



Reason

Reason Foundation
Policy Brief No. 128
June 2015

Paying Down Unfunded Pension Liabilities Through Asset Sales and Leases

by Leonard Gilroy



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Part 1

Introduction

State and local governments across the nation are facing massive unfunded public pension liabilities, with estimates ranging anywhere from \$1.1 trillion to \$4.7 trillion.¹ Fortunately, there is now a robust discussion about pension reform. That discussion has focused mainly on reforms to government employee retirement plans, such as changes to future pension benefits that have not yet been earned and shifts to defined-contribution or cash balance plans. Such policies are designed to make pension systems more financially sustainable and avoid *additional* unfunded liabilities, and they form a critical foundation of any serious pension reform effort.

However, to date there has been relatively little discussion about how to reduce *existing* unfunded liabilities. One problem is that any reform that would result in significant reductions in already-promised benefits to current workers and retirees understandably has little public support and may face major legal and political obstacles.² That means municipalities and states with underfunded pension systems will, at some point, have to make additional contributions in order to meet their obligations.

From an accounting and legal standpoint, unfunded pension liabilities have not historically been treated in the same manner as general obligation bonds and other types of public debt. Yet, pension liabilities are implicitly an off-balance-sheet debt obligation of the government. As such, there is an urgent need not only to account for them properly but also to fund them in ways that impose the least additional burden on taxpayers.

One promising strategy that policymakers are starting to consider is the sale or lease of government assets—such as land, buildings, infrastructure or enterprises—and the use of proceeds to pay down existing pension debts and thereby put public pension systems on a healthier financial footing. This brief considers such an approach as a complement to comprehensive pension reform efforts that seek to reduce future unfunded liabilities by shifting away from traditional defined-benefit pension systems.

Part 2

The Rationale for Leveraging Assets to Pay Down Pension Debt

State and local governments own many different types of valuable assets—from large swaths of developed and undeveloped land to public housing projects, from public utilities and roads to public buildings, and strategic real estate parcels that have been land banked for purposes from economic development to historic preservation. In some cases, government-owned land or public buildings may have at one point in time served a particular purpose that is no longer viable or justified, making them expendable as surplus assets. In other cases, government-owned land parcels or buildings may be in locations that have seen a tremendous increase in property values, creating an opportunity for windfalls from sales and a significant ongoing fiscal benefit by placing such assets back on the tax rolls.

Other types of government assets—such as water and wastewater treatment plants, energy systems, parking garages and metered parking systems—generate revenues for governments. In such cases, governments may have no desire to relinquish ownership of these assets but could stand to reap a financial windfall—as well as potentially improve operations, enhance customer service and attract capital investment in new technology—through leasing such assets to private sector investors and operators.

In either case—asset sales or leases—there is an opportunity to generate significant one-time revenues that could be sensibly used to pay down unfunded pension liabilities. The most responsible way to spend the windfall from an asset sale or long-term (20+ year) leasing arrangement is to redeploy it for some long-term economic benefit, such that there is a temporal nexus: taking the proceeds from divesting a long-lived asset and using them to address some long-term public need. Examples of the proper use of such proceeds would be investing in infrastructure, paying down bonded debt, and—as recommended herein—paying down pension debts.

It would be inappropriate to spend the one-time proceeds from an asset sale or lease on recurring operating expenditures or to close short-term budget deficits in all but a dire, emergency situation. A 2011 *Government Finance Review* article likens it to “a short-sighted strategy that can rapidly deplete resources accumulated over decades.”³ And in a

2006 World Bank report, an Urban Institute researcher equated asset sales to municipal borrowing (since both effectively result in upfront payments being generated from future revenue streams) and noted that the “fiscal risk is that municipalities become dependent upon asset sales for covering recurring costs, and, at a future date, when the assets are gone, face more severe budget shortfalls.”⁴

Some skeptics of asset leases (and public-private partnerships more broadly) have claimed that underfunded pensions are a short-term problem manifested in operating costs and that dedicating the proceeds of long-term asset leases toward pension debts is thus an inappropriate fix. Regarding one such transaction in Allentown, Pennsylvania (detailed in the following section), Pennsylvania State University law professor Ellen Dannin commented that, “[t]his is really a long-term way to deal with a short-term problem.”⁵ However, this view is mistaken on several fronts:

- Underfunded pensions cannot be conceived of as a short-term problem when pension systems are fundamentally designed to pay out benefits for decades to come. Further, it is common actuarial practice to amortize pension debts over a 15–30 year period, sometimes even longer.
- Unfunded pension liabilities are best viewed as *implicit* pension debt. In a pension system, workers and retirees have implicit claims on current and future governments. As three World Bank researchers noted in a 2001 *Empirica* article, “[t]aking money (contributions) now with the promise to repay (benefits) out of future contributions (taxes) makes the underlying debt akin to government borrowing.”⁶ Other economic research echoed a similar sentiment in a 1996 article in *Finance & Development*, noting that unfunded pension liabilities involve claims on government coffers “that are not unlike those of government bondholders.”⁷ These obligations are typically interpreted as contractual in nature—with some degree of protection under the U.S. and state constitutions—and some states have enacted specific constitutional protections against any diminution or impairment of pension benefits. Further, recent bankruptcy proceedings in Detroit, Michigan, Stockton, California and San Bernardino, California offer evidence that pension obligations to current workers and retirees may be given more protection against losses than traditional municipal bondholders.⁸
- In fact, the entire basis of funding public pension systems is built on a range of long-term assumptions involving inflation, mortality, investment returns, and the like. Some of the problems that have led to pension underfunding result from inappropriate actuarial assumptions.
- Unfunded pension liabilities must be paid—and are thus technically debt obligations—but because they do not manifest through formalized debt instruments (like general obligation bonds) and are not counted against debt limits, they are not

officially counted in the government's balance sheet. In fact, unfunded pension liabilities are a particularly insidious type of hidden debt. Unlike pay-as-you-go systems, such as Social Security, public employee pension systems are supposed to be pre-funded and at any given time should be fully funded, meaning that the liabilities (the value of all future benefits promised to workers) should equal the current value of assets in the system plus the expected future return on the system's invested assets. But for a variety of reasons—which can include systematic underfunding, poor market performance, poor actuarial assumptions, unsustainable benefit increases, and combinations thereof—many systems have seen unfunded liabilities skyrocket over the past decade as growth in liabilities outpaces assets. The result is debt that both current and future taxpayers are obligated to pay for something that was supposed to be fully prefunded.⁹

In addition to reducing or eliminating a significant source of government debt, leveraging assets to pay down unfunded pension liabilities can offer other important potential benefits:

Avoiding interest costs: Because pension debts are typically amortized over 15 to 30 years, any opportunity to immediately pay down some portion of unfunded pension debt today will save taxpayers money in long-term interest costs, akin to making additional principal payments to an auto loan or home mortgage, or paying more than the minimum credit card payment. In the short-term, these savings translate into lower annual pension contributions, thus freeing up general fund resources today to deploy to other government services.

Improving credit ratings: Notwithstanding current pension debts, governments are likely to need to periodically access the capital markets by taking on bonded debt to develop infrastructure, undertake capital improvements and the like. Although the empirical literature is unclear regarding the extent to which pension funding ratios have historically affected municipal credit ratings and the costs of borrowing, there is evidence that suggests a positive correlation between pension funding ratios and bond rating levels—in short, the higher a jurisdiction's pension funding status, the higher its bond ratings tend to be, generally speaking.¹⁰

Perhaps more importantly from a practical perspective, however, credit rating agencies like Standard & Poor's and Moody's have been sending strong signals of late that the health of public pension systems figures to be an increasingly important factor in ratings decisions moving forward. "Pension funding status varies significantly among states and has played a significant role in relative creditworthiness over time," Standard & Poor's credit analyst Robin Prunty noted in a March 2015 release of a report suggesting that funded ratios and the growing gap between well-funded and poorly funded pension systems are among the

pension-related factors that will influence credit quality, public policy and government budgets in the near term.¹¹

In early 2014, Moody's officially revised its methodology for issuing credit ratings on municipal general obligation bonds, doubling the weight in its overall assessment on debt and pensions to 20% from 10%, while decreasing the weight on economic factors to 30% from 40%. The change "recognizes the potential for large pension liabilities to constrict a local government's financial flexibility," according to Moody's, given that "pension liabilities and debt each represent enforceable claims on the resources of local governments."¹²

It is also clear from recent history that the presence of large unfunded pension liabilities can be detrimental to a government's creditworthiness, which ultimately translates into higher municipal borrowing costs (and thus fewer resources available for services and pension payments). As one prominent example, in May 2015 Moody's downgraded Chicago's credit rating on its general obligation debt from Baa2 to Ba1, dropping it into non-investment grade ("junk") bond status, citing as a rationale the likely increase in fiscal strain posed by the \$20 billion in unfunded pension liabilities across the city's four main pension systems in the wake of a state Supreme Court ruling that invalidated a statewide pension reform law.¹³

Overall, the more that municipalities can do to pay down their unfunded pension liabilities now, the better it will be for their creditworthiness and the lower will be the costs of borrowing to improve essential infrastructure projects that have been neglected for far too long, all things being equal. If governments are going to continue to borrow, they should do everything possible to lower the costs of borrowing.

Avoiding future tax increases and service cuts: Under typical actuarial accounting, unfunded pension liabilities are amortized over a period generally between 15 and 30 years—and infinity in some cases, specifically in "open amortization" situations when the pension debt amortization schedule is essentially reset every year—which translates to significantly higher annual contributions to pension systems by governments than would be incurred in the absence of unfunded liabilities. To cover these additional costs, policymakers generally have two simple—and undesirable—default options: raise taxes, or cut funding for other services in the budget. Both options punish taxpayers and service recipients today in order to make up for the legacy decisions and risks taken on by policymakers in the past with regard to pensions.

Leveraging government assets to pay down pension debts offers a third and more palatable option all around, benefitting taxpayers and service recipients who don't face higher costs and lower services, while also benefitting pension systems and their beneficiaries by making their systems more solvent.

This is not to say that we should assume that all current spending is absolutely essential and that additional cuts, government reforms or streamlining are not necessary. Rather, asset sales and leases should be combined with comprehensive pension reforms that avoid future unfunded liabilities, as well as other types of reforms aimed at lowering government's operating costs and improving service efficiency. Each of these strategies plays an important role: prospective pension reforms should place a cap on unfunded pension liabilities, asset sales and leases can be used to then help lower those liabilities, and reforms aimed at reducing government spending can free up resources to help pay off the remaining pension debt.

Shedding underutilized or unnecessary assets: Governments have a mixed track record on asset management, and there is often an unfortunate tendency for governments to accumulate real property assets like land and buildings, but then fail to properly account for them and regularly evaluate the justification for continued ownership. Hence, assets tend to accumulate like dust bunnies, with government asset portfolios tending to swell more than shrink over time.

For example, the federal government owns over 900,000 buildings and structures worth hundreds of billions of dollars, as well as nearly 30% of the total land area in the country.¹⁴ Yet, the U.S. Government Accountability Office (GAO) has long identified major deficiencies in federal real property management and since 2003 has deemed it a “high risk” activity, noting the persistent challenge of identifying and reducing unnecessary and underutilized property.¹⁵ One 2011 GAO report identified over 45,000 underutilized federal buildings costing taxpayers \$1.6 billion per year to operate; this was just across a subset of federal agencies, so the true costs of holding unneeded properties are much greater.¹⁶

Though smaller in scale, state and local governments face similar challenges in managing their asset portfolios. One important aspect of real property management is maintaining a comprehensive inventory of land and building assets. This enables the government to assess whether public property is being used and maintained in the most efficient manner possible and whether there is potential value in divesting underutilized or unnecessary land or assets to generate revenues, lower maintenance and operations costs, expand the tax base and encourage economic growth.

Taking proactive steps to improve asset management can help policymakers alleviate the general fund burdens associated with increased pension contributions and put states and municipalities on a more sustainable path. The prospect of being able to restore services by reducing significant unfunded pension liabilities can motivate jurisdictions doing a poor job of asset management today.

An analogous example of this type of thinking comes from Oklahoma, which passed legislation in 2011 requiring the state’s director of central services to publish a report detailing state-owned properties, including the value of the most underutilized properties and the potential for purchase if sold. Separate legislation the following year created a revolving fund for state building maintenance to which proceeds from any state asset sales are deposited and dedicated to the maintenance and repair of the state’s aging buildings and properties.¹⁷ Elsewhere, a similar structure could be established for the deposit of asset sale proceeds that could then be used to make supplemental pension payments.

Opportunities to improve service and modernize infrastructure through leasing: For revenue-generating assets like water and parking systems, long-term lease arrangements typically include provisions requiring specific performance standards and dictate when to make needed capital improvements, as well as require the end-of-lease return of the asset to the original government owner in “as new” condition. These sorts of provisions require the lessee to make significant capital investments in the leased asset regularly over the life of the contract. Hence, in addition to the major benefit of generating upfront revenues that can be used to pay down unfunded pension liabilities, asset leases can also bring about major improvements in the condition of the assets themselves. This could mean replacement of deteriorating water mains or improved filtration systems in a water context, for example, or more efficient metering and introduction of new payment technologies in a parking context.

As one recent example, in 2012 the city of Bayonne, New Jersey signed a 40-year concession (lease) agreement with United Water and private equity firm Kohlberg Kravis Roberts that will not only allow the Bayonne Municipal Authority to retire \$130 million in debt, but is also expected to produce over \$100 million in system efficiency improvements, such as wireless metering, the replacement of aging pipes and reduced water loss through leakage.¹⁸ Prior to the lease, the system had a history of deferred maintenance and no ongoing program of capital improvements; further, the system operated under vague operational and technical standards, compared to the performance-based contractual operating standards introduced in the concession agreement.¹⁹

Returning assets to productive commerce: Government assets are not part of a community’s taxable base and do not generate revenue from property taxes, much less corporate income and other taxes that apply to commerce occurring on private property. Not only does selling or leasing government-owned assets effectively unlock the capital “trapped” in those assets—making it available for more pressing needs like paying down pension debts—but it can also result in putting those assets back onto the tax rolls, thereby generating tax revenue and economic activity that contributes to gross domestic product.

Part 3

Precedents

Over the past decade, policymakers have increasingly sought creative ways to transfer government assets to the private sector or other public authorities through sales or lease arrangements. One of the most notable was Indiana’s 2006 lease of the Indiana Toll Road to a private consortium—a 75-year contract that involved a \$3.8 billion upfront payment to the state.²⁰ At the time of the lease, the state faced a multibillion-dollar transportation funding gap, and the toll road was losing money, resulting in deferred maintenance and under-investment in the asset. The state invested most of the \$3.8 billion proceeds into new and upgraded transportation infrastructure across the state, as well as paying off \$200 million in outstanding toll road debt and investing \$500 million into a trust fund designed to provide stable, long-term maintenance funding for new transportation infrastructure. Overall, the lease allowed the state to turn an underperforming asset into an opportunity that facilitated billions of dollars in transportation investment now and into the future—achieving the temporal nexus described in the previous section.

By contrast, Chicago had a very different experience with its 2008 parking meter lease, a deal that saw a private consortium take over operations and maintenance of the city’s downtown metered parking system for 75 years in exchange for a \$1.15 billion upfront payment.²¹ While a full discussion of this lease is beyond the scope of this policy brief, the deal has been controversial in part because policymakers opted to spend the bulk of the upfront proceeds to help close city budget deficits in the years immediately following, which were hard hit in the Great Recession. While the merits of other aspects of the deal—including a total overhaul and modernization of the metered parking system and more convenience and payment options for consumers—can be debated, the way policymakers opted to spend the upfront payment from the transaction did not meet the “temporal nexus” test of aligning the use of proceeds from a long-lived asset with long-term needs.

Given that the city is currently facing an estimated \$20 billion in unfunded pension liabilities across its four main public pension funds, a reasonable argument could be made that city officials would have been wise to invest the proceeds of its parking meter lease (as well as some of the \$2.3 billion in proceeds from other long-term asset leases prior to the parking meters deal) toward paying down its pension debt obligations.²² Notably, after the parking meter lease, Chicago officials struck a deal in 2008 for a long-term lease of Midway Airport that would have netted a \$2.5 billion upfront payment that under state law

would have seen the bulk of the proceeds (at least 90% of what remained after defeasing existing airport debt) dedicated exclusively toward infrastructure investments or toward paying down the city’s unfunded pension liabilities.²³ However, the deal fell apart in the wake of the financial market turmoil of the Great Recession, and a subsequent lease effort collapsed in 2013.²⁴

While the “assets-for-pensions” concept may not have gotten off the ground in Chicago, since 2010 several Pennsylvania municipalities have actively explored or finalized asset sales or leases that are motivated either in whole or in large part by a desire to shore up underfunded pension systems.

The most prominent example is **Philadelphia**, where Mayor Michael Nutter’s administration launched a solicitation in 2013 seeking a potential purchaser for the Philadelphia Gas Works (PGW), a city-owned gas utility, in order to generate revenues to pay down the city’s pension debt, which is facing an unfunded liability in excess of \$8 billion. In March 2014, the Nutter administration announced that UIL Holdings Corp., a Connecticut-based energy company, had agreed to buy the utility for \$1.86 billion, which the administration expected to generate between \$424 million and \$631 million for deposit into the city’s municipal employee pension fund (after paying off the remaining debt obligations of the utility).²⁵ “Selling PGW will infuse hundreds of millions of dollars into our struggling and severely underfunded pension system—tackling a problem decades in the making,” Nutter said at the time.²⁶

However, the deal did not ultimately receive the backing of the Philadelphia City Council. Without holding any public hearings or taking a vote on the proposal, Council leadership issued a press statement in October 2014 outright rejecting the proposed PGW sale over concerns regarding its financial and labor terms and potential future rate hikes after an initial three-year freeze built into the deal.²⁷ In rejecting the utility sale, Council leadership announced that they would seek new ways to improve the operations of the Gas Works—perhaps through some form of public-private partnership—but did not discuss any plans to take action on the underlying issue: the city’s unfunded pension liability that the sale was intended to address.

“Unfortunately, the only other option to generate that kind of money [to shore up pensions] would be to either take it from the general fund or increase citizens’ taxes,” Mayor Nutter told reporters in response to the Council’s rejection.²⁸

While the efforts to divest assets to pay down pension debt ultimately sputtered in Philadelphia, nearby **Allentown** successfully inked its own deal. In April 2013, the Allentown City Council approved a 50-year lease of its water and wastewater systems to the nonprofit, quasi-public Lehigh County Authority, a move designed to generate upfront

revenue the city could use to pay down underfunded pension obligations and avoid rapidly spiraling annual pension payments, the result of overly generous public safety pension benefits.²⁹

In exchange for a \$211.3 million upfront payment and an annual \$500,000 royalty fee, the Authority took over operations and maintenance of the utilities.³⁰ The city directed \$160 million of the proceeds to cover the unfunded liabilities in its pension funds—thereby lowering the city’s required annual pension contributions moving forward—and it used the remaining proceeds to pay down \$29.3 million in water/wastewater debt, and put \$15 million into its rainy day fund.³¹

Allentown’s transaction brought a number of significant benefits that illustrate the rationale of leveraging assets to shore up underfunded pensions:

- Facing pension costs that would have consumed upwards of 30% of general fund spending in the near term if left unaddressed, the city was able to dramatically lower its annual pension contributions in the coming years and stave off a financial crisis. As a result of the deal, the city was able to reduce its annual required pension plan contributions from a projected \$24 million before the lease to \$6.3 million last year.³²

“We solved a critical fiscal problem that was going to bankrupt us if we didn’t address it in the very near term,” Mayor Ed Pawlowski told *Governing.com* in September 2013, adding that “[i]f I have a building next to me that I own, and I have a problem paying my own mortgage, maybe I should rent that building out.”³³

- The lease allowed policymakers to avoid a massive tax increase and was viewed by the capital markets as a credit-positive transaction. The year before the lease, Moody’s had downgraded Allentown’s general obligation bonds to A3, and S&P had the city rated at BBB+, both of which are on the lower end of the investment-grade ratings spectrum; after the lease, Moody’s and Standard & Poor’s revised their outlooks on Allentown to stable and positive, respectively.³⁴
- With the lease, most maintenance, equipment purchases and infrastructure repairs are no longer the responsibility of the city, and thus no longer have to compete with the city’s many other spending priorities for a limited pool of funds. “[The Lehigh County Authority] is only focused on two things: water and wastewater, nothing else [...] Whereas the city’s got a million other things to worry about,” according to Lehigh County Executive and Authority board member Tom Muller.³⁵
- Given some public concerns expressed about a potential lack of responsiveness to customers once the city was no longer directly responsible for day-to-day operations, the deal included several elements aimed at ensuring—and even arguably enhancing—transparency and accountability. For example, the lease

agreement mandated the creation of a compliance office to oversee Authority operations and address customer disputes between the authority and residents, and Allentown officials created a separate five-member compliance review board for additional oversight of the lease.³⁶

The Allentown transaction has caught the attention of other policymakers in Pennsylvania, where a variety of other state and local proposals to leverage assets to address pension underfunding have either advanced or are under consideration:

Middletown, Pennsylvania: In December 2014, the Borough of Middletown entered into a 50-year lease of its water and wastewater system with a joint venture of water service provider United Water and international investment firm KKR. Upon closing the deal, the joint venture made an upfront payment of \$43 million to the Middletown Borough Authority—a windfall that is being used to eliminate its existing debt and pension liabilities—and the United Water/KKR team plans to finance another \$83 million for system infrastructure improvements over the lease term.³⁷ United Water will operate and maintain the system assets during the 50-year contract, while the Authority will maintain ownership of the assets and will continue to control rates and enforce contractual operating and safety performance standards on behalf of users.

Scranton, Pennsylvania: In early 2015, the Scranton Sewer Authority issued a request for proposals seeking a private partner to potentially sell or lease the city’s wastewater system in order to address an imminent pension crisis.³⁸ The city’s pension funds are collectively only 23% funded, and pension costs are rising rapidly—up from \$3.8 million in 2008 to \$15.8 million in 2015—threatening to bankrupt the city within five years, according to city and state officials.³⁹ At press time, the city was still awaiting bids.

Altoona, Pennsylvania: In September 2014, officials in Altoona put on hold a process exploring a potential long-term lease of its water and wastewater systems to generate revenue to pay down debt and exit Act 47—the state’s municipal financial distress designation—status as officials try to work out a similar type of leasing arrangement with the Altoona Water Authority.⁴⁰ Earlier in the year, a financial consultant hired by the city projected that a system lease would generate an upfront payment between \$180 and 240 million that could be used to defease debt and pay down pension obligations, but public concerns over a potential loss of local control of the system under privatization prompted some city officials to seek an alternate arrangement with the local water authority.⁴¹

Reading, Pennsylvania: A proposal to monetize Reading’s water system to pay off debt and enhance city revenues prompted fears of privatization, leading to the passage of a charter amendment in November 2014 requiring a public vote prior to any asset sale or lease proposal exceeding \$10 million in value. However, city officials continue to explore

potential options with the Reading Area Water Authority that could include an Allentown-style lease or an agreement that would increase the Authority's annual payments to the city.⁴²

Commonwealth of Pennsylvania: It's not surprising that the idea of tapping asset sales and leases to backfill ailing pension systems seems to be taking hold in Pennsylvania. Though the state generally has not seen the same level of public awareness of state and local pension woes as peers like Illinois, New Jersey and California, the Commonwealth's pension challenges are significant. The state is facing approximately \$50 billion in unfunded liabilities across its pension systems, and a February 2015 report by Pennsylvania's Auditor General found that 562 of the 1,223 pension plans administered by municipal governments—or 46%—are “distressed” and underfunded by at least \$7.7 billion.⁴³

To address this, the new administration of Governor Tom Wolf is proposing to create a new statewide public authority that would lease local assets to generate upfront payments to allow municipal governments to shore up underfunded pensions and lower annual pension payments. The municipal governments would in turn be required to relinquish control of their pension systems, turning them over to the Pennsylvania Municipal Retirement System, the state-run plan that manages more than 900 local pension plans statewide totaling over \$1.4 billion in assets.⁴⁴ Separately, the Wolf administration's first budget included a proposal to modernize the state-run wine and spirits wholesale and retail monopolies to generate increased revenues. This would allow the state to send \$80 million to school districts to help cover teacher pension payments in FY2016 and to generate \$185 million annually to cover the debt service on a proposed \$3 billion pension obligation bond that would be issued to pay down the unfunded liability in the Pennsylvania School Employees' Retirement System.⁴⁵ While not technically an asset sale or lease proposal, it nonetheless demonstrates an interest in leveraging an asset to shore up an underfunded pension system.

Part 4

Policy and Process Considerations

Given the related policy and operational issues involved, selling and leasing government assets can be complex endeavors. While it is beyond the scope of this paper to detail all related policy considerations, there is a long history of asset sales and leases that policymakers can draw from.⁴⁶ A general set of policy considerations is discussed below.

Know what you own: Managing real property holdings is not necessarily a core competency of most governments. Oftentimes, government agencies have their own monitoring and tracking methods, which are typically fragmented and not compatible or interoperable with other agencies, leading to a lack of standardized reporting methods at the enterprise level. A government that doesn't know what it owns cannot hope to manage its assets in a cost-effective and efficient way.

For this reason, governments should develop a robust, standardized portfolio management system for publicly owned real estate—a real property inventory—as a sensible step toward improved asset management and public accountability. Having in place a comprehensive and current list of land and assets would allow the government to assess whether public property is being used and maintained in the most efficient manner possible, and the inventory can serve as a tool to assess the potential value of divesting underutilized or unnecessary land or assets to generate revenues, expand the tax base, and lower operations and maintenance costs.⁴⁷

Recognize that each asset is unique: Government asset transactions can take a variety of forms, and there are no cookie-cutter solutions. The approach for each asset needs to be considered on its own merits and solutions designed to fit the government's long-term goals and objectives. In some cases, such as vacant land or buildings or non-essential holdings, such as municipal golf courses, governments may choose to sell real property outright, either in an “as is” state or after a different zoning and regulatory structure has been put in place to facilitate a different future use upon sale (thereby increasing the potential asset value).

In other cases—particularly those that involve a revenue-generating asset such as a water or wastewater plant, or a parking asset for which the government may want to retain long-

term ownership while getting out of day-to-day operations—a long-term lease agreement or concession may be the preferred approach.

Lastly, there may be situations when government wants to continue to use an asset but doesn't want to continue to have the burden of ongoing maintenance and other management issues, in which case it might undertake a sale-leaseback, whereby a private entity purchases the property and leases it back to the government entity.

While these three scenarios represent very different approaches, in each case the government asset owner receives an upfront cash payment that could be used to pay down pension debt.

Retain expert consultants for due diligence and transaction guidance: In-house legal and financial experts in governments rarely have significant experience conducting complex asset sale or lease transactions, so it is good policy to engage world-class consultants to serve as advisors on sale and lease opportunities, conduct due diligence, and ensure that the public sector—and thus taxpayers—are getting a good deal in any asset transaction. For example, governments routinely hire a suite of legal, financial and technical advisors to help them navigate complex infrastructure public-private partnerships in the water and transportation sectors, which often involve long-term asset leases. Because the private bidders in these procurements are very experienced—perhaps negotiating several deals in any given year—they will be seasoned, and the public sector needs to have consultants of equivalent experience to sit across the negotiating table to ensure that any resulting deal is in the public's best interest.

Even in a pure asset sale situation, governments would be wise to hire real estate brokerage firms or auction specialists to ensure that asset value is maximized in any transaction; any commission these firms receive on the sale will likely be more than made up for by the benefits of tapping their expertise in navigating such processes to a successful conclusion.

Maximize competition and transparency in asset sales and lease procurements: In asset sale and lease situations, governments should maximize the use of competition by seeking a broad pool of bidders and avoiding sole-source deals. Robust competition will maximize asset values, thereby maximizing the amount of revenue that can be generated to deploy toward paying down pension debt.

Competition can come in several steps or stages. In an asset sale context, all of the services a government needs to identify and prepare valuations for all eligible properties and commercialize their sales can be procured through requests for proposals (RFP) and subsequent contracts. This could come through a two-step process in which the government can issue one RFP seeking services for identifying, inventorying and valuing

underutilized or surplus properties themselves. This information would then be used to develop a subsequent RFP seeking a private partner to commercially market and professionally sell these properties through open and competitively transparent sales or auctions that any and all interested stakeholders can observe and freely participate in.

Similarly, a lease scenario may play out in several similar steps. A government may hire a suite of financial, legal and/or technical advisors to help value the asset and determine what the parameters of a lease would resemble. Then the government may issue a request for information (RFI) or request for qualifications (RFQ) to test the market of potential bidders, prequalify those with the requisite experience and qualifications, and solicit general feedback on the potential lease structure. Then a more detailed, final RFP can be issued to the pool of qualified bidders to outline the final parameters of the lease and narrow down the pool to one selected bidder with whom to enter final negotiations.

Governments should also establish publically accessible websites to house all of the relevant documentation associated with each of these steps—along with presentations, press releases, frequently asked questions and other explanatory materials—to ensure that the project rationale and procurement process are accessible by all possible bidders, as well as the public and the media. Final bid documents (with any proprietary business information redacted) and evaluation documentation (e.g., bid scoring and the like) should be made available immediately after the announcement of final procurement decisions so that a history of the decision-making remains available for public access.

Use performance-based contracting to ensure high quality operations and protect the public interest: In an asset lease scenario, the public sector’s key role is setting the agenda—outlining the public’s expectations and goals, as well as the desired standards and performance outcomes to be achieved over the entirety of the deal—and then working to design a lease agreement that protects the interests of both parties in the partnership. The agreement should be structured to require achievement of a range of performance goals by the lessee, as well as mitigate any concerns and adequately protect the public interest by providing clear guidance on such topics as who pays for future expansions and asset modernization; how decisions on the scope and timing of rehabilitation projects will be reached; what levels of service will be required; how the contract can be amended in the future; how to deal with failures to comply with the agreement; provisions for early termination of the agreement; and what limits on rates charged to users will be.

As such, concession agreements for public assets tend to be several hundred pages long, detailing how a wide variety of “what-ifs” will be handled and defining performance levels that the lessee is legally required to meet or face penalty. For example, the Indiana Toll Road lease discussed in the previous section included an array of enforceable provisions and performance standards built into the contract to protect the public interest, such as:

- Requirements for the concessionaire to fund future repairs and maintenance, including required expansions of the roadway in the event that traffic levels reach certain targets.
- Caps on the amount that toll rates could be increased by the concessionaire without prior government approval;
- Performance standards in operations, safety, maintenance, and electrical and mechanical systems. As an example, the contract specifies the maximum amount of time that the concessionaire has to respond to vehicle incidents (15 minutes), remove snow (4 hours after storm), remove roadkill (8 hours), remove graffiti (24 hours) and respond to hazardous incidents (immediate), lest they face a penalty;
- Provisions for contract amendment in the future, as well as provisions for early termination; and
- A requirement that the concessionaire return the roadway to the state in like-new condition at the conclusion of the 75-year lease, creating a strong incentive for the concessionaire to perform proper asset management over the life of the contract.⁴⁸

Lease agreements also need to clearly delineate which risks are allocated to the contractor and which to the public sector, as well as under what conditions the government could cancel the contract and resume operations of the asset should the contractor fail to perform.

Once a lease agreement has been signed, government does not just walk away. Instead, the role of the public sector shifts to that of oversight and evaluation, so it is critical to ensure that lease agreements include strong reporting, evaluation and auditing components.

Create a dedicated “pension solvency account” for the deposit of sale/lease revenues: As a practical matter, in most cases the revenues from an asset sale or lease could simply be placed in the government’s general fund to be spent later, but this approach may engender public skepticism that the money might not ultimately be spent for the original reason for the transaction—paying down unfunded pension debt. A better approach policymakers should consider would be to establish a dedicated account—a “pension solvency” account—that all asset sale or lease proceeds can be deposited into that is clearly dedicated to holding funds that can later be appropriated directly toward pension debt. Additionally, this fund may be used as a “destination” for annual ending fund balances through the established budget process, thus creating one more source of funds to pay down pension debt.

The account should include clear restrictions on using the monies for anything other than paying down unfunded pension liabilities, should disallow using the monies to pay for enhanced pension benefits or actuarially required contributions to the pension system,

should prohibit borrowing against the account, and should have clear provisions on what happens to monies in the account once pension debts are paid off.

As an example of this concept, when it leased the Indiana Toll Road, the state of Indiana placed approximately \$2.6 billion of the lease proceeds into a new Major Moves Construction Fund used to fund transportation projects and an additional \$500 million in lease proceeds into a new Next Generation Trust Fund, created to generate interest income to provide long-term maintenance funds for the new assets built using the construction fund.

In short, both funds were created for a specific purpose—in this case, funding transportation infrastructure—that was designated in statute, signaling a clear intention regarding the use of proceeds. The proceeds from asset transactions designed to pay down pension debt should follow a similar model.

Make the case to the public: Sometimes the sale or lease of government assets will go practically unnoticed, but in many cases they can garner significant public attention and raise reasonable concerns, even if the underlying rationale—in this case, using proceeds to shore up underfunded pension systems—is sound. Thus, it is critical for policymakers to communicate early and often with the public to explain the rationale and the merits of their proposals, not only to ensure a full public debate but also to garner public support behind their decisions.

This means that policymakers need to commit early on to an open and transparent process. They will need to formulate comprehensive outreach strategies to communicate to the public through various means that include the traditional media channels, social media, the Web, public meetings and direct outreach through community meetings and the like. It is also important to involve public employees and other interested parties that may be directly affected by a potential sale or lease, who might otherwise be predisposed to oppose the asset transaction from the outset.

Combine asset sales and leases with comprehensive, prospective pension reform: As discussed earlier in this report, asset sales and leases alone are an insufficient solution to long-term pension debt. Rather, they should be paired with prospective, structural reforms to pension systems—primarily shifting new hires away from defined-benefit pensions to defined-contribution, 401(k)-style plans that are more sustainable financially and reduce or eliminate the prospect for new unfunded pension liabilities. Otherwise, without structural reforms to unsustainable pension systems, at some future point pensions debts could easily rise again, and taxpayers would have nothing to show for the asset sales/leases.

Prospective pension reforms and asset sales/leases are complementary strategies.

Prospective reforms, like shifting all new hires to a defined-contribution retirement system, are typically designed to cap current unfunded liabilities and reduce the risks of future liabilities materializing. Meanwhile, asset sales and leases can then be used to pay down those capped liabilities and reduce debt amortization costs for decades in the future.

Part 5

Conclusion

Most pension reform efforts seen across the country involve either adjusting current pension benefit levels to lower future liabilities or prospective structural changes aimed at capping liabilities and avoiding adding to pension debts in the future. These are important reforms to implement. But even if future liabilities are capped or reduced, there is still a need in many systems to address the unfunded liabilities—or pension debts—that are increasing annual required pension contributions and poaching funds away from other public services.

To avoid letting pensions “crowd out” other categories of government spending, policymakers should avail themselves of opportunities to reduce or eliminate those pension debts, and asset sales or leases offer a powerful option that can avoid pressures to raise taxes or reduce government services. While several Pennsylvania communities—and the state itself—have been early movers in adopting or exploring ways to leverage assets to shore up pension systems, the concept is likely to spread nationwide given heavy pension debt loads in many state and local governments and the relative undesirability of higher taxes and/or service reductions as alternate solutions.

About the Author

Leonard Gilroy is the director of government reform at Reason Foundation. Gilroy researches privatization, government reform, fiscal, transportation, infrastructure and urban policy issues, and he is the editor of the widely read *Annual Privatization Report*, which examines trends and chronicles the experiences of local, state and federal governments in bringing competition to public services.

Gilroy has worked closely with legislators and elected officials in Texas, Arizona, Louisiana, New Jersey, Utah, Virginia, California and several other states and local governments in efforts to design and implement market-based policy approaches, improve government performance, enhance accountability in government programs and reduce government spending. Gilroy's articles have been published by leading media outlets that include *The Wall Street Journal*, *The New York Times*, *Los Angeles Times*, *The Economist*, *New York Post*, *The Weekly Standard*, *Washington Times*, *Houston Chronicle*, *Atlanta Journal-Constitution*, *Arizona Republic* and more.

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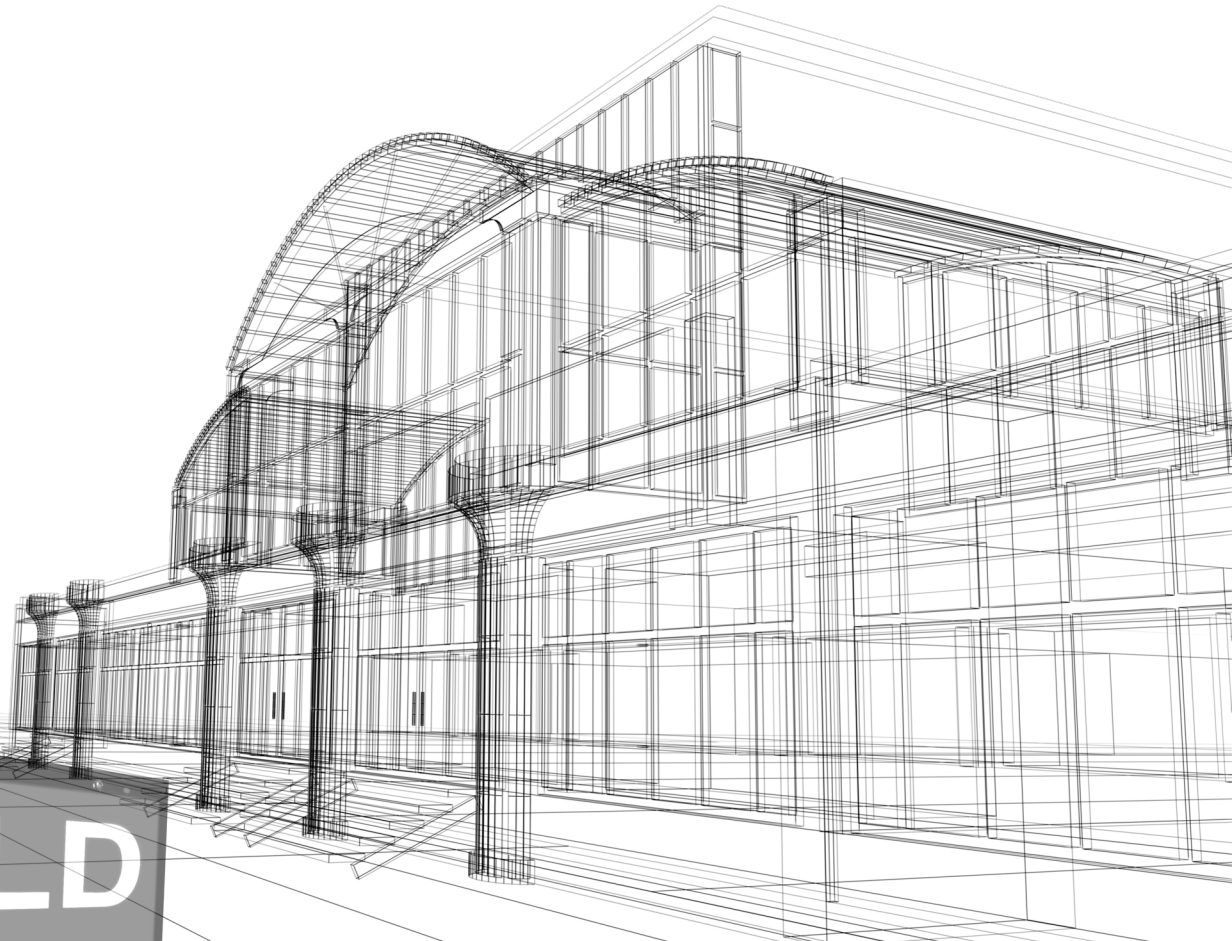
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Los Angeles, CA 90230
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