

PRIVATIZATION OF PUBLIC WATER SERVICES:

The States' Role in Ensuring Public Accountability

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CHAPTER 1

THE CONTROVERSY OF WATER PRIVATIZATION

There is a controversial trend towards privatization of public water services in the United States. Although privately-owned water suppliers provide only about 11 to 15 percent of all U.S. public water services, this portion has increased dramatically over the past two decades, consistent with political forces and public policies favoring privatization of public services generally. States have enacted statutes expressly authorizing municipalities and other public entities to contract with private firms to provide various kinds of water services, and even to sell their waterworks. Large international water companies and their national and local subsidiaries have won contracts to provide water services to a growing number of cities of all sizes. And private-market advocates have released reports stating that privatization of water services is a trend that will only grow.

At the same time, local citizens' groups, environmental groups and others have expressed concern over, and often opposition to, privatization of public water supplies and services.¹ In some cases, public opposition has defeated proposed privatization arrangements. In other cases, dissatisfied cities have

terminated contracts or bought out private water suppliers.

This report examines the issues that arise in privatization of public water supply services and makes recommendations about how state legislatures can increase and ensure accountability to the public when cities and local districts undertake privatization measures. This report does not address

privatization of wastewater and sewer systems, or private markets in water supplies themselves, except as directly relevant to privatization of local water services. It also does not address global trends towards privatization of water services and supplies, which are considerably greater than in the United States.

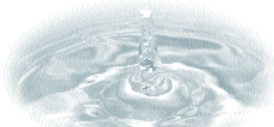
There are no simple and easy truths about privatization of water services, despite rhetoric on both sides of the issue.

Economic-theory libertarians advocate for private provision of

public services on economic efficiency grounds, and social-theory statisticians advocate for government provision of public services on public interest grounds.

But the rhetoric will inevitably lead to bad public policy, because privatization of public water services is neither completely beneficial nor completely harmful to the public. The more important questions involve under what conditions water privatiza-

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tion should occur and what safeguards and accountability mechanisms should be provided to protect the public. There are several reasons why the issue is more nuanced than advocates often reveal.

First, privatization does not have a single meaning. Privatization of public water services is a broad category that encompasses many different arrangements ranging from outsourcing of specific services like billing or maintenance to private ownership and control of a city's water facilities and supplies. In some circumstances, some types of privatization might make sense while others might not.

Second, private provision of public water services is not always more efficient than public provision. The efficiency is highly context-specific: it depends on the size and scope of the city's water service operation; the financial and political condition of the city government; the potential for changing municipal management and operations to increase efficiency; the private provider's size, financial condition, management strengths and weaknesses, operational efficiencies, experience with similar water systems, and corporate culture; the customers' consumption patterns; and other factors. The most operationally efficient outcome for one city may be vastly different for another city.

Third, being operationally efficient is not the same as being optimally economical. Even if a private provider of public water services could operate with lower operational costs than a public provider, there might be substantial public costs, such as lesser environmental protection, greater risk to the

security and stability of municipal water supplies, decreased water quality and less public input into the types of desired services. As many economists note, private markets do not always reflect or price public values and costs adequately. The benefits and costs of privatization in particular circumstances have to be considered broadly, not merely in terms of operational inputs and outputs.

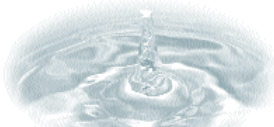
Fourth, private control and provision of public water services are not always a threat to the public's

interests and protection of a resource vital to life, community, environment and economy. There are circumstances in which private supply of public water services can result in lower rates and more reliable and cleaner drinking water than existing public institutions can provide. Privatization agreements can be subject to safeguards, conditions and restrictions that serve to protect the public's interest.

Finally, just because property is private does not mean that it

is not subject to public controls and interests. Studies of property arrangements in practice in the United States show that the distinctions between private and public control are not clear; they are more a matter of theory, ideology or advocacy by affected interests than a social and legal reality.² In fact, most private property is subject to public controls and regulation and is limited by the rights of the public and of third parties like neighbors or other property owners. Water, in particular, is an area in which private interests are substantially limited by public interests. Private rights in water are limited by state ownership, the public trust doctrine, permit systems, prohibitions against wasteful use,

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public interest criteria and the rights of other interest holders (e.g., other appropriators, riparian landowners or owners of land overlying underground aquifers).³ These limitations on private ownership go back far in history and serve not only political and social goals but also optimal economic utility and the system of private property generally.

Thus private water providers can and should be limited by public controls, regulations, conditions and rights that ensure accountability to the public. Evidence from the U.S. experience with municipal water privatization offers an important lesson: **the critical issue is public accountability.**

Neither absolute prohibitions on privatization nor unlimited authorization and facilitation of privatization are proper functions of law and public poli-

cy. Instead, law and public policy do serve, and should serve, to impose limits and conditions on privatization designed to protect the public's interests. These limits apply to: 1) whether or not to privatize; 2) under what conditions and circumstances it is permissible and/or desirable to privatize; 3) whether the operations and results of a private provider meet expected or required standards; and 4) under what conditions and circumstances the parties may modify or terminate their arrangement. This report not only identifies some of the important areas of water privatization in which accountability is needed but also recommends state legislation establishing standards and processes to ensure accountability in the approval of water service privatization contracts.

WATER PRIVATIZATION IN THE UNITED STATES

History

Public provision of water services has not always been the norm in the United States. While water systems serving the public began in the mid-1700s in Pennsylvania and Rhode Island, they developed slowly. By 1850, there were 83 such water systems in the United States, of which 50 were privately owned. And by 1900, there were more than 3,000 such water systems, with slightly more than one-half of them publicly owned.⁴ It was only in the first few decades of the twentieth century that public ownership and provision of water services became the overwhelmingly dominant mode by which the public received water.

Several factors contributed to the rise of public provision of municipal water services.

First, urban population grew, not only in absolute terms but also as a percentage of the U.S. population. Thus, the percentage of U.S. households served by their own wells or their own withdrawals from surface water dropped, and the need for centralized water systems grew.

Second, cities grew in power and legal authority. Around the turn of the century, cities were con-

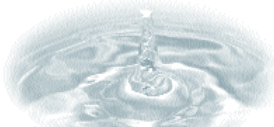
strained by what was known as “Dillon’s Rule,” a judicial principle (arising out of concerns over large cities’ corrupt political machines) that denied municipalities any powers and authorities not expressly granted by the state legislature. Over time Dillon’s Rule eroded and was replaced by liberal judicial interpretation of municipal authority and state statutory and constitutional recognition of home rule status for many cities.

Many private water suppliers of the late nineteenth century failed to provide adequate services at reasonable prices.

Third, many states authorized special-purpose water districts, which are public entities having missions, expertise, powers, duties and sources of financing that are more narrowly tailored to providing water services than the typical general-government municipality.

Fourth, favorable federal tax treatment of interest on state and municipal bonds created incentives for public investment in, and ownership of, basic public utilities.

Fifth, many private water suppliers of the late nineteenth century failed to provide adequate services at reasonable prices. For example, the Los Angeles City Water Company, a private firm supplying Los Angeles with water in the last three decades of the nineteenth century, charged high rates to its customers, failed to provide adequate service (e.g.,



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low pressure and malfunctioning hydrants) and illegally diverted water to which it was not entitled, thus making a significant profit at the expense of the public. Likewise, the Spring Valley Water Works, a private firm supplying San Francisco with water during the same time frame, had difficulty meeting the high demand for water in the rapidly growing area and had high rates for poor service. The company refused to sell its facilities to the city until the state legislature mandated city ownership of utilities in San Francisco.⁵ Ultimately, the public reacted to unreliable private supply of water by demanding government provision of water services.

Current Status

The Trend Towards Privatization

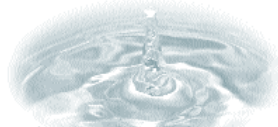
Even though private companies operate about 33 percent of all community water systems in the United States, they serve only about 15 percent of the customers or volume of water handled, take in only about 14 percent of total water revenues, and hold only about 11 percent of all water system assets in the United States.⁶ Nonetheless, in recent years privatization has become increasingly attractive to many cities or government (or quasi-government) water institutions, as evidenced by the growing number of contracts to privatize water services. According to one report, from 1997 to 2000, 70 cities entered into long-term contracts with private entities to operate and maintain their local water supplies or wastewater systems.⁷ As of 1997, though, only slightly more than one-half of the states had any private contract operation-and-maintenance water systems at all, and the bulk of them were in Texas and Puerto Rico (together comprising over 60 percent of all such systems nationally and over 46 percent of the water supplied by such systems).⁸

The Types of Privatization

One of the most critical things to understand about water privatization is that it takes several different forms. At the most limited level, a public water supply entity may “outsource” responsibility for one or more specific services normally provided by the public agency, such as billing and collection, routine maintenance, environmental services, training, technology upgrading and maintenance, procurement management, or other such tasks. This practice is widespread and is not discussed extensively in this report.

At the next level, a public entity may contract with a private entity to fully operate, maintain and manage its water supply system or some significant portion of it (an OMM contract). A third type of contract is the design-build-operate (DBO) contract, by which a private entity agrees to design and build needed water facilities and to operate them for the public entity. These last two levels may be written as service contracts, licenses or leases, with some variation in the legal rights and allocation of risks associated with each.

Nonetheless, in both types of arrangements, the city or public entity retains ownership of its water system. In addition, the city is often involved in financing of infrastructure development and improvements due to the tax advantages of tax-exempt municipal bonds, but with the expertise and cost-efficiencies of the private participant. Rarely but in notable examples involving Atlanta, Tampa, and Cranston, Rhode Island, a city may enter into a design-build-own-operate-transfer (DBOOT) contract, in which the private entity finances and engages in the design, building and operation of the facility as a private owner and then transfers it to the city at a particular time. DBOOT contracts place more of the risk on the private entity than do DBO contracts. The final type



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of privatization is a sale of the municipal or water district water system, or some of its assets, to a private firm.

The Forces Pushing Privatization

There are many forces behind privatization. Municipalities face significant financial limits in making the enormous investments required to meet both public demands for water and regulatory requirements regarding the quality of drinking water and treatment of wastewater. Much of the current water service infrastructure in the United States is aging or obsolete. The American Water Works Association estimates the necessary investments in replacing water infrastructure in the U.S. to be \$250 billion over the next 30 years.⁹ The U.S. Environmental Protection Agency estimates needed infrastructure investment to be \$140 billion over the next 20 years.¹⁰

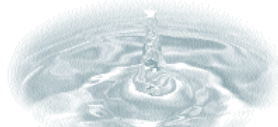
Two significant reasons for the large investments needed in water systems are the failure of municipalities and public entities to make major investments during the life of aging facilities (often due to other demands for public finance, the desire to keep water rates low, and limited legal and financial capacity to engage in debt-financing), and the increasingly stringent federal requirements for drinking water quality under the Safe Drinking Water Act. Many small and medium-size publicly owned utilities (i.e., serving populations of 50,000 or less) lack the financial capacity and scale of operations to make the imminent investments required without immediate, severe rate increases for water service (and in some cases lack the capacity to engage in such large capital improvements even with immediate, severe rate increases). Private firms, generally subsidiaries of large multinational or national water corporations, may have the financial strength, construction efficiencies and

operational economies-of-scale to upgrade and operate public water supplies more efficiently through DBO contracts.

Another force behind privatization was a change in the tax treatment of private operation of municipal water systems. Historically, public water systems have had a two- to three-percentage-point tax advantage over private water systems because of the tax-exempt status of interest on state and local bonds. If a private entity purchased or even entered into a contract to operate a public water supply funded by public tax-exempt bonds, the tax benefits would be lost. There was an exception for five-year operation and maintenance contracts, provided that the contract includes a termination clause allowing cancellation after 3 years. Three-year contracts provide insufficient incentives for many firms to operate facilities financed with tax-exempt bonds.

However, in 1997, the Internal Revenue Service issued Revenue Procedure 97-13, which maintains the tax-exempt status of bonds financing public water works that are subject to private operation and maintenance contracts for up to 20 years. Under the new rules, though, a contractor may not share in any net profits from their operation of the water system and may share in cost savings or revenue enhancements, but not both. These limits are designed to prevent abuse of tax-exempt financing of public water supplies. There is some discussion in Washington, D.C., of possible tax code changes to allow more equal treatment of private and public utilities. A major change could result in even greater privatization of water services.

Similarly, Executive Order 12803, signed by President George H.W. Bush in 1992, abolished the requirement that private firms have to repay the federal government in full for federal investments in public infrastructure that is subsequently sold to a private firm.



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In addition, many private water suppliers that have promoted privatization of municipal water services have highlighted their successes in and predictions of lower operating costs and increased operating efficiencies when making proposals. As will be discussed below, a comprehensive review of the efficiency of private versus public water suppliers is inconclusive. However, it is clear that some private firms can operate some public water supply systems substantially more efficiently than the government entities that have been or were operating them. For example, a National Association of Water Companies' study of 29 water privatizations showed operating cost savings from 10 to 40 percent, with some avoiding planned rate increases and providing more funds for capital improvements.¹¹

Furthermore, even where localities have not privatized water services, privatization has had beneficial effects by creating competitive incentives for public water managers to improve performance and efficiencies and providing benchmarks for performance.

Finally, the 1980s to the present have seen a surge in political forces favoring privatization generally and a decreased role for government. Private-market advocates like the Reason Foundation have produced policy reports and studies supporting increased privatization of many government functions, including public water supply and wastewater treatment services. Their arguments, often grounded in a combination of economic and political theory, have been supported by political leaders sympathetic to reducing gov-

ernment, bolstering the private sector or stretching public funds.

The Response to Privatization

Nonetheless, the trend towards privatization has recently suffered some major setbacks. Most notably, in 2003 Atlanta retook control of its water system from United Water after 4 years of complaints about poor quality of service, maintenance

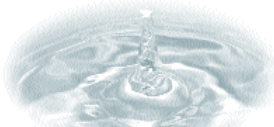
backlogs and a rate increase. Atlanta's privatization experiment was largely seen as a test of privatization of large urban water systems. In 2003, Phoenix's decision to privatize part of its water system fell apart when its top bidder encountered financial problems due to its parent company's top executives looting the company.

In 2000, Indianapolis moved to condemn by eminent domain its water utility, which had been privately owned since 1881. The city then contracted out opera-

tion of the system to a private firm (i.e., a move from private ownership to public ownership with private operation). Lexington-Fayette's (Kentucky) combined city-county government has made moves towards repurchasing its local water facilities from American Water Works, which has mounted a public relations campaign opposing the effort.

In 2002, the New Orleans Water and Sewerage Board rejected a proposal to privatize its water and sewer system under strong pressure from citizen groups concerned about service and cost to low-income city residents, impact on city employees, compromise of environmental standards and other public-impact issues. The Mayor of New Orleans

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has since replaced two Board members and a second effort at privatization is underway, but it remains bogged down in public opposition.

Residents of Elizabeth, New Jersey, attempted to defeat the privatization of municipal water supply by a voter referendum, but a New Jersey court held that the state statute governing privatization of public water supplies evidenced a legislative intent that these decisions not be subject to public referendum.¹² However, a citizens' group was successful in overturning Stockton, California's, water privatization contract for failure to complete an environmental impact report as required by the California Environmental Quality Act.¹³ Following approval of Stockton's contract with OMI/Thames in February 2003, the voters of Stockton passed an initiative requiring that any new water privatization contracts be submitted to the voters for approval.

Likewise, residential customers in the Santa Margarita Water District strongly opposed a proposal to privatize the district, which serves suburban areas in Orange County, California. The opposition arose even after allegations of corruption among the public water district's directors, which were addressed with institutional changes. The residents/customers were concerned that a lack of oversight by the California Public Utilities Commission and the monopoly characteristics of a water provider would result in poorer service for higher costs. As a result, the Orange County Local Agency Formation Commission (LAFCO) voted to reject the privatization proposal.¹⁴

More nationally, various environmental groups and social justice groups have expressed concerns, prepared studies and called for greater public scrutiny and control over water privatization.¹⁵

LEGAL AUTHORITY AND LIMITS

Legal Authorization of Privatization

In general, most states have legal authority for municipalities or other public entities to enter into contracts with private entities to supply water to the public. Many states have statutes expressly authorizing the sale, lease or long-term operational contracting of public water works facilities.¹⁶

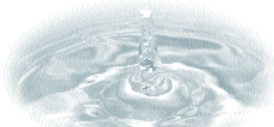
The best source of legal authority for privatization is a comprehensive, detailed state statute that not only specifies what types of privatization are authorized but also mandates specific standards, conditions and procedures to govern the privatization. For example, the New Jersey Legislature enacted the New Jersey Water Supply Public-Private Contracting Act,¹⁷ which provided clear legal authority for public-private contracts for operations and maintenance or operations, maintenance and management in such localities as Allamuchy, Camden, Edison, Elizabeth, Hoboken, Jersey City, Manalapan, Manchester, North Brunswick, Rahway and Wildwood, among others. However, many state statutes authorize privatization and may even exempt a private operator of a public water system from public utility regulatory review, without providing significant oversight or limits on privatization in practice.

In other states, courts have historically upheld the inherent power of cities to enter into contracts with private firms concerning public utilities, with some significant exceptions. The powers of cities or other political subdivisions to contract with private

entities for performance of specific functions like billing, certain maintenance and upkeep services, computerization of customer records, and environmental monitoring are not in doubt. However, the lease or sale of a public water utility — or arguably its equivalent, a long-term contract to operate, maintain and manage a public water utility — is a more complicated question without express statutory authority. Historically, jurisdictions were split as to whether or not a municipality or other public entity had the power to sell or lease a public water works system without express statutory authority, although the passage of statutes in many states resolved the confusion there.¹⁸ A recent Pennsylvania case reflects the trend of courts to allow such sales even in the absence of statutory authority on the theory that water services are a proprietary, not governmental, function of municipalities and therefore can be transferred to private entities.¹⁹ Nonetheless, there is some judicial authority recognizing a public trust in a city's water system and prohibiting city officials from avoiding their trust duties to the public by transferring their powers or duties to private entities.²⁰

Legal Limits on Privatization

State statutes may also impose limits on the privatization process. Even though a comprehensive statutory system of public input and regulatory substantive review of privatization contracts may preempt voter control via public referendum,²¹ statutory



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requirements themselves may ensure public input. These statutes might include open government laws, such as open meetings and open records laws, as well as statutes that mandate particular procedures for public hearings on municipal or water district decisions.

State laws mandating assessment of environmental impacts of government actions might also apply. For example, as noted earlier a California trial court judge recently invalidated the City of Stockton's water privatization agreement for failure to prepare an environmental impact report under the California Environmental Quality Act (CEQA). The court's opinion observed that private firms make decisions on the basis of profit motive, not the broader set of informed planning objectives that must be considered under CEQA, and that it was reasonably foreseeable that substantial changes to operations and to facilities would be made under a privatized arrangement that could affect the natural environment.²²

State statutory or constitutional limits on replacement of the civil service workforce with private contractors²³ might apply to water service privatization arrangements, but the recent use of such an argument by Atlanta public employees against Atlanta's privatization agreement failed. According to the court, budget concerns necessitated privatization.²⁴ Furthermore, private water contractors will often agree to hire many to virtually all of the city's water service employees, making the arguments about impacts on the city's civil service workforce even harder to make.

Perhaps the best example of a useful state statutory constraint on water privatization contracts comes from the New Jersey Water Supply Public-Private Contracting Act (Act).²⁵ The Act is a stream-

lined, privatization-promoting version of the more cumbersome New Jersey Water Supply Privatization Act.²⁶ The Act requires that any city or other public entity seeking to enter into a contract with a private entity to operate and manage local water services must follow certain procedures and meet certain requirements. These procedures include public notice, access to information, hearings and opportunity to submit written comments. They also include compilation of a detailed record about the proposal, including a negotiated contract. Finally, they require submission of the proposal, contract and record to three state agencies, all of which review, and two of which must approve, conditionally approve or deny the contract. The authorizing and reviewing agencies are the New Jersey Board of Public Utilities and the Local Finance Board within the New Jersey Department of Community Affairs. The reviewing agency is the New Jersey Department of Environmental Protection. The criteria for approving or denying the contract include the financial and technical capabilities of the private contractor, the reasonableness of the contract terms, the protection of the public/water customers from risks or subsidization of the contract, the financial terms for the city and impact of the contract on its ability to repay its indebtedness, and inclusion of statutorily required terms (i.e., subjects that must be addressed by the contract). The three state agencies must make their reviews and/or decisions within 60 days after receiving a completed application. This process, while not addressing all the issues that arise with water privatization, has worked well in New Jersey and could provide a useful starting point to many other states in providing review and accountability mechanisms to guide water privatization.

ISSUES IN PRIVATIZATION OF PUBLIC WATER SERVICES

Unique Characteristics of Public Water Services

Provision of water supplies and services to the public is not like the typical provision of goods and services by private firms or even the typical government function that can be privatized. Water service is unique in several respects. First, a sufficient, clean and reliable supply of drinking water is a necessity of life.

Moreover, most Americans are completely dependent on a single local water provider. As history has shown, inadequate planning and infrastructure, mistakes or carelessness can result in risks and harms to human health, epidemics, deaths and declines of entire civilizations. Problems with a private supplier's quality, quantity or reliability of water can have devastating consequences.

Second, water is not always a renewable resource in practice. Depletion of water resources result from groundwater extractions at a rate higher than recharge, contamination of both surface water and groundwater sources, diversions of surface waters that exceed flows from feeder sources and threaten both water quality and the physical characteristics of the water body, and consumption patterns that exceed the capacity of the

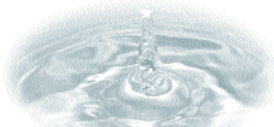
water basin or the region to accommodate them. As a study by the Pacific Institute for Studies in Development, Environment, and Security points out, water is not only an economic good but also a social good, and is not only a renewable resource but also a non-renewable resource.²⁷ Private water suppliers generally plan for return on their investment, not for long-term public goals and interests.

Third, water service in a particular geographic area is typically a monopoly. Due to the costs associated with constructing systems for acquiring, treating and delivering water supplies to a local community and the public interest in avoiding duplication, most states have granted municipalities or privately-owned water utilities monopolies in their service areas. As a result, customers are often at the mercy of the water service provider, who is constrained from charging exorbitant rates either by political pres-

ures of customer-voters if the provider is public, or regulatory oversight of state public utility commissions if the provider is private.

Lastly, a municipality's or water district's decision to shift from public ownership and operation to private operation and/or ownership has the potential for "sell out" of the public interest in a one-sided contract due to political influence, unequal bargaining

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power or corruption. According to the National Research Council of the National Academy of Sciences, “[a] review of media coverage in competitive bid processes [for water privatization] such as those in Birmingham, Atlanta, and New Orleans reveals charges that political favors were granted in connection with these bids.”²⁸ Also, a review of several privatization contracts show widespread divergence among localities as to the contracts’ protections of the public, scope and comprehensiveness, performance standards and coverage of issues like modification, termination and dispute resolution. For example, the text of Baton Rouge, Louisiana’s, 50-year franchise to the Baton Rouge Water Works Company is only 3 pages in length, while the operation, maintenance and management agreement between Manalapan Township, New Jersey, and United Water Mid-Atlantic, Inc., numbers 73 pages plus attachments and a 3-page amendment. While length of an agreement does not necessarily reflect whether it protects the public’s interest on critical issues, it is clear that city officials “sold” on a privatization proposal as a quick-fix to public infrastructure financing and operating deficiencies may be less-than-diligent in protecting the public’s interest — and arguably the public trust — in its municipal water supply.

Given the unique nature of privatization of public water supplies, certain issues are universally regarded as critical for localities — and arguably states in authorizing and regulating water privatization — to address. These are issues not only identified by independent experts and skeptics of privatization but also by the private water industry itself and advocates for privatization.

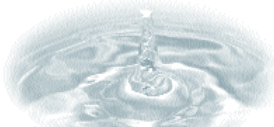
Operational Efficiency and Cost Savings

The issue that cities or water districts initially face when deciding whether or not to privatize is whether or not a private firm will really save money in capital

costs and/or operations. The common — but simplistic — wisdom among advocates for privatization, and perhaps even among some policy makers, is that private firms both construct and operate water supply systems more cost-effectively than do public entities. However, two economists’ comprehensive review of all of the empirical studies by independent researchers comparing private and public water utilities in the United States show inconclusive results. Four studies found that private utilities have lower costs or are more efficient, while five studies found that public utilities have lower costs or are more efficient, and three studies show no difference in costs or efficiency. They conclude that the most informative study shows that the size of the utility makes a difference, with large-scale public utilities operating more efficiently than large-scale private utilities, but small-scale public utilities operating less efficiently than small-scale private utilities.²⁹

Thus private utilities are not necessarily more efficient than public utilities. Instead, the specific benefits of each proposed plan of privatization must be analyzed. Reports show cost savings of between 10 and 40 percent, with resulting increases in capital available to localities for infrastructure or other public goods. But as evidenced by selected privatization experiences in the United States in recent years, the benefits of privatization vary greatly. These variations depend on the size and scope of the city’s water service operation; the financial and political condition of the city government; the potential for changing municipal management and operations to increase efficiency; the private provider’s size, financial condition, management strengths and weaknesses, operational efficiencies, experience with similar water systems and corporate culture; the customers’ consumption patterns; and other factors.

There must be a careful scrutiny of assertions of proposed savings. Private water suppliers or city



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officials committed to a privatization proposal may predict savings based on faulty methods, inaccurate assumptions or comparisons to other privatizations that are incomparable. Two examples illustrate the potential problems. First, the Reason Foundation issued a study comparing the performance of three privately-owned water utilities in California with ten government-owned utilities in California that demonstrated that the privately-owned utilities were more efficient.³⁰ The report has been used to argue for the superiority of privatization generally. However, the report has been roundly criticized as “comparing apples to oranges” in at least two respects: 1) the government-owned utilities that were studied depend mostly on surface water, which is substantially more expensive than the groundwater on which the privately-owned utilities rely; and 2) ten government units together are the same approximate size of the three private utilities together, thus meaning that each private

utility has a substantially larger scale than is typical of each of the ten government units.³¹ In addition, the total sample size was small and region-specific.

Second, an independent review of the analysis performed by Alternative Resources Incorporated (ARI) for Stockton, California’s, water privatization proposal showed arguable underestimation of inflation based on assumptions instead of historic figures. It also showed arguable overestimation of the City’s energy expenditures, using the energy crisis year of 2001-02 as a baseline.³² Similarly, the review contended that capital cost savings were overstated, because the entire system did not need to be privatized in order to capture most of the cap-

ital cost efficiencies associated with a treatment plant expansion.

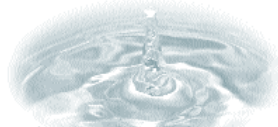
State legislation should mandate at least two stages of review for any proposal by a municipal or public water district to privatize the operations of all or most of its water service: 1) public opportunity to comment on studies supporting privatization: public access to proposals, studies and data used by the private water supplier, city or independent consultants to assess the need for and impact of the pro-

State legislation should mandate at least two stages of review for any proposal by a municipal or public water district to privatize its water service.

posed privatization, with ample opportunity for the public to review and comment on these studies and data in writing and a requirement that the governing body consider all comments and reviews that it receives and address any substantial criticisms of data, support or methodology when reaching a final decision; and 2) substantive review by a state regulatory agency: requirement that the proposed privatization be submitted for approval, conditional approval or denial by an expert

state regulatory agency, including assessment of predicted operational cost savings and capital cost savings, proposed rate plans, and environmental impacts, among other factors. The former is typical in California, with its strong history of public participation and environmental impact laws, while the latter is typical in New Jersey under its water privatization statute.

However, experience in both states shows that strict statutory time frames should be imposed to prevent the review process from simply becoming a process for defeat of privatization proposals by delay and cost. Worthwhile privatization proposals that offer increased efficiencies and better environ-



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mental and water quality performance should not be stymied by process alone. While interested members of the public and regulators need adequate time to evaluate proposed privatization, substantive standards and outcomes — not red tape and procedural hurdles — should be the barriers to poor proposals. At the same time, though, the process must be sufficiently long and complete to allow a full and fair evaluation of the proposal and contract terms. Many examples of failed privatization efforts, such as that in Atlanta, involved rushed bidding and approval processes (in Atlanta's case, due to the mayor's political ambitions), failure to gather and evaluate detailed information, or failure to carefully negotiate and draft adequate contract terms. In addition, another common theme of privatization failures is that quick approvals raise public suspicions and create ongoing public animosity towards the private water supplier. In all of these instances, the costs saved up-front were greatly exceeded by the costs to all parties of a failed arrangement.

Rates

Customers of a public water system, and their elected officials, are often concerned with the impact of water privatization on rates for water service. If the system were to remain publicly operated, customers would have political influence over water system officials to keep rates reasonable (although arguably perhaps below market costs). On the other hand, if the system were privately owned and operated, it would be subject in all but

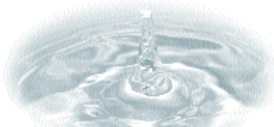
Rate increases may be due to costs associated with expensive capital improvements, perhaps overdue system replacement or upgrade.

five states to public regulatory agency review of rates to protect consumers from excessive charges due to the monopoly situation and limited ability to reduce consumption due to human necessity. However, where the public entity retains ownership of its water system but contracts with a private operator and manager, the private firm may be setting the rates without supervision or control from a state regulatory agency. In fact, several states have expressly exempted such arrangements from state

utility commission regulation.³³ The result is that the private entity may be insulated from any sort of constraints in rate-setting, except as provided in the operation, maintenance and management contract with the city or water district.

The problem is not increased rates in themselves. Increased rates following privatization may be the result of profit-seeking behavior by a private controller of a monopoly without adequate rate controls, but they may be the result of

legitimate and perhaps necessary factors. Rate increases following privatization may be due to costs associated with expensive capital improvements, perhaps overdue system replacement or upgrade or perhaps modifications necessary to meet increasingly stringent water quality and environmental regulations. Thus, rates would have likely increased (or alternatively taxes if tax revenues were used to subsidize water rates) even if the system had remained publicly owned and operated. Indeed, surveys of water utility customers show that they would be willing to pay significantly more for water that exceeds federal water quality standards.³⁴ Rate increases may also be



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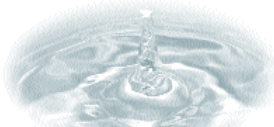
due to efficient and conservation-minded efforts to price water at its true cost and to eliminate free-riding by nonpaying or underpaying customers. Marginal-cost pricing principles, metering and increasing block rate structures should be encouraged as means to promote water conservation. Finally, private entities that do not enjoy the advantages of tax-exempt financing incur demonstrably greater costs associated with carrying debt than do public entities, and these additional costs may necessitate increased rates.

The real issue is whether there are meaningful regulatory controls on rate increases to ensure that they reflect legitimate costs and allow for a reasonable return on investment, instead of exploiting the private monopolist's powerful rate-setting position. One option is for all private water companies owning or operating public water services in a state to be placed under the regulatory jurisdiction of the relevant public utility commission. A second option is for the terms of the privatization contract (i.e., sales contract, lease, OMM contract, DBO contract, franchise concession, etc.) to specify the standards for calculating or increasing rates, or to attach schedules of rates that are applicable under different specified scenarios. A third option is for the terms of the privatization contract to provide that the public entity shall set the rates or that the private entity cannot increase rates without the consent of the public entity. For example, Manalapan, New Jersey's, OMM contract, and Hawthorne, California's, lease, operation and maintenance contract — both lengthy, detailed documents — provided for some significant degree of municipal control over rates and rate increases. However, states should have a process by which a state agency is required to review all privatization contracts for operation/management, lease or sale to ensure that the contract provisions contain adequate provisions governing rates and any rate increases.

Service Quality, Reliability and Water Quality

The public's greatest concern, though — far ahead of increased rates — is whether a private operator or owner of the local water system will provide high quality, reliable service. The public cares about the quality of its drinking water, including the presence of health-risking chemical and biological contaminants, clarity and odor, and taste. The public also cares about being able to count on a reliable supply of water and efficient responses to service calls or service interruptions. Often with privatization proposals, there is a public fear that profit-seeking private companies will cut costs to earn profits by cutting service quality or by reducing safeguards to ensure water cleanliness. There is also a fear that a private entity with a local monopoly on water services will not be responsive to complaints from the public, whereas a public entity ignores its constituency at its own peril.

There is good reason for public concern based on some communities' experiences with water privatization, even though many communities receive clean, reliable supplies of water from private providers. For example, Atlanta's debacle with United Water turned on quality-of-service issues. Tap water regularly ran a rusty brown color, and United Water had to issue numerous "boil orders" due to insufficient water pressure making the water unfit for human consumption without boiling. United Water also had a maintenance problem with Atlanta's aged and failing water delivery infrastructure, accumulating a backlog of 14,000 work orders by summer of 2002. A review of United Water's practices found that in order to cut costs so that it could operate within its astonishingly low bid parameters, the company was reducing the number of employees and the amount of training they received, which



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arguably further compounded the service delivery problems.

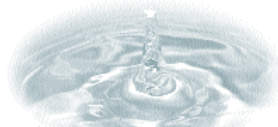
A facility in Santa Paula, California, was raided by federal authorities in 2003, because according to investigators, the facility's private operator, OMI, was violating terms of its discharge permit and had filed false water-quality reports. OMI-Thames, owned by the German water conglomerate RWE, has been fined repeatedly in England for violations of environmental laws. Incidents of poor water quality or poor service evoke images of private water companies operating in the nineteenth century in cities like Chicago, Los Angeles and San Francisco that provided notoriously inadequate water service for high rates while making substantial profits to the public's detriment.

One significant issue is whether private water companies have the financial strength to perform their contractual and public obligations. For example, in summer 2003, Phoenix had to eliminate a proposed contract with Earth Tech to privatize some of the city's water service and to re-evaluate its privatization goals when Earth Tech failed to obtain a letter from a bank guaranteeing a \$20 million line of credit. Earth Tech hit financial troubles because its parent company, the Bermuda-based Tyco International, had allegedly been looted by former top executives for up to \$600 million. Another example was an attempt by the infamous now-bankrupt Enron Corporation to form a private water service corporation, Azurix, in 1999 and offer publicly-traded stock in the corporation. Azurix was unable to compete with well-established multinational water conglomerates, and within a little more than a year, it had lost \$1 billion in market value and was deemed a failure by Enron.

Despite the examples of quality failures among private water companies, there is no evidence that private operators or owners of public water systems inevitably produce worse results regarding water

quality and reliability than do government operators and owners. In some notable examples, privatization has brought improved service over what the public entity was able to provide. Often privatization is a means by which revenue-strapped localities can finance water system infrastructure improvements that are needed to comply with the federal Safe Drinking Water Act (SDWA). In addition, private operators and owners of public water systems are required to comply with the SDWA, just as are public operators and owners, and are subject to federal and state enforcement. Privatization highlights the need for strong, effective enforcement of the SDWA.

Nonetheless, the concerns over whether a profit-motivated, cost-cutting private water company will provide reliable, clean water to the public necessitate three approaches to water privatization. One is for the local governmental entity that is considering privatization bids to obtain comprehensive, detailed information about the bidders' qualifications, financial and operational capacity, and history of performance and environmental compliance with other communities. Public officials should carefully scrutinize and thoroughly question information that selectively highlights successes but does not systematically identify performance in all systems operated by the bidder. EPA databases offer independent sources of information about SDWA compliance. Public officials should also demand information on the financial practices, performance histories and environmental compliance histories of the parent company(ies) of each bidder, because parent companies' practices tend to influence and shape the practices of their subsidiaries, especially if the subsidiary has been acquired recently and may be undergoing changes in structure, corporate culture and practices, and standard operating procedures. For example, if a community's water system oper-



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ations were ultimately governed by a corporation like Enron, the impact on the public might eventually be disastrous.

The second approach is for the local government to establish clear performance standards in the terms of the contract, enforceable by penalties for failure to meet baseline standards and enhanced by incentives for exceeding standards by specified levels or degrees. The contract should contain provisions for modification or termination of the arrangement if failure to meet standards occurs frequently enough as to constitute a substantial breach of the contract. For this reason, privatization arrangements of leasing, DBO contracts and OMM contracts are preferable to outright sale of a public water system to a private entity.

The third approach is to require the private operator to establish a well-designed system for receiving and responding to customer complaints. At the same time, the public entity should recognize that it will receive far more complaints, including first-contact complaints, from upset customers than will the private entity, especially in the first two years following the commencement of the private arrangement. Prior to the commencement of the private arrangement, the public entity should establish a system for receiving customer/public complaints about water service and then forwarding them to the private operator. In addition, the private operator should be required to submit to public officials monthly summary reports on the types of complaints received, their resolution and the speed with which they were resolved. With this reporting requirement, public

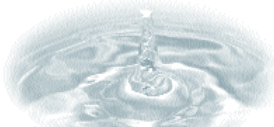
officials will be able to monitor progress towards performance goals and potential problems before they grow.

Take-or-Pay Contracts

Some private water utilities are advocating take-or-pay contracts, in which the city is obligated to pay for a minimum amount of water usage, regardless of whether consumers actually use it. Although these take-or-pay provisions are designed to minimize risk to the private provider from losses due to market-based, rate-based or conservation-based dips in consumer demand, they discourage conservation of water resources. Promotion of conservation and discouragement of waste is a matter of state law and state water policy in many jurisdictions. Demand for water resources is high and growing, while supply in many parts of the country — at one time mainly the arid West, but now also parts of the East as well — is limited.

Thus, take-or-pay contracts for municipal water supplies should be prohibited or discouraged by legislation. Instead, cities and private providers should negotiate a graded system of financial incentives for increasing levels of water conservation and for decreasing levels of unbilled or underbilled water consumption (except for equity-based protections of low-income consumers for basic household needs). These financial incentives would reward private providers for more efficient, and ideally decreased overall, use of water. However, these incentives should also be tied to adequate planning for drought scenarios, because

Take-or-pay contracts, in which the city is obligated to pay for a minimum amount of water usage, should be prohibited or discouraged.



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improved conservation during wet years can result in “water hardening,” which is the decrease of waste that can be cut during drought years.

Long-Term Capital Investment, Maintenance and Public Agency Capacity

Often privatization facilitates immediate infrastructure upgrades or improved operational capacity. However, privatization may hurt the long-term capacity of a public entity to improve, maintain or operate its system after the period of privatization is over. The city typically no longer has officials or employees who are well familiar with the management and operation of a water system, unless the city hires the private supplier's staff.

Moreover, private firms have the incentive to invest in capital improvements and maintenance only so much as will produce financial results for them during their period of private control. There may be little forward-looking planning done to ensure capital infrastructure conditions necessary to meet public demands and regulatory standards in the years following the contract term, and cities may not develop adequate resources themselves to do so.

Thus, cities may become dependent on private water suppliers for successive contract terms. One possible solution is to tie compensation of the private operator at least partially to the operator's planning, upgrade and maintenance activities that address post-contract water system needs. Similarly, the contract could contain financial incentives to the private operator, payable during the contract

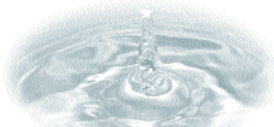
term, for continual planning, upgrades and maintenance with life-spans well beyond the term of the contract.

Environmental Protection and Impact

Several different environmental issues arise when the owner or operator of a public water system is a private for-profit company. One issue involves the protection of watershed and groundwater generally. There is every reason to believe that private operators and owners of water systems have incentives to protect the quality of the water supplies on which their business depends. However, it is possible that a private water company might cut corners on watershed and groundwater protections to save costs if the impacts on the water supply were to be experienced in the distant future. In contrast, public water agencies may be more accountable to the public's environmental goals and demands.

A more specific manifestation of the first issue involves the sale and development of a public entity's watershed reserve lands or groundwater recharge overlay lands. These are lands set aside as natural open space to provide buffers between developed areas and flows into surface waters and groundwater and thus protect watersheds and groundwater sources. One version of the problem occurs when the city or a public water entity generates revenues by selling the lands to private developers. Another version of the problem occurs when a private water company owns such lands, perhaps as part of acquiring all or part of a public

Private firms have the incentive to invest in capital improvements and maintenance only so much as will produce financial results for them.



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entity's assets, and sees the potential to increase revenues by developing the lands or selling them for development. Development, of course, increases impervious cover and contaminated runoff, results in loss of important habitat and ecosystem services, affects hydrology patterns and diminishes open space. Conflicts over the sale and development of watershed lands have arisen in Connecticut and New Jersey, resulting in public opposition and government restrictions on sales and development.³⁵ A Connecticut statute prohibiting sales of watershed lands to private parties was upheld by federal courts.

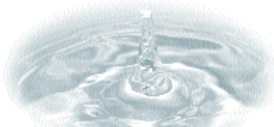
Another issue is the failure of a private water company to consider impacts on the natural environment, including watershed ecosystem services, instream flows and aquifer health, when seeking inexpensive sources of water. Public water entities are guilty of the same thirst for cheap water, as one can see with the Los Angeles Department of Water and Power's infamous appropriations from Owens Lake, Mono Lake and the Colorado River. Nonetheless, L.A.'s agreement to vastly cut appropriations from Mono Lake's feeder streams (contributing now to a rising lake level and renewed ecological health) resulted in large part from public pressures following a major public education and advocacy campaign by the Mono Lake Committee.³⁶ This example illustrates that while public water entities are not immune from acting in environmentally harmful ways to provide plentiful, cheap water, they are also not immune from public and political pressures to protect the environment. Private water entities are more insulated from such pressures.

Similarly, private water companies may have insufficient incentives to pursue conservation and reclamation projects because of the costs associated with developing such projects and perhaps the loss of revenues if overall consumption decreases.

Conservation and reclamation are critical to making the most efficient use of water and to ensuring adequate instream flows in arid regions with large populations that have rising demands for water.

Finally, when a local water supply is served by a private company, there is less potential for cross-resource coordination by a single entity. In contrast, when a municipality regulates land use and development, implements water quality controls in its jurisdiction and provides local water services, there is a single entity to coordinate land use planning and water planning. In numerous examples, coordination between public water agencies and public land use regulators has resulted in controls on growth (which would exceed available water resources) through limits on new water hookups.³⁷ The integration of land use and water resources is a topic of growing importance nationally and has spurred experimentation in state legislation and local regulation.³⁸ Involving private water suppliers — which may have very little interest in land use regulation and planning — presents something more of a challenge than incorporating public water service agencies into such coordination and integration efforts.

Two approaches may provide some measure of accountability in the area of environmental protection when water services are privatized. One is for the state legislature to adopt legislation, like Connecticut, prohibiting the transfer to a private party of certain lands held for watershed or groundwater protection. The other is for environmental performance standards to be incorporated into privatization contracts. These should require basic minimum standards and performance goals for which there are incentives and rewards. The minimum standards should focus on prohibiting degradation of watersheds and groundwater sources. The incentives should focus on increased conservation and reclamation, improved coordination of water planning



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with local, state, and regional land use regulatory and planning authorities, and decreased impacts on ecologically stressed water systems.

Global Commerce in Water

Much U.S. water privatization involves American subsidiaries of large multinational water companies. The three major multinational water companies are the French corporations Vivendi SA (which owns U.S. Filter Services) and Suez Lyonnaise des Eaux (now called Ondeo, which owns United Water in the U.S.) and the German corporation RWE (which owns Great Britain's Thames Water and American Water Works Company in the U.S.).

One issue raised by control of U.S. water systems by international entities is whether local state, or federal laws could prohibit the export of U.S. water supplies owned or controlled by multinational corporations. International trade agreements like GATT and NAFTA leave the issue murky, turning on an interpretation as to whether water is a non-renewable natural resource or goods in commerce. Legal experts are split over whether the United States could prohibit the export of U.S. water supplies internationally, but a U.S. Supreme Court case declaring groundwater to be an article of interstate commerce does not help the case for protecting domestic supplies of water.³⁹ Privatization contracts should be drafted in such a way as to retain ultimate ownership of the rights to the water in the governmental entity, even if the private entity manages and distributes the water.

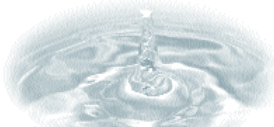
Security of Water Supplies and Terrorism

Private control over water services, supplies and facilities raises domestic security concerns, especially in this age of terrorism. The domestic water sup-

ply has received considerable security and anti-terrorism attention by all levels of government since September 11, 2001. In 2002, the U.S. Congress enacted the Bioterrorism Preparedness and Response Act of 2002, which requires public water systems to prepare emergency response plans to address threats to water supplies and to conduct and submit vulnerability assessments to the EPA. Both public and private water systems have beefed up security, and many states have passed legislation or implemented programs to enhance security of the water supply.

The security concerns are often misunderstood by the general public and even policy makers. Much attention has been given to protecting reservoirs and large water holdings from introduction of chemical or biological contaminants. However, the amount of a contaminant needed to pollute such large amounts of water, as well as the fact that such water is usually held pre-treatment (i.e., treatment processes would eliminate any contaminants), make this issue a virtual non-threat, according to experts. Much less attention has been given to protecting water pumping and distribution facilities. Although introduction of contaminants into distribution pipes could pose a serious problem, the greatest harm could be done by simply damaging pumping or distribution equipment, possibly shutting down the supply of water to large parts of a city. The potential for such an act is greater than one might expect if one considers that terrorists aim to create public fear and chaos more than to kill or injure the maximum number of people. It has been said that great harm could be done by someone with merely a hammer, screwdriver and access to water system machinery or pipes. An explosion at a key point in the distribution system could cause even greater harm.

Private water suppliers, just like municipal and governmental water suppliers, have called for government attention to (and funding for) security and



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have engaged in heightened security measures. However, private water companies usually operate with less transparency and accountability to the public than do public entities. This fact raises three particular concerns about private control over the public's water supply.

First, a private water system operator may have less of a close working relationship with local law enforcement than would a municipal water department or local water district. In general, public operators of water systems are either under municipal control or closely connected to local government, and therefore involvement of local law enforcement and local emergency response and public health officials is likely to be greater (recognizing, though, that some interdepartmental or inter-agency communication within government can be quite poor). A private company may be less likely to cooperate with such local officials simply due to poorly developed lines of communication, unfamiliarity of local officials with the private company's operations or desires to keep proprietary information confidential.

Second, private entities may be less likely to reveal information about private operations, employees, breaches of security and system security status than would public entities. For example, when Congress was considering the Bioterrorism Preparedness and Response Act of 2002, private water companies objected to submitting assessments to the EPA and instead wished merely to certify that they had done so, but Congress added provisions to exempt these assessments from the Freedom of Information Act and unauthorized dis-

closure.⁴⁰ The conflict over disclosing assessments to a federal agency illustrates a possibly inherent tension between private interests in keeping water management practices private and public interests in a well-informed, well-prepared set of anti-terrorism specialists at local, state and federal levels.

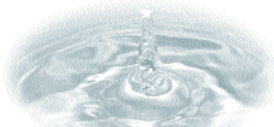
Third, it might be more difficult to ascertain if there are security breaches or threats from a private company's employees. There is no reason to believe that private companies on average have poorer

employee screening and background check systems than do public entities. What is at issue, though, are whether public officials concerned with public water supply security have adequate opportunity to check a private company's processes, practices and safeguards. Both public and private water service providers have access to certain confidential water security information. However, it is not clear how widely this information is disseminated throughout large multinational water companies and what

degree of risk there might be that an employee sympathetic to terrorists could get access to it.

Water privatization agreements should mandate that private companies not only undertake standard security measures that are now normal for water systems in this age of terrorism, but also fully cooperate with, and disclose relevant information to, appropriate law enforcement and anti-terrorism planning officials to ensure maximum security of local water supplies. In addition, public officials should investigate the employee screening system and internal security systems of a private entity with which they are considering contracting, and satisfy themselves that such measures are adequate.

Private entities may be less likely to reveal information about private operations, employees, breaches of security and system security status.



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Equity

When ownership or operation of the public's water supply shifts from a governmental entity to a profit-motivated private entity, there is the potential that those in society who lack resources will be priced out of the market for water. Public entities are concerned with policy considerations, social equity, politics and impacts of thirsty low-income residents on society. They have every reason to structure water services, rates and assistance programs so that water for basic human needs is not limited to those able to pay high rates. However, private suppliers have few, if any, reasons to consider social equity in structuring water services and rates, because social equity considerations do not contribute to profits or operational efficiencies. Although there is some evidence that sometimes officers and managers in private corporations consider social-regarding norms if the corporate culture includes these norms, in most circumstances a corporation's primary interest in social equity is for good public relations.

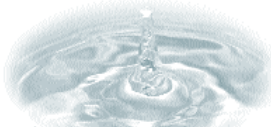
Therefore, the responsibility for ensuring that low-income persons are able to afford privatized water services will fall on the public entity that is contracting out, or selling, its water system. One study notes that while water and sewer bills can consume as much as 20 percent of a welfare recipient's benefits, only 19 percent of cities surveyed have a discount rate, credit or financial assistance program for low-income customers of water and sewer services.⁴¹ In addition to the obvious reason that cities may have

limited resources for such programs, there is some evidence that public providers of water services artificially hold down or subsidize rates for water services, especially for residential customers. However, as rates rise to meet new infrastructure needs and to reflect market pricing standards, there is a critical need for low-income assistance programs. A portion of the money that cities save through privatization should be earmarked for such programs.

It is more cost-effective and less complicated for the city or water district to set up with the private operator a system of low-income customer assistance, perhaps through credits on the customers' bills, at the time of the privatization than to do so after the private operation has begun and/or rates have been increased. One source of public funding for such assistance could be by offsets (i.e., reductions) in the payments of income or franchise/concession fees from the private operator to the public owner if an outsourcing arrangement is used, or through direct cash subsidies to the private owner/operator if the system is sold. However, the private water company must be contractually obligated to offer and account for the low-income credits or subsidies in its water billing and collection, under the terms provided by the city or district.

Another equity issue has to do with discrimination in service provision. Several famous equal protection cases over the past several decades involved racial discrimination in the provision of municipal services, including water supply.⁴² In many communities, neighborhoods predominated by racial or ethnic minorities were underserved by the municipal water system.

As rates rise to meet new infrastructure needs and to reflect market pricing standards, there is a critical need for low-income assistance programs.



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Presumably private suppliers of water may be less likely to discriminate on the basis of race or ethnicity, because all customers, regardless of race or ethnicity, contribute to the company's revenues and profits. However, this theory may not always work out so well in reality. Individual decision makers within a business entity may make decisions with conscious or even unconscious prejudices, unchecked by internal safeguards. Or specific decisions about service may be economically rational but have a discriminatory impact, such as when years of neglect of facilities and lines serving minority neighborhoods make repairs or upgrades disproportionately expensive to the revenues generated by those neighborhoods, yet the failure to make the repairs and upgrades further widens the gap between minority and non-minority neighborhoods. It is important to remember that the lack of water and other basic public services in low-income Latino *colonias* in Texas resulted from decisions by private developers of those communities.

The concern about possible discriminatory decisions or racially disproportionate impacts of business decisions is that the constitutional constraints on cities and public providers of water services may not operate on private providers. The Equal Protection Clause of the U.S. Constitution applies only to "state action," not private discrimination. The U.S. Supreme Court's standard for private contractors providing public services is vague and uncertain. If the private entity performs a government function or has a "symbiotic relationship" that is essentially a close partnership between the government and the private contractor, the state action requirement is met and the private entity will be subject to the Equal Protection Clause.⁴³ However, often state courts define provision of municipal water services as a proprietary function, not a government function. Federal civil rights statutes, which prohibit discrimination in interstate commerce, might protect minori-

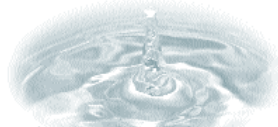
ty communities from private discrimination in water service, but nondiscriminatory business reasons, such as the costs associated with upgrading older minority neighborhoods, serve as a defense to discrimination claims. In short, it is less than clear whether courts would mandate a private water utility to upgrade service to underserved minority neighborhoods the way they have directed cities to do.

Therefore, antidiscrimination provisions should be included in any contract for the outsourcing, lease, or sale of water systems to private entities. In addition, both parties to the contract should have frank discussions about sub-areas (especially neighborhoods) within the system's overall service area that have aging, inadequate or sub-normal distribution systems.

Public Employees

One of the most vocal concerns raised when a municipality decides to privatize operation of its water system is what happens to the city's water employees. City employees fear loss of their jobs or unfair treatment by the private operator or owner. Effective opposition by the city's employees can undermine a city council's decision to privatize its water system. For example, even though Atlanta's city employees lost their arguments in both city hall and the courthouse against Atlanta's privatization contract with United Water, their animosity towards the arrangement resulted in a consistently poor working relationship between the city and United Water, negative oversight reports and audits, and ultimately the city's termination of the 20-year agreement after only 4 years. Incidentally, United Water had hired most, but not all, of the city's employees but had begun reducing the workforce in order to achieve necessary cost savings.

Because the loss of city workforce is a major political, equity and often legal issue, most contracts for water service privatization provide that the con-



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tractor will hire the city employees and will not eliminate jobs except through natural attrition or under certain financial exigencies. Interestingly, well-conceived privatizations can result in increased skills for (former) city employees. However, one issue to consider involves employee benefits, especially if the city has an unusually good set of benefits in comparison to those offered by the private water company.

Public Opinion

As discussed previously, privatization proposals have generated fierce public opposition in some communities and strong support in others. Policy makers are undoubtedly aware that turning control over something as essential and publicly valued as the local water supply system is likely to be met with suspicion, fear, concern and opposition. Privatization failure tends to occur in communities in which pro-privatization local officials attempt to circumvent public scrutiny and participation with quick decisions, as was the case in Atlanta and in Stockton, California. State legislatures have a role in ensuring that the process of privatization: 1) is open and transparent to the public; 2) has ample, but organized and timely, opportunities for public participation; and 3) is limited by standards and conditions designed to protect public health and safety, particularly the public's interest in a reliable, clean supply of water at an affordable rate.

Limited Authority of Regional Public Water Institutions

In many circumstances in which a city or local water agency is considering privatization, the pri-

mate firm's advantage is not its investor-owned status but instead its capacity to bring the efficiencies of economies-of-scale to the provision of water services. This is especially true for small- and medium-size municipal water systems, but it can also be true for large cities. An alternative to privatization is participation in or partnership with a regional public water institution: a public entity that serves a region, instead of a single city. Regional government-owned water systems have tended to enjoy success, in part due to their economies of scale and in part due to their water-specific mission and powers, freed from the constraints of local multi-issue governance and empowered to aggressively pursue water development and distribution.⁴⁴

Unfortunately, some states do not authorize the creation of regional public water institutions, others grant only limited authority and others authorize regional institutions poorly equipped to overcome local political resistance.⁴⁵ For example, one New Jersey case held that the North New Jersey District Water Supply Commission lacked the authority to contract to manage, operate and maintain the City of Bayonne's water system, because the state legislature did not grant the Commission the authority to do so, even though Bayonne could have entered into the same contract with a private water supplier under state statutes.⁴⁶

State legislatures can encourage greater efficiencies in operations, increased sources of capital for needed water system improvements and healthy competition to private water suppliers by expressly authorizing regional water authorities as special-purpose governmental entities with the powers to operate, manage, maintain, design, build, lease and acquire local water systems.



CHAPTER 5

STATES' ROLES IN ENSURING ACCOUNTABILITY

State legislatures have an important role and responsibility to play in the emerging trend towards privatization of municipal water services. The benefits of private sector involvement in the operation, management, construction and perhaps even ownership of public water supply systems can be great, but the dangers from lack of accountability to the public are even greater. A comprehensive state statute, establishing minimum standards and processes for local public entities seeking to enter contracts with private firms to operate, manage, maintain, lease or own public waterworks, would greatly enhance accountability of the privatization process to public interests and needs.

A comprehensive state water privatization statute would apply to any governmental entity, including municipality or water district, that seeks to contract with a private entity for that entity to operate, manage, maintain, lease, buy or own public waterworks. It would expressly authorize such contracts. It would not need to apply to outsourcing of specific operational functions of a publicly operated water system, unless all such private outsourcing in the aggregate constitutes the majority of the public entity's operations, because most states have existing clear authority for outsourcing.

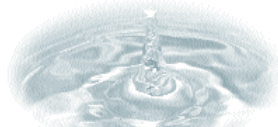
The statute should neither expressly encourage nor discourage privatization as a matter of state public policy. Instead, the ideal state policy is to facilitate privatization of public water services where significant net benefits can be gained by private operation of a particular public water system and where appropriate limits, safeguards, conditions and procedures ensure accountability to the public interest.

A comprehensive state statute would greatly enhance accountability of the privatization process to public interests and needs.

In addition to express authorization of privatization contracts, the statute should establish: 1) minimum baseline processes and standards for public entity decisions to privatize; 2) minimum requirements and presumptions for contract terms; and 3) state substantive review of privatization contracts prior to final approval.

The general standard governing privatization contracts should be that a governmental entity holds its water system in trust for the public and can enter

into such a contract only if it demonstrably serves the public's interest in a reliable supply of clean drinking water at a reasonable rate and if the contract is appropriately limited by conditions, restrictions and safeguards to protect the public's interest. This standard could clearly be met in the many examples of wise, well-negotiated privatization contracts that currently benefit local customers of priva-



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tized water services, but would guard against inadvisable arrangements that harm the public.

The statute should require a competitive bidding process in which the top bidder is selected according to a pre-established formula of highest bid price and best qualifications to run the local water system. The statute also should establish basic procedural requirements that ensure transparency of the process and opportunity for public input: 1) public notice of the intent to seek bids for a privatization contract; 2) public notice of public hearings to consider awarding a contract to a specified bidder (i.e., potential contractor); 3) availability of detailed information on the privatization proposal, impacts, contract terms and qualifications for public review; 4) public hearings in which members of the public have an opportunity to comment on the proposed contract; 5) opportunity for members of the public to submit written comments in lieu of testimony at the hearing; and 6) consideration by the government decision maker of the evidence, comments and testimony received from the public.

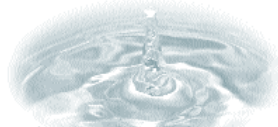
The state statute should mandate the preparation of an Impact Assessment and the submission by the potential contractor of a Statement of Water Services Provider Qualifications and History. The Impact Assessment should be prepared by the local government entity or its expert consultant(s) and should address impacts of the proposed privatization on water system operations and efficiencies (including costs and capital investments), water service rates, performance of water service obligations (including water quality and reliability), the natural and human environment, social equity

(especially low-income customers and historically underserved areas) and the city's workforce. The Statement of Water Services Provider Qualifications and History should be signed under penalty of perjury by an officer of the water company (i.e., the private provider or potential contractor) and should provide an accurate summation of the status and performance of the company and its parent company(ies) with respect to financial health, operational efficiency, quality and reliability of water service provided to public customers, compliance with applicable federal, state, and local environmental and health laws (including the SDWA), impacts on the natural and human environment and breaches of contracts with public entities (including any terminations of privatization agreements).

The statute should expressly prohibit take-or-pay contracts and transfer or development of watershed and groundwater protection lands to or by private entities.

The statute should require review and approval, conditional approval, or disapproval of the contract terms by an appropriate state agency, perhaps with input from one or more other agencies. The reviewing agency should consider, among other things, whether the contract sufficiently addresses — if necessary — the following terms: 1) clear controls over rates and rate increases, such as requirements of local public entity approval and/or clear standards governing rates; 2) clear performance standards governing the quality, supply, reliability and maintenance of water services delivered and response to customer complaints; 3) establishment of a customer complaint system and a monthly summary

The statute should prohibit transfer or development of watershed and groundwater protection lands to or by private entities.



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reporting requirement to the local public entity; 4) incentives for planning, maintenance and improvements for lifespans exceeding the life of the contract; 5) minimum standards regarding protection of watersheds and groundwater; 6) incentives for increased conservation and reclamation, improved coordination of water planning with local, state, and regional land use regulatory and planning authorities, and decreased impacts on ecologically stressed water systems; 7) a declaration that water supplies remain property of the city despite management and distribution by the private contractor; 8) requirements of security measures (including employee screening) and cooperation with and information disclosure to law enforcement, antiterrorism, emer-

gency response and public health officials; 9) coordination of publicly-funded low-income customer assistance programs with the billing and collection practices of the private contractor; 10) antidiscrimination policies; 11) retention of public employees by private entities, as well as standards governing employee benefits and workforce reductions; and 12) standards for modification, termination and dispute resolution.

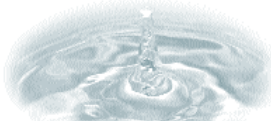
A system of effective public and state involvement in the consideration of contracts with private water companies provides the needed accountability in water privatization that protects the public's interest in reliable supplies of clean drinking water at reasonable rates and in a clean, healthy environment.



APPENDIX

NOTES

- 1 For an example of a major environmental group's opposition to water supply privatization, see www.sierraclub.org/policy/conservation/commodification.asp
- 2 See Craig Anthony (Tony) Arnold, "The Reconstitution of Property: Property as a Web of Interests," 26 *Harvard Environmental Law Review* 281 (2002); Eric T. Freyfogle, *The Land We Share: Private Property and the Common Good* (2003); William Joseph Singer, *Entitlement* (2000).
- 3 See generally A. Dan Tarlock, *Law of Water Rights and Resources* (1993 & Ann. Supp.).
- 4 National Research Council, *Privatization of Water Services in the United States: An Assessment of Issues and Experience* (National Academy of Sciences 2002), at 30, 34.
- 5 Isabelle Fauconnier, "The Privatization of Residential Water Supply and Sanitation Services: Social Equity Issue in the California and International Contexts," 13 *Berkeley Planning Journal* 37, 52-53 (1999). (citing Norris Hundley, Jr., *The Great Thirst: Californians and Water, 1770s-1990s* (1992)).
- 6 National Research Council, *Privatization of Water Services in the United States: An Assessment of Issues and Experience* (National Academy of Sciences 2002), at 2-3, 15 (Table 1-3).
- 7 Robin A. Johnson et al., *Long-Term Contracting for Water and Wastewater Services* (Reason Found. 2002), at 4-5.
- 8 Privatization Database, Water, Table 1 (Contract O&M Water Systems (1997)), at www.privatization.org/Collection/SpecificServiceAreas/Water-local.html (Sept. 2, 2003).
- 9 Id. at 3.
- 10 National Research Council, *Privatization of Water Services in the United States: An Assessment of Issues and Experience* (National Academy of Sciences 2002), at 18 (Box 1-2).
- 11 National Association of Water Companies, *Public Water Supply Facts* (1999).
- 12 *We the People v. City of Elizabeth*, 325 N.J. Super. 329 (App. Div. 1999).
- 13 *Concerned Citizens Coalition of Stockton v. City of Stockton*, Case No. CV 020397, Ruling on Petition for Mandamus (Cal. Super. Ct., Oct. 17, 2003).
- 14 Isabelle Fauconnier, "The Privatization of Residential Water Supply and Sanitation Services: Social Equity Issue in the California and International Contexts," 13 *Berkeley Planning Journal* 37, 57-59 (1999).
- 15 See, e.g., Peter H. Gleick et al., *The New Economy of Water: The Risks and Benefits of Globalization and Privatization of Fresh Water* (Pacific Inst. For Studies in Dev., Env't. & Security 2002); Texas Living Waters Project, *Privatization of Water and Wastewater Services*, Issue Paper No. 6.
- 16 V. Woerner, "Power of Municipality to Sell, Lease, or Mortgage Public Utility Plant or Interest Therein," 61 A.L.R.2D 595 (1958; updated 1999), at § 3b. McQuillin Mun. Corp. § 35.40 (3d ed. 1997 & Supp. 2001) (referencing statutes in Kentucky, New Jersey, Texas, and Utah). Cal. Pub. Util. Code § 10061; Ky. Rev. Stat. §§ 107.700-107.770; Utah Code §§ 73-10d-1 to 73-10d-7. See also Tex. Water Code §§ 13.511-13.515 (sewage treatment and disposal).
- 17 New Jersey Water Supply Public-Private Contracting Act, N.J.S.A. §§ 58:26-19 to 58:26-27.
- 18 V. Woerner, "Power of Municipality to Sell, Lease, or Mortgage Public Utility Plant or Interest Therein," 61 A.L.R.2D 595 (1958; updated 1999), at § 2b & 2e. McQuillin Mun. Corp. §§ 35.32; 35.36; 35.40 (3d ed. 1997 & Supp. 2001).
- 19 *Boyle v. Municipal Auth. of Westmoreland County*, 796 A.2d 389 (Pa. Cmwlth. 2002).
- 20 *Pikes Peak Power Co. v. Colorado Springs*, 105 F. 1 (8th Cir. 1900); *Huron Waterworks Co. v. Huron*, 62 N.W. 975 (S.D. 1895).
- 21 *We the People v. City of Elizabeth*, 325 N.J. Super. 329 (App. Div. 1999).
- 22 *Concerned Citizens Coalition of Stockton v. City of Stockton*, Case No. CV 020397, Ruling on Petition for Mandamus (Cal. Super. Ct., Oct. 17, 2003).
- 23 See, e.g., *Colorado Assn. of Public Employees v. Department of Highways*, 809 P.2d 988 (Colo. 1991).
- 24 *Abedi v. City of Atlanta*, 536 S.E.2d 255 (Ga. 2000).
- 25 New Jersey Water Supply Public-Private Contracting Act, N.J.S.A. §§ 58:26-19 to 58:26-27.
- 26 New Jersey Water Supply Privatization Act, N.J.S.A. §§ 58:26-1 to 58:26-18.
- 27 Peter H. Gleick et al., *The New Economy of Water: The Risks and Benefits of Globalization and Privatization of Fresh Water* (Pacific Inst. For Studies in Dev., Env't. & Security 2002), at 5-8.



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- 28 National Research Council, *Privatization of Water Services in the United States: An Assessment of Issues and Experience* (National Academy of Sciences 2002), at 26.
- 29 Steven Renzetti & Diane Dupont, "The Relationship Between the Ownership and Performance of Municipal Water Utilities," at 8-9 & 15 (Table 1) (2003) (working paper, available at <http://spartan.ac.brocku.ca/~srenzett/>).
- 30 Kathy Neal et al., *Restructuring America's Water Industry: Comparing Investor-Owned and Government Water Systems* (Reason Found. 1996).
- 31 See id. at I.B.; Isabelle Fauconnier, "The Privatization of Residential Water Supply and Sanitation Services: Social Equity Issue in the California and International Contexts," 13 *Berkeley Planning Journal* 37, 57 (1999).
- 32 Gary H. Wolff, *Independent Review of the Proposed Stockton Water Privatization* (Pacific Inst. for Studies in Dev., Env't. & Security 2003).
- 33 National Research Council, *Privatization of Water Services in the United States: An Assessment of Issues and Experience* (National Academy of Sciences 2002), at 97-99.
- 34 National Research Council, *Privatization of Water Services in the United States: An Assessment of Issues and Experience* (National Academy of Sciences 2002), at 43 (Box 3-1) (summarizing a study by the American Water Works Association Research Foundation).
- 35 National Research Council, *Privatization of Water Services in the United States: An Assessment of Issues and Experience* (National Academy of Sciences 2002), at 104, 105 (Box 6-1).
- 36 Craig Anthony (Tony) Arnold & Leigh A. Jewell, "Litigation's Bounded Effectiveness and the Real Public Trust Doctrine: The Aftermath of Mono Lake," 8 *Hastings W.-N.W. J. Env'tl. L. & Pol'y* 1 (2001).
- 37 Dennis J. Herman, "Sometimes There's Nothing Left to Give: The Justification for Denying Water Service to New Consumers to Control Growth," 44 *Stan. L. Rev.* 429 (1992).
- 38 See *Wet Growth: Should Water Law Control Land Use?* (Craig Anthony (Tony) Arnold, ed.) (Env'tl. L. Inst. forthcoming 2004).
- 39 *Sporhase v. Nebraska ex rel. Douglas*, 458 U.S. 941 (1982).
- 40 National Association of Water Companies, 2002 Annual Report, at 10.
- 41 Isabelle Fauconnier, "The Privatization of Residential Water Supply and Sanitation Services: Social Equity Issue in the California and International Contexts," 13 *Berkeley Planning Journal* 37, 64-65 (1999).
- 42 See, e.g., *Dowdell v. City of Apopka*, 698 F.2d 1181 (11th Cir. 1983); *Hawkins v. Town of Shaw*, 437 F.2d 1286 (5th Cir. 1971), *aff'd* 461 F.2d 1171 (5th Cir. en banc 1972); *Johnson v. City of Arcadia*, 450 F. Supp. 1363 (M.D. Fla. 1978).
- 43 See, e.g., *Magill v. Avonworth Baseball Conference*, 516 F.2d 1328, 1331 (3rd Cir. 1975).
- 44 See, e.g., Robert Gottlieb & Margaret Fitzsimmons, *Thirst for Growth: Water Agencies as Hidden Government in California* (1991); Barton H. Thompson, Jr., "Institutional Perspectives on Water Policy and Markets," 81 *Cal. L. Rev.* 671 (1993). See also National Research Council, *Privatization of Water Services in the United States: An Assessment of Issues and Experience* (National Academy of Sciences 2002), at 32-33 (Box 2-3), 83 (Box 5-1).
- 45 National Research Council, *Privatization of Water Services in the United States: An Assessment of Issues and Experience* (National Academy of Sciences 2002), at 90.
- 46 *United Water Resources, Inc. v. North New Jersey Dist. Water Supply Comm'n*, 701 A.2d 434 (N.J. 1997).