GOVERNING

THE STATES AND LOCALITIES MARCH 2012

BIG DEALS

By Kirk Victor

To fix fiscal gaps, cities are playing around with more creative solutions.

Julien X. Neals doesn't sleep well at night. Even when Newark, N.J.'s business administrator nods off, it is, he says, "on a surface level where you are thinking, 'OK, how are we going to tackle this problem tomorrow?'"

The fitful nights are understandable. Newark faces fiscal challenges that are extraordinary. When Neals was sworn in more than a year ago, Mayor Cory Booker said he was counting on the new administrator to help guide Newark as it faced "one of the worst economic crises in our city's modern history."

Newark is hardly alone. The litany of economic woes are a fearsome foursome: persistently high unemployment, soaring pension and health-care costs, dwindling property values that have robbed cities of revenues, and cutbacks in federal and state assistance that have further eroded the revenue available to the cities.

The magnitude and depth of the problems are daunting. Several mayors have likened it to a generational event where local officials can't look back and say, "We've dealt with this before." It has been decades since anything like this has happened.

Faced with this reality, it's not surprising that city leaders may be open to new ways to finance their fiscal challenges. Some of these solutions may be brought to their attention by investment bankers who come to the table armed with an array of exotic—and often difficult-to-understand—financing tools.

That combination of cash-strapped local government leaders and aggressive dealmakers has produced a situation in which the inadequacy of the usual means of balancing the budget meets the risky road to immediate access to capital. That was at the heart of two of today's high-profile municipal struggles—Harrisburg, Pa., and Jefferson County, Ala. "So often politicians do not look long term; they are just looking to push the buck or the can down the road until they won't be responsible," says Daniel Miller, the city controller of Harrisburg, which is struggling with fallout from the unfortunate financing of an incinerator deal that left the city with a $317 million budgetary hole.

Even when the cutting-edge deal stems from a genuine try at solving long-term fiscal issues, experts in municipal restructuring say they worry that city leaders don't have the knowledge base to analyze the deals sufficiently. The lack of sophisticated investment analytical abilities puts them and their cities at risk of making ill-informed decisions or even of being taken to the cleaners. The level of sophistication when city leaders and Wall Street bankers come to the table is "wildly asymmetric," says David Johnson of Chicago-based ACM Partners, which advises a range of clients, including municipalities and their bondholders. As he describes it, when bankers and city managers sit down together, the bankers may face a city manager who has been doing municipal finances for 20 years, and possibly doesn't have an MBA. Meanwhile, the city manager is probably sitting across the table from three bankers who have a combined 500 transactions behind them. "I would never bet on the city manager in that case," Johnson says. "Not that city managers aren't good at what they do, but there is so much asymmetry. [They need help] to get through these complicated transactions."

While the terms of a deal can be highly technical, complicated and confusing, sometimes the deal-making leads to illegal conduct. For example, Jefferson County's municipal bankruptcy was precipitated by a combination of aggressive Wall Street bankers and local leaders on the take. At issue was a complex financing deal to modernize the sewer system.

An investigation by the Securities and Exchange Commission (SEC) of the sewer deal revealed bid rigging, bribes and other misdeeds. The SEC settled charges with J.P. Morgan Securities, which forked over $750 million for illegal payments that it had steered to influential people in the county to help the firm win the bond deal. Some 20 city employees were convicted of bribery and conspiracy.

Part of the Jefferson County story is about corruption, but another part centers on the failure of leaders to understand the deals being pushed by aggressive Wall Street pitches. "When there is a need, the investment banking community will figure out a product to match it," observes David Hooks, chief of staff to Jefferson County Commissioner Jimmie Stephens. Stephens was elected in 2010 after the illegal conduct had occurred and is trying to clean up the mess as head of the Finance Committee. Hooks points out that city leaders often simply fail to ask questions when they don't understand the ins and outs of a deal. "Elected officials," he says, "never want to get embarrassed by looking like they don't know what they are doing."

It's a sentiment echoed by William Brandt, chair of the Illinois Finance Authority. Brandt, having talked with a number of people involved with the deal, reports that "there were too many meetings where nobody understood the true nature of the securitization, and there was a lot of illusionary language about what was going to occur that didn't."

Misunderstandings may stem less from the lack of a deep knowledge of the deal than from an eagerness for a quick fix. In late 2008, Chicago leased its parking meters to a Morgan Stanley-led partnership. Then-Mayor Richard Daley was trying to close a budget hole, and the deal called for Morgan Stanley to hand Chicago $1.16 billion in exchange for a 75-year agreement to lease and manage the meters. The transaction has since provoked outrage among residents who were subsequently hit with repeated hikes in parking fees.

The thinking of city leaders, says Brandt, was that the public-private partnership deal to lease the city's parking meters would gain the city a bundle of money. If that meant the folks who leased the parking meters were to triple, quadruple and, in some cases, quintuple the rates, so be it.

To Brandt's way of thinking, the parking meter situation could have been handled in a far better way if the mayor had the political will to raise the parking meter rates himself. Politically, "there would have been hell to pay," Brandt says, "but the city wouldn't have had to quintuple the parking rates. It could have tripled them and then sold that revenue stream into revenue bonds and probably come out in the same place and still owned the damn parking meters."

Subsequent reporting by Bloomberg News revealed that the Morgan Stanley partnership will receive at least $11.6 billion for the parking concession over the course of the deal, or 10 times what it paid. As to Chicago, Brandt says "it doesn't appear that the analysis on a best-practices basis or cost-benefit basis is getting done."

Not every deal is a bad deal. Even critics of privatization deals don't necessarily rule them out as an option. But they caution that privatization must be done smartly and transparently. Deals should not be cut behind closed doors.

Transparency, Newark's Neals argues, is the course his city has taken. Newark worked with New York-based Class Green Capital Partners, a firm that is a member of the U.S. Conference of Mayors Business Council. It is a specialized municipal advisory firm that helps cities get low-cost capital through real estate and infrastructure properties that then undergo energy retrofits to make them more efficient. At the end of the 20-year lease, when the structures are returned to the city for $1, the projects are more valuable—and the cost of maintaining and running them is less.

In the sales-leaseback transaction with the Essex County Improvement Authority, Newark sold 16 buildings, including the courthouse and police and fire stations, to the improvement authority. The authority then issued a $73 million tax-exempt bond, with the buildings as collateral. Newark used roughly $40 million of the bond proceeds to plug the budget, $20 million to retrofit the buildings and do an environmental clean-up, and the remainder to pay down existing debt and transactional costs. "This not only preserved vital city services and jobs," Neals says, "but reduced by more than half an otherwise significant property tax increase."

It was not, of course, free money. Newark now has to take on an additional budget item: paying back bondholders.

Neals concedes that if the economy had not crashed, the city probably would not have done the deal,

"but it was the best of some pretty bad alternatives." The new reality in the public sector, he argues, is that with rising health-care and pension costs "if municipalities didn't do something to plug budget holes as a bridge to try to cure structural deficits, they would go out of business."

The deal is one part of Newark's balanced approach that includes cutting city jobs and raising property taxes—a combination that has reduced the deficit from roughly $175 million in 2009 to $80 million at the start of 2012.

Class Green's co-founder and chief executive John Hirschfeld notes that the firm is in talks with about 20 cities that are interested in pursuing a similar course.

Not all budget mavens are sold on these kinds of one-shot deals in which city leaders sell or lease assets to cover a budget shortfall and saddle the city with debt for years—even with the advantage of the energy retrofit. "I wouldn't say no one-shots ever. You would like them to be financially and programmatically sensible," says Don Boyd, executive director of the Task Force on the State Budget Crisis, a group evaluating the fiscal situation in five big states. "In general, the extraordinary pressure to do something other than raise taxes or cut services makes it very attractive to do things that don't make financial sense. Taxpayers ought to be wary."

Providence, R.I., like Newark, worked with Class Green and leased buildings used as collateral for bonds that generated $35 million, $30 million of which went to close its budget gap while about $5 million was earmarked for energy efficiency upgrades to the buildings. That deal prompted Rhode Island's revenue director, Rosemary Booth Gallogly, to raise concerns similar to Boyd's. "I am certainly not saying they should never be done," she says. "I just think when possible, they should be avoided, and when used, they should be part of an overall long-term plan."

The problem with the deals is that, though they solve a short-term problem, they push the bill for the solution down the road, says ACM Partners' David Johnson. When leaders earmark the capital for one-shot budgetary fixes, "they are selling the family silver," he says. "You need to use that to change your structure and not to just fill a one-time budgetary hole. Next year could be just as bad, and then what do you do?"

But Class Green's Hirschfeld counters that his firm encourages cities to devote a large portion of the proceeds of transactions to energy upgrades. By so doing, they can blunt, if not eliminate, the criticism that the transaction is primarily deficit financing. His company suggests that cities spend 50 percent or more of the proceeds of each transaction on actual upgrades to produce efficiencies and lower the net effective cost of capital of the entire transaction.

The lesson in all of this is that there are no magic financing techniques. Put another way, Johnson says, his advice to hard-pressed municipal leaders is: "Just because someone is coming to you with a bag of money doesn't necessarily mean the deal is in your favor."