PRIVATIZATION
RESOURCE GUIDE
and
STATUS REPORT
(Revised Draft)
November 1995
PREFACE

This is the second privatization resource guide and status report prepared by the National Performance Review (NPR). The first was published in draft on February 13, 1995. Once again, it is designed to give federal managers, employees and private sector interests a sense of the Federal management environment and a common understanding of the privatization terms and options. This guide is a compilation of selected information about reinvention and privatization concepts--who is doing them, what documents might be of interest, implementation strategies and constraints.

From its inception in early 1993, the NPR has focused on four powerful reinvention themes:

- Putting Customers First,
- Cutting Red Tape,
- Empowering Employees To Get Results, and
- Cutting Back to Basics.

Further, the NPR has promoted a new cultural environment within the Federal establishment that will:

- Create a clear sense of mission,
- Steer more and row less,
- Delegate more authority and responsibility,
- Help communities solve their own problems,
o Replace regulations with incentives,
o Develop budgets based on outcomes,
o Inject competition and choice into everything we do,
o Search for market not administrative solutions, and
o Measure our successes by customer satisfaction.

This background is critical to an understanding of the Administration’s overall approach to reinvention and the role that privatization can play in it. To the extent that privatization implements these principles, it can be an important tool of reinvention. As a term, the word “privatization” has been used with many meanings and, at times, interpreted according to the special interests of the user. Generally, privatization refers to a range of different combinations of governmental and private ownership and operational control. It has been used to describe asset sales, the conversion of work from in-house to contract performance, the formation of Government Corporations, the use of vouchers and decisions to terminate particular government services. In each case, the process of “privatization” describes an increasing level of competition and choice.

In the past, discussions of privatization have all too often implied that private-sector employees were somehow better than civil servants, and that Federal work should be converted, as a matter of principle, to the private sector whenever possible. That implication is false. The Vice President's September 1995 report on NPR to the President and the American people, Common Sense Government: Works Better Costs Less, details the progress being made by Federal employees to meet reinvention and cost effectiveness goals and evidences the excellence of which Federal workers are capable.

Privatization, as used here, is the process whereby the Government actively reassesses its role in the economy, seeks the appropriate mix of in-house and contract resources and expands the opportunities for competition and choice in the performance of all its activities.

This resource guide is organized into ten chapters, which address individual privatization options available to Federal managers, and six appendices which outline special problems or provide additional resource materials. This guide is not, nor should it be construed to present any official policy of the United States Government or convey rights or obligations upon any managers or Federal or private sector employees. It is provided for informational purposes only.

Questions regarding this document may be addressed to Mr. Robert Dodge, National Performance Review, at (202) 632-0185, or to Mr. David Childs, Office of Management and Budget, at (202) 395-6104.
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CHAPTER 1

PRIVATIZATION OVERVIEW

Privatization can take many forms. For example, the lead story in the Vice President’s Third Report of the National Performance Review, “Common Sense Government: Works Better and Costs Less,” (September 1995), is about Bill Freeman, the Occupational Health and Safety Administration's (OSHA) man in Maine. Freeman's inspection team won award after award for finding and then fining local companies for worker safety violations, yet he knew that injury rates were not improving. So he sat down with the companies with the most injuries, and negotiated special agreements that would really work. Now, the companies' own workers are finding and fixing 14 times as many hazards as Freeman's people could have found. Worker injuries are dropping, and it's costing the companies involved less in lost production, workers’ compensation and fines. What Freeman did was to effectively privatize the function, through the establishment of proper incentives.

Americans want to “get their money’s worth” and want a Government that is more businesslike and better managed. The reinvention of Government begins by focusing on core mission competencies and service requirements. Managers must begin by asking some fundamental questions like: why are we in this business in the first place? Has the industry or mission changed so that our involvement in this business or our current level of involvement is no longer required? Is our approach to accomplishing the mission still cost effective? Finally, if the activity is a commercial activity and there is a sense that the Government has a legitimate role to play in performing that activity, are we prepared to compete head-on with the private sector for the right to continue to provide that service or product?

Thus, the reinvention process must consider a wide range of options, including the consolidation, restructuring or reengineering of activities, privatization options, the adoption of better business management practices, the development of joint ventures with the private sector, asset sales, the possible devolution of activities to State and local governments, the termination of obsolete services or programs and, in Bill Freeman’s example, the development of new and creative public-private partnerships. These options empower managers to make sound business, quality and performance decisions. Taken in this context, privatization is not simply an ideological preference for strict reliance on the private sector, but represents a wide range of important reinvention options that are available to Federal managers to meet their mission requirements in a cost effective manner.

What follows is a quick review of privatization options organized into four categories:
1. ASSET SALES

This category of privatization is the most generally recognized. It involves a Government decision to exit a business line or a part of a business line, through the sale of assets or current operational capabilities. Examples include the proposed sale of the Naval Petroleum Reserves, National Helium Reserves, the United States Enrichment Corporation, and the Power Marketing Administration.

Executive Order 12803 was issued to encourage privatization of federally financed infrastructure assets by states and local governments. The Order requires proceeds of sale of infrastructure assets be distributed first to state and local governments for project costs, then to the federal government for the grant amount—less accumulated depreciation—and to use any remaining equity for new or expanded infrastructure, debt or tax relief.

2. OUTSOURCING

There are three different types of outsourcing to be considered, as follows:

(a) REPROCUREMENT. This involves the decision to continue to procure products or services from private sources or to purchase new or expanded requirements directly from the private sector without cost comparison. Reprocurements are governed by the Federal Acquisition Regulations (FAR);

(b) FRANCHISING. Franchising refers to the enhancement of competition and choice in the provision of products or services through non-mandatory interagency support agreements, often through a combination of in-house and contract resources. It seeks the most cost effective Government provider of a service, and

(c) CONTRACTING OUT/IN. Conversion of work to or from in-house or contract performance must be in accordance with the cost comparison requirements of Section 5.g. of the Federal Workforce Restructuring Act (P.L.103-226) and OMB Circular No. A-76, “Performance of Commercial Activities.”

3. DIVESTITURES AND TERMINATIONS

This category of privatizations includes government decisions to divest equity shares or management control of existing government entities, such as Amtrak, or the proposed elimination of the Government Printing Office. It can also include the shedding of functions from strict government performance responsibility through formation of new or quasi-governmental corporations or government sponsored enterprises (GSEs), such as the National Weather Service or the proposed Air Traffic Control Corporation.

4. USING INCENTIVES TO DELEGATE DECISION-MAKING TO
PRIVATE ACTORS

Joint ventures, as discussed in Chapter 7, fundamentally changes the way government does business. Disposing of government-held assets through incentivized joint venture agreements is one example.

Vouchers, which also rely on competition and private choice, also fit into this category. Recipients are given the resources for which they are eligible in the form of vouchers. With a minimum level of oversight, the vouchers are used to make market-based decisions in the best interests of the recipients. Often, the use of vouchers results in a significant restructuring of an existing public service. For example, instead of the government providing public housing, with its associated construction, management and operational responsibilities, vouchers rely on the decisions of assisted tenants in the private sector market.

There are impediments, both legal and regulatory, to many of the privatization options available. A listing of legislative barriers to contracting out is provided at Appendix A. The work has begun, however, to eliminate many of these impediments or, at least, to make them less burdensome. Executive Order 12861 directed that internal Federal regulations be reduced by not less than 50 percent, over the next 3 years. The goal of this reduction effort is to "...weed out needless regulations so that: (1) the outcomes to be achieved are clearly articulated; (2) responsibilities for decision making and action are clearly assigned; (3) a direct and objective measurement of accomplishment exist; (4) oversight can shift from process to outcome; (5) there is a clear understanding of the fiscal and ethical propriety required in public administration; and (6) the remaining regulations and requirements for uniformity are given the highest priority."

Improvements and new initiatives are being implemented. Among the most notable are the following:

- Wright Patterson Air Force Base, needed a housing facility. Rather than obtain Military Construction funding, however, an RFP was issued to the private sector for the construction and operation of an on-base temporary housing facility. The Government provided the land, since they wanted special and easy access, but made no guarantees as to durations of stays or occupancies. Surprisingly, the private sector was ready and willing to invest its funds to meet the Air Force’s capital investment needs - the result being that there is now a non-mandatory use facility on the Base built and operated entirely by the private sector.

- The Franklin Area Waste Water Treatment plant in Franklin, Ohio, was recently sold for $6.8 million, to Wheelabrator EOS, Inc. The transition marks the first public-private partnership involving the sale of a Federally-financed municipal waste water treatment plant. Executive Order 12803, signed in 1992 by President Bush, and Executive Order 12893, signed in 1994 by President Clinton, were designed to encourage private capital investment to help municipalities and cities meet growing infrastructure needs.
The Commission on Roles and Missions of the Armed Forces issued its May 1995 report. The report cites a number of potential privatization opportunities within DOD. For example, the report suggests that all new support requirements; wholesale level warehousing, distribution, and weapon system maintenance; property control and disposal, and incurred-cost auditing of DOD contracts be considered for outsourcing. It also recommended that activities in family housing, base and facility maintenance, and data processing be outsourced, and advocated choices between military and civilian medical care for DOD health care beneficiaries.

The initiatives of OPM Director James King have introduced new creativity and meaning into Federal privatization discussions. On July 1, 1995, OPM's training operations were terminated. In an effort to minimize the adverse impact of this decision on employees, OPM arranged to have its training employees transferred to the USDA Graduate School, a non-appropriated Fund Instrumentality, to the Brookings Institution, and elsewhere. The USDA Graduate School is completely self-supporting, and employees are not part of the Federal workforce. The initial feedback from these former civil servants has been very positive.

OPM also made a decision to terminate its background investigations services. Again, in an effort to minimize the adverse impacts of this decision on employees, OPM has forged ahead with the development of an Employee Stock Ownership Plan (ESOP). OPM awarded a market feasibility study and has just recently awarded a contract for the development of final arrangements for the development of necessary corporatization requirements and the establishment of a Trustee for the formation of a 100 percent employee owned and operated background investigations company. (See Chapter 5).

There have been numerous meetings, focus groups, and seminars held throughout the year for Federal employees on the subject of privatization and subordinate topics such as outsourcing. Two in particular were sponsored by the National Council on Public-Private Partnerships, in cooperation with the NPR and OMB. These were held on March 30-31 and September 18-19, and were unusually well attended by Federal employees seeking a broader understanding of the concepts and the realities.

A highly successful "1995 Franchising Workshop" was held June 12-13, covering the "How To's" of franchising. Draft Franchise Fund Implementation Guidance was also distributed at the Workshop and used as a working text. To help coordinate the ongoing dialogue between potential service providers and users, a Directory of Reimbursable Government Services has been developed and is available on the Internet (http://www.gsa.gov/pubs/owi/fraindex.htm). Many services are covered including: finance, information technology, legal, logistics, mail, organizational development, payroll, personnel, printing and reproduction, property, security, telecommunications, training, dispute resolution, employee health care, engineering, environmental, and facilities. Agencies may also contact Phil Labonte, GSA/CASU Program, at (202) 273-4660.
The long awaited proposed revisions to the OMB Circular A-76 Supplemental Handbook were issued for agency and public comment (see Federal Register Notice, dated October 23, 1995 page 54394). The proposed revisions are designed to enhance Federal performance through competition and choice. They seek the most cost effective means of obtaining commercial support services and provides new administrative flexibility in the Government's make or buy decision process. A summary of these changes is provided at Appendix C.
CHAPTER 2

REINVENTION

The National Performance Review’s first year reinvention effort (referred to as NPR Phase 1), dealt primarily with the first three principal reinvention themes: Putting Customers First, Cutting Red Tape, and Empowering Employees to Get Results. All three of these have a common thrust in that they deal with improving current operations and the processes of Government, i.e., how can the Government get its job done better. The fourth theme—Cutting Back to Basics, deals with what Government does and who should do the work.

Cutting Back to Basics means taking a hard look at the things which government does and determining what changes to make in Federal programs and functions, if any. It also means moving the service delivery capability to the most effective provider and putting incentives into place to bring about the desired results.

In many ways, the current dialogue for cutting back to basics and for privatization originated at President Clinton's December 19, 1994 press conference in which the OPM Director, the Administrator of the General Services Administration, and the Secretaries of the Departments of Energy, Transportation, and Housing and Urban Development introduced an array of initiatives to improve service delivery and reduce costs. Building on the innovations introduced, the Vice President held a meeting with all agencies on January 12, 1995, at which he introduced the decision framework illustrated in Exhibit 2.

How do you sort through programs and functions to make these considerations? First, a determination is required that the program or function is critical to the agency’s mission. Functions that are not critical should be considered for termination or, if termination is not feasible, for performance by some other entity that may bring special expertise or efficiencies to the performance of the activity.

Second, and as shown in Exhibit 2, a determination must be made as to whether the function could be transferred to the state or local level, which may also involve some joint partnership on a short-term or continuing basis. Again, some aspects of "privatization" may emerge, as State and local governments work to accept these responsibilities.

The third factor involves creating the necessary risk and incentives to ensure both short term efficiencies and long term service improvement. Competition increases risk, so as to keep managers on their toes to improve performance and creates proper competitive pressures to control costs. This can be accomplished through a number of outsourcing techniques, discussed in this guide.
In a strict sense, cutting back to basics implies that the government is currently providing the service, but no longer sees the need to be in direct control of its provision, operations or maintenance. Privatization reflects the sale of assets and related service requirements (rights) by the Government. However, it also includes assumptions that services are necessary and must be provided in the future. It is rarely simple divestiture. The sale agreements themselves establish and refer to the regulatory and oversight environment that will continue to exist to assure that public and/or agency access and service requirements are maintained.
INSERT

Exhibit 2. Decision Table
CHAPTER 3

INHERENTLY GOVERNMENTAL FUNCTIONS

Public and private perceptions as to what the Federal Government's role is and what services or functions should be provided by the Federal Government are changing. In the process of reinventing and downsizing, more and more interest is being given to the array of available options to meet mission and administrative support requirements. These include performance by Federal employees, through business-like revolving or industrial funds, government corporations, and other public-private ventures, and non-Federal alternatives, such as outsourcing, enterprise funds, the use of vouchers, asset sales, and devolutions of authority to State and local governments. As a result, there has been a corresponding change not only in the perception as to what can be "privatized" and how, but also in what is an "inherently governmental activity."

Contractors provide a wide variety of services to the Federal Government and continue to play an important role in meeting Federal mission requirements. Agencies use contractors to acquire special knowledge and skills not available in the Government, obtain independent analyses of programs and program implementation alternatives, plan for, design and implement complex and highly technical projects, and to obtain recurring commercial services or temporary, emergency or intermittent services on a cost effective basis. This use of contractors is proper and is increasingly common to most western nations and cultures.

Nevertheless, not all functions should be performed by the private sector or by Federal contractors. Some activities, for reasons of law, or as a matter of policy, will not be contracted out, irrespective of the qualifications within the private sector or the Federal contracting community. The difficulty is in determining which of these services fall into this category. As a matter of policy, an "inherently governmental function" is defined by the Office of Management and Budget's (OMB) Office of Federal Procurement Policy (OFPP) Policy Letter 92-1, dated September 23, 1992 (Federal Register, September 30, 1992, page 45096), as being so intimately related to the public interest as to mandate performance by Federal employees. These functions include those activities that require either the exercise of discretion in applying Government authority or the making of value judgements in making decisions for the Government. The policy letter includes a list of activities that have been determined to be inherently governmental.

Clearly, inherently governmental functions do not include gathering information for or providing advice, opinions, recommendations, or ideas to government officials. They also do not include functions that are primarily ministerial and internal in nature, such as building security; mail operations; the operation of cafeterias; housekeeping; payroll operations, most accounting or information management and auditing functions, background investigations, facilities operations and maintenance, warehouse operations, motor vehicle fleet management, or other recurring or
routine administrative services. In effect, if the function is procedural in nature or is, has been or
could be provided by the private sector, either for a Federal, State or local government, it is
unlikely that it will be considered inherently governmental.

It is also important to place the definition of what is inherently governmental in an
historical context, as this definition has tended to expand and contract over time. From the
Continental Congress’s contracts for the construction of the USS Constitution to the construction
toll roads, the C&O canal, the development of the telegraph, railroad, telephone and electrical
power systems, the private sector has played an important part in our nation’s infrastructure and
service development. Few Americans would accept the idea today that telephone services should
be provided by Federal employees or considered inherently governmental, yet, the telephone is a
fundamental part of our every day experience. It provides basic personal and corporate security
and emergency communications. From Wall Street to the Defense Department there is a heavy
reliance on the assurance that these systems are in place and operating efficiently, yet they are not
inherently governmental.

New industries have emerged in response to new technology developments and service
requirements. Cable television services are a recent example. Another recent example lies in the
development of the corrections and prison industry. As early as 10 or 15 years ago, most
Americans would have generally considered the operation of a prison or prison hospital to be an
inherently governmental function. Today, however, there is a growing and vibrant prison service
industry at the Federal, State and local levels. A Department of Justice initiative in the President's
FY 1996 Budget, for example, is the privatization of prison operations for all new low and
minimum security prisons and pre-trial detention facilities. One more example of how these
definitions are changing may be appropriate. In the 1940s and 50s, there was a call to provide
high quality and specialized care to returning veterans and, as a result, a system of Government
owned and operated hospitals was created. In the 1960s and 70s a similar call was made to
provide health care services for our older and poorer citizens. In this case, however, a series of
insurance and grant programs were created that relied, fundamentally, on the provision of both
direct and administrative services through the private sector.

An inherently governmental function involves, among other things, the interpretation of
the laws of the United States and the execution of those laws as a sovereign power, so as to:

1. bind the United States to take or not to take some action by contract, policy, regulation,
   authorization, order, or otherwise;

2. determine, protect, and advance its economic, political, territorial, property, or other
   interests by military or diplomatic action, civil or criminal judicial proceedings, contract
   management, or otherwise;

3. significantly affect the life, liberty, or property of private persons;
4. commission, appoint, direct, or control officers or employees of the United States; or

5. exert ultimate control over the acquisition, use, or disposition of the property, real or personal, tangible or intangible, of the United States, including the collection, control, or disbursement of appropriated and other Federal funds.

While inherently governmental functions necessarily involve the exercise of substantial discretion, not every exercise of discretion is evidence that such a function is inherently governmental. For example, when contracting for custodial or building maintenance services it is the contractor who, within specified delegations of authority, determines what work is needed and is responsible for the purchase of materials and supplies. Contract performance inspections and audits, like other data gathering services are important but are not inherently governmental oversight functions. There is no discretion other than the value judgement exercised as to whether performance meets pre-established criteria. Contract administration or the issuance of a final audit finding, on the other hand, may be considered inherently governmental, in that the Government is making a final determination or authorizing contract payments.

Thus, while the Government has a responsibility to be thoroughly involved in the performance of its mission policy and management functions, an inherently governmental position must also have the effect of committing the Government to a course of official action when two or more alternative courses of action exist. Additional examples would include; the decision to purchase a minicomputer rather than a mainframe computer, hiring a statistician rather than an economist, supporting proposed legislation rather than opposing it, devoting more resources to prosecuting one type of criminal case than another, awarding a contract to one firm rather than another, adopting one policy rather than another, and so forth.

One concern that is often raised has to do with the level of reliance an agency has on contractors. While the level of reliance on contractors is not by itself a cause for concern, agencies must have a sufficient number of trained and experienced staff to manage government programs properly. Likewise, it is important to remember that there are a variety of privatization options available. In each case, the current level of inherently governmental support may be significantly altered by the option chosen.

Thus, there is no factor or determinative ratio of Federal employees to contract employees or between inherently governmental employees and in-house or contract employees. In some cases the Congress has specifically required functions to be contracted out, while in others reliance on contracting is only encouraged. GAO's Report to the Chairman, Federal Services, Post Office and Civil Service Subcommittee, Senate Committee on Governmental Affairs, entitled, Government Contractors: Are Service Contractors Performing Inherently Governmental Functions, GAO/GGD-92-11 (Washington, D.C.: U.S. General Accounting Office, November 1991), noted that in certain instances Congress had authorized agencies to contract for functions that might otherwise have been considered inherently governmental, such as the auditing functions of the agency Inspectors General.
In this same context, there are a large number of activities performed by the Government that are considered by the agencies as "core mission functions." Again, these are not inherently governmental functions. A core capability is a commercial activity operated by a cadre of highly skilled employees, in a specialized technical or scientific development area, to ensure that a minimum capability is maintained to properly manage and oversee workload. While a core capability of in-house or contract resources may be maintained for reasons of the national defense, security or rotational necessity, or to meet patient care or research and development requirements, they should not be confused with an inherently governmental function. Assertions regarding the efficiency of Federal employees or with respect to an agency's ability to control and better manage Federal employees, notwithstanding, the determination of an activity as inherently governmental is not an efficiency or a span-of-control determination.

It is up to the agencies, working with OMB, to identify their inherently governmental activities. There is no substantive or procedural basis on which to challenge any agency action or inaction, enforceable at law, with regard to the determination of an activity as inherently governmental. There are, of course, exceptions to the rule and OMB stands ready to work with agencies whenever there is any question as to whether an individual activity is inherently governmental. One such exception lies in the drafting of Congressional testimony, responses to Congressional correspondence, and agency responses to audit reports from an Inspector General, GAO, or other Federal audit entity. While the approval and issuance of a Federal document is an inherently governmental function, the technical drafting of letters, reports and memorandum, generally is not, unless, such drafting may be perceived as being inappropriate. Because of the appearance of private influence with respect to documents that are prepared for Congress, law enforcement or oversight agencies, responses to Congressional correspondence; or agency responses to audit reports from an Inspector General, GAO, or other Federal audit entity are considered, as a matter of policy, to be inherently governmental activity.

What is inherently governmental? In the final analysis, it depends on the function, its size, the alternatives available, and the extent to which the activity is vested with the powers of the sovereign. While few would argue that the management of the national defense, the conduct of foreign relations or the provision of direct support to key of senior policy officials should be contracted out, the degree to which contractors should be used to implement those policies or otherwise advise government officials is much more a question for senior policy officials.

Note: Questions regarding whether a function is likely to be considered inherently governmental by OMB may be addressed to Mr. David C. Childs, Office of Management Budget (202) 395-6104.
CHAPTER 4

OUTSOURCING

INTRODUCTION

A decision to outsource reflects a fundamental decision by the Government to remain fully responsible for the provision of services and related management decisions. The question is whether the service can be more effectively provided through in-house or contract sources.

Outsourcing may be discussed under three different approaches, e.g., (1) recompetition under normal Federal Acquisition Regulation (FAR) procedures; (2) the development of interservice support agreements, or; (3) the conversion of work to or from in-house or contract performance. In each case, outsourcing relies on the dynamics of competition and choice to determine who shall do the work. Management efforts to improve in-house productivity, accountability, increase the incentives to be cost effective and customer oriented and to better define work are severely limited without the use of competitive pressures. In recompetitions, the Government relies on the dynamics of full and open competition to encourage offerors to develop new approaches to improved quality and reduced cost. In the use of interservice support agreements (Franchise Funds, Revolving Funds, Working Capital Funds) the Government seeks the benefits of potential economies of scale, reduced administrative burdens, reduced oversight and the dynamics of public-public and public-private competition. In considering conversions to or from in-house or contract, once again, the competitive dynamics of the Government’s Most Efficient Organization (MEO) are competed, on a level playing field, against the efficiencies of private sector offerors. In making these “make or buy” decisions, the provisions of OMB Circular No. A-76, “Performance of Commercial Activities,” apply. Appendix C provides a brief summary of the status of proposed changes to OMB Circular A-76.

RECOMPETITION

In the development of a competitive solicitation for the recompetition of commercial, contractable work, a Performance Work Statements (PWS) should be developed. The PWS defines what is being requested and when. It provides the technical performance sections of the Request for Proposals (RFP) or Invitation for Bid (IFB) issued by the contracting officer.

Special care should be taken when developing the PWS to ensure that it does not limit service options, arbitrarily increase risk, reduce competition or violate industry norms.

In selecting the method of procurement and contract type, the contracting officer should analyze the Performance Work Statement and apply the guidance contained in OFPP Policy Letter 91-2 and FAR Part 16. The results achieved under any service contract are strongly influenced by the structure of the solicitation, the method of procurement, the contract and the incentives that are provided to the contractor. Critical factors include the uncertainties and risks, performance period, urgency of the requirement, contract start date, transition or phase-in requirements, and the relative importance of cost and quality.

In effect, the Contracting Officer issues a solicitation based on the PWS. The contracting officer reviews the PWS to ensure that it is adequate and appropriate to serve as a basis for award. The contracting officer;

a. when contracting by sealed bid, inserts in cost comparison solicitations the provision at FAR 52.207-1, Notice of Cost Comparison (Sealed Bid).

b. when contracting by competitive negotiation, inserts in cost comparison solicitations the provision at FAR 52.207-2, Notice of Cost Comparison (Negotiated).

c. when contracting by the Source Selection or other method, inserts in cost comparison solicitations the provision at FAR 52.207-2, Notice of Cost Comparison (Negotiated).

FRANCHISING

In the September 1993, NPR Accompanying Report, *Improving Financial Management*, Recommendation FM06 urged agencies to "Franchise" internal administrative services. This term is used to describe cross-servicing common administrative services between agencies on a reimbursable basis.

The term is also intended to recognize that interservice support agreements can involve both commercial and inherently governmental activities and to give agencies direct incentives to treat users of their services as customers, replacing monopolies with competition. For example, an unsatisfied "customer" (an agency) could seek services for information systems procurement from another agency - perhaps one that has specialized in this type of acquisition - rather than being compelled to use its own procurement office. The providing agency is willing to perform inherently governmental functions for another agency on a reimbursable basis. The customer agency benefits from the additional expertise of the provider and, hopefully, reduces its overall procurement costs. In another example, an agency might consider the outsourcing of its motor vehicle fleet management or payroll requirements. Again, the customer agency seeks improved performance at reduced cost. In this example, however, the functions sought are commercial in nature and are, therefore subject to the cost comparison requirements of OMB Circular A-76.
In either example, the providing agency acts like its private sector counterpart, in terms of service and must meet customer needs to be financially self-sustaining. Franchise funds that cannot attract new business or satisfy existing customers will eventually cease to exist.

In accordance with the provisions of the Federal Property and Administrative Services Act of 1949, and the Economy Act of 1932 (31 USC 1535), excess property and common administrative services available from other Federal departments or agencies may be used, unless the needed product or service can be obtained more economically from commercial sources.

In accordance with OMB Circular A-97, "Rules and Regulations Permitting Federal Agencies to Provide Specialized or Technical Services to State and Local Units of Government," Federal agencies must also conduct cost comparisons, conducted in accordance with OMB Circular A-76, before offering to provide or receive competitive commercial services to or from State or local agencies. The provisions of Circular A-76 do not apply to the consolidation of inherently governmental activities or to commercial services within a Department or agency, unless that consolidation would include the conversion of work to or from in-house or contract performance.

The implementation of the NPR recommended franchising initiative was accomplished by the Government Management Reform Act which was enacted in November 1994. The Act authorizes the Director of OMB to designate up to six agencies to establish franchise fund pilot programs, but only after consultation with appropriate congressional committees. Since passage of the Act, significant progress has been made in the franchising implementation effort. An interagency Franchise Fund Working Group has been organized under the auspices of the government wide Chief Financial Officers' Council, and it has met regularly to plan and direct activities related to implementation of the pilots. Guidance on how to apply to become a fund was developed by the Working Group and issued by OMB in early February 1995. In May, the CFO Council endorsed the applications of six agencies and forwarded the endorsement to OMB.

CONVERSION TO CONTRACT / IN-HOUSE

As previously noted, competition is an effective management tool to control quality, reduce cost and ensure the continued improvement of services over time. Contracting for commercial services should increase choice, competition, accountability and, thus, efficiency.

Increased use of contracting can also be done incrementally as a way to progress along the reinvention continuum. The NASA Space Shuttle Program, for example, has long been implemented through a number of private service and R&D contracts. NASA maintained many functions as governmental, including coordinating and bringing together the efforts of the separate contractors. However, NASA is now considering the possibility of further privatizing the Space Shuttle Program by bringing separated pieces together under a new prime contractor. That will remove many steps duplicated by NASA staff and contractors (and remove the confusion of
accountability inherent in such duplication). Greater accountability through the prime contractor is a key goal of this NASA privatization effort.

Section 5 (g) of the Federal Workforce Restructuring Act requires the President to take appropriate action to ensure that agencies do not convert the work of employees included in the 272,900 reduction target, or the work of employees that accept a buy out, to contract performance unless a cost comparison demonstrates that there is a financial advantage to the government.

In those cases where contracting out may be appropriate, agencies have been advised by OMB Director Rivlin to comply with section 5(g) of the Act through the conduct of OMB Circular A-76 comparisons, where applicable. In those cases where Circular A-76 does not apply, such as Research and Development activities and activities that involve less than 10 Full-Time-Equivalents (FTEs), agencies may develop alternative cost comparison approaches that respond to the requirements of Section 5(g) or they may use Circular A-76 procedures. That guidance appropriately addresses the concern that agencies might otherwise be inclined to contract out activities to meet personnel ceilings, without a cost comparison to demonstrate a net benefit to the Government.

Agencies that have pursued A-76 competitions, to both contract out performance and to contract in, indicate that it has been an effective mechanism for achieving savings without reducing the provision of needed services. It has also been effective in ensuring that the determination of a financial advantage to the government is fair, open to all parties and based upon a level playing field. Savings are achieved through efficiencies identified as a part of the competition process, both in-house and through contract bids, and through the implementation of improved contracting techniques. Circular A-76 cost comparison and appeals procedures have ensured that all parties to the competitions have an equal access to the information and input to the decision process.
CHAPTER 5

EMPLOYEE STOCK OWNERSHIP PLANS

In the private sector, employees are taking over their businesses and providing competitive services at an ever increasing rate. Over the past ten years an innovative approach to the conversion of employees to owners, called an Employee Stock Ownership Plan (ESOP), has created new opportunities for employees to become full or partial owners of their companies, while protecting jobs and creating new pension opportunities. From relative obscurity in the early 1970's, there are over 10,000 employee ownership plans, involving 11 million workers--and the numbers are growing. According to the National Center for Employee Ownership, ESOPs control over $150 billion in corporate stock, excluding $140 billion owned through 401(k) plans.

An equity-based, deferred compensation plan, ESOPs are IRS-recognized, tax qualified, defined contribution plans that invest primarily in the stock of the employer. There are several forms of employee stock ownership. This paper, however, provides a conceptual framework for the consideration of ESOPs, in the context of a possible conversion of work from in-house to contract performance. It describes the legal and financial structures necessary to establish ESOPs and the restrictions posed by the Federal Acquisition Regulations (FAR), ethics and conflict of interest statutes. The information should be useful to employees whose work is being considered for conversion to private sector performance and to those interested in submitting offers to perform such work. It should be particularly helpful to Federal employees involved in Base Closures, service termination decisions, OMB Circular A-76 cost comparisons or other privatization initiatives, permitted or required by law.

The use of an ESOP facilitate the transition of Federal employees to private sector performance, should address such issues as employment guarantees, pension portability, stock ownership, opportunities to share profits, and other incentives that may serve to mitigate the potential adverse employee impacts of an agency's conversion decision.

OVERVIEW

An employee-owned business is a voluntary association of individuals who incorporate themselves to do business for profit. The business is owned, in full or in part, and operated by the employees. To create an ESOP, the employees must form an association that is designed to work toward the creation of an ESOP. The association borrows money--often from the company itself--to purchase corporate stock, which is then placed in a trust for the employees.

The trust, acting for the employees, buys an established number of shares of company stock at predetermined rates, until it owns the negotiated percentage. The sponsoring company
invests in the ESOP by making defined contributions to the plan each year, which is then used by the trust to repay the loans taken out to buy the stock. The trust then allocates the shares to individual employee accounts in accordance with a pre-determined formula, which may include salary, seniority and other vesting considerations.

The employees receive salaries, other fringe benefits, including pensions, as well as dividends or a share of profits. The shares entitle the employees to some control over the business through the stock held in trust and through direct ownership. Because the corporate contributions to the ESOP are fully tax deductible, both the principle and the interest payments on ESOP loans (to purchase stock) are indirectly tax deductible to the sponsoring corporation. Indeed ESOPs are unique in that lending institutions may deduct 50 percent of their interest income on loans to leveraged ESOPs if the ESOP owns more than 50 percent of the corporate sponsor’s stock.

When an employee leaves the firm, the company or the trust buys back the shares at an appraised value, if not otherwise publicly available.

ESOPs may be considered by agencies as a part of their overall outsourcing strategy. Once a commercial requirement is identified for possible conversion to contract performance, Federal employees may opt to form an association for the purposes of developing an ESOP bid. The government, in concert with existing ethics and conflict of interest statutes, may award a service contract to any firm bidding with ESOPs as a part of their overall approach and may opt to limit offers to those that include ESOP provisions. The Government may also include the ESOP provisions in their overall evaluation and selection of best offers. If an ESOP service contract is awarded, the employees would be performing essentially their same jobs--but as private contractors not as Federal employees.

The government benefits from continuity of service, increases in productivity, cost efficiencies, and efforts to mitigate the adverse impacts on employees. The employees have continued employment, stock ownership, increased control over their lives, and the opportunity for increased financial rewards.

ESOP-related service contracts may be awarded non-competitively or competitively using a variety of sole source, source selection, partnerships, and other procurement approaches. Equipment transfers could be made at no cost, minimal cost, on a leveraged buy-out basis or transferred at book value. Real property assets could be retained by the government and made available to the ESOP on a case-by-case basis.

Another alternative would be to provide existing equipment and facilities as Government-Owned-Contractor-Operated (GOCO). Again, the service contractor could be owned in whole or in part by employees. The contract and the assets transferred or otherwise made available should be sufficient for the ESOP to obtain financing and perform required services. Indeed, the service
contract could be structured to require offerors to provide a stated percentage of the initial capitalization necessary to fund the ESOP.

The goal of the Federal ESOP initiative is to change the workplace culture by creating incentives for cost-effective services and to mitigate the adverse impacts of an agency decision to convert to private sector performance. ESOPs can, however, also be expensive to set up and run. The legal, accounting, actuarial, and appraisal fees for a small or even mid-sized ESOP can total $50,000. Annual expenses in the administration of trust accounts and annual appraisals should be expected to exceed $10,000 per year. Thus, it is recommended that agencies and employees consider only activities with a minimum annual payroll of over $500,000 for an ESOP.

SELECTING ACTIVITIES FOR AN ESOP

The agency, in conjunction with the employee association or unions, and the private sector, must identify a specific level of commercial work that is subject to conversion to contract performance, in accordance with the Office of Federal Procurement Policy's (OFPP) Policy Letter 92-1, dated September 23, 1992. The four criteria identified in Exhibit C-1 should also apply.

CONFLICTS OF INTEREST AND FEDERAL ETHICS LIMITATIONS

Employee participation in the development of an ESOP-related service contract is fundamental to the success of the process. However, to ensure compliance with conflict-of-interest laws (18 USC 201 et. seq.) and ethics considerations, and to protect employee interests, great care must be taken to insulate employees from the government's decision process. Great care must also be taken to ensure that employees do not represent the interests of potential or current contractors to the government, while still Federal employees.

Any employee that is directly involved in the development of the government's procurement documents is potentially at risk. The risk is that their involvement could qualify them as "procurement officials," and therefore make them ineligible for employment by the service contractor. For example, the Procurement Integrity Act and the FAR define a procurement official as any civilian or military official or employee who has participated "personally and substantially" in any of the following activities: drafting a specification or statement of work; review or approval of a specification or statement of work; preparation or development of a procurement or purchase request; preparation or issuance of a solicitation; evaluation of bids or proposals; source selection; and contract negotiation or the review and approval of a contract award or modification. If the award is contingent upon a cost comparison conducted pursuant to Section 5(g) of the Federal Workforce Restructuring Act or OMB Circular A-76, employees who are substantially involved in the development and approval of the Management Plan, Most Efficient Organization, and government in-house bid may be considered procurement officials.

The Procurement Integrity Act, 41 USC 423, governs the relationships between Federal officials and current or potential contractors. The conflict of interest statutes, which include 18
USC 210, 203, 205 and 208, generally prohibit any Federal employee from engaging in official activities that could conflict with personal interests. The "revolving door" or post-employment restrictions at 18 USC 207 may also apply. In some cases, Part 3.601 of the FAR may apply, which prohibits the award of a contract to a government employee or to a business concern or other organization owned or substantially owned or controlled by one or more government employees. As noted in the FAR, however, this restriction is intended to avoid any conflict of interest that might arise between the employee's interests and the employee's continuing government duties. Since the contract will not be awarded to Federal employees, this is not seen as a major cause for concern. Other restrictions, such as those at 10 USC 2397 or Section 3.104 of the FAR, may apply to specific agency employees.

**Exhibit 5-1. ESOP Selection Criteria**

1. **The business line should be one for which there is a continuing need in both the public and the private sectors.** This will permit the ESOP to diversify and enter into non-Federal markets, thereby strengthening the ESOPs viability and the potential benefits to employees.

2. **The agency or association must have a reasonable expectation that the ESOP is a financially viable option.** Revenue and cost, market, capitalization and even a merger and acquisition analysis may be required. Without a strong potential for earnings and reasonable profits, a company does not qualify for an ESOP. General feasibility studies may be conducted by the government and made available to the public, employees union, and/or the association.

3. **The activity or business line must be large enough to be financially viable as a business entity.** By law, the ESOP may cover the lessor of 50 employees or 40 percent of all employees in the corporation. Activities that could involve less than 50 employees must be approved by the Department of Labor (see Internal Revenue Code (IRC) Sections 401 (a)(26)(d) and 410 (b)(3)(A)).

4. **The agency must have the authority to contract out for commercial services.** In recent years, certain legislative restrictions have restricted agencies' ability to contract out, or levied specific requirements affecting how conversions may be accomplished. In addition, the provisions of Section 5(g) of the Federal Workforce Restructuring Act (103-226) and OMB Circular A-76 may apply. An agency's General Counsel or A-76 Program Manager should be consulted to determine any limitations.

As a practical matter, these restrictions do not materially affect the ESOP initiative or most of the employees involved in an ESOP, but they could! Employees should be consulted prior to making the actual decision to participate in an ESOP initiative, and they must be protected from violating conflict-of-interest laws.

**EMPLOYEE PARTICIPATION**

Within the limitations outlined above, Federal employee participation in the formulation of any ESOP is required. This can be accomplished in two ways. First, employees may participate in the collection of data for feasibility studies and solicitation documents and the development of more efficient methods, through quality circles, performance standards, and Total Quality Management (TQM) techniques.

These efforts will ensure that the full range of requirements are presented to offerors and will highlight opportunities for improved performance. For employees that are not subject to the restrictions noted above, the second way for Federal employees to participate lies in the formation of a "ESOP Association" or "Liaison Committee."
An ESOP Association is a voluntary association that is formed to explore the possibility of establishing an employee-owned company to compete for the service contract to be awarded by the agency. It is a private, non-Federal and usually a non-profit organization, whose fundamental purpose is to obtain necessary legal and financial support and discuss options with prospective offerors in the development of an ESOP proposal. Thus, the employees--on their own time and on their own volition--can develop proposals that will reflect their unique needs and goals. The association may also seek to represent the employee's interests in the public review of a statement of work or any related activities. At no time, however, may an association activity or membership in the association conflict, interfere with or be conducted by Federal employees while on duty. In particular, procurement officials may not be members of such an association. Indeed, the association should be treated as a potential contractor, with financial interests and concerns.

The Association may form a partnership with another management firm to bid on the agency service contract or may submit a bid on the work itself. While FAR 3.601 states that a contracting officer shall not knowingly award a contract to an organization owned or substantially owned or controlled by one or more government employees, this policy does not restrict an employee organization from competing for a contract. If the employees at the time of the award "own or substantially own" the likely awardee, the Association employees must resign, retire or be severed before the contract is awarded. If, however, the employees do not "own or substantially own" the firm, but will vest an interest in a pre-existing firm sometime after the award, the award may progress prior to the termination of employment and normal separation procedures may be applied.

GOVERNMENT PARTICIPATION

Employees and employee groups are unlikely to have the resources or the incentives to commit their own financial resources to seek, form or negotiate for the development of ESOP alternatives. Experience in negotiating the financial transactions attendant with ESOPs and knowledge of the legal relationships that must exist between the ESOP trustee, the employees and the "firm" is required. Since the government also needs much of this information, the cost of retaining--at least in part--the legal, financial and valuation specialists necessary may be borne, in whole or in part, by the Association, prospective offerors and the government.

Like re-training, relocation or other "good employer" expenses, the agency considering the conversion may award advisory and assistance service contracts to provide certain ESOP-related analyses and support to the government, association members, and other public and private sector interests. In any case, all potential interests must have equal access to the government information. Information can be made available as public information--even if related to a specific initiative, through retired and separated former Federal employees, releases made pursuant to the Freedom of Information Act or, the "bidder's library."

ISSUING A REQUEST FOR ESOP PROPOSALS
The decision to facilitate, assist or even restrict the award of work to an ESOP service contractor is a matter of agency discretion. There is no judicial or administrative appeal to this decision. The solicitation must encourage competition, yet it should give both the employees and the government the opportunity to negotiate in their own best interests. Detailed documentation is recommended. In some cases an independent evaluation process may be necessary.

The government may award the ESOP contract and the ESOP may then hire any additional employees needed to perform the work and to fill vacancies created by employees who opt not to participate. If the agency determines that there are no satisfactory responses to an ESOP solicitation, the agency may cancel the solicitation and re-announce the work as an unrestricted solicitation.

Within the context of an ESOP initiative, the awarding agency should prepare and issue a formal Request for Proposals, that includes the provisions recommended in Exhibit C-2.

**APPRAISAL OF ESOP SHARES**

As noted above, ESOP offerors must submit, as a part of the technical proposal, a certified assessment of the potential valuation of ESOP shares at conveyance. This means that the ESOP offeror must hire an independent appraiser or other accounting firm familiar with the requirements of both the related IRS rulings and ERISA (Employment Retirement Income Securities Act).

**IMPLEMENTING THE ESOP**

With award, the offeror incorporates the ESOP as described in the solicitation and capitalizes the employee stock into a trust fund. The capitalization is a matter of law, competitive assessment and evaluation.

Within the solicitation’s transition period, all employees are severed from Federal employment and transferred to the ESOP. While there is a Right-of-First-Refusal condition of employment, the wages and other benefits available will be determined by negotiations between the association/union and the ESOP firm. This is in addition to any severance received from the federal Government. The contractor shall provide the agency's personnel office a listing of all job openings created by the award of the contract and minimum qualifications. The personnel office should be tasked to conduct interviews with all employees affected by the transfer.

Preferences and options for retirement or placement in Federal, contractor or other employment should be identified, with their impact on possible each wages, pension, and other benefits, as provided under the contract.

As a matter of law, the ESOP must create an account for each participating employee—a trust account (initially all employees are participating). Stock and stock values are calculated
based upon the capitalization of the ESOP and placed--first in a suspense trust account for one year. For this period, employees may not trade or otherwise sell their stock, while still employed by the firm. In addition to their Federal severance pay, employees terminated or who otherwise separate from the ESOP during the first year would be permitted the maximum allocation permitted under law of 25 percent of their total ESOP compensation package.

Once terminated from Federal employment, ESOP employees receive their ESOP stock in trust and may: share in voting rights; share in the information regarding the company; share in dividend decisions and dividends; and retain the right to sell shares provided by the ESOP.

Employees pay no tax at the time the trust acquires the shares nor do they pay when the shares are allocated to their individual accounts. They only pay tax when they leave the company and receive their ESOP distribution, e.g., at death, disability, retirement, quitting or firing. Other options also exist to cushion the tax liability, such as rollovers to IRAs, income averaging, etc.

Federal employees become private sector owners and employees in a firm with a Federal service contract. At the end of the initial contract period, the ESOP firm competes with other bidders on a firm, fixed-price basis for the performance of work. The existence of an ESOPs should not be a requirement in this re-competition. Additional savings or cost controls are expected to the government by this competition. Of course, with re-competition comes additional risks to the Federal employees placed in the ESOP. If the ESOP looses the re-competition, the ESOP must dissolve or transfer employees and assets to other Federal or private sector contracts. Employees would have any corporate severance plus the value of stock in the ESOP. In addition, ESOP employees would have the "Right of First Refusal" for jobs in the successor contract, as provided for by E.O. 12933, dated October 20, 1994. Pension portability is always a major issue.

Upon separation from the Federal service, FERS employees transfer much of their accrued pension value. Civil Service Retirement employees would begin to earn private sector pensions in addition to the value of their CSRS retirement. Because they are owned by employees, most ESOPs have pension plans in addition to stock values.

Exhibit 5-2. Recommended ESOP Request for Proposal Provisions

Notification that award may be contingent upon:

• The submission of an acceptable ESOP or other equity sharing arrangement. Equal access to stock, stock options, stock purchase discounts or other performance based programs, such as profit-sharing proposals, should be demonstrated.
• The submission and acceptance of technical performance and transition plans, which include information on the number of employees required, and detailed schedules for the transition of shares to employees.
• The provision of educational and training opportunities for employees.

The solicitation should be for not less than one year plus three option years, nor exceed four option years. At a minimum, the agency's solicitation should require that any ESOP submitted by offerors will:

• Meet the requirements of IRC Section 4975(e)(7), which establish that the ESOP is a qualified stock bonus plan with specific distribution requirements.
• Ensure that former Federal employees who are offered and accept employment with the ESOP firm become participants in the plan upon commencement of work under the contract.

• Provide that former Federal employees whose service with the ESOP firm terminates during the first year of the contract, other than by voluntary quitting or by firing for cause, shall receive the maximum annual additions to their accounts permitted by IRC Section 415.

• Provide that the fair market value of employer securities acquired and not readily traded in an established securities market, shall be determined by an independent appraisal firm, shall be purchased by the employer when an employee leaves the firm (within stated conditions) and shall be made available to the association or trust for re-purchase.

• Provide that the trustee or custodian of all ESOP assets under the plan is an independent trustee.

• Provide that all employer securities acquired by the ESOP trust shall be allocated to the accounts of ESOP participants performing services for the commercial activity contracted. The securities shall be allocated at a rate not less rapid than would apply under 26 CFR Section 54.4975-7(b)(8) if the securities had been acquired with the proceeds of an exempt loan payable in equal annual installments over the duration of the contract awarded, including all optional extensions thereof. If allocation at such a rate is prohibited by Section 415 of the Internal Revenue Code, then allocation shall be made at the maximum permissible rate until all employer securities so acquired have been allocated to the participants.

• The ESOP and benefits provided under the ESOP during the period of the contract, including any optional extensions, shall conform to IRC Sections 401(a)(4) and 401(a)(5).

The agency must establish evaluation criteria for comparing alternative offers, ESOP proposals, past performance and transition plans. Preference would be given to equity partnerships in which employees would ultimately own more than 50 percent of the company at the outset, or options to buy controlling interest within the period of performance.

At award or before the commencement of work, the ESOP trustee shall have acquired employer securities of a type described under offerors ESOP transition plan for allocation to ESOP employees upon the formula stated and in accordance with ESOP vesting plan.

Employees shall be afforded the “Right of First Refusal” for any jobs for which they are qualified that are created in the ESOP by the award of the contract.

EMPLOYMENT GUARANTEES

Consistent with the government post-employment conflict-of-interest regulations, Federal employees who are identified for release from their competitive level by an agency in accordance with 5 CFR Part 351 and Chapter 35 of Title 5 USC, as a direct result of a decision to convert a commercial activity to ESOP contract performance shall be afforded the Right-of-First-Refusal for jobs for which they are qualified, created by the award of the contract.

Personnel officers shall coordinate with the contracting officer and employees to assure compliance with this provision. Offers of employment by the contractor shall be communicated to each former Federal employee in writing, specifying at a minimum the following:

1. Title, description and location of employment opening being offered;

2. Pay and benefits of position;

3. Hours of work; and

4. Final date employee may accept job offer.
At a minimum, employees shall be given five working days after receipt of an offer to accept or reject it. At the contractor's request, the government shall determine if an employee has waived his or her employment right by not responding to a job offer.

Upon request, the contractor shall make available for examination by the Contracting Officer all pertinent records requested to determine compliance with these requirements.

**ESOP PLACEMENT PROVISIONS**

All employees in the affected activity will have existing statutory and negotiated placement rights, which would include provisions for veterans preferences and seniority. Those who do not opt to work for the ESOP firm will be placed on a retention register for consideration in other jobs within the agency based upon four factors; type of appointment; veterans preference; length of service, and performance rating. Depending on their standing on the retention register, employees will be afforded normal bump and retreat rights to jobs in the competitive area.

In addition, employees will have the right to be placed on the agency Reemployment Priority List, as well as be enrolled in the Interagency Placement Assistance Program and the Displaced Employee Program.

**TYPES OF SECURITIES**

The ESOP will normally be invested in parent company stock to ensure that the parent company will not bid against the subsidiary at the end of the initial contract period. Indeed, holding publicly traded stock benefits employees in several respects:

1. Securities laws guarantee greater availability of information about publicly traded stock;

2. There is no controversy about fair market value appraisal of publicly traded stock--the market sets the price;

3. Employees will receive readily marketable stock distributions from the ESOP; and

4. Risk-adverse employees may feel more comfortable with stock of a major, diversified company.

If, however, the parent company is closely held, then an alternative valuation method is used. An independent appraiser will be used to value the stock and to set the selling price when an employee decides to cash in his ESOP shares, the employee is protected from under- or over-valuation.
Once the type of securities to be attained by the ESOP have been decided, the conditions in Exhibit C-3 must be met.

GOVERNMENT FOLLOW-ON TASKS

With the conversion of work from public to private sector operation, the government must construct a new relationship between itself and the service contractor and itself and its former employees. First, the government must designate an agency to administer and monitor performance under the contract. The agency that awarded the contract may delegate or transfer the administration of the contract or parts thereof to those agencies receiving services. This includes the performance of work and compliance with the ESOP-related provisions of the contract. Second, the awarding agency will need to establish a mechanism for resolving disputes, including fact finding.

CONCLUSION

Employee ownership can be an essential part of any agency effort to convert from public performance to private sector ownership and operations. As outlined here, the design and implementation of an ESOP is not, and should not, involve the giveaway of Federal assets or potential savings. The government simply facilitates the transition of employees to become investors in the assets and facilities necessary to provide commercial activities. The government facilitates the conversion of these employees, while expecting long term economic savings to the taxpayer.

Will an ESOP work? Numerous studies provide evidence that ESOPs have a positive impact on corporate performance and that ESOPs can provide employees earning a modest income with significant additional retirement incomes. It is not, however, risk free.

Careful planning, financial analysis and a free flow of information is needed. Legal and financial structures must also be tailored to the individual activity under consideration.

OPM IS CHARTING NEW GROUND

On December 19, 1994, the Office of Personnel Management (OPM) announced the President's decision to transition from an operational agency to a regulatory agency with oversight responsibilities. As a result, OPM is terminating its investigations function, so that it can now operate as a private business, with all the management freedom, financial incentives and risks of a private business. Today OPM performs background investigations for other Federal agencies for a fee. The unit has long been organized as a revolving fund (a step toward privatization in which operating costs are paid from fees charged agencies receiving the service). The revolving fund structure helped OPM become aware that operating as a government unit, the investigation staff did not have sufficient flexibility to respond to changing workloads and make a profit or break
even as a revolving fund. OPM decided to cease doing investigations itself and launched a creative approach to Federal privatization.

**Exhibit 5-3. ESOP Securities Requirements**

Securities acquired by the ESOP may not be securities issued by the firm that is a party to the contract, unless the following conditions are met:

- No other member of the firm's controlled group within the preceding three years have been engaged in a line of business similar to that of the commercial activity;

- Within 90 days of commencement of the contract, the ESOP trust is given in writing the option of purchasing for cash all outstanding securities issued by the ESOP firm. The option will be exercisable during the six-month period following the expiration of the contract, including all optional extensions. The option will be exercisable during at the fair market price of the securities, determined by an independent business appraiser selected by a majority vote of the employees of the firm and compensated by the ESOP, shall be appointed to arrange any financing that may be necessary to accomplish the transaction.

If any securities issued by any entity of the firm are readily tradeable on a national securities exchange, then the securities acquired by the ESOP must be readily tradeable on a national securities exchange.

An ESOP Trustee has been hired by OPM to give the investigations employees the opportunity to join (and own) a new private company which will contract with OPM, and other agencies, to perform investigations. The new, private organization will be able to compete in the private market to perform investigations for non-Federal clients (e.g., state and local agencies) to expand its work base and increase efficient use of resources.

The company will, like any private company, be able to balance its capabilities and costs to the market demand for the service. Initially, it is proposed that the new company will have a sole-source contract, but increasingly over a period of a few years, additional competition can be introduced into the Federal contracting for investigation services and, in three to five years, the new company will be transitioned into a completely competitive, free-market environment, with all of the efficiencies (and potential benefits to the owners and employees of the company) of the free enterprise system.

Use of an ESOP provides an additional alternative to government employees who may be affected by termination of a function. Each will have an opportunity to continue similar investigative work as an employee, and owner, of a private company with all of the challenge and potential that entails.
CHAPTER 6
GOVERNMENT CORPORATIONS

INTRODUCTION

Creating a government corporation to replace a more traditional government organization can increase flexibility and the ability to respond to customers. That can be an important step to operating "more like a business" and thus a step towards privatization.

The establishment of government corporations recognizes that there is a definite public need for a service at the Federal level. While it may be a service that can be provided by the private sector, it is usually the case that there is no commercial service market able or willing to take on the responsibility. In effect, instead of providing the service directly as a public (in-house) good, the Government opts to create a corporation and a market where there is none today. Fannie Mae and Connie Mack are two good examples. Another example is Conrail, where there was a public need and no private sector interest in providing the financial or operating assets necessary--the risks were simply too high relative to expected returns. Amtrak is currently considered a part of this category. Government exerts control through a combination of limited operational and management controls, (board member, owner of preferential stock, budget review authority, appropriations, etc.) and regulatory controls.

A consistent methodology has not existed for identifying the need for and establishing government corporations, and as a consequence, there has been a great variation between those which have been established. In some cases, this type of an entity has been sought merely as a relief from Federal procurement and/or personnel regulations, when an easier approach might have been to simply provide the exemptions in the authorizing legislation for the agency.

The following provides an brief overview of the issues attendant with a decision to create a government corporation. The framework was developed by senior Federal officials through the spring of 1995 as a means for structuring specific proposals. It is offered here not as an established policy, but to convey a sense of the issues which agencies need to address if they are considering developing and submitting a proposal to the Office of Management and Budget for approval.

I. Background

The following analytic framework should be used only when a public businesslike function, which requests to become a government corporation, asserts a prima facie case that it cannot continue to operate effectively without changing its organizational structure.
a. A first-order question is to determine whether the Government should perform this function at all. ¹

b. The presumption should be that the private sector, operating in a competitive environment, will operate a businesslike entity more efficiently. The Federal Government should limit or focus its operations to those functions:

1. Not performed by the private sector;
2. More appropriately performed by government; and
3. To those that continue to demonstrate that performance by government is in the best interests of the taxpayer.

c. The possibility should be considered of moving operations (in whole or in part) that can sell goods or services on a self-sustaining basis into the private sector.

d. If a public purpose discourages privatization, it should be recognized that creating a government corporation under the Government Corporation Control Act does not, by itself, guarantee efficiency or accountability.

e. A government corporation should be established only when the effective performance of a public businesslike function would benefit from the distinct legal entity accompanying incorporation, not merely as a convenient desire to escape legitimate discipline and proper executive controls.

II. Is it a businesslike enterprise?

If the answers to the following questions are negative, the entity should be dropped from further consideration under this analytic framework. If the answers to the questions are affirmative, the businesslike entity should next be considered for privatization.

a. Is this an operation that is, or could be, predominantly of a businesslike character - that is, does it act like a private business or what we would think of as a private corporation?

1. Does the enterprise deal with the public as a businessman, insurer, or banker, and not as a sovereign?

2. Is its primary purpose to produce goods and services for sale to the public (rather than regulate, make grants, or provide goods and services to the public without a price)?

¹ This is not a rhetorical question. In keeping with the Administration's reinvention effort and the current budgetary realities, the Government should perform a function only if it involves an important public purpose that Government can best serve.
3. Does it have customers (i.e., individuals or organizations who freely choose to purchase the product or service)?

4. Is it, or could it be, substantially self-financing (i.e., does the income generated from selling the product or service cover operating expenses and the cost of capital)?

5. Is there likely to be continued demand for its goods and services over a long period?

b. Does the proposal correctly identify a service or product that could be separated from other noncommercial activities so that the commercial activities can be fully privatized?

III. Why not privatize?

If the answers to questions A, B, C, and D below are negative, the businesslike enterprise should become a private corporation with no Federal control or backing. (In the event the entity is privatized, provision should be made for the entity to reimburse the Government for its investment in the enterprise in accordance with Federal financial policies.) If the answers are in the affirmative, then move to the next step of the analysis.

a. Are there good and sound reasons this entity cannot compete in the private sector? (For example, if the private sector does not produce these or similar services, would that still be the case if Government intervention is removed?)

b. Are there market impediments that could make privatization inappropriate?

1. Absence or imperfection of a viable market?

2. Need to protect or continue service to "unprofitable" segment of market (i.e., would there be an inclination to service less than the entire market, or need for/desirability for cross-subsidization)?

3. Regulatory/safety or other public function that is intrinsic to the entity's operation and cannot be separated from its commercial aspects and carried out by a separate governmental entity?

c. Does the entity serve primarily public policy as opposed to private purposes?

d. If it failed, would the Government feel obliged to bail-out the entity to maintain the provision of a public policy or for some other reasons?

IV. Should the entity become a government corporation?
The legal and financial powers of a corporation do not themselves justify the corporate form; they are a means, not an end in and of themselves. The burden of proof is upon the agency or function seeking to become a government corporation to demonstrate:

1. It is sufficiently businesslike,

2. It cannot privatize, and

3. Its proposal is superior to other alternatives (e.g., removing specific constraints, financing and operating as franchising or revolving funds, or using service contracts).

The businesslike enterprise should make a “presentation” that explains the benefit of incorporating the operation, addresses the need for each element or feature of incorporation, justifies the removal of each statutory constraint, and explains why alternatives are not an equal (if not superior) way to achieve more efficient or effective operations. Assuming an entity is needed and is sufficiently businesslike (first step in the analysis) and not suitable for immediate privatization (second step in the analysis), and makes a compelling programmatic presentation, there are two primary reasons to form a corporation:

1. As a transitional state, pending private ownership, or

2. When the operation of the entity would benefit from the distinct legal identity accompanying incorporation.

If such an entity satisfies one of these two tests, and it is willing to operate under the standards described in sections V and VI below, it can propose to become a government corporation. Consideration should be given to whether creating the corporate form increases (or reduces) the risk and exposure of the Government, and if so, how the proposal addresses it politically and substantively.

V. Standards for a businesslike entity which proposes to become a government corporation.

Overview

1. Government corporations should be subject to the provisions of the Government Corporation Control Act (31 USC 91).²

² The Government Corporation Control Act provides specialized budgetary reporting requirements, which are in addition to the reporting required of other Federal entities. Specifically, GCCA requires wholly-owned government corporations to prepare and submit business-type budgets to the President each year. The Act also imposes certain audit and reporting requirements on both wholly-owned and mixed-owner ship government corporations.
2. All government corporations should be included in the Federal Budget, follow established budget principles, and be subject to Presidential review, modification, approval, and apportionment.

(a) The President and the public need to be assured that a government corporation is:

   (i) Fiscally sound and viable (e.g., that the corporation is presently, and is expected to remain, self-sustaining), and

   (ii) Not deviating from its public purpose (i.e., the public purpose is being fulfilled).

(b) The President has the same authority to review a government corporation as any other government entity.

(c) In choosing to exercise his authority, the President can stipulate the timing and format of budgetary submissions, and compel financial reporting.

(d) In practice, the application of budget requirements to a government corporation will differ depending upon whether OMB determines each year whether the corporation is:

   (i) Clearly operating on a self-sustaining basis (e.g., revenues meet or exceed expenses) and consistently with its charter -- in which case, it will not be subject to further OMB budget review.

   (ii) Not-self-sustaining (e.g., those which require appropriations as a one-time, or regular event, including appropriations for subsidy costs of credit) or is not operating consistently with its charter -- in which case, it will be subject to full OMB budget review, modification, approval, and apportionment.

(e) Publication of the President’s budget and the management report required by the CFO Act (which includes the Corporation's financial statements, auditor's report and statement by the head of the agency on the corporation's internal accounting and administrative control systems) give the Congress as well as the public the opportunity to review the operation of government corporations.

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For example, the intent of apportionment is to prevent the over-obligation of appropriated funds and is inappropriate for self-financed corporations.
3. **Credit Reform.** All government corporations that make direct loans or guarantee loans should be subject to the budget and accounting requirements of the Federal Credit Reform Act of 1990 (Title V of the Congressional Budget Act of 1974). The estimated long-term cost to the Government (as defined by the Act) must be estimated and an appropriation of the cost, if any, must be provided before any direct loans or loan guarantees can be made.

4. **FTE limitations.** Employees of government corporations are Federal employees and are subject to the Federal Workforce Restructuring Act and OMB Circular A-76.

   (a) If a corporation can make a case why its businesslike operations need relief from agency-specific FTE limitations, it should seek adjustments from OMB. (Generally, such relief should be considered only if the corporation has the funds to finance the FTEs and can demonstrate that business conditions demand greater flexibility (e.g., seasonal or surge workloads) or other defined business requirements.

   (b) If on the other hand, a corporation seeks to be exempt from the statutory limitations, its employees must cease to be Federal employees and surrender all benefits under Title 5.

5. **Employee benefits and pay limits in Title 5.** Government corporations should not be exempt from limitations on employee benefits and pay. The top salary should not exceed that of Executive Level I. While as a general matter exemptions should not be made for government corporations, exemptions could be appropriate:

   (a) If necessary to keep or recruit select personnel with unique technical background and skills (due to competitive pressures from the private sector). (If exceptions are sought for large numbers of personnel, it is appropriate to reexamine whether the corporation operates sufficiently like a private entity that it should be privatized.)

   (b) To facilitate moving the corporation into the private sector (e.g., if it is expressly understood that this corporation is moving toward privatization).

6. **Generally-applicable laws.** If corporations seek exemption from generally-applicable statutory requirements, they must make a specific case, tied to the nature of their business. Absent specific, compelling reasons, government corporations will be subject to generally applicable statutes.

**Placement and structure.**

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*Government corporations engaged in direct loan and loan guarantee activities are subject to Credit Reform.*
1. Government corporations should be Title 31 executive agencies of the United States.

2. Government corporations should remain under the head of an existing department or agency (rather than established as an independent executive agency) to ensure coordination with common programmatic missions or activities, and general supervision.\(^5\)

3. All government corporations should receive and be responsive to policy instruction from the President and/or agency head, though such policy coordination and oversight would not, in general, extend to day-to-day operational control and direction. (See also section VI below.)

4. In accordance with the Government Corporation Control Act, government corporations cannot create a subsidiary without approval of Congress. A subsidiary of a government corporation should be subject to the same budget controls as the parent corporation, and should not be in a position, by itself, to increase the Government's exposure to loss.

5. While there should be no provision for a governing Board of Directors, it may be useful to have an advisory board if input from business advisors on business operations is desired.

**Regulation.**

1. Regulatory functions are not normal, businesslike activities, since they involve the exercise of inherently governmental (sovereign) powers.

2. The President and the Congress need to maintain direct public policy control of regulatory functions.

3. Consequently, regulatory functions should be separated from the entity's businesslike functions and carried out by a separate governmental entity.

4. The regulator should have sufficient powers (e.g., to obtain necessary information on corporate activities and take action when unsafe conditions exist) and funding to do an effective job.

**Financing**

1. Generally appropriate for businesslike activities, and hence government corporations.

\(^5\) While legally “separate” and distinct, government corporations should still remain under the policy supervision and oversight of a special Secretary and Deputy.
2. Revenues should be sufficient to cover all costs, including the full cost of employees' pensions, other pension benefits, and other benefits, interest and depreciation on Federal capital utilized by the corporation, repayment of debt, etc.

3. If the proposed government corporation will be selling a Government asset, it should pay the Treasury for the asset and build this cost into its prices.

4. Except for funds deposited in credit financing accounts, which are subject to Section V.A.3., funds should be deposited in the Treasury and invested by the Secretary of the Treasury in public debt securities.

5. Interest on balances should be credited to the government corporation.

**Borrowing.**

1. Limitations on borrowing:
   (a) Outstandings at any one time must be limited by law.
   
   (b) Only from Treasury. (Should not say that its debt is not guaranteed by the federal Government since all government corporation debt is Federal debt.)
   
   (c) Subject to Treasury approval of terms and conditions.
   
   (d) Stock should not be issued to Treasury in lieu of Borrowing from Treasury. If stock is needed to sell the corporation, it can be created at the point of sale.
   
   (e) Lease-purchase transactions, being equivalent to borrowing, will be scored as indicated earlier (section V.A.3) under standard budget scoring rules.

2. Use of borrowed funds:
   
   (a) For start-up costs.
   
   (b) For expansion of capital investment.
   
   (c) Not for operating expenses, except (subject to OMB approval) for specific, emergency cash-flow requirements.  

**Financial management.**

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5. Cash-flow problems may be an indication that a corporation is not self-sustaining. This provision is intended to enable corporations to avoid short-term, cash-flow deficiencies, not provide permanent access to additional capital.
1. A government corporation should always be subject to Federal accounting standards. (If a corporation is in a transitional stage pending privatization, it can elect to also use those of the Financial Accounting Standards Board.)

2. A corporation should have a Chief Financial Officer (CFO).

3. A government corporation should produce an annual audited financial statement pursuant to the CFOs Act.

4. To the extent the corporation engages in profitable lines of business, the nature and amounts of profit should be revealed in the financial statements (lines of business analysis).

5. For corporations with fewer than 20 FTE involved in audits and investigations, the Inspector General (IG) function should be performed by the IG for the Department or agency under which they are located. Corporations with more 20 or more can consider creating their own IG.

Operating flexibilities.

1. Personnel rules. Consideration should be given to granting corporations flexibility from personnel rules (if, for example they need to quickly adjust to changing workforce requirements, or need to define jobs more broadly, or have more pay setting flexibility.)

2. Procurement rules. Consideration should be given to granting corporations flexibility to procure more efficiently or effectively (if for example, they are having difficulty in obtaining necessary goods and services while following red tape, e.g., present rules for IT acquisition that make small, modular acquisition of a large system virtually impossible).

Periodic reauthorization.

1. A corporation should be subject to reauthorization not less often than every five years.

2. Reauthorization should be an opportunity to:

(a) See how the corporation has performed (including a review of published performance measures) and

(b) Consider privatization.

3. The corporation should be asked to make a formal presentation to OMB reviewing its business operations and programmatic performance, particularly in terms of its charter and other requirements, and against these standards.
VI. The "Bottom Line."

Government corporations should be accountable for results that focus on programmatic outputs and outcomes.\(^7\) The corporation should be formed with a “charter” that spells out the scope of its activities to assure that government corporations are established and conduct their operations fully accountable for their financial soundness and programmatic activities. Corporations should be created with strategic goals and defined objectives (what the corporation should do) that will enable the Secretary and the Congress to judge how well the corporation is performing, including:

1. Program measures,
2. Financial measures, and
3. Specific actions if goals are not met.

The Secretary (and OMB) should:

1. Focus on strategic priorities and away from intervention in a corporation's day-to-day operations.
2. Link budget negotiations more closely with a corporation's strategic objectives and performance measures.
3. Develop other frameworks through which performance is given greater focus and attention.

\(^7\) Consistent with the Government Performance and Results Act, results should, to the extent appropriate, focus on outcomes.
Exhibit 6-1. Government-Sponsored Enterprises (GSE)

Government Sponsored Enterprises (GSEs) are different by related type of business entity:

A. Broadly defined, a GSE is a private corporation chartered by the federal Government to achieve public purposes that has nongovernmental status and is excluded from the Federal Budget.

B. As a general matter, GSEs occur infrequently, and are limited to being a privately owned, Federally chartered financial institution that has nationwide operations and specialized lending powers and that benefits from an implicit Federal guarantee that enhances its ability to borrow and from other ties to the federal Government.

C. GSEs were created because wholly private financial institutions were believed to be incapable of providing an adequate supply of loanable funds at all times and to all regions of the nation for specified types of borrowers.

D. A fundamental policy judgement about a GSE is whether the achievement of its public purpose is worth the amount of risk that the government must accept.

E. GSEs should have a Federal overseer created in law, with a regulatory regime that establishes and monitors performance of their mission and ensures that the entity is operating in a sound manner that minimizes risk to the government while enabling it to accomplish its mission.

F. GSEs should only be created with a clearly articulated "exit strategy" and an express sunset date in their charter.

G. A GSE could be fully privatized when the:

1. Assigned functions themselves are no longer necessary or appropriate for Federal involvement.
2. Business conditions which prompted its creation have changed (i.e., the special privileges bestowed upon them are no longer necessary to perform the functions for which they were created), or
3. GSE is no longer the most efficient way to achieve the public purpose.
Exhibit 6-2. Examples of Government Corporations and Other Entities

Government Corporations Classified in the Budget:

Commodity Credit Corporation
Community Development Financial Institutions Fund
Corporation for National and Community Service
Export-Import Bank of the United States
Farm Credit Insurance Corporation
Federal Crop Insurance Corporation
Federal Financing Bank
Federal Deposit Insurance Corporation
Federal Housing Administration
Federal Prison Industries (UNICOR)
Government National Mortgage Association
National Credit Union Administration Central Liquidity Facility
Overseas Private Investment Corporation
Pennsylvania Avenue Development Corporation
Pension Benefit Guaranty Corporation
Resolution Trust Corporation (RTC)
Rural Telephone Bank
Saint Lawrence Seaway Development Corporation
Tennessee Valley Authority (TVA)
United States Enrichment Corporation

Government corporations that are not in the budget:

Corporation for Public Broadcasting
Legal Services Corporation
National Railroad Passenger Corporation (AMTRAK)

Proposed government corporations:

Air Traffic Corporation
Bonneville Power Authority
Federal Housing Corporation (FHC)
U.S. Petroleum Corporation
Patent and Trademark Office (PTO)
Presidio Trust

Government-Sponsored Enterprises:

College Construction Loan Insurance Corporation ("Connie Lee")
Student Loan Marketing Association ("Sallie Mae")
Federal National Mortgage Association ("Fannie Mae")
Financing Corporation (FICO)

All entities now designated as government corporations that are included in the budget.
Federal Home Loan Mortgage Corporation ("Freddie Mac")
Federal Agricultural Mortgage Association ("Farmer Mac")
Farm Credit System institutions (Banks for Cooperatives, and Farm Credit Banks)
Federal Home Loan Banks System institutions

Does not meet the definition of a GSE as defined in Appendix I.
CHAPTER 7
ASSET SALES

Government can use many different techniques for introducing market dynamics, incentives, competition and choice to "privatize" government operations. Sometimes the Federal Government finds itself performing an essentially business function through no choice of its own. That is true, for example, in the case of converting real and personal property assets to cash, which often occurs when government is providing insurance—-as it does for depositors in banks and Savings and Loans and for housing loans through the Federal Housing Administration (FHA).

When government pays insurance claims, it generally takes over residual assets for liquidation. Also, real or personal property no longer needed by government creates a similar need to convert property to cash.

Where an activity is essentially a business activity, that is, the job is simply to make money, or minimize losses, a business-oriented joint-venture between government and the private sector may offer an excellent option for maximizing financial return to taxpayers with minimum effort and involvement of government.

RTC EXPERIMENTATION IN PROPERTY DISPOSITION

Much of the experience drawn on in this paper is that of the Resolution Trust Corporation (RTC), established to handle the recent crises for savings and loan organizations (S&Ls). RTC had explicit authority to use a wide variety of business techniques, including joint-ventures.

So long as an agency has no specific prohibition, such specific authority does not appear essential. The Federal Deposit Insurance Agency (FDIC) which does not have the same explicit authority, has carried out similar privatizing joint-ventures. Relevant techniques tried by RTC for converting assets to cash are:

- "Retail" by government staff
- Incentive Contracts
- Bulk-Sales
- Joint-Ventures

RTC had a sudden and massive volume of assets from failed S&Ls to convert to cash and statutory direction to make maximum feasible use of the private sector. It was thus a hospitable environment for experimentation. Previous government practice had been to manage and dispose of problem assets (like real estate and non-performing loans) directly by government, using government staff and procedures. That was largely the case with FDIC and the Department of
Housing and Urban Development (HUD). That government "retail" technique was certainly used in RTC, but it was clear that RTC volume was too great to be handled by any reasonable and likely level of government staffing.

In addition, carrying out retail business functions is, arguably, a particularly difficult operation for a government organization. Government emphasizes process, mistake-avoidance, and documented justification of actions taken. That makes it difficult to move fast, bargain, respond flexibly to new problems--in other words, to do the things that make an entrepreneurial business successful.

RTC (which was specifically created unencumbered by Federal procurement regulations) moved quickly to use a network of incentive-driven contracts to manage and dispose of problem assets.

Using a Standard Asset Management and Disposition Agreement (SAMDA) more than $36 billion of real estate and non-performing loans and other problem assets were placed with more than 100 private contractors. Those contractors in turn hired thousands of sub-contractors and negotiated sales, foreclosures and work-outs to convert the assets to cash. The SAMDA was certainly more workable than trying to use government staff, but the program had only mixed success. It was not possible to freely delegate decision-making to contractors and significant policy and procedural changes by RTC disrupted the program.

A major policy change affecting the SAMDA Program was the decision to make extensive use of bulk-sales, often of the same assets that were assigned to SAMDA contracts. Bulk-sales proved highly effective in privatizing disposition and work-out of individual assets. The main drawback is the discount given up to the bulk-sale buyer.

Problem assets are inherently risky and the market requires a high return on the capital ventured by bulk-sale purchasers. It was to avoid this discount (or, alternatively stated--to take advantage of some of the high-return earned by the middleman buyers) that led RTC to the joint-venture technique.

In a joint-venture, assets were transferred in bulk to a new, private, legal entity: a limited partnership or a business-trust, for example. A private investor purchased an equity interest in the new partnership entity and the government held an equity interest. In some cases, debt secured by the pool of assets was issued in private capital markets with the proceeds going to the government. The private equity partner assumed management of the new partnership entity and the government interest remained "passive" with respect to management.

Because the assets were sold by the government to the new entity, the joint-venture, unlike the SAMDA contract permitted a complete privatization of management. Management of the business function of converting problem assets to cash was performed using entirely private-sector techniques, including contracting procedures and financial incentives for staff. Compared
with bulk-sales, the joint-venture approach gave up a smaller discount (because of the retained
government interest) but still permitted movement of the assets "off-the-plate" of government in
bulk.

**Exhibit 7-1. Summary of Performance**

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<thead>
<tr>
<th></th>
<th>Net Return</th>
<th>Bureaucratic/Staff Intensive</th>
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<tbody>
<tr>
<td>Government Retail</td>
<td>Good</td>
<td>Not Good</td>
</tr>
<tr>
<td>Government Contract</td>
<td>Good</td>
<td>Mixed</td>
</tr>
<tr>
<td>Bulk-Sale</td>
<td>Fair</td>
<td>Good</td>
</tr>
<tr>
<td>Joint-Venture</td>
<td>Good</td>
<td>Good</td>
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**PRINCIPLES FOR SUCCESSFUL JOINT-VENTURES**

No management process is perfect, a contract or joint-venture can be good or bad depending on its design. From RTC and other experience, principles of successful asset disposition joint-ventures have emerged. These principles (many of which should be common for public-private joint-ventures for business functions other than asset disposition) are discussed below.

The most important factors are the first four--choice of objectives; transfer of title; equity investment; and, alignment of the parties interests.

- Have the right objective--to carry out a business function
- Transfer title from government to the private partnership entity
- Require substantial equity investment
- Assure full alignment of interests of private partner with government partner
- Address conflicts of interest--especially control of affiliate transactions
- Define oversight
- Transfer assets to partnership entity at fixed, up-front price
- Define the procedure for conflict resolution
- Sell "as is" to partnership entity
- Address dissolution procedures
- Correctly size the government interest retained

**Have the Right Objective**

A well structured public-private, property disposition, joint-venture is effective because it places full management control in the hands a highly incentivized private party with a very clear
objective—to maximize net present value financial return for itself by converting the assets to cash with the best combination of high gross income, minimum cost and speed of execution. So long as the government and the private party have exactly the same goal, the joint-venture can be highly successful in reaching the objective.

Government usually has many responsibilities besides maximizing financial return from assets. Generally, it is best to set up mechanisms separate from the joint-venture to carry out those responsibilities. For example, if government has a social objective related to property being disposed of, it is best to use government staff, a separate service contractor, or a separate direct subsidy to the beneficiaries, rather than to expect the private, joint-venture partner to take on the task. The social objective will be inconsistent with the simple, money-making goal and create conflicting objectives.

To assure accomplishment of the social objectives (in spite of the money-making incentive) government will have to maintain contractual controls which will interfere with effective delegation of decision-making to the private partner. The result will be a confusion of goals and of relationships between to the parties—to the detriment of both the social goal and the goal of maximizing financial return.

**Transfer of Title**

So long as assets belong to government, government rules, procedures, and decision-making must apply. Also third parties doing business with the joint-venture will use access to other political and administrative levels to interfere with the business operations of the joint-venture. Fully privatizing management and disposition of assets requires full private ownership of the assets.
Substantial Private Equity Investment--At Risk

A well-structured joint-venture requires the private, operating partner to have made a substantial, cash, at-risk, equity investment. Ideally, the private investor should a return on investment only from its share of the net proceeds of successful conversion of the assets to cash. There should be no other source of profit or return to the investor.

Besides the obvious point of creating a strong financial incentive to avoid loss and maximize return, equity investment has a more subtle, but essential impact. While government contractor may enter a contract of questionable workability (so long as it does not expect to lose money and there is a chance of making money), investors have a higher standard.

An investor will take a careful look at a transaction before writing a check for a major equity investment. They will want to assure that the business entity will be able to succeed. If the proposed joint-venture has confused objectives or the possibility of government interference in business decision-making--the equity capital will not be forthcoming. The entire venture is thus put to a "market-test" which goes a long way to assuring that government will be successful in its goal of maximizing financial return.

Alignment of Public and Private Financial Interests

For the venture to operate as a successful privatized business, government must delegate full management decision-making to the private partner. Government can only responsibly do so when the interests of the private party are fully-aligned with the government interests.

The private partner and government should share, pari passu, in all income and expenses and should receive all distributions of net proceeds, pari passu, at the same time and in direct proportion to the equity interest held by each party. Any other formula will cause some mis-alignment of the parties' financial interests.

It is tempting to have the private party pick up costs out-of-pocket (or to be covered from a fixed management fee--not tied to net proceeds). Because the private party will bear the full amount of such expenses, but share in only a percentage of benefits from the expenditures, the private partner will have a incentive to underspend partnership money. That is, money will not be spent on expenses even when it is in the interest of the partnership (and the government partner) to have the money spent because the expenditure will increases net return.

Affiliate Transactions and Other Conflicts of Interest

So long as the private operating partner is loyal to the partnership and proportionally sharing in all income and expenses with the government partner, financial interests are fully aligned. If, however, the private party can steer benefits to affiliated parties, or parties which will
directly or indirectly pass back benefits, there will be a distinct conflict in the financial interests of the public and private parties.

These issues must be fully addressed in the joint-venture documents and in the procedures for government oversight. The following is one good combination of joint-venture contract provisions.

- A complete prohibition on all "affiliate transactions" (with an exception noted below). That is, no partnership funds can be spent on transactions with the private partner or an affiliate of the private partner.

- Costs of the employees of the private partner who devoted 100 percent of their effort to the joint-venture can be paid with partnership funds, but compensation for a person doing any other work for the private partner or an affiliate would be a prohibited affiliate transaction--for which no partnership compensation can be paid.

- The private partner should be obligated that if it receives any benefit from a third party resulting from that third party doing business with the joint-venture, the value of the benefit must be paid over to the partnership.

- Sales of assets to affiliated parties should be prohibited.

- The private partner should have an explicit duty of loyalty to the partnership, as well as general obligations under applicable business law and specific prohibitions against foreseeable conflicts of interest included the joint-venture documents.

- Government oversight should include provisions for spot-checking transactions (preferably by a private, compliance monitoring contractor) to create a reasonable possibility of improper transactions being found.

An exception on the prohibition of affiliate transactions can be made on a case-by-case basis when clearly in the mutual interest of the parties. For example, if use of the private partner's computer system would be clearly more cost-effective than purchase of services from a non-affiliated third party, such an exception can be granted. The terms of payment and services should be negotiated up-front, should not create a "profit-center" for the private partner and the terms should be included in the joint-venture agreement documentation.

**Government Oversight**

Procedures for government oversight and partnership reporting should be fixed up-front in the joint-venture documents. Oversight and reporting are too important to be left to later, and the obligations of the private partner cannot be unilaterally changed by government.
Correct alignment of the parties' interest involves a combination of appropriate financial incentives, specific contractual prohibitions of conflicting actions and a believable and reasonable oversight process.

**Conflict Resolution**

All matters cannot be addressed up-front. Procedures for interpretation of the joint-venture documents and for resolving disputes should be included in the agreement. A procedure for arbitration is one good option.

**Fixed-Price Transfer of Assets**

The pool of assets should be priced by a competitive sale of the private partnership interest before the partnership goes into operation. That is, selection of the private partner should be by open competition, included cash bidding for the partnership interest to be held by the private partner.

"Open pools" in which price, quantity or other significant terms of sale are left for later determination should be avoided.

The idea of the joint-venture is to have the private party working with an identity of interest with the government partner. If terms of sale are not settled, there is a major conflict of interest and much of the attention and effort of the private partner will be devoted to working against the government's interest.

Government will want bad assets included at a high price and the private party will want good assets included at a low price. Such conflicts of interest can greatly injure successful achievement of government goals.

"As Is" Sale

Offering representations and warranties on the assets transferred to the joint-venture create another break in the alignment of interests. It will be in the interest of the private partner (but not the government partner) to take every advantage of such warranties to benefit the partnership at the cost of the government. That will result in effort of the private party to be spent working against, not with, government.

Generally, "as is" terms can be handled by the private party by adjusting the price paid for the partnership interest. Giving up that "as is" discount is generally advantageous for government to maintain the alignment of interests. Where warranties and indemnifications are unavoidable, they must be structured carefully with the greatest concern as to how they will affect the private party's incentives. (Once the agreement is executed, the private party will control the business decision-making.)
**Dissolution Procedures**

Although there is no perfect procedure for hostile dissolution of a complex business arrangement, procedures should be agreed upon in advance to the extent feasible and stated in the joint-venture documents.

One possibility is a bulk-sale of remaining assets followed by distribution to partners. Government should be given the right to bid on the bulk-sale, but not be obligated to do so. The private partner should have a reduced distribution (especially if its default caused the dissolution) to avoid creating an incentive to force a dissolution.

Detailed procedures and timing for winding-up the joint-venture (in non-hostile circumstances) should also be laid out in the documents.

"**Sizing**" the Government's Retained Interest

Government will sell an interest in the pool of assets (a percentage interest in the joint-venture) and retain an interest. The portion sold will be priced as a "wholesale" purchase, that is, there will be a substantial discount from the conservatively projected proceeds of eventual sale or other "retail" disposition of the assets.

The interest retained by government will reap the full advantage of the private, incentive-driven, "retail" conversion of the assets to cash. The rule is, thus, to sell as small a percentage of the "deal" to the private sector as can be done *and still have the private party act as though it had purchased the whole pool.*

The smaller the ownership interest of the private party, however, the greater will be the temptations to make profits from handling the government's money by ways other than partnership distributions--so there is a de minimis private share which would be against the government's best interest.

The RTC has had success with well-structured, relatively large, joint-ventures in which the private party held only a 20 percent interest. That produced a high return for RTC. Other RTC transactions gave the private parties as much as 50 percent or more of the ownership.

The SAMDA contract, which typically provided a two or three percent share of net proceeds as a "disposition fee" did not give a large enough share to have the contractor act fully as an "owner."

**DOD ASSET SALES LOOK AT JOINT VENTURES**
The Commission on Roles and Resources recommended that the Department of Defense (DoD) privatize many of the logistic functions which, although important, are non-core operations of DoD. As part of that reinvention, the Defense Reutilization and Marketing Service (DRMS) is working to develop a creative, joint-venture, public-private partnership for disposing of excess DoD personal property. Large quantities of excess personal property are a normal product of aging material and replacement with improved equipment. In a period of downsizing, the job of disposing of an increased amount of excess personal property becomes even more important—and increasing financial return from property sales becomes even more important to the American taxpayer.

Until now, DoD had essentially two choices, DRMS could sell property singly or in small lots, i.e., retail sales. Arguably, government organizations with all their restrictive staffing and other rules are not likely to be the most efficient retail marketers. The other choice is for DRMS to sell in bulk to middlemen who then market the property retail to the eventual end-user. Naturally, the middlemen want to buy cheap and sell high to earn a good margin for themselves.

Under the new approach, DRMS would transfer large blocks of excess property to competitively selected new joint-venture which will be managed by private investors, but with DRMS holding a large interest in the profit to be generated. As the private investor operates in the free market to maximize its own financial return by efficiently disposing of the excess property to the best paying end-users, the return to DoD (and taxpayers) will also be maximized through the DRMS share of the joint-venture. In carrying out this privatization reinvention, DRMS is drawing on some of the experiences of other agencies, especially the experience of the Resolution Trust Corporation (RTC) in selling and joint-venturing in sales of property taken over by government from failed savings and loans.

The Department of Housing and Urban Development (HUD) is also drawing on the RTC experience with joint-ventures to try to privatize the restructuring of some $28 billion of outstanding FHA-insured mortgages on apartment buildings now receiving Section 8 rental assistance from HUD. As HUD privatizes tenant assistance programs by replacing expensive project-based, Section 8, rent contracts with less expensive vouchers, most of the projects will require some form of restructuring of their FHA-insured mortgages. If HUD uses a joint-venture approach to mortgage restructuring, it will be privatizing the implementation of this important housing reform.

In some cases, the appropriate privatization approach is to entirely remove government from a function. Initiatives to sell the Naval Petroleum Reserve, Helium production, the Power Marketing Administrations, and other assets fit that strategy.

EXECUTIVE ORDER 12803, INFRASTRUCTURE PRIVATIZATION

Executive Order 12803 was issued in April 1992, to encourage Federal, State and local governments to leverage public and private sector investment in infrastructure and to use the
equity in existing infrastructure for new or expanded infrastructure. Prior to E.O. 12803, the disposition of Federally-financed infrastructure was controlled by the "Common Rule." E.O. 12803 added to the "Common Rule," as follows:

1. States/locals could consider the sale/lease of assets that would continue to be used for original purposes.

2. Federal recoupment for the sale/lease of these assets may be calculated by multiplying the original contribution rate by the depreciated value. In many cases, this greatly reduces the payment required by the Federal Government and removes that hurdle to privatization.

3. State/local proceeds could be used for infrastructure, debt or tax relief.

**EXECUTIVE ORDER 12893, PRINCIPLES FOR INFRASTRUCTURE INVESTMENT**

This order, which was issued in January 1994, requires agencies to perform systematic analysis of benefits and costs of infrastructure programs. The analysis should be quantitative and monetized to the maximum extent practicable, and it should consider a comprehensive set of policy options.

Federal grantees constructing infrastructure are required to consider alternatives--including public-private partnerships.

Major programs (those with annual budgetary resources of $50 million or more) should be justified using the principles described above. The order applies to direct spending and grant programs in the following areas:

- transportation (Federal Highway Administration, Federal Railroad Administration, Federal Transit Administration, Federal Aviation Administration, and Coast Guard);
- water resources (Army Corps of Engineers, Bureau of Reclamation, and Department of Agriculture);
- environmental protection (EPA Clean Water State Revolving Funds and proposed Drinking Water State Revolving Funds, and USDA rural water and wastewater facilities grants and loans); and
- energy (Power Marketing Administrations).
CHAPTER 8

DEVOLUTION TO STATE AND LOCAL GOVERNMENTS
CHAPTER 9

VOUCHERS

HOUSING VOUCHERS

The Department of Housing and Urban Development has proposed a dramatic reinvention of its programs and operations that rests on two broad principles. One is granting more flexibility to States and cities to tailor HUD programs to local needs within the parameters of national objectives. Accountability will be achieved through broad performance measures with emphasis upon outcomes. The other major principle is using market forces to improve program efficiency. Examples include the use of portable rental certificates, or vouchers, to allow assisted renters to choose their dwelling. These have the benefits of allowing renters to seek out the best available housing, freeing them from substandard projects, and creating incentives for property owners to be responsive to tenant needs. Conversion to tenant-based assistance is the cornerstone of the Mark-to-Market proposal that adjusts the financing of FHA-insured multi-family properties to reflect market conditions and for providing a new form of assistance to residents of obsolete public housing.

Housing vouchers, or certificates, empower low income tenants to make their own choice of apartment in the competitive free, rental-housing market. Ownership and management of the buildings is left to the private sector. Property managers and owners can only succeed if they please their customers. These portable, voucher subsidies have been around for more than a decade, but the major focus of HUD housing programs has been the expensive, and questionable, "low-income housing projects" of the public housing program and other programs in which privately-owned properties were operated under government regulation as low-income housing projects. Recognizing the difficulties and expenses of those programs, Secretary Cisneros of HUD has proposed legislation to privatize low-income housing by moving out of the business of housing "projects." Public housing and Section 8 project-based assistance will be replaced by portable subsidies, vouchers or certificates. Properties will be operated according to market-principles: competition, choice and responsiveness to customers.
CHAPTER 10

SERVICE TERMINATIONS

*Program cancellation (or service termination)* reflects a government review of the existing commercial, State or local government service market and a decision that a service need not be provided by the Federal Government. This option includes many Federalism concepts. Electrical power generation and distribution (rural electrification), and helium production and sales are also examples of services that fit into this category.
APPENDIX A

LEGISLATIVE RESTRICTIONS TO COMPETITION AND CONTRACTING OUT IN THE FEDERAL GOVERNMENT

Over the years Congress enacted a number of legislative restrictions to contracting out or placed other restrictions on managerial flexibility. The following is a list of legislative impediments. The elimination of such restrictions could result in additional managerial flexibility to improve performance and cost effectiveness.

Agriculture

None. Agriculture was previously restricted from contracting out in its Agricultural Stabilization and Conservation Service (ASCS) and in the Soil Conservation Service, but these legislative restrictions are no longer present.

Commerce

1. P.L. 102-555 - "Neither the President nor any other official of the government shall make any effort to lease, sell or transfer to the private sector or commercialize, any portion of the weather satellite systems operated by the Department of Commerce or any successor agency."

2. 15 USC 3704(b) - "The functions of the NTIS are permanent Federal functions to be carried out by the Secretary through the Service and its employees, and shall not be transferred from the Service, by contract or otherwise, to the private sector on a permanent or temporary basis, without the express approval of the Congress."

"Regardless of any change in circumstances subsequent to the enactment of this Act, even if such change makes it appear to be in the national interest to commercialize weather satellites, neither the President nor any official shall take any action prohibited by Section 601, unless this title has first been repealed."

Defense

1. Title 10 Section 114(a)(2) - Prohibits contracting out of R&D functions under Circular A-76.

2. Title 10 Section 2461 - Requires cost comparisons, compressional notifications, Most Efficient Organization (MEO) certifications and annual reports to CoNPResst to contract out.
3. Title 10 section 2462 - Permits contracting out if a cost comparison is fair and includes certain costs.

4. Title 10 Section 2463 - Requires a semi-annual report of all conversions to the private sector involving more than 50 FTE.

5. Title 10 Section 2464 - Limits contracting out of logistics support functions, unless waived by the Secretary.

6. Title 10 Section 2465 - Prohibits conversion of firefighting and guard services to contract performance.

7. Title 10 Section 2466 and 2469 - Limits contracting out of Depot Maintenance functions - the 60/40 in-house to contract rule.

8. Title 10 Section 2467 - Requires DOD to consult with employees on the performance work statement and MEO and include in the in-house bid certain retirement costs.

9. Title 10 Section 2468 (Nichols Amendment, P.L. 100-800) - Removes from the Secretary and assigns to the local installation commanders the authority to determine whether any function will be studied for possible conversion to contract performance and how many FTE will be studied. Extended through September 30, 1995, by P.L. 103-337 Section 386(c), FY 1995 Authorization Act.

10. Title 10 Sections 4532/9532 - Provides for the mandatory in-house use of DOD factories and arsenals.

11. P.L. 103-335 Section 8020, DOD FY 1995 Appropriations Act - Requires MEO certifications and reports to CoNPres regarding contracting out.

12. P.L. 103-335 Section 8043, DOD FY 1995 Appropriations Act - Prohibits the use of DOD funds to complete any A-76 cost comparison that is more than 24 months old and involves a single function or is more than 48 months old if it involves multiple functions. Designed to cancel studies and prevent conversions to contract.

13. P.L. 103-335 Section 8057, DOD FY 1995 Appropriations Act - Prohibits the use of A-76 to cost compare depot maintenance services. As a result, the DOD Depot Maintenance Cost Comparison Handbook was developed.

14. P.L. 102-392 Section 207 - Prohibits DOD from contracting for printing services, except as permitted by the GPO.

Education
None. Education was previously restricted from contracting out library services, but this legislative restriction has expired.

**Energy**

No legislative restrictions have been identified.

**Environmental Protection**

No legislative restrictions have been identified.

**General Services**

1. Part 51-5.2, Federal Acquisition Regulations - Effective October 28, 1991, it became mandatory for Federal agencies to order commodities on the CBOSH Procurement List which are in the FSS supply system from GSA.

2. 40 USC 490(c) or P.L. 100-440 Section 507 (Edgar Amendment) - Prohibits GSA from contracting for guard, elevator operators, messengers and custodians (services).

**Health and Human Services**

No legislative restrictions have been identified.

**Housing and Urban Development**

No legislative restrictions have been identified.

**Interior**

1. 16 USC 668(d), Wildlife Refuge Administration Act - Prohibits the Fish and Wildlife Service from contracting for the management, operation and maintenance of wildlife refuges.

2. 43 USC 1707(204)(a) - Requires that Bureau of Land Management (BLM) lands be managed directly by Federal employees.

3. 43 USC 1701(e) - Prohibits BLM from replacing Federal employees with volunteers.

**Justice**

No legislative restrictions have been identified.
Labor

No legislative restrictions have been identified.

NASA

No legislative restrictions have been identified.

OPM

42 USC 2165 - The Nuclear Regulatory Agency must acquire personnel background investigations from OPM or the FBI. This limits the competition available to NRC and imposes continuing service requirements on OPM.

Transportation

No legislative restrictions have been identified.

Treasury

No legislative restrictions have been identified.

Veterans Affairs

Title 38 Section 8110(c), P.L. 103-446 suspended - Section 8110(c) limits the DVA's ability to contract out. Legislatively required cost comparison provisions serve to raise the cost of contract performance, in conflict with the requirements of OMB Circular A-76. In DVA, for example, a 15 percent differential is required vice the 10 percent differential required by the Circular. The Government's cost of conducting the comparison (PWS, management study and cost analysis) is also added to the contractor's bid. P.L. 103-446 suspends Section 8110 (c) for five years.
**Railroad Retirement Board**

1. 45 USC 2331(f)(b)(3), 45 USC 362(m) and 45 USC 355 - Appeals of RRB decisions can only be reviewed by board members. Taken in combination these provisions prevent the RRB from contracting for alternative dispute resolution services.

2. 26 USC 6103(l)(1) - Limits the distribution of tax information necessary to the provision of services, thereby effectively requiring in-house performance.

**Small Business Administration**

No legislative restrictions have been identified.

*Note: The material published in this appendix is identical to that released by the NPR as a June 16, 1995 paper.*
APPENDIX B
SELECTED REINVENTION INITIATIVES

Set forth below is just a sampling of successful privatization efforts at Federal agencies. It should not be surprising that the Department of Defense seems to have the "lions share" of actions underway. Approximately 70 to 75 percent of the type of initiatives which have lent themselves historically to "privatization" fall within DoD. Creativeness and innovation are necessary ingredients to learning from the examples at hand and developing new avenues of action. Appendix A contains information about privatization initiatives from the recently released fiscal year 1996 budget of the United States.

Department of Defense

801-Leased Family Housing Program. This program created more than 12,000 military family housing units, on and off-base, which were built, financed and in some cases operated by private developers.

802-Rental Guarantee Program. This program was used to develop privately built, operated and financed housing on-base for military families. The owner collects rents directly from qualified tenants. The government guarantees a specific occupancy level.

Land Leasing under 10 USC 2667 for Military Family Housing. Started as a test program, the Army awarded two long-term leases to private sector developers to build and operate housing developments for military families at a base which had a critical housing shortage. The developers received no guarantees and were required to collect rents directly from tenants.

Navy Limited Housing Partnership Program. The Congress recently granted the Navy the authority to provide equity capital to developers of private sector affordable housing for military families. The government's risk will be limited to its equity contribution, and it may share in future profits of each project funded. Eligible projects must be built on privately owned land and will be open to civilian tenants. All tenants will pay rent directly to the owner-operator.

Maritime Prepositioning Program. Designed to serve as forward deployed equipment and supplies for the Marine Corps, this 13 ship fleet is owned, crewed and maintained by the private sector. In times of crisis, such as the recent Gulf War, the ships sail from their deployment areas to ports near the crisis and off-load cargos of equipment to Marines for use in combat or related missions. Several similar government-owned ships are operated by government-contracted crews for the other services.

Army Family Medical Care. The U.S. Army, in support of DoD eligible beneficiaries in the Northern Virginia area, has joined with a private contractor to provide primary care services
within a specific geographical area. Primary care offices (outpatient clinics) have been established in civilian residential neighbors which have high concentrations of military families. The offices are manned by uniformed and contractor medical personnel.

**Military Member, Dependent and Retiree Medical Care.** In places where eligible service members, their families, and military retirees can not receive medical care from military hospitals, the DoD contracts with private doctors to provide health services. The administration of this program, has been privatized in several areas for the country. The contractor of this billion dollar program provides claims processing and provider qualification services that reduce the administrative burden on the military services.

**Day Care Centers.** At the Pentagon and Tracy Depot, California, the day care centers are owned and operated by private day care providers. The buildings in which the service is provided sit on leased government land and have been privately financed. Users of these services pay directly to the provider, who has guaranteed that Federal employee dependents will have priority in placement and reduced rates. Day care slots not needed for dependents of Federal employees can be sold to private sector users. If there is insufficient demand for day care services to meet the debt service on the buildings, DoD has committed to make-up the short-fall.

**Utility Systems.** DoD has privatized power generation, energy savings, and water treatment at various bases. It has purchased utility services from private, as well as public, providers. Utility systems have been transferred to communities and utility companies, in exchange for continued service, upgrades or cost reductions.

**Department of Veterans Affairs**

**Pershing Hall.** The Department of Veterans Affairs (VA) recently entered into a 99-year lease with a private sector developer to rehabilitate and operate the famed Pershing Hall in the heart of Paris, France. Built after World War I as a monument to General Pershing and American Forces, it fell into disrepair. The Congress authorized the Department to grant the lease in exchange for rehabilitation of the building, future cash lease payments and free administrative space and ceremonial use during the lease term. The developer is also required to establish and maintain a memorial honoring General Pershing.

**Day Care.** The VA recently awarded contracts to two day care providers to build and operate centers on land owned by the VA in Washington, D.C. and New Haven, Connecticut. In each case, the land was leased for 35 years at a nominal ground rent. The providers are required to build day care centers that will accommodate a specified number of Federal employee dependents at set rates. Day care slots in excess of those required for Federal employee dependents can be used by private sector parents, who will pay market rate tuition. The Department did not provide the contractors with any guarantee on usage or debt service.

**Other**
Australian Billpay Arrangement. In January 1992, the Australian Taxation Office and the Australian Post (AP) established an agency arrangement, whereby taxpayers could pay tax bills at any of the AP's 4,500 post offices and post office agencies.

New Zealand Government. New Zealand has had extensive experience in transferring governmental functions to the private sector. In a report on their efforts they identify the seven key elements of a successful privatization program in their country: (Quoted from New Zealand Reformed State Sector, P.17, published by the New Zealand State Services Commission, Wellington, New Zealand, 1994.)

1. Unflinching political determination.

2. Very clear objectives, agreed at the highest levels, and based on an intelligent appreciation of the community's tolerances.

3. A set of comprehensive and well integrated basic principles, agreed upon at the highest levels.

4. Sound legal architecture that redefines the rules outright.

5. A demanding but realistic timetable.

6. A core of unified, highly motivated, experienced, and imaginative senior public servants, provided with sufficient resources and discretion to manage implementation.

7. Very effective information and public relations systems.

The table which follows was prepared using a variety of inputs, including the President's FY1996 budget proposal and selections from the 1995 report of the NPR entitled, Common Sense Government. Two footnotes apply:

* Items noted with an asterisk were previously identified by the agency involved in some sort of public statement, but not included in the current NPR list. They still appear to be valid activities. The four Privatization initiatives in Italic were not reflected in their agency's NPR Phase II proposal, but were reflected in the agency's FY1996 budget request.

** Activities included in the list are: AID2-03; USDA2-01, 2-03, 2-05,2-06,2-07,and 2-08; DOC2-01, 2-02,2-03,2-052-06,2-07,and 2-10; ED2-01, 2-02, 2-06, and 2-11; DOE2-01, 2-02, 2-03, and 2-05; EPA2-03 and 2-06; FEMA2-01, 2-02, and 2-03; HHS2-02, 2-03, 2-062-07, 2-08, 2-10 (combined savings with HHS2-03), and 2-11; HUD2-01 and 2-02; INT2-01; DOJ2-01, 2-01, 2-03, 2-04, 2-05, 2-06, 2-07, 2-08, 2-10 (cited as a revenue source not a saving), and 2-14; DOJ2-02, 2-03, and 2-08; DOL2-02, 2-03, 2-05, 2-15, and 2-19; NASA2-08; OPM2-02; SBA2-
<table>
<thead>
<tr>
<th>Consolidation</th>
<th>USDA will consolidate servicing of its $30 billion single-family housing loan portfolio and can save $250 million. USDA will consolidate its Nutrition Program for the Elderly with the Administration on Aging and save $150 million. HUD is consolidating 60 grant programs into 3 performance grants: Housing Certificates, and Community Opportunity Fund. The Intelligence Community will consolidate Imagery Intelligence by October 1, 1996 to improve resource allocation and service delivery. DOI will consolidate activities of the Denver National Park Service Center with similar operations and save $17 million. DOJ will consolidate administrative support to the Bureau of Prisons' Correctional Institutions, the U.S. Marshals Service prisoner and INS detainee transportation, and Federal law enforcement laboratories. DOL will consolidate its regional alien labor certification processing facilities and devolve some responsibilities to the States to save $224 million. DOL will transfer its Community Service Employment for Older Americans to HHS to provide a better service and save $171 million. SBA will realign its field operations through consolidations and relocations to save $225 million and enhance service delivery through increased use of public-private partnerships. SSA will consolidate its regional offices from ten to five and save $52 million. * DOT will consolidate its 10 agencies into 3 around the themes of either (a) land, sea, or air, or (b) infrastructure, safety, and Coast Guard. * DOT will consolidate its 30 grant programs into 3: a unified grant to states and cities, new state discretionary grants. * EPA will allow states to consolidate up to 12 media-specific grants (water, air, hazmat). HHS will consolidate 107 Public Health Service into five Performance Partnerships and 11 states and local communities more flexibility, with a resultant savings of $218 million. HHS will combine the Office of the Secretary and the Office of the Assistant Secretary for Instrumentation, an entire organizational layer of management, and merge to PHS agencies--the Agency for Toxic Substances and Disease Registry, and the Centers for Disease Control and Prevention--with savings of $154 million.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Vouchers</td>
<td>HUD will transform public housing by shifting funding from 3,400 public housing authorities to tenants who can then determine where to purchase support (similar to G.I. Bill). * DOL will eliminate all state role in JTPA by paying skill grants to workers rather than passing private contractors.</td>
</tr>
</tbody>
</table>
### Devolution

- EPA will increase the State role in the Superfund Program to save $148 million.
- DOT will give states more power over transportation-related spending as part of $6.7 billion plan.
- DOI will transfer the Bureau of Indian Affairs program operations to Tribes.
- DOI will begin an aggressive program to transfer title and operations and maintenance responsibilities for some facilities to state and local governments on a "willing buyer" basis, and save $126 million.
- DOI will transfer the responsibilities for selected MD and VA parkways to the states and save $31 million.
- DOI will divest of its private land restoration program to the states and private sector to save $51 million.
- GSA will delegate additional responsibility to Federal agencies regarding their performance of administrative and support activities.

### Cancellation/Termination

- USDA will terminate the Emergency Farm Loan Program and save $142 million.
- Commerce will eliminate the National Oceanic and Atmospheric Administration Corps and save $35 million.
- Education will terminate low priority education programs to save $555 million.
- EPA will phase out non-essential assessments of sites on National Priorities List to save $44 million.
- OMB will eliminate Circular A-106 and modify E.O. 12088 reporting requirements to save $2 million.
- FEMA will eliminate the Disaster Housing Mobile Home Inventory and the Federal Crime Insurance Program.
- SSA will stop collecting attorney fees as a middle-man between clients and their attorneys, to save $80 million.
- DOE will shave $1.2 billion over five years from its applied research programs, including ending the Clean Coal Technology Program, and close at least one laboratory facility.
- DOI will eliminate its Office of Territorial and International Affairs and save $5 million.
- The Interstate Commerce Commission will be terminated (FY96) to save $123 million.
- OPM will terminate its operational training and investigations activities.
- DOT will cancel Highway Demonstration Projects and save $290 million.
- VA will terminate the Mobile Home Loan guaranty Program.
- The Army Corps of Engineers will eliminate its local projects role to save $837 million.

### Administrative Changes

- USDA will allow States greater flexibility to change Food Stamp Program administrative procedures to enhance service delivery to those in need and reduce program costs.
- USDA will shift the cost of its Peanut Program to industry and save $300 million.
- USDA will reform the Forest Services' land acquisition procedures and save $110 million.
- Commerce will reengineer its methodology for the decennial census to save $1 billion.
- Education will streamline its headquarters and consolidate regional offices from ten to five.
- EPA will reduce Superfund's National Institute of Environmental Health Science's role in HHS will improve the Food and Drug Administration's regulatory process by eliminating unnecessary components and save $37 million.
- DOI will allow the private sector to buy-out current offshore oil and gas royalties and generate revenues of $3 billion.
- DOL will simplify procedures of the Pension Benefit Guarantee Corporation and save $6 million.
- SBA will shift the cost of its loan and surety bond guaranty programs from taxpayers to program beneficiaries and provide more loan guarantees while saving $976 million.
- Treasury will relieve employers of the burden of filing duplicate information between Treas and SSA will delegate authority to SSA to disburse benefit payments electronically, thereby reducing administrative costs.
**payment processes and saving $42 million.**
**Treasury will mandate a State bank examination fee and save $1 billion.**
* HUD will save $800 million through administrative changes, attrition, and buyouts over five years.
* DOE will make unspecified cuts in the management and operations of its nuclear and chemical program
  to save $4.4 billion.
* OPM will eliminate 1,800 more positions over the next five years.
* USDA will maintain 14 rural development loans and grant programs as separate entities, but a funds
  between programs at the state level to address the State's rural economic development needs.
**SSA will spread out its monthly benefit checks for new beneficiaries to distribution workload rather
it once monthly, to save $241 million.**
* HHS (FDA) will allow drug and biologics manufacturers to change the way they manufacture pre-
  approval if the risk is negligible; the drug industry will no longer be burdened with outdated, insulin
  and antibiotic drugs.
* HHS (FDA) will exempt from environmental assessments virtually all applications for human, animal
  drugs. Industry will no longer have to wait for pre-market review for up to 138 categories of products
  such asfinger exercises and oxygen masks.

### Privatization

| Commerce will privatize portions of the National Weather Service to save $40 million. DOE will sell the Naval Petroleum Reserves at Elk Hills and Teapot Dome to private industry and save $1 billion. DOE will also (in FY1996) convert the Bonneville Power Administration to a government corporation remaining Power Marketing Administrations and the U.S. Enrichment Corporation. FEMA will privatize its Open Learning Fire Service Program HHS will privatize the NIH Clinical Center Management and save $87 million. HHS will privatize the development of its clinical practice guidelines and its selected technol $18 million. DOT will convert its Air Traffic Control function into a government corporation (FY96 budget), operations and its 40,000 employees to a semi-public corporation as part of $6.7 billion pack Sallie Mae will convert from a government corporation to a fully privatized entity (FY96 budget) Connie Lee will convert from a government corporation to a fully privatized entity (FY96 budget). DOI will privatize the Helium Program (FY96 budget) to save $16 million. DOL will privatize OSHA and MSHA's accreditation process to save $3 million. NASA will rely on private sector for NASA's communication with space craft to save $170 million. USDA will privatize its Rural Telephone Bank and Federal Disaster Insurance for crops (FY96) |

### Other Divesting

| Commerce will reform the Patent and Trademark Office, the National Technical Information Service, the National Oceanic and Atmospheric Administration Seafood Inspection organization into separate government corporations and save $20 million while enhancing service delivery. HUD will establish the Federal Housing Administration as a government-owned corporation. * GSA will review each of its operational business lines to determine which should be transferred and privatized. * GSA will also consider the use of Employee Stock Ownership Plans (ESOPs). DOE will sell uranium no longer needed for national defense purposes after rendering it suitable for commercial power reactors. |
BACKGROUND

On January 15, 1955, the Bureau of the Budget issued Bulletin No. 55-4. Since that time, it has been the general policy of the Federal Government to rely on the free enterprise system to provide the commercial support services it needs. Bulletin No. 57-7 (February 1957) added an evaluation of commercial activities, provided initial cost comparison concepts and introduced controls over starting new in-house activities. Circular A-76 was first issued on March 3, 1966; stating that the "cost comparison guidelines of this Circular are in furtherance of the Government's general policy of relying on the private enterprise system to supply its needs." Revised on March 29, 1979 and, again, on August 4, 1983, the Circular seeks to balance the needs of Federal managers, employees, and the private sector against the interests of the Federal taxpayer. It does this by establishing an acceptable level of analytic rigor in making the Federal Government's "make or buy" decision.

Circular A-76 does not ask "should we be in this business?" Its purpose is not to facilitate the sale of assets, close or move facilities or operations, suggest a fundamental re-engineering of requirements, nor does it make normative or ideological decisions to move operations to or from the private sector. These are policy level decisions that do not involve A-76 make or buy competitions. What A-76 does do is ask, given a determination of a continuing need for a stated service, who should do the work? A-76 is designed to identify the most cost effective method of performing a recurring commercial service requirement. It is designed to use competition and the incentives that competition brings to service quality and cost to ensure that taxpayers receive the full benefit of their tax dollar. In establishing common ground rules for competitions between public and private sector alternatives, A-76 protects the procurement process, establishes a common baseline for cost and quality assessments, creates certain "good employer" relationships for affected Federal and contract employees and determines competitively, who is best prepared to do the work.

INTRODUCTION

The proposed OMB Circular A-76 Revised Supplemental Handbook is designed to enhance Federal performance through competition and choice. It seeks the most cost effective means of obtaining commercial support services and provides new administrative flexibility in the Government's make or buy decision process. The revisions modify and in some cases eliminate cost comparison requirements; reduce reporting and other administrative burdens; provide for
enhanced employee participation; ease transition requirements to facilitate employee placement; maintain a level cost comparison playing field; and seek to improve oversight to ensure that the most cost effective decision is implemented. A few of the more significant revisions are summarized below:

1. **SCOPE**

   Inherently governmental functions, as defined in the Office of Federal Procurement Policy (OFPP) Policy Letter 92-1 (Federal Register, September 30, 1992, page 45096) are not subject to performance by contract and are, therefore, not subject to the cost comparison requirements of Circular A-76. The Circular also exempts certain commercial functions from the cost comparison process, including: mobilization requirements within the Department of Defense, the conduct of research and development (R&D), and direct patient care activities in Government hospitals or other health facilities. To ensure that needed commercial support skills are available and to minimize cost comparison requirements, the revision authorizes agency heads to exempt the following activities from the cost comparison requirements of the Circular: national security activities, a limited percentage of mission critical core activities, and any temporary requirements. Because these activities represent special technology and highly skilled technical support service requirements, the revision permits agency heads to convert these activities to or from in-house or contract performance without cost comparison. Activities that are currently contracted, new requirements and expansions will continue to be performed by contract, unless a cost comparison determines that conversion to in-house performance is appropriate.

   The revision clarifies that the Circular applies only to recurring commercial activities. As a matter of policy, non-recurring activities should be acquired by contract or, if necessary, performed in-house on a temporarily justified basis only. Recurring and separable activities in support of R&D will continue to be subject to cost comparison, unless contract performance is not otherwise feasible.

2. **ANNUAL INVENTORY AND REPORTING REQUIREMENTS**

   The revision eliminates OMB's required study schedules and quarterly study status reporting requirements, as unnecessary and administratively burdensome. Other factors, such as annual budgetary limitations, the Chief Financial Officers Act (CFO Act), the Government Performance Results Act (GPRA), the Government Management Reform Act (GMRA), and increasing agency compliance with Federal accounting standards, will influence agencies to consider their current in-house to contract mix.

   Agencies will, however, maintain an inventory of commercial activities with a minimum level of information on completed cost comparisons and other conversions for review by OMB and other parties. The information that agencies should maintain, by function and location include, for example: the activity's designation as exempt, core or non-exempt; number of FTE, status (contracted out/in); and dollar savings.
3. **COST COMPARISON REQUIREMENTS**

Circular A-76 exists to facilitate competition between Federal and private sector providers of recurring commercial support services. It is designed to ensure that the parties compete on a level playing field; prevent the manipulation of cost and performance information; prevent cross subsidies from skewing the results of a competition; ensure that all relevant costs are considered; ensure that make or buy decisions are based upon economic justifications not administrative conveniences; and to ensure that the rights of affected parties are protected throughout the process. More importantly, the Circular exists to ensure that agency make or buy decisions are in the best interests of the Federal taxpayer. As a result, the process generally requires that agencies define their workload, identify their Most Efficient In-house Organization (MEO), and then, compete that MEO against offers from the private sector and other Federal agencies, when appropriate. The revision proposes the following changes:

a. **Waivers**

The current Circular provides that cost comparison waivers may be granted by the assistant secretary designated in paragraph 9.a. of the Circular, without review, if certain conditions exist. These conditions include an economic justification for the conversion to contract and a determination that the MEO could not effectively compete with the private sector. Added to these conditions is a recognition that waivers may also be granted to convert to in-house performance, the consideration of the Government's best interests, significant financial or service quality improvements and the existence of effective price competition. The revision also makes the waiver decision subject to public review and an administrative appeal process.

b. **Employee Participation**

Additional guidance is provided regarding the development of the Performance Work Statement, in-house management plan and cost estimate. The revision encourages agencies to consult with employees and involve them at the earliest possible stages of the competition process, subject to the restrictions of the procurement process and conflict of interest statutes. Agencies are requested to afford employees and private sector interests an opportunity to comment on solicitations prior to the opening of bids. This will ensure that the solicitation is complete and that all parties are treated fairly. The revision also affords additional time to interested parties to submit cost comparison appeals.

c. **Performance Standards**

The revision authorizes conversion to or from in-house or contract performance if an agency determines that performance meets or exceeds generally recognized performance and cost standards. While recognizing that Federal performance and financial measurement systems may not yet exist, the revision establishes the opportunity to conduct competitions based upon output
performance measures. This process may permit agencies to avoid the formal cost comparisons otherwise required by the Circular. These competitions must reflect the agency's fully allocated costs of performance and must be certified as being in full compliance with the Managerial Cost Accounting Concepts and Standards for the Federal Government, Statement of Recommended Accounting Standards Number 4, or subsequent guidance. Cost comparability procedures described in the Supplement, such as those related to fringe benefit factors, will also be used in assessing in-house or contract performance against these standards.

d. Conversions with Federal Employee Placement

In an effort to balance the needs of current Federal employees against the cost and performance obligations of Government managers, conversions to contract could be authorized, without cost comparison, if fair and reasonable prices can be obtained from qualified commercial sources and all directly affected Federal employees serving on permanent appointments are reassigned to other comparable Federal positions for which they are qualified.

e. The 10 FTE or Less Rule

As a matter of equity, the current 10 FTE or less rule, that permits the conversion of a function to contract performance without cost comparison - even with adverse employee impacts - would be extended to permit similarly sized conversions to in-house performance, without cost comparison.

f. MEO Implementation

The current 180-day MEO implementation requirement is eliminated. In its place, agencies are required to provide a transition plan and schedule for each competitive solicitation (PWS). All parties will compete under the same transition schedule. This approach should permit agencies to plan for employee placements and facilitate a more orderly transition of work from in-house to contract or from contract to in-house performance.

g. Cost Comparison Completion

The revision requires agencies to provide detailed reports to OMB on any study that is not completed within 18 months for single function studies and 36 months for multi-function studies. This will minimize employee uncertainties and create needed incentives for the timely completion of cost comparisons. Under the current Circular, a function cannot be converted to contract without the completion of a cost comparison. If there has been a bias towards retaining the function in-house, there has been an incentive not to complete the cost comparison.

h. Post-MEO Implementation Audits
To ensure that in-house performance is reasonable and that the MEO was fully implemented, the revision requires agencies to conduct Post-MEO Implementation Audits on not less than 20 percent of all functions retained or converted to in-house performance. Like contract inspections, these audits will confirm that the MEO was properly bid, implemented and that work is being performed in accordance with the terms, quality standards and costs specified in the PWS.

I. The BRAC Exemption

The revision formalizes OMB guidance on DOD Base Closures and expands the provision to civilian agencies. Commercial activities at locations that have announced a date-certain closure may be converted to or from in-house or contract without cost comparison.

j. The Streamlined Cost Comparison Alternative

In addition to the generic cost comparison methodology, a streamlined cost comparison process has been developed for activities involving 50 or less FTE. This approach avoids the cost comparison's current reliance on the procurement process, until a final decision to contract has been made. Within the policies and procedures laid out by the revision, existing contracts could be used to determine competitive private sector costs.

k. Sector-Specific Cost Comparison Methodologies

The revision provides sector-specific cost comparison methodologies for aircraft and motor vehicle operations. Additional sector-specific cost comparison methodologies are expected and interested parties are encouraged to work with OMB on their development.

4. COSTING CHANGES

The proposed costing changes are designed to make the cost comparison itself easier to prepare and to reduce the administrative burdens of compliance. There has been a "false sense of accuracy" in the development of in-house and contract cost estimates, well beyond the level of detail needed to make magnitude of order make or buy decisions. At best, A-76 requires the development of estimated costs to the Government for MEO in-house and contract operations that, in most cases, do not yet exist. The Circular then adds a 10 percent differential to contract bids to cover other undefined costs and minimum savings. This approach has been replaced by a uniform costing method.

a. Labor. The annual available productive hours per Federal employee is increased from 1744 hours to 1776. Fringe benefit factors are updated and expanded to include the projected costs of retirement health benefits to the Government.

b. Material Costs. The escalation rates for supplies received from GSA and DLA are removed - lowering in-house costs.
c. **Overhead.** The inclusion of direct and indirect operations and general and administrative overhead has long been an area that has led to unnecessary difficulty and controversy. This controversy has been aggravated by the fact that A-76 calculates the competitive costs of in-house MEO performance, not the fully allocated cost of in-house (or contract) performance. In an effort to resolve this problem and improve the integrity of the cost comparison process, the revision would require a standard overhead cost factor of 12 percent of direct labor costs (Line 1).

d. **Cost of Capital.** The cost of capital is not required by the current Supplement. The revision requires that agencies include the cost of capital for those assets purchased two years before or during the cost comparison performance period and not provided to the contractor as Government Owned and Contracted Operated (GOCO) equipment or facilities. Neither capital nor depreciation costs of GOCO facilities and equipment are included in the cost comparison. They are common costs to both the in-house and contract offer. This change is designed to remove current incentives to delay cost comparisons, while new, more efficient equipment is acquired and to reflect the real costs of new assets to the taxpayer.

e. **Severance Pay.** The current Supplement permits agencies to calculate severance at 2% of direct labor or as determined by a Mock RIF. Based upon the low actual severance rates incurred to date and to avoid the significant administrative costs and delays attendant with conducting a detailed Mock RIF, the revision limits severance costs added to the contract bid to the 2% factor. Agencies may also develop agency-wide severance pay factors, with associated documentation, for approval by OMB.

f. **Contract Administration.** The current Supplement permits agencies to use a contract administration factor (Table 3-1) or more accurate data. Again, in an effort to improve upon the integrity of the cost comparison process, the revision requires the use of Table 3-1, but the factor has been increased for most studies. This approach balances recent changes in Federal procurement regulations that make contract administration easier, with concern that proper oversight is achieved.

g. **Gain or loss on Assets.** The current Supplement permits agencies to add to the contract price the loss taken on any asset excessed, even if the asset is used by the in-house MEO and not made available to the contractor. The revision does not permit any losses to be calculated on any asset not included in the MEO. Assets used by the MEO and not made available to the contractor can only be calculated as gains and subtracted from the contractor's bid.

5. **OTHER CHANGES**

Other changes in the proposed revision are designed to address specific problems that have been raised over the years. These include the following:

a. **Franchises and Interservice Support Agreements**
The current 1983 Supplement requires agencies to conduct cost comparisons with the private sector prior to entering into any interservice support agreements. The 1983 Supplement also required all interservice support providers to cost compare their operations not later than September 30, 1987.

The revision clarifies policies regarding the use of interservice support agreements and establishes revised cost comparison requirements. The revision permits agency heads to consolidate support services into intra-service revolving or franchise funds without cost comparison - assuming that such a consolidation does not involve the conversion of work to or from in-house or contract performance. Unless otherwise exempt from the cost comparison requirements of the Circular, new or expanded interservice support requests must be justified by a cost comparison. Revolving or franchise funds that have conducted a cost comparison with the private sector are not required to undergo further cost comparisons, until the increases exceed a 30 percent threshold.

b. **Military Personnel.**

The current Supplement provides that commercial activities performed by military personnel are to be converted to civilian performance. This has made the Services reluctant to cost compare certain activities. The revision would permit the Services to cost military personnel at the composite rate issued by the DOD Comptroller and, if retained in-house, would permit these activities to continue to be performed by military personnel. This change does not, however, authorize the conversion from in-house civilian to military personnel.

c. **Source Selection.**

There have been complaints that the Circular is too cost determinative and that it relies too heavily on the low bid offeror. The benefits of competition should be expressed in terms of the quality of services and in terms of cost to the taxpayer. The problem has been how the Government's quality of services will be evaluated and by whom, when; (a) the Government itself has a vested interest in the competition, and (b) the best overall private sector offeror chosen from among qualified and responsive offerors is not the low contract offeror. Guidance is provided on the use of competitive negotiation or source selection techniques in A-76 cost comparisons. The revision permits agencies to conduct cost comparisons and award to other than the low private sector offeror.

d. **Appeals**

Following a tentative cost comparison decision announcement, the A-76 Administrative Appeals process is invoked. The individual(s) selected to conduct the Appeal must be independent of the activity under review or at least two organizational levels above the official who certified the Government's in-house Management Plan or MEO. The procedure does not
authorize an appeal outside the agency or judicial review, nor does it authorize sequential appeals. The appeal process is to provide reasonable assurances that the lowest cost alternative has been chosen. Therefore, all directly affected parties are expected to submit their appeals within the initial appeal period.

The revision also extends the timeframe that appeals may be submitted from 15 working days to 20. The agency may extend the appeal period to a maximum of 30 work days if the cost study is particularly complex.

e. **OFPP Pamphlet No. 4**

   All references to the pamphlet have been removed from the draft. The 1980 Pamphlet is dated and no longer adds to the discussion.

f. **Right of First Refusal**

   The concept of the Right-of-First-Refusal was created by the current Circular. This concept holds that, as a condition of contract award, the contractor in an A-76 decision to convert from in-house to contract performance shall provide adversely affected Federal employees the "Right-of-First-Refusal" for jobs created in the contractor's organization created by the award of the contract. The revision reaffirms this as a superior requirement, while incorporating E.O. 12933, "Non-Displacement of Qualified Workers under Certain Contracts," dated October 20, 1994, which extends the Right-of-First-Refusal to existing and to subsequent contract employees in this or follow-on contracts.
Mr. Chairman, Members of the Subcommittee, I am pleased to be here today to discuss the implementation of the Chief Financial Officers Act of 1990 (CFOs Act) and the Government Management Reform Act of 1994 (GMRA).

Passage of the CFOs act reflected The Congress' commitment to better manage Federal resources, and produce information that is accurate, timely, and helps policy makers make better decisions. This Administration has a strong and deep commitment to better management of the Federal Government and has worked closely with the full Committee and the Senate Governmental Affairs Committee to improve the management of the Federal Government. The CFOs Act, the GMRA, and the Government Performance and Results Act (GPRA) together provide the legislative foundation for developing accurate and reliable cost information and performance data. Such information is essential if the Executive branch and The Congress are to make informed decisions and move successfully toward a smaller, more efficient government that focuses on accountability and manages for results.

In this time of resource constraints and questions about the fundamental value of government programs, it is more important than ever for elected officials and policy makers to know how much programs actually cost, which programs are working and providing good value, and where changes are needed to improve program effectiveness and efficiency. I believe the topics you asked me to address today all play an essential role in providing policy makers and
elected officials with the information they need to make informed decisions on the critical issues faced as we all strive to downsize the Federal Government.

Today I will provide information on each of the specific topics you requested.

**FEDERAL ACCOUNTING STANDARDS**

The Federal Accounting Standards Advisory Board (FASAB) was established on October 10, 1990 by Memorandum of Agreement among the three principal agency heads (the Secretary of the Treasury, the Director of the Office of Management and Budget, and the Comptroller General) concerned with overall financial management in the Federal Government. At that time, the Federal Government did not have a comprehensive set of accounting standards. However, it was widely recognized that a comprehensive set of accounting standards was needed, and that compliance with these standards should be measured on a regular basis in order to ensure the integrity of the financial information reported to the American taxpayers, elected officials, and policy makers.

By the fall of this year FASAB will have recommended a framework for Federal financial reporting and the basic standards needed to carry it out.

**FASAB PROGRESS**

**Accounting Concept Statements**

FASAB has recommended and OMB has issued two accounting concept statements ("Objectives of Federal Financial Reporting", and "Entity and Display").

- **The Objectives of Federal Financial Reporting** are designed to guide FASAB in developing accounting standards that address four major objectives:

  - **Budgetary integrity** -- This objective recognizes the importance of budgeting in federal financial management, the complementarity of budgeting and financial accounting, and the need to assure the accuracy of budget execution.

  - **Operating Performance** -- This objective recognizes that a myriad of performance measures are the Government's counterpart of business income, that expenses need to be matched to the services and goods provided to the public, and that federal managers require cost and other information to manage efficiently and cost effectively.

  - **Stewardship** -- This objective recognizes that Federal financial condition involves not only the Government's own balance sheet, but its financial ability to continue to carry out its Constitutional responsibilities and its contribution to the wealth and well-being of the Nation.
Systems and Controls -- This objective recognizes that the size and nature of the Federal Government requires particular attention to having systems and controls that would provide appropriate information and reasonably assure the integrity and efficiency of operations.

- Entity and Display is a conceptual statement that provides guidance as to what should be encompassed by Federal Government entity's financial reports, establishes guidelines for establishing the makeup of each type of reporting entity, identifies new types of financial reports for communicating information for each type of reporting entity, and suggests the type of information each type of report should include.

  Among the reports identified in "Entity and Display" is the "Statement of Net Costs." This statement would show the entity's cost of providing goods and services. The gross cost would be offset by revenue earned when such services are sold to users. The "bottom line" of the Statement of Net Costs would show the entity's cost left to be financed by the general taxpayer or by borrowing.
Statements of Federal Financial Accounting Standards (SFFAS)

FASAB has recommended, and OMB has issued, three Statements of Federal Financial Accounting Standards (SFFAS) providing accounting standards for sixteen financial reporting categories. FASAB has recommended, and OMB is about to issue, a fourth statement encompassing both concepts and standards for managerial cost accounting.

- **SFFAS #1 Accounting for Selected Assets and Liabilities** -- This statement provides standards for five asset categories: Cash, Fund Balance with Treasury, Accounts Receivable, Interest Receivable, and Advances and Prepayments; it also provides standards for four liability categories: Investments in Treasury Securities, Accounts Payable, Interest Payable, and Other Current Liabilities.

- **SFFAS #2 Accounting for Direct Loans and Loan Guarantees** -- This statement was designed to complement budgeting for Federal Programs under the Credit Reform Act of 1990. This standard represents a break from traditional accounting valuation in that the net present value of the total Federal Subsidy for direct and guaranteed loans is accounted for at the time the loan is made.

- **SFFAS #3 Accounting for Inventory and Related Property** -- This statement provides standards for six asset categories: inventory (held for sale), operating materials and supplies, stockpiled materials, seized and forfeited assets, foreclosed property, and goods held under price support and stabilization programs.

- **SFFAS #4 Managerial Cost Accounting** -- This statement encompasses both standards and concepts relating to managerial cost accounting. Presently most Federal entities do not have systematic cost accounting methods or procedures. This statement requires Federal entities to accumulate and report the full costs of their activities. This cost information will be useful to elected officials, policy makers, and citizens in making decisions about resource allocation and program priorities. Also, cost information will be essential to accurately report on and evaluate performance.

Accounting Standards in Process

FASAB is currently developing standards covering: Liabilities, Property and Equipment, Revenue, and Stewardship. Work on these standards is expected to be completed before the end of the fiscal year with issuance by OMB expected by late fall. When these standards are complete, the Federal Government will have, for the first time, a comprehensive set of basic accounting standards. These standards in process are expected to be effective for reporting periods that end on or after September 30, 1997. Earlier application is encouraged.
• **Liabilities** -- This proposed statement will provide a definition and general principles for the recognition of liabilities. The statement includes specific standards for the recognition and measurement of liabilities for: contingencies, insurance and guarantee programs (other than loans), pensions, other retirement benefits, other post employment benefits, federal debt, and capital leases.

• **Property, Plant, and Equipment (PP&E)** -- This proposed statement divides the diverse universe of PP&E held by federal agencies into 4 categories: General PP&E, Federal Mission Property Plant and Equipment, Heritage Assets, and Stewardship Land. The only category that would require depreciation would be general PP&E. In addition to PP&E, this statement includes accounting standards for deferred maintenance and cleanup costs.

• **Revenue** -- This proposed statement deals with basic standards for classifying, recognizing, and measuring resource inflows. The statement describes revenue as coming from two sources: exchange and non-exchange transactions. Exchange transactions occur when a Federal entity provides goods and services to the public or another Federal entity for a price. Non-exchange transactions arise primarily from the government's power to demand payment from the public, e.g., taxes, duties, fines.

• **Stewardship** -- This proposed statement is to recommend standards for reporting on the Federal Government's responsibility for certain resources entrusted to it. This information would be reported as "Supplementary Stewardship Information." Generally the costs of these resources are reported as expenses in the financial statement. However, these expenses are intended to provide long term benefits to the public. Therefore, in the proposed stewardship statement, the Board has proposed that data on these resources should be highlighted to show the long-term nature of these resources and to demonstrate accountability over them. The statement identifies the following stewardship categories:

  o **Stewardship PP&E**
    Heritage Assets, Federal Mission Assets, Stewardship Land

  o **Stewardship Investments**
    The costs incurred in providing education and training programs financed by the Federal Government for the general public, and the costs incurred in financing research and development efforts

  o **Other Stewardship Information**
    Information that will aid in assessing the sufficiency of future budgetary resources to meet obligations as they become due, including social insurance.

**FUTURE FASAB WORK**
After completion of the basic standards described above, there will remain considerable work for FASAB, including codification of the standards and assisting in interpreting the standards. In addition, FASAB has identified issues that require attention, but are not addressed in the basic standards. These include: accounting standards for natural resources, the recognition and measurement of expenses, and accounting for the cost of capital.

**IMPLEMENTATION OF THE CFOs ACT**

Since passage of the CFOs Act, the Federal Government has made significant progress in addressing the challenges faced in improving the financial management of the largest institution in the world. However, much work needs to be done. Progress to date has been considerable in a number of areas including:

**Financial Management Systems**

The poor condition of financial management systems has been at the heart of the government's financial management problems. The CFOs Council recognized the extent of the problem and has made improvements to financial management systems its number one priority for the coming year. Progress has been made in developing financial management systems policy and defining financial systems requirements.
Several organizations are working on improving Federal financial management systems including the CFO council, the Joint Financial Management Improvement Program (JFMIP), OMB, Treasury, and individual agencies. Their accomplishments include:

- In January 1995, Treasury implemented FACTS which collects agency standard general ledger (SGL) account balances to be used in producing the Government's Consolidated Financial Statement.


- In July 1995 OMB began using its government-wide budget system, MAX, to provide budget execution information and related analytical capabilities to OMB program analysts.

Progress is also being made in consolidating and standardizing systems through the use of department-wide systems to replace individual bureau systems. The percentage of agency systems designated as department-wide standard systems has increased from 26% as of September 30, 1993 to 29% as of September 30, 1994. In addition, the number of systems under development designated as department-wide standard systems has increased from 57% to 62% during the same period.

Progress has been made, but significant work remains to improve and upgrade the agency and government-wide financial management systems themselves. As an example of the task ahead, agencies reported that 53% of their operational systems will need to be replaced or upgraded in the next five years. Without substantial improvements in financial management systems, efforts to improve financial management in the federal government will be severely hampered.

**Improved Federal Financial Reporting**

In November 1993, OMB reported to Congress on the benefits, accuracy, difficulties and costs associated with Federal agencies' audited financial statements. The report concluded that audited financial statements are bringing about marked improvements in the timeliness and accuracy of financial information used for decision making. It also pointed out that the preparation and audit process is uncovering important systems deficiencies, stimulating the strengthening of internal controls, fostering improvements in financial systems, and arousing interest in better measures of program performance.

An indication of the financial management improvements agencies are making can be seen in the increase in agencies' financial statements determined by independent audit to be in conformity with prescribed accounting standards (unqualified opinions). For FY 1993, 47.1% of agency audited financial statements were given unqualified opinions by their independent auditors. This is a
marked increase from the 34.5% of FY 1991 audited financial statements receiving unqualified opinions. This steady improvement in the quality of agency financial statements is encouraging.

As a result of passage of the GMRA of 1994, major segments of the Federal Government's operations that had not benefited from the organizational discipline brought about by the CFOs Act, which applied only to limited agency functions and certain pilot agencies, will now benefit from that experience. These operations include:

- about $16 billion, or nearly 63%, of the Department of Energy's annual appropriations accounted for by its integrated contractors
- about $90 billion appropriated to the Navy
- more than $11 billion, or about 90%, of the Department of Justice's budget authority.

In addition to requiring agency-wide financial statements, GMRA requires the Director of OMB to designate agency components that must prepare and submit separate stand-alone audited financial statements. OMB is working closely with the agencies to develop criteria for determining the agency components subject to this requirement.

We anticipate that the improvements in the timeliness and accuracy of financial information reported by OMB to the Congress in November 1993, will extend to all agency activities as a result of the expansion of the audited financial statement requirements of the CFOs act.

**Strengthening Financial Management Personnel and Organizations**

Essential to successful achievement of the CFOs Act requirements is a quality Federal financial management work force and appropriate CFO organizational structures to achieve financial management priorities. To achieve these objectives, agency CFOs

- have established CFO organization structures to ensure effective delegation, communication, and accountability;

- are working to improve recruitment, training, and retention of qualified financial management personnel; and

- have developed a shared, government-wide vision for financial management, and goals and strategies for achieving this vision.

The CFO Council's Human Resources Committee published a document entitled *The CFOs Role in Strengthening Financial Management at the Component Organizational Level*. It identifies ways that CFOs can strengthen the relationships between headquarters and financial and program personnel in the field.
The strength of a CFO organization can be measured by the quality of the personnel it employs. In order to strengthen the quality of financial management personnel, a variety of training and continuing professional development programs have been established by the CFOs community.

In May 1995, the CFO Council established priorities for the upcoming year consistent with their vision statement goals, and strategies. The 1995 Financial Management Status Report and Five Year Plan, required by the CFOs Act, will address the status and plans for each of these priorities.

Management Accountability and Control

Improving management accountability is the goal of a number of related efforts underway across the Federal Government. OMB and the CFO Council have given priority to two specific initiatives: (i) implementing a new approach to management controls that helps managers achieve results, and safeguard the integrity of their programs; and (ii) integrating and streamlining management reports to provide more useful information, especially performance reporting, to decision makers.

OMB has revised Circular A-123, Management Accountability and Control, to eliminate the requirement for paperwork intensive, stand-alone management control programs in agencies. Too often these programs focus on the reporting process, rather than on building appropriate controls into agency operations to ensure good management.

Agencies have traditionally produced a myriad of program and management reports. Producing separate, overlapping management reports has not served internal or external decision makers well. Therefore, the CFO Council has recommended that management reports produce better planning information and performance data. This initiative was undertaken after enactment of GMRA which permits the streamlining of financial management reports after consultation with the appropriate Congressional Committees.

GOVERNMENT-WIDE AUDITED FINANCIAL STATEMENTS

The Congress and this Administration saw the need for an audited government-wide financial statement that would provide the Congress and the American public with a complete picture of where its government stands financially. Our Federal Government is the world's largest financial operation. Yet, it operates without ever knowing its overall financial status, a situation that would be short-lived in State and local governments or the private sector. The National Performance Review recommended an audited consolidated annual report on the finances of the Federal Government and the Congress took steps to make the recommendation a reality by including a provision in the GMRA of 1994 requiring a government-wide audited financial
statement. The first government-wide audited financial statement is to cover fiscal year 1997 activity and is due by March 31, 1998, and each year thereafter.

OMB, Treasury, and GAO have been working closely with agency CFOs and Inspectors General to develop a strategy and a plan for preparing and auditing the first ever consolidated financial statement of the U.S. Government.

One of the first steps taken was to request agencies to complete an auditability self-assessment. The self-assessment was designed to highlight impediments that agencies will face in preparing and auditing FY 1996 agency-wide statements. The following is an example of the information disclosed by the self-assessment:

- Seven agencies reported that their financial management systems could produce auditable agency-wide financial statements (with limited manual intervention) for FY 1996.
- Seven agencies expect that systems enhancements will be completed in time to produce auditable agency-wide financial statements (with limited manual intervention) for FY 1996.
- Nine agencies reported system enhancements will not be completed in time to produce auditable agency-wide financial statements (with limited manual intervention) for FY 1996.
- One agency, the Department of Defense, does not expect to produce auditable financial statements for FY 1996 even with manual intervention.

After analyzing the survey results, OMB, GAO, and Treasury formed a task force comprised of agency CFO and IG representatives. The objective of the task force is to develop a strategy and a plan to overcome impediments disclosed by the self-assessment and to assure preparation and audit of the fiscal year 1997 government-wide financial statement.

Two subgroups have been established within the task force to address separately preparation and audit issues and bring those issues to the full task force for resolution. The full task force and the subgroups have been meeting regularly and are making substantial progress.

This concludes my prepared testimony, Mr. Chairman, and I look forward to answering any questions.
APPENDIX E

PRIVATIZATION INITIATIVES
IN THE FY 1996 BUDGET
This section provides an initial list of selected articles, reports, and periodicals of potential utility to Federal agency staff wishing to explore their privatization options. Copies of the material should be obtained from the authors or may be found in either the Library of Congress or through Internet to the library of the foreign nation involved.

ARTICLES AND REPORTS


General Services Administration, "Draft Bibliography on Providing Government Services," January 17, 1995. Copies are available from the GSA Library, Room 1033, 18th and F Streets, N.W., Washington, D.C.,


Management Association for Private Photogrammetric Surveyors, "Elimination of the federal Government's Duplication of and Unfair Competition with Private Surveying and Mapping Firms," circa 1990. The Association is located at 12020 sunrise Valley Drive, Suite 100, Reston, Virginia 22091.


National Academy of Public Administration, Washington, D.C., reports on aspects of privatization and franchising include:


Student Loan Marketing Association, Restructuring Sallie May (Washington, D.C., September 1994).


**PERIODICALS**

*Council Insights*, a newsletter published monthly by the National Council for Public-Private Partnerships, see Organizations for contacts.


*Public Works Financing*, a newsletter published monthly with quarterly international supplement by William G. Reinhardt, 154 Harrison Avenue, Westfield, NJ 07090.