



BEST PRACTICE

Role of the Finance Officer in Privatization (2009) (CEDCP and DEBT)

Background. Funding and maintaining infrastructure and critical services is a vital and recurring government function. The need to provide cost-effective options while maintaining expected levels of service can cause governments to search for alternative service delivery options. While not a guaranteed solution, privatization provides an alternative that, given the proper research and due diligence, may present governments with numerous advantages. Recent examples demonstrate the effectiveness as well as the concerns surrounding privatization initiatives. This recommended practice develops the role of the finance officer and presents a high-level framework for evaluating the policy decisions if a government decides to pursue a privatization initiative.

Within this recommended practice, privatization encompasses the long-term transfer or sale of public assets or asset management rights to a private entity in exchange for a range of government financial, liability transfer, and risk mitigation benefits. Privatization resulting in an outright sale is a permanent transaction where title transfers from the government to a private entity(s). This may consist of all or part of the entire government facilities/asset network. Outright sales may include potential reversionary provisions should the private entity fail to perform, particularly in the sale of core government functions.

As opposed to outright sale, privatization initiatives may also result in management contracts, in which a private entity(s) assumes day-to-day operational responsibility for financial compensation from the government counterparty. Other responsibilities may also include ongoing capital maintenance, repair, and replacement. Operational responsibilities such as staffing and customer service are normally subject to government quality standards and enforcement. In a lease or concession agreement, the private entity(s) assumes operational responsibility and certain incidence of ownership such as rate setting, service area expansion, capital financing (which, as with management contracts, is normally subject to government procedures), mandates, and other limits. In lease agreements, government may retain revenue sharing rights. At the termination of the agreements, all affected asset rights and responsibilities revert to the government entity.

Public institutions assume a fundamental role in developing and pursuing privatization. Included in this role are a number of factors that public institutions often follow. The government entity establishes the direction for the privatization initiative and participates in the due diligence process, which includes confirming or, as necessary, establishing required legal authority to implement the intended privatization approach. Moreover, the public entity defines and documents the government's objectives and major constraints in privatization. This includes identifying available alternatives and establishing a privatization approach that best achieves the stated privatization objectives. When pursuing privatization, the government solicits proposals from qualified private entities, which may include a prequalification phase and should determine the feasibility of privatization proposals. This includes establishing a method for accepting a proposal and negotiating a privatization agreement. Following implementation of privatization, the due diligence process expects governments to closely monitor the performance of the private entity throughout the term of the agreement and enforce contract provisions. Effective management and monitoring of privatization includes continued communication and reporting with interested parties throughout the privatization process.

Recommendation. The Government Finance Officers Association (GFOA) recognizes the risks and rewards associated with privatization initiatives and recommends that finance officers play an active role in performing due diligence and facilitating privatization policy decisions. Finance officers should assume the following roles:

- **The Finance Officer should play a central, functional role in considering the feasibility of a long term Privatization.** Many if not most privatization initiatives are driven by a government’s financial needs and constraints. As such, the finance officer is well positioned to function as the lead member of the government team exploring privatization. In the decision-making process and in implementation, the finance officer acts as steward to protect the long-term public interest associated with the asset. In the implementation stage, finance officers play a vital role in promoting adequate controls and standards of safety and maintenance. Recognizing that privatization agreements will involve not only public–private entity agreements, but also major intra-governmental financial decisions that include major, complex financial matters (use of privatization proceeds, public debt defeasance, accounting–financial reporting, etc.), the finance officer acts as an interpreter and communicator of financial results to elected officials and the general public.
- **The Finance Officer should lead the development of a process to evaluate and implement a potential privatization.** In leading this process, the finance officer helps establish a competent, experienced team to assist in the entire privatization undertaking. Once constituted, the team works to produce clear, documented objectives of the privatization at the outset along with measurable standards/criteria to gauge achievement of those objectives. This process should include a thorough feasibility analysis and, if justified, a broadly competitive and transparent solicitation of private entities to serve as privatization counterparty(s). The finance officer should assume primary responsibility in assessing the financial strength and viability of all bidders to the privatization agreement to evaluate their capacity. The assessment process needs to exhibit professional due diligence in establishing and applying the asset valuation methods used to support the privatization agreement. Within the evaluation process, the privatization agreement should include appropriate enforcement features to promote service quality and compliance with all standards and requirements. The finance officer also helps incorporate suitable accounting, auditing, and financial reporting requirements and standards in the privatization agreement.
- **The Finance Officer should provide options and policy recommendations for the prudent, sustainable application and use of all financial benefits expected as a result of the privatization agreement.** This policy should be in effect prior to the receipt of any funds by the government. The finance officer should help establish a plan for the funds BEFORE the funds are received. This includes the disposition and use of government cash proceeds at the beginning of deal. The finance officer should establish a dialogue on how to apply that cash, including the creation of an “endowment” or permanent reserve. This dialogue helps facilitate the decision-making process and determines how financial benefits will be applied. This consideration arises from the potential danger that government will raise service levels or lower taxes in the short term rather than look at the long term. As a result, the finance officer helps establish policies for how to apply this money (e.g., to reduce or eliminate one-time unfunded liabilities instead of taking for short-term benefit).

During negotiations, the finance officer should keep the CEO and other local elected officials apprised to help these decision-makers fully understand the type and nature of the give and take occurring. This helps to ensure that priorities are laid out in advance to prevent the legislative body from making ill-informed decisions.

The finance officer helps ensure good stewardship of the proceeds by properly structuring the on-going management of such upfront proceeds. For example, creating a permanent endowment capitalized by the proceeds and establishing a professional board of trustees functioning as a fiduciary for the endowment institutionalizes a permanent public asset. Coupled with the use of a professional advisor and fund managers, this structure would promote long-term return and safety of principal.

References

- GFOA Best Practice, “Managed Competition as a Service Delivery Option,” 2006.
- “Alternative Service Delivery,” The Civic Federation, December 2006.
- *An Elected Official’s Guide Competitive Options: From Managed Competition to Privatization*, GFOA, 2008.
- GFOA Best Practice, “Public-Private Partnerships for Economic Development,” 2008.

Approved by the GFOA’s Executive Board, February 27, 2009.