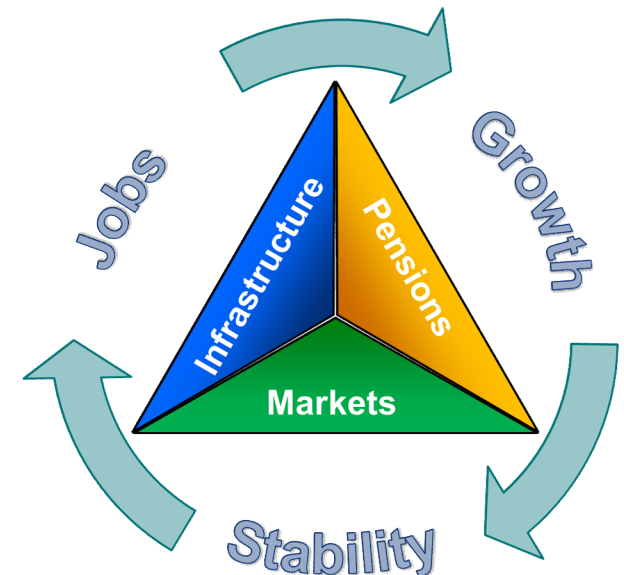


# Asset Contributions In Lieu Of Cash – Asset-In-Kind

*Using Municipal Assets to Address Pension Underfunding*

Keeping Public Assets under Public Stewardship for Public Benefit



September 2018

# **Significant Competition For Available Cash**

# Significant Competition For Available Cash

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- **Debt** – Municipalities had \$322 Billion of long-term bonded debt in 1980 rising to \$2.9 Trillion by 2015<sup>1</sup> – total debt (short & long-term) approximately \$3.9 Trillion
  - Shifted away from general taxes and G.O.'s to user fees and Revenue Bonds
  - Heavier dependence on Voter Referendum
  - Pension Bonds and Asset Monetization often considered
- **Municipal Expenditure Growth** outpacing revenues
  - Public Safety
  - Services
  - Health care costs
  - Pension costs crowding-out program spending
- **Public Pensions** by Fed estimates underfunded by \$1.7 Trillion<sup>2</sup> – Others have range as high as \$2-3 Trillion
- **Nearly \$2 Tr Infrastructure Gap** – Balancing budgets by deferring maintenance and infrastructure investments



# Limited Traditional Options

# Limited Traditional Options

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- **Revenue Initiatives**

- Income Taxes
- Sales Taxes
- Real Estate Taxes
- Direct User Fees
- Fees

- **Cost Cutting**

- Wage and hiring freezes, furloughs
- Reduction in services
- Consolidation

- **One Shots**

- Scoop and Toss
- Securitizations
- Pension Obligation Bonds



# Asset Transfer – A Different Approach to Consider

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- **Asset Contribution In Lieu of Cash – The Use of Asset-In-Kind (AIK) - *Public-Public Partnerships (P2Ps)***
  - Municipal Governments own and operate a wide variety of assets and services
  - Many of these activities have counterparts in the private sector
  - Many represent assets that have real value
  - A Public-Public transfer through AIK would help Municipal Governments realize that value
    - De-Politicize/Reform pricing and delivery of infrastructure services
    - Generate savings via performance-driven management of construction, operations, life-cycle investment, etc.
  - Capture “***Hidden Wealth***” of assets carried at “cost less depreciation” pursuant to an auction sale/concession or an asset in-kind contribution at appraised fair market value



# **Keeping Public Assets in the Public Domain – Public to Public Transfer**

**Making Public Pension Funds Part of the Solution**

# Public Pensions Transforming Public Assets

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*Larger Public Pensions are active investors in “Alternative Investments” including Infrastructure; however, because access to U.S. infrastructure is highly limited, most investments are abroad*

**Public Pensions, together with Private Partners, have a fiduciary responsibility to drive value and Transform Public Assets into strong investments**

- Public Pensions are looking for long lived, “Core Infrastructure” assets
- Fiduciary obligation to pensioners to maintain and find assets that increase in value
- Growing appetite for direct investments; however, ill equipped to compete in auctions
- Pension look to own infrastructure in a managed fund or directly with outside asset manager
- Experienced asset manager is responsible for driving value and transforming public asset into strong investment





# Public Pensions Are Increasingly Infrastructure Investors

*Infrastructure offers investors several portfolio enhancing features: Asset/Liability Matching – Low Market Correlation – Limited Risk of Competition – Inflation Protection*

- **States & Municipalities** – Own 85% of public infrastructure, largely core:
  - Utilities – Over 90% of 50,000+ water, nearly all wastewater, and over 2,000 electric
  - Vast majority of toll facilities
  - All commercially served airports, except one, and most ports/
  - Education facilities, including student housing
- **Core U.S. Infrastructure** – Offers lower risk & attractive returns (No Currency/Country Risk)



# Fusing Best Practices to Create Powerful Solutions

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*AIK aligns interests and avoids the pitfalls of privatization – Pairing public control of monopoly-like assets & benefits of private management: synergy savings, innovation and business discipline*

## US Experience with AIK

- It is not uncommon for corporations to contribute assets to their pension funds under strict ERISA rules
- New Jersey transferred the State Lottery to the Pension Fund (est. value: \$13 Billion)

## ERISA Model

- Public pensions are not subject to ERISA, however, like ERISA plans they are subject to the “prohibited transactions rule” and must follow similar procedures to assure that any transaction between related parties is deemed clearly to be “arms length transaction at fair market value”

## Proof of Concept – AIK Works and Can Work Very Well for Public Assets

- Although novel approach for US Municipal Government, AIK Contribution proposal is built on well accepted business practices: 1) Corporate ERISA Standards for Related Party Transactions, 2) Public-Private Partnership (P3) Structures and 3) Alternative Investment Strategies for Public Pension Funds
  - **Queensland’s** AIK of tolled motorway to pension plan reduced unfunded liabilities when contributed as well as when sold for more than twice its original value few years later
  - **New Jersey Lottery** demonstrated stakeholder support for AIK to public pensions and the reduction in unfunded liabilities, freed up budget resources for other needs
  - **Indianapolis W&S Utilities** sale to Citizens Energy, the local gas utility, created \$900 million in savings over 50 years, half of which was recycled into new infrastructure investments



# **How Others Have Responded**

# Queensland Australia Motorway Asset Transfer

*In-Kind Contributions are not uncommon in corporate finance or abroad —  
Queensland is a great example of its application for public plans*

**Queensland, Australia.** On May 2011, the State sold Queensland Motorways (QML), 70 km tollroad network in Brisbane metro area, to Queensland DB Fund for **AUD\$3.1 billion** per negotiations with QIC, the Fund's asset manager — In 2014, QIC sold QML for **AUD\$7.1 billion** — *Gain of AUD\$3.8 billion or 2.1 times*

**Commercialization.** QIC transformed public agency into a business focused on better management, earnings, & growth— upgraded service, systems, & risk management —  
***Immediately increased earnings 37%***

**Expansion CapEx.** Built genuine regional tollroad network via acquisitions and improvements

- Savings from improved Capital Execution, Synergies & Scale
- Greater Infrastructure Investment

## **Across the Board Benefits**

- Better Service & Quality
- Lower Overall Cost Burden
- Political **“Win-Win”**



# New Jersey Lottery Transaction

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Landmark Transaction — First municipality to transfer an asset of this magnitude (**\$13.5 Billion**) for the benefit of its public pension systems

**Overwhelming Bipartisan Support.** Passed legislation and signed “memorandum of contribution” in July 2017 to irrevocably contribute NJ Lottery to pensions for a 30-year term



- **State’s 4th Largest Revenue Source.** Net \$1 billion annually
- **Fair Market.** Actuary’s DCF estimated value at **\$13.5 billion**
- **Pension Funding.** AIK dramatically improved funding ratios, replacing unsecure IOU
- **Irrevocable Contribution.** While no legislature can bind a future legislature, an irrevocable transaction based on Federal Tax Code’s “Exclusive Benefit Rule”, which is also State law

**Application.** Developed a new actuarial technique to set annual required contribution (ARC)

- **Pension Funding.** Lottery Enterprise is treated as a special asset, necessitating an annual adjustment (credit) to the ARC — Initially budget neutral, it shifts to level credit over time
- **Upfront Funding.** Similarly, can structure front-end budget relief and earmark pension cost savings to new infrastructure investment
- **Over-Time Funding.** Using level credit approach to the special asset adjustment, can fund infrastructure investments on pay-go or with bonds (matching debt service and credits)



# New Jersey Economic & Fiscal Policy Workgroup - NJEFPW

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## – NJEFPW

- Created as a Bi-Partisan Effort by the Assembly and Senate of the State of New Jersey
- Co-Chairs:
  - Senator Paul Sarlo – Chairman, Senate Budget and Appropriations Committee
  - Senator Steven Oroho – *Senate Republican Conference Chair*
  - Assemblyman Louis Greenwald – *Assembly Majority Leader*
- Included Legislative Members and Non-Legislative Member experts

## – Subcommittees

- Five subcommittees which developed recommendations in the following categories:
  - Pension & Benefit Reform
  - Leveraging Assets to Stabilize the Pension System
  - Education Reform at the Administrative Level
  - County & Municipal Government Reform and Shared Services
  - State and Local Government Tax Structure



# New Jersey Economic & Fiscal Policy Workgroup - NJEFPW

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## **Leveraging Assets to Stabilize the Pension System Subcommittee**

- The subcommittee on Leveraging Assets to Stabilize the Pension System made the following recommendations:
  - Explore the viability of transferring major assets such as the New Jersey Turnpike system to the State pension system to lower the unfunded liability and generate new revenue streams for the pension system.
  - Develop an inventory and establish values of State assets and study those assets to evaluate which are best suited for dedication to State pension funds. The State could also provide funding and/or technical assistance to local governments that are interested in the concept of transferring their assets as a form of pension contribution.
  - Develop legislation to lay the framework for any future public asset transfer. The legislation would outline the authorization process and transfer procedure as well as permit the creation of limited liability companies that could be delegated the power of the governmental entity to operate the asset. It would also set forth a procedure for local governments to dedicate local assets in lieu of cash pension contributions



# Conclusion



# Making Public Pension Funds Part of the Solution

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## Solving Complex Problems Requires Developing a Guiding Strategy – Addressing Multiple Problems – Avoiding Financial Gimmicks and “One Shots”

- **Problem** – Budgets, Pensions & Infra are financial challenges at all levels of government
- **Traditional Responses** – Scoop and toss, higher taxes & fees, more debt, Risk Avoidance, rarely innovative, etc.
- **Vision** – Asset *In-Kind Contribution* to pension addresses challenges by transforming public assets into sound long-term investments — ***Creating Value through Entrepreneurship***
  - **Strategy** - Transfer assets to pensions and engage private experts to drive value through *innovation, business discipline* and *strong accountability* as well as a *modern rate regime*
  - **Addressing Problems** - Growing earnings and asset valuations can help offset rising pension costs and finance critical infrastructure
  - **Operating and Management Improvements** - Sound business practices (Regular Maintenance, Technology and Life-Cycle Management) will strengthen assets and provide improved services
  - **Drive Value** –
    - Operating Efficiencies driven by economies of scale, technological investment and innovation, better management
    - Capital Project planning, implementation and optimization
    - Revenue Growth



# Making Public Pension Funds Part of the Solution

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## Solving Complex Problems Requires Developing a Guiding Strategy – Addressing Multiple Problems – Avoiding Financial Gimmicks and “One Shots”

### ■ Benefits –

- **Pensions** - Recognize the value of the enterprise in calculating the market value of its asset. Future increased asset value reduces pension UAAL - AIK preserves economic upside
- **Budgetary Relief** - Improved pension funding ratios will lower current and future annual required contributions – freeing resources for other priorities
- **Ratings** – improved funding levels should improve municipality’s credit ratings
- **New Infrastructure Investments** – resources freed for new investments

### ■ Types of Assets –

- **Municipal Utilities**
- **Toll Facilities**
- **Private Sector Comparable**
- **Revenue Generating Asset**
- **Underperforming Asset**

- **Key Take Away** – Asset In-Kind Contribution is NOT a “silver bullet;” but, budgetary stability, stronger pensions and better infrastructure are key ingredients for economic growth and more JOBS



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## *Endnotes:*

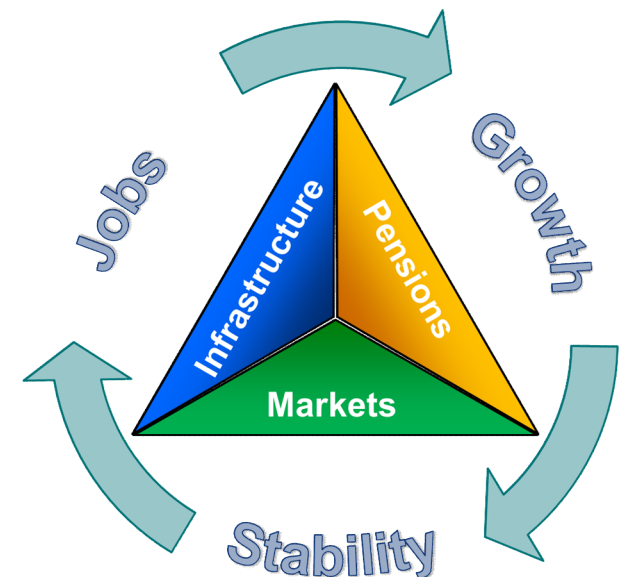
- <sup>1</sup> Federal Reserve System (2016), “Federal Reserve Statistical Release: Z.1 Financial Accounts of the United States,” Table L212, March 10, 2016.
- <sup>2</sup> Federal Reserve System (2016), “Federal Reserve Statistical Release: Z.1 Financial Accounts of the United States,” Table L120, March 10, 2016.



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