POLICIES AND PROCEDURES UPDATE FOR PRIVATIZATION OF AIR FORCE UTILITY SYSTEMS

PURPOSE:

This document provides clarification to the Air Force utilities privatization strategy, procedures, and special issues presented in the *Air Force Utilities Privatization Policy and Guidance Manual*, Oct 98. This document is an update, not a substitute for existing guidance.

REFERENCES:

a. Defense Reform Initiative Directive #49, Dec 98
b. OSD Policy, Privatization of Defense Utility Systems, Dec 98
c. Defense Reform Initiative Report, 10 Nov 97
d. HQ USAF/CC Memo to ALMAJCOM/CC, Update of Utilities Privatization, 8 Feb 99
e. Air Force Utilities Privatization Policy and Guidance Manual, Oct 98
f. Air Force Utilities Privatization Implementation Plan, 22 Feb 99
g. SAF/MIQ Memo to ALMAJCOM/CV, Environmental Policy, 12 Nov 98
h. SAF/AQC Memo to ALMAJCOM Contracting Offices, 18 Feb 99
i. HQ USAF/ILEV Memo to ALMAJCOM/CEV, Environmental Requirements, 26 Jan 99
j. HQ USAF/ILE Memo to ALMAJCOM/CE, Call for Statements of Work, 22 Dec 98

AIR FORCE UTILITIES PRIVATIZATION GOALS:

a. **Utilities Privatization Goal:** Divest the Air Force of, and privatize all utility systems where they prove economical and do not degrade the security/readiness mission of Air Force installations by 30 Sep 03.

b. **Interim Utilities Privatization Goals:** Complete determinations of feasibility ("go/no-go" decision) to privatize for all utility systems by 30 Sep 00. Solicit requests for proposals for all utility systems by 30 Sep 01.

PROCEDURES:

a. **Utility Systems:** All installation exterior utility systems (electrical, natural gas, water and sanitary wastewater) will be considered potential privatization candidates. Utility privatization is the transfer of ownership of the utility system to a public or private sector entity. The Air Force, including Active and Reserve Components, conveys the entire system and no longer operates, maintains, or repairs these systems.

(1) The Secretary of Defense has mandated that all systems subject to privatization be privatized by 30 Sep 03, and established milestones for accomplishing and tracking these actions.

(2) Systems are defined as follows:

(a) Gas Distribution System: All regulating valves; pressure reducing valves; meters and metering devices; pumping stations; mains; laterals; and branches from point of entry onto the installation to the point of entry into a government facility or structure. The point of entry may normally be considered to be that point where a meter would be installed on a similar, commercial facility. For housing, transition at the meter of the residence. If no meter exists, transition at shut-off valve at residence. If no shut-off valve exists, install a meter and transition at that point. For commercial and industrial facilities, transition at the meter to the building. If no meter exists, install a meter and transition at that point.

(b) Water System: All plants, regulating valves, control valves, pressure reducing valves, meters and metering devices, booster pump stations, mains, water treatment facilities, water tanks, laterals, and branches from point of entry onto the installation to the point on the water line where it enters a government facility or structure. The point of entry is normally considered to be that point where a meter would be installed on a similar, commercial facility. For housing, transition at the meter to the residence. If no meter exists, transition at shut-off valve at residence. If no shut-off valve exists, install a shut-off valve and meter and transition at that point. For commercial and industrial facilities, transition at the meter to the building. If no meter exists, install a meter and transition at that point. Include fire hydrants and piping from water main to hydrants as integral parts of the water distribution system to be privatized. Include supply lines for fire suppression systems from the water main to the building transitioning at the first valve down stream from the back flow prevention device. Do not include deluge systems or interior suppression systems, but do include supply lines feeding these systems transitioning at the first valve or post indicator. Do not include water sprinklers, irrigation systems or non-potable water systems unless it is unseverable from the water system. Transition supply lines to these systems at the connection to the water main.

(c) Wastewater System: All plants, sanitary sewer collection pipes and lines from a point 5 feet outside the serviced building or facility, normally the yard clean out, to the point where the system leaves the installation. Recommend installation of cleanouts where none exist. Include all pumping stations; treatment facilities, lift stations; and industrial wastewater treatment systems. Do not include grease traps, oil-water separators, septic tanks, leach fields, or pretreatment systems as these systems are a function of the building and its use and can be contracted separately for maintenance.

(d) Electrical System: All plants, power transmission lines, distribution lines, wire, conduit, poles, transformers, switching stations, and signaling equipment used in the distribution of electrical power from a point of entry onto the installation to the point of entry into each facility on the installation. For housing, the point of entry may normally be considered to be that point where a meter would be

installed on a similar, commercial facility. If a meter does not exist, transition at the meter sockets. If a meter or meter socket does not exist, transition at the weatherhead. If a weatherhead does not exist, transition at the main panel disconnect. For commercial and industrial facilities, transition at main lugs on panel board or disconnect switch for situations where meter and/or transformer serves a building but is greater than 5 feet from the building. Transition at the transformer if it is less than 5 feet from the building, to include the transformer. Transition at primary side of the transformer if the transformer is inside the building, to include the transformer. Transition at the meter on the facility if one exists. Install a meter at the building if none exists. Note that 100% metering of installation facilities is not recommended. It is important to note the electrical distribution system does not include airfield lighting. As an option to the MAJCOMs, privatization actions may include street lights, parking lot lights, exterior pole-mounted lights, sports lighting, ramp lighting, and signal systems; including controls and branch circuits. Careful consideration must be made prior to including these items in any privatization deal. In some cases, utility providers may not be able to own these systems, thereby limiting potential owners and competition, which is not the intent of this effort. These systems are a function of the facility they serve and its use and may be contracted for maintenance separately. A request to exempt these optional items from analysis of the electrical system is not required. Do not include area lighting mounted to buildings, signage or walkways.

(3) These category codes generally describe systems being considered for privatization:

(a) Water: 841-161, 841-163, 841-165, 841-166, 841-169, 841-423, 841-425, 841-427, 842-245, 842-246, 842-249

(b) Sanitary Wastewater: 831-145, 831-165, 831-168, 831-169, 832-255, 832-266, 832-267

(c) Electrical: 812-223, 812-224, 812-225, 812-226, 813-228, 813-231

(d) Natural Gas: 823-243, 824-462, 824-464, 824-466, 824-468

(4) Total Privatization versus Partial Privatization: Privatizing a portion of a specific system, (i.e., only the plant), does not fit the OSD definition of privatization/total divestiture of that specific system. Systems shall not be partially privatized. The entire system must be conveyed in order to be defined "privatized."

(5) Ownership: Government-owned utility systems may be identified by reviewing appropriate DD Forms 1354, *Transfer and Acceptance of Military Real Property*. Additionally, if a system is on the AF real property records, then the AF is the likely owner. Systems with uncertain ownership must be identified and ownership resolved at the earliest opportunity.

(6) Housing Privatization Conflict: Many initiatives are underway to privatize housing at Air Force installations. On-going housing privatization efforts differ in their conceptual approaches with regards to utility systems. Consult your MAJCOM housing privatization staff for information regarding the disposition of utility systems for these on-going initiatives. Future housing privatization efforts which seek to convey units and underlying real estate should include the underlying utilities. Future housing privatization efforts which seek to convey units, but lease the underlying real estate, should not include the underlying utilities. Rather, under the utilities privatization program, transition of these utility systems should occur at the meter, meter socket, weatherhead, main panel shut off, shut-off valve or clean-outs as discussed in paragraph (2) above.

b. **Contract Support:** To alleviate some of the burden of execution for our already heavily tasked installations, we have prearranged and funded contracts designed to support execution efforts. This contract support will be provided and managed through HQ AFCESA and HQ AFCEE to support your installations. The program is centrally funded.

(1) Installations will tailor a generic statement of work (SOW) to include all systems at each installation as well as any systems at support sites tied to those installations (like recreational sites, geographically separated units (GSUs) or auxiliary fields). The majority of installations have off-base sites of varying size and distance from the installation. These sites are not programmed for in the Utilities Privatization Program. Although not specifically covered in DRID #49 (major and minor installations only), current policy requires installations to include any auxiliary/support sites in the tailoring of the SOW for the main installation. As sufficient funds are not programmed to support all additional sites, for those systems exempt due to readiness requirements or that are already privatized, no analysis will be conducted on like systems at any of that installation's sites.

(2) To take advantage of economies of scale, HQ AFCESA will review and seek opportunities to consolidate systems at installations within a particular region or state.

(3) HQ AFCESA will consolidate statements of work for contractor support, as appropriate.

c. **Exemptions:** When applying the exemption for unique security concerns, consider the following: If privatization is found to impact the unique security of an installation as determined by unmitigatable findings in an operational risk management assessment, such as adversely impacting the readiness core and thereby jeopardizing the Prime BEEF mission for the installation, then the exemption should be applied to the specific utility system. Decreased opportunity for training of Prime BEEF team members is not a reason for exemption as this is a mitigatable circumstance. Insufficient manpower to fulfill the wartime requirement is reason for exempting a utility system. All efforts to provide sufficient manpower, through reassessing the Mil/Civ mixture and/or offering positions with AFS's

which are excess to the wartime requirement at an installation, should be exhausted prior to seeking this exemption.

d. **Utilities Privatization Process:** All utilities privatization candidates will be analyzed utilizing the Air Force Utilities Privatization Process. All analyses will be awarded through contracts established through HQ AFCESA. All funding will be provided through AF/ILE. Upon conclusion of the first phase of analysis, the installation commander will review and approve analyses, sign decision documents making the "go/no-go" decision and forward a notification letter to the MAJCOM/CE indicating intent to proceed with phase two actions or seek exemption from privatization. Forward exemption packages to AF/ILE with specific justification and MAJCOM/CE endorsement.

e. **Divestiture Strategy:** The utilities privatization process may result in different acquisition strategies. Approval of the divestiture strategy ultimately resides with the source selection authority (SSA).

(1) **Full and Open Competition:** Title 10 U.S.C. Section 2688 provides that if more than one utility or entity expresses interest in a conveyance, the conveyance of the system shall be carried out through the use of competitive procedures. The sale of a utility system under Section 2688 is a disposal of personal property since only the equipment making up the utility system is being disposed of. A right-of-way for the owner to gain access to the system will accompany the bill of sale. It is not a sale of real estate. The Air Force will have to contract with the new owner to distribute the utility commodity. The resulting contract may address supplying the wholesale commodity itself, although this is not necessarily a requirement in every sale. It may be beneficial and necessary to combine the supplying of the commodity with the distribution service as in the case of water and wastewater systems. It may be beneficial to separate the two, as in the case of electric and gas systems, in order to take advantage of future deregulated markets. In either situation, there will be a sale of the utility system under Section 2688—a property disposal—and an acquisition of utility services under the Federal Acquisition Regulation (FAR). These are two distinct actions, but they are necessarily connected since they must be done at the same time and, presumably, in the same action. Title 10 U.S.C. Sections 2302 and 2304 provides the rules governing when and how competitive procedures are to be used. If disposal action and acquisition action are handled as a single transaction, the solicitation will contain FAR terms and conditions governing the entire process and the resulting services contract, but not the resulting disposal. In other words, use FAR provisions to conduct the entire action, but only apply the substantive FAR provisions to the resulting services contract, not to the resulting sale.

(2) **Sole Source:** If an installation resides in an area served by a franchised and regulated utility, that franchise holder shall not be considered the presumptive conveyee, nor shall another responsible and responsive utility or entity that expresses interest be excluded from competition. Installations may not rely on the assertions of franchised or regulated utilities in this regard. Rather, an independent legal finding, based on

State law and regulatory policy, must be made by the installation legal office determining that the franchised or regulated utility is the only entity authorized to own and operate the utility system to be privatized. In most cases, only when a franchise is exclusive, (meaning both a franchise is required and that only one entity may hold the franchise at any one time), will sole source be an alternative. In either case, DRID #49 requires an independent finding to determine that the franchised or regulated utility is the only entity authorized to own and operate the utility system being privatized. Mere convenience is not sufficient reason to find a sole-source situation.

SPECIAL ISSUES:

a. **Reversionary Statements:** Once the system is turned over to the new owner, the Air Force has no reversionary interest in the utility privatization process. We can retain a right of first refusal, in the bill of sale, if the new owner later decides to offer the system for sale to someone else.

b. **Defense Energy Support Center:** The Air Force has entered into an agreement with the Defense Energy Support Center (DESC) of the Defense Logistics Angency (DLA) to test the feasibility of privatizing Texas utility systems on a regional basis. Under this agreement, DESC will partner with the Air Force and provide contracting support to assess and, if possible, privatize utility systems. When requested by a MAJCOM, DESC can provide contracting support to execute utility privatization efforts or provide program management capabilities. The Air Force will provide the source selection evaluation team chief for all projects.

c. **Training & Manpower:** Retaining government ownership of a utility system on an installation, solely for wartime training, does not constitute a valid reason to exempt that system from privatization. However, training on core tasks (those tasks tied directly to wartime and/or contingency mission accomplishment) is a military requirement and maintaining utility systems is a direct avenue to receive that training. Should a system be privatized, costs of accomplishing that (lost) critical training must be factored into the analysis. Training may be accomplished through various avenues such as agreements with the utility owner, contractor provided training, established formal training, mock-up systems, and/or use of AFRC Specialty Training Locations and ANG home station training sites. As in any military training program, strong consideration must be given to a standardized training regimen that meets the needs of the CE Community and maintains stringent AF guidelines on training and certification of that training. Any increased cost associated with developing alternate training methods should be included in the economic analysis and must be factored into any final privatization directives. The decision to exempt a system is dependent on the wartime manpower requirements and the military/civilian mix at the respective installation. In general, the decision process is: If a unit does not have a wartime mission, the peacetime workforce should be civil service or contract, and utility systems should be privatized where economically feasible. If a unit does have a wartime mission, the peacetime workforce should be composed of civil service, contract, and enough military to

meet the wartime mission. Utility systems on these installations should be privatized where economically feasible and where doing so would not reduce the military manpower below the wartime requirement. For example, at an installation with a wartime mission (for example, Prime BEEF, etc.), the workforce must contain enough military electricians to meet the core Unit Type Code (UTC) requirement. If privatizing the electrical distribution system takes the military electrical manpower below the core UTC threshold, that system may be exempted. If manpower does not go below the UTC requirement, the electrical distribution system is not exempt. If a system is subsequently privatized, a condition may exist where the unit has a training requirement for military electricians, with no electrical distribution system on which to train. However, wartime task proficiency and training is a critical readiness issue and can be pursued through the other avenues mentioned above.

d. **A-76 Deconfliction:** As a result of DRID #49, the Air Force's accelerated privatization program now overlaps current and future Air Force A-76 actions. AF/XPMS memorandum, dated 7 Jan 99, recommended ALMAJCOM/XP/CE to cancel or hold in abeyance specific A-76 actions regarding utility systems pending the results of privatization feasibility analysis. After HQ USAF has received and analyzed all responses, MAJCOMs will be notified specifically which of their A-76 studies have been approved for cancellation or abeyance. Until that time, MAJCOMs should proceed with all A-76 studies as planned. The memorandum included a list of utility A-76 projects affected and provides guidelines for deconflicting utilities A-76 studies with the Air Force Utilities Privatization Program as follows:

(1) A shift from A-76 to privatization will not drive a dollar or end-strength bill for the MAJCOM.

(2) Cancel all started and defer (until privatization determination is made) all future stand-alone utility A-76 projects.

(3) Separate and exclude the four utility systems (electric, water, wastewater and natural gas) from all A-76 BOS studies prior to releasing the RFP. Four installations with pending A-76 awards were excluded from this requirement (Tinker, MacDill, Eglin and Maxwell AFBs), but privatization analyses will be completed and transfer, where appropriate, will occur at an appropriate break point.

e. **Future Projects:** Unless a system was exempted from privatization due to readiness impacts, any future requirements for MILCON, repair, maintenance and minor construction projects (operations and maintenance or environmental) planned and programmed for utility systems must fully demonstrate why such requirements must be accomplished prior to privatization rather than accomplished as part of a privatization effort. All program requests for utility systems must state that privatization was considered and justify specific reason(s) for exclusion.

f. **Determining Availability of Personnel for Source Selection:** Individual requiring activities must justify and obtain necessary approvals for use of A/E contract support in

technical evaluations (A&AS requirements). Source Selection Draft Policy and Procedures, Subpart 5315.303(g)(2), requires the contracting officer to ensure necessary approval has been obtained IAW FAR Part 37.2. Current A/E contract support provides for technical assistance and negotiation support. FAR 37.204 requires head of agency determination to use contractor support when government personnel are not available to support source selection. Individual requiring activities must process required justification in accordance with the 19 Jul 96 SAF/AQX policy letter on Air Force Advisory and Assistance Services.

ISSUES UNDER REVIEW

a. **Bill of Sale and Rights-Of-Way:** Utility systems will be conveyed through a bill of sale. The bill of sale transfers ownership of the system alone. We are not conveying real estate (land) to the new owner. In lieu of conveying real estate, we will lease real estate under plants, in some cases, to the new owner. Otherwise, for distribution and collection systems, we will issue rights-of-way, not easements, for new owners to gain access to these systems for operations and maintenance. The length of the right-of-way will be nominally set at 75 years, but may be changed as determined necessary. The term of the right-of-way must be long enough to assure new owners that any investment including any improvements made to the system can be recouped. The term of the right-of-way is not connected to the utility service contract, rather it is a part of the system being sold, a property interest. HQ AFREA is revising the model rights-of-way agreement, and developing the boilerplate lease instrument.

b. **Contract Length:** Privatization will result in two actions—the sale of the utility system (a property disposal)—and an acquisition of utility services (a FAR transaction). These are two distinct actions although they may be combined in the same contracting action. While the sale of the utility system is a permanent action, the acquisition of utility services may be limited in duration. Section 201(a)(3) of the Federal Property and Administrative Services Act of 1949 (40 U.S.C. §481(a)(3)) currently limits the length of term for an acquisition of utility services to 10 years. Legislation has been proposed with the FY00 Defense Appropriations Bill to revise the term to a period not to exceed 50 years.

c. **Delegation of Authority:** Delegation of conveyance authority has entailed an amendment of the Secretary of the Air Force Order (SAFO) 715.2. The SAFO package is now in coordination. Further delegation will be accomplished through memo, but will not be delegated below SAF/MII level. Delegation of Source Selection Authority (SSA) is covered under AFFARS 5301.601-92, *Delegation of General Contracting Authority*, which states SAFO 650.4, 21 May 92, in conjunction with SAFO 100.1, 1 May 90, delegated general contracting authority to the Deputy Assistant Secretary (DAS) (Contracting). AFFARS 5315-3, Table A, delegates source selection authority (SSA) to the following individuals for the respective actions:

- Contracting Officers for actions under $10M;
- MAJCOM Commanders (non-AFMC) for actions from $10M to $500M;

- AFMC Single Managers for actions from $10M to $50M;
- AFMC Program Execution Officers (PEO) and Designated Acquisition Commanders (DAC)/Center Commanders for actions from $50M to $500M; and
- Principal Deputy Assistant Secretary of the Air Force (Acquisition & Management) for actions greater than $500M.

Although SSA is at the MAJCOM Commander level, overall authority to approve a privatization deal will be retained at SAF/MII level. SAF/MII will submit all privatization deals for congressional notification. Following the 21-day notification period, SAF/MII will approve the privatization deal, sign the bill of sale (conveyance), sign any right-of-way documentation, sign any lease-hold documentation, and notify the installation contracting officer to proceed with signing of contractual agreement(s). SAF/MII will issue a memorandum further clarifying authorities and any redelegations.

d. **Land Conveyance Authority:** Authority currently does not exist for conveying land under utility plants. Current policy is to provide lease-hold arrangements for land under utility plants. Land conveyance may provide a more attractive deal in some situations. Proposed legislation amending Title 10 U.S.C. Section 2688 was submitted for congressional consideration in the FY00 Defense Appropriations Bill, but not included. Similar language will be submitted for consideration in the FY01 Defense Appropriations Bill.

e. **Changes to Installation Utility Bills:** Following privatization, the installation utility bill will likely increase as it will now include not only the cost of the commodity (i.e., electricity or water) but also the new owner's cost of operating and maintaining that system(s). Installation customers (MWR category "C" activities, banks, Burger King, AAFES, DeCA, etc.) may be individually metered and in some cases billed directly by the new utility owner. Federal installations are generally offered lower utility rates because of the volume of the utility used. Installation customers currently benefit from these lower rate service contracts. Direct billing to customers outside the installation's service contract could negate the benefit customer's currently realize. Higher utility rates may negatively impact the financial viability of these operations. Thus, direct billing should be avoided where possible. DoD and Air Force policies governing MWR category "C", AAFES, and DeCA activities is under review by a working group to the Air Force Utilities Privatization Integrated Process Team to determine if these customers will be charged for overhead, maintenance, and repair to utility systems or capital investments in the utility infrastructure system following privatization actions or if those costs will be paid with appropriated funds. Current inter-service support agreements will need to be appropriately amended and affected users prepared for any new billing system and potential cost impact. AF/ILV was added to the Air Staff Utilities Privatization Integrated Process Team to facilitate this review. HQ AFCESA is reviewing privatization options and the impact of those options on customer bills. Installations and MAJCOMs will need to identify and shift funds from the various accounts impacted by utilities privatization to cover any increases in utility bills as O&M and recapitalization responsibilities are transferred to the new owner and reflected in the utility bills. In some cases, a utility bill will be created were one did not previously exist (i.e. an installation

producing its own water…now purchasing water from local municipality). Lessons learned from studies completed to date indicate it is difficult to establish a reliable algorithm/formula to fit each instance, as each base/system possesses different economic criteria/conditions. Any algorithm used to amend inputs to the Program Objective Memorandum (POM), if needed, should utilize the status quo "adjusted" cost as a starting point for determining the maximum total cost of future utility bills. This data will be available 6 months after analysis begins with the feasibility "go-no go" analysis report. The report details the costs of labor, operations, maintenance, materials and supplies, and vehicles from which funds may be reduced from these accounts and credited to the utility accounts. Final costs for amending the POM again will be available when binding proposals are obtained 18-20 months after analysis begins. As an alternative, privatization contracts may include a requirement that no increases will occur during the first 2 years following a transfer of ownership. This will allow installations to reprogram and the Air Force to amend the POM for future increases in utility costs.

f. **Environmental Requirements:** The Air Force will conduct environmental baseline surveys (EBSs) for utility privatization projects when site specific determinations indicate a need in accordance with SAF/MIQ policy, dated 12 Nov 98. Implementation guidance for a Phase I and II EBS is outlined in the draft revision of AFI 32-7066, *Environmental Baseline Surveys in Real Estate Transactions*. HQ AFCEE will administer the contracts. Funding will be provided centrally from AF/ILEI to HQ AFCEE. Environmental impact analysis process (EIAP) requirements will be met in accordance with SAF/MIQ policy, dated 12 Nov 98, and shall be prepared for utility privatization projects in accordance with implementation guidance outlined in AFI 32-7061, *Environmental Impact Analysis Process* (EIAP). HQ AFCESA will administer any required EIAP contracts. Funding will be provided centrally from AF/ILEI to HQ AFCESA. AF/ILE, with SAF/MIQ concurrence, directed the preparation of EBSs and environmental assessments (EAs) for the initial 55 systems to undergo privatization analysis (Texas Regional Demonstration and FY98 program projects). AF/ILEV is reviewing environmental actions completed to date to determine need for any further guidelines for future environmental requirements.

g. **Economic Exemption Considerations:** When applying the exemption for uneconomical considerations, think about the following. As clearly stated in the goals of utilities privatization, the Air Force will not privatize systems where it proves to be an uneconomical decision. During the phase III implementation of privatization, a certified economic analysis will accompany the notification package to Congress. It is the Air Force intent to divest of systems even if the certified economic analysis indicates a breakeven cost. During the phase I feasibility analysis, a *preliminary* economic analysis is conducted to determine the status quo cost of operating and maintaining a utility system. This analysis is intended to identify glaring reasons for not expending additional resources on pursuing privatization of clear examples of non-privatizable systems. Since the actual costs incurred in operating and maintaining the utility system may reflect inadequate levels of maintenance and condition, an "adjusted" status quo cost is also calculated, in accordance with DoD guidance, reflecting the costs that *should be* incurred if the systems were operated and maintained in accordance with all applicable legal and regulatory requirements as well as adequate maintenance and

condition levels. These costs are compared to a cash flow life cycle cost analysis for a privatized system. This preliminary analysis is considered to have at least an 80 percent confidence rate as it uses best available industry information and engineering judgement, but cannot reflect the strategic business value of these systems which can only be determined through the solicitation of binding proposals. In addition, systems that may indicate a negative return on an individual basis may prove to be positive when bundled with other systems (i.e., water with wastewater system, gas with electric, or several gas systems at nearby installations leveraged together under the same solicitation. With this in mind, any requests for exemption for economic reasons based on the *preliminary* economic analysis will be heavily scrutinized and will need to provide supporting evidence that no overall benefit can be obtained through bundling with other systems and that all reasonable efforts have been made to increase the confidence. The Air Staff IPT is reviewing the establishment of a rule that unless the *preliminary* economic analysis indicates a negative return of 20 percent or more, MAJCOMs should proceed on to phase II comprehensive analysis obtaining binding proposals from industry for development of a certified economic analysis.

h. **Economic Analysis:** The preliminary and certified economic analyses will be prepared in accordance with AFI 65-501, *Economic Analysis*, and AFMAN 65-506, *Economic Analysis*, and published policy and guidance for utilities privatization. Attachment 1 contains a simplified example of a preliminary cost analysis for utilities privatization which replaces Appendix H of the Utilities Privatization Policy and Guidance Manual released October 1998. Appendix H is intended to be solely a simplified example of a cost analysis for a typical privatization project. It is not intended to serve as an example preliminary economic analysis. Preliminary economic analyses will provide the basis for making a determination of feasibility for privatization resulting in a decision to proceed to Phase II of the privatization process. The preliminary cost analysis will consist of a 25-year cash flow of both the status quo and privatization alternatives and comparison of the present value of each. Status quo costs will include capital costs and annual operating costs such as operations and maintenance (O&M) and general and administration (G&A) costs. Capital costs cover deficiency correction costs and renewals and replacements. Privatized costs will include the rate charged to the Air Force for utility service by the new owner plus the Air Force's own management costs (contract administration) to oversee the new owner's operation. Experience has shown that, in most cases, it is not necessary to estimate a utility purchase price in order to conduct preliminary cost analysis of Air Force utility privatization. This is because most utility systems considered for privatization will only be used to provide utility service on base after privatization occurs. Once the system is privatized, the new owner would need to recover all costs associated with the system, including the cost of purchasing the system, through its service contract with the Air Force. Assuming a competitive or regulatory setting, the new owner would charge a rate that is directly based on its costs. If the rate were based on the cost of service to a number of the new owner's customers, the purchase price would likely be based on the margin the new owner would make on those rates. As such, the net cost to the Air Force would be the new owner's incremental, direct cost to serve the base. For the purposes of preliminary economic analysis, it can therefore be assumed that the purchase price received by the Air Force for sale of the utility system will be recovered by the new owner in the rate it charges to the Air Force for service.

Accordingly, the purchase price for the utility need not be calculated. The net cost of privatization (the new owner's incremental direct costs) need only be considered. These net costs include the new owner's operating costs (O&M and G&A), the cost of remedies to system deficiencies, and the cost of routine renewals and replacements as described elsewhere in the policy and guidance document. There are two exceptions to this guidance. First, the utility may have excess capacity that has value for off-base uses. Under these conditions, it would be necessary to credit the privatization option with the market value of the excess capacity. Second, state regulation may restrict privatized service on base to a local franchise or permit holder that would charge service rates on the basis of an authorized percentage of the acquired system's value. Obviously, this would require that the prescribed system value be calculated. Policy for establishing how G&A costs will be assumed is currently under review. At this time, G&A costs equaling 12 percent of civilian and military personnel costs are considered to be a conservative assumption and in line with estimates currently used for cost comparison calculations made under provisions of Circular A-76. +

Simplified Example: Preliminary Cost Analysis of Utility Privatization (Revised June 8, 1999)

Background

A wastewater utility system is being considered for privatization at an Air Force base in year 2001. The following conditions exist:

- The wastewater utility system consists of a collection and treatment system that has a capacity of 3 million gallons per day (MGD). The current system throughput is 1.5 MGD. Throughput is expected to increase to 2.0 MGD in year 2005.
- The facility condition assessment identified a number of physical deficiencies. Corrections will cost $2,500,000. In addition, changes in the throughput in 2005 will require reconstructing lift stations and some piping at a cost of $4,800,000. It is expected that these projects could be accomplished over a four-year period.
- Annual renewals and replacement costs are projected to occur as existing plant and equipment wear out. In many years, there will be no expenditures on renewals and replacements; in other years, expenditures are projected to range from $1.0 to $3.0 million.
- Current annual operation and maintenance (O&M) costs total $800,000. However, it was determined that only 90 percent of the manufacturer's maintenance procedures are being followed.
- Current O&M costs are determined to be 60 percent fixed and 40 percent variable based on throughput.
- General and administration (G&A) costs are estimated to be $93,000.
    - The Air Force is willing to accept payment for the wastewater system on the basis of uniform monthly payments over a period of 10 years.
- From the industry market analysis, it is determined that there is substantial market interest in acquisition of the wastewater collection and treatment system. This market interest includes the municipal wastewater utility that is surrounds the Air Force base.
    - The real discount rate is 2.9 percent.

Analysis

A preliminary cost analysis is needed to determine if privatization has enough promise to proceed to Phase II of the utility privatization process. This cost analysis consists of preparing a 25-year cash flow of both the status quo and privatization alternatives and calculating the present value of each. Components of this analysis are discussed below and shown in the example table.

Status Quo Costs

- Operating costs (O&M costs plus G&A costs) are estimated initially to be $982,000 per year. This includes adjusting operation and maintenance costs to $889,000 to account for insufficient maintenance ($800,000 / 0.9 = $889,000).

- Annual operating cost will increase to $1,113,000 in year 2005 to account for increased loads. O&M costs are projected to increase to $1,007,000:

  - 0.6 x $889,000 = $533,000 (fixed costs)
  - 0.4 x $889,000 x (2.0 MGD/1.5 MGD) = $474,000 (variable costs)
  - Totaling $1,007,000 annually

  G&A costs are projected to increase by the same proportion as O&M costs in 2005.

  - Capital costs:

  - Deficiency capital costs are assumed to be incurred on an equal annual cost basis for the four years from 2001 through 2005.
  - Renewals and replacements will be made as existing facilities are fully depreciated and need replacement. Projections of actual expenditures are developed on the basis of replacement cost estimates and estimated dates of full depreciation.

Privatized Costs

The cost of privatization will include the rate charged to the Air Force for utility service by the privatizing utility, plus the Air Force's own management costs to oversee the utility's operation, less the proceeds the Air Force receives for sale of the utility system.

It is assumed that the local municipal utility surrounding the base will be the least-cost service provider among the interested parties. Further, it is assumed that the rates charged by this utility would be set to cover the following costs[1]:

- Operating costs are projected to be less than those for the status quo. This projection is based on economies of scale that can reasonably be achieved from the adjacent municipal utility incorporating the Air Force collection and treatment facilities into its existing operation. O&M costs are projected to be $711,000 per year; G&A costs are projected to be $75,000 per year. With increased flow in 2005, these costs are projected to increase by the same percentage as they are projected to increase in the status quo scenario.

- Total capital costs are projected to be the same as projected for the status quo[2].

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[1] The costs described here include the purchasing utility's incremental cost to add the system to its own operation, plus the capital costs for needed remedies to system deficiencies and normal renewals and replacements, plus the cost to pay for the utility system over a 10-year period. Alternatively, the analysis might consist of applying the privatizers existing rates for service to individual facilities. Under those condition, the purchase price would logically be base on the capitalized earnings value from revenues generated from these rates less the incremental cost of adding the system to the privatizer's existing operation. This would yield the same result as shown in the example.

[2] Since the amortization rate for the assumed privatizer, the local municipal utility, is assumed to be the same as the Federal discount rate, the present value of capital expenditures as they are made by the privatizer is the same as the present value of these expenditures amortized over a long-term period. Therefore it is not necessary to adjust the cash flow for capital expenditures to reflect the fact that the privatizer would logically set its rates based on long-term financing of capital costs. If the market analysis were to show that the least cost privatization proposal would likely come from a privately owned entity, the analysis would need to be adjusted to reflect the fact that the privately-owned entity has a higher cost of capital than the Federal government. This

- It is logically assumed that the privatizing entity will also recover the cost to purchase the utility in its charges for utility service. For the purposes of this example, it is assumed that the purchase price is $20 million amortized over a 10-year period at a real interest rate of 2.9 percent (the same as the assumed discount rate).

Air Force management costs with privatized ownership and operation is assumed to include 0.25 FTE to oversee utility service from the privatizing entity.

The cost of the privatization is reduced by the payment the privatizing entity makes for the system. As noted above, this payment is made over a 10-year period at an interest rate of 2.9 percent. As the Example Table shows, this payment nets out to zero since it is included as a cost in the utility rate. For preliminary economic analysis, this assumption is valid as long as the system is assumed to provide value only to the Air Force[3]. Under these circumstances, it is not necessary to include the purchase price in the preliminary economic analysis. This has the benefit of allowing the analysis to focus on true cost differentials between the status quo and privatized alternatives and to avoid speculation about market value of the utility system during Phase I.

Present Value Comparison

The present value of both the status quo and privatization alternative cash flows is calculated on the basis of the Federal discount rate of 2.9 percent (from OMB Circular A-94). As the Example Table shows, the present value of the Privatization cash flow is $3.7 million, or 9.8 percent, less than that for the Status Quo cash flow.

Conclusion

The preliminary cost analysis in this example shows promise for significant savings from privatization of the wastewater system. A recommendation for proceeding to Phase II of the privatization process would therefore be supported by this analysis.

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adjustment should exclude the implicit Federal income tax component to the private entity's cost of capital, since that component is a revenue to the Internal Revenue Service and therefore not a true cost to the Federal government.

[3] If it is assumed that it can provide benefits to off-base customers, then the privatizing entity would have more than just the Air Force from which to recover payments for system acquisition.