# Key Features of Privatization Financing

LAWRENCE D. SHUBNELL

**This paper is a brief outline of the types of projects that are good candidates for privatization, the essential cost components and savings potential of privatized projects, and the essential elements of a structure for financing privatized projects.**

The types of projects that are the best candidates for privatization are

- Projects that lend themselves to the provision of services, are operationally oriented, and require manpower and equipment. It is most desirable to have both management and operation under the control of a private party through a service contract. It is also helpful if the facility can serve multiple users and is equipment intensive.
- Projects that require new construction are better candidates because they are unencumbered by existing public asset transfers or leases that may taint the privatization contract. It is also easier to package performance guarantees, personnel, and ownership.
- Projects with track record technology are easier to finance, as are projects whose essentiality of service is unmistakable. In some cases in which new technology is involved, privatization may be easier to implement because the private party may be party to the development of the technology and offer complete performance guarantees.

## ESSENTIAL COST COMPONENTS AND SAVINGS POTENTIAL

The principal savings in a privatization result from the equity contribution. The amount of equity will usually range between 20 and 30 percent of the fully capitalized cost. The equity participants receive their compensation from the tax benefits (savings in federal income taxes) and from cash flows that result from project operation. The savings in financing cost alone resulting from private participation may approximate 10 percent of the annual debt service payment that would otherwise be required. Additional savings may be realized through lower construction and operating cost (resulting collectively from lower labor cost, faster procurement timetable, value engineering, vendor buy-ins, and economic incentives).

Although there may be reasons other than savings to enter a privatization (such as avoiding the incurrence of direct debt or avoiding seeking voter approval at referendum), savings will be an important aspect of the decision. In this regard, the governmental entity should determine the overall acceptable level of savings that must be realized in order to justify entering the transaction. Experience indicates that savings in the range of from 5 to 20 percent are acceptable and expected by most governments, depending on the sharing of project risks and the presence of other considerations (such as the desirability of obtaining "off-line" project implementation). In measuring the materiality of savings the technique of calculation ought to be agreed on in advance, understood, and benchmarked for calculation by all parties to the transaction. A preferred technique is the discounted–cash flow method whereby the present value of the stream of payments under the privatization agreement is measured against payments under conventional government borrowing. The bottom line to calculating savings is comparing the life-cycle cost of a project under the privatized and nonprivatized scenarios and determining if the savings are "worth it" in terms of contract procurement and negotiations, risk sharing, and the buy-out features of the service contract.

There are certain threshold costs that must be dealt with during the earliest stages of a privatization. If not adequately accommodated, these costs could obviate any savings that might otherwise be realized. More particularly, private-sector owners of tangible personal property and real estate are subject to governmental fees, levies, and taxes that might not be incurred as a cost under public ownership. If the private project cannot bear the cost of these charges and still demonstrate a savings, the project may be financially unfeasible, particularly in instances in which the public charges are interjurisdictional in nature and therefore become tantamount to intergovernmental transfers. Likewise, insurance coverage may be required for such risks as business interruption and catastrophic loss; these costs add to the cost of a privatization project in a direct way whereas they would be "hidden" if the project were publicly owned. Finally, if entering a privatization means that federal or state grants are lost, these lost revenues must be accounted for in the measurement of savings.

## ESSENTIAL ELEMENTS OF FINANCING STRUCTURE

An important objective in structuring a privatization transaction is attaining a security structure that supports a credit-quality bond rating. It is most desirable to seek a credit level that is as near as possible to that which the service recipient (government) enjoys. To accomplish this, the following criteria are important credit concerns:

- The service being provided should be essential public service that is basically nondiscretionary in nature.
- There must be a pledge of project revenues and assets to the bond trustee in order to establish the bondholders' lien on these sources of repayment. In some cases the flow-of-funds may be through the trustee.
- Although the actual appropriation of funds may occur through an annual budgetary process, the enforceability of the

Public Finance Department, Legg Mason Wood Walker, Inc., 7 East Redwood Street, Baltimore, Md. 21203.

monies due under the service contract ought to be incumbent on the appropriating entity.

- Legal opinions must be rendered on the enforceability and assignment of all contracts; such opinions should cover bondholder and trustee rights in bankruptcy.
- Force majeure (uncontrollable circumstances such as changes in laws) events must be resolved as to risk in favor of the bondholders.
- The private partnership or entity engaged in the transaction with the public sector should be limited in purpose to the scope of the transaction.
- The contracting public agency must enter an agreement guaranteeing the payment of a fee for a service; service fees should be payable without set-aside or offset.
- The obligation to pay fees begins when the facility has passed acceptance tests; therefore, debt service on any issued bonds must be provided for until acceptance tests are met.
- The contracting private party must agree to provide the service and to guarantee such, save force majeure; liquidating damages at least equal to the amount required for debt service must be available for any interruption of service.
- Methods of providing for facility expansion or modification should be provided for in advance; provisions governing additional indebtedness must set certain affordability tests.
- Construction will be for a fixed price with completion on a date certain. Payment and performance bonds must back up construction guarantees, including liquidated damages covering debt service.
- Partnerships making guarantees must have substance to back up obligations and commitments. Partnership structure and right of substitution are important.

# Public-Private Involvement in the Development of Roadways and Interchanges in Colorado

JOSEPH F. DOLAN

**This paper is a history of private-sector involvement in the provision of roadways in Colorado. Major early developments are sketched to provide background for what has occurred since 1975. Financial and political problems associated with unmet present demand, land use planning for future growth and development, and quality-of-life issues are discussed. Three ways in which the private sector is involved in the provision of roadways are described: *(a)* private contributions to finance interchanges, *(b)* governmental associations to provide major transportation improvements, and *(c)* involvement of private interests with local governments to build major highways without the participation of state or federal government.**

In 1821 William Becknell, a Missouri businessman who wished to further his trade with Mexican soldiers in what is now New Mexico, forged the first road through Colorado—the Santa Fe Trail. Forty years later a fur trapper built a shortcut on this same route over Raton Pass in southeastern Colorado, set up a booth, and established Colorado's first toll road: a dollar a wagon, funerals and Indians free.

One of Colorado's earliest and greatest state legislators, Otto Mears, made his fortune the same way, building and operating toll roads throughout the state. In all, he owned 383 mi of tolled "wagon roads," including the Million Dollar Highway between Ouray and Silverton, so named because supposedly a million dollars' worth of gold was discovered in the gravel used to surface the road.

As the free enterprise system crisscrossed Colorado with roads, other visionaries saw a dollar to be made in Denver transportation. Five full years before Colorado attained statehood in 1876, Denver had fixed-guideway transit: horse-drawn cars on 2 mi of track. By 1886, Denver was the second city in the world to have electric-powered streetcars; and by the 1890s, eight different companies were plying 156 mi of city lines with cable cars, streetcars, and trolleys.

Colorado Department of Transportation, 4101 South Colorado Boulevard, Englewood, Colo. 80110.