Public Works Financing

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Cranston, RI, Opts for Private Finance for Wastewater Upgrade

White House To Review Long-Term Leases (5/96, p.6)

The Clinton Administration slammed the brakes on long-term leases as a privatization tool early this month, demanding that Cranston, R.I., and Wilmington, Del., submit their proposed wastewater transactions for detailed review by White House lawyers.

Plans by at least seven other mayors to auction sewage plant operating concessions or O&M contracts to the highest bidder may also be delayed by the federal reviews.

The Environmental Protection Agency (EPA) advised the mayors of Cranston and Wilmington on May 3 that their proposed long-term management contracts would fall under Executive Order 12803, which governs the terms for repayment of federal grants in any municipal sale of federal-aid assets.

Both cities assumed that transfers of management control through long-term leases would not trigger federal reviews because their wastewater assets would remain under public ownership. The municipalities' desire to structure leases so that they can tax the private operators and collect generous up-front concession fees on federal-aid facilities has triggered concern in Washington, however.

"It's a very big unknown," says Raphael Stein, EPA's new privatization point man. "I don't want municipalities to go down a path and have the door slammed in their face. I seriously doubt we're going to give a definite thumbs up on any of these deals."

The 1992 order signed by President Bush requires EPA and the Office of Management Budget (OMB) to review transactions where municipalities intend to dispose of federal-aid infrastructure. The order focuses almost exclusively on asset sales; it only mentions long-term leases once in its introductory section. A source involved in drafting the executive order maintains that long-term leases were not intended to be covered.

Richard T. Kuhlman, Stein's boss in EPA's water programs office, disagrees. "EPA's position now is that a long-term lease falls under Executive Order 12803," he says.

Funding constraints and the absence of any political push for privatization is causing EPA to take a go-slow approach on regulatory matters. The water programs office is deferring all questions on lease transactions to its own General Counsel, Steve Pressman, and to legal counsel in the office of OMB's deputy director for management.

Unless Congress steps in or a municipality signs a contract without waiting for Washington's consent, sources say it could take months—or longer—to get proposed contracts reviewed by federal lawyers and approved by the White House.

Wheelabrator and others are hoping that Sen. John H. Chafee (R-R.I.), who chairs the Senate Environment & Public Works Committee, will push EPA to expedite or eliminate federal reviews of municipal leases. At least two cities in Rhode Island are hoping to sign long-term concessions with private operators this summer.

. . . Meanwhile, the Waiting List Grows (5/96, p.6)

A growing number of cities along the Atlantic Coast are hoping to negotiate wastewater leases this summer and could be held up by White House reviews of transactions with private operators.

Wheelabrator EOS expects to sign a 20-year O&M contract in June with Wilmington, Del., that provides an up-front fee and $3 million a year in savings at the city's 90-mgd regional wastewater plant. About $20 million in capital improvements would be funded in the O&M contract.

In Cranston, R.I.three finalists—Wheelabrator EOS, American Anglian and PSG-Poseidon Resources—are in simultaneous negotiations for a 20-year concession to manage a wastewater plant and four pump stations.

The city had been negotiating to turn the system over to the Narragansett Bay Commission (NBC), a regional public authority. The private financial offers were two to three times better than NBC's, sources say, which convinced Cranston to seek a long-term lease with an option to sell its system to one of the three finalists.

PSG is the plant's contract operator. Its advantage was reduced when all offers were opened for public review by the city in hopes of negotiating a favorable deal this month and signing a contract in June.

Woonsocket, north of Providence, is seeking qualifications now from private firms willing to bid on a 20-year concession to operate its debt-free 16-mgd advanced treatment plant. The staffing, complexity and capital needs of the wastewater system have outstripped the city's ability to meet its environmental obligations, says DPW Director Mike Annarummo.

The NBC had also been negotiating to take over Woonsocket's regional system. However, at the insistence of Mayor Susan D. Menard, the public authority will be invited to bid against private offers. "The numbers we've looked at elsewhere are extremely promising," says Annarummo. "This is the time to lock in this type of arrangement."

Camp, Dresser & McKee Inc., Malcolm Pirnie and the Providence law firm of Hinckley, Allan, Schneider are advising Woonsocket and its four municipal partners in Rhode Island and Massachusetts. The regional authority hopes to issue a request for technical and price proposals in July and to sign a long-term lease with no purchase option in September, says Annarummo.

Taunton, Mass, has issued a draft RFP to gage the financial advantage of a long-term private lease vs. continued contract operation of its 8.4 mgd wastewater treatment plant and 25 pumping plants, currently run by OMI Inc. Alternative Resources, Inc., Concord, Mass., is advising on the RFP, which will be issued in June, with proposals due July 31.

The 20-year-old system is nearing the end of its design life. Major capital improvements are required to ensure NPDES compliance and prevention of combined sewer overflows into the Taunton River. The city of 80,000 has myriad competing needs for its capital and seeks new sources of funding and credit to handle the wastewater system upgrade, says ARI's Paul Doran.

Consulting engineer ARI helped Worchester get enabling legislation allowing it to award the state's first wastewater design-build contract, to Black & Veatch/PKF Mark IV, earlier this year (PWF 2/96).

Springfield, Mass., has hired Rothschild Inc.'s William Mulrow to advise the city on how much to charge private operators for a long-term lease or sale of its 67-mgd wastewater treatment plant, the second largest in New England. Comments on a draft RFP are due by the end of May. A final RFP with a proposed concession fee or purchase price is expected to be on the street later this summer.

Also in Massachusetts, the Greater Lawrence Sanitary Commission by a 6-1 vote this month approved plans to issue an RFP for a lease or sale of its regional wastewater plant. It has hired Camp, Dresser & McKee Inc. to advise on the procurement.

Leominster, Mass., is expected to rebid a 20-year concession for capital improvements and O&M of the city's water and wastewater plants. Its original procurement was scuttled in April after PSG Inc. protested to the state's Inspector General about RFP irregularities giving an unfair advantage to the city's wastewater plant operator, Wheelabrator EOS.

Farther south, Bridgeport, Conn., is evaluating five proposals now and is likely to select a contract operator next month for two wastewater plants with combined flows of 41 mgd. Rothschild's Mulrow is advising the city and says debt defeasement problems will eliminate consideration of long-term management options unless one of the competitors can structure an efficient refinancing.

Competing in Bridgeport are Wheelabrator EOS, Ogden Yorkshire Water Co., OMI Inc./Aquarian, US Water/United Infrastructure Co. and PSG Inc.

Also in the East, the Bergen County Utilities Authority in northern New Jersey is evaluating proposals from privatization advisors now to help it procure a contract operator or concessionaire for its 100-mgd regional wastewater plant. High unionized labor costs are driving the effort in Bergen County, a wealthy Republican enclave.

EPA Moving on Three Private Deals (9/96, p.10)

The U.S Environmental Protection Agency (EPA) has named a new privatization manager who expects to announce policy on long-term leases and other questions after the November elections as part of the agency's review of wastewater privatizations proposed by three cities.

"These three are forcing us to sort this thing out," says Haig Farmer, the new privatization manager. "We will be able to give a lot of direction to a lot of people on how to move forward on these projects within three to six months."

Leading the list right now is Cranston, R.I.'s proposed $75-million contract-backed project revenue financing of its wastewater plant and sludge incinerator. EPA's review of that proposed privatization is being closely watched by Sen. John Chaffee (R-R.I), Chairman of the Senate Environment and Public Works Committee.

Cranston will submit its position paper in early October on why its proposed lease should not trigger the extensive federal reviews under Executive Order 12803. The city expects EPA to provide a definitive answer two weeks later, says Peter Alviti, Jr., Director of Public Works.

Also on the table are proposed long-term contracts being negotiated by Wheelabrator EOS in Wilmington, Del., and by Ogden Yorkshire for a 3.8-mgd tertiary plant and collection system built 18 years ago in Plainville, Conn.

Both of those projects have political hurdles to overcome before final contract details can be reviewed with EPA. Plainville is a sole source deal at this point. And Wilmington still has not gotten New Castle County to sign off on its proposed 20-year service contract and $12-million concession fee with Wheelabrator.

EPA has agreed to provide input as all three deals are being negotiated, however, which solves a key concern about the timing and uncertainty of approvals. Cranston's representatives met recently with Farmer and other staffers in EPA's water programs office. Farmer replaces Raffael Stein who moved to the Office of

Management and Budget after a short run as the agency's part-time privatization watcher. Farmer has a business administration degree as well as a masters in engineering

"EPA demonstrated a clear willingness to discuss issues as the project is evolving," says Eric Petersen, of Hawkins, Delafield & Wood, Cranston's legal advisor.

Cranston Aims at Pure Project Finance (9/96, p.11)

Cranston, R.I., on Sept. 11 issued its third try at a request for proposals for the private operation, major repair and upgrading of its 23-mgd wastewater plant to tertiary treatment. The city has proposed a 25-year service contract that offers only use and occupancy of the city's land and facilities in exchange for a $75-million infusion of private capital financed solely through the service contract.

Private proposals will be evaluated against the city's cost of financing the state-mandated capital program itself. DPW Director Peter Alviti, Jr., estimates the city's construction cost would be $10 million to $20 million higher than private delivery of the improvements. Moreover, voters are not likely to approve a bond referendum anytime soon, says Mayor Michael A. Traficante, whose term of office expires in two years. Cranston has a $5 million operating deficit and is in the midst of a tax revolt, he adds.

The contract-backed project revenue financing is intended to retain ownership and the residual value of the assets for the city, says Eric Petersen of Hawkins, Delafield & Wood, Cranston's legal advisor. Lenders get no assets and no corporate or municipal credit, he says. Instead, in addition to operator equity, lenders can cure cash flow interruptions due to poor contract performance by replacing the operator.

The proposed lease asks operating companies to post parent financial guarantees, a performance bond for the plant and operations, plus a direct-pay letter of credit for about $12 million to fund any transition to a new operator.

The three finalists in the competitive negotiations are Wheelabrator EOS; PSG Inc. with Poseidon Resources; and American Anglian Water Co. PSG has operated the city's plant and 21 pump stations since 1989. The 1996 contract cost is $4.2 million.

The three competitors will be asked to price O&M for 25 years, major repairs and replacement, and a set of nine capital improvement projects, including automation of the plant. Separate price proposals are being sought for the upgrade to tertiary treatment and an optional rehabilitation of the collection system.

About $43 million of the $75 million in taxable debt and equity will be paid up front to the city. About $30 million would be used to fund the upgrade to tertiary. The rest would be used to defease $23 million in tax-exempt sewer bonds, and to repay $8.2 million borrowed by the wastewater enterprise fund from the city's general fund, plus a $5.9 million state grant.

The low $10-million to $15-million net to the city is intended to avoid triggering the general criteria set by the U.S. Environmental Protection Agency (EPA) for classifying Executive Order 12803 transactions as a sale or "disposition of assets," says Petersen. Either would mean detailed reviews by lawyers at EPA and the Office of Management and Budget. In addition, Cranston has agreed to use most of the funds for rate stabilization, providing further comfort to EPA.

The city scheduled a meeting of three prequalified private teams on Sept. 24 to review the proposed contract terms and specifications prepared by the city's advisors over the past 14 weeks. Price and technical responses are due from the private bidders in five weeks, on Oct. 21, with the aim of having a signed contract by year-end.

Peterson is working with HDR's municipal advocacy group to advise the city on its procurement. They were hired after the city failed in two previous attempts to craft a workable procurement approach.

Cranston Wastewater: 25 years, $400m (11/96, p.2)

Cranston, R.I., has selected a joint venture of project financier, Poseidon Resources, and the city's current plant operator, PSG Inc., to negotiate a $400-million, 25-year service agreement by year-end that leaves ownership of the wastewater system in public hands.

If the Cranston deal closes as expected early next year, it would be the second largest full-service wastewater contract in North America, behind PSG's five-year, $500-million management contract for Puerto Rico's water and sewer systems.

A competing proposal from Wheelabrator EOS is being held open by Cranston in case the city, advised by Hawkins, Delafield & Wood, fails to come to terms with PSG/Poseidon Resources Group. A third prequalified bidder, American Anglian, did not submit a proposal. Contestants spent about $300,000 each to prepare detailed submissions over a five-week period this fall.

A proposed contract with full financial commitments for the proposed $48 million contract payment is to be presented to the nine-member City Council the week of Nov. 25. If approved, the contract would then be reviewed by the U.S. Environmental Protection Agency (EPA) to ensure that it complies with the public policy goals and ratepayer protections called for in Executive Order 12803 on infrastructure privatization.

O&M savings for the full contract term are monetized in the contract payment, to be paid within 120 days of the contract signing. Those funds would be used to repay $8 million owed by the sewer enterprise fund to the general fund; to eliminate a $9-million budget deficit; defease $20 million in general obligation bond debt carried in the sewer enterprise fund.

Federal grants would probably not have to be repaid as a result of recent legislation sponsored by Senate Environment and Public Works Committee Chairman John H. Chafee (R-RI) directing EPA to waive repayment for five privatization projects (see below).

The proposed contract with PSG/Poseidon would not increase current sewer rates beyond normal inflation and commodity price rises, according to Department of Public Works Director Peter Alviti Jr.

The city now charges a flat annual fee of $231 per dwelling unit to support its sewer enterprise fund. That includes a 25% surcharge added a few years ago to pay down a loan from the general fund and to make up for inadequate fees and a retrospective billing system used during the early years of the fund.

PSG's original O&M contract for $2,545,200 was negotiated with the city and its plant employee unions in 1989 and renewed in 1993. The 1996 contract cost is $4,240,400. PSG's successive O&M contracts have already produced accumulated savings of over $4 million from the city's budgeted staffing and O&M costs, according to Alviti.

Further savings in the new contract come from expanding the term and scope of PSG's management responsibilities, says Alviti. These now will include repair/rehabilitation and capital improvements to the city's 23-mgd wastewater plant, built in the 1970s, and its sewage collection system, comprising 190 miles of pipes and 21 pumping stations spread out over 29 square miles.

The private operator also would be responsible for satisifying a consent decree requiring the city to upgrade its extended aeration secondary plant to tertiary treatment. A consulting engineers' estimate of $40 million for that work would be slashed to about $3 million under PSG's plan to add single-stage nitrification in existing tanks. Wheelabrator proposed a similar approach at an even lower cost, according to Don Rogers, its Northeast regional manager.

The capital cost savings solves a major problem for Cranston Mayor Michael A. Traficante, who otherwise would have to convince tax-wary voters to approve a new, $53-million sewer bond to pay for the tertiary upgrade and other improvements required in a nine-year capital plan.

Tax-exempt financing of about $17 million for major repairs and capital improvements to be managed by PSG still would have to be raised by the city as part of the proposed deal. Plans are being drawn by the city's financial advisor, Bear Stearns & Co., to try to structure the financing of the contract payment and capital program for issuance in the tax-exempt bond market.

During the past 12 years, Cranston has awarded short-term contracts in competitive bidding for refuse collection and recycling; citywide paving; snow plowing; building maintenance; municipal ice rink O&M; landscaping; emergency sewer cleaning; industrial pretreatment program; and wastewater plant O&M. Its public works budget has remained level at about $9.1 million during the past eight years, according to Alviti.

Located just south of Providence, Cranston has a population of 78,000. The wastewater system serves 29,000 residential units, 2,500 commercial units and 300 industrial customers.

EPA Grant Waivers Not A Free Lunch (11/96, p.3)

A clause inserted by Rhode Island Sen. John Chafee into the Environmental Protection Agency's fiscal 1997 appropriation bill signed last month directs EPA to waive federal grant repayments for five municipal wastewater privatizations that pass the new law's public interest tests and comply with Executive Order 12803.

The new law is aimed at expediting the federal approval process for Cranston, R.I.'s proposed 25-year management contract with PSG Inc. and Poseidon Resources (see above). EPA sent letters in mid-November to Cranston, Wilmington, Del., and Plainville, Conn., informing them of the waiver and of EPA's position on enforcing the public interest tests in the new legislation.

Except for removing the need for the Office of Management and Budget to set an exact grant recapture amount, the new law isn't likely to save much time or reduce the regulatory uncertainty surrounding EPA's treatment of long-term leases or sales, private experts say.

EPA's privatization point man, Haig Farmer, agrees: gaining federal approval is "still a long arduous process," he says, adding that the grant repayment waiver "is not a free ticket. A lot of municipalities have started talking about big concession fees, but the ratepayers are going to get stuck paying the bills" whether federal grants are paid back or not.

Cranston and Wilmington both argue that their proposed long-term service contracts should not trigger the federal reviews required for asset sales under the 1991 executive order on municipal infrastructure privatization signed by former President Bush. EPA appears to be using the new law's requirement for a public interest determination to justify its involvement, however.

In addition to the three cities already working with EPA, Fairbanks, Alaska, the Greater Lawrence Sanitary District in Lowell, Mass., Orange, N.J., and a few small communities in Connecticut and New Hampshire have approached the agency to discuss wastewater privatization plans. San Diego and Petaluma, Calif., Milwaukee, Wis., St. Louis, Mo., Woonsocket, R.I., Taunton, Gardner and Springfield, Mass., Orange County, N.Y., and others are also evaluating long-term private contracts for upgrading and operating their wastewater systems. San Diego, Springfield and Woonsocket have hired Cranston's attorney, Eric Peterson of Hawkins, Delafield & Wood, as their legal advisor.

"I wouln't hazard a guess as to how we'll hand out the free passes," says Farmer. "It could be first come-first served, or be based on need or some political consideration. Nobody has made that call yet."

Cranston Council OKs 25-Year Wastewater Deal (12/96, p.1)

A new benchmarking study done for the Water Environment Research Foundation finds that the average public wastewater utility has seven layers of internal management that are overseen by an average of three different city departments.

Addressing that problem, Cranston's lame-duck city council voted 8-1 on Dec. 17 to authorize Mayor Michael A. Traficante to sign a 25-year lease and service contract transfering management control of the city's industrial pretreatment program, collection system and treatment plant to an operating company formed by financier Poseidon Resources.

"It's not about public vs. private," says city's legal advisor, Eric Peterson of Hawkins, Delafield & Wood. The real benefit in Cranston comes from the total integration of responsibility and control under one entity within a long-term contract, he says. Effectively, "The city council in Cranston has agreed ahead of time not to defer maintenance," he says. "The repair and rehab budget is part of the contract price."

Poseidon's operating company, Triton Inc., will pay a $48-million contract fee that nets about $17 million to the blue-collar city of 78,000 after defeasing old sewer bonds. A letter of credit securing that financial benefit is due in Cranston by early February. Poseidon then has four months to complete its nonrecourse financing for the full contract fee plus a long-term capital improvement program included in its management contract.

At the same time, Cranston and its advisors will be working to gain federal approval of the proposed $400-million, 25-year deal from both the Environmental Protection Agency and Office of Management and Budget. Both have assured the city that their assessment of grant payback provisions and public interest reviews will be done by the scheduled financial close in June, says Traficante.

Poseidon has contracted with Metcalf & Eddy Inc. for design and construction services, and Professional Services Group Inc. (PSG) for operations. Their corporate parent, Air & Water Technologies, will guarantee schedule, cost and performance. In addition, Triton will post a $1.5-million letter of credit and $3-million performance bond, enough to cover a year's operating cost in case of a default for cause.

Poseidon's contract fee included an interest rate factor that places the spread risk against future Treasury bills or 30-year revenue bonds with the private operators, who now must obtain firm commitments from lenders.

About $17 million of the contract fee would be funded with tax-exempt governmental purpose bonds. The balance—$31 million—would be taxable debt and equity, says Peter Alviti Jr., Public Works Director. Private activity tax-exempt bonds would be sold for the capital improvements, he says. Both the taxable and tax-exempt financing will be nonrecourse to the city and Poseidon. "We've completely privatized the financing," says Peterson.

Proceeds would be used to retire some or all of the sewer fund's $20 million in bonded debt; pay $10 million owed to the general fund by the sewer fund; eliminate the city's $12-million budget deficit; and create a $5-million surplus in the general fund, says Alviti.

To fund the Triton contract, sewer rates, currently $231 a year, will drop slightly and remain flat for the first three years, says Alviti. After that, charges will track inflation according to a CPI-related formula for the remaining 22 years.

The current $231 flat rate includes a $46 annual surcharge added two years ago that was orginally set to expire in 1998. Instead, it will become part of the base rate to help fund a $17-million capital improvement program agreed to in the Triton contract.

Poseidon and its commercial banking partner, Banque Paribas, are seeking firm commitments on the LOC and the long-term institutional debt now. Equity would come from Warburg Pincus, one of Poseidon's backers.

Once completed, says Winrow, "This transaction easily could be applied in lots of other places, and we intend to do just that."

Cranston retains ownership of the asset and will continue to set rates and handle billing and collection. The private operators will manage all others aspects of the wastewater operation, including major maintenance and repairs and all capital improvements.

Triton also will be responsible for meeting terms of a consent order that requires the city to upgrade its 23-mgd plant to tertiary treatment. Cranston is seeking state approval now for Triton's low-cost approach in which fine-bubble aerators are to be installed in existing tanks to neutralize ammonia and prevent fishkills. The city's consulting engineer estimated the cost of a separate denitrification treatment train at $35-$40 million. Triton's proposed solution is expected to cost about $5 million.

Proposers had five weeks to prepare final submissions this fall. A preferred bidder was selected on Nov. 8 after competitive negotiations between the finalists, Poseidon and Wheelabrator EOS/Lehman Bros. Contract terms were drafted by Nov. 25, reviewed by a special committee of the council, presented at two public hearings, and approved by the full council on Dec. 17.

Last-minute concerns about an FBI probe of PSG in Houston did not affect the council's vote, says Traficante. That's partly because of PSG's seven-year track record as contract operator of the city's 23-mgd treatment plant. Cranston's "dream team" of hired advisors also gave the council members confidence in the benefits of extending the O&M contract to 25 years, says the Mayor.

Attorney Peterson led the team of advisors, which included HDR Engineers' Allan Cohen and Frank McDonough, managing director at Bear Stearns. Their "pristine negotiations" with the competing proposers, their depth of experience with similar deals, and their lack of ties to Rhode Island "pulled the discussion away from the political arena," says Traficante.

Privatizers Fear Untested EPA Oversight (9/97, p.10)

A letter sent to mayors last month by the U.S. Environmental Protection Agency appears to set national policy on municipal privatization by requiring detailed review and prior approval of any agreements, including qualified management contracts, that attempt to capitalize O&M savings on federal-grant-funded wastewater systems.

The willingness of investors and institutional lenders to finance the savings guaranteed by contract operators has energized the municipal privatization market, especially in older cities with escalating infrastructure needs. In the first such deal, Poseidon Resources wired Cranston, R.I., $48 million on Sept. 11 as its up-front payment for a 25-year lease of the city's wastewater treatment and collection system (see p. 24).

EPA's approval came months ahead of the financial closing in Cranston. "We had a very positive regulatory experience," says Eric Petersen, of Hawkins, Delafield & Wood, Cranston's legal advisor.

Cranston's Public Works Director, Peter Alviti Jr., adds that state and federal review of the proposed lease helped the city to understand and assign its regulatory risks. "You don't want to make any mistakes in a 25-year contract," he says.

For most investors and their advisors, EPA's open-ended request for financial information and its expansive view of its authority under Executive Order 12803 add to fears about over-regulation of the municipal privatization market. Some privatizers worry that the federal government will use the 1992 executive order to try to recoup some of its huge investment in municipal wastewater plants as more cities try to recapitalize their assets.

Also a concern is the risk of having a hard-won agreement rejected by EPA. The lack of experience on all sides with long-term, municipal transactions means private participants now must trust that reasonable people at EPA will approve reasonable contracts. EPA's Michael Cook says the agency is working to refine its guidance so that cities will know before they start negotiating contracts what deal terms will trigger closest scrutiny by regulators.

Again, Cranston's experience suggests that EPA will approve fair deals, says Petersen. He adds that federal regulators recognized that the government's interests were well served by having a private company financially committed to clean water compliance for 25 years.

Skeptics point out that Cranston's negotiations with EPA were watched carefully by Rhode Island Sen. John H. Chafee, Chairman of the Senate Environment and Public Works Committee. Chafee had a paragraph, Section 586 (a)(2), included in the Water Resources Development Act of 1996 that allowed EPA to waive federal grant repayment provisions for up to five E.O. 12803 privatizations, for example. Cranston got the first waiver and did not have to repay $5 million in undepreciated federal investment.

Many municipal advisors assumed EPA would lose its authority to review the financial elements of transactions under E.O. 12803 once a city's bond counsel ruled that a proposed service contract qualified as a management contract, not a lease. Liberalized municipal bond rules adopted by the IRS in January allow certain types of management contracts to extend for 20 years (PWF 1/97 p. 1).

"The IRS creates a safe harbor that is intended to save time and reduce uncertainty and then EPA comes along and says we don't care. We'll do our own review under our own rules," says a privatization attorney. "What's to prevent EPA from regulating the user fees charged by municipalities in these deals?" he asks.

Local governments are also concerned: "The last thing cities want is for EPA to second-guess them on these complex transactions," says Michael Gagliardo, director of the Urban Water Council of the U.S. Conference of Mayors. "There is a lot of uncertainty out there, and EPA's letter has added to the confusion."

Danbury, Conn., expects to collect a $10-million contract fee from U.S. Filter Operating Services, using corporate funds, on October 1. To avoid federal review, Danbury signed a 20-year agreement in early September that it says qualifies as a management contract—not a lease—under the new IRS safe harbor tax rules.

Based on documents supplied to EPA by the city during its first meeting on Sept. 23, EPA agrees with Danbury that the city's $5.8-million federal grant is fully depreciated. Because of the up-front payment to the city, however, the agency's privatization point man, Haig Farmer, insists that the management contract must be reviewed and approved by EPA and the White House budget office under Executive Order 12803. "Whether they're upset or not, those are the rules," he says.

Case Study

Financial Close on Cranston, R.I., Wastewater Lease Puts $48 Million of Savings into City's Cupboard Now (9/97, p.24)

By William G. Reinhardt, PWWF editor

Municipal water developer Poseidon Resources wired its long-promised $48-million contract payment to Cranston, R.I., on Sept. 11 and took management control of the city's wastewater system under a market-making lease and service contract that leaves user fees steady, in real terms, for the 25-year duration of the agreements.

The $76-million in debt and equity financing arranged by Poseidon this month also pays for close to $24 million in capital improvements to the publicly owned system. Works include the first phase of the city's planned upgrade to tertiary treatment, pump station improvements, automation of the plant and pump stations, and rehabilitation of the city's two sludge incinerators.

According to Public Works Director Peter Alviti, Jr., the long-term private management of the city's wastewater assets is expected to result in $76 million in accumulated savings and $24 million in present-value benefits. Those numbers, from its consultant HDR Engineering, are based on the city's best-case estimate of its own cost to provide the services specified in the privatization contracts. "I'll take that result to every other department in the city," Alviti says.

[According to Alan Cohen, HDR's Director of Municipal Economics, about $5 million of the present-value savings come from reducing the rate of increase in user fees. The balance, about 70% of the benefits, result from use of the up-front fee to avoid a tax increase that would have been needed to eliminate the cumulative deficits in the city's general fund. Cohen adds that the fee was entirely funded by capitalizing the contractually guaranteed reductions in the cost of O&M and repair and replacement.]

The city will retain ownership of the wastewater system and improvements, establish and collect all user fees and enforce the municipal industrial pretreatment program (MIPP). The special purpose project company created by Poseidon, Triton Ocean State LLC, will operate and maintain the city's 23-mgd extended aeration secondary treatment facility, 21 pumping stations, force mains, 190 miles of sewer interceptors and the rest of the collection system. Also part of its fixed-price contract, Triton will administer the MIPP and finance, design and build major repair and replacement works to the wastewater treatment system.

Most of the operating risks are assigned to Poseidon's technical partner, Professional Service Group Inc. (PSG). Metcalf & Eddy Inc. has guaranteed the price, schedule and performance of the capital improvements. Both are subsidiaries of Air & Water Technologies Corp. (AWT), which stands behind their obligations. There is no covenant requiring AWT to meet a financial threshold to back its guarantee, however.

AWT Back from the Brink

In August, AWT's surety, U.S. Fidelity & Guaranty, said it would stop issuing performance or bid bonds for new or renewed contracts starting on Sept. 30 unless Compagnie Générale des Eaux (CGE) indemnified USF&G for 20% of its future liabilities. AWT's stock then skidded to $1.50 in mid-September after the company's third quarter report showed losses through July had grown to $81.3 million. The third blow came when the American Stock Exchange told AWT that it no longer met its requirements for listing AWT's common stock, 42% of which is owned by CGE.

CGE has invested or loaned close to $450 million to AWT since 1991, with little return. Without additional credit support—or a fast sale of its air pollution control company, Research Cottrell—AWT would have been in violation of several covenants with its senior debt holder, First Chicago, by Oct. 31.

CGE came to the rescue on Sept. 24 when it agreed to a proposed recapitalization plan for AWT that included backing for AWT's bond agreements with USF&G starting on Oct. 1, 1997 (see p. tktk). CGE also promised to work with its U.S. subsidiary to "explore various ways to enhance AWT's participation in the emerging privatization market in the wastewater management industry," once the recapitalization is closed.

PSG, the largest contract operator in North America, was wedded to AWT a few years ago by CGE's current President, Jean-Marie Messier. The Houston-based company had sales of $195.4 million through July. PSG reported a small gain in third-quarter earnings from its second-quarter results, but has accumulated losses of $5 million so far this year.

Cranston's primary concern is PSG. "As long as PSG performs on its operating obligations, [AWT's financial problems] should have no impact at all on Cranston," says HDR's Cohen.

Poseidon and Cranston have been following AWT's financial situation closely for the past year, says Brad Dore, who led the development effort for Poseidon. AWT's financial condition is a concern, he says, but adds, "There are a lot of different forms of security in the deal."

Not the least of them is the resolve of the private participants to create a market for similar long-term contracts with other municipalities by honoring their hard-won agreements with Cranston's political leaders. Triton is ultimately responsible for providing the $3-million performance bond in Cranston, for example. Dore says Poseidon would step in, if necessary, to provide the bond, which must be renewed annually.

Douglas Herbst, PSG vice president of corporate development, says, "This public-private partnership can serve as a model for others because it is truly a win/win situation. The city has entrusted its system to PSG and we will continue to deliver reliable, high-quality and cost-effective service to Cranston for the next 25 years."

Public Partners

"This deal would not have gotten done without the fortitude of Peter Alviti and Cranston's Mayor Michael Traficante," says Dore.

Mayor Traficante, a Republican, recruited Rhode Island's Senator John H. Chafee, also a Republican and Chairman of the Senate Environment and Public Works Committee, to help shepherd the transaction in Washington.

Alviti headed the city's negotiating team and secured local approvals for the contract last December (PWF 12/96 p. 1). He also led the effort to gain permission for the lease from the U.S. Environmental Protection Agency (EPA) and Office of Management and Budget under the terms of Executive Order 12803 on infrastructure privatization (PWF 5/97 p. 34). EPA's approval on May 15 included notice that it would not seek repayment of $5 million the agency says it would be owed under federal regulations on municipal lease transactions involving grant-assisted facilities.

"I was amazed at the amount of benefit we reaped from having EPA and the state as part of the process," says Alviti. "They were proactive. They didn't hold us up. And they added valuable input on contract provisions" related to regulatory risk, he says.

Besides, Alviti adds, "You don't get banks and large investors to finance these deals for 25 years unless they are dead sure all of the legal and regulatory entitlements are in place."

Complex Financing

The financial close on this first long-term lease financing for a municipal wastewater system took two and a half months longer than expected, largely due to the complexity of meshing the taxable and tax-exempt project debt. Further, the debt was placed on a non-recourse basis, which means that the project acts as the security, not the city or Poseidon.

The transaction includes over $7 million in equity and development costs, $39.5 million in taxable institutional debt sold to insurers New York Life and John Hancock (at an all-in cost of about 8.05%), and $28.5 million in MBIA-insured, tax-exempt revenue debt issued through the state Clean Water Finance Agency (at a cost to the city of about 5.8%, not including MBIA's $860,000 premium, which was paid by Poseidon). Tax-exempt proceeds are to be used to fund most of the privately managed capital improvements and retire $4.2 million in bond anticipation notes issued by the city.

Poseidon was advised by its general counsel Dickstein Shapiro Morin & Oshinsky LLC, Washington, D.C. and by Edwards & Angell locally. Smith Barney Inc. advised on the tax-exempt conduit bonds. Paine Webber Inc. was senior manager and underwrote the bonds, along with co-managers Roosevelt & Cross, Inc. and Smith Barney.

Despite the delay in closing, the interest-rate-spread factors agreed to by Poseidon in its initial agreement with Cranston last December were not changed. Likewise, a downgrading of the city's credit in June had no impact on the pricing of the institutional debt. For the tax-exempt tranche, the rating agency bobble was offset by a drop in municipal bond interest rates since June. "By happenstance, the city was better off as a result of the delay," says HDR's Cohen.

[The city's rating was dropped before the credit agencies reviewed the lease transaction. By contract, the downgrade would not allow Cranston to draw on a $15-million letter-of-credit issue by Chase Manhattan and posted by Poseidon last fall to ensure that the financing would be done by June 30, 1997.]

Cranston's accountants allowed an amendment to the city's fiscal 1997 results to include Poseidon's up-front payment, which will be used to defease old sewer bonds and repay borrowings from the general fund. The net effect is expected to be a budget surplus for the blue-collar city of 78,000, and a partial or full reversal of the rating downgrade from A to BBB+ by Standard & Poor's and Baa1 to Baa2 by Moody's.

Shifting Risk

In addition to improving the city's finances, the stack of contracts used by Poseidon to secure $68 million in nonrecourse debt also transfers substantial risk to the private sector.

It puts a 25-year corporate guarantee behind Cranston's promise to operate its system in compliance with the state's clean water permit, which will be jointly held by the city and Triton once construction is completed.

It puts the responsibility for major repairs and maintenance at the facility in private hands for 25 years. The amounts budgeted by PSG are substantially less than the city's historically high costs, which are largely due to deferred maintenance.

It requires PSG to maintain underground sewer pipes, mains and process works as part of its contract. PSG must fund the work itself with no adjustment in its fee or performance for repairs costing less than $25,000 for pipes and $50,000 for mains. More costly fixes or modifications to the collection system will be done after fees are renegotiated.

It moves responsibility for the municipal industrial pretreatment program (MIPP) to the private operators. The city's prior engineer, Tutela Engineering Associates, had been administering the MIPP under contract with the city. It will continue to perform that work under a new subcontract with PSG that pays $387,000 in the first year.

It put the substantial cost of structuring and shepherding the complex transaction to closure in Poseidon's lap. Until the city violated a key condition of the developer's letter of credit—that Cranston maintain its credit rating—Poseidon had $15 million at risk if it could not close on the project financing by June 30.

The service contract gives the city a half-share of any electricity savings from efficiency gains in O&M and all of the savings stemming from price adjustments from deregulated power suppliers. A share of the revenue from handling other municipalities' sludge and septage may also be possible. PSG agreed to a price for processing sludge, septage and grease. If the city can sell those services to other towns at a higher price, it keeps the difference.

Cranston is already making money by treating about 6 dry tons per day of outside sludge. Poseidon and PSG have guaranteed to maintain a design capacity of 30 dry tons per day in the city's two incinerators. Agreed-upon repairs and design improvements are intended to increase the system's capacity to 40 dtpd, about double the expected demand from the city's wastewater system.

Sharper Pencils

The contract substantially tightens the pricing of the city's previous five-year O&M agreement with PSG. The company was paid about $3.7 million last year to operate the treatment plant and a few pumping stations. The new contract runs five times longer than the old one and adds responsibility for operating all pump plants, major repair and replacement and maintaining the collection system. The O&M component of the new service fee for 1998 starts at $5.7 million and escalates annually at a weighted average of two indices: 94% of the Consumer Price Index change and 6 % of the change in the chemical component of the Producer Price Index.

Key savings are in staffing. PSG believes it can operate the city's full system with 36 workers, equal to its staffing under the previous O&M contract. However, it agreed to hire all sewer workers who apply for a job and pass drug-screening tests. Twelve of the 15 workers transferred and three got other city jobs, says Alviti. Staff reductions for the first five years of the contract are limited to attrition or dismissals for cause. In addition, the workers hired by PSG retain "bump rights" on city jobs for a year if they choose to leave their private-sector job.

The capital spending program approved by the city funds the addition of a control room, and full automation of the process control and instrumentation, particularly at remote pump stations. Those improvements, plus increased preventative and predictive maintenance, are expected to increase labor productivity.

Because of the intense competition for this first long-term wastewater lease, "I don't think other municipalities will be able to improve much on this agreement," says Eric Petersen, a partner at Hawkins, Delafield & Wood. "This is about it on the O&M side."

Contractual Hammers

Cranston's new agreement also includes large hammers. It allows the city to immediately cancel the lease and service contract—without providing an opportunity to cure—if its private partners fail to deliver in key areas relating to financing, permit compliance, and construction schedules.

The service contract requires Poseidon or PSG to post a $3-million performance bond and a $2-million irrevocable standby letter of credit, adjusted for inflation, to help pay transition costs if its contract is terminated. (PSG's surety required annual renewals of the bond so Poseidon may be required to secure the performance guarantee itself if AWT'f financial troubles are not resolved next year.) Poseidon and project lenders are given up to 730 days to find a replacement operator willing to assume PSG's contract before service fees are cut off and the contract is terminated. Poseidon is still required to provide the contracted-for services to the city at the agreed-upon price during the cure period.

Finally, Air & Water Technolgies Corp. guarantees all financial and performance obligations of its subsidiaries, PSG and M&E. Under the worst case, according to the lenders' engineer, R.W. Beck, liquidated damages could total as much as $1.4 million a year for violating the city's discharge permit and up to $3,600 per day for failure to meet construction schedules.

Fruits of Competition

"Traditionally, under the old O&M agreements, the large operators would write the contract themselves," says Alviti. PSG has operated the city's 23-mgd wastewater treatment plant since 1989. Its most recent contract renewal "probably got 10 minutes of scrutiny by a city board," says Alviti.

The new service contract is "a major departure" from the old approach, Alviti says. It's agressive terms are largely the product of simultaneous negotiations held last summer with two teams: Poseidon/ PSG/ M&E and Wheelabrator EOS.

In all, Cranston spent 18 months and $1.2 million in advisory fees on the privatization procurement to get the best contract possible, says Alviti. He adds: "Every point was precisely negotiated by the city and its expert advisors," attorney Petersen and HDR'S Cohen.

A total of seven public notices and hearings were held to gain support for the agreement, which was approved in an 8-1 vote by the City Council on Dec. 17, 1996 (PWF 12/96 p. 1). In addition, attorneys for eight other parties plus R.W. Beck reviewed the contract. "They've all signed off on this deal," says Alviti.

Capital Cost Savings

Alviti says that the $24-million present value savings doesn't include over $100 million in capital and interest savings to the city over 25 years from adopting the alternative design proposed by Metcalf & Eddy Inc. for upgrading the city's plant to provide tertiary treatment.

Cranston's consulting engineer had proposed a capital-intensive approach for meeting the advanced treatment permit requirements for ammonia removal by building a separate train of reactors sized to handle all 23-mgd of design flow. Maximum monthly influent averaged only 16.2 mgd in 1996, however, and is not expected to hit 19.1 mgd until 2022, according to R.W. Beck.

The city had asked bidders for alternatives and accepted Poseidon/ M&E's $2.5-million plan for retrofitting an existing aeration tank and modifying its operation to provide nitrification for 19 mgd of flow. A second-phase expansion to treat the full 23 mgd is included in the service contract, at a cost of $3.6 million, but may not be required by the state.

The city has agreed to share the permitting risk if the phased approach for the upgrade is not accepted by the state. In that case, the city will renegotiate the service fee to reflect the higher capital cost of completing the first and second phases together. However, the city still will require full compliance with the original fixed-price construction contract and two-year completion schedule.

Triton's lease allows the parties to agree on a five-year extension to 30 years. That would give the city and Triton room to try to renegotiate the contracts, if under the worst case, the state forces Cranston to adopt its earlier plan to build separate reactors to treat all 23 mgd, at a construction cost of about $40 million. The city may also elect to bid and build the tertiary upgrade itself. n

Long-Term Service Contract Benefits (9/97, p.25)

- Creates an economical and cost effective means to provide wastewater treatment services and meet financial objectives through increased private sector participation. Savings to city over 25 years is $76m.

- Provides economies of scale, increase operating efficiency of the wastewater facilities which result in an improved environment.

- Contractor assumes responsibility for operating and maintaining all wastewater facilities and capital improvement construction.

- Assured compliance to facility plan and all other state and federal regulations and environmental mandates.

- $8.6m enterprise fund debts to general fund paid in full.

- $25m existing sewer related bonded indebtedness paid in full.

- $6.9m general fund deficit paid in full.

- Creation of $6m general fund surplus.

- Elimination of city's interest expense for short-term borrowing.

- Increase in city's long-term investment income.

- Eliminate the need for future city bonded indebtedness of $58m capital improvements over the next 9 years, and all future improvements or mandates.

- Initial lease payment of $48m and $24m system improvements paid by Triton are non-recourse and insure company compliance with the contract provisions.

- Long-term stability of sewer user fees.

Source: HDR Engineering

The Managed Competition Illusion (9/97, p.29)

By Anonymous

Managed competition—a concept whose time has come? Before we embrace it, let's look at it from a different perspective. Privatization must be a bonafide service delivery option; managed competition was developed to allow the public sector to compete with the private sector in privatization procurements. However, an illusion is being created that managed competition can be shaped to "fit into" privatization procurements.

Consider a hypothetical procurement in which the rules of engagement are as follows:

- The selected operator will not have to enter into a legally binding and enforceable contract—only a non-binding expression of intent in the form of a memo of understanding (MOU) is required.
- The price in the offer will only be a good faith, reasonable estimate. If there are cost overruns, the operator will not have to pay for them; the municipal ratepayers or taxpayers will.
- Cost overruns exceeding a specified amount will be deemed a breach of the MOU. The remedy and penalty for the breach, however, will be the right—not the obligation—of the government to seek an alternative service provider. The operator who breached would be precluded from competing for the same contract.
- The operator will not have to assume any financial risk, including the payment of damages or fines due to its own negligence or actions.
- No indemnifications will have to be provided by the operator.
- The operator will not be obligated to provide a guarantee for its performance. The government will act as the operator's guarantor.

As incredible as this transaction sounds, these are the rules of engagement for the public sector in a managed competition in San Diego. The rules for the private sector are the opposite of those listed above. The private sector is being asked to be accountable, to guarantee, to take risk, to indemnify and be subject to penalties for breach. With this as the "competitive environment," it is no wonder that my firm chose not to bid.

If the public sector cannot compete under the same rules as the private sector, then is there a common ground where both can compete under the same rules? The answer is, of course, yes, common ground can be found: Let the private sector compete under the same rules set for the public employees.

Of course, no public official would ever agree to such a procurement. But with managed competition, that is exactly how the public sector is competing in the privatization procurement area.

Unless these serious shortcomings can be addressed to protect the public interest, managed competition will only be a price competition at best, with different rules for the private sector and the public sector.

If low bids are the ultimate object—with no accountability, no guarantees and no risk allocation—then managed competition is the way to go. However, it is important that public decision-makers understand these distinctions when they deliberate what is best for the ratepayers of their community.