

Privatization Raises Both Questions and Opportunities

by Laurie Klappauf
Water Sense Editor

Editor's Note: This theme issue of Water Sense focuses on privatization, or ways of involving the private sector in providing water and wastewater services. This overview article and the stories on the following pages will introduce some of the privatization options and provide sources of additional information.

Privatization and public-private partnerships have attracted much attention in recent years. Just as often, they've drawn confusion as well, particularly from small community officials who may not understand the basic terms and concepts.

Privatization Can Mean Many Things

"People tend to use the word 'privatization' to cover many types of alternative arrangements,"

Town, Business Team Up for New System

by Michelle Moore
NDWC Contributing Writer

Editor's Note: This story illustrates how a private enterprise and community officials in one small New York town cooperated to meet their mutual need for clean water.

About five years ago, the town board in Clifton, New York, found themselves in a predicament when the state health department told them the local water system needed to be replaced. People there already knew the water was contaminated. Many had been boiling their water, and some had given up drinking it and bought bottled water.

Replacing the water system was complicated by the fact that there was no established water district, and the treatment plant was owned by a private business, Stora Papyrus, a paper manufacturer headquartered in Sweden. The paper mill had been operating since before the turn of the century with a



Residents of Newton Falls, part of the township of Clifton, New York, gather near Main Street to learn about the new drinking water system being built with the help of a local business.

says Judy Carlson, fixed utility supervisor with the Pennsylvania Public Utility Commission.

The common thread in these arrangements is that they all involve the private sector in providing some part of a service—such as drinking water or wastewater treatment—to the public.

This private sector involvement can cover a wide range of options, from simply contracting out engineering or billing services, to contracting with a company to operate a system, to what is sometimes called "full privatization," where a private company actually owns and operates the facility. This "spectrum" of private sector involvement is visually presented on pages 10 and 11.

Emotions can run high when the term "privatization" is used. "If there is one misperception, it's that the private sector is inherently better than the public, or that public is inherently better than private," says Jim Smith, *Continued on page 4*

succession of owners, and had, essentially, built the town to house its workers.

The company drew its water from the nearby Oswegatchie River and shared it with the 450 Clifton Township residents at no charge. This arrangement worked well until the health department ruled that the town needed to upgrade its

water system. The town board voted to form a water district and begin the process of applying for funding to build a new water system. They contacted the local Rural Economic and Community Development (RECD) office (now called Rural *Continued on page 3*

Water Sense

Special Issue on Privatization:

Working with the private sector to provide drinking water and wastewater services





Volume 3, Issue 3
Summer 1997

Water Sense

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The National Drinking Water Clearinghouse (NDWC) assists small communities by collecting, developing, and providing timely information relevant to drinking water issues. Established in 1991, the NDWC is funded by the Rural Utilities Service and is located at West Virginia University.

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Water Sense is a free publication, published quarterly. Articles, letters to the editor, news items, photographs, or other materials submitted for publication are welcome.

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ISSN 1080-0603

Water Sense is printed on recycled paper.



New RUS Regulations Simplify Applications

The U.S. Department of Agriculture's Rural Utilities Service (RUS) has issued new regulations to streamline the application process for its water and waste disposal loans and grants, with an emphasis on reaching the neediest communities.

"The new regulations direct grant funds to the communities that need them the most," says Larry Bowman, chief of operations for RUS water and environmental programs.

The revised regulations, issued June 19, eliminate the preapplication from the process of applying for funds. The new procedures will enable potential applicants, when they find it necessary, to get a determination of basic eligibility for funding prior to filing an application. "Applicants may make a written request to the agency for an eligibility determination without filing a full application," says Bowman. "We will respond in writing to the degree that sufficient information is available."

He adds that many applicants, particularly those who have had loans in the past, will not need to make the written request before applying.

A preliminary engineering report is still required with the application, as before. However, since there is no longer a preapplication to fill out, the preliminary engineering report will be needed sooner in the application process.

"We believe this makes sense because with a clear picture of what the applicant wants to build, we can help them move right along with the process," says Bowman. "We can say 'yes' or 'no' sooner."

The new regulations also slightly revise the process used to select projects for funding, to direct the funds toward small, low-income communities that need to correct health problems.

Under the new rules, the maximum grant allowed for the lowest income, most needy communities has not changed—it is still 75 percent of eligible project costs. However, the maximum grant allowed for most grant-eligible communities is reduced from 55 percent to 45 percent of the project costs.

"The new regulations continue the policies of limiting grant consideration to the amount necessary to achieve reasonable user rates, and prohibit grants to communities where the median household income is above the state's nonmetropolitan median household income," says Bowman.

The new policies also include changes required by the 1996 Farm Bill, such as a requirement for the applicant to notify the public of the application and new guidelines for employing consulting engineers.

"We are constantly working with other potential funding sources, such as Community Development Block Grants, state revolving fund programs, and sources of private credit, in an effort to get more projects built with the available dollars," says Bowman. "We also offer to work with applicants to help them plan and develop their projects into something that is fundable."

All RUS water and waste disposal loans and grants are processed and approved at state and local Rural Development offices. The funds may be used for drinking water systems, sanitary sewer systems, solid waste disposal facilities, and storm drainage systems.

For the phone number of your state Rural Development office, call the National Drinking Water Clearinghouse at (800) 624-8301. \$

No Change in RUS Interest Rates Again This Quarter

The interest rates for Rural Utilities Service (RUS) water and wastewater loans remain unchanged this quarter, marking three consecutive quarters with no movement in these rates.

The RUS interest rates are set quarterly at three different levels, which have specific qualification criteria. The rates for the fourth quarter of fiscal year 1997 apply to all loans issued from July 1 through September 30, 1997.

These rates are:

- *poverty line* rate: 4.50 percent;
- *intermediate* rate: 5.00 percent; and
- *market* rate: 5.50 percent.

RUS loans are administered through local or state Rural Development offices, which can provide specific information concerning RUS loans and applications.

For the phone number of your state Rural Development office, contact the National Drinking Water Clearinghouse at (800) 624-8301. \$

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Development) to learn about loans and grants. Meanwhile, Stora sold the company to Appleton Paper Company of Wisconsin.

New Owner Inherits Water Problem

Appleton Paper is known to be a “community friendly” company and promptly began to prove that reputation to the people of Clifton, said Charles Hooven, town supervisor. Although Appleton no longer wanted to be in the business of providing water to the town’s residents, it still acknowledged a responsibility toward the small community.

For instance, the state required that the new system draw its water from an underground source. To help Clifton, Appleton spent \$250,000 drilling wells, but was unsuccessful in finding sufficient water. The town council then asked the state health department to let the water system continue drawing from the Oswegatchie River “like it had been doing for the last hundred years,” Hooven said. The health department consented, but required the town to build a treatment plant to filter the water. The company agreed to install a new intake system and donated the land for the treatment facility. The town itself would actually build the new plant.

Clifton’s town council was prepared to borrow \$290,000 from RECD for the project. However, a closer inspection revealed that the town not only had bad water, but decaying water lines, Hooven said. The council decided that building a water treatment plant without replacing the water lines would be shortsighted.

“With the condition the plumbing was in, we knew that the pipes would have to be replaced very soon,” Hooven said.

Initially, the project was estimated to cost \$800,000. Hooven said they eventually learned that this amount would barely buy the materials to build the treatment plant. As the project grew to include new water lines, the amount the town would need to borrow grew too. They knew that the community, with a median income of about \$22,000, couldn’t afford to pay back a larger loan. So, the project was stalled for a while.

Self Help Group Opens Doors

The council learned of the Self Help Support Program (SHSP), an independent program that operates through New York Secretary of State Sandy Treadwell’s office, in partnership with the state Department of Health and the New York Environmental Facilities Corporation. SHSP could help council members move faster through the intricate process of receiving the aid they needed to fund their water project.

“We were kind of overwhelmed when we approached a project of this magnitude,” Hooven said of their inexperience with acquiring state and federal grants. “We were floundering around when someone told us about this group in the state office who could cut red tape with regulatory agencies. They quickly clarified what requirements we had to meet to help keep the ball moving. The Self Help Support Program opened doors for us and got us talking to the right people.”

The district finally received a \$1,060,000 grant, in addition to the \$290,000 loan, from RECD to fund the project. The paper mill contributed an additional \$350,000 for construction of the treatment plant and for the distribution lines. A groundbreaking ceremony was held in July, and Hooven said the project should be done “before the snow flies in November.”

The new plant will process about 150,000 gallons of water per day. Rates for residences and businesses will be the same, based on usage. Appleton Paper Company, as the largest water user, will end up paying back a good bit of the loan through its bills.

Hooven had this bit of advice for other small communities facing similar situations of outdated water systems: “Don’t be afraid to talk to businesses in your area, because they too have a vested interest in the community. And, they have a responsibility to help.” **\$**



The small town of Clifton, New York, will soon have a new drinking water system, thanks to a partnership between local officials, the largest business in the area—Appleton Paper Company, federal funders, and a state self-help program.

Pictured in the July 1997 groundbreaking ceremony are (left to right) Jim Swinger, Appleton Paper’s local mill manager; Tom Gartung, regional development district manager for the U.S. Department of Agriculture’s Rural Development; Charles Hooven, supervisor for the Town of Clifton; Dale Coats, manager of the local Rural Development office; Bruce Greenwood, representative from State Assemblywoman Cloe Ann O’Neil’s office; and Joel Gray, representative from State Senator Ray Meier’s office.

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executive director for the Council of Infrastructure Financing Authorities.

In reality, say experts, the distinction is not so black and white—there are good and bad examples in both sectors. The important thing is to examine all options to come up with the best solution for your community.

“In weighing these options, you shouldn’t get caught up in the private-public debate,” says Smith.

Another misperception is that there is only one right way to form partnerships with the private sector. However, what works for one community may or may not be the right solution for another community.

“This is not a one-size-fits-all solution at all,” says Don Schwartz, senior water resource specialist, Northeast Rural Community Assistance Program.

Whatever the controversy about private sector involvement in providing water and wastewater services, the issue is not likely to go away soon, as communities struggle to repair aging systems and make improvements to meet water quality requirements.

“The infrastructure need is huge,” says Jim Harrison, vice president and treasurer with Pennsylvania-American Water Company, a private company that serves more than 300 communities in the state. A recent survey conducted by the U.S. Environmental Protection Agency (EPA) concluded that drinking water systems in the U.S. will need to invest more than \$138 billion on infrastructure improvements over the next 20 years to help protect public drinking water supplies.

“I don’t see how federal and state governments can bridge that gap,” says Harrison. “Public-private partnerships with companies like ours may be the only alternative to raise needed capital to fix infrastructure.”

Some small communities may wonder, “How does this apply to us? Isn’t most ‘privatization’ occurring with larger towns and systems?”

Not necessarily. In some states and regions, private companies are buying or contracting with small systems to form regional entities.

In fact, as new federal requirements are enacted that require all drinking water systems to have the financial, technical, and managerial capacity to provide safe drinking water, many states are encouraging regional solutions. In some cases, this regionalization involves municipalities working together. However, in other cases, private companies may be the link, perhaps by running the operations of several systems in close proximity

to each other or by purchasing and consolidating a number of systems within one region.

Reasons To Privatize Vary

There are many reasons why a small system might want to work with the private sector to help find solutions to its problems.

“A community that has limited technical or operational skills may need support from the private sector to solve a water quality or regulatory compliance problem,” said industry consultant George Raftelis during a 1996 American Water Works Association roundtable on public-private partnerships.

In particular, a larger, private company may be able to provide the resources and expertise needed by small community officials, who often have difficulty keeping up with changing regulations and technological developments.

Money is a big reason some communities look to the private sector. Private companies may offer an alternative source of financing when communities need to replace deteriorating infrastructure, especially when other sources of funding, such as government grants and loans or municipal bonds, are scarce or not feasible.

“If private financing is used, the burden on public debt capacity can be reduced,” according to *A Guidebook of Financial Tools*, issued by EPA’s Environmental Finance Program. The use of private financing might free up some traditional funding, such as bonds, to fund other local projects.

Ways to tap into private funding vary. A private company that has contracted to run a municipally owned utility might pay for upgrades itself and work those costs into the monthly service fees paid by the town.

A town may even sell its facility. “A municipality’s equity interest in its water system may be a valuable asset,” writes Daniel Kucera, a partner with the Chicago law firm of Chapman and Cutler, in a column on privatizing water systems.

“A sale of the water system may be the only practicable source of needed capital funds,” he writes, noting that these funds can then be used for improvements to other infrastructure assets in the community.

In some cases, the town council or water board may simply want to avoid the day-to-day hassles of managing and operating a system, and would prefer to pay a flat monthly fee to a private contractor. Similarly, the board may conclude that private operations may provide more reliable and better quality service.

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“If there is one misperception, it’s that the private sector is inherently better than the public, or that public is inherently better than private.”

Jim Smith,
executive director,
Council of
Infrastructure
Financing
Authorities

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From the private sector perspective, companies seeking to provide water and wastewater services are generally looking to make a profit. They often plan to do this by implementing more efficient operations or by locating in regions with potential for future growth.

At first glance, smaller systems that are already struggling may seem unlikely to attract private investors or operators. However, firms that operate or buy water or wastewater systems often look beyond individual systems and may be drawn to entities within a particular region as part of their strategic plans.

For instance, Florida Water Services looks for systems that meet the firm's overall objectives, says Tracy Smith, manager of government relations for the private firm. "And part of our long-term plan is growth," he says.

Still, private companies generally are not interested in the smallest, most geographically isolated systems, according to Schwartz. For one thing, it would be difficult to connect these systems

to a company's existing network. "It's unlikely that you would go over a mountain to connect only 50 or 100 more homes," he says. And it would be inefficient for a company to hire and send an operator for only the part-time work that would be needed. Private contractors will ask, "How can I make a buck if I have to drive 100 miles to do the work?" says Schwartz.

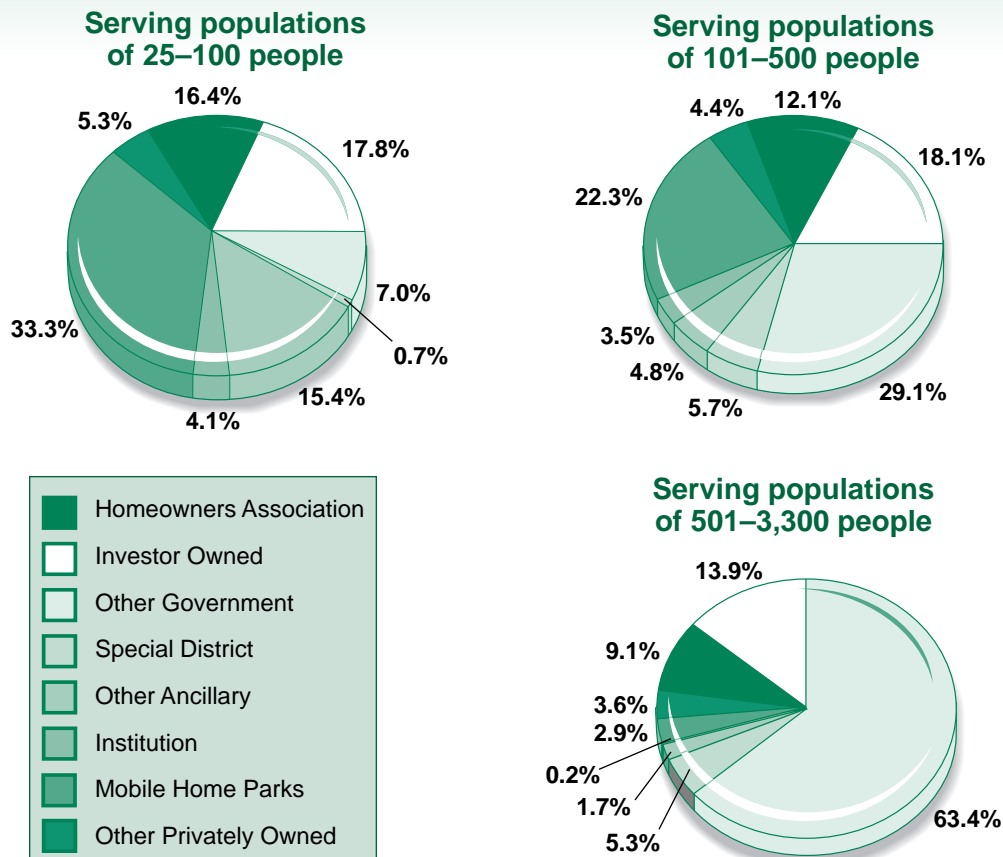
However, there still may be opportunities for some of these communities to work with the private sector. Other types of private businesses in or near a small community may decide to help the local water or wastewater system in order to reap some of the indirect benefits of enhanced infrastructure, such as attracting and keeping key industries and employment opportunities.

These types of partnerships can be quite creative—a local company may donate land, design or construct a facility, or even provide money. The story on page 1 illustrates how one such arrangement worked in a small New York community.

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Ownership of Community Water Systems

(Percent of Systems)



Source: U.S. Environmental Protection Agency, 1997

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Obstacles Curb Privatization

Small communities considering privatization may face a number of obstacles. Some of these include the following.

Loss of local control. The most frequently cited barrier to public-private partnerships is local governments' fear of losing control over their utilities.

"The issue of local control overpowers everything else," says Amy Swann, director of the Water and Wastewater Division of the West Virginia Public Service Commission.

That fear is often compounded by distrust, or even dislike, of neighboring towns. These combined factors may prevent communities from exploring any sort of teamwork with neighboring towns, with or without private sector involvement.

"That's a big issue in small communities—trying to get them to work with each other without suspicion," says Schwartz.

Lack of information. Many local officials, particularly in small communities, simply do not understand how they might form partnerships with the private sector.

"A lot of board members need to educate themselves on these issues before they make privatization decisions," says Pat Weber, licensed water plant operator and former authority board member from north central Pennsylvania. He suggests that local officials seek out all sources of information and options, starting with their operators, community members, state environmental agency, Rural Water Association or other technical assistance organizations, and trade groups, such as the American Water Works Association.

"Either way you look at it—public or private—run your water system like a business," he advises. "Collect good system data, use the bidding process wisely, know your limits, and plan for the short and long term."

Employee concerns. Public employees and unions may fear that they would lose their jobs. "The union concerns may be more pronounced in larger towns and utilities, but job security is a real issue in small towns," says Carlson.

Legal issues. Local governments may not have legal authority to enter into contracts with private parties. The state or municipality may face restrictions on using tax-exempt bonds for a system with private firm involvement. There also may be laws governing the bidding and selection process for private owners or operators.

If you're considering working with the private sector for the first time, it's important to learn about state and local laws and requirements.

"A reasonably astute attorney or financial advisor should be helpful," says Haig Farmer,

privatization coordinator with EPA. Other potential sources of help include public service commissions, state environmental agencies, and other communities that have gone through a similar process.

Funding restrictions. Tax-exempt financing, grants, and low-cost government loans are often not available when private partners are brought in. Until recently, utilities built with federal grants could not be sold to private investors without substantial reimbursement of those grants.

However, some of this is changing.

For instance, the Safe Drinking Water Act Amendments of 1996 allow states to make low-interest loans to privately owned water systems from the newly created drinking water state revolving fund.

In addition, some new federal rules and policies ease restrictions on entering into long-term management contracts or selling public facilities to private companies. (See articles on pages 9 and 14.)

Little incentive for the private sector. Some systems may be in such poor financial or physical shape that private companies don't see how they could recoup an investment in the utility.

Barriers Can Be Overcome

Still, obstacles that hinder cooperative solutions with other municipalities or with the private sector are not insurmountable, says Harrison.

"I think a combination of two things—price and [customer demand for] water quality—will bring down barriers," he says.

He is not alone in characterizing small, 100-customer systems as "dinosaurs" moving toward extinction once pipes start to break, expensive infrastructure needs to be replaced, and customers start facing annual water bills of \$600–\$800.

"When people have to pay \$50 or more a month in water bills, solutions will come, political barriers will come down, and regionalization or privatization will look better," he says.

The key is to look at the private sector as one more tool, or resource, available to run or finance drinking water and wastewater systems. Small communities should explore all options—including state and federal funding programs, self-help possibilities, and public-private partnerships—and then carefully choose the best solutions for their unique situations.

"The bottom line is that you want to provide the most cost-effective service to your customers," says Farmer. \$

The key is to look at the private sector as one more tool available to run or finance drinking water and wastewater systems—small communities should explore all options, and then choose the best solutions for their unique situations.

State Regulators Play a Role in Privatization

All water systems are regulated by state environmental agencies, which ensure compliance with environmental regulations. Systems also might have to secure water withdrawal permits or rights from a state water resource agency.

In addition, private systems (and some public systems in some states) are regulated by public utility commissions, which oversee rate setting and other legal and economic issues. Communities should be aware of how these agencies might influence privatization decisions.

Agencies Ensure Clean Water

The responsibility for running a state's drinking water program is often housed in the state's department of environmental protection, health department, or similar agency.

This agency exercises the same authority for both public and private systems: it ensures compliance with federal Safe Drinking Water Act requirements and state drinking water standards.

The state environmental agency also usually oversees activities related to water quality, including nonpoint source pollution and other state and federal Clean Water Act requirements.

Some of these regulations may affect privatization decisions. For example, the state environmental agency may have authority to issue permits to wastewater systems that discharge into surface water. Since most wastewater systems have been publicly owned, the permit has traditionally been issued to the municipality.

However, if the wastewater system is being sold to a private company, it raises a new question. "Who is the actual holder of the permit?" asks Jim Smith, executive director for the Council of Infrastructure Financing Authorities. He notes that the community may still hold the permit, even if it no longer owns the treatment facility. This may be necessary because a municipality might have the power that a private entity would not to enforce, say, a pretreatment requirement at a local industry.

"Many laws and regulations were predicated on public ownership," explains Smith. "So it's those types of complexities you get into."

PUCs Look at Rates and More

In most states, public utility commissions (PUCs) regulate economic aspects of investor-owned utilities, including water and wastewater systems.

"The public utility commissions in 45 states regulate water utilities," says Janice Beecher, director of regulatory studies at Indiana University's Center for Urban Policy and the Environment. Other names for PUCs include

public service commissions or even commerce commissions.

"States have various approaches to what they regulate," says Beecher, explaining that there's a huge range both in types of systems and kinds of activities the commissions oversee.

For instance, in some states, such as Maryland, commissions may also regulate municipalities that serve customers outside municipal limits. In other states, such as Texas, the PUCs regulate homeowners' associations as investor-owned systems. Wisconsin and Rhode Island regulate municipalities, and in Indiana, municipal water utilities can choose whether or not they want to be regulated, says Beecher. Some states even exempt smaller systems from regulation.

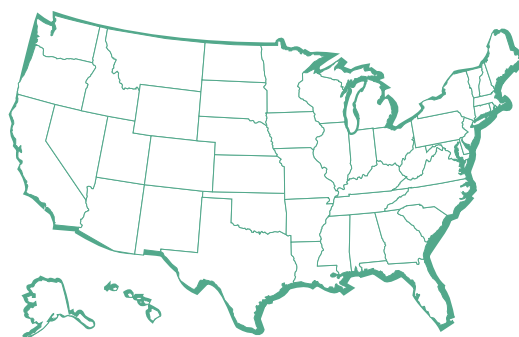
Nationwide (as of 1995), commissions regulate approximately 4,000 investor-owned water utilities and about 4,500 other kinds of water utilities, such as water districts, municipally owned systems, and cooperatives, according to Beecher. However, some of these water *utilities* provide service through multiple community water *systems*. Therefore, the number of commission-regulated systems is just over 11,000, or approximately 20 percent of the more than 55,000 community water systems in the U.S.

"The role of regulation is to prevent the abuse of monopoly power by utilities," says Beecher. "Regulation substitutes for public ownership on the one hand and competition on the other hand."

The thinking here is that publicly owned utilities are ultimately accountable to voters, who can express dissatisfaction with rates or service at the ballot box. In the extreme, such political pressures can sometimes prevent municipalities from making necessary rate increases to keep up with system repairs and operations. Funding agencies are often reluctant to finance the resulting

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Commissions Can Regulate Drinking Water Utilities



Forty-five states have commissions, such as a public utility commission, to regulate investor-owned water utilities, according to Janice Beecher, director of regulatory studies at Indiana University's Center for Urban Policy and the Environment. Some of these commissions also regulate homeowners' associations, water districts, or other nonprivate systems as well.

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“deferred maintenance,” says Amy Swann, director of the Water and Wastewater Division of the West Virginia Public Service Commission (PSC).

The private sector, however, normally relies on competition to provide consumers with choices and thereby keep prices in line. But water is considered something of a natural monopoly, since customers can't switch water companies as they do gas stations or grocery stores. In the absence of local competition, regulators may need to step in to ensure that rates are fair and affordable, and that service meets standards.

“Regulators must balance the needs of ratepayers against the needs of the utility, which must be kept financially viable,” says Beecher.

How do PUCs regulate?

Most PUCs “regulate” water utilities by conducting at least some combination of the following activities.

Approve rates and revenues. All state PUCs have authority to review and approve water rates, ensuring that the resulting revenues are adequate to operate the system. For investor-owned systems, commissions usually use a “rate of return” method to set rates that will cover operating expenses and provide a return, or profit, to investors. “This doesn't guarantee a profit; it just authorizes it,” says Beecher. “It's still up to the utility to earn the profit.”

PUCs also approve the rate structure, or what water utilities charge to specific customer groups, such as residential, commercial, or industrial groups, and variations in rates, such as seasonal pricing. Commissions sometimes may encourage a series of gradual increases to avoid the “rate shock” of a sudden large increase in rates.

Review finances. Most commissions require annual financial and operating reports from utilities they regulate. They may approve how much debt or equity (stock) the company issues. Some PUCs also conduct periodic financial and management audits.

Review mergers and acquisitions. In some states, when one system takes over or purchases another, the PUC will review the transaction if either system comes under the commission's jurisdiction. The PUC looks at the financial stability and future plans of the acquiring entity, as well as the legal aspects of the transaction.

The commission hopes this thorough review will prevent any failures. “There is not a 100 percent guarantee,” says Judy Carlson, fixed utility supervisor with the Pennsylvania Public Utility Commission, who concedes that they've seen the occasional bankruptcy following an acquisition.

Certify systems and service areas. Most PUCs have “certification” authority, meaning they can grant a utility an exclusive franchise setting out the terms of service, such as who will be served and in what area. This is often done through a “certificate of convenience and necessity.”

Mediate disputes, hear customer complaints. Most PUCs will review and help mediate rate disputes. “They usually try to resolve these informally, but formal processes are available if needed,” says Beecher.

No two PUCs are exactly alike, and their impact on private sector involvement can vary.

“Regulatory policy can influence privatization,” says Beecher. For instance, commission policies may create an environment conducive to mergers or acquisitions. Some commissions do this by providing financial incentives to firms that take over troubled systems. A few states have even passed laws allowing the commission to require a larger, financially stable system to take over failing ones. (*See sidebar on page 9.*)

Some commission policies may discourage privatization. A major disincentive is that regulation may be perceived as limiting profitability. As another example, a PUC may require that rates be set according to what percentage of the facility is “used and useful.” This means that costs of building extra capacity for future growth could not be recovered in rates, even if these costs might be more economical in the long run, critics contend. Potential buyers of systems sometimes see such policies as obstacles to growth and disincentives to acquire utilities that need improvements.

PUCs Can Provide Help

Small systems considering private sector involvement can often look to PUCs for help and advice.

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Commission Inventory Available

For more information about the scope and characteristics of commissions that regulate water and wastewater utilities, see the 45-page report, *1995 Inventory of Commission-Regulated Water and Wastewater Utilities*, authored by Janice Beecher of the Center for Urban Policy and the Environment at Indiana University. To order a copy of the report, contact Shannon Cooper at Indiana University, at (317) 261-3011. The cost is \$15 plus \$3 shipping and handling. \$

Laws and Incentives Encourage Takeovers

A few states have passed legislation that would allow public utility commissions to force the takeover of small, failing utilities—such as drinking water or wastewater systems—by other utilities.

Connecticut, New Jersey, Pennsylvania, Washington, and Oregon have some type of takeover authority, according to Janice Beecher, director of regulatory studies at Indiana University's Center for Urban Policy and the Environment.

And at least 10 state commissions provide takeover incentives, she adds. "These are incentives that commissions offer buyers to take over troubled utilities," says Judy Carlson, fixed utility supervisor with the Pennsylvania Public Utility Commission (PUC), which has both legislation and commission policies. "For instance, we might allow a utility to earn a higher rate of return on capital assets."

This would be attractive to regulated utilities, which are usually permitted to set rates and generate revenue according to a commission-approved rate of return. This rate of return is set as a percentage of the utility's "rate base," or allowable depreciated investment, which would include the value of the acquired system. A higher rate of return makes the takeover of a troubled system more palatable to investors.

The pressures driving takeover legislation are not new. "The biggest pressure was the need to meet filtration and treatment requirements of the Safe Drinking Water Act (SDWA), and to find money to replace aging infrastructure," says

Carlson. Small systems tend to have the most difficulty meeting these needs.

For the most part however, takeover—or forced acquisition—legislation is seen as a last resort, only to be used when positive incentives or other efforts have failed. According to Carlson, the Pennsylvania PUC initiated such proceedings just twice; in one case, a deal was negotiated, and the other case is still in progress.

And, indeed, such laws lay out stringent requirements governing takeovers. For instance, in some states, the system being acquired must be privately-owned, have fewer than 1,000 or even 500 connections, and have exhausted other alternatives to become financially sound and meet all necessary regulations. The laws may also specify characteristics that an acquiring system must have to ensure that it can successfully run or replace the system being acquired.

"Takeovers are really a last resort, and nobody takes this process lightly," says Beecher. "Incentives and voluntary acquisitions generally are preferred. But takeover authority can be considered one of several tools in a state's capacity development toolbox," she says, referring to the SDWA provision requiring states to ensure that water systems have the financial, technical, and managerial capacity to meet national primary drinking water regulations.

"There's going to be more attention up front in controlling the creation of new systems [to ensure that they're healthy] that could make these policies unnecessary in the future," says Beecher. **\$**

Some commissions offer incentives to encourage buyers to take over troubled utilities.

State Regulators Play a Role in Privatization

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"A lot of utilities fear we're strictly regulatory, not advisory, so some small utilities have been hesitant to call for advice," says Carlson.

She points out that the Pennsylvania PUC works closely with other environmental and financial agencies in the state to help resolve problems facing small water and wastewater systems.

"Sometimes we try to negotiate deals when it seems like there's not a real good solution. Sometimes we can facilitate sales and help mediate rate disputes—we work as an unbiased party," she says.

"In some ways, we've pushed utilities to become more efficient," she adds. For instance, the Pennsylvania PUC offers a uniform system of accounts, can help systems put together rate increases, and encourages a good relationship with the state Department of Environmental Protection.

Some states may offer more help than others. For instance, the West Virginia PSC is required by statute to provide legal, financial, regulatory, and engineering assistance to utility districts and small municipalities, says Swann.

"Never go into a deal blindly," advises Beecher to communities considering private sector involvement or who are concerned about regulation.

"Talk to your state commission, find out about their jurisdiction and requirements. Some commissions may have authority to review major privatization agreements involving cities and nonutility contractors," she says. "For help, start by calling the PUC public information officer." **\$**

Privatization Spectrum

Water and Wastewater Utilities

No Private Sector Involvement

Utility is municipally owned and operated

“Privatization” can cover a broad range of possibilities—from very little private sector involvement in water services to complete private ownership and operations.

Contract out specialized services

- billing
- meter reading
- engineering
- lab work

Glossary

- **asset sale** - The sale of an entire water or wastewater system, including its physical components (buildings, wells, equipment) and customer base, to another owner, usually a private business. (*See story on page 12.*)

- **bond** - An interest-bearing certificate issued by governments and corporations when they borrow money. The issuer agrees to repay a fixed principal sum on a specified date (the maturity date) and at a specified rate of interest.

Interest on municipal bonds is generally exempt from federal income taxes, while interest on corporate bonds is not exempt. Because of this tax advantage, municipalities can pay a lower rate to bondholders, which reduces the cost of borrowing.

Tax laws limit the amount of tax-exempt bonds that municipalities can use for private activities that meet public needs, including wastewater or drinking water facilities.

- **capital costs** - Expenditures that typically result in the acquisition of or addition to fixed assets that have a useful life of over one

year. Capital costs include expenditures for replacements and major additions, but not for routine repairs.

- **contract services** - A community contracts with a private company to provide a service or to run a facility that is owned by the community (such as a wastewater treatment plant). Communities also may contract with firms or experts to perform specific duties, such as accounting or maintenance of electrical systems. (*See story on page 16.*)

Other terms often used include: contract operations and maintenance (contract O&M); contract management; “con ops,” and outsourcing.

- **debt limit** - The statutory or legal limit on the amount of debt a municipality, county, or state may issue or have outstanding. Also called a “debt ceiling.” A community that has reached its debt limit may look to the private sector for additional funding.

- **debt service** - The amount of money necessary to pay interest and principal charges on an outstanding debt.

Full Privatization

Utility is privately owned and operated

Contract operations and maintenance (O&M)

- daily operations
- water monitoring and testing
- routine repairs and purchases
- other tasks, as negotiated

Long-term contracts, Leases

- 10, 15, 20 years
- may require special approvals

- **executive order 12803** - An order issued by President Bush in 1992 directing all federal departments and agencies to support the privatization (sale or long-term lease from a state or local government to a private party) of infrastructure assets financed in whole or part by the federal government. (*See story on page 14.*)
- **public-private partnerships** - A variety of techniques and activities to promote more involvement of the private sector in providing traditional government services. Partnerships may include involving a private partner in construction, financing, operation, or ownership of a facility.
- **RFQ (Request For Qualifications)** - A document inviting consultants to submit information about their qualifications. Communities use the information to generate a list of firms that will be invited to submit proposals to perform services, such as contract operations of the water or wastewater utility. Usually included in the request are the number of years in business, type of services offered, qualifications of key

technical personnel, and details of previous projects.

- **RFP (Request For Proposals)** - A detailed document that describes a project, such as a contract operations arrangement, so consultants can develop preliminary proposals. (Specific consultants are often preselected from responses to RFQs.) Included in the RFPs should be a statement of the scope of work, a thorough description of the community and residents, an explanation of the current problem and its history, plus ideas, goals, or requirements the community has for the project.
- **service contract** - A detailed written document that identifies exactly what duties a contractor will perform, what those services will cost, and what the penalties would be for nonperformance. This contract should clearly define which risks and responsibilities will be borne by the contractor and which will remain with the community. (*See box on page 17.*) \$

Sources for these definitions include: U.S. Environmental Protection Agency, U.S. General Accounting Office, and the National Regulatory Research Institute.

Investors Own Private Systems

At one extreme of the privatization spectrum (see pages 10–11), the private sector owns and operates an entire system. The “assets” of a system refer to any of its physical components as well as the customer base itself. For a drinking water system, these assets might include such items as a treatment plant, pumping stations, a well or reservoir, distribution pipes, and storage tanks.

In some cases an individual, a real estate developer, or a group of investors built the system in the first place and retained it as a business. Many of the smallest water systems are owned by mobile home parks, homeowners’ associations, and subdivision developers.

In other cases, private companies in the water business are buying and consolidating both existing private systems as well as municipally owned systems.

Economics and Regulations Prompt Sales

It’s not hard to see why this is happening.

“As we get more and more stringent requirements for monitoring and operations, it’s getting more costly to provide service,” says Tracy Smith, manager of government relations with Florida Water Services, the largest private water, wastewater, and reuse utility in the state.

He notes that 20 years ago drinking water systems had to monitor for fewer than 30 contaminants. “Now it’s 130 and growing,” he says.

Add to that the high cost to replace decaying infrastructure, and the price tag increases dramatically for small systems, with few customers to foot the bill. Many simply cannot afford to make the major investments needed to provide adequate water quality and service. In addition, some private developers have little incentive to invest more money in systems once they’ve been installed and the new homes on that system have been sold.

“If you look at it from the developer’s standpoint, they don’t want to be in the water or sewer business,” says Smith.

The options? “They’re thinking either the county will acquire them or [a private company like] Florida Water will,” he says.

In fact, most of the 120 communities served by Florida Water are suburban areas with developer-installed water systems.

Large, private water companies, on the other hand, see ways to help many of these systems and still make money.

“What we bring to these communities are huge economies of scale,” says Jim Harrison, vice president and treasurer at Pennsylvania-American Water Company, a private firm serving more than half a million customers in Pennsylvania.

Both Smith and Harrison point to their companies’ ability to raise large amounts of capital relatively quickly.

“We can arrange debt financing through a consortium of 10 banks,” says Harrison, illustrating one mechanism used by Pennsylvania-Water to finance big capital investments.

Florida Water keeps costs down by centralizing many functions, such as billing, customer services, accounting, laboratory services, and legal work, at the company’s headquarters in Orlando, says Smith.

Many Factors Affect Sales Decisions

Not every system is a candidate for purchase by the private sector. Many of the smallest, most remote systems are not attractive to private investors.

Although every situation is unique, some of the factors a private company may look at when considering a purchase include:

Customer base. System size can matter. When Pennsylvania-American goes into a new area, say 35 or more miles away from their nearest site, they generally look for a system that serves at least 3,000 to 5,000 customers, says Harrison.

This volume enables the company to establish a base—a “nucleus of expertise”—such as a manager, an operator, meter readers, or other essential staff to run the operation. “It is not cost-effective to do this for a system serving only 300 to 500 customers,” says Harrison.

Proximity to existing service area. Once a base system is established in an area, it’s easier to add small, nearby communities to the distribution system without bringing on more staff.

“If you’re talking about 20 customers in remote areas and our pipeline’s a mile away, it makes the most sense to abandon their well and hook up to us,” says Harrison.

Pennsylvania-American is just completing a series of acquisitions in the state’s Poconos region that started with the 1995 purchase of a bankrupt water and wastewater system serving 3,500 customers. The company now plans to add to the system by acquiring smaller, neighboring systems plagued with water quality or supply problems.

“Once we staffed [the first system], we didn’t have to add more staff to add the others,” says Harrison, who expects this small regionalization to eventually serve approximately 12,000 customers. “That’s how we create economies of scale.”

In some parts of the country, especially in western states, geography may play an even larger role. “There’s not too much privatization
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going on in Montana,” says Rory Schmidt, program specialist with the Montana Rural Water Systems Association. “We’re so spread out, it’s not cost affordable to take over systems, and we can’t really consolidate,” he says, adding that many small systems in his state are 70 to 100 miles apart.

Potential for growth. Part of what led Pennsylvania-American to invest in the Poconos was the influx of people to the area. “We obviously want to be where the growth is,” says Harrison.

Condition of facilities. If a system needs repairs or upgrades, those costs become part of the sales negotiation. The impact of such costs on rates also must be considered.

In some cases, a poorly functioning component of an existing system, such as a contaminated well or failing treatment plant, may be purchased and immediately put out of service. The customers would simply be added to the acquiring company’s nearby distribution system. In a few cases, the acquiring system may not even buy components that it doesn’t plan to use.

Regulatory and financial factors. In most states, privately owned systems are regulated by public utility commissions (PUCs). Depending on the state, PUC regulations and policies may provide either incentives or disincentives to take over small, troubled systems. (See stories, pages 7–9.)

Financial negotiations are also a crucial part of every sale. When one private company is buying another private system, the transaction can be similar to a real estate deal—both parties agree on a price and terms, and the buyer pays the seller for the assets.

However, if tax-exempt bonds or government grants or loans have been used to finance the original facility, as is often the case with municipal systems, the transaction can get very complicated when a private company tries to buy those assets. (See sidebar on page 14.)

Rates and Control Are Concerns

Of course, not everyone embraces sales of local water utilities to larger companies.

“The number one question is, and always will be, rates,” says Smith.

“In many cases, people think you’re bringing in an expensive solution, especially if they were used to paying \$5 a month,” says Harrison. “People still don’t understand that water costs money.”

“Certainly in many parts of Florida, the cost of the product is not reflective of the full cost of providing it,” says Smith, adding that much of the subsidized funding that had been available for municipalities is also disappearing, further increasing costs.

The way rates are structured by different companies or in different states can also influence customer perceptions. For instance, Pennsylvania-American Water charges a single-tariff rate, meaning that virtually all customers in the state pay the same rate regardless of where they live. “For 5,000 gallons of water, the typical bill is \$28 per month,” says Harrison.

Some customers question this uniform rate, concerned that they’re subsidizing improvements to another system 200 miles away.

However, there are two sides to single-tariff pricing, says Amy Swann, director of the Water and Wastewater Division of the West Virginia Public Service Commission. “It suddenly becomes attractive if you’re the system getting the upgrades.”

Harrison pointed out two instances in Pennsylvania in the last two years where the single-tariff pricing resulted in lower rates. In another case, a feasibility study concluded that a town’s residents would have to pay monthly water bills of \$40-\$50 if the town were to finance needed improvements on its own.

Sometimes the new company can avoid “rate shock” by gradually phasing in new rates, especially if the previous rates were significantly lower. This is being done with the newly acquired water systems in the Poconos, says Harrison.

Another reason citizens or local officials are sometimes opposed to these sales is the fear of losing local control of the water system.

“There’s that thing called autonomy,” says Bill McQueen, utility consultant with Environmental Response, based in North Carolina. “We all want to be in control of what’s ours.”

Communities that want to retain control, but still need help with compliance or other problems, might ask, “Why should we sell if a company is willing to do contract operations?” says McQueen.

“And I’ve not seen that many privates want to come in and buy [a system] if they can make money doing contract operations,” he says.

Every Situation Is Unique

“For privatization to occur, you have to have a willing buyer and a willing seller,” says Janice Beecher, director of regulatory studies with Indiana University’s Center for Urban Policy and the Environment.

“Every deal is different. There is no set formula on anything,” emphasizes Harrison. In some cases his company may buy everything, while in other cases, it may negotiate to buy only certain assets, or in still other instances, the deal may get

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“People still don’t understand that water costs money.”

Jim Harrison, vice president and treasurer, Pennsylvania-American Water Company

Government Funding Can Complicate Deals

If a private company wants to buy or lease a publicly owned system that was built using government financing, the transaction can get complicated.

In general, facilities built using federal funds require federal approval to sell or lease, according to Haig Farmer, privatization coordinator with the U.S. Environmental Protection Agency (EPA).

"Once you take federal money, there are federal strings attached," he says.

For instance, during the 1970s and 1980s, many municipal wastewater systems were built with EPA construction grants (which have since been replaced with a revolving loan program). As these grant-funded plants age and require major upgrades, towns and cities are looking to other sources, including the private sector, to help finance needed improvements.

However, until recently, a municipality selling its wastewater system to a private company would need to repay a substantial portion of the federal grant.

"The requirement to repay grant funds to EPA typically wrecks the economics of a deal," says Michael Deane, vice president for government relations at Air and Water Technologies Corporation. "Municipalities and their private partners have no magic pool of free money. This is money

that ultimately comes from the customers through user charges and cannot be invested in the facility or improved service. It simply goes to the U.S. Treasury."

Under these regulations, there was little incentive to enter into a deal that would be so unpalatable to the customers, the municipality, and the private company.

Flexibility Is Encouraged

To remove such disincentives, President Bush issued executive order 12803 in 1992. This order directed federal government agencies to work with state and local governments to remove impediments and increase flexibility for private investment in environmental facilities.

One result is that now municipalities selling or leasing grant-funded facilities to private companies may have to pay back only the portion of the federal grant that is not depreciated, or essentially "used up" over time. Furthermore, sales proceeds now can be distributed first to the municipality to repay any investment it made in the system. Only the remaining proceeds, if any, are available to repay federal grants.

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In general, facilities built using federal funds require federal approval to sell or lease.

Investors Own Private Systems

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bogged down in negotiations over rights-of-way or financing arrangements.

"We want to get the most cost-effective transaction we can, since costs are spread to customers across the state," he adds.

One's willingness to buy—or sell—may also change over time. McQueen tells the story of a man who, about 10 years ago, bought some land near Fayetteville, North Carolina, along with the 180-connection water system that was on it.

"He soon learned what it meant to be in the water business," says McQueen. "And he realized he needed to buy more systems to be cost-effective."

At first, owners of nearby systems hesitated to sell or demanded high selling prices.

"But as regulations continued to increase, it's been easier for him to acquire systems," says McQueen, explaining that many of those small systems were unable to keep up with monitoring, testing, and other requirements needed to ensure safe drinking water. "It got to the point where people who at first wanted a lot of money finally just gave their system to him. The demand was out there for someone to provide water service," continues McQueen, but not everyone was in a position to provide it.

Over time, as he acquired more systems, the buyer was able to purchase a computer and hire someone to read meters and help with operations. "He could reach some economies of scale," says McQueen. "Before it was all over, he had about 14 systems and about 1,100 customers. He formed a corporation and registered with the utility commission."

A few more years have passed and retirement looms. "Now he's selling out to a larger for-profit utility," says McQueen, noting that this transition was a gradual process that met the region's need for safe water while responding to changes in the drinking water industry.

Private companies are not the only ones competing to take over small systems and create regional entities; many counties and municipalities are doing the same thing. "There's plenty of room for both private and municipal water systems," says Harrison.

In the end, the bottom line is the same: "Ultimately what we want to see is high quality, safe, affordable water service by financially healthy providers," says Beecher. 💰

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However, the many regulations impacting sales or leases of public facilities to private entities are complex and housed in numerous agencies, including EPA and the Internal Revenue Service. Most are being dealt with on a case-by-case basis. The first real “asset sale” test case under the new executive order was concluded in 1995 when the wastewater treatment plant in Franklin, Ohio, was sold to Wheelabrator after several years and many rounds of review and approvals.

It’s still not clear whether all federal agencies providing water and wastewater funding would treat asset sales the same way, says Deane.

Given the complexities and time involved in sales of federally funded facilities, the long-term impact of executive order 12803 has yet to be seen.

“On the wastewater side, I think that asset sales will be few and far between,” says Deane, who instead predicts more long-term leases offering the benefits of a long-term relationship, but without a transfer of ownership. On the drinking water side he says private ownership tends to be more accepted and more common, at least in certain parts of the country.

State and Local Funding

If federal funds are not involved, sales may be less cumbersome, since federal approval would not be needed to sell the facility.

However, there may be state or local regulations governing sales of municipally owned facilities to private entities. The state might require a municipality to pay off a state-issued loan, “especially if the loan came from bond proceeds,” says Jim Smith, executive director for the Council of Infrastructure Financing Authorities.

Sometimes the private entity can assume the debt and take over payments, says Jim Harrison, vice president and treasurer, Pennsylvania-American Water Company.

“To solve the problems of non-viable water systems, state agencies [in Pennsylvania] are a little more amenable to us assuming the debt,” he says. “They’re especially interested in getting their loan paid back.” If the company runs into significant problems in assuming a loan, it may give the community or current owner enough money to pay off the debt, he adds.

Some communities may want to sell systems that were built using municipal bond funds.

“What wasn’t grant financed was probably financed with tax-exempt bonds, so you may have to ‘defease’ those, or essentially pay them off,” says Smith. That’s because federal tax laws limit the portion of tax-exempt debt that a community can use for private sector activities, he explains. Usually this private activity portion is limited to 10 percent of the amount of the bond.

The ratings on municipal bonds, their security structures, and other characteristics were based on the understanding that the community was responsible for repayment, says Smith. “If you change to private ownership, that relationship changes, and you might need to reevaluate the bond, reassess the ratings,” he explains. “So it’s probably best to defease.”

Communities considering sales of government-funded facilities should talk with their funding agencies or legal counsel to find out what restrictions might apply to their situations. \$

Definitions Are in the Eye of the Beholder

If federal funds were used for your system and you’re considering privatization, definitions of many terms, such as “lease,” will be important.

So just what is a lease? The answer depends on who you ask, says Haig Farmer, privatization coordinator with the U.S. Environmental Protection Agency (EPA).

“EPA’s definition of both operational contracts and leases can fit the same definition as the Internal Revenue Service’s (IRS) management contracts,” he says.

If a community pays a company simply to operate a water or wastewater system, EPA would consider that normal “contract operations,” says Farmer.

However, if the company is paying any money—or “concession fee” to the community—in connection with the contract, or if the company is making any capital improvements to the system, the arrangement would likely be considered a lease under the EPA definition, he says, even though it might still be a management contract in IRS eyes.

“The only time EPA’s definition becomes important is when federal funds are involved in the project,” says Haig. “If you’re trying to sell or lease a facility that was built using federal funds, you have to get agency approval.”

These myriad definitions among different agencies and even among consultants can create confusion, concedes Farmer.

“Everybody has their definition based on their own experience,” he says.

Any community considering selling its system or entering into a contract arrangement should find out what laws or requirements it needs to meet. If the system used any federal funds, the community should consult with the agency(ies) that provided them. If no federal funds were used, the community should still see if any local or state ordinances on selling or leasing municipal property apply.

“It’s probably best to start with a contract attorney,” suggests Farmer. Other sources of help include the state environmental agency and technical assistance organizations (see page 19). \$

Contract Services Cover Many Functions

by Laurie Klappauf
Water Sense Editor

Most "privatization" involves contracts for operational services. These arrangements may go by different names—contract operations and maintenance (O&M), contract services, contract management, or even simply "con ops"—but they all mean that an outside company is paid to perform certain duties for a water or wastewater system.

According to a July 1995 report by the National Regulatory Research Institute, "more than 400 water and wastewater contracts, totaling about \$450 million, were let in 1992; industry sources

have estimated that more than 800 contracts will be 'outsourced' by 1998."

Exactly which duties are contracted out depends on what the community wants and needs. For instance, one small town might decide it needs to paint its water tower. "But if no one in town has a tall enough ladder, they would need to hire someone to do the painting," says Haig

Farmer, privatization coordinator with the U.S. Environmental Protection Agency (EPA).

More often, a community contracts with a private firm to run the bulk of its system's day-to-day operations. Such functions might include management, planning, engineering, record-keeping, reporting, and evaluation.

"We ask 'What are the needs of the community?'" says Bill Ames, director of business development for Americas' Water Services, which offers private contracting services in five states, with a focus on the upper Midwest.

He says his company would handle the following tasks in a typical full-service contract for a water utility:

- all personnel issues, including benefits, payroll, managing, and, if necessary, hiring staff;
- water monitoring and testing;
- regulatory liaison, such as completing and sending monthly reports to appropriate agencies; and
- payment of all bills for routine operations, including purchases of chemicals and spare parts.

In addition, the company can also handle customer billing, meter reading, collections, and customer service functions.

All of these tasks are usually open for negotiation—some systems may want to contract out more functions; other systems, fewer.

Contracting Can Help Meet Needs

There are a variety of reasons why communities might consider contracting out their operations.

"Generally they're looking for some stability in the cost of their operation and for technical support," says Ames.

He says that contractors typically budget their costs for the year and then divide them into 12 equal amounts to arrive at a fixed monthly fee to charge to the community. This provides communities with some stability in their cash flows, because they know exactly how much the water or wastewater operations will cost.

Furthermore, says Ames, small communities often need the most help in getting qualified operators and keeping up on technical issues and requirements, such as changes in drinking water regulations. He says contract firms can provide such technical expertise, through either a qualified operator or the company's technical support staff in the region.

Contract operations may—or may not—be less expensive than the status quo. "People ask 'how can you do it cheaper than us?'" says Ames. "We don't always do it cheaper, but for the most reasonable cost to provide quality service," he answers. "And if it's not cheaper, maybe they haven't been doing what they should have been."

Convenience may be another reason why communities would opt for contract operations.

"Water boards who want the contract O&M are sometimes willing to pay a little more to not have to put up with the daily hassle of operating a system and looking over someone's shoulder," says Don Schwartz, senior water resource specialist with the Northeast Rural Community Assistance Program. "They could hire a person to do the running, monitoring, and reports."

In many of these cases, the community may still want to keep local control and ownership.

Size, Location Are Considerations

While virtually any system could hire out some functions, negotiating a contract to operate a system can be complex and time-consuming. Given differences in systems' needs and in service providers, it's difficult to specify a minimum system size that could feasibly enter into a contract arrangement.

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Know Your Contractor

Contract operations may not be the right solution for everyone. But if you do decide to explore this route, several experts advise that the key to making it work is to get a good understanding of the company you'd be working with and what its experience has been working with the public sector.

"The number one thing is to get to know the firm and the key players," says Bill Ames, director of business development for Americas' Water Services. "Understand how you're going to be treated. How you're treated in negotiations is how you'll be treated forever."

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Russian River Utility, a private contracting firm in northern California, operates 13 systems—some public, some private—ranging in size from 15 to 1,000 connections. “Most of them have just over 100 customers,” says Hal Wood, company president.

Since most of those systems have no employees and little equipment beyond wells, pumps, and pipes, Wood’s firm provides everything else, including trucks, pipe locators, generators, billing systems, and a telemetry system that allows the contractor to monitor much of the operations from a central location.

“We try to visit every place at least twice a week,” says Wood, explaining that they still need to replenish chemicals, take samples, and do other tasks on-site. For typical contract operations, his firm charges an average of \$12–\$15 per customer per month, says Wood.

On the other hand, one industry consultant in North Carolina says he sees most contract operations occurring in communities with populations of between 7,500 and 11,000.

“Those are where you have a city manager or someone who has the wherewithal to do a financial analysis,” says Bill McQueen, utility consultant with Environmental Response, based in Hope Mills, North Carolina. That analysis allows the municipality to compare its cost of operation with what a private company would charge, he says.

Larger communities—which tend to have adequate staff, bulk purchasing abilities, and other economic advantages—are less likely to use contract operations in his state, says McQueen.

However, system size is only one of several factors that a private company may consider.

Location is another factor. Americas’ Water Services provides contract operations for a number of drinking water systems serving 700–1,000 connections, in communities of 2,000–3,000 people, “especially if they’re near our other projects,” says Ames. This allows the contractors to have more resources, particularly operators and other skilled staff, within easy reach of other systems.

One thing that’s very important to contractors is the level of interest and support from the town board, according to Ames.

“We need to look at communities that are really interested,” he says. “We put a lot of work into putting together a proposal,

and that cost gets passed on,” he says, explaining that his firm may spend up to a week evaluating a system on-site, and additional time pricing out a budget, looking for local vendors to help with emergency repairs, and developing the scope of work that the company would provide.

Service Agreement Is Key Document

Defining the scope of services is crucial for both the community and the contractor.

“The big burden with privatization is to draw up a good contract at the beginning between the municipal entity and the private entity, so the municipal entity protects itself, its customers, and the environment,” says Farmer.

This contract—also called a service agreement—should clearly spell out risks and responsibilities assigned to both parties, and identify what will happen if any parts of the contract are not met.

“Your safeguard is to have a well-defined contract which stipulates penalties for nonperformance,” says Farmer. For example, the contract may identify a specific financial penalty for a wastewater contractor who fails to meet the discharge permit.

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Service Contract Assigns Risks, Responsibilities

A detailed, written service contract is the principal document in a contract operations arrangement. This agreement defines what the contractor will do and what those services will cost. This document also clarifies which risks and responsibilities will be borne by the contractor and which will remain with the municipality.

Other components of a service contract may include the following:

- Contract period and general terms
- Guarantees, warranties, insurance, and indemnification
- Cost allocation and terms of payment
- Mechanisms for financing upgrades and expansion
- Procedures for accounting, reporting, and auditing
- Responsibility for securing permits and certificates
- Responsibility for regulatory compliance
- Accountability to customers and guarantee of customer satisfaction
- Operational requirements and performance standards
- Methods of conflict identification and resolution
- Options and conditions for takeover, repurchase, and renegotiation
- Incentives for performance excellence
- Penalties for nonperformance, delays, or default
- Limits on liabilities and damages
- Procedures for emergencies, unanticipated events, and natural disasters

Adapted from the National Regulatory Research Institute’s July 1995 report, Regulatory Implications of Water and Wastewater Utility Privatization.

Contract Services Cover Many Functions

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Ames suggests additional items that should be in a contract. "You want to clearly define budget issues in there. What will the contractors provide, and what will they be paid?"

He says it's also important to include a maintenance cap, which defines dollar limits for routine operation and maintenance costs to be borne by the contractor. This cap helps determine where these costs change from routine expenses, covered by the contractor, to capital improvements, which are normally not part of the contract.

"You also need to define baseline conditions," he continues, referring primarily to the volume of wastewater flows or drinking water to be pumped and treated. If the baseline volume changes more than expected, due to growth or other factors, that needs to be accounted for in the contract, says Ames.

Until recently, contracts were limited to terms of five years or less. However, that is changing with a recent Internal Revenue Service ruling that
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New IRS Rules Extend Lengths of Contracts

New Internal Revenue Service (IRS) rules pave the way for state and local governments to sign long-term management contracts with private firms to run water and wastewater systems.

In the past, contracts enabling private companies to operate utilities built with tax-exempt financing were limited to five years. Anything longer, or a sale or lease to a private party, would be thought of as serving a "private business use." This might trigger the bonds to be classified as private activity bonds, with more restrictions and a potential loss of tax-exempt status.

The new regulations, which went into effect on May 16, 1997, allow communities more flexibility to enter into contracts for up to 10–20 years without losing their tax-exempt financing or raising private use concerns.

Proponents of the new regulations suggest that the longer time frames will encourage private sector investment in public utilities, such as water and wastewater facilities.

Until now, capital improvements typically would be funded by the municipality through the issuance of tax-exempt bonds. But a community that had reached its limit of issuing such bonds or that needed them to fund other community projects might look to a private contractor to run the utility and finance needed improvements.

However, there was little incentive for a private contractor to spend its own money on major upgrades. An operations contract of five years or less was considered too short a time for a contractor to make a return on a large investment.

"Now [with the new regulations], if a facility needs capital improvements, we could fund the improvements and amortize [or spread out] those costs over the life of a longer contract," says Bill Ames, director of business development with Americas' Water Services, a private contract operations firm.

The town may still prefer to issue new bonds, says Ames. But town officials also may decide it's not worth the time and expense to issue bonds, hire a bond counsel, and obtain voter approval for a half-million dollar repair. They might conclude it's easier and less expensive for the contractor to fund the improvements, he says.

"A real value of the new rules is protecting the bonds already out there," says Michael Deane, vice president for government relations with Air and Water Technologies Corporation. These provisions reduce the chance that existing tax-exempt bonds would suddenly become taxable to bondholders. Such a change in tax-exempt status could hurt the town's ability to find buyers for more of its bonds in the future, he explains.

A longer-term contract also can provide municipalities with more stability in rates and other planning needs, says Deane. "They can know what their rates will be in 2010," he says.

Some fears exist about such long-term arrangements. "You'll always hear 'you're going to run the plant into the ground by the end of the contract and then will walk away,'" says Deane. "But reputable companies won't do that," he says. "You can't if you want more business. Good contracts take care of those concerns."

In the meantime, industry experts see the new rules as a way to open up more sources of capital funding.

"We'll see a real mix and match of financing arrangements," predicts Deane.

Many state and local laws govern management contracts for municipal services. These can vary greatly from place to place, so it's important to check on statutes governing your state and community. For information about laws in your state, contact your legal counsel or state environmental agency. \$

Privatization Resources Are Available

Listed here are just some of the documents, Internet Web sites, and other resources that can provide additional information about involving the private sector in providing drinking water or wastewater services.

- The Water Environment Federation (WEF) Internet Web site offers a “hot topic” discussion group devoted to privatization. It is located online at <http://www.wef.org/wwwboard/hottopic/wwwboard.html>.
- The U.S. Environmental Protection Agency’s (EPA) Web site provides information on environmental finance, including privatization and public-private partnerships. Documents that can be viewed include a draft *Guidebook of Financial Tools*, which offers an entire section on “Tools for Building Public-Private Partnerships.” Start with EPA’s Environmental Finance Program menu at <http://www.epa.gov/efinpage/index.html>.
- The American Water Works Association (AWWA) Web site at <http://www.awwa.org> offers discussion forums and other resources related to drinking water, including a “white paper” on privatization.
- Check out the Public Policy Connection Web site on privatization for links to organizations, research, articles, events, and other information.

Located at <http://members.aol.com/Adriantm/privitin.htm>, this site includes some links targeted specifically to water and wastewater utilities.

- Another list of Internet privatization resources is provided on the FinanceNet Web site at <http://www.financenet.gov/financenet/start/topic/private.htm>.
- The National Regulatory Research Institute’s July 1995 report on *Regulatory Implications of Water and Wastewater Privatization* provides an in-depth discussion of privatization issues and options. The 271-page report includes case studies, relevant data and statistics, and an extensive bibliography. To order the report, call NRRRI at (614) 292-9404, and request item #9509. The cost is \$49.20.
- Small-community officials can often get free information and help evaluating options from staff at their state drinking water programs or from technical assistance organizations such as the Rural Community Assistance Program or state Rural Water Associations.

For phone numbers of contacts for these organizations in your state or region, call the National Drinking Water Clearinghouse at (800) 624-8301. \$



Contract Services Cover Many Functions

Continued from page 17

allows some contracts to extend up to 20 years. (See sidebar on page 18.)

Still, some small systems entering into contract arrangements for the first time may opt for shorter terms. “We usually start with a six-month or one-year contract to make sure everyone is happy,” says Wood, adding that most of his contracts have subsequently been renewed for three to five years.

Be A Smart Buyer

Any community considering contract operations first needs to educate itself. “Does everyone on the council or board understand what contract operations is?” asks Ames. “And if they understand it, is there a strong consensus that they want to pursue it?”

As with many services, word of mouth is one of the best ways to learn about the concept and providers. Ames suggests talking with other communities and with contract operation firms.

“It’s like finding a doctor,” advises Farmer. “You ask others who have done it who they used and what was their experience.”

Other sources of advice include local attorneys, financial advisors, state regulators, or consulting

engineers that the community has worked with. Many contract operation firms advertise in trade magazines, such as *Governing* or *American City and County*. In addition, most small and rural communities can get free technical assistance or help exploring a variety of options, including contract services, from such sources as the Rural Community Assistance Program or state Rural Water Associations.

Some good tips for finding outside help are also included in the Winter 1997 *Pipeline*, which focuses on choosing a consultant for a wastewater project. The issue describes how to prepare for a search and how to solicit proposals through a request for qualifications (RFQ) and request for proposals (RFP). It also offers interview tips and advice on negotiating a contract. This issue of *Pipeline* costs \$0.20, plus shipping and handling.

To order Pipeline, call the National Small Flows Clearinghouse, a sister organization of the National Drinking Water Clearinghouse, at (800) 624-8301. \$

Special Privatization Issue

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Finance, Privatization Products Available

The National Drinking Water Clearinghouse (NDWC) offers the following products, many related to privatization and public-private partnerships. The free items are limited to one of each per order. Call (800) 624-8301 to order products, or order via e-mail at http://www.ndwc_orders@estd.wvu.edu.

Please allow two to four weeks for delivery. Actual shipping charges are added to each order.

■ *State and Local Government Guide to Environmental Program Funding Alternatives*

Item #FDBLFN14

This booklet, produced by the U.S. Environmental Protection Agency (EPA), provides an overview of traditional funding mechanisms for environmental programs, and introduces state and local governments to alternatives to traditional funding. Although the booklet focuses on nonpoint source pollution, the information provided can be applied to environmental programs in general. A list of contacts and references are included for additional information. (1994, 28 pages)

Cost: \$0.00

■ *Public-Private Partnership Case Studies: Profiles of Success in Providing Environmental Services*

Item #FDBKPP02

This book, compiled by the EPA, presents 23 case studies of public-private partnerships in the U.S. that have used innovative approaches to financing environmental protection. Organized into three environmental areas (solid waste, wastewater, and drinking water), it explains the

types and benefits of these partnerships and provides the characteristics of successful ones. (1989, 124 pages)

Cost: \$17.85

■ *Public-Private Partnerships for Environmental Facilities: A Self-Help Guide for Local Governments*

Item #FDBKPP03

Intended for local officials, this EPA-developed guide contains information about establishing public-private partnerships. A primer on the benefits of such partnerships, it includes a checklist for building them, a review of necessary agreements, and a list of resources. (1990, 43 pages)

Cost: \$0.00

■ *Alternative Financing Mechanisms for Environmental Programs*

Item #FDBKFN12

This EPA document provides information about alternative financing mechanisms at both the state and local levels, their advantages and disadvantages, and some of the key questions and issues associated with their use. (1993, 211 pages)

Cost: \$17.50

■ *Financing Models for Environmental Protection: Helping Small Communities Meet Their Environmental Goals*

Item #DWBKFN05

This casebook provides real-life models that have been implemented through EPA's Public-Private Partnerships Demonstration Program for financing environmental projects. (1992, 98 pages)

Cost: \$0.00

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