

The Privatization of Water

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Infrastructure repair,” Atlanta Mayor Bill Campbell said a few years ago, “will be second only to crime as the major defining issue for cities.” Indeed, in Atlanta, some \$1 billion will be required in the next four years to bring the city’s water and wastewater treatment facilities up to EPA standards.

The rest of America is facing a similar crisis. The U.S. Environmental Protection Agency (EPA) estimates that 20 percent of the nation’s municipal wastewater treatment facilities don’t comply with federal regulations, and that nearly \$190 billion will have to be spent over the next 20 years to comply with the federal Clean Water Act (CWA).

The EPA also estimates that \$138.4 billion will be needed over the same period to replace or upgrade the nation’s drinking water infrastructure - its treatment plants, reservoirs, pipes and storage tanks - to ensure compliance with the federal Safe Drinking Water Act (SDWA).

Faced with these financial challenges, some cities are choosing to ‘privatize’ their drinking water and wastewater treatment plants. In the extreme, privatization means the outright divestiture of both management responsibilities and capital assets to private companies that agree to provide water and wastewater management services. But more common are “public-private” partnerships, in which the facilities are still owned by the government, but with private vendors providing water and wastewater management services under fixed, short-term contracts lasting 3-5 years.

A Favorable Political Climate

Although water industry privatization is just beginning, the privatization and deregulation of America’s other utilities are well underway. Telephone systems are arguably more competitive than ever before, due to deregulation. The Energy Policy Act of 1992, meanwhile, has created a new class of independent power producers, authorized to sell electricity nationwide.

Overall, privatization reflects new thinking about the role of government in America—a philosophy that demands the application of market competition to all public works. Former New York Governor Mario Cuomo noted this shift when he remarked, “Government’s role is not necessarily to provide services anymore, but to see that they are provided.”

In the water industry—which has been called “America’s last great monopoly”—this shift is poised to bring great economic changes as well. “We believe the industry will be reshaped through consolidation and acquisition, the increasing privatization of municipal systems, competition and investment from global water companies, and the emerging investment in the water industry by electric utilities,” reported HSBC Securities, which follows the industry.

Indeed, when Ted Turner was asked which industry reminds him most of the cable industry 20 years ago, he replied, “Water.”

Market Structure

America’s water supply industry is highly fragmented. There are more than 60,000 drinking water companies across the country. Some 60 percent of these are privately owned, and 40 percent municipally owned. (But while the private companies have few customers overall, averaging 3,000 customers each, the big municipal water providers have many more—some 228 million customers in all.)

The wastewater treatment industry, on the other hand, has less than 2 percent of the country’s 16,000 wastewater treatment plants privately owned and less than 10 percent privately operated by delegated service firms. By comparison, 70 percent of water and wastewater services in Western Europe are privately operated.

After years of conservative investment and slow growth, America’s private and investor-owned water utilities (called IOUs) are seeing the value in new acquisitions, particularly of the small, private and municipal water supply companies that don’t have the resources to comply with new water and wastewater standards.

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For instance, America's top three IOUs - American Water Works Company, United Water Resources and the California Water Service Company, are broadening their customer bases and increasing operating revenues rapidly through a program of acquisitions and public/private/partnerships (PPPs) with municipal companies. Overall a growth of 20 percent to 30 percent can be expected in the private sector of the American water industry.

Driving Forces

Unlike telecommunications, and even electric power, water is fundamental to life. This puts water in a different category than other utilities — and makes the restructuring of the industry so important.

There is growing public concern, for example, about the quality of tap water. More than 600 waterborne disease outbreaks have been reported to the US Centers for Disease Control (CDC) since 1971, and, according to US EPA records, more than 50 million Americans were exposed to contaminated municipal water in 1995. Nearly 900 communities — including New York City and Washington D.C — have issued boil orders since 1991 to protect citizens against possible illness caused by waterborne contaminants.

Cost is another concern. According to the American Water Works Association (the water utility trade association), the cost of 1000 gallons of municipal water in the United States rose 79 percent between 1987 and 1995 - from \$1.74 to \$3.11. Meanwhile, the unit price of wastewater has grown over the last decade at about twice the rate of inflation.

Legal Framework

The federal government is pushing the idea of private/public partnerships. Executive Order 12803, for instance, signed by President Bush in April 1992, encouraged public infrastructure privatization by clarifying the terms under which the federal government must be repaid for its investment upon the sale of a federally funded asset to the private sector. In essence, EO 12803 abolished the requirement to repay the federal investment in full, greatly reducing the potential sales price and giving a significant incentive to private firms. To date, only two projects have been approved under EO 12803. The first in 1995 saw the Miami Conservancy District in Ohio sell a WwTP in Franklin, Ohio, to Wheelabrator EOS, which is now part of US Filter, as part of a special EPA demonstration project.

The second project, which began in July 1997 when the City of Cranston, R.I. leased its entire wastewater treatment, collection and pumping system to a private contractor for 25 years, is likely to herald a new era in municipal privatization in the United States.

Cranston is the first contract in America where the private contractor is required to assume full financial responsibility for the wastewater system over the term of the service agreement. Such an arrangement is unheard of in three-to-five-year 'operate and maintain' contracts where the city normally pays for major repairs and replacements.

Another significant change to the law relating to management contracts for public services came into effect in May 1997. An Internal Revenue Service rule change now allows municipalities to contract out facility operations for up to 20 years without the need to pay back tax-exempt debt. Prior to this, the exemption from taxes on securities issued to finance public infrastructure projects was only five years.

This new measure — which was voted in by Congress — opens the way for long-term management contracts. It also allows for greater levels of private investment, the result of which is greater economies for the cities struggling to maintain their quarter-century-old infrastructure.

Changes in state legislation are also improving prospects for privatization. The New Jersey Water Supply Public Private Contracting Act extends the maximum life of contracts to 40 years.

In California, Senate Bill 2111 now allows Californian cities to conclude whatever leasing agreements they choose and to award such leases in whatever manner they think fit. SB 2111 also permits the leasing of water services to private companies by a simple majority vote by the electorate, rather than the previous two-thirds majority vote.

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Privatization: Friend or foe?

Privatization is certainly inching forward, but there's another side to the story: how the threat of privatization is causing public utilities to suddenly become more efficient and competitive. Indeed, many are ripping pages from the privatization manuals themselves, with the intent of proving that public utilities—following a shakeup and streamlining—can be highly competitive players themselves.

In particular, some wastewater managers are starting to “re-engineer” their operations. This often entails building self-evaluation and self-assessment processes into their operating plans. Several have become among the most consistently efficient and successful operators in the business. As costs are reduced, many public utilities claim that they can out-compete even the most efficient private operations firms.

Privatization has another challenge: Water has long been viewed as a community asset in the United States (particularly in the West). The decision to keep a water utility in the public realm, therefore, may often be a political decision rather than a financial one. And there's another problem: It makes many people nervous to mix protection of the environment and public health—two highly-charged issues—with profits.

So is privatization good for the water utility business? When the National Regulatory Research Institute studied privatization a few years ago, it concluded that while privatization proved successful in many cases, empirical evidence was lacking to call it a hands-down winner.

Some cities have considered privatization and rejected it, plagued by doubts about the private sector cost savings and the effects of privatization on public employees. There have also been instances when the public sector has taken back control of systems where private partners have not met expectations.

Nevertheless, the new era of water privatization is arriving in the United States. Whether it succeeds, and in what forms, will be largely decided in the decade ahead.