



BORROWING TROUBLE

Water Privatization Is a False Solution for Municipal Budget Shortfalls

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The 2008 global financial crisis left many governments around the world with serious fiscal challenges. Eroded tax bases and growing health and retirement costs created or worsened local budget deficits across the United States,¹ and a sovereign debt crisis rattled the European Union.² Instead of confronting these problems head-on, a number of public officials across the globe sought to lease or sell public water and sewer systems to fund ongoing government functions or to pay down liabilities. That is, they have tried to use water privatization to create the illusion of having balanced the budget, when in fact they are just digging the hole deeper.³

Water privatization is not a real solution to government financial challenges. It is a one-shot ploy that masks the underlying problems and that delays the hard decisions necessary for real fiscal sustainability.⁴ Instead of reducing public bills or mitigating the financial burden on taxpayers, it increases the long-term costs borne by households and local businesses.⁵

Expensive Loans

“You know what it was? People went into it [the sewer system lease] with the wrong purpose. They didn’t go in there to improve the sewer service for the public. The deal was done to get [the city] through another month, another year. ... What we got is money to pay bills. That’s it. What they [the company] made sure is they got their money back in the end. They didn’t invest in improvements. ... They didn’t spend a dime.”

— **Chris Doherty**, mayor of Scranton, Pa., who inherited the privatization from his predecessor, telling the *Times-Tribune* that the lease of the Scranton Sewer Authority was not in the interest of the public and that the private company got the better end of the deal, 2007⁶

The government’s primary objective in these privatization arrangements is to obtain a sizable upfront payment from the company or consortium that takes over the water or sewer system, often as a desperate response to a fiscal

crisis. As a consequence, governments usually award contracts to the bidder that offers them the most money, instead of selecting the highest-quality or least-expensive option for households and local businesses.⁷

This money is not free; rather, it should be thought of as a loan.⁸ Residents and local businesses will have to repay it, with interest, through their water bills.⁹ In a 1997 report about wastewater privatization, the U.S. Environmental Protection Agency said as much: “In summary, any payments a local government receives from the sale or lease of a wastewater infrastructure asset represent a loan from the buyer or lessee which must be repaid with interest by the wastewater users in the form of additional user fees.”¹⁰

High Financing Costs

*“As for the County’s so-called ‘Debt-Reduction Plan,’ in my 35 years as an investment banker, I have never come across such an ill-conceived plan. ... The County expects to select a private investor who will finance \$850 million to pay down existing low interest cost tax-exempt sewer debt and County debt. This is a form of backdoor borrowing. ... To use such costly funds to pay down low interest tax-exempt County and sewer debt makes no sense. **This would be like drawing down the credit line on one’s VISA card at 15 percent interest per year to pay down one’s home mortgage which has a 4 percent annual interest rate. Sheer folly!**”*

— **George Marlin**, director of the Nassau County Interim Finance Authority, lambasting the proposed privatization of the wastewater system in Nassau County, N.Y., 2012¹¹

This type of loan is expensive for consumers. The interest rate on the loan reflects the private entity’s weighted average cost of capital and ranges from a minimum of 7.5 percent to 14 percent or higher.¹² This is far more expensive than government borrowing typically is.¹³ In the United States, for example, a typical interest rate on long-term municipal debt is about 4 percent.¹⁴ Globally,

government bonds usually carry interest rates of between 1 percent and 6 percent, depending on the location and term.¹⁵ In many countries in the global South, the cost of private financing usually exceeds 15 percent.¹⁶

In concessions and sales (see box on page 5 for definitions), not only do consumers have to pay back what the government receives up front, they also must cover the increased cost of financing system improvements. So, for comparison, using typical interest rates and a 30-year term, privatization would increase financing costs by 46 to 147 percent, adding \$0.8 million to \$2.5 million onto the total cost of every \$1 million investment (see Figure 1). Because of the high cost of private financing, one analysis of U.S. wastewater privatization found that selling a system would be an “economic disadvantage” for a municipality if the system’s existing debt carries an interest rate of 8 percent or less.¹⁷

Making matters worse, long-term privatizations can also cause a government utility in the United States

to lose the tax-exempt status of its existing bonds. In these cases, local governments have to retire the utility’s outstanding debt,¹⁸ often using part of their upfront payments from the company to do so. For example, when Cranston, R.I., leased its wastewater utility, it used \$25 million of its \$48 million concession fee to retire the system’s outstanding municipal bonds.¹⁹

In this way, water privatization forces local governments to refinance existing cheap public debt with expensive private capital. To illustrate the associated costs, in 2012 Rialto, Calif., privatized its water and sewer systems and, as a consequence, had to refinance \$27.4 million in existing public debt with private capital, at a cost of about \$6.2 million.²⁰

Rate Hikes

“The New Jersey Water and Wastewater Assets are managed by different government entities at operating margins that are well below those of comparable investor-owned utilities. The differing aged facilities already have significant debt outstanding and may require significant capital expenditures to ensure safety and reliability. Consequently, it appears that meaningful rate increases would be required to allow equity investors to achieve threshold equity returns.”

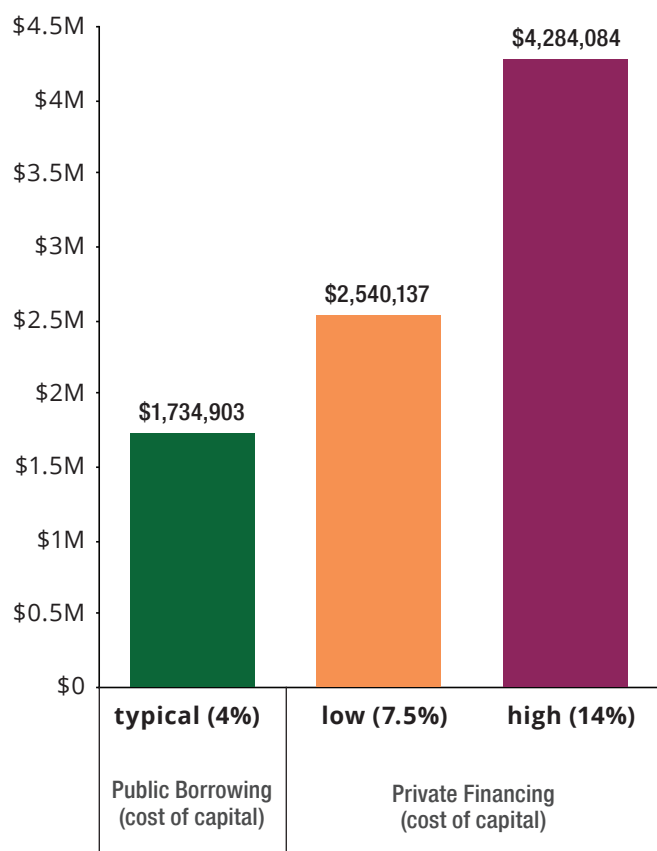
— **UBS Investment Bank** in a report for the state of New Jersey about the potential value of privatizing state assets, determining that the state’s water assets were “unattractive” candidates for privatization, 2006²¹

Because the private entity recovers its investment and profit through user bills, privatizing water and sewer systems can lead to considerable rate hikes for consumers.²² In fact, consumers can expect future rate increases to reflect the size of the upfront payment that a local government receives in a privatization scheme. Or, from the perspective of the company, in the words of consulting firm KPMG, “The greater the ability of the concessionaire to raise charges, the larger the upfront payment they will likely make.”²³

Because it is more expensive than government borrowing, the use of private financing by itself translates into higher prices.²⁴ A World Bank report on infrastructure concessions in Latin America said that a 5 percentage point increase in capital costs corresponds to a 20 percent rate hike or a 35 percent cut to the concession fee or sale price.²⁵

In the United States, after purchasing a municipal water or sewer system, investor-owned utilities typically

Figure 1. Public Versus Private Financing: Total Cost Per \$1 Million Spent on Infrastructure Improvements Over 30 Years





increase household rates by 18 percent every other year, adding hundreds of dollars onto their annual bills within the first decade.²⁶ According to data from the U.S. Environmental Protection Agency, on average households pay higher water bills to privately owned water systems than to publicly owned ones.²⁷ Several academic surveys have arrived at the same finding.²⁸ For example, a survey of the largest water utilities in the Great Lakes region found that privately owned systems charged more than twice as much as municipal systems. The researchers attributed this difference to private companies' profits, ratemaking practices and higher overall service costs and taxes.²⁹

Evidence from France, where long-term water privatization contracts are common, also shows that privatization results in significantly higher water rates. Eshien Chong *et al.* analyzed water prices in several thousand French municipalities and determined that consumers pay more when water systems are privatized through any type of contract.³⁰ Compared to direct public provision, average water prices were 17 percent higher in leases and 26 percent higher in concessions (see box on page 5 for background about these types of contracts).³¹

Budget Gimmickry

“Simply put, a great risk the State faces is that it will use any lump sum payments or revenue streams it is offered by the private sector as ‘one-shot’ revenues and other short-term budget expedients, without regard to structural balance in the budget. ... Some asset maximization proposals are little more than new ways to perpetuate unsound financing practices, such as using new debt to pay for current expenses. This may lower costs in the short-run, but would end up costing much more in the future.”

— Office of the State Comptroller of the State of New York, 2011⁵⁸

Fiscal crises have driven water privatization schemes, but these schemes do not actually help governments address their underlying budget problems. According to Janet Werkman and David Westerling of the Office of the Inspector General of Massachusetts, privatizing a water system to obtain a “one-time, up-front payment as a quick fix for a budget shortfall is short-sighted and fiscally irresponsible.”⁵⁹ Privatization fails to address the reason for the deficit and increases long-term costs for households and local businesses,⁶⁰ saddling them with expensive loans and future rate hikes.

The New York State Comptroller’s Office called this practice “budget gimmickry” because it “provides a short-term cash benefit while pushing costs to the future and potentially increasing public debt.”⁶¹ Credit rating agencies typically disapprove of using these so-called “one shots” as short-term fixes for budget deficits.⁶² For example, Fitch took a negative view of a proposal in Nassau County, N.Y., to lease its sewer system to fill budget gaps in 2013 and 2014.⁶³ Similarly, Moody’s Investors Service assigned a “negative outlook” on the county’s general obligation debt partly for using “one-time revenues” to fill budget gaps.⁶⁴

Even privatization proponents have advised against this practice. Stephen Goldsmith, a pro-privatization former mayor of Indianapolis, rejected the idea of leasing or selling public assets to balance budgets, saying, “Monetizing a capital investment as a one-time way to close a budget deficit is a bad idea.”⁶⁵ In an article in *Governing Magazine*, Goldsmith encouraged other privatization advocates to reject this practice as well: “Those who favor privatization should not support monetizing a physical asset to fill a budget hole without dealing with the underlying conditions that created the hole in the first place.”⁶⁶

Off-Budget, Out-of-Mind

Another trick of these privatization schemes is the use of off-balance-sheet financing to obscure the real fiscal costs of government. Privatization deals create liabilities that are off budget in the sense that governments fail to account for the upfront payments as loans on their balance sheets despite being obligated to repay the funds through the sacrifice of future water revenues.⁶⁷ Such off-balance-sheet financing of general government functions interferes with transparency and accountability, and indeed in some cases, it is done deliberately.⁶⁸ This legerdemain can generate hidden fiscal risks, result in manipulated project appraisals and distort government decision-making.⁶⁹

BACKGROUND: Water System Leases, Concessions and Divestitures

Terminology — In the water sector, the terms *lease* and *concession* each refer to a contractual form of privatization in which a government transfers long-term control over its water or sewer system to a private firm or consortium, called the lessee or concessionaire. Usually, the private entity pays the government an upfront fee known as a concession fee, a recurring annual fee often called a lease payment, or both. The government retains nominal ownership while the private entity maintains, operates and manages the system.³²

In contrast, a *divestiture* occurs when a government sells its water system to the private entity. The local government is no longer involved in the provision of water or sewer services, and the private entity has complete control of the system subject to state or national government regulation of water quality and pricing.

The privatization industry may refer to these different types of privatization as:

- Public-private partnerships³³
- Securitization³⁴
- Asset maximization³⁵
- Monetization³⁶

Differences — Divestitures are easily distinguished because they involve the actual sale of a system, unlike other forms of privatization. The terms lease and concession, however, are often used interchangeably, and differences between the two are technical and can vary by country (see Table 1). The primary difference involves the responsibility for financing capital improvements: the private entity is responsible in a concession, and the government is responsible in a lease.³⁷

Because local governments retain responsibility for financing in leases, in the United States they usually structure these leases as management contracts that enable them to retain tax-exempt status on the water-related municipal bonds, in accordance with IRS rules.³⁸ This restricts how the private entity is paid, in that its compensation cannot be “based, in whole or in part, on a share of the net profits from the operation of the facility,” since otherwise the water system financed with the municipal bonds would be deemed “for private use.”³⁹ Under such contracts, the

local government oversees the water system’s budget and, using system revenues, pays the lessee a fixed periodic fee for operations, maintenance and management.

Outside of the United States, a lessee’s compensation may come directly from the profit of the water system that it is leasing; the lessee is in charge of the system’s budget and compensates the government for any capital investments.⁴⁰ (See Table 1.)

History — The contractual forms of water privatization — which the industry often refers to as public-private partnerships — originated in France and are known as the “French Model” of water privatization.⁴⁶ Divestitures are often referred to as the “British Model” because of the full-scale sell-off of water systems in England and Wales (but not Scotland) in 1989,⁴⁷ although the United Kingdom was not the first government to sell a water system.

Trends — Multinational water corporations, led by the big Parisian firms and aided by international financial institutions, exported these models across the globe. In the 1990s, South America was a primary target for long-term water privatizations, but after strong public opposition, high risks and failure there, privatizers shifted their focus to China and Eastern European countries during the 2000s.⁴⁸ Following the financial market collapse of the late 2000s, the United States and several European countries including Greece, Portugal and Bulgaria became hot spots for privatization as governments needed new capital.⁴⁹

Prevalence — Public provision is the dominant form of water and sewer service delivery worldwide.⁵⁰ Privatized systems are common in only the United Kingdom, France, Chile and a handful of other countries.⁵¹ The contractual models of privatization are more prevalent than divestitures.⁵² In low- and mid-income countries, concessions have occurred more often than leases,⁵³ although the number of new concession deals has declined since 2008,⁵⁴ possibly because of the private sector’s increased unwillingness to invest capital in those countries.⁵⁵ The lease is the more prevalent model in France.⁵⁶ Until recently, concessions of water systems were basically unheard of in the United States,⁵⁷ but two municipalities — Bayonne, N.J., and Rialto, Calif. — finalized concession contracts in 2012.

Table 1. Typical Differences Between Leases, Concessions and Divestitures

KEY DIFFERENCES	LEASE	CONCESSION	DIVESTITURE
Owner (Who owns the system?)	Local government	Local government	Private entity
Party responsible for setting water prices (Who sets the water prices?)	Local government	Private entity according to contract provisions	Private entity with state (U.S.) or national (e.g., U.K.) government regulatory oversight
Party responsible for financing capital improvements ⁴¹ (Who finances improvement projects?)	Local government, but the contract may require some investment from the private entity	Private entity	Private entity
Method of payment to the private entity (How does the private entity get paid?)	U.S.: Annual fixed fee from the local government ⁴² Other countries: Revenue directly from customers ⁴³	Revenue directly from customers ⁴⁴	Revenue directly from customers
Typical contract length ⁴⁵ (How long is the typical contract?)	15 to 20 years	25 to 30 years	Indefinite

In the *Journal of Public Budgeting, Accounting & Financial Management*, Hana Palackova Brixi found, “Often, particularly in times of deficit reduction and a short-term political horizon, policymakers exploit the fact that off-budget commitments and obligations are not necessarily reported so that the cost of government policies is hidden.”⁷⁰ It can be difficult to hold elected officials accountable for making these off-budget decisions, especially since the real costs and risks often are not known until the future.⁷¹

Selling Out Future Generations

“This use of creative borrowing not only increases the public debt burden, it also allows elected officials to evade the politically painful necessity of balancing their budgets by either cutting back on spending or raising taxes or water and sewer rates. Using privatization to generate short-term government revenue generally produces a transfer of costs to future taxpayers rather than any real savings.”

— **Janet Werkman and David Westerling** of the Office of the Inspector General of Massachusetts, 2000⁷²

Privatizing water systems to cover budget shortfalls forces future generations to pay for current financial imprudence and mismanagement. The schemes provide a cash advance of future water revenue to pay for current financial needs.⁷³ Privatization is borrowing against the future.

Future generations will inherit the responsibility to repay the upfront concession fee or purchase price with interest through their water bills. That is, such deals obligate a community’s children or grandchildren before they are even born to pay for government services that they are not yet alive to receive.⁷⁴ John Gilmour, a professor at the College of William and Mary, in an article about the Indiana Toll Road referred to such a long-term lease of public assets as an “intergenerational cash transfer.”⁷⁵ He explained, “These transactions have important consequence for intergenerational justice because they enrich current citizens and governments at the expense of future citizens and governments by transferring future revenue to current budgets.”⁷⁶

A long-term lease is similar to a revenue bond in that, Gilmour explained, “Both the asset lease and the revenue bond exchange a stream of future revenue for cash today.”⁷⁷ Because asset leases can have a longer duration than revenue bonds, which are usually capped at 30 years, they can generate a larger upfront payment. “It is easy to see why current politicians view asset leases with



up-front payments as wonderful, allowing them to spend today without raising taxes or appearing to incur debt,” Gilmour added.⁷⁸ “This can be very attractive to current decision makers,” he said, “but the higher up-front payment is possible only because more future revenue is being sacrificed.”⁷⁹

Adrian Moore of the Reason Public Policy Institute, a libertarian think-tank known for advocating privatization, made a similar observation about the burden placed on future generations:

*“A darker development arising from long-term contracts raises the question of inter-generational equity. Some contracts included large concession fees, paid by the contractor to the local government ... the practice means that future ratepayers will pay higher rates than they might otherwise have to as a result of current policymaker’s desire for a pot of unencumbered dollars to spend as they will.”*⁸⁰

Elected officials also tend to structure deals so that any benefits occur early on while the costs are deferred until after they have left office.⁸¹ Nicholas Miranda observed in the *Yale Law Journal*, “Concession agreements provide a particularly acute incentive for government officials to take short-term over long-term benefits because the agreements last much longer than a leader’s time in office.”⁸²

One way to do this in a water privatization deal is to simply require a rate freeze for the first few years, resulting in steeper rate hikes later on.⁸³ For example, the mayor of Allenton, Pa., promised that water rates would remain unchanged through 2015 under his proposal to privatize the city’s water and sewer system.⁸⁴ When Rialto, Calif., privatized its water and sewer utility for 30 years, the city had the concessionaire finance a rate stabilization

fund to, as city officials reported, “minimize the scope of the proposed water and wastewater rate increases during the early years of the Agreement.”⁸⁵

Betraying the Public Interest

“It’s become a model for the way not to do such deals. ... The people saw themselves getting screwed.”

— **David Spaulding**, mayor of North Brunswick, N.J., who inherited a privatization scheme from his predecessor, telling the *Star-Ledger* that the lease of the town’s water system was a bad decision that led to hikes in household bills, 2003¹⁰⁰

Water privatization has “the potential for ‘sell out’ of the public interest in a one-sided contract due to political influence, unequal bargaining power, or corruption,” according to Craig Anthony Arnold in an article in the *Pepperdine Law Review*.¹⁰¹ Arnold also found, “[I]t 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 — regarding municipal water supply.”¹⁰²

In *Public Administration Review*, Pamela Bloomfield observed that government officials and their privatization consultants even have strong “disincentives to disclose

accurate information regarding the budgetary consequences of long-term contracts.”¹⁰³ An elected leader may also strong-arm and rush through the privatization for personal political gain, forcing the public into a bad deal.¹⁰⁴ For example, several residents have accused the mayor of Allentown, Pa., of trying to do this in his pursuit of a long-term concession of the city’s water and sewer systems.¹⁰⁵

According to Arnold, “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.”¹⁰⁶ Many privatizations around the world have failed. World Bank data show that nearly 60 concessions and leases of water and sanitation systems — about 15 percent of all such deals — have been canceled or are in distress in low- and mid-income countries.¹⁰⁷

The lack of transparency and accountability in the privatization process makes corruption, high long-term costs and disproportionate rate increases more likely.¹⁰⁸ To help protect the public interest, privatization decisions should be made in an open and transparent manner with public involvement at every step.¹⁰⁹ But, Nicholas Miranda in the *Yale Law Journal* found that the privatization process essentially precludes “democratic deliberation” because governments treat concession agreements as private contracts instead of matters of public policy.¹¹⁰

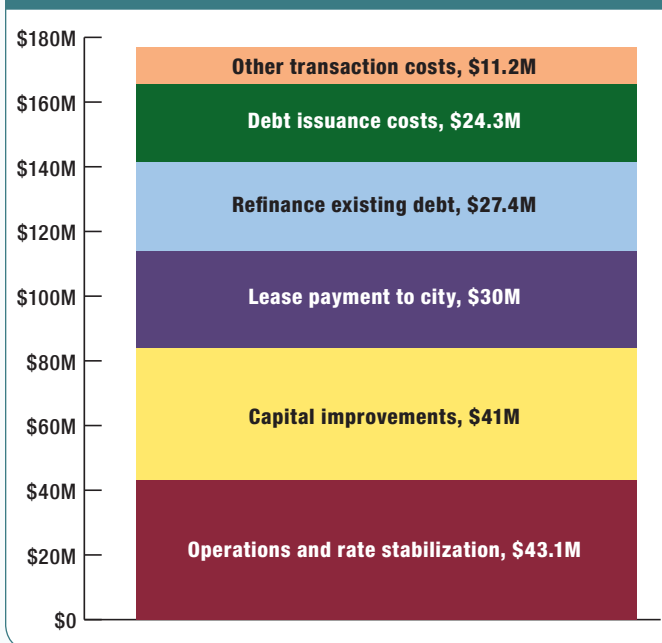
Rialto, California: The Finances of a Water and Sewer Concession

In 2012, the city of Rialto, Calif., privatized its utility authority through a 30-year concession contract with a company controlled by Table Rock Capital.⁸⁶ The private equity firm delegated the management and operation of the water and sewer systems to Veolia Water North America.⁸⁷ Through privatization, the city expected to receive \$30 million up front,⁸⁸ and will receive about \$2 million annually,⁸⁹ but the city also agreed to more than double water and sewer rates within four years.⁹⁰

Rialto’s mayor claimed that the rate increases — which would total about 115 percent from 2012 to 2016⁹¹ — were necessary to renovate the utility and to replace the financing option lost when California closed the city’s redevelopment agency.⁹² But this is only part of the story.

Consider that the deal involved a total upfront capital investment of \$177 million, with \$7 million coming from the utility’s existing reserves and the rest from the concessionaire.⁹³ Of this investment, only about 40 percent was for improvement projects: \$41 million for

Figure 2. How Did Rialto Plan to Use the Upfront \$177 Million Capital Investment From Privatizing Its Utility Authority?



utility upgrades and \$30 million for lease payments to the city, which was going to use the money on other projects. The rest of the money, \$106 million, was going to be used to cover the costs of refinancing the existing debt, issuing new debt, paying legal and other transaction costs, offsetting increases in operating costs and mitigating rate increases during the early years of the deal (see Figure 2).⁹⁴ Thus, costs specific to privatization were a main factor driving the rate increases.

For example, through the privatization, Rialto refinanced its utility's low-cost public debt with expensive private capital and increased the utility's total liabilities. It had to retire about \$27 million of existing low-cost debt, which had an average interest rate of 3.8 percent (see Table 2). At the same time, the city signed up its residents to repay the concessionaire's \$170 million capital investment with an interest rate of 8.6 percent, which includes a 19.6 percent return on its equity investment.⁹⁵

At this higher financing cost, ratepayers will have to pay about \$16 million a year to cover the \$170 million capital investment through the privatization. In contrast, public financing of the capital improvements would have cost less than half that (see Figure 3). That is, the city could have saved its residents more than \$8 million a year if the utility had simply remained public, kept the existing debt and issued revenue bonds to finance the \$41 million of planned capital improvements and the \$30 million that the city received as the upfront payment in the privatization scheme.⁹⁹

Figure 3. Annual Cost of Capital Investment in Rialto: A Comparison of Public and Private Financing of the \$30M Lease Payment, \$27M of Existing Debt and \$41M of System Upgrades

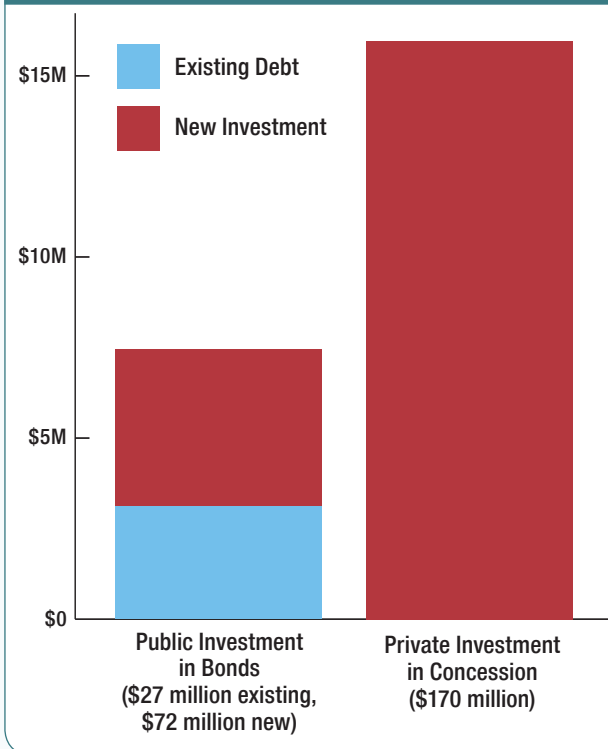


Table 2. Capital Cost Comparison for the Concession of Rialto Utility Authority
(Preliminary Figures, March 2012)*

	FINANCING SOURCE	AMOUNT	COST	WEIGHTED COST
Defeased Public Debt	Installment Sale	\$13,970,000	4.6%	2.3%
	State Revolving Fund Loan	\$10,141,000	2.5%	0.9%
	Revenue Bonds	\$3,322,000	4.4%	0.5%
	TOTAL	\$27,433,000		3.8%
New Private Capital	Tax-Exempt Debt	\$41,037,000	6.1%	1.5%
	Taxable Debt	\$103,494,000	6.9%	4.2%
	Equity (pre tax)	\$25,505,000	19.6%	2.9%
	TOTAL	\$170,036,000		8.6%

DATA SOURCE: STEEL, ROBB R. ET AL. CITY OF RIALTO. AGENDA REPORT FOR THE CITY COUNCIL/RUA MEETING OF MARCH 27, 2012. TAB 2. MARCH 22, 2012 AT 15.

***Note:** Because the city has not publicly reported final capital costs, only preliminary figures are included in the above table. The concessionaire has reported lower borrowing costs through a private placement with a 5.5 percent coupon,⁹⁶ which would reduce the weighted cost of capital by 100 basis points, with all else constant. However, using the revised capital charge limit of \$15.65 million that customers would be obligated to pay each year,⁹⁷ and the company-reported final cost of debt and investment of \$172.1 million,⁹⁸ Food & Water Watch calculates that the actual weighted cost of capital would be 8.3 percent, with a pre-tax return on equity of as much as 23.8 percent.

Government officials pursue privatization without open public discussions about the proposal beforehand. According to Miranda, the government official pushing the deal often makes unilateral and heavy-handed decisions to fast track it, while a “small cadre of government officials” negotiates and signs the contract behind closed doors and without public approval.¹¹¹ Government officials also suppress public participation by refusing to disclose important information, including details about the potential private operators and about how the government will select the winning bid.¹¹²

Making matters worse, privatization schemes can be inherently opaque. Bloomfield outlined three major barriers to transparency in long-term privatization contracts:

- The “sheer complexity” of the privatization contract, which makes taxpayers dependent on public officials, and the privatization consultants, for information about the implications and effects of the deal,¹¹³
- The “willingness of some public officials and consultants to obscure or misrepresent the real costs and risks of long-term contracts;”¹¹⁴ and
- The “lure” of private investment and concession fees as off-budget-financing approaches that “enable local government to borrow funds without regard for local restrictions on debt.”¹¹⁵

By limiting public knowledge about the deal, government officials severely undermine the public’s ability to weigh in on the fate of their essential water and sewer services.¹¹⁶

“Engineered Ignorance” and Allentown, Pa.

But privatizers sometimes do more than just limit public knowledge. Some public officials have deliberately misled the public about the costs and consequences of privatization. According to Bloomfield, these officials engage in what John Donahue, a public policy scholar at Harvard’s Kennedy School of Government, has called “engineered ignorance.”¹¹⁷ Bloomfield defined engineered ignorance as “public ignorance resulting from deliberate deception on the part of public officials and others.”¹¹⁸

A common way that public officials engineer ignorance in water privatization plans is through budget gimmickry. They deliberately deceive the public by claiming that privatization allows them to balance the budget without burdening taxpayers. While taxes may not directly increase under a privatization scheme, taxpayers are still responsible for repaying any upfront payment to the

Chicago’s Parking Meter Privatization: Worst Case or the Norm?

“While we do not question the seriousness of the City’s budget problem that was presented in Fall 2008 because of the recession, the hasty, ‘crisis’ nature of the decision-making process meant that short-term budget problems and the large upfront payment the City was receiving overshadowed all other legitimate, long-term, public interest issues — the exact concern raised in the best [public-private partnership] studies.”

— **Office of the Inspector General of Chicago, III.**, in an analysis of the lease of the city’s parking meters, 2009¹²⁶

After taking over the Chicago parking meter system in 2008, a Morgan Stanley-led consortium quadrupled rates in some areas and began charging for parking on Sundays, outraging consumers.¹²⁷ The city received a concession fee of \$1.15 billion, which it used to help balance its budget, but analysts expect the consortium to make about 10 times that amount over the course of the 75-year contract.¹²⁸ It is understandable why the city’s inspector general characterized the lease as “a dubious financial deal.”¹²⁹

government with interest. They just pay through their water bills instead of their tax bills. Leonard Connors, a former New Jersey state senator, has called this “taxing through the tap.”¹¹⁹

A telling example of an elected official’s attempt to engineer ignorance occurred in Allentown, Pa. In August 2012, Ed Pawlowski, the mayor of Allentown, told residents about his scheme to pay down the city’s liabilities by leasing the water and sewer systems for 50 years. He tried to sell the public on his plan by claiming that because a lease would generate upfront funds without a tax increase, “... the burden of this debt is not paid for by the citizens of Allentown.”¹²⁰ This is false. Allentown citizens would bear the burden of repaying the concession fee through their water bills; in fact, they would have to pay more with a lease than with a simple tax increase because of the interest rate on the concession fee.¹²¹

Pawlowski also misled the public about how much water rates could increase under the proposed concession agreement. His administration repeatedly said that the concession would cap rate increases so that rates would increase by no more than 2.5 percentage points over inflation.¹²² The proposed contract, however, clearly

indicated that the capped rates would be just one line item on a customer's water bill. Specifically, the contract authorized an additional charge to cover the cost of capital improvements,¹²³ which are a major component of a utility's budget. Water systems are the most capital-intensive utility, having to invest about \$3.50 in capital improvements for every dollar of revenue.¹²⁴

Food & Water Watch's analysis of the proposed concession contract found that after incorporating a conservative estimate of these capital costs for a private company, the typical household would experience a 15-fold increase in its annual water and sewer bill by the end of 50-year deal; after adjusting for inflation, in constant 2013 dollars, this would increase household bills by at least 418 percent.¹²⁵

By intentionally omitting the extra charges for capital improvements under the deal, Pawlowski presented an inaccurate and deceptive picture of the financial implications of his proposal.

In April 2013, the Lehigh Valley Authority won the auction for city's lease, outbidding American Water and United Water.

Taxing Through the Tap

"The company getting the lease and leasing the water supply would naturally put the concession money in the rates, so some grubby mayor — and I am a mayor (of Surf City), so I can say this — could balance the budget on the lease. It was basically taxing through the tap."

— **Leonard Connors**, a former New Jersey state senator, explaining his opposition to the New Jersey Water Supply Public-Private Contracting Act, passed in 1995, that authorized water system leases and concession fees¹³⁰

Some government officials use water privatization as a way to transfer revenue from water rates to fund general government. This circumvents legal limitations on taxes and public protections for taxpayers, and can increase the financial burden on residents who are less well-off.

Taxes are the vehicle that governments use to raise funding for general purposes, such as police and fire departments. With taxation, there does not have to be a connection between the person taxed and the use or beneficiary of the revenue.¹³¹ Because of this, taxation — on income, property, etc. — typically includes special provisions to protect taxpayers, including limitations on taxation without express authorization, as well as requirements that ensure uniformity across geography and across income categories.¹³²



In contrast, water rates are user fees, not taxes. According to Hugh Spitzer, an affiliate professor at the University of Washington School of Law, "From a legal standpoint, these various user charges [user fees] are distinctly different from taxes — different both in terms of who bears the burdens and benefits and in terms of the distinct legal protections surrounding and regulating the use of those charges."¹³³

In the *Florida Law Review*, Laurie Reynolds explained that a user fee is supposed to "correspond to the cost of the governmental activity being funded rather than reflect a general government desire to raise revenue."¹³⁴ Charging user fees that are higher than the cost of service to fund other government purposes may be considered an unconstitutional taking or impermissible tax in some states, including Michigan and Washington.¹³⁵ Courts in other states, however, have sanctioned the practice,¹³⁶ and thus, as Reynolds observed, "... provide a convenient way for local governments to raise general revenues without having to worry about anti-tax strictures."¹³⁷

Some local officials seem to view water privatization as a way to avoid popular anti-tax sentiment. Spitzer noted, however, "... if an imposition is made to raise money for general public purposes, it is a tax."¹³⁸ Thus, water rate increases that accompany privatization deals should be considered a "wolfish tax which is cloaked in the garb of a sheepish fee," as a West Virginia state supreme court justice once called a fire service protection fee.¹³⁹

Governments foster inequality when they use water rates and other user fees as “an all purpose revenue raising device.”¹⁴⁰ That is because user fees are more regressive than most taxes,¹⁴¹ so using user fees as a substitute for taxation would, the U.S. Governmental Accountability Office explained, “shift additional burden on those less able to pay.”¹⁴² This is especially true for water rates because lower-income families tend to have larger household sizes and older homes — two factors that drive up water usage and thus water bills.

Public’s Lack of Bargaining Power

“Putting us against the investment banks in a deal like that is like having little leaguers play the New York Yankees.”

— **Thomas Allen**, a Chicago alderman, discussing the lease of the city’s parking meters with *Bloomberg BusinessWeek*, 2010¹⁴³

Local governments have less bargaining power than national or multinational companies, especially the large financial institutions that finance privatization deals.¹⁴⁴ Even without fiscal pressure, municipalities usually lack the skills necessary to effectively negotiate long-term privatization contracts,¹⁴⁵ and a cash-strapped municipality can have particular difficulty affording adequate legal and other assistance necessary to evaluate and negotiate a deal.¹⁴⁶ Because of the complexity of these long-term privatizations, Aidan Vining *et al.* observed, “Indeed, one way of thinking of P3s [public-private partnerships] is simply government contracting out under relatively unfavorable conditions.”¹⁴⁷

Privatization Consultants

“Their end result is always the same: Sell assets, sell assets.”

— **Brad Koplinski**, a Harrisburg city councilmember, said of the consulting firm Scott Balice Strategies, in the *Wall Street Journal*, 2010¹⁴⁸ (In 2011, Scott Balice Strategies was acquired by PFM,¹⁴⁹ which the following year became the lead advisor on the proposed deal in Allentown, Pa.¹⁵⁰)

Even when local governments pay high fees for legal and financial advice, it does not guarantee that the advice is accurate and trustworthy. Lynn, Mass., spent more than \$3 million on consultants as it negotiated a deal to privatize its wastewater facilities for 20 years, but according to Robert Cerasoli, the Inspector General of Massachusetts in 2001, “[U]nfortunately, this expensive investment in expertise has not protected the ratepayers from a bad

deal.”¹⁵¹ His audit found that the privatization was “likely to result in unnecessarily high costs for ratepayers.”¹⁵²

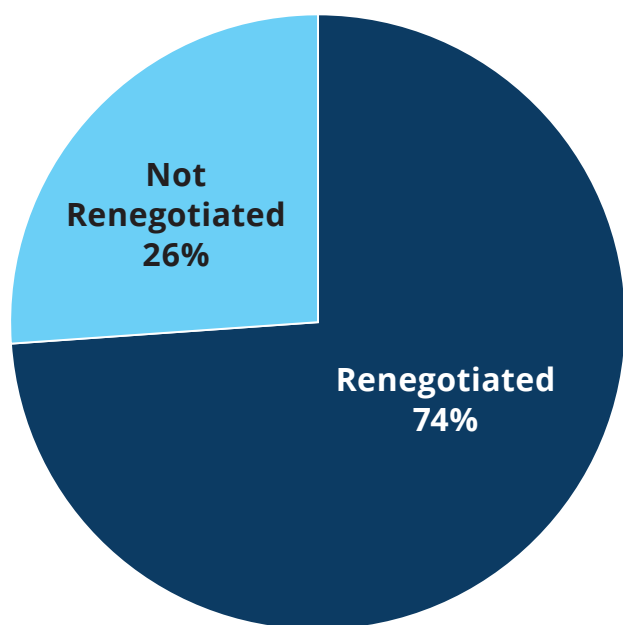
The likely reason is that financial advisors are not impartial judges of privatization contracts. Even though they are not bidding on the privatization project, they still have a strong incentive to push through a big deal because their compensation as a consultant often depends on it. Their payment typically includes a “success based” or “contingent” fee that they receive only if the privatization goes through. This fee is usually a percent of the transaction value,¹⁵³ so the advisors can increase their earnings by recommending the biggest deal possible, regardless of the consequences for the public.¹⁵⁴ This presents a serious conflict of interest. Local governments in fiscal duress, eager for a windfall, are especially vulnerable to being misled.¹⁵⁵

Incomplete Contracts and Renegotiations

Long-term contracts for water systems are complex.¹⁵⁶ They require specific contract language to ensure adequate service, but there is an inherent difficulty in drafting specifications for the service of a full utility.¹⁵⁷ Even with lengthy and expensive negotiations,¹⁵⁸ these complex contracts are “invariably incomplete” and must be revised and renegotiated over time to account for changing circumstances and new developments.¹⁵⁹ This creates inefficiencies,¹⁶⁰ and further inflates contracting costs.¹⁶¹



Figure 4. Water and Sanitation Concession Contracts in Latin America



DATA SOURCE: GUASCH, 2004

A World Bank study of concessions in Latin America and the Caribbean found that three-quarters of the water and sanitation contracts were renegotiated, typically within the first two years.¹⁶² Specifically, renegotiations occurred in 102 of the 137 water and sanitation concession deals from the mid-1980s to 2000,¹⁶³ with the renegotiation occurring 1.6 years into the deal, on average.¹⁶⁴

Renegotiation can be a serious problem for governments because they give up what little bargaining power they have when they enter into long-term privatization deals. When these incomplete contracts come up for renegotiation, the private contractor will have even more leverage over the government and will tend to “behave opportunistically” at the public’s expense.¹⁶⁵

Some companies anticipate this advantage from the outset. According to Elizabeth Brubaker, “[O]pportunities for contractor-led renegotiation may attract bidders that excel at renegotiation rather than at efficient service provision; they may encourage competitors to low-ball their bids in the expectation that they will recover their costs at a later date.”¹⁶⁶

According to the World Bank study, more than 60 percent of renegotiations of water contracts occurred at the request of the private operator,¹⁶⁷ and the results of the renegotiations usually favored the private operator.¹⁶⁸ The three most common outcomes were:

- Delayed investments by the concessionaire (69 percent of renegotiations);
- Reduced investments by the concessionaire (62 percent of renegotiations); and
- Increased prices for consumers (62 percent of renegotiations).¹⁶⁹

Other Factors and Considerations

“In summary, the evidence indicates that the advocates of privatisation have attempted to oversimplify the issues associated with privatisation. They have done so by simplifying the nature of the activity analysed and the scale, scope and complexity of the management and regulatory controls required to manage it in the public interest. In other words, the costs associated with privatisation have been significantly downplayed.”

— **Michael Johnson** at the University of New South Wales, in a review of government privatization in Australia, 2008¹⁷⁰

No Efficiency Gains

Numerous studies have established that private operators of water and sewer systems are no more efficient than public operators, and that privatization does not reduce costs.¹⁷¹ Yet some public officials have used absurd claims about private sector efficiency to try to rationalize privatization plans.

The county executive of Nassau County, N.Y., for example, suggested that a private company could cut the cost of operating the county’s sewer system by 30 to 40 percent — enough to profit from its investment and give the county a \$750 million concession fee, without increasing user fees above the rate of inflation.¹⁷² Meanwhile, a member of the authority that oversees the county’s finances scoffed at the claim, saying, “... well, anyone who believes that, I have a coliseum in Hempstead I would like to sell to them.”¹⁷³

Claims about cost savings through water privatization typically fail to hold up under independent scrutiny.¹⁷⁴ After mentioning several cases where independent evaluations debunked the cost savings figures of privatization advocates, Bloomfield concluded, “[T]hese troubling examples underscore the public’s vulnerability to erroneous, biased cost-savings claims that appear to be aimed at selling long-term contracts to the public rather than informing the public of the full financial implications of long-term contracts.”¹⁷⁵

When private operators do cut costs, it is usually by downsizing the workforce or reducing employee benefits.¹⁷⁶

As a result, these changes are likely to worsen service, for example, by slowing responses to customer service requests or broken water lines. In addition, such cost cutting likely translates to private profits, not savings for consumers.¹⁷⁷

A state investigation of the lease of the Lynn Water and Sewer Commission in Massachusetts found that the company planned to cut the workforce by 20 percent and “... any cost savings achieved through future staff reductions will produce increased profits for U.S. Filter [the company] rather than lowering rates for Commission ratepayers.”¹⁷⁸

Inadequate Risk Transfer

Another common claim is that privatization shifts risks to the private sector, so despite the higher cost of private financing, the public may gain based on a risk-adjusted cost.¹⁷⁹ But, the models that seek to account for risk transfer are flawed because they fail to treat risk as probabilistic.¹⁸⁰ Also, it is not possible to share or transfer many risks, particularly environmental and political risks.¹⁸¹

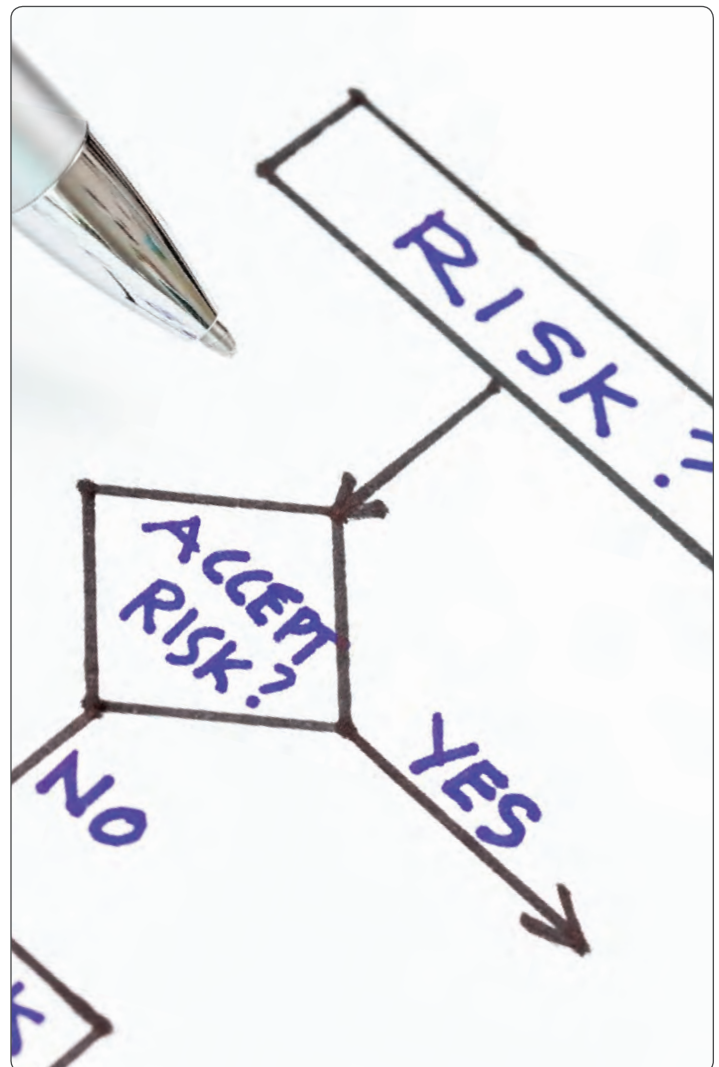
For example, in long-term privatization contracts, ratepayers and the government bear the risk of unforeseen changes in law and economic conditions.¹⁸² Even when the government sells a system, it still retains some risk. In an article about wastewater privatization, Douglas Herbst listed several risks that stay with the municipality after the sale of a wastewater treatment plant: “For example, the risk for change in law and other unforeseen events and the quantity and quality of the influent wastewater still rests with the municipality. The municipality may have to indemnify the new owner for all environmental liability prior to the sale.”¹⁸³

According to a review of major North American public-private partnerships by Aidan Vining *et al.*, “Private sector participants frequently go to considerable lengths to *avoid* risk...”¹⁸⁴ Private entities have even threatened or declared bankruptcy to avoid large losses.¹⁸⁵ A concessionaire often forms a “stand-alone corporation that is isolated from their other corporate activities, thereby reducing the costs of bankruptcy if it becomes necessary.”¹⁸⁶ Concessionaires also often pass on many project delivery and operating risks to subcontractors.¹⁸⁷

When the companies do assume some risks, they are “adept at ensuring that they are fully compensated for risk taking,” Vining *et al.* added.¹⁸⁸ Operators will try to pass on risks to consumers by increasing rates or reducing service quality.¹⁸⁹ Contract provisions can further limit risk transfer by directly or indirectly guaranteeing the company’s profits and allowing for contract renegotiations.¹⁹⁰

Concession contracts also often allow the company to apply a surcharge to pay for costs associated with unforeseen events and regulatory changes. For example, a proposed concession agreement for the water and sewer systems in Allentown, Pa., would require the city to compensate the concessionaire for lost revenues in certain situations, such as if the city modifies or changes operating standards or takes an action that has a “material adverse effect” on the concessionaire.¹⁹¹ A city spokesperson acknowledged this, telling the *Express-Times*, “... it’s logical that if we make a deal and get a big payment, we have to compensate if we diminish their investment.”¹⁹²

The city of Chicago is not bending over backward to accommodate the private consortium set to make huge profits from taking over the city’s parking meter system. In December 2012, the city was fighting claims by the concessionaire of the parking system that the city owed it \$61 million for revenue lost because of city policies and activities, including giving free parking to handicapped drivers and closing streets for festivals and repairs.¹⁹³



Hidden Public Costs

The process of privatizing water systems is complicated, expensive and time consuming,¹⁹⁴ and the cost of monitoring a private water operator's performance can be substantial.¹⁹⁵ Other public costs include contract procurement and administration, conversion of the workforce from public employees to employees of the private contractor, unplanned work, and the private use of equipment and facilities owned by the public.¹⁹⁶

Governments often exclude many of these costs when deciding whether or not to privatize a public service.¹⁹⁷ But, these costs add up and become significant. One study of water and sewer systems estimated that transaction costs range from 2 percent to 10 percent of total project costs, although it noted that "consistent and comparable data on transaction costs are rare because of the proprietary nature of the data."¹⁹⁸ For small municipalities, these costs can be prohibitively high,¹⁹⁹ and for very large regional wastewater treatment systems, the U.S. Environmental Protection Agency said, "... the process may become so complex that it would be difficult to implement."²⁰⁰

Public operation is the best option when privatization contracts are highly incomplete and transaction costs are considerable.²⁰¹

Conclusion and Recommendations

Public officials should not privatize water and sewer systems to offset financial shortfalls and fund general government. These privatization deals reduce transpar-

ency and accountability in government activities and water service provision, and they increase the long-term costs borne by the public. They are shortsighted, irresponsible and costly.

Politicians may find privatization appealing because it gives them money to spend now while avoiding the tough decisions needed for real financial stability. This may help their image, but water and sewer services are too important for public health to be sacrificed for short-term political gains. Public officials should be stewards of our public resources and work to ensure the best and most affordable water service possible.

To help protect the public, policymakers must ensure *real* public involvement in the process:

- **Transparency:** The public should have access to all studies, proposals and information of the government, the privatization consultants and the bidding companies that the government used to develop, assess and evaluate water privatization plans and contracts.²⁰²
- **Public participation:** The public should be able to weigh in at every step of the privatization process. They should be able to review and comment on all initial plans to privatize, assessments of those plans, proposals, bids, project selection criteria and analyses, and draft and final contracts. The government should consider, review and respond to all public comments and suggestions.²⁰³
- **Public approval:** Governments should require a public referendum on any proposed lease, concession or sale of public water or sewer systems.



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