# Legal Aspects of Successful Municipal Utility Assets Public-Private Partnerships

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## I. INTRODUCTION

Once a municipality has selected the project delivery system which is best-suited for the municipal utility project which it is procuring, municipal officials must turn their attention to the legal issues relating to such decision. For the traditional delivery system the legal framework for such procurement processes have generally been developed over the years and the municipal officials are familiar with such precedents. If a municipality chooses to deliver a utility project pursuant to an alternative delivery method (design/build or design/build/operate), it must address legal issues that are specifically related to such delivery methods, and also issues it did not have to address in its traditional procurements. This paper will provide municipal officials with a general understanding of the legal issues relevant to the procuring of a municipal utility project pursuant to such alternative delivery approaches.

## II. LEGAL AUTHORITY

The implementation of municipal utility projects, due to the complexity associated with such transactions, calls for a "best value" rather than a "lowest responsible bidder" approach. A "best value" approach consists of a municipality soliciting proposals through the issuance of a request for proposals, and evaluates the proposals on factors (qualifications, technical, and business capabilities) other than price, allowing the municipality to select a service provider who provides the most advantageous proposal. Unlike the traditional procurement approach, the municipality will generally be able to negotiate the terms of the service agreement with the preferred proposer prior to its execution.

Not every state allows a municipality to undertake a municipal utility project under a design/build or design/build/operator delivery approach. Some states' municipal procurement laws are limited solely to the traditional "lowest responsible bidder" approach while some allow "best value" procurements generally while others authorize the use of such procurement alternatives through the enactment of special legislation specifically related to the project. Finally, some states allow the use of such delivery mechanisms based on a municipality's local charter.

Prior to undertaking a municipal utility project pursuant to an alternative delivery method, a municipality must first determine whether it has the necessary legal authority to conduct such a procurement. The following is a summary of procurement laws in various states where the use of an alternative delivery approach by a municipality is allowed. Such summaries

are presented as examples of the different ways states have addressed this legal issue, and are not intended to provide a full legal analysis of such laws.

*New Jersey*

Under the laws of New Jersey, a municipality may conduct a "best value" procurement for water and wastewater projects pursuant to the New Jersey Water Supply Privatization Act, the New Jersey Wastewater Treatment Privatization Act, the New Jersey Water Supply Public-Private Contracting Act and the New Jersey Wastewater Treatment Public-Private Contracting Act. All four acts provide a municipality with the authority to procure a water or wastewater utility project on a design/build or a design/build/operate basis, and allows for long-term contractual relationships. Under any of these acts, a municipality is not required to select the lowest cost proposal.

*New York*

New York is predominately a "lowest responsible bidder" state. Thus, the use of alternative delivery approaches is severely limited. Not only is the traditional means for implementing public works projects the norm, but it is further made more limited by the requirement that separate bids for plumbing, electrical and heating, ventilation and air conditioning must be solicited for certain construction contracts. Thus, municipalities in New York have not had the opportunity to procure municipal utility projects on a "best value" basis.

The law in New York, however, has seen some recent developments which may provide alternatives to the traditional approach. A New York State appellate court has held that the contract for the management of a municipal water system was similar to a professional services agreement, and, therefore was exempt from the competitive bidding requirements. Such professional services exemption has not been extended beyond the management of a water system but it is a limited means by which a New York municipality may undertake a procurement on other than a "lowest responsible bidder" basis. Finally, two counties in New York have sought and received special legislation to procure wastewater plants on a design/build/operate basis. Orange County received such authorization, but to date has not utilized it. Rockland County is procuring a new wastewater plant under the authority provided by such legislation. The special legislation adopted for each county are very similar, and grant such counties with the ability to select a private company to design, construct and operate a wastewater plant on factors other than the lowest price. In addition, the City of Glens Falls, New York received similar legislation to procure a water treatment facility.

New York municipalities may also procure solid waste facilities on a design/build/operate basis. Such approach has been successfully utilized for a number of projects throughout the State.

*Arizona*

In Arizona, municipalities generally have the ability to procure public works projects under multiple alternative delivery approaches. Such authorized approaches are design/build, design/build/operate and construction manager at risk. When utilizing such approaches, typically the municipality must follow a procurement process which includes a request for qualifications process and a request for proposal process, with the request for proposal being issued only to those firms which were short listed via the request for qualifications. When submitting a proposal, a proposer is required to submit its price separately from the technical proposal. The applicable statute dictates that the request for proposal shall set forth the factors to be used in the evaluation of proposals as well as the evaluation scoring method. The applicable statute does not allow for contract negotiation per se, but clarification discussions limited to preliminary technical proposals that may have been requested. The municipality shall award the contract to the proposer that received the highest score based on the application of the evaluation scoring method included in the request for proposal.

*California*

Under California law, there are charter cities and general law cities. A charter city is subject to statutes except to the extent of "municipal affairs" which are controlled by the charter. A general law city is subject to the laws of the state. The power of a Charter City to enter into a contract has generally been held to be a "municipal affair"; therefore, a charter law city need only look to its charter to determine whether it may utilize an alternative delivery approach to procure a municipal utility project. Some City charters clearly provide for such authority while others do not. A general law city only has the power granted to it by the State statute. California Government Code Section 5956 does allow general law cities to procure municipal services and public works contracts for design, construction and operation utilizing a "best value" alternative project delivery approach provided that there is a private financing component included in the transaction.

*Massachusetts*

Over ten Massachusetts municipalities have procured municipal utilities projects on a design/build/operate basis pursuant to the enactment of special legislation. While municipalities

have long been able to enter into contracts on a competitive proposal basis, such laws have not allowed for the full aggregation of services required for a successful design/build/operate project. Each such special legislation provides for almost identical procurement processes. Under such laws, non-price proposals must be submitted separately from the price proposals with the non-price proposal being evaluated independently from the price proposal. Once the proposal evaluation is completed, the municipality's chief procurement officer makes a preliminary determination of the most advantageous proposer and commences negotiations of the non-mandatory contract terms. If at the end of negotiations the preliminarily determined most advantageous proposer is still the most advantageous proposer, the chief procurement officer makes a final determination that such proposer is the most advantageous proposer. At such time, the municipal legislative body votes to approve the contract. If after negotiations, the chief procurement officer determines that the preliminarily determined most advantageous proposer is no longer advantageous, the chief procurement officer may commence negotiations with the next most advantageous proposer.

*Georgia*

Georgia law allows any municipality to enter into leases and contracts with private firms for the design, construction, repair, reconditioning, replacement, maintenance and operation, or any combination thereof, of water, sewer, storm water or wastewater treatment systems. Such contracts can be procured through a competitive proposal process. Simultaneous negotiations of competing proposers may be utilized as part of the proposal evaluation process, and the proposals may be ranked based on such negotiations.

*Connecticut*

Connecticut, similarly to California, allows municipalities to use an alternative procurement process based on the power such municipality derives from its own charter. Generally, such charters provide for a traditional "lowest responsible bidder" award when procuring municipal utility projects. Some charters, however, allow the municipalities to specifically choose to exempt themselves from such traditional approaches if they so desire and utilize an approach which they deem to be in its best interest, including, competitive sealed proposals.

Therefore, prior to commencing a municipal utility project by way of an alternative delivery system, a municipality must first research whether it has the legal authority to undertake

such alternative procurement. Not until such determination has been made should a municipal official feel comfortable proceeding with such a procurement.

## III. SERVICE AGREEMENT

The fundamental aspect of a design/build or design/build/operate contract is the aggregation of multiple services under one contractually responsible company. Such aggregated services may include design, construction, operation, maintenance, repairs, replacement and management. The success of such contractual arrangements is that there is a single point of responsibility to guarantee the full performance of each of the aggregated services, and to further ensure that such services are fully integrated. The following sets forth a basic outline for a design/build/operate service agreement as well as an explanation of certain provisions to be contained therein.

The table below provides an outline of a typical service agreement that would be entered into between a municipality and a private service provider for the design, construction and operation of a municipal utility asset on a "full service" design/build/operate basis. Each of the major provisions of the service agreement will be summarized, and certain legal issues relating thereto shall be identified.

**Table 1**

Definitions
Representation and Warranties
Term
Development Period
Design/Build Responsibilities
Acceptance
Operation and Maintenance
Performance
Future Capital Improvements
Service Fee
Breach and Events of Default

*Definitions*

The defined terms used in any service agreement assist in accurately delineating the responsibility of the parties. For example, the existing assets that the service provider is to be responsible for operating pursuant to the terms of the service agreement should be clearly defined so that no questions may arise during the term of the service agreement as to which party bears such responsibility. Similarly, the site or sites upon which assets are to be constructed or current assets are to be operated should be specifically identified. Metes and bounds descriptions being favorable if such exit. There are certain defined terms that are integral to the balancing of risk between the parties. These are the definitions of applicable law, changes in law and uncontrollable circumstances.

Applicable Law. When defining applicable law, it is important to capture all statutory laws (federal, state and local), case law and regulations and permits. Further, if there are any guidance documents that are currently required to be adhered to by the regulatory agencies such documents should generally be referenced in the definition. Finally, if there are proposed regulations or statutes that would require more stringent performance, and such proposed regulations or statutes are readily discernable, the standards set forth in such proposed regulations or statutes should be included in the definition of applicable law or the required performance guarantees so that the service provider may not claim a change in law, thereby seeking additional compensation, when such proposed regulations or statutes are enacted.

Change in Law.

If the applicable law becomes more stringent and such increased stringency causes the service provider to incur additional costs or experience project delays when performing its affected contractual obligations, the service provider is generally entitled to price, schedule and performance relief. The key to such determination is whether the change in law actually caused a price increase or a schedule delay. Thus, the definition of applicable law and change-in-law must be developed in connection with the required performance guarantees in order to mitigate a municipality's exposure in this area.

The typical definition of change in law generally includes: (a) the adoption, amendment or repeal of the administrative or judicial interpretation of any applicable law on or after the contract date; (b) the order or judgment of any governmental body issued on or after the contract date to the extent such order or judgment is not the result of willful or negligent action, error or omission or lack of reasonable diligence of the service provider or of the municipality,

whichever is asserting the occurrence of a change in law; or (c) the denial of an application for, a delay in the review, issuance or renewal of, or the suspension, termination, or interruption of any regulatory approval, or the imposition of a term, condition or requirement which is more stringent or burdensome than the contract terms in connection with the issuance, renewal or failure of issuance or renewal of any regulatory approval. The definition may also include certain events, the occurrence of which does not specifically constitute a Change in Law.

Uncontrollable Circumstances. Similarly to the relief granted to a service provider on account of a change-in-law, a service provider should be entitled to price, schedule and performance relief due to the occurrence of an uncontrollable circumstance. Generally, the service provider has an obligation to provide notice of the uncontrollable circumstance event, and prove that such event caused the relief it is seeking. The service provider should also have a duty to mitigate the effect such uncontrollable circumstance has on its ability to meet its contractual obligations. One way to incentivize the service provider to mitigate the impact of an uncontrollable circumstance is to require the service provider to bear a share of the costs incurred due to the occurrence of an uncontrollable circumstance event up to a contractual set amount. Typically, such amount would be nominal, however, bearing some of the uncontrollable circumstance related costs tends to cause the service provider to more aggressively meet its duty to mitigate.

The usual uncontrollable circumstance events are acts of god, change in law, terrorism, war, explosion and failure of title. Generally, these are insurable events with the service provider providing insurance which benefits both the service provider and the municipality. Some events, such as change-in-law, are uninsurable, and, therefore, as previously stated it is important to make sure the contract is clear on what triggers a change-in-law.

Just as the service agreement identifies that which may be deemed an uncontrollable circumstance, it may also clearly identify those events the occurrence of which do not constitute an uncontrollable circumstance. Such events may include: any act, event or circumstance with respect to which the service provider has assumed the "as-is" risk under the service agreement; any act, event or circumstance that would not have occurred if the affected party had complied with its obligations under such service agreement; changes in interest rates, inflation rates, wage rates, insurance costs, commodity prices, currency values, exchange rates or other general economic conditions; the consequences of error, neglect or omissions by the service provider, any subcontractor, any of their affiliates or any other person in the performance of the contract

services; any impact of prevailing wage or similar laws, customs or practices on the service provider's costs.

*Representation and Warranties*

The representations and warranties article of a service agreement sets forth the municipality's and the service provider's mutual agreement regarding essential representations and warranties made by the parties relating to the service agreement.

The municipality generally represents and warrants: (i) its legal existence and powers under the laws of the state to enter into and to perform its obligations under a service agreement; (ii) the due authorization and binding obligation of the municipality; (iii) that execution of a service agreement does not conflict with any applicable law; (iv) any approvals required for the valid execution of a service agreement have been obtained; (v) that there is no legal proceeding, other than what is already disclosed to the service provider, which may have a material and adverse effect on the execution of a service agreement; and (vi) that the municipality has obtained or will obtain necessary regulatory approvals to effectuate its responsibilities under a service agreement.

Similarly, the service provider generally represents and warrants: (i) its legal corporate existence and powers; (ii) the due authorization and binding obligation of the service provider; (iii) no conflict, approvals and litigation statements; (iv) its regulatory approvals responsibilities; and (v) that the information supplied by the service provider and its guarantor to the municipality are true, correct and complete in all material aspects.

*Term*

The term of a service agreement is generally dictated by state procurement law and federal tax law. For example, many state procurement laws provide that a municipality may enter into a service agreement for a term not exceeding twenty years. Such laws govern the term of the service agreement to be procured pursuant to such law.

If the municipal utility asset has been financed or is being financed with municipal tax-exempt bonds, tax law considerations relating to the term of such contract must be adhered to. I.R.S. Revenue Procedure 97-13, as more specifically discussed later in this Chapter, allows the private management of tax-exempt bond financed property so long as the requirements set forth therein for a "qualified management contract" are complied with. The contract terms provided for in Revenue Procedure 97-13 range from 5 to 20 years, and are determined by the service fee structure. In order for a service agreement to have a term of 20 years and be deemed a "qualified

management contract" under I.R.S. Revenue Procedure 97-13 the annual service fee must be structured so that 80% of the annual compensation to the service provider is fixed and only 20% is variable.

*Development Period*

The period between the date the service agreement is executed and the date the service provider is given notice-to-proceed to commence the design and construction of the municipal utility asset is generally known as the "development period". In order for the development period to close and the notice-to-proceed to be granted, certain condition precedents must be met. Such conditions precedents usually include having all required security instruments, insurance and permits obtained. The primary condition precedent is obtaining all necessary permits. This may be the service provider's responsibility or it may be the responsibility of the municipality. Until such conditions have been met or waived by the other party, the development period continues to toll.

*Design/Build Responsibility*

In a design/build or design/build/operate approach, the service provider takes full design, construction, project completion and performance responsibility, and the service agreement should explicitly transfer such risk to the service provider. This is one of the most significant benefits of utilizing a design/build or design/build/operate alternative procurement approach. To this end, under the service agreement, the service provider shall be specifically liable for the design, construction and performance of the municipal utility asset notwithstanding that the request for proposals included certain minimum design criteria and certain performance standards. Further, the service provider shall be required to indemnify the municipality for any loss or expense arising out of the design, construction and performance of such asset.

The design and construction of the municipal utility asset should be done in accordance with a set of design requirements which are developed based on the minimum design requirements that are included in the request for proposals and the technical design requirements, as negotiated, of the selected proposer. For the construction aspect of the project, the service provider should have exclusive responsibility for all means and methods of construction necessary for completion of the project.

*Acceptance*

One of the major differences between a design/build/operate delivery approach and the traditional design/bid/build delivery approach is that in a design/build/operate approach

the municipal utility asset must be accepted by the municipality upon the completion of construction. Generally, under a design/bid/build approach, the municipality's consulting engineer designs the asset and the lowest responsible bidder constructs the asset. Once construction of the asset is complete, the construction contractor's responsibilities are generally limited to equipment warranty, not asset performance. Under a design/build/operate or design/build arrangement, the service provider is obligated to have the asset meet certain acceptance tests which demonstrate that the asset, as constructed, can perform as designed. If the asset does not meet such tests, the service provider is responsible for improving the assets, at its sole cost, in order to cause the asset, as constructed, to meet such test, and to have the asset retested.

In order to maintain a schedule for project delivery, the service agreement should include a scheduled acceptance date. The scheduled acceptance date is the date upon which the service provider anticipates the asset passing the acceptance tests. If the asset is not accepted by the municipality as of such date, the service provider should be obligated to pay liquidated damages for each day thereafter, that acceptance is not achieved. It is not uncommon for the service agreement to include an end date whereby if acceptance is not achieved, an event of default is deemed to have occurred.

*Operation and Maintenance*

Operation

The service provider, when operating and maintaining the municipal utility assets, should be required to perform such services in accordance with certain specified "contract standards". Such contract standards generally include applicable law, performance guarantees, good industry practice, the operation and maintenance manual and operation and maintenance procedures. It is also common to have various operating plans included in the service agreement which the service provider must comply with when operating and maintaining the municipal utility assets. Such plans are typically related to safety, staffing, operation and maintenance as well as others which are specific to each project. These plans are prepared by the service provider and reviewed by the municipality for conformity with the terms of the service agreement.

In long-term contractual arrangements, where the service provider undertakes the operation and maintenance of an existing municipal utility asset, it is customary for the service provider to bear the "as-is" risk of such assets. That is the risk that the existing assets can be operated to meet the specified contract standards which is borne by the service provider. The

service provider, however, before it can bear such risks, must be granted an opportunity to fully and completely examine the existing conditions of the municipal utility assets to be operated. The "as-is" risk of buried infrastructure, such as water and sewer pipes, is generally not transferred to the service provider because the service provider cannot adequately examine such assets prior to proposal submission. Therefore, the inclusion of such assets in the service provider's "as-is" risk responsibilities would cause the service provider to include a substantial risk premium in its proposal in order to adequately price such unknown risks. In addition to exceptions related to buried infrastructure, certain subsurface conditions and preexisting environmental conditions are typically not included in the "as-is" risk transferred to and borne by the service provider. These risks include those relating to hazardous waste, archeological finds and subsurface structural integrity, and are generally included in the definition of uncontrollable circumstances.

Maintenance

The service provider's maintenance responsibilities may range from normal, ordinary maintenance to full capital maintenance. The trend, especially in long-term contracts, is for the service provider to have the full range of maintenance responsibilities, ordinary to capital.

In a service agreement that only requires the service provider to perform ordinary maintenance (usually a short-term contract for operation of an existing municipal utility asset), the distinction between ordinary maintenance and capital maintenance is a per incident dollar threshold. The municipality continues to have an active role in the maintenance of the municipal assets, especially in the area of capital maintenance. Typically, the municipality and the service provider will agree on annual capital maintenance projects to be performed by the service provider, but funded by the municipality.

In a long-term contractual arrangement, where capital maintenance responsibility has been shifted to the service provider, the service provider is responsible for performing all asset maintenance, including making all repairs and replacements to such assets for the term of the service agreement. Similarly to the "as-is" risk transfer of responsibility, the service provider cannot effectively propose such capital maintenance services unless it has been afforded a full opportunity to conduct due diligence of the municipal utility assets to be maintained.

The service provider is paid for such capital maintenance through the annual service fee; therefore, the municipality must be diligent in enforcing the service provider's capital maintenance obligations. The enforcement procedures often found in long-term service

agreements that provide for service provider capital maintenance responsibility include periodic asset condition inspections, the keeping of detailed maintenance logs, the reporting to the municipality of capital municipality undertakings, the compliance with a repair and replacement plan and the performance of an asset condition audit at the beginning and end of the term.

*Performance*

In that the service agreement is a performance based contract, the most essential language in the service agreement is that which relates to the service provider's performance obligations, and the consequences for its failure to comply with such obligations. Typically, such consequences are payment of any regulatory fines and penalties as well as liquidated damages.

The most significant performance guarantee is the operation of the municipal assets in accordance with current applicable law. Accordingly, the definition of applicable law should be broad enough to include all laws relevant to the operation of the municipal utility assets.

It is also not uncommon to include in the performance guarantees, standards which are more stringent than the then current applicable law. Often such enhanced performance standards are based on the historical performance of the municipal assets or anticipated near future changes to applicable law.

*Future Capital Improvements*

The service agreement usually provides for the design and construction of capital improvements to the municipal utility assets during the term of the service agreement. Prior to including such provisions in the service agreement, the municipality must be aware of the applicable law governing such matters. In some jurisdictions, such as Massachusetts, any future capital improvement that costs in excess of $100,000 must be bid pursuant to the Commonwealth's "lowest responsible bidder" laws. The service provider may design such improvements, act as the municipality's agent when soliciting bids and serve as the construction manager, but it may not design/build such improvements on a sole source basis. In other jurisdictions, there are no restrictions on the service provider's ability to design and construct any future capital improvements. See, for example, the applicable New Jersey statutes set forth in this chapter.

When structuring the future capital improvements language in the service agreement there are generally three concepts that should be included: future capital improvements at the municipality's election, future capital improvements at the service provider's election and procedures for implementing future capital improvements. In that the municipality is the owner

of the municipal utility assets, it has the right to direct the service provider to design and construct future capital improvements in its sole discretion. Such improvement is generally undertaken at the municipality's sole expense, and any modifications to the service agreement which are necessary on account of such improvement must be negotiated with the service provider. For future capital improvements requested by the service provider, the service provider shall bear the full cost of such improvements and shall not be entitled to any adjustments to the terms of the service agreement. Further, it is common to have any service provider requested future capital improvements approved by the municipality prior to the implementation of such improvements.

The service agreement also usually provides the procedures that are to be followed when the service provider is designing and constructing a future capital improvement. Much of the language in this section is governed by applicable procurement law. Even though a municipality may be able to have the service provider design/build future capital improvements, it is prudent for the municipality to reserve the right to have a third party design and construct such improvements so long as relief is afforded to the service provider due to any changes in any term or condition of the service agreement caused by the services performed by such third party.

*Service Fee*

The service fee section of the service agreement is one of the most essential provisions in the contract because it sets forth the municipality's payment obligation for the operating and maintenance services rendered by the service provider, which is the municipality's primary contractual obligation. Service fees generally may be structured as fixed fees, per unit fees or a combination of the two. If private financing is included in the transaction, the service fee is likely to include a financing component as well.

In that most municipalities finance their municipal utility assets through the issuance of tax-exempt municipal bonds, a municipality must be sure that the service agreement complies with applicable federal tax law. Internal Revenue Service Revenue Procedure 97-13 sets forth the requirements that must be met when entering into a private management contract for bond financed municipal assets. Revenue Procedure 97-13 sets forth various compensation formulas, based on the length of the term of the service agreement, which must be complied with in order that such contract is a "qualified management contract" under federal tax law. An overlying principle in the tax law is that the service provider may not have any interest in the net profits of

the municipal utility assets, and the assets must not be leased to the service provider. A more detailed discussion of IRS Revenue Procedure 97-13 is set forth later in this Chapter.

Beyond the actual fee to be paid to the service provider, the service fee section of the service agreement should also include the mechanics for annually adjusting such fee as well as the mechanics for paying the service provider. In past service agreements, typically the service fee was adjusted based on percentages of various indices. The current trend, however, is to have the service fee component annually adjusted based on the increase in the applicable consumer price index, or a percentage thereof, as may be proposed by the successful service provider.

In determining the proper payment mechanics, it is important to pay attention to the timing of the payments, and how the timing of such payments corresponds to the municipality's payment process. The time by which a municipality has to pay the service provider generally ranges from 30 days to 60 days after receipt of the applicable monthly invoice. A municipality should be aware that the greater the time it has in which to pay the service provider, the greater the increase in costs to the municipality due to the service provider's having to include "carrying costs" in its service fee. At the end of each year, the service provider is usually obligated to prepare an annual reconciliation statement which reviews all payments made by the municipality for the previous year, and provides reconciliation of any payment discrepancies. One final note, it makes it easier to administer the service agreement, especially the municipality's payment obligations thereunder, if the year under service agreement begins and ends on the same dates as the municipality's fiscal year. The initial year's payment can be prorated, as necessary, to accomplish this goal.

*Breach and Events of Default*

Under the terms of the service agreement, either party may terminate the service agreement if an event of default has occurred on the part of the other party. There are generally two types of events of default that are commonly included in a service agreement. First, an event of default which does not require additional notice and an opportunity to cure prior to termination. Second, an event of default requiring notice and an opportunity to cure prior to termination. Such provision requires that, prior to the occurrence of an event of default, the defaulting party must have been given notice of the event which constitutes an event of default, most often a material breach of a party's obligation under the service agreement, and a time period, commonly 30-60 days, whereby, if such breach has not been cured or steps taken by such

party to challenge the claim that an event of default has occurred, the non-breaching party may terminate the service agreement.

In order to provide greater protection to the municipality, the municipality may want to have the right to terminate the service agreement without providing the service provider with any opportunity to cure upon the occurrence of certain events of default, as indicated. These events of default may include the failure to obtain or maintain in full force and effect the applicable security instrument (performance bond, letter of credit or guaranty), the failure to meet certain performance guarantees, the failure to achieve acceptance of the new or improved municipal utility asset by the time specified or the bankruptcy of the service provider or guarantor. The service provider would typically receive relief from each of these events of default due to the occurrence of an uncontrollable circumstance or if such event of default was due to the fault of the municipality.

## IV. REVENUE PROCEDURE 97-13

Management or other service agreements between a state or local governmental entity and a nongovernmental provider of services may cause bond-financed facilities that are governmentally owned to be considered used in the trade or business of the service provider. Revenue Procedure 97-13 established safe harbor guidelines, compliance with which avoids satisfaction of the private business use test under Section 141(b)(1) of the Federal Tax Code. By its terms, the revenue procedure also applies in determining whether a management contract would cause the test in Section 145(a)(2)(B) of the Code to be met with respect to qualified 501(c)(3) bonds. In the discussion that follows, "qualified user" refers to both governmental entities and entities described in Section 501(c)(3).

*Compensation*

Under Revenue Procedure 97-13, the compensation of a provider of management or other services must be reasonable; it must not, in any event, be based in any part on a share of net profits; and it must come within one of the following permitted arrangements:

- *Periodic Fixed Fee Arrangements.* A periodic fixed fee is a stated dollar amount for services rendered for a specified period of time. Such a fee is permitted to be increased automatically according to a specified, objective, external standard that is not linked to the output or efficiency of a facility, such as the Consumer Price Index. Three basic fixed fee formulations, which are characterized most prominently by the required percentage of compensation that must remain fixed,

are permitted by Revenue Procedure 97-13. A fourth is limited to arrangements involving public utility property. These are as follows:

(i) 50 Percent Fixed Fee Arrangements. At least 50 percent of the compensation paid during each year included in the contract term must be based on periodic fixed fees. The remaining compensation (at maximum, 50 percent of the total) could be "incentivized" – *e.g.*, based on a percentage of gross revenues or a percentage of expense mitigation, but not both. Alternatively, the remaining compensation could take account of capitation fees or per-unit fees. In any case, the maximum term of the contract, including all renewal options, must not exceed 5 years, and the contract must be terminable by the qualified user on reasonable notice, without penalty or cause, at the end of the third year of the contract term.

A penalty might include a limitation on the qualified governmental user's right to compete with the contracting service provider or that the user purchase equipment, goods or services from the service provider. Another contract between the qualified user and service provider, *e.g.*, a loan or guarantee by the service provider, might also be treated as creating a contract termination penalty if the terms thereof are not customary or arm's length and could prevent the qualified user from actually terminating the contract. The requirement, effective on cancellation, that a qualified user reimburse the service provider for expenses previously incurred on behalf of such user, or a restriction limiting such user's right to hire key personnel from the service provider would not generally be considered a contract termination penalty.

(ii) 80 Percent Fixed Fee Arrangements. At least 80 percent of the compensation paid during each year included in the contract term must be based on periodic fixed fees. In this case, the maximum term of the contract, including all renewal options, must not exceed the lesser of 80

percent of the reasonably expected useful life of the bond-financed property and 10 years.

(iii) 95 Percent Fixed Fee Arrangements. At least 95 percent of the compensation paid during each year included in the contract term must be based on periodic fixed fees. In this case, the maximum term of the contract, including all renewal options, must not exceed the lesser of 80 percent of the reasonably expected useful life of the bond-financed property and 15 years.

(iv) Arrangements Involving Public Utility Property. If all of the financed property subject to the management contract is one or more facilities consisting predominantly of public utility property, then 20 years is substituted for 10 years and 15 years in the fixed fee arrangements set forth above in (ii) and (iii), respectively.

"Public utility property" is defined by reference to Section 168(i)(10) of the Code which provides that such term means:

"property used predominantly in the trade or business of the furnishing or sale of–

"(A) electrical energy, water, or sewage disposal service

"(B) gas or steam through a local distribution system,

"(C) telephone services, or other communication services if furnished or sold by the Communications Satellite Corporation for purposes authorized by the Communications Satellite Act of 1962 (47 U.S.C. 701), or

"(D) transportation of gas or steam by pipeline,

"if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof, by any agency or instrumentality of the United States, or by a public service or

public utility commission or other similar body of any State or political subdivision thereof."

The phrase "rates ... established or approved by a State or political subdivision thereof" is pivotal to the conclusion that bond-financed utility property that is owned by a State or lesser division of municipal government is "public utility property". Taken literally, it appears to apply to a wide variety of situations.

For purposes of each of the foregoing rules, "contract renewal option" refers to a legally enforceable renewal right which resides in a *service provider* (as opposed to a qualified user). A provision under which a contract is automatically renewed for one-year periods absent cancellation by either party is not a renewal option, even if such provision is expected to be exercised. Also, in the case of arrangements described in (ii), (iii) and (iv), a fee does not fail to qualify as a periodic fixed fee as a result of a one-time incentive award under which compensation automatically increases when a gross revenue or expense mitigation target (but not both) is reached. The award must be equal to a single, stated dollar amount.

· *Per-unit Fee Arrangements*. If the contract has a term no longer than three years and is cancelable by an issuer without penalty or cause after two years, compensation may be based on a clearly specified per-unit fee, *i.e.*, a stated dollar amount payable for each unit of service provided, or on a combination of per-unit fees and fixed periodic fee. Examples of per-unit fees are a stated dollar amount for each specified medical procedure performed, car parked, or passenger mile driven. Separate billing arrangements between physicians and hospitals generally are treated as per-unit fee arrangements.

· *Capitation Fee Arrangements*. A capitation fee means a fixed periodic amount for each person from whom the service provider or the qualified user assumes the responsibility to provide all needed services for a specified period and is

permitted only if the quantity and type of services provided differ substantially from person to person. A capitation fee may include a variable component of up to 20% of the total capitation fee to protect the service provider against risks such as catastrophic loss.

Where all of the compensation to be paid under a service agreement consists only of capitation fees, the maximum term of the contract, including all renewal options (as defined above), must not exceed 5 years, and the contract must be terminable by the qualified user on reasonable notice, without penalty or cause, at the end of the third year of the contract term. Capitation fees may also be part of the mixed compensation stream. If the other portion consisted of periodic fixed fees, the rules governing fixed fee arrangements would apply and, for this purpose, the capitation fees would be considered as under the "incentivized" portion. Similarly, if the non-fixed fee portion of compensation consisted of per-unit fees, the rules governing per-unit fee arrangements would apply and, for example, the maximum contract term would be limited to 3 years.

- *Percentage of Revenue or Expense Arrangements.* In the case of contracts involving the provision of services to third parties (*e.g.*, radiology services to patients) or relating to facilities during an initial start-up period in which on-going annual gross revenues and expenses cannot be reasonably estimated, compensation may respectively be based on (x) a percentage of fees charged or a combination of a per-unit fee and a fee based on a percentage of revenue or expense, or (y) a percentage of either gross revenues or expenses. In either instance, the term of the contract, including renewal terms, may not exceed 2 years, and the contract must be terminable by the qualified user on reasonable notice, without penalty or cause, at the end of the first year of the contract term.

*No Substantial Limitation on Exercise of Rights*

Based on all the facts and circumstances, the service provider must not have any role or relationship that effectively limits the qualified user's ability to exercise its rights,

including cancellation rights, under the contract. This requirement is satisfied if: (i) not more than 20% of the aggregate voting power of the governing body of the qualified user is vested in the service provider and the directors, officers, shareholders and employees of the service provider; (ii) overlapping board members do not include the chief executive officers of the service provider (or its governing body) or the qualified user (or its governing body); *and* (iii) the qualified user and the service provider are not "related parties" under Treasury Regulation §1.150-1(b).

*Arrangements Not Treated as Management Contracts Involving Private Use*

Consistent with Treasury Regulation §1.141-3(b)(4)(iii), Revenue Procedure 97-13 provides that certain arrangements will not be treated as management contracts that give rise to private business use. These are:

- Contracts providing for services that are incidental to the basic governmental function(s) of a bond-financed facility (e.*g.*, janitorial or office equipment repair services).

- The granting of admitting privileges by a hospital to a doctor, if such privileges are available to all qualified physicians in the area, consistent with the size and nature of the facilities.

- A contract for the operation of facilities that consist predominantly of public utility property (as defined above), if compensation is *not* paid for the services of the operator and payments under the contract are limited to the reimbursement of actual, direct expenses and the reasonable administrative overhead expenses of the service provider.

- A contract under which the only payments are to reimburse actual, direct expenses paid by the service provider to unrelated parties.

Recent Revenue Procedure 97-13 Private Letter Ruling

In a recent private letter ruling (PLR), the Internal Revenue Service (IRS) issued its first decision pertaining to a proposed compensation arrangement under a water or wastewater contract since the issuance of Revenue Procedure 97-13. On April 17, 2003, the IRS ruled favorably on a service agreement for the design, construction and operation of a municipality's water treatment assets, allowing such municipality to proceed with its planned tax-exempt financing for development and construction activities of over $200 million.

The primary challenge in structuring the service fee in the project to comply with Revenue Procedure 97-13 involved a significant potential increase of water demand in the developing service areas over the course of the 15-year operation period. Selecting one annual water production level, and paying one related fixed fee, would not have been in the municipality's best interests. The expected variability in the scope of water treatment services over the 20-year contract term had the potential to be the basis for "private business use" issues arising under the service agreement.

Accordingly, the municipality structured the service fee to include three fixed fee "resets" corresponding to three different water production levels at 15 mgd intervals. There is a separate fixed fee payable for each reset level, which fees were competitively established through the procurement process. The service agreement obligates the municipality to select one of the three reset levels and related fixed fees on an annual basis. If actual demand exceeds the selected reset level, a competitively established unit-price for the additional water applies. The "reset" structure is intended to conform to the general principle of a fixed fee for a fixed workscope on a pre-negotiated basis.

As to variable compensation, the service agreement calls for variable payments to the contractor, in addition to those for water demanded above the selected annual reset level, for electricity usage savings and extra chlorine used for supplemental water treatment. In recognition of the possibility that annual variable payments might exceed the 20% limitation in some years, the service agreement contains a "carry forward" provision. If any annual variable payment excess not paid in a prior year can be paid in a future year without violating the 80-20 fixed/variable compensation rule for that year, the variable payment excess which was carried forward can be paid in such future year. This provision protects the contractor in part from the arbitrary denial of compensation for work performed that would otherwise result from a year-by-year application of the 80/20 rule.

The PLR concluded that the service agreement would not cause the bonds to be issued for the project to meet the private business use test under Section 141(b)(1) of the Internal Revenue Code based on all of the facts and circumstances. The IRS reasoned that the fixed fees would constitute at least 80% of the compensation paid to the contractor in each annual period, and that neither the fixed fees nor the variable payments would be based on a sharing of the net profits from the operation of the project. The PLR further confirmed that the reimbursable costs and any payments with respect to capital modifications that are in the nature of capital expenditures for the project were not management compensation under the service agreement. Neither the three fixed fee "resets" nor the carry forward of excess variable payments elements of the service agreement caused the IRS any concern as to the private business use question, nor as to compliance with Revenue Procedure 97-13.

In general, the PLR validates the absence of private business use in a long-term management contract of this nature. It is an unavoidable reality that long-term management contracts will involve additional work to be performed by a service provider, not known in establishing the original fixed fee, as changes in circumstances arise over the term of the contract. In light of the recent PLR, the IRS appears to be comfortable in affirming long-term water and wastewater management contracts as not involving private business use if they adhere to the basic fixed fee/variable fee strictures of Revenue Procedure 97-13 and do not involve private project ownership, leasing or financing or compensation arrangements based on a sharing of net profits from the operation of the facilities.

## V. SECURITY FOR PERFORMANCE

*Parent Company Guarantee*

The primary instrument for securing the service provider's performance under the service agreement is the parent company guaranty. Under the parent company guaranty, the parent company unconditionally guarantees the service provider's performance of its obligations under the service agreement, including its design, construction, operation, maintenance, repair and replacement obligations. The municipality, when seeking a parent guaranty, should look for a parent guarantor that carries an investment grade rating.

Previously, the guarantees provided by parent companies were unlimited. Such unlimited guarantees have posed problematic for parent companies. Thus, the current trend is to have liability limits imposed on such guarantees. A municipality should take care when agreeing to such limits of liability. If limits of liability are included in the guaranty agreement, such limits

should not apply to the payment of liquidated damages, operating losses, third party claims, regulatory fines, indemnity payments, or insurance and performance bond proceeds.

*Construction Performance Bonds*

Construction performance bonds as well as labor and materials payment bonds are often required as security for the design/build of municipal assets due to applicable procurement law, long-standing practice or financing requirements, such as state revolving funds. Construction performance bonds are to assure that the project will be built. Such bonds, unlike the guaranty, do not provide security that the project will perform.

In a design/build or design/build/operate transaction, the construction performance bond may be structured to run from the construction contractor to the service provider with the municipality included as a dual obligee. Such structure reduces the project costs by allowing for only one bond while providing adequate protection to the municipality. Such bonds traditionally only cover the construction of the municipal asset even in a design/build arrangement. Design/build performance bonds are still not generally common in the design/build or design/build/operate industry. It is usually recommended that the surety providing the construction performance bond have an acceptable rating from A.M. Best Company's Insurance Report and be listed in the United States Treasury Department's Circular 570, "Companies Holding Certificates of Authority as Acceptable Sureties on Federal Bonds and as Acceptable Reinsurance Companies".

*Operation Performance Bond*

Operation bonds may be used as security for the performance of the service provider's operation of the municipal utility assets. When used, such bonds usually run from the service provider to the municipality. Similarly as with the construction performance bonds, the surety that is providing such bonds should have an acceptable rating from A.M. Best Company and be listed in the Untied States Treasury Department's Circular 570.6

*Letters of Credit*

Letters of credit ("LOC") provide the municipality with a security instrument that can be drawn upon when the service provider has breached its performance obligations under the service agreement. As such, service providers tend to be reluctant to provide LOC's as security for performance.

LOC during the design and construction tend to be an amount which is set based on the estimated cost of construction. For the operation period, the amount of the LOC is usually equal

to one times the service fee or one-half of the service fee. In that the service providers have raised concerns on the amount of the LOC, and the corresponding liability that such LOC places on their balance sheets, the trend is to set the amount of the LOC at a level which will provide resources to the municipality in the event of service provider non-performance, but not so high as to impose unreasonable liability upon the service provider.

The service agreement should set forth the requirements of the LOC as well as the drawing rights of the municipality. It is important for the municipality to actively monitor the service provider's obligation to annually renew the LOC. Service agreements typically provide that the LOC may be drawn upon if not renewed within a set period of time, such as 30 days, prior to the LOC's contractual date of renewal. The failure of the service provider to maintain the LOC, or any other security instrument required under the service agreement, may allow the municipality to terminate the service agreement.

## VI. LABOR

Many design/build/operate projects are for the upgrading and operation of an existing municipal utility asset. In such transactions, the public employees operating such assets often become employees of the service provider upon the commencement of the operation of such utility assets by the service provider. In such transfers, the industry standard is that the public employees will receive equivalent or better wages and benefits from the private employer than it did from its public employer. Further, the private company is generally obligated to recognize any applicable labor unions and collective bargaining agreements.

Some states have certain procedural steps that must be followed before services that are performed by public employees may be "contracted out" to a private company. One of the leading cases addressing this subject is from the State of California.

In Professional Engineers v. Department of Transportation, 15 Cal. 4th 543 (1997), the California Supreme Court reasoned that the implied mandate arising under the civil service provision of the State's Constitution limited the State's ability to contract with private entities to perform services that the State has historically or customarily performed. The Court held that the purpose of this "civil service mandate" is to encourage efficiency and economy in State government, and to eliminate the "spoils system" of political patronage by ensuring that demonstrated fitness, rather than political consideration, spurs all appointments to public service. The "civil service mandate" prohibits contracting out services traditionally performed by civil service employees unless the services cannot be adequately or competently performed by those

employees. The Court noted that there are, however, four exceptions to the civil service mandate: (1) the nature of services test; (2) the new function test; (3) experimental programs; and (4) cost savings. The California Supreme Court recognized that courts should usually apply these tests on a case-by-case basis, evaluating particular contracts rather than entire areas of operation such as "engineering" or "project development."

Nationally, there are generally three different standards that are applied when reviewing whether services performed by public employees may be "contracted out" to a private company.

*The "Nature of Services" Test*

Under the "nature of the services" test, the court will inquire as to whether the nature of services contracted to private firms for provision of state services is such that they could have been performed by civil servants; if so, the agency must proceed under the civil service mandate.

*The "Bad Faith" Test*

Under the "bad faith" test "privatization violates civil service laws only if the employer acts in 'bad faith' or with intent to circumvent the civil service laws." Under this approach, a public employer whose motive is economic efficiency is generally considered to act in "good faith". However, efficiency is almost always the justification given for privatization. Therefore, civil service laws are effective against privatization only in the rare instances in which there is actual proof of improper intent/motive.

*The "New State Function" Test*

Under the "new state function" test, courts will ask whether the services contracted to private firms for the provision of state services displace existing state civil service functions or, instead, embrace a new state activity or function. The constitutional policy of a merit employment system does not prohibit legislative experimentation in new forms to fit new functions.

## VII. EXECUTIVE ORDER 12803

Executive Order 12803[*] of 1992 was promulgated to lessen the federal restrictions related to the disposition of infrastructure assets which were funded with federal grant proceeds to encourage the privatization of such assets. The Executive Order defines

[*] *For reference on Executive Order 12803 and more information regarding "Guidance on Privatization of Federally Funded Wastewater Treatment Works", please read EPA-832-B-00-002, August 2000, which is available on http://www.epa.gov/owmitnet/cwfinance/cwsrf/.

privatization as "the disposition or transfer of an infrastructure asset, such as by sale or by long-term lease, from a State or local government to a private party." The United States Environmental Protection Agency ("EPA") has set forth guidelines as to how the requirements of such Executive Order may be applied to federally funded wastewater projects. Accordingly, when a municipality is structuring a design/build/operate transaction, it must be aware of the requirements of Executive Order 12803, and the terms of any federal grants received in connection with the construction of its municipal utility assets.

If as a result of the design/build/operate transaction there is a disposition of a federal grant funded infrastructure asset, the municipality must request and receive approval from the EPA prior to entering into the proposed contractual arrangement as well as receive a deviation from the applicable federal grant regulations relating to the disposal of federally grant funded assets. The Executive Order does allow state and municipal governments to receive the proceeds from any such privatization prior to any federal claim for repayment of federal grant funds. Federal grant funds are only required to be repaid by a state or municipal government if any disposition-related payment exceeds municipal and state investment, and then, only at the federal grants depreciated value. For design/build/operate transactions which do not include a disposition of the federal grant funded assets, such as contract operations, there is no requirement for a municipality to receive EPA approval for compliance with Executive Order 12803.

Contract operations agreements are defined as agreements that include operations, maintenance, repair, replacement and management services, and may include asset investments by the service provider. Contract operations agreements are the more typical arrangements that municipalities enter into when seeking public-private partnerships to improve municipal utility assets-related services.

## VIII. PROJECT LABOR AGREEMENTS

A Project Labor Agreement ("PLA") is a pre-hire agreement negotiated between a municipality and local unions that are involved in a particular construction project that establishes common work rules for an entire construction site. The primary purposes of PLAs are to eliminate delays, ensure a steady supply of skilled labor and provide a means of resolving union construction issues. These types of agreements are favored by construction project owners because PLAs avoid delaying the project by utilizing procedures to address labor issues that last for the duration of the project. Thus, PLAs address issues important to a municipality, including its need for predictable costs and a steady supply of skilled labor.

These agreements are often used in large, complex, and time-sensitive construction projects because they standardize the construction project terms. One major advantage of PLAs is the streamlined negotiation process of having only one set of employment terms for all employees that the municipality hires. Consequently, this approach ties in all different trades and contractors in accomplishing overall project goals rather than respective individual tasks.

Typically, unions negotiate exclusive collective bargaining agreements for all union and non-union employees working on a project. Although union hiring halls are used exclusively during this process, the unions cannot discriminate on the basis of a worker's union or non-union status. The terms most often used in PLAs deal with grievance procedures, wages, hours, working conditions and work schedules. The most important term in PLAs, in general, is the requirement that all unions agree to a total ban on strikes, work slow downs, and other disruptive activities for the life of the agreement.

On February 17, 2001, President George W. Bush issued Executive Order No. 13202 (subsequently amended on April 4, 2001 by Executive Order 13208) entitled, "Preservation of Open Competition and Government Neutrality Towards Government Contractors' Labor Relations on Federal and Federally Funded Construction Projects." Executive Order 13202 reverses former President Clinton's policy of promoting union-only PLAs on federally funded construction projects. Although the legality of this Executive Order was challenged at all levels of the federal courts, the Supreme Court upheld its legality on January 27, 2003.

Executive Order 13202 provides that government agencies shall be "neutral" towards PLAs in that such order prohibits executive agencies from requiring bidders or contractors to adhere to PLAs and from discriminating against bidders for declining to adhere to such agreements. The order further provides that executive agencies "issuing grants [or] providing financial assistance . . . for construction projects, shall ensure that neither the bid specifications, project agreements, nor other controlling documents for construction contracts awarded . . . shall contain any of the requirements or prohibitions" relating to a bidder's ability to adhere to or refrain from entering into PLAs.

Funding for construction projects are administered by various federal agencies and state agencies distributing federal funds on behalf of federal agencies which may be affected by Executive Order 13202. It would be wise for a municipality to review its project funding sources

to determine the effect of Executive Order 13202 prior to having a PLA included in a transaction.

## IX. BINDING FUTURE BOARDS

An issue often arises in connection with the execution of the service agreement as to whether the current municipal legislative body may enter into a multi-year contract which binds future legislative bodies. The general rule is that, unless specifically provided by statute or charter provisions, one municipal legislature may not bind the hands of its successors in areas relating to governmental or legislative matters. The exception to the general rule, however, is that contracts in an area relating to proprietary or corporate matters are not limited to the term of the present legislature. The determination of whether a municipality is engaged in a governmental or proprietary matter is a question of law and is decided by a trial judge. In addition, each matter is decided based on the specific facts of each case.

Generally, the following governmental duties have been accepted as a governmental matter in most jurisdictions:

(1) establishment and maintenance of schools, hospitals, parks, day care programs, employee personnel files, fire department and police department;

(2) collection of garbage;

(3) controlling animals running at large;

(4) control and regulation of bus companies;

(5) discharging of civil service employees;

(6) construction of waste disposal systems; and

(7) some jurisdictions recognize the following as a governmental matter: the operation and maintenance of a municipal airport; the cutting of tree limbs; road work; and failure to redesign a sidewalk area adjacent to a market.

In addition, the following corporate functions are generally accepted as being corporate/proprietary matters:

(1) construction and maintenance of municipal water and light plants;

(2) measuring and marking of the boundary lines of property owners;

(3) snow removal operations;

(4) hauling and distribution of sand needed for municipal purposes;

(5) construction and operation of garages and parking facilities for motor vehicles;

(6) generally, the management of property owned by the municipality; and

(7) any business conducted by the municipality for profit; however, acts incident to the operation of a business may be governmental in nature.

Accordingly, the municipal corporation's attorney must review the relevant common law of the state to ensure that a multi-year contract contemplated by the municipality will bind its legislative successors.

## X. BID OR PROPOSAL PROTESTS

Bid or proposal protests result when an interested party to a bidding or proposal process challenges either the procedural or substantive requirements of such process. An aggrieved bidder/proposer, a taxpayer or an organization representing taxpayers' interest generally have a legal standing to bring such an action (i.e., Article 78 Proceeding in New York) against a public body or office pursuant to applicable law to challenge alleged illegal procurement procedures or results.

One general ground for such an action is where the body or officer failed to perform a duty enjoined upon it by applicable law. This is the classic writ of mandamus to compel the performance of a duty that is merely ministerial in nature and involves no exercise of judgment or discretion. Another ground for such an action is where a determination was made in violation of lawful procedure, was affected by an error of law or was arbitrary and capricious. Such claim is the classic writ of certiorari to review whether the determination was based on a sound basis in reason and with regard to the relevant facts.

Bid or proposal protests under applicable law are not without any limitations. An interested party generally must bring such an action within the prescribed period allowed by the applicable statute of limitations. For example, in New York, an Article 78 Proceeding must be commenced within four months after the determination being challenged becomes final and binding upon the petitioner. Accordingly, the statute of limitations generally begins to run when the determination becomes "final and binding."