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Using Asset Recycling as an Infrastructure Funding Mechanism.

"Where will the funding come from?"

It's a question that had dogged President Trump's infrastructure plan – and more broadly, many U.S. infrastructure improvements in general – from the get-go. And while public-private partnerships (also known as P3s) have been cited as a key to filling the funding gap at the state and local level, how exactly such P3s could — or must work may depend on the specific project and its host municipality's regulations, including bidding, procurement, and other requirements, some of which are decades old.

For the most part, when people think about a typical P3, they picture design, build, finance, operate, and maintain (DBFOM) agreements, such as with Florida's I-595 Express Corridor Improvements Project. At their core, such P3s involve state or local governments partnering with private organizations on the construction of one specific project. While DBFOMs have been successful in bringing some projects to life that otherwise wouldn't have been possible, they do little to replenish the dwindling coffers of local governments.

A separate type of public-private partnership — "asset recycling" can help generate immediate revenue for municipalities while at the same time ensuring infrastructure improvement needs are met. Asset recycling P3s have generated a lot of buzz in other parts of the world (Canada, Australia and the UK, specifically) but such transactions are used less often domestically for a number of reasons, not the least of which are the aforementioned antiquated regulatory hurdles, which often deter investors from pursuing possible asset recycling transactions.

So, what exactly is asset recycling, how does it work, what are the challenges associated with making it possible in the U.S., and what does the future hold?

In its simplest terms, asset recycling involves the sale or lease of a government owned asset to a private entity to raise funds for the governmental entity. Such assets are typically unused or underutilized land or buildings, or assets that are more valuable, for any number of reasons, if they are sold or leased to a private entity for an up-front payment. The private entity agrees to assume operation of the leased or sold asset, such as an airport, bridge, toll road, wastewater facility, or parking facility, and to improve or maintain the asset according to predetermined standards.

Also referred to as asset "monetization," asset recycling enables municipalities to receive upfront proceeds and shifts the operational burden to a private entity, who assumes all operation and maintenance ("O&M") costs associated with the monetized asset. If applicable, the private entity also collects any revenue generated from such operations. After being sold or leased, the up-front funds received by the governmental entity can be used to finance construction of a new asset, repair or make improvements to an existing asset or to invest in any other way the municipality deems appropriate, such as investing in pension shortfalls or retiring old debt.

For public entities, the first step in the asset recycling process involves taking a full inventory of owned assets to assess which, if any, may be attractive and appropriate to sell or lease to a private operator. Assets ripe for monetization often include those capable of generating predictable revenue so that the private operator can ensure both a sufficient rate of return and identify, at the outset, funds that will be available to improve and maintain the leased or purchased asset. Examples of such revenue-generating assets that we have seen monetized in the recent past include sewer and water treatment facilities, parking garages and meters, school district buildings, courthouses, libraries, and golf courses. In New York City, for example, an audit from the city comptroller's office revealed more than 1,100 vacant lots that were essentially unused and ripe for asset recycling.

In order to determine the fair market value of the asset and to set reasonable expectations for up-front revenue that could be earned, local officials must collect detailed information regarding revenue generation figures and lifecycle costs. In a majority of cases, this requires assembling experts in the legal and financial fields who have experience in the sale and/or lease of public assets. It is important to note, however, that the only way to extract maximum value from monetization as an asset is often to set in place a competitive bid process whereby multiple potential private owner-operators bid against each other for the right to lease or purchase a revenue-generating municipal asset. In Pittsburgh, for example, local officials set a benchmark for what they hoped to net from the monetization of the city's parking system. Much to the city's surprise, its well-executed and designed competitive bid process produced a winning bit that was several times the initial target amount. Although the Pittsburgh parking transaction ultimately cratered for political reasons it is an excellent example of how competition and a well-designed procurement process can flesh out the true market value of public assets.

With a lease agreement, the municipality maintains ownership of the leased asset, and at the end of the lease period can either resume operation of the asset or negotiate a new lease agreement with the same or a different operator. Unlike with an apartment lease, however, the private entity assumes many (if not all) of the risks of ownership, including unexpected repair and maintenance costs. While up-front proceeds are certainly a "plus" with asset leases, shifting risk and obligation to a private entity can be the true motivating factor for a municipality looking to monetize an asset.

One particularly successful and creative asset leasing example that our team facilitated was the long-term lease of the parking assets of the city of Scranton, Pennsylvania, where the city hoped to lease its parking assets to help shed crippling debt. Facing stiff competition from local parking facilities and fatigue and frustration from taxpayers who for years were called upon to bail out a severely over-leveraged parking system, our team was able to negotiate a lease with a non-profit entity that featured sacrificed lower up-front proceeds in exchange for long-term rate and fee control. Not only did the deal help eliminate the city's approximately $3 million in annual parking-related debt, but it appeased taxpayers because the non-profit entity could offer fee and rate increases that were less than what the government operators would have implemented. Moreover, the city of Scranton was able to shift burden away from the municipality to the non-profit.

For many, the benefits of asset recycling, on both the public and the private side, seem obvious. The public gets the chance to raise funds to support infrastructure improvements by selling or leasing often burdensome assets, and private parties get the chance to turn unused property or inefficient operations into profitable assets with predictable returns.

However, asset recycling transactions face regulatory and political hurdles that are sometimes impossible to clear.

From a regulatory standpoint, certain states and municipalities either outright prohibit public-private partnerships, have rules in place that make it extremely difficult for monetization P3s to work as intended, and/or have no concept of how to manage a P3 transaction effectively and in a way that creates benefits for both sides.

Even Pennsylvania, which passed the Public and Private Partnerships for Transportation Act in 2012 to allow P3s for use in transportation projects, has limitations on the extent to which P3s can work. Not only does Pennsylvania's P3 Act apply only to transportation projects, meaning needs in water and wastewater systems, energy, brownfield sites, and more, are not specifically addressed in the Act, but the Commonwealth's P3 Act also mandates compliance with Pennsylvania's Separations Act, which requires the competitive low-bid award of multiple prime contracts for mechanical, electrical and plumbing (MEP) work. The P3 Act is a step in the right direction, and adherence to the Separations Act is by no means impossible, but the limitations imposed by both laws, especially the century-old Separations Act, can add additional layers of complexity and added costs to complex projects that already have thin margins and many other challenges.

Beyond formal regulation, the politics that surround asset monetizations can derail transactions before they even start.

For example, taxpayers may be wary of a private company taking over operations of a public asset with the goal of generating revenue for itself. Even if the private company can show that it will operate the asset more efficiently, save money in the long run, and generate immediate revenue for the public to use on more pressing infrastructure needs, it can still be a challenge to convince the masses that P3s are in the public's best interest. After all, a taxpayer may reason, the private operator is outside the reach of standard checks-and-balances that police how the current government operates the asset.

Careful thought and planning must go into explaining to constituents the benefits of a P3 as taxpayers – understandably so – often see only that their government is selling an asset to a private operator. And, along with such sale, the municipality is giving up control over rate setting. Although reasonable, this initial reaction is generally misplaced and could torpedo a P3 that would otherwise be in the best interest of the municipality. Local elected officials should offer transparency and access early and often to avoid the spread of misinformation.

Whether or not an infrastructure bill passes any time soon shouldn't limit asset recycling from becoming more prevalent in the U.S.; when structured properly, asset monetizations work well and should be strongly considered in appropriate circumstances. In the meantime, private entities and municipalities can take action to ensure asset monetization P3s are here to stay.

On the private side, companies should work with federal and state legislators to remove prohibitive regulations that can discourage private investment in public infrastructure. Simply explaining the benefits and international success stories of asset recycling to lawmakers is a good first step.

For state and local governments, officials first need to realize the potential benefit to taxpayers in allowing private companies to lend their expertise and access to capital to more efficiently operate struggling, municipal owned assets. Not only will the up-front windfall help generate new infrastructure or improve existing assets, but asset monetizations can also prevent tax hikes by finding alternate sources of revenue. Finding a way to finance infrastructure improvements without correspondence tax hikes can also be a nice feather in the cap of an official come election time.

While the country's leaders continue to search for an answer to the question, "Where will the money come from?", one thing appears likely: the existence of valuable municipal assets to sell or lease, when coupled with appropriately tailored regulations, and public-private buy-in, suggests asset recycling will become an even more useful tool for state and local governments struggling to identify sources to fund infrastructure improvements.

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