues. All net profits will stay on the table until the project seasons, thereby limiting the county's financial exposure.

In many lease transactions, the private party will have an operating contract for a term equal to all, or a substantial portion, of the lease term. If the transaction utilizes tax-exempt financing, the operating contract must meet certain requirements discussed subsequently in this article.

Lease-Leaseback

In a lease-leaseback transaction, the government leases assets to a private party who then renovates or improves the asset and then releases it to the government. For tax purposes, the lease to the private party usually is considered a true lease and the leaseback to the government is treated as a sublease. In these situations, the government will be deemed the tax owner and no tax benefits related to ownership of the assets are available to the private party.

A sale-leaseback locks in the future control of a facility for a government on known terms. A sale may not necessarily do so. Since, as described above, the sale-leaseback may confer private tax benefits while the lease-leaseback will not, the former transaction may result in better terms to the government initiator of the transaction.

D.Sale-Service Contract or Lease-Service Contract

An asset sale or long-term lease may be coupled with an arrangement by the private purchaser to furnish services with the asset for a specified period of time. Such a service arrangement both provides the government with use of the asset and provides the private party with a firm cash flow stream (which may assist project acquisition financing). Under these arrangements the private party acquires ownership or a leasehold interest in an asset in exchange for agreeing to provide a service to the government or the general public. Under applicable IRS rules, the government is not permitted to share, or assume, the risks associated with swings in service contract revenues or to exercise control over asset management.

Service contracts have been utilized to operate many solid waste resource recovery and wastewater treatment facilities. Service agreements typically contain several mechanisms to assure governments of acceptable asset utilization by the private purchaser, including: 1) very specific performance standards and associated damage obligations; and 2) government rights to assume facility operation in the event of continuing sub-par operations. A city might choose to do a sale-service contract for its integrated waste disposal system, for example, if it no longer wishes to carry the operating costs associated with ownership, or if the facility is going to require expansion and the city does not wish to raise the necessary additional funds.

E.Asset Exchange Arrangements

A simple form of a public-private swap is exchanging an asset or facility currently held by a government, for either a comparable asset, or for agreement by the private party to develop a comparable asset.

In swap arrangements, governments exchange valuable assets which they cannot develop to their full economic potential—such as downtown real estate, underutilized rights of way or stadiums—for facilities that are sufficient for public purposes. The additional revenue or consideration received in the exchange by the government can then be directed to other public purposes. Swaps have been used often in developing courthouses and other similar public facilities. In asset swaps, it is critical from a legal, economic and political standpoint that the balance of value (whether assets or legal rights) received by the government is equal to that transferred to the private sector.

Swaps typically will be subject to state laws on disposing of public property unless special legislation is adopted in connection with the project. Because of the complex nature of the assets involved, swap arrangement terms will have to take into account a wide range of issues including the following:

·rights to the residual value of the assets which have been swapped;

·continued sharing by the government and the private party respectively in the revenues from each of the assets swapped;

·agreement of the private party to participate with the government in joint development of public property in consideration for the property swapped;

·franchise, tolling, grant application, or other rights conveyed by the government to the private party along with the swapped property; and

·future commitments of services to the government in exchange for site conveyance.

F.Value Capture Transactions

Value capture is a means of the government utilizing the new value realized as a consequence of a newly developed infrastructure project. Such economic value, for instance, may take the form of property adjacent to an infrastructure project, such as a road that opens up property development opportunities. Alternately, value capture could be in the form of certain aspects of an infrastructure project which have not been adequately exploited, such as air and subsurface rights with respect to property.

Governments may participate in capturing the value associated with new infrastructure projects in several ways.

·Insist on up-front concession payments or commitments based on the projected future value to be realized by the private party.

·Share directly in the property appreciation as it is realized by the private party after the infrastructure project is completed.

·Establish tax increment or special-assessment districts.

The objective of any of these arrangements is to achieve a basic fairness in the swap of public property and concessions for private property and considerations. This is accomplished by preserving public contractual rights in the future value that is captured in assets transferred to the private sector.

V. COMMERCIAL AND FINANCIAL CONSIDERATIONS

A.Commercial Terms/Legal Requirements

From a public standpoint, to maximize the value of mining the balance sheet, a transaction should include terms compelling the private party to upgrade or modify the facility, and for public receipt of the benefits of such an upgrade. For example, the transaction may be based either on expanding facility capacity or on applying a portion of existing capacity to revenue- generating purposes in which the public will share. In the event that additional revenue sources are not achieved, risk allocation must be taken into account. From the private sector's standpoint, the public will not allow service to the government to be jeopardized by the failure to realize private expectations. These kind of arrangements for public-private revenue and risk allocation may be subject to state statutory or constitutional limitations which require examination.

For financing reasons, it is critical that governmental obligations take and pay for services from the transferred asset to be firm, so that lenders can rely on this as a future revenue source. Because such firm governmental commitments may be deemed to be equivalent to public debt obligations, they may either be subject to limitations as to when they may be incurred or treated as already-incurred debt for purposes of determining whether budgetary ceilings have been exceeded. Most transactions, however, are premised on government obligations not constituting debt. Therefore, great care must be taken to structure these governmental obligations in a way so they are not treated as debt.

Another issue is whether, in conjunction with the sale of the asset, the private purchaser will receive some type of concession or franchise from the government to perform the service provided by the asset. If the answer is yes, then the nature of regulation of the concession must be worked out. Legal issues which must be examined in connection with the grant of a concession include the following:

- permissibility of private performance of the services which have previously been publicly performed;

- applicability of government procurement requirements;

- permissibility of commingling public investment, if any, with private investment;

- possible lending of government credit to a private party granting the concession;

- permissible term of such arrangements; and

·exclusivity of the franchise granted.

States typically enact special privatization statutes to deal with these issues. Such statutes frequently pertain to specialized areas such as surface transportation and environment.

B. Financing Alternatives

Government-owned assets may be transferred to a private company which then owns and operates the asset or the asset may be transferred to a public body as owner with the private firm operating the facility. The extent of private sector involvement in the project, in turn, determines whether the project is eligible for tax-exempt financing. Because of the substantial difference between taxable and tax-exempt rates, the availability of tax-exempt financing may be crucial to the successful development of a project.

1. Private Ownership and/or Operation

With the exception of certain types of facilities, projects with private ownership or long-term operation contracts must be financed with taxable financing. Projects structured as asset swaps and service contracts are also usually required to be financed with taxable debt.

If the private party is the owner of the asset, it will be entitled to depreciation and the tax credits, if any, available to an owner of the asset. With service contracts, because the private party uses the asset in the course of providing a service to the government, it may claim the depreciation normally available for the particular type of asset. On the other hand, if the private party leases the asset to the government under an operating lease, only straight line depreciation over the ACRS (Accelerated Cost Revenue System) life of the asset will be allowed.

Certain statutorily enumerated infrastructure assets may be privately owned and operated and still be eligible for tax-exempt financing. Most of these assets are revenue-producing projects and involve major governmental programs. Airports, docks, mass commuting vehicles, water and sewer facilities, solid waste disposal facilities and certain energy facilities are included in this group of assets (see Figure 2). The tax-exempt bonds used to finance this class of assets are private activity bonds, meaning the asset is used in a private party's trade or business.

A public authority or industrial development agency issues the private activity bonds. The bond issuer sells the asset to the private party in exchange for an installment note or it leases the asset to the private party via a lease-purchase agreement. In both cases, the user payments are the source of funds for the payments due on the private activity bonds.

Figure 2

Privately Owned Assets Eligible for Tax-Exempt Debt

_Airports
_Docks
_Mass Commuting Vehicles
_Water and Sewer Facilities
_Solid Waste Disposal Facilities
_Some Energy Facilities

Not surprisingly, there are a number of statutory requirements and Internal Revenue Service regulations affecting the financing of projects with private activity bonds. In many transactions this results in mixed tax-exempt and taxable financing. Usually, a major portion of the project qualifies for tax-exempt financing and the balance of the project is financed with taxable debt.

2.Public Ownership and Private Operation

Rather than selling the asset, the government may continue to own the asset and either lease it to a private firm or enter into a multi-year contract with the private firm to operate the facility. Unless the asset is one of the assets eligible for private activity-bond financing, however, leasing the asset to a private party causes the asset to be financed with taxable debt.

In many infrastructure projects, a private company may have a multi-year contract to manage and operate the project. The assets comprising these projects are eligible for tax-exempt financing if the management or operations contract meets the following requirements:

- ☑7The contract must terminate at the end of 5 years and must be terminable at the end of any 3-year period. Successive contracts may be entered into but they must be relet at the end of each 5-year period.

- ☑8No portion of the operator's income can be based on net profit.

- ☑9Fifty percent of the operator's income must be fixed and periodic.

If these rules cannot be satisfied, transactions with an operations contract must be financed on a taxable basis.

For assets qualifying for tax-exempt financing, the government issues its own obligations in the form of bonds, certificates of participation, or notes. Revenues generated by the financed asset or by service payments by the government are the normal source of funds for repayment of amounts due on these obligations.

C.Credit Support for Financing

Projects suitable for development are usually self-sustaining, meaning revenues generated by the project are sufficient to meet operating expenses and debt service. This type of arrangement is called project financing because the debt is nonrecourse to either the government or the private parties participating in the project.

From a lender's standpoint, for nonrecourse debt in a project financing to be adequately supported, a credit package must be assigned to the lender. The credit package consists of obligations and assets sufficient to enable the lender to conclude that debt service will be met. Depending on the structure of the particular transaction, the credit package may include one or more of the commitments from the government listed. There are also private-party commitments which may constitute part of the credit package (see Figure 3).

In many projects, the lenders and the government will be concerned as to whether the private party will be able to meet its obligations. Reason: the private party in many transactions is a special purpose subsidiary of a parent company that has united capital. To address this concern, many projects require an equity investment by the private party or the issuance of a subordinated class of debt whose rights are similar to those of an equity investor. An alternative to a direct equity contribution is a performance and/or financial guarantee by the subsidiary's parent corporation or a contingent equity contribution arrangement.

Figure 3

Government Commitments for Credit Package

- Mortgage and/or security interest in assets sold by the government to the private party and the improvements to those assets made by the private party subsequent to the sale.
- Lease-rental payments by the government.
- Service payments by the government.
- Dedication of revenues from pre-existing public projects (or specific user charges or taxes).
- Value capture receipts from a tax or special-assessment district.

Private-Party Commitments for Credit Package

- Revenues from other private projects owned by the developer.
- Corporate guarantees or "keep well" arrangements.
- Mortgage or security interest in the acquired asset, the improvements to the assets and/or other assets of the private party.
- Value-capture revenues from private development of the asset transferred by the government or of other assets.
- Privately acquired credit enhancement or bond insurance for all or a portion of the debt used to purchase the public asset.

The final structure for the financing of a private acquisition of public assets may take a variety of forms. In all cases, however, there a several key issues to be examined to assure project soundness. These are:

- adequacy of credit package securing the debt;
- extent of recourse to the private project sponsor and other forms of private participation;
- availability of taxable debt; and
- need for direct or indirect equity contribution by a private party.

D.Mixing of Publicly and Privately Financed Assets

The transfer of assets to a private party raises operational and legal issues which must be addressed early in the structuring of the transaction. Sufficient rights associated with the use of the asset must be transferred to the private party to permit the asset's development and operation. The rights granted the private party must not be so extensive, however, that they constitute government support of private business which is prohibited by most state constitutions. For example, a solid waste facility may require an agreement by a government to deliver its waste to the facility in order for the facility to be financed. However, the commitment by the government to deliver waste cannot be so unconditional as to constitute a lending of the government's credit.

A second major area of concern regarding transferring an asset to a private party is the effect of the transfer on any financing of the asset which is still outstanding. Many of the assets suitable for transfer were financed with tax-exempt governmental obligations. In many situations, the government cannot or does not want to retire the financing on the asset at the time of the transfer. There currently is no statutory or regulatory prohibition on transferring an asset without retiring the outstanding nonprivate activity bond, tax-exempt financing. The IRS has identified this issue as one of its regulation projects. It is possible, therefore, that in the near future the agency may issue regulations addressing this question.

VI.FEDERAL POLICIES

There have been two major federal initiatives to facilitate mining the balance sheet by state and local governments. They help to deal with the constraints on public and private financing of the asset transfers summarized above.

A.Presidential Executive Order on Infrastructure Privatization

The development of public infrastructure has been a beneficiary of federal assistance in several fields; notably environment, health and highways. Previously, state and local governments that sold infrastructure assets had to turn over the lion's share of the sale proceeds to the federal government. Reason: they were required to pay back to the federal government the same proportion of the asset's purchase price as was put into the asset originally by the federal government.

No allowance for depreciation was taken into account in calculating the amount due the federal government. This rule effectively restricted ownership and use of federally financed assets to the public sector and served as a major barrier to the development of many public-private projects.

The May 1992 Presidential Executive Order on Infrastructure Privatization broadened and encouraged agency waiver of this requirement, thus removing these financial disincentives to privatization.[i] With the Executive Order, the state or local government first recaptures its original investment from the sale proceeds and the federal government receives an amount equal to the depreciated value of its original investment, computed on a modified accelerated basis. The remainder is kept by the state or local government and can be used for debt relief, tax relief, or new infrastructure investment. The order also directed the relevant federal agencies to adjust their policies to facilitate state and local efforts to sell or lease infrastructure facilities.

B.Intermodal Surface Transportation Efficiency Act (ISTEA)

Another barrier in transferring assets from the public to the private sector has been the costs associated with facility upgrade. Payment of the debt necessary to pay these costs has been hampered, in the highway field, by the virtually blanket prohibition against federal funds being made available to tolled projects, whether publicly or privately owned. Since toll revenues would represent a significant part of the "credit package" to secure debt for privatized road development, this has represented a significant barrier to private road infrastructure development.

The provisions of the Intermodal Surface Transportation Efficiency Act (ISTEA) authorize states to make federal highway funds available to private parties as grant or loan assistance for upgrading existing roads, bridges or tunnels and converting these facilities to toll facilities. Federal support may be equal to up to 80 percent of financing for bridges and tunnels (which may be on interstate highways) and 50 percent for noninterstate highways. Private developers must enter contractual arrangements with states, which among other matters, commit toll revenues to repaying the state loans. In other words, public assets are converted to private ownership by using debt repayable from user charges on the public.

The ISTEA legislation followed several state programs to stimulate private toll road development. The relationship of ISTEA and state toll road legislation to mining the balance sheet strategies is still evolving.

Both California and Arizona, for instance, invited developers to develop "grass roots" highway projects, and in the process stimulated examination of what existing public tangible assets and other property rights may be incorporated into that process. Both statutes provided for the state to exercise eminent domain to acquire necessary rights of way. Other forms of assistance include the following: assignment of previously publicly acquired rights of way; public planning studies; environmental studies; issuance of permits and air rights. In addition, it has been suggested that tolls be installed on existing highways and that the resulting toll revenues be applied to new private project developments. In most jurisdictions, special legislation may be required to enable a state or local government to exercise its sovereign powers in these ways. It is to be anticipated that more and more states will pass such legislation, in order to maximize the potential ISTEA presents for mining the public balance sheet.

VII.CONCLUSION

Mining the public balance sheet enables state and local governments to transfer assets to the private sector and thus realize substantial nontax revenues while also retaining control of the quality of the services performed for the government. The government thereby realizes the locked in economic value of existing facilities.

Moreover, if these transactions are structured properly, governments can secure operational benefits, such as facility upgrade to comply with health and safety requirements, compliance with performance standards, and control over operating costs. In addition, transactions can result in "public capture" of a portion of the enhanced value of facilities which may be created through private development, either at the facility's own site or on adjacent real estate.

Different forms of transactions may be suitable to achieve these objectives depending on the particular circumstances of a transaction. The transactions may take the following form: asset sales, long-term leases, sale-leasebacks, lease-leasebacks, sale-service agreements, and asset swaps. A substantial number of these transactions may be financed in whole or in part with tax-exempt financing. Federal incentives may be available in the forms of affirmative programs such as loans and grants under ISTEA or substantial mitigation of restrictions on public federal grant repayment obligations.

Mining the public balance sheet represents a strategy which must be carefully planned. Public law and tax issues must be considered for each transaction. Such effort can be rewarded, however, by maximizing not only of current tax dollars, but also the value of expenditures which already have been made.

ABOUT THE AUTHORS

Roger D. Feldman and Thomas M. Ingoldsby are partners in the Washington D.C. Office of the Law firm, McDermott, Will, and Emery. Mr. Feldman is also Chairman of the National Council for Public-Private Partnerships.

ENDNOTE

Former President George Bush, “Executive Order 12803 of April 30, 1992, Infrastructure Privatization,” Federal Register, Vol. 57, No. 86, May 4, 1992.