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COST AND CONTROL ADVANTAGES OF PUBLIC OWNERSHIP/ PRIVATE OPERATION OF SOLID WASTE PROCESSING FACILITIES

Elected officials frequently are pressured to privatize solid waste operations. This presentation explores a compromise: public ownership (and financing) with private operations. It argues that public ownership (and financing) of solid waste processing facilities operated pursuant to agreement with your private entities can lower capital costs, retain negotiating leverage to secure cost-wise renewals at expiration of the operating agreement term, and increase negotiating leverage when directing program changes. (This is especially true if you competitively secure the operation agreement.)

COST AND CONTROL ADVANTAGE #1: LOWER CAPITAL COST. In the United States, municipalities have access to tax exempt financing of the capital cost of constructing and equipping their publicly owned processing facilities on terms unavailable to private companies. Governmental entities can finance MRFs with the proceeds of municipal bonds, which will usually be less expensive than a private company's taxable debt (e.g. corporate bonds or bank loans) or equity subject to each company's prescribed rate of return¹. For example, if tax-exempt bonds bear interest

¹Note that although private companies can qualify for tax exempt private activity bonds for privately owned solid waste facilities meeting Internal Revenue Code requirements (including limited and therefore extremely competitive volume cap allocation), private activity bonds are subject to the alternative minimum tax, and their interest costs may consequently be relatively

at 8%², a bond holder/taxpayer in an hypothetical 50% tax bracket would have to get a 16% return on a taxable bond in order to retain the same earnings. Therefor an investor is willing to accept a lower interest rate on municipal bonds when he can keep all the interest earnings without netting out tax liabilities.³

Sometimes your elected officials may feel that they cannot politically support your municipality's incurring debt because it is more popular to turn to the private sector to provide financing. But remember that your municipality nevertheless pays for private financing through the service fee which will contain the private contractor's capital recovery component. And your municipality will likely pay more for private financing indirectly through the service fee than paying for public financing directly.

COST AND CONTROL ADVANTAGE #2: RETAIN NEGOTIATION LEVERAGE TO SECURE OPERATING FEE REDUCTIONS AT TERM'S END. It is easier to bring a new operator to your publicly owned facility than it is for you to take your materials to a new privately owned facility with possibly longer transportation costs or even capital costs of green field development. Ownership is leverage when the time comes to renegotiate operating fees.

Renegotiation With Existing Operator at End of Fixed Term. At the end of the fixed term of your operations agreement you may have experienced small or large friction and dissatisfaction with your existing operator and want to bring in a new operator. In such event you probably would want to competitively procure a new operator. But if you are basically happy with existing service yet feel that it's time to negotiate a new price, especially if you have been escalating your originally negotiated operations fee and feel the index has veered far from contractor's actual costs, then you may want to return to the negotiating table with your existing operator. The leverage is largely on your side, because if you don't reach agreement with the existing operator you can easily bring in

higher than governmental bonds.

²The interest rate on municipal bonds depends on the underlying credit of the issuer (or on the credit support of a letter of credit or bond insurance), which in the case of solid waste management-related bonds is increasingly the financial creditworthiness of the solid waste enterprise fund.

³In some jurisdictions, a consequence of securing public financing may be that workers in the processing facility must be paid prevailing wages, which results in increased operating costs over the term of a operating agreement as compared to non-prevailing wages which might have been paid by a private contractor providing service at its privately financed and owned facility under a service agreement. However, these increased costs may be offset by elimination of the private owner/operator's requisite return-on-investment and income tax liabilities. (Note that sometimes municipalities require private contractors to pay prevailing wages as a policy position, regardless of whether the law requires it.)

another. It's a virtual certainty that there are more private waste companies willing to come to your community to run a MRF than there are MRFs in your community.

Public Owner Term Extension Options. Especially if you procure your operation agreement through a competitive bid process, you may be able to retain your option to extend the operations agreement for one/two/five etc. year options on the same terms and conditions (usually including continuing escalation of the operations fee). If you are being well served and the operating fee you pay is still acceptable, extension delays the time and expense of a new procurement. When it's your facility you may have more leverage to secure this option. (On the other hand, in order to give your operator incentive to increase recovery, marketing and diversion, you might reward it with term extension rights based on super-performance over and above basic performance guaranties.)

Termination for Convenience. Termination for convenience allows you to pay your operator a pre-agreed sum to end your contractual relationship. You may wish to do this because you have been experiencing deteriorating service quality but find termination for default fraught with argument, even costly litigation. Or you may wish to do so in order to take over operations yourself or to reduce or change the scope of operations. For whatever the reason, having a termination for convenience right increases your options and may keep your operator keen to perform well, knowing that you can replace it. When you own the facility you need not compensate your operator for his unamortized capital costs, but only for some level of wind-down costs and lost profits. (The level of lost profits may be minimized if made part of a competitive bid along with the base operating fee.)

COST AND CONTROL ADVANTAGE #3: INCREASE NEGOTIATION LEVERAGE WHEN DIRECTING SERVICE CHANGES.

Fluctuating Materials Volume and Additional Capital Investment. You know for a certainty that your waste volume will vary with the general state of the economy, rapid development and population growth or delivery of additional materials by neighboring municipalities. Owning your own facility gives you greater flexibility to increase and decrease materials volume. (The degree to which you want to develop excess physical capacity in order to process merchant waste- just like a private operator- and achieve economies of scale to reduce the per ton cost of processing your own waste, is a policy decision.)

When you bring your materials to a privately owned facility you may pay a service fee on a stepped up scale, with lower per ton fees as your volume increases due to increased economies of scale which spread fixed costs (e.g. capital, administrative) over larger tonnage. However, at certain tonnage stepped increases, your service provider may have to invest in additional capital equipment as well as labor. If in the future your volume decreases and you want to step back down to a lower level, you cannot return to the same previous step charge because your contractor has made that additional capital investment which is outstanding, even if you no longer need it.

When you bring your materials to your own facility, you may pay an operating fee on a stepped up scale as well. But as you step up your tonnage, your operator need only provide additional labor while you provide the additional equipment. If your volume decreases, you can fully drop down to

your previous operating fee after allowing operator a time to reduce labor. True, you may still have to pay debt service on additional equipment you may have acquired, but you retain the value of that equipment in the form of ownership.

Protocol for Operational Change Orders. Ideally from the public perspective you want the ability to direct - not merely request - changes on operations, e.g. additional volumes or materials (green waste). The only issue remaining is price. Especially in a competitive procurement you can include a change order protocol which provides first for your requests for change proposals, next for your contractor's responsive proposal and lastly, possibly arbitration of price by an independent engineer third party in the event of disagreement. (This direction right may be difficult to obtain outside of a competitive procurement, because contractor may argue that it could be bankrupted by an arbitrated fee determination, whereas it only represents "pennies" per ton to you. An alternative is termination.)

Reservation of Rights to Contract for Changes. You might retain the option to bring in a third party to perform the requested change where the change is a function sufficiently distinct from your operator's existing operations, e.g. a third party to turn windrows outside the processing facility building on your site. Practically, you have this option only when you own the facility, since you can't bring in another party to a private operator's facility or site. Retaining this right may give your leverage when renegotiating the service fee impact of additional services.

Risk Allocation for Changes in Law/Uncontrollable Circumstances. In the event that a change in law (e.g. retrofitting your facility under new OSHA laws with respect to enclosed worker stations) or an uncontrollable circumstances which significantly increases the cost of processing, you might secure a termination right. Arguably, since a change in law or uncontrollable circumstance is neither party's fault, arguably you should not have to buy out your operator for lost profits. However, you might structure a termination for convenience based on such negotiated (or competitively bid) buy out price.

CONCLUSION. Public ownership accrues advantages of capital cost reduction and of operating fee renegotiation leverage at term or in the event of service changes. And a final note: in the United States, the market participation exception to the Commerce Clause also gives a municipality more flow control over materials imported to its facility.

Addendum: Public financing and ownership does not significantly shift responsibility for design, construction and operation of the facility from the contractor. Contractor's accountability and day-to-day activities are much the same as if the contractor had financed and owned the facility itself. However, the attached addendum highlights some instances where public ownership requires some adjustment of the parties' rights and responsibilities *inter se*.

ADDENDUM: PUBLIC FACILITY OWNERSHIP IMPLICATIONS

Selected implications of hiring a private contractor to operate a municipally owned facility follow:

Satisfactory Financing Terms Condition. At the time that your municipality enters into a design/construct/operation (and marketing) agreement for a processing facility it probably has not yet secured its facility financing. Among numerous conditions precedent to its obligations under the agreement (perhaps securing the site, obtaining permits etc.) should be securing financing on terms satisfactory to the municipality. You do not want to be in a position where your borrowing is much more expensive than you predicted due to bond market fluctuation, inability to secure cost-effective credit support or a lower credit rating than anticipated. In general, contractual provisions will be interpreted by courts in the context of "reasonableness" unless otherwise provided, and you do not want a court second guessing what a reasonable interest rate should be. So you should make clear that you will determine whether financing is satisfactory solely in your discretion.

Processing Contractor's Design Responsibility. When your municipality owns the facility you will naturally have a major, even primary, interest in its design and specifications, including capacity and quality. You can hire your processing contractor to provide designs for your review and approval. In fact, it may be preferable to ensure that your processing contractor is responsible for the facility from design through construction and operations testing to operations, because then it is easier to hold contractor to performance guaranties for vehicle turnaround, materials throughput, recovery/residue limits etc. If multiple subcontractors are responsible for design, construction and operation it is easier for the operators contractor to argue, for example, that recovery is poor because the pick lines are designed inefficiently, or that alleged poor maintenance is not the issue but rather shoddy construction. Contracting with one entity who in turn is responsible for subcontractors' performance allows you to forge links in a chain of responsibility from conception to operation.

Securing permits and renewals. As facility owner you will be named on permits, but the degree to which you want your contractor to work for you to secure those permits is up to you. (You may have in-house planning staff do so.) At a minimum, you need contractual commitments for contractor to cooperate in providing information for securing - and renewing- permits over the term of your operations agreement.

Public Bidding of Construction and Equipping. In the United States, another consequence of public ownership may be the public bidding requirement. As described above with respect to design, it can be important to hold contractor responsible for this project development stage, so your agreement can provide for construction management by your processing contractor.

Operations Testing. Following completion of construction, your operator must demonstrate that it can meet your performance guaranties for vehicle turnaround, throughput, recovery, marketing, etc. before commencing permanent operations under your agreement. Your agreement will prescribe the protocol for performing the tests, compiling the test result report and resolving differences over test results. It will also set an operations date and describe events which justify extending such date, including payments (e.g. your debt service and alternative service costs) by contractor for its delays.

Contractor Maintenance of Publicly Owned Facilities and Equipment. Hiring someone else to operate and maintain your building and equipment can cause worry, since they will not have the same motivation to care well for your assets as you, the owner, would. Your operations agreement needs to include maintenance protocols and reporting, including complying with manufacturers warranties and recommended maintenance. It might provide for annual equipment inspection by manufacturer representatives or other independent third parties combined with contractor obligation to implement identified maintenance and repair recommendations. In addition, it may require operator to employ a specified number of described maintenance employees to assure due care and attention. Prior to the end of the agreement, the parties should tour the facility and draw up an exit punch list of repairs the operator needs to make prior to ceasing service.