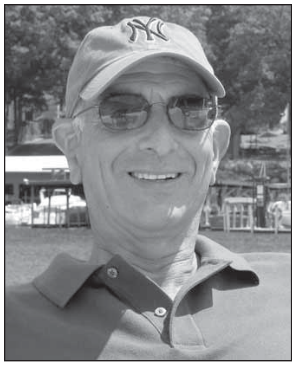
Public Authority Controversies: Root Causes and Lessons Learned

By Scott Fein



Root cause analysis (RCA) has become a popular problem solving methodology among management consultants.[1] RCA is premised on the assumption that incidences of systemic problems may be minimized or eliminated by identifying and addressing the root cause of the problem, as opposed to merely fixing the surface symptoms. RCA seeks to determine what happened, why it happened, and what can be done to reduce the likelihood of reoccurrence. It seeks to distinguish between human causes (people acting without authority) and action and organizational causes (is the system or process policy used to make decisions faulty?).[2]

The question is whether an RCA could have application to public authority reform in New York State. In 2005, the Public Authorities Accountability Act (PAAA) was enacted primarily to enhance the operational and fiscal transparency of state and local public authorities.[3] With greater understanding of the operation of public authorities, the legislature and Governor concluded that a second phase of authority reform was warranted. This past December the Public Authorities Reform Act of 2009 was signed into law. The Act in many respects is unprecendented and appears to go well beyond what other states have adopted. It should, when fully implemented, enhance compliance, board independence, programmatic and fiscal operations, and provide a new standard of contract review. Commentators suggest that in due course a third phase of reform should be considered to address several of the bedrock fiscal issues including limitations on conduit financing and State supported debt.

In evaluating the potential efficacy of the newly enacted reform and any need for additional reforms, we thought it worthwhile to look backward and seek to identify the root cause(s) of several of the more significant public authority operational problems of the last fifty years.

To provide geographical breadth, authorities selected operate in different states. To provide topical diversity, each of the authorities' missions differ ... ranging from housing to highway infrastructure, mass transit to energy generation.

The Urban Development Corporation of New York State (UDC)

In 1975, the Urban Development Corporation (UDC) achieved an unusual distinction: it became the first major issuer of municipal bonds since the Great Depression to default on its obligations. The results were notable. Private capital markets shut their doors to the State, and New York's impending fiscal problems were exacerbated. The UDC's origin, similar to most public authorities, began with a desire to improve the quality of people's lives.[6]

The UDC was created in 1968. New York State was facing a severe housing shortage. It was suggested that there was a 500,000-unit gap between the market and demand. The impact was particularly pronounced on minority residents in urban areas.

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Soon after Nelson Rockefeller took office, he stated that increasing affordable housing for low-income residents would be among his administration's objectives. Beginning with the post-war period and return of the GIs, the State's focus had been on assistance for middle-income groups. No meaningful attention had been paid to low-income residents. By the late 1950s, middle class flight from the City was increasing. Urban blight was on the rise.

The State Constitution required public approval of indebtedness. Governor Rockefeller sponsored a referendum seeking public approval of funds to support a housing initiative. The referendum was defeated on five separate occasions. The Governor, in response, created three public authorities to try to stem urban decay. Of the three, UDC was the most innovative, established to build low-cost housing, provide jobs, and eliminate urban blight. To ensure it had sufficient revenue the Governor arranged that the UDC would have authorization to issue $2 billion in bonds backed by the moral obligation of the State to repay the bonds. The objective was for the UDC to build housing with an economic mix of residents to stabilize the area. The housing was to contain 70 percent of residents with middle and moderate incomes, 20 percent low incomes, and 10 percent low-asset senior citizens.[7]

The first challenge was largely political. The State legislature and the Mayor of New York objected to the establishment of the UDC. The UDC was intended to be a super-authority, authorized to override local zoning in order to avoid the "not in my backyard" objections and unduly politicizing the process. The UDC was, by design, to be unstoppable.

Within a year after its creation, the UDC had developed plans for 50 projects throughout 23 cities within the State. Less than two years later it had 45,438 housing units in various stages of completion. Although focused on urban renewal in New York City, the bond revenue was also used for projects statewide.

Problems developed quickly. The projects failed to, and did not have the potential to, generate sufficient revenue to pay the debt service. Projects, even at their inception, failed to meet basic revenue feasibility standards. Each time the legislature or media raised a question concerning the means to satisfy the approximately $1 million-a-day debt service, the Chief Executive Officer of the UDC said, "I don't believe there is any evidence to support your conclusion and I do not propose to go looking for any. We are going to build as much as we can. The need is now."[8] In large measure UDC's response was easily understood. The Governor, using a relatively new financing model, grounded the UDC debt on the "moral obligation of the state." With guidance from John Mitchell, a then well thought of bond lawyer, a mechanism was developed to overcome Wall Street's reluctance to purchase non-guaranteed authority revenue bonds. The concept was to secure the bonds, not by the State's full faith and credit, but by the State's non-binding promise, or moral obligation, to use State revenue to make up any shortfalls in debt service.

While the UDC was to enjoy notable success with projects on Roosevelt Island and in Battery Park City, it had encountered major challenges in efforts to build low-income housing in middle class neighborhoods. Many of their inner city projects, which were the principal impetus for the UDC, proved difficult to implement. A number of the projects were unable to pay off their bonds.[9]

By the 1970s, the UDC was moving away from its stated mission. At the encouragement or insistence of elected officials, it underwrote projects such as the Jacob Javits Center and Apollo Theater. The projects further stretched the Authority's resources.

In 1973, Moody's[10] publicly raised questions concerning the UDC's ability to support debt service based upon its revenue stream and lowered the Authority's bond rating. From that point, problems cascaded. In 1975, the UDC defaulted on bonds. Ultimately Governor Carey and Governor Cuomo and the legislature stabilized the UDC, but limited its future role to safe economic development. However, the lure of bond revenue was difficult to resist. Governor Cuomo used the UDC revenue to construct and maintain prisons, following the defeat of a public referendum, and Governor Pataki looked to the UDC to help rebuild lower Manhattan after 9/11.[11]

The UDC default has been subject to considerable analysis by commentators. There appears to be consensus that the root causes of the UDC's crisis included that:

1. The UDC mission was unduly broad and, in some measure lacked clarity…the "build we must" mandate constituted the mission, vision, implementation strategy.
2. Elected officials considered the UDC bond revenue a cornucopia that without limit could achieve objectives.
3. The enabling legislation expressly authorized the UDC to preempt local zoning codes and unilaterally overrule local objections. By marginalizing the concerns of the local communities, it introduced barriers to implementation that ultimately undermined the projected revenue streams.
4. There was no economic feasibility analysis conducted to determine if the rental income and other proceeds could satisfy the debt service.
5. There was little fiscal oversight…neither the Legislator, State Comptroller, nor any other elected official carefully monitored on an ongoing basis the finance and expenditures of the UDC.
6. The UDC's reports to the Legislature and public did not contain sufficient detail to inform on issues confronting the Authority.
7. Wall Street appeared more concerned about enjoying the benefits of debt issuance than making an ongoing and meaningful effort to monitor the fiscal condition of the authority.
8. Many of the UDC's board members were not selected based upon relevant expertise, but rather were friends or colleagues of the appointing authority, and thus, unlikely to take issue with the requests for off-mission or questionable programmatic expansion.

Massachusetts Bay Transportation Authority (MBTA)

Beginning in the 1800s, private railroads and horse-drawn trolleys provided public transportation in the Boston area. In 1853, much of this was eclipsed by electric street trolleys and in 1947, the Massachusetts Transit Authority (MTA) acquired much of the rolling stock and responsibility for public transit.

As the successor to the MTA, the Massachusetts Bay Transit Authority (MBTA) was established in 1964 to provide bus, ferry, commuter rail and subway service to the greater Boston area, including 78 municipalities.

The MBTA has become the largest consumer of electricity in Massachusetts and the second largest land owner. Initially, the MTBA was formed to help subsidize existing commuter rail operations. Over time, the MTBA absorbed these local service lines.[12]

The MTBA's ability to bond projects without voter approval led to inevitable expansion in scope. The most recent expansion in scope occurred at the same time that a revenue limitation was imposed on the authority. The consequence was a dramatic increase in debt.

From the establishment of the MBTA in 1964, the operating deficit grew each year. To back its capital program, the MBTA issued bonds backed by the Commonwealth's full faith and credit, with the Commonwealth responsible for a contractual obligation to pay a portion of the debt service.

In 2000, the Commonwealth, facing fiscal pressure, sought to reduce its contribution to the MBTA. Establishing a program referred to as Forward Funding, the MBTA was given its own funding stream (20 percent of the Commonwealth's sales tax revenue and an assessment on the cities and towns in the MBTA district). The Authority was also given full responsibility for the amount of debt that had accumulated to that point. The debt referred to as "Prior Obligations" or "Legacy Debt" makes up a significant portion of the MBTA's enormous debt load.[13]

Since 2000, the Legacy Debt and ongoing debt have materially increased. Smaller than anticipated revenue growth, larger operating expenses and slower sales tax growth (which constitutes 55% of the MBTA's revenue base) added to the debt. Aggravating the situation further were the costs the MBTA was obliged to assume as a result of the Big Dig's air pollution mitigation settlement. In order for the Commonwealth to comply with federal air pollution standards resulting from increased traffic created by the enhanced Central Artery, public transit had to be expanded. The Commonwealth looked to the MBTA, which was required to bond an additional $1.8 billion to satisfy this obligation. Commentators have suggested that the projects should have been factored into the Big Dig's budget and not paid for by the MBTA.[14]

As a result, the MBTA is in a spiral in which it cannot generate revenue necessary to achieve a state of good repair, improve service quality, retain and attract riders and increase revenue over time.[15] Notably, MBTA is currently the transit authority with the highest debt service expenses as a percentage of its operating budget in the nation.

In an effort to address the growth in debt and increase coordination among the other Commonwealth public transit authorities, a new super-authority has been proposed. The new authority would absorb existing transit and turnpike authorities. Its nine-person board will be dominated by city planners, rail transit official and special interests. The Governor will only have two appointees. They will have considerable discretion to issue bonds and allocate revenues among the merged authorities.[16]

The MBTA, much like the New York UDC, was founded on a desire to improve the quality of people's lives. The attraction of a single entity to provide an affordable option for mobility, easing traffic congestion, saving millions of gallons of oil and corresponding emissions, reducing sprawl, and decreasing automobile accidents was undeniable. What went wrong?

- The MTBA operated, with respect to fiscal issues, on a largely autonomous basis.
- The seven-member MBTA board was controlled by local interests focused on increasing service to their towns rather than the overall welfare of the authority.
- Gubernatorial and legislative fiscal oversight was, in practice if not by design, limited.
- Elected officials felt comfortable adding programmatic responsibilities to the MBTA, with insufficient consideration for their corresponding cost.
- Feasibility studies were developed; however, they quickly proved unrealistic.
- When strapped for cash in 2000, elected officials of the Commonwealth simply reconfigured the relationship with the MBTA so that the Authority would assume the Commonwealth's share of prior debt.
- There was insufficient transparency. The public was largely unaware of the amount of debt the MTBA was amassing as a result of the continuing operations and new programmatic initiatives.

The New Jersey Turnpike Authority

By the 1930s, US-1, which passed through New Jersey, was often clogged with traffic. Superhighways were planned to supplement US-1, but the Depression and then World War II suspended any further planning and construction. In 1947, the concept of a superhighway was revisited, and the following year the legislature enacted the New Jersey Turnpike Act which, in 1950, created the New Jersey Turnpike Authority. The Authority was established based upon the premise that the Authority would be completely financed by the sale of revenue bonds to private investors. The Turnpike Authority currently operates two toll supported highways—the New Jersey Turnpike and the Garden State Parkway, the latter of which was acquired by the Authority in 2003.

By the early 1980s, having acquired the reputation as one of the more congested and dangerous roadways in America, the Turnpike was in need of expansion and repair. The then longtime Chairman of the Authority was persuaded that the most efficient way to raise money to undertake the repairs was to engage in fiscal arbitrage. Relying principally on the guidance of the investment banking house that originated the idea and the Authority staff, the Chairman decided to plan a $2 billion tax-exempt offering. The concept would be to be engage in arbitrage; that is, to invest the bond proceeds with the investment banking house in investments having a higher rate of return (the following year, the practices of engaging in arbitrage with the proceeds of tax-exempt bonds were prohibited by federal law). The legislature was not involved in evaluating the financing scheme. Unlike most states, the Governor of New Jersey has veto power over the policies of most State public authorities, including the Turnpike Authority. Although the Governor had misgivings, he perceived the bond offering to be a done deal and was told by the Authority's executive director there was no other alternative to address Turnpike congestion. Moreover, suggested the Chairman, the arbitrage scheme was too far along and any effort to rescind it would jeopardize the State's fiscal position on Wall Street. As it turned out, the financing approach was fatally flawed. The highway construction costs materially exceeded even the wildest projections. Arbitrage profits were insufficient to pay for the debt service. Significant toll increases were required.[17]

Compounding the problem, in 2003 the State decided that the Turnpike Authority should assume operational responsibility for the toll-free Garden State Parkway. This was accomplished by merging the New Jersey Highway Authority into the New Jersey Turnpike Authority. The merger added considerable responsibilities and capital costs without a corresponding funding source.[18]

The deficit grew to such an extent that in 2008, the Governor proposed a 50% toll increase for four four-year periods. Under this plan, which was rejected, the tolls would have increased from $6.45 to $43.92 in 2022. A series of ever more curious proposals to maintain the roadways and pay debt service followed. The State explored privatizing the New Jersey Turnpike to generate cash. Failing that, the Governor considered privatizing fast lanes. Most recently, temporary relief appeared in the context of the American Recovery and Reinvestment Act, which made available funds for infrastructure improvements. The Act required projects to have met with environmental approvals. Despite the fact that the Turnpike was never subject to such approvals, the Authority Board proceeded to bond $1.375 billion under the Act. The Governor challenged the decisions, asserting it was illegal. The impasse remains.[19]

Commentators suggested the key problems were:

- The failure of the elected to remain mindful of fiscal limitations and revenue projections.
- The decision by elected officials to increase the scope of the Authority's operations without a reliable revenue analysis.
- The failure of the Governor and legislature to examine the underlying arbitrage proposal.
- The potential for collusion and the existence of conflicts of interest in the bond financing and arbitrage approach.
- The lack of specialized training among board members.
- The increase in responsibilities imposed upon the Turnpike Authority without a corresponding increase in funding.
- A lack of transparency in explaining the fiscal issues and constraints to the public.

State of Washington Public Power Supply System

The State of Washington Public Power Supply System (WPPSS) was created in 1957 to guarantee low-cost electric power to homes and industry in the Northwest. It was established as a joint operating agency of smaller Washington State public utilities. Its corporate structure was designed to insulate utility decision-making from legislative and gubernatorial control. The board of directors was comprised of members of the various utility districts, each of whom would receive and pay for power produced by WPPSS.

WPPSS's major accomplishment had been to build and operate the Hanford Reactor generating system that converted heat from the federal plutonium-producing reactor into electricity. By the 1960s, it appeared that hydroelectric resources would not be sufficient to provide electric power over the long term to the Northwest. In 1968, they proposed a hydro-thermal power plan which envisaged completion of 20 large thermal power plants, mostly nuclear, in the region by 1990. The public utilities were concerned that the investor-owned utilities would control the new generating facilities unless they acted quickly. Most of the public utilities were too small to consider development of a nuclear project on their own. WPPSS looked like the best structure for the cooperative venture.[20]

By 1973, WPPSS was chosen to build three large nuclear plants. Eighty-eight regional public utilities agreed to participate in the project. Engineering work for the first plant began in 1971 and the construction was estimated to cost $400 million. By 1984, the construction was more than eight years behind schedule and the cost of the plant had risen to $3.2 billion. Notwithstanding this delay and cost overrun, WPPSS agreed to build two more nuclear plants. Tax-exempt bonds to support the construction would be issued on an as-needed basis. Problems ensued. Each of the five plants slipped years behind its original schedule and each suffered billions of dollars in cost overruns. The original estimated cost for completing the five plants was $4.5 billion; this grew to $23.8 billion. The energy demand grew less than half of the estimate which prompted the

WPPSS plan. The credit market declined to lend more money. The utilities faced a task of paying for construction that would not likely result in an operating facility. The death knell was a Washington State Supreme Court decision in 1983 concluding that the agreements entered into between the local utilities and WPPSS lacked legal basis for contract and were null and void.[21]

In 1981, WPPSS voted to terminate plants four and five. The following year, it halted construction on plant 1 and, in 1983, on plant 3. Upon termination, WPPSS was the largest single issuer of municipal bonds in the country.

The circumstances which gave rise to the ultimate default were broad in scope:

- Elected officials who, without sufficient analysis, encouraged expansion of WPPSS responsibilities and capital plan.
- Insufficient management and engineering expertise and experience by WPPSS to undertake the projects.
- WPPSS was a small organization (some 81 people at its inception) which simply could not manage the contractors, who ended up managing the projects.
- WPPSS reports and meeting minutes were less than transparent and failed to reflect the problems plaguing the projects.
- The WPPSS Board was comprised of a representative from each member utility and met quarterly. They were amateurs in the field of nuclear power and represented local perspectives and simply rubber-stamped decisions made by staff and the consultants.
- WPPSS management chose to design and build the plants on a concurrent schedule, leading to inevitable cost overruns.
- On the issue of financing, there was little coordination and even less forecasting. A coherent strategy for minimizing costs, including interest, did not exist.
- Even as interest rates for borrowing rose beyond expectations, financing was not slowed.
- Elected officials had virtually no involvement in decisions relating to bond financing; rather, investment house and bond advisors developed and coordinated the strategy of bond offerings.
- Brokerage firms continued to sell WPPSS bonds without disclosing the management and construction problems.
- The bond-rating agencies ignored the warnings and rated the bonds highly.

It appears that faltering public authority governance and fiscal problems for each of the four authorities are the product of two general organizational weaknesses: significant control by elected officials over programmatic issues, without a corresponding concern about the feasibility or adequacy of revenue to support the programmatic initiatives. With respect to each of the four authorities, elected officials appeared captivated by the availability of bond revenue outside of the conventional state capital budgeting process. Exacerbating the problem, the boards of the four authorities examined neither imposed sufficient discipline on expenditures, nor insisted that projects requested by elected officials demonstrate that these activities were revenue neutral.

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It is possible that the following remedial actions may help forestall future occurrences:

(i) Careful monitoring by elected officials of authority debt.

(ii) Establishing limitations on the cumulative debt each authority can issue.

(iii) Ensuring transparency in reporting the existence of the debt to the public and documenting how the authority debt adds to the State's overall indebtedness.

(iv) Independent professional review of proposed authority projects to ensure the revenue stream is sufficient to satisfy indebtedness.

(v) Ensuring that proposed projects are consistent with the statutory mission of the authority.

(vi) Enhancing authority governance through greater independence and professionalism of board members.

(vii) Monitoring the relationship between the authority and investment banks to ensure the mechanism for issuing debt accord with acceptable investment principles.

Endnotes

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