TEXAS WATER DEVELOPMENT BOARD

MARKET STRATEGIES FOR IMPROVED SERVICE BY WATER UTILITIES

May 28, 1999

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Texas Water Development Board

Market Strategies for Improved Service by Water Utilities

Acronymns

AMSA	Association of Metropolitan Sewerage Associations
AMWA	Association of Metropolitan Water Agencies
AWBD	Association of Water Board Directors
AWWA	American Water Works Association
DBO	Design Build Operate
E.O.12803	Executive Order 12803
EPA	Environmental Protection Agency
IRS	Internal Revenue Service
LCRA	Lower Colorado River Authority
NPDES	National Pollutant Discharge Elimination System
O&M	Operations and Maintenance
OMB	Office of Management and Budget
OMI	Operations Management Inc.
PSG	Professional Services Group
RCRA	Resource Conservation and Recovery Act
SB 1	Sebate Bill 1
SRF	State Revolving Fund
TAC	Texas Administrative Code
TML	Texas Municipal League
TMUA	Texas Municipal Utilities Association
TNRCC	Texas Natural Resource Conservation Commission
TRWA	Texas Rural Water Association
TWCA	Texas Water Conservation Association
TWDB	Texas Water Development Board
TWUA	Texas Water Utility Association

Executive Summary

Increasing numbers of Texas cities are having problems with their water and wastewater systems due to population growth, limited funding, infrastructure deterioration, high operating costs, regulatory requirements and shortages in skills and technology.

These problems act in harmony with new legislation for competitive market and privatization solutions. No longer are competition and privatization "buzz" words that are exclusively restricted to the telecommunications, airline, natural gas and electric industries. Competition and privatization are now also being encouraged by new laws to solve city operation, maintenance, funding and infrastructure problems in the municipal water and wastewater sector. As new federal and state legislation remove barriers to water and wastewater competition and contractual agreements, growing numbers of cities are looking to partnerships with private companies for water and wastewater services and operations.

With significant major industry changes occurring in the state, cities need to think about how their traditional responsibilities are affected by new regulations. Administrators, regulators and legislators must think outside the current venues of the last thirty years to visualize a new market and regulatory venue where legislation and regulations will have to prepare for future business conditions. Understanding competitive marketing strategies enables informed cities to benefit from a new system of market rules and increased competition from private water and wastewater services providers. Uninformed cities will either miss benefits, or enter into poor contractual agreements.

The purpose of this report is to describe current and emerging water and wastewater competition and privatization strategies, summarize conclusions and make recommendations on how Texas cities can effectively choose a strategy for implementing cost effective water and wastewater improvements. The contents of the report are summarized below:

Chapter 1 describes the current state of municipal water and wastewater funding and infrastructure requirements that show cities' need to seek private sector assistance to increase efficiency and performance. The Introduction is located at page 7.

Chapter 2 provides background on key government initiatives to facilitate solutions that improve municipal water and wastewater services, infrastructure and lower costs. The timeline highlights some of these key initiatives that are discussed at length beginning on page 10.

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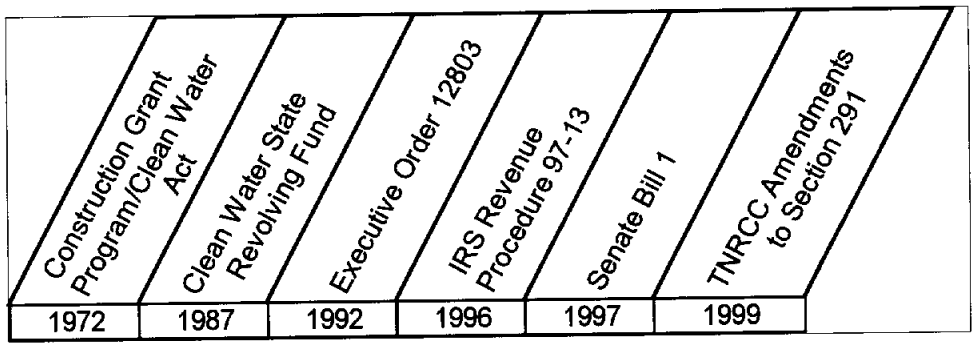


Construction Grant Program/Clean Water Act: Cities' interest in private operations agreements began to increase in 1972 with passage of the Environmental Protection Agency's (EPA) Construction Grant Program and the Clean Water Act.

Clean Water State Revolving Fund Program: Implementation of the Clean Water State Revolving Fund Program (SRF) in 1987 heightened municipal interest in infrastructure investment by increasing availability of low-interest loans.

Executive Order 12803: Executive Order 12803 was issued in 1992 to increase public and private interest in privatization of system assets.

Internal Revenue Service Revenue Procedure 97-13: In 1997, the Internal Revenue Service (IRS) implemented Revenue Procedure 97-13 that removed limits on long-term contracts.

Senate Bill 1: 1997's Texas Senate Bill 1 enables regionalization, among other things.

Amendments to TAC Section 291: Most recently, in 1999 the TNRCC approved amendments to Section 291 of the TAC to promote regionalization and consolidations through positive acquisition adjustments.

Chapter 3 details the four general types of competitive marketing strategies that are available to cities. Summarized below are the strategies that have been identified and implemented in Texas and the nation. Chapter 3 begins on page 14.

Competitive Market Strategies
Managed Competition (see page 18)
City employees plan and develop strategies for improving municipal operations to implement efficiencies that are competitive with private service operations companies. The option may include competing with private operators in a competitive bid process to provide municipal water and/or wastewater services.
Operations Contract (see page 22)
Contract agreement with a company for operations management . Agreement is for a fixed period of time. Scope of services are limited to the terms defined in the agreement.
Lease (see page 29)
Contractual transfer of asset ownership to a company to operate facilities for a specific period of time.
Asset Sale (see page 31)
The sale of infrastructure to a company transfers title of the asset in perpetuity. Revenues from the sale can be used to retire outstanding debt, finance improvements or transfer revenue to the general fund.

In deciding whether there are areas for improving water and wastewater system operations and services, cities must first weigh some key considerations regarding the extent of their need, including the infrastructure condition, capital funding, regulatory compliance, required technology and expertise. The table below provides some examples of questions that cities should consider in weighing their need for assistance through the competitive market. Further discussion of key issues regarding cities' possible needs can be found at page 17.

Indications of Need for a Competitive Market Solution	
Issue	**Need**
Efficiency	Can private companies operate water and wastewater systems more efficiently and at lower cost?
Capital	Is there adequate access to funds to meet compliance and operating costs? Can private financing access funds otherwise not available?
Rates	Will costs put upward pressure on retail rates?
Technology	Is there need for technical expertise to perform complex treatments? Do companies offer cost effective technical solutions?
Economies	Are scale economies for operations and purchasing materially different for the city than a broader based company?
Compliance	Are there existing or expected environmental compliance concerns that may require out-sourcing?
Rate pressure	Can rate pressure be mitigated by competitive options?
Planning-Growth	Will load growth increase the need for infrastructure & planned improvements?

Chapter 4 documents the range of interviews that were conducted with Texas and U.S. cities, company representatives, federal/state regulators, legal experts and industry association representatives during the study. The interviews were organized into stages, or "phases" where different groups of industry professionals were interviewed for information about privatization and competitive marketing strategies at different stages of the study. Each interview stage in the process, results and conclusions are described below. Chapter 4 begins on page 35.

Executive Summary - Interview Summary

Phase 1 Interviews (see page 37)	
Purpose	Water industry associations and companies operating in Texas were interviewed to learn about current practices and membership in Texas.
Conclusion	Cost savings, operational efficiencies, system improvements, and environmental compliance are possible through the company's expertise, experience, scale, and experience

Phase 2 Interviews (see page 40)	
Purpose	Texas cities identified during Phase 1 interviews were contacted to learn about "best practices" operations contracts.
Conclusion	Virtually all cities expressed satisfaction with operation contracts. Quality is appropriate. Agreements allow cities to lock in savings. Comprehensive terms and detailed language are essential for successful results. Important contract terms and rights include accountability, enforcement and monitoring. With good contracts, benefits result through economies of scale, improved system management, technical expertise, cost effective operations, maintenance and improvements. Estimated savings between 20% to more than 40%.

Phase 3 Interviews (see page 44)	
Purpose	EPA and IRS representatives were contacted about Executive Orders and IRS Revenue Procedures intended to promote competition and privatization.
Conclusion	IRS 97-13 best improves privatization opportunities by longer term agreements. In E.O.12803, there is concern that EPA's position on jurisdiction over contract agreements with concession fees will cause delays and discourage contracts.

Phase 4 Interviews (see page 50)	
Purpose	EPA, AWWA, AMWA and other representatives were contacted to identify 60 cities that have implemented privatization, competition and other competitive market strategies in the nation.
Conclusion	The surveys identified a nationally dispersed group of 60 cities that have implemented privatization and competition agreements that were contacted in Phase 5.

Phase 5 Interviews (see page 52)	
Purpose	60 cities identified in Phase 4 were contacted to learn about their specific privatization, sale, lease and managed competition experiences.
Conclusion	Cities that have needs for cost savings, improvements, environmental compliance, technology expertise or financing benefited from competitive solutions. Each city's unique needs made each solution unique. Cost savings, operational benefits and technical capabilities were clearly reported under operations contracts. Carefully written contracts with specificity in language, terms, expectations, monitoring, accountability, and enforcement are necessary.

Phase 6 Interviews (see page 56)	
Purpose	TNRCC, TML and private legal counsel were interviewed to identify potential statutory amendments to facilitate privatization and/or competition.
Conclusion	No recommendations were offered for changes to existing Texas statutes for improving opportunities for privatization during the interviews. A full legal review of existing Texas statutes would be needed to identify recommendations for changes to existing statutes to facilitate privatization.

Chapter 5 summarizes the key policy conclusions and findings in the study. A full discussion of the study's conclusions is located beginning at page 61. There is a clear consensus that cities' needs for cost savings, improvements, expertise, compliance, financing and operations can be solved through careful choice and negotiation of a competitive market solution. Consensus opinions also concurred that in weighing options, numerous technical and financial factors must be considered, as well as attitudes, public acceptance and political concerns. Results of the surveys indicate that the vast majority of competitive marketing strategies in Texas and the nation are contractual agreements with private operating companies. To a much lesser extent municipal sales and internal employee/process improvements were also implemented as competitive solutions.

If urgency or severity are key considerations in the need for a competitive market solution, then an operations contract or asset sale are the likely solutions. Factors such as EPA sanctions for compliance violations, need for costly infrastructure improvements, technical expertise, financing needs and high operating costs may narrow the range of options available to a city.

A common issue reported by many cities as a critical prerequisite for implementing a successful contract was the need for detailed contractual language and specific clauses to clearly define work requirements and allow for ongoing performance monitoring. Summarized below are specific examples of recommended contract terms. A comprehensive listing of recommended contract terms is provided beginning on page 73.

Recommended Contractual Elements

Performance standards	Performance penalties
Performance monitoring	Termination rights
Monthly reporting	Contract changes
Billing review	Cost responsibility
Services rendered	Payment schedules

Opinions on length of contract were divided between short-term versus long-term agreements. Some cities valued shorter contracts to permit competition between operators and increase incentives to perform. In contrast, other cities preferred longer-term deals to increase savings, improve cooperative planning with the company, incorporate infrastructure improvements and stabilize rates.

In contrast to partnering with a private company, a certain number of cities were motivated to maintain operations and solve its needs internally. In these cases, cities decided to implement an employee competition strategy that included internal review and improvement.

Regarding government measures that were implemented to facilitate competitive market solutions, responses clearly indicated that IRS Revenue Procedure 97-13 (97-13) was the most effective governmental measure promoting competition. 97-13 changed the limit from 5 years to 20 years for management contracts without risk to tax exempt status. This changed greatly improved cities' ability to implement long-term planning, savings and asset improvement plans within the context of a contractual agreement.

Chapter 6 presents three recommendations that respectively assist cities in deciding, choosing and implementing a competitive market solution. Regarding potential statutory amendments to facilitate privatization and/or competition, no recommendations for changes to existing Texas statutes were offered during interviews with selected legal counsel in Texas. A full legal review of existing statutes would be needed to appropriately identify recommendations for changes to existing statutes to facilitate privatization. Chapter 6 is located at page 65 of the study.

The first recommendation encourages cities to perform a systematic, self-evaluation of needs to determine if a city can benefit from privatization or a competitive market solution.

The second recommendation provides a three-step process for selecting a competitive market solution. The first step establishes a detailed action plan and timeline for evaluating alternative competitive options. The second step addresses competitive bid solicitations and the option of internal municipal improvements as a possible private sector solution. This step provides a detailed listing of issues and requirements for cities to use in developing a competitive bid solicitation and in formulating a strategy for evaluating and scoring bids.

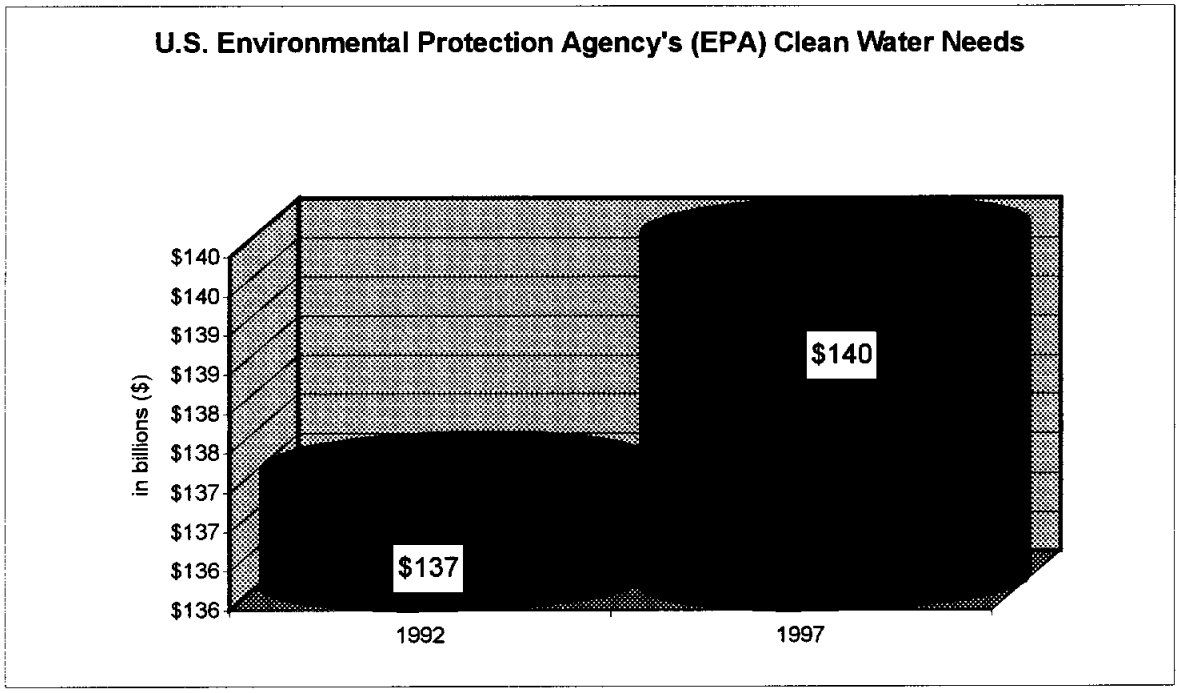
The study's third recommendation presents a detailed listing of key contractual terms and related financial considerations that a city should consider using in negotiating and constructing a contractual operations and improvements agreement with a private operating company.

Introduction

Aging systems, increasing customer demand, financial concerns and compliance regulations are placing increased pressures on cities that provide water and wastewater services to their customers.

Nationally, the EPA's 1992 Clean Water Needs Survey states that more than $137 billion in new wastewater infrastructure construction is necessary to satisfy all eligible for State Revolving Fund categories through 2012[1]. In 1997, the EPA estimated that approximately $140 billion will be needed to meet State Revolving Fund needs through 2016.[2] Figure 1 compares EPA's 1992 and 1997 Clean Water Needs Survey estimates for project new wastewater infrastructure construction:

Figure 1

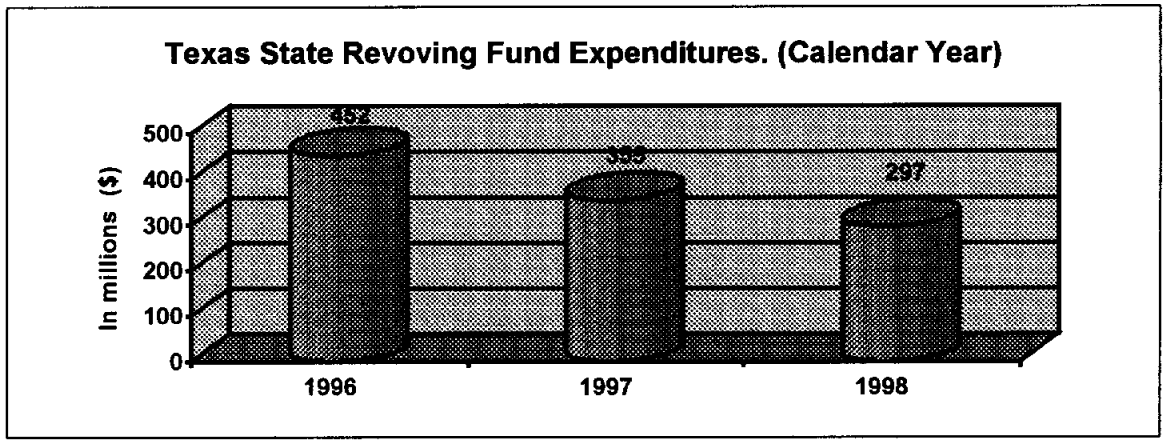


Data Source: 1992 EPA Clean Water Needs Survey
1996 EPA Clean Water Needs Survey

While the trends indicate increasing municipal needs for infrastructure investment, Figure 2 shows that SRF expenditures have gradually declined over the last three years[3].

[1] U.S. Environmental Protection Agency, *1992 Needs Survey Report to Congress* (Washington, D.C., October 1993).
[2] U.S. Environmental Protection Agency, *1996 Needs Survey Report to Congress* (Washington, D.C., September 1997).
[3] Texas Water Development Board, March 1999.

Figure 2



Data Source: Texas Water Development Board

These trends and projected levels of need and expenditures indicate that funding programs are a declining and insufficient source of capital for cities to rely on for meeting water and wastewater infrastructure needs[4]. In Texas and the nation, these pressures are causing cities to widen their search into private sector and internal solutions to increase efficiency and implement infrastructure improvements, without adversely impacting customer services and bills.

Numerous interviews with cities that have implemented actual, private sector and internal competitive strategies prove that well-informed, well-prepared cities can improve their compliance, infrastructure and financial performance without exposing customers to extra risk. These interviews indicate that many cities have already injected additional efficiencies, savings and capital into water and wastewater services and operations through marketing and competition efforts. It is hoped that this report will help cities and legislators understand how competitive marketing strategies can generate savings, efficiencies and infrastructure benefits.

A. Scope of Work

Listed below is a description of the scope of work performed in the study. Included in each chapter of the report are descriptions of research performed, survey methodology, conclusions and recommendations, including tables, graphics and references.

[4] There are other sources of federal agency funding available than the SRF for infrastructure improvements, buts this availability does not of mitigate the trend of declining funding and increasing needs that has been evidenced in recent years.

Following Chapter 1's Introduction, Chapter 2 presents a background that reviews initiatives and regulations that have either promoted or impeded improvements in city water and wastewater services and infrastructure. Chapter 2 begins on page 10.

Chapter 3 provides a detailed discussion on the types of competitive marketing strategies that are available to cities and describes how different market competition strategies work. Chapter 3 begins on page 14.

Chapter 4 documents the survey procedure that was used in this study and summarizes the interviews of Texas and U.S. privatizing cities, company representatives, federal and state regulators, legal experts and industry association representatives. Chapter 4 begins on page 35.

Chapter 5 presents the report's conclusions that are based on research and surveys that were performed in this study. Chapter 5 begins on page 61.

Chapter 6 presents three sets of recommendations that offer cities a roadmap to assist in deciding need and choice among competitive water and wastewater strategies. Chapter 6 starts on page 65.

Reed-Stowe & Co., Inc. is an environmental economic and financial consulting firm that specializes in providing services to the public sector with regard to water, wastewater, solid waste, gas, electric, telecommunication, and stormwater drainage utility services. The firm has offices in Austin and Richardson, Texas.

In December 1997 Reed-Stowe & Co. was acquired by Navigant Consulting, Inc. (formerly the Metzler Group.) Navigant Consulting, Inc. is a leading national and international provider of consulting services to water, wastewater, solid waste, gas, electric and other utility related industries. Other Navigant Consulting, Inc. companies include Reed Consulting Group, Bookman-Edmonston Engineering, Inc., Resource Management International; Peterson Worldwide; and Sterling Group. Navigant Consulting, Inc. has combined revenues of over $250 million and is comprised of over 1,500 consultants.

Background

A. Summary

During the last twenty-five years, key Federal and State initiatives have been implemented to assist cities to improve water and wastewater system efficiencies, costs and infrastructure. Many of these initiatives have been geared toward reducing government barriers and increasing private sector participation in city operations:

Construction Grant Program: Cities interest in private operations agreements began to increase in 1972 with passage of the EPA's Construction Grant Program and the Clean Water Act[5]. (See the Appendix for a copy of the EPA's Guidance on the Privatization of Federally Funded Wastewater Treatment Facilities.)

State Revolving Fund Program: Implementation of Texas' State Revolving Fund Program (SRF) in 1987 heightened municipal interest in infrastructure investment by increasing availability of low-interest loans.

Executive Order 12803: E.O. 12803 was issued in 1992 to increase interest in selling systems.

IRS Revenue Procedure 97-13: Passage of IRS Revenue Procedure 97-13 removed IRS limits on long-term contracts.

Texas Senate Bill 1: Most recently, 1997's Texas Senate Bill 1 agencies, cities and companies to promote and implement, among other things, regionalization and consolidation.

Texas Administrative Code Amendments to Section 291: The rulemaking amendments to Section 291 of the TAC in 1999 will encourage privatization and regionalization and consolidation by allowing positive acquisition adjustments associated with the costs of merging and acquiring systems.

B. Discussion

Texas water and wastewater customers are served by more than 7,000 privately owned utilities, municipal utility districts, municipal utilities and public systems[6]. The service areas range in size from small systems with less than one hundred customers to systems in Texas' largest cities.

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[5] See Appendix. U.S. Environmental Protection Agency. *Guidance on the Privatization of Federally Funded Wastewater Treatment Facilities*, (Washington, D.C., April 1998).

[6] Patrick Barta, , "Liquid Gold", Wall Street Journal, August 5, 1998. (Note: calls to the author were unable to confirm the source of the cited 7,000 figure. Discussion with the TNRCC to verify the 7,000 number indicated that the number of water suppliers in Texas is approximately 9,000 and the total number of individual systems owned by Texas suppliers is 12,333.)

Decreasing government infrastructure funding, population growth and pressures to comply with increasing regulations represent major issues that are confronting local Texas governments.

Indications that cities will be faced with increasing infrastructure demands have been documented, as in recent projections that the population will double in Central Texas within the next 20 years[7]. In addition, numerous cities across the state are facing rising needs for capital improvements in order to remain compliant with state and federal water and wastewater regulations. The problem of facing these pressures without major increases in retail rates is becoming common to cities of all sizes in Texas.

Interviews and surveys with Texas and national cities strongly indicate that private sector companies are being utilized as viable sources for funding, technology efficiency and economies of scale to meet these water and wastewater infrastructure and service needs.

The Texas Water Development Board (TWDB) was financing local water facilities since the late 1950's. In addition to the TWDB's assistance, Texas cities historically have relied on self-management and municipal funding to finance water and wastewater infrastructure and services. To assist cities, during the last 40 years, the federal government began contributing funds to cities. Since 1972, the EPA's Construction Grant Program has invested more than $67 billion nationally on wastewater treatment infrastructure[8].

The popularity of contracts started to increase by the late 1970's due to the passage of the Clean Water Act and the Construction Grants Program. Encouraged by increased city interest in wastewater treatment plant investment, private management companies intensified efforts to market water and wastewater treatment services, technology and management expertise to assist cities[9].

This trend of private sector interest continued to increase through the early 1980's. However, the momentum hit a roadblock with the passage of the Tax Reform Act of 1986 which severely discouraged private sector investment by eliminating significant benefits, including tax incentives

[7] Commentary, "Smart Growth", Austin American Statesman, December 13, 1998.
[8] U.S. Environmental Protection Agency. *Guidance on the Privatization of Federally Funded Wastewater Treatment Facilities*, (Washington, D.C., April 1998).
[9] Douglas Herbst, "The Pros and Cons of Buying and Selling Wastewater Treatment Plants", accessed November 11, 1998 online at the Water Online Web site, http://news.wateronline.com/feature-articles/psga1.html.

Regarding potential state and local statutory amendments to facilitate competition and/or privatization, no specific recommendations were made during interviews with selected private and government counsel. However, during the course of the surveys with the attorneys, other issues came up that may be of relevance to the issues of privatization and competition in Texas.

First, guidance under Senate Bill 1 was approved by the Texas legislature in 1997 to promote privatization and regionalization in Texas. Under S.B.1, the TWDB has approved state and regional water planning programs and long-term strategies to meet future supply needs while the TNRCC is implementing rules that promote viable water systems as well as consolidation and regionalization. This rule change promotes consolidation, regionalization and competitive market strategies by allowing filed rate requests for approved rate recovery of "positive acquisition adjustments" including a return on these approved acquisition costs. It is expected that this rule will have a significant effect on promoting water and wastewater utility mergers and acquisitions in the coming years. The relevant sections of these amendments include Sections §§ 291.3 and 291.31 of the TNRCC's Permanent Rules.

During the interviews, the issue of requirements for competitive bidding and asset acquisitions was raised. For most cities, the language of a city's city code dictates its ability to contract with private companies either with or without a request for proposal (RFP.) Regarding this issue of competitive bidding requirements for municipal water and wastewater services, contrasting positions reflected either support of competitive bidding or concern that in certain cases, required competitive bidding may unintentionally cause extra costs and inefficiencies through delays and extra costs.

To facilitate the acquisition of utility systems in Texas and promote mergers, regionalization, consolidations and privatization, the TNRCC implemented amendments to Chapter 291 of the Texas Administrative Code (TAC) effective February 4, 1999 that allow companies to request financial recovery of positive utility acquisition cost adjustments.

Competitive Marketing Strategies

A. Summary

The range of competitive marketing options available to cities for system operations can be grouped into four general categories;` managed competition, contract operations, leases and system sales.

The range of choices under each competitive market option ranges from complete company ownership under sales and lease agreements to service agreements under contract operations and managed competition. In evaluating which strategy will work best, the unique circumstances and needs of each city and its water and wastewater systems will dictate each strategy's appropriateness. All four strategies have been proven as successful and generally accepted solutions to city infrastructure and operational needs. Table 1 summarizes the four types of competitive market strategies that are generally available for cities.

Table 1

Competitive Market Strategies
Managed Competition
City employees plan and develop strategies for improving municipal operations to implement efficiencies that are competitive with private service operations companies. The option may include competing with private operators to provide city services in a competitive bid process.
Operations Contract
Contract agreement with a company for operations management . Agreement is for a fixed period of time. Scope of services are limited to the terms defined in the agreement.
Lease
Contractual transfer of asset ownership to a company to operate facilities for a specific period of time.
Asset Sale
The sale of infrastructure to a company transfers title of the asset in perpetuity. Revenues from the sale can be used to retire outstanding debt, finance improvements or transfer revenue to the general fund.

B. Comparison and Evaluation of Strategies (Advantages and Disadvantages)

Since each city's needs and circumstances are different regarding need for improved infrastructure, services, costs, funding, staffing, politics and local attitudes, it is impossible to definitively state which particular competitive strategies will always be the most successful.

Ultimate decision responsibility will continue to belong to the city's management, based on a spectrum of considerations.

Specifically, although each strategy offers to accomplish similar results (regulatory compliance, operational efficiencies, infrastructure improvements) the technical circumstances and attitude by the city regarding control and ownership will influence the feasibility of different solutions. Table 2 compares key advantages and disadvantages of each strategy regarding the city's obligation, ownership rights, span of control and capability to implementation improvements.

Table 2

Comparison and Evaluation of Strategies (Advantages and Disadvantages)

	Obligation/ Commitment	Ownership	Control	Improvements Implementation
Managed Competition	City commits resources for internal staff and process improvements.	City retains 100% ownership	City retains full control for operating system.	City receives no private assistance
Operations Contract	City executes a contract with a private company for specific services for a specific period of time.	City retains 100% ownership	City can maintain control of quality and performance through Negotiation of specific contract terms.	City is enabled to implement improve--ments through the. contract, allows long term planning of operations and upgrades.
Lease	City gives up entire operational autonomy To the company that Leases its assets.	Leasor assumes 100% ownership for a fixed period of time.	City gives up entire rights to control operational decisions other than terms of lease.	System upgrades will be performed only as stipulated in the lease.
Sales	City gives up entire responsibility for operations and decisions.	City terminates ownership in in perpetuity	City gives up entire rights to control.	New owner assumes autonomy and responsibility for improvements.

Bottom line, the appropriateness of a particular strategy for meeting a city's needs depends on each city's unique circumstances and needs, including the condition of its infrastructure, environmental compliance status, financial need, rates, local and political disposition toward private operators and privatization.

In general, if the city's needs are reasonably urgent and/or involve need for system improvements, preparations for a well-negotiated and detailed contractual agreement reflect actual best practices reported by cities. On the other hand, if a city does not need complex technical, or significant capital improvement, or if it otherwise is inclined to improve efficiencies through internal employee improvements, then a managed competition strategy for internal municipal improvements will be preferred. If a city wants to be rid of water and or wastewater responsibilities for particular reasons, then a sale or long-term lease agreement may be more appropriate. Table 3 below summarizes the expected benefits and risks under each method.

Table 3

Benefits and Risks of Competitive Market Strategies

Managed Competition

Benefits
Cooperative purchasing/contracting
Performance based incentives
Resale of by-products
Selling services
Cross-training efficiencies
Staff reductions through attrition
Bureaucratic reform
Scheduled maintenance
Reduced inventory costs
Instrumentation and automation

Risks
Weaker performance enforcement
Financial risk
Regulatory risk
Labor and technical needs
Long lead time preparation

Operations Contracts

Benefits
Savings over municipal costs
Operations experience
Problem solving success
Technology & skills expertise
Regulatory compliance
Capital improvements
Enforcable performance

Risks
Contract risk:
- Financial control
- Monitoring
- Communications
- Enforcement

Leases

Benefits
Infrastructure financing
Rate stabilization
Debt reduction
Expertise
Focus on other priorities

Risks
Loss of oversight
Loss of operational control
Loss of enforcement
EPA approval and need to eliminate federal interest

Asset Sales

Benefits
Financial
Retire debt
Improve infrastructure
Economies of scale
Technical expertise
Accelerated debt depreciation
Lowers city responsibility

Risks
No monitoring
Rate risk
Loss of control
No contractual recourse
No decision authority
Legal, regulatory, financial risk
Loss of tax-exempt bond status
Higher regulatory requirements

C. Discussion

Key Issues

Key questions and considerations crystallize the influences on a city's decision of whether a water or wastewater system has a need for competitive improvements. These issues relate to whether a city is facing aging water and wastewater infrastructure, regulatory compliance and sanction, technology skills or funding problems. By answering the following questions, cities can begin to formulate opinions on whether privatization or competitive marketing offers benefits that otherwise might be difficult to obtain under current municipal practices[12].

Efficiency: Is it possible that private companies or municipal competition can operate water and wastewater systems more efficiently?

Capital: Does the city have adequate access to funds to meet expected regulatory compliance and operating costs? Is it possible that private capital financing can offer cities access to financing sources that otherwise were not available?

Rates: Can the cost of the private capital be recouped through increased company efficiency and repayment over time to the company by the city without putting upward pressure on retail rates?

Technology: Do municipal employees have appropriate technical expertise and capabilities to perform increasingly complex treatment methods for water and wastewater? What is the most cost-effective strategy to meet these increasingly complex technical and management requirements?

Economies of scale: Are the city water and wastewater operations and purchasing practices efficient compared to private companies that may serve numerous cities in the region?

Regulatory compliance: Are the city's water and wastewater infrastructure and operations meeting regulatory compliance requirements? If there is expected need

[12] U.S. Environmental Protection Agency. *Response to Congress On Privatization of Wastewater Facilities*, (Washington, D.C., July 1997).

for improving regulatory compliance? What will be the effect on retail user fees?

Regulatory rate pressure: Can the growing upward pressures on retail rates be mitigated by competitive market strategies?

Load growth and planning: Will city population needs increase to the extent that infrastructure improvements will be required? Is the city prepared to plan and finance.

The answers to these questions establishes a framework from which a city can improve its understanding of the risks, benefits and implementation of different competitive market strategies. At this point, the city must attempt to identify the appropriateness and risks of each option in matching its needs.

D. Managed Competition

Characteristics

Managed competition represents improving municipal workforce efficiency and operations. It is an alternative to contractual service agreements with private companies. If extended to its logical conclusion, the municipal team competes with private companies in a competitive bid proposal for an operations contract.

The Association of Metropolitan Sewerage Associations (AMSA) has taken the lead in promoting "managed competition" as a method for improving municipal operations and efficiencies. AMSA contends that managed competition by municipal employees is a substitute to private contracts and can provide better savings than private operation companies. Reasons for the superiority of managed competition is that municipal utility departments do not make a profit, are tax exempt and have access to tax-exempt state revolving funds[13].

Managed competition requires "re-engineering" by municipal water and wastewater departments. For optimal results, managed competition contracts should have similar performance, accountability and savings goals as private operations contractual agreements.

Benefits

According to AMSA, there are numerous efficiency opportunities under managed competition[14].

[13] *Managed Competition*, Association of Metropolitan Sewerage Agencies, Washington, D.C., 1997.
[14] *Evaluating privatization*, Association of Metropolitan Sewerage Agencies, Washington, D.C., 1996, p. 12-15.

Cooperative purchasing and contracting: Coordinated purchasing and contracting for materials and services by public entities can reduce operation and material costs to cities through group negotiation and contracting of private operations services to lower costs. It allows cities to allocate municipal employees to areas of special need and contract for certain O&M services while maintaining control over the system.

Performance based incentives: Part of the process in selecting managed competition as a city's competitive strategy includes awarding it over other competitors in a competitive selection process. Incentives for accomplishing the bid proposal's goals should include tying municipal employees' compensation levels to specific performance and savings criteria. This method was a vital element in the managed competition approach implemented by the City of Charlotte, North Carolina (Appendix: Case Studies.)

Resale of by-products: The reclamation and sale of bio-solids as soil conditioners and treated effluent as irrigation for parks can generate revenue streams as part of the managed competition strategy.

Selling services: Under managed competition, cities sell services to other jurisdictions and business as a competitive marketing strategy.

Cross-training efficiencies: Efficient use of existing staffing can be improved by training staff to perform differentiated services. This strategy was identified in numerous interviews by municipal employees as an attribute of working at a private company. Combined with attrition and retirement packages, this strategy complements labor savings and lowering staff numbers (see next.)

Staff reductions through attrition, retirement: Layoffs can be averted through staff reduction processes, cross training and reassignment. Examples show that cities can achieve significant staffing reductions through strategies like attrition and early retirement.

Bureaucratic reform: Reassigning procurement responsibilities to align purchases with accountability can remove current impediments to efficient purchasing practices. To accomplish these economies, cities may need to revise their local Municipal Codes on procurement.

Scheduled maintenance: Improved scheduling of maintenance can significantly reduce emergency and corrective maintenance and reduce costly emergency maintenance. This strategy complements the strategy of improving "cross-training" by allowing cross-trained employees to perform scheduled maintenance responsibilities as part of their expanded scope of accountable responsibilities.

Reduced inventory costs: Similar to improving efficiency measures in the manufacturing industry, "just-in-time" delivery of parts and supplies can reduce warehousing costs.

Instrumentation and automation: Computer instrumentation can improve efficiency by identifying bottlenecks and identifying exact quantities of ingredients and energy for optimizing water and wastewater system performance.

Risks

Certain private sector competitors have gone on record to identify particular risks and inadequacies from managed competition for accomplishing comparable efficiencies and savings as private contacts[15].

Contract enforcement: It has been claimed that performance goals are generally more difficult to enforce and manage with municipal employee competition proposals than with private companies. Contracts with private companies can, and should be written with clear and enforceable performance, monitoring, measurement, penalties and termination, clauses. However, accomplishing comparable enforcement and severance measures may

[15] "Managed Competition", accessed December 11, 1998 online at the Professional Services Group, Inc. Web site, http://www.psgwater.com/managedcompetition.htm

not be as easy under managed competition agreements for municipal employee performance.

Private parties claim that managed competition agreements likely will have comparable enforcement provisions to private sector contracts and exclude legal, punitive and non-performance enforcement clauses.

There is great risk in exempting managed competition contracts from accountability. Without enforcement and threat of penalty for non-performance, incentives are diminished. Therefore, under managed competition, (as with contract operation agreements), specific contractual language must stipulate accountability standards, monitoring provisions and non-performance penalties. Enforcement and penalty incentives are critically important to ensure benefits[16].

Financial and Regulatory Risk: Consistent with risks from decreased enforcement, regulatory and financial risks to the city are greater under managed competition than under private contracts. Since all operations remain under the city, all regulatory risk resides with the city, rather than being shared with the private company. Therefore, in comparing choices between managed competition and private contract operations, disparities in regulatory and financial risk should be properly assigned[17].

Labor and Technical Skills: It has been claimed by critics of managed competition that the technical expertise and specialization skills of company employees may be greater than for municipal employees. Therefore, in evaluating competitive options, the city should consider the comparative technical and skills qualifications for performing water and wastewater operations and treatment tasks between municipal and private sector staff.

The Charlotte, North Carolina case study which is located in the Appendix: Case Studies describes how a successfully managed competition process and municipal services contract, including performance clauses, was implemented by the City of Charlotte, North Carolina.

[16] "Managed Competition", accessed December 11, 1998 online at the Professional Services Group, Inc. Web site, http://www.psgwater.com/managedcompetition.htm.

E. Operations Contracts

Characteristics

The framework for "contracting out" has long been a practice of cities for managing utility functions. Contracting for services works well in providing services that are needed by cities because the services can be controlled in scope, limited to a fixed period of time and be enforced. The range and scope of services available under contractual agreement extends from isolated services to total responsibility for system operations and maintenance.

Contractual agreements also avail cities to specialized skills, efficiencies and scale economies that typically are not available in the municipal governments. Seeking a contractual agreement for service also injects competition into the provision of government services. Listed below are summary descriptions of key contract operations characteristics. Following this list is a detailed description of considerations for each element:

Types of services: Services under contractual agreements can range from "Design-Build", to "Design-Build-Operate" through complete contractual operations to performance of specific tasks (such as O&M, accounting or collections.)

Term of duration: The terms of contractual agreements can extend up to 20-years under revised IRS rules for management contracts without affecting the tax-exempt status of municipal debt.

Capital investment: Under contractual operations agreements, the city can either remain responsible for capital investments or provisions for capital improvements can be included in the terms of the contract.

Responsibilities: Although the city continues to be the owner of the water and wastewater assets under contractual agreements, legal and regulatory responsibilities must be coordinated between the city and the private partner through the terms of the contract. Liability and performance clauses are important for monitoring and enforcement by the city.

Contract structure: The structure of contractual agreements between the cities and private water and wastewater companies should include specific and carefully negotiated standards and clauses for performance, responsibility, risk

[17] "Managed Competition", accessed December 11, 1998 online at the Professional Services Group, Inc. Web site,

assignment and other obligations. Examples of specific contract elements should include: scope of services, staffing, maintenance, capital improvement and repair responsibilities, reporting, responsibilities, insurance, termination, indemnification, performance, penalties, cost responsibilities and payment schedules.

Types of Services: The types of services available under contract operations agreements can vary widely. According to the 1997 U.S. Conference of Mayors **Status Report on Public/Private Partnerships in Municipal Water and Wastewater Systems: a 261 City Survey**, the most common water services being provided to communities by a private company are distribution system operations and maintenance (O&M), treatment facility O&M, design & construction, meter reading, bio-solids management, meter reading and billing and collection. For wastewater systems, in addition to the above services, collection system O&M was a primary contractual service provision[18].

Based on population, small communities utilized the private sector more for billing and collection, meter reading, source water management and distribution system O&M services and less for design & construction. Large communities used private companies less for meter reading, billing and collection.

Table 4 lists examples of the types of contract services available from private companies:

Table 4

Contract Operation Services

♦ water treatment	♦ wastewater treatment
♦ operations and maintenance	♦ collections
♦ capital improvements	♦ emergency services
♦ meter reading	♦ rate studies
♦ repairs	♦ accounting
♦ leak detection inspections	♦ management services
♦ meter replacement	♦ computer services
♦ legal instrumentation security	♦ landscaping
♦ financing	♦ payroll
♦ engineering	♦ SCADA maintenance

http://www.psgwater.com/managedcompetition.htm.

[18] The United States Conference of Mayors, *Status Report on Public/Private Partnerships in Municipal Water and Wastewater Systems*, "A 261 City Survey", September 1997.

Term of Duration: Contractual operations agreements have a specifically defined duration. With the implementation of IRS Revenue Procedure 97-13 in 1997, management contract rules have been extended to allow contracts up to twenty-years without affecting the tax-exempt status of municipal bonds. This change in IRS limits on terms of duration has greatly improved the attractiveness of contractual agreements. Many cities believe that opportunities for savings and rate stability are facilitated through increased flexibility to plan operations and infrastructure upgrades between the city and the company.

Capital Investment: Long-term contracts improve opportunities for capital improvements and financing. By improving the opportunities to recover capital investment costs through savings, long-term contracts can reduce upward pressure on rates.

Responsibilities: Under contract operations agreements, the city continues to be the owner of the water and wastewater facilities. Capital improvements can be performed under the agreement only if stated in the terms of the agreement. The issues of rate-making, collections and regulatory compliance will continue to be the city's responsibility unless specifically designated as the company's responsibilities under the terms of the contract.

Company performance under the contract is monitored and enforced through detailed contractual language that clearly specifies the performance criteria, obligations, remedies, reporting and monitoring responsibilities by the company and city.

Obligations and rights should be fully documented and agreed in the contract. Risk and liability often is shared by the city and private company, particularly when co-permits are held, as in the case when the city and company are jointly permitted on a National Pollutant Discharge Elimination System (NPDES) permit[19].

As will be discussed in subsequent chapters, negotiation of clear and specific contract language between the city and the private company in the contract structure is the best way to assign responsibilities and rights, including management and financial obligations.

Contract Structure

The content and structure of contractual agreements between the cities and private water and wastewater companies should reflect earnest negotiation and rigorous consideration of an

extensive range of details involving terms, requirements, legal factors and obligations of the parties.

The following sections on contract elements are relevant to both contractual agreements and lease agreements.

Contract Elements[20]

Scope of services: A very important element of a performance contract is the scope of services section. It describes the expectations of work to be performed by the company.

Staffing: Staffing requirements of the engagement, including provisions for hiring and methods for reducing the current level of public employees should be clearly defined in the contract. These clauses should also stipulate that staffing must identify and detail the individuals by name and their qualifications.

Other services: Tasks that will fall under the contractor's obligations for service, probably performed previously by municipal employees should be specifically identified in the contract.

Maintenance and inspections: The contract should describe maintenance inspection, repair and safety criteria and responsibilities by each party to clearly assign responsibilities to the parties for maintaining the facility's reliability and code compliance.

Improvements: Specific obligations for planned capital improvements, performance guidelines, monitoring provisions and penalties for non-performance should be described in the contract terms.

Reporting requirements: The contract should identify and assign responsibility to each party. Accountable officers, lines of communication, internal performance,

[19] Daniel Kucera, "Are 'Public-Private Partnerships' Really Partnerships?", accessed November 23, 1998 online at the Water Online Web site, http://www.wateronline.com/daniel/kucera4.html.
[20] New England Interstate Environmental Training Center, "Draft Outline, 'Contract Operations Guidance Document' Getting From Here to There", accessed November 5, 1998 online at the Water Industry Council Web site, http://www.waterindustry.org/neietc-a1.htm

complaint procedures and regulatory reporting responsibilities should be described in the contract.

Regulatory responsibilities: The contract should identify which parties are accountable for specific regulatory filings, identify which company and city representatives are responsible for each filing and identify which parties are responsible for regulatory penalties and fines.

Emergency communications: Specific emergency procedures, required chains of communications and conditions must be delineated. These terms should include specific persons of authority and contact persons under emergency conditions.

Insurance: Responsibilities for insurance coverage should be identified in the contract as city or company obligations. Descriptions of responsibility should include which parties are responsible for required coverages, premium payments and liability.

Materials and equipment ownership: The contract should describe and clearly assign responsibilities for providing and paying for materials and equipment, including ownership of the materials and equipment after the term of the agreement is concluded.

Contract termination: The contract should identify specific reasons and conditions under which either the city or company can enforce appropriate termination rights under the performance agreement prior to the expiration date.

Contract cost obligations: Costs related to the issues in the contractual agreement. The contract language should clearly identify the amount agreed between the city and the company for the specific services identified to be rendered.

Schedule of payments: The contract should clearly identify the schedule and conditions of payments to be performed by the city and the company for provisions under the contract.

Penalties: Clear and specific criteria and associated penalties for non-compliance under the terms of the agreement should be described in the agreement.

Inter-contract responsibilities: The city and company should clearly describe each parties' responsibilities for concluding obligations at the end of the contractual agreement, including transitioning to a new agreement among parties.

Awarded bid: The contract should have a copy of the company's formally awarded bid proposal as an attachment.

Financial Integration: Contracts should be integrated into the owner's financial statements and audit processes.

Definitions: This section should include a listing and definitions for key terms in the agreement.

Benefits

Benefits from private contractual agreements emanate from the company's mandate to succeed in a competitive environment where there are numerous companies and cities. This competitive mandate places pressure on companies to offer valuable services at competitive costs. Listed below are key aspects of competitiveness that make private contract successful:

Savings: Under contractual agreements, the company commits to perform services according to a payment schedule. Negotiated payments under the contract will reflect savings to the city over its municipal operating costs.

Experience: Private operating companies bring experience that has been gained through years of working on numerous water and wastewater systems. This experience provides a strong framework for effective problem solving, improved regulatory compliance and long-term resolution of infrastructure and performance.

Technology: Based on the company's scale and responsibility for serving numerous cities at the same time, the in-house capability for technological skills and expertise are competitive requirements for the company. On an as-needed basis, these skills can be brought in to help the city.

Regulatory compliance: As federal and state regulatory requirements become increasingly stringent on governments, the broad based skills, experience, and technical capability of the company increase the city's ability to solve infrastructure problems and meet compliance requirements.

Capital improvements: The scale economies and experience of the company promote cost competitiveness for performing infrastructure improvements. By building the terms of infrastructure upgrades into the terms of the contract, the city is empowered to negotiate improvements through efficiency savings and payments.

Enforcement: The terms of the contractual agreement should include provisions for performance, enforcement, penalties and termination. Formal provisions for penalties and contract termination are strong incentives for performance under the agreement.

Risks

Risks from contractual agreements are associated with the shifting of system operation from the non-profit, city to the for-profit, private company. In addition, inadequate preparation by the city, ineffective review of options and negotiations, and deficient contract construction will expose the city and its customers to unnecessary risks under a contractual agreement. Listed below are key risks associated with private contractual agreements. See Chapter 6 of this report for recommendations to reduce a city's exposure to risk from competitive marketing strategies.

Financial: Private firms often are not eligible for capital grants, State Revolving Fund loans, and the ability to issue tax exempt debt. Unless specifically stipulated in the agreement, private financing of capital may result in increased costs to the city. Therefore, cities should ensure that all financing costs under the contract are explicitly stated in the agreement and reflected in the contract's cost provisions. In the absence of such

specificity, future, unforeseen costs may escalate and shift cost risk to the city.

Regulatory: There is a possibility that a contractual agreement may require EPA approval if up-front payments (termed concession fees by the EPA) are made by the company to the city. The point of contention is whether an up-front concession fee makes the contractual agreement a "lease" that falls under EPA jurisdiction. It is the position of city and industry representatives that unless an up-front concession fee encumbers the city's asset, the agreement is not necessarily under EPA Jurisdiction. Placing the contract under EPA jurisdiction for approval exposes the agreement to potential delays through the EPA review and approval process.

Communications, monitoring and performance: Unless explicitly stipulated in the agreement, the contract may not have sufficient provisions to ensure effective and successful monitoring, reporting and communications between the company and the city. It is essential that the city construct clear contract language for adequate reporting, communications and monitoring to prevent deterioration of infrastructure, equipment and customer service[21].

F. Leases

Overview

Water and wastewater lease agreements represent the contractual transfers of a facility to the company. Under a lease, the company makes payments to the city for the right to operate the facilities for a specific period of time. The timing and frequency of payments are specified in the terms of the agreement. The city subsequently pays the company periodic (annual) service fees that represent annual payment on the debt incurred by the company for operations, payments to the city and capital improvements. Rates, user fees and capital improvements may or may not remain as responsibilities of the city.

[21] New England Interstate Environmental Training Center, "Draft Outline, 'Contract Operations Guidance Document' Getting From Here to There", accessed November 5, 1998 online at the Water Industry Council Web site, http://www.waterindustry.org/neietc-c6.htm

Lease payments fall under jurisdiction of the EPA for formal review and approval when wastewater facilities were constructed with federal grant funds and an undepreciated balance remains on the city's books.

In the case of a lease/concession arrangement, a private entity may also make capital investments in the water or wastewater facility. This may take the form of agreed up-front or periodic schedule of payments to the city. It is possible that the lease agreement may require EPA approval, including the need for a construction grant deviation filing. When remaining, undepreciated asset value was financed with federal funds, it is also possible that the agreement will trigger a requirement for the municipality or company to reimburse the state and federal governments for the remaining undepreciated value of the asset[22].

Lease Elements

To ensure that the concerns of the city council, ratepayers, and other stakeholders will be met, the city should include specific performance, monitoring, reporting, liability and termination elements into the terms of its leasing agreement with the private company. The types of performance and enforcement criteria to be considered for use in the lease agreement are similar to the elements that would be included in a contractual operations agreement. Examples of these types of clauses are listed in the "Contract Elements" section of this chapter.

Benefits

Infrastructure financing: A lease agreement may include company injected funding for infrastructure upgrading.

Rates: A lease agreement may enable the city to negotiate a fixed schedule of future user fees that reflects rate stabilization for retail customers.

Municipal debt: The payment of a fees to the city by the company may enable the city to retire or reduce existing debt and transfer revenue to the general fund.

Expertise: Engagement with a private contractor allows the city to benefit from the company's accumulated expertise.

Municipal services enhancement: The lease agreement lessens the city's water and/or

[22] New England Interstate Environmental Training Center, "Draft Outline, 'Contract Operations Guidance Document' Getting From Here to There", accessed November 5, 1998 online at the Water Industry Council Web site, http://www.waterindustry.org/neietc-a2.htm

wastewater operational burdens. Reduced administration responsibilities may enable city management to focus on other priorities.

Risks

Risks from leases are associated with the shifting of operational autonomy completely to the company. Listed below are key risks associated with system leasing agreements.

Control: Privatization through a lease denotes an inherent loss of local control over the operation and oversight of the facilities. Without significant contractual stipulations, operational decisions would be made at the sole discretion of the company, without legal basis for legitimate city input. Specific lease provisions for review and input can remedy this lack of legal right for operational input. Therefore, communications between responsible company contacts and the city will only occur to the extent formal communications and reporting are stipulated in the lease. It is recommended that clear contract language for specific lines of communications, reporting of operations and performance will contribute to a successful lease agreement for the city.

Regulatory Jurisdiction: Lease agreements may fall under E.O.12803 and the EPA 's jurisdiction for approval. In this case, it is also likely that the city will be required to apply to the EPA for approval including a Grant Deviation. In addition, either the city or the company must pay off any remaining undepreciated federal grant balance under Executive Order 12803.

G. Asset Sales

Overview

Under the sale of a water or wastewater system to a private company, revenue from the sale can be used to retire outstanding debt, improve municipal infrastructure or transfers to the general fund. Upon private ownership the water or wastewater facility, the company has the autonomy to modify equipment, infrastructure, processes and operations as necessary to reduce costs or improve performance. Customer and city benefits from the sale of its system to a larger private operations company include economies of scale, technical expertise, and financial capability at levels that are not possible under municipal operations.

The sale price of a municipal system to a private company represents an investment in the facility by the company with the costs of its investment flowing through to the public in the form of higher fees and efficiencies in operating the facility. Therefore, under an asset sale, retail rates may rise, stay the same or decrease depending on the relative costs of the sale and any savings through increased operational efficiencies.

Among its features, E.O. 12803 allows municipal wastewater investments to be recovered from the proceeds of a sale prior to any claim by the federal government for funds provided by EPA construction grants.

EPA's construction grant regulations specify that when a grantee sells a facility that received grant funds, the grantee must request a deviation from certain grant regulations and possibly repay the grant funds. Repayment of federal grants only occurs to the extent that the transfer price under the sale is higher than the total municipal investment in the facility. In addition, grants are recouped at their depreciated value. In the event that all EPA construction grants are fully depreciated, there would be no federal grant recoupment.[23]

Monitoring

Privatization through a sale results in a large loss of local control over the operation of the facility. Other than regulatory oversight, without significant contractual restrictions for city monitoring, involvement and input, all operational decisions would be made at the sole discretion of the new owner.

Benefits

Financial:

E.O. 12803 establishes a framework for privatization of facilities funded with federal grants that improves a city's opportunity to sell its federally funded assets and generate revenues with improved opportunity to avoid repaying its balance of federal funds to the government. Under E.O. 12803 local and state governments are the first to receive proceeds from an asset sale with the federal government behind state and city debt in order of precedence. If the transfer price is higher than the local and state investment, then federal construction grants are repaid at their depreciated value to a maximum of the transfer price or concession fee. E.O 12803 allows accelerated depreciation to be calculated on the remaining balance of the originally funded amount. E.O. 12803 results

in repayment of federal grants at a much lower level that would have otherwise resulted under construction grant regulations. If an EPA construction grantee decides to pursue an asset sale or lease under E.O. 12803, it is necessary to submit a request to the EPA for approval in combination with a grant deviation request. Upon approval by the EPA, revenue from the sale or lease concession fees can be used to retire outstanding wastewater facility debt, for infrastructure investment, or for general property tax relief.

Accelerated depreciation: E.O 12803 allows the city to reduce the remaining federal interest under a sale (see above.)

Contractor expertise: Engagement with a private contractor allows the city to benefit from the company's accumulated expertise and economies of scale in labor utilization and materials purchasing.

Municipal enhancement: Sale of the water and/or wastewater systems lessens the city's operational burden and responsibility and enables it to focus on other municipal priorities other than procurement of supplies, emergencies and the like.

Risk

Many questions remain regarding a municipality's risk through an asset sale. Although some risk can be shifted to the private company, it is not easy to summarize the complex legal, financial, and regulatory considerations associated with a water or wastewater system sale.

While under city ownership, user rates are based on a plant's municipal debt service and operation and maintenance costs, with an asset sale to a private company, the purchase price would involve an equity component. Subsequent customer rates would reflect the company's capital structure including a combination of equity and debt to cover both the company's return on the equity investment and debt service costs. In considering to sell its water and wastewater systems, cities must also consider the treatment of outstanding bonded debt in the sale of the asset.

[23] U.S. Environmental Protection Agency. Response To Congress On Privatization Of Wastewater Faciliities, (Washington, D.C., July 1997.)

Tax-exempt status of existing bonds: There is risk that under an asset sale, the tax exempt status of bonds sold to finance the facility may become taxable under the 1986 Tax Act. The city must carefully explore the specific steps that can be taken to avoid making tax-exempt bonds subject to tax by the IRS. It is essential that the city retain professional legal and financial advice on these matters to clearly understand its exposure regarding compliance with tax regulations. As stated previously, cities must also consider the treatment of outstanding bonded debt in the sale of the asset.

Regulatory Compliance: When city wastewater assets are sold to a private company, the buyer may become subject to Resource Conservation and Recovery Act (RCRA) requirements because the EPA's domestic sewerage exemption to a city may not transfer to the private company. If the city's domestic sewerage exemption does not transfer to the buyer and the treatment facility becomes designated as a RCRA hazardous waste treatment, storage or disposal facility it is possible that higher operating costs will result in higher rates.

Therefore, prior to closing the sale, the city and buyer should make sure that the domestic sewerage exemption will be continued by the EPA for the private buyer.

Surveys

A. Summary

The research, surveys and interviews performed in this study were conducted in accordance with the study's tasking objectives to research privatization opportunities and practices in Texas and the nation. The interviews were organized into stages, or "phases" whereby different groups of industry professionals were interviewed at specific times.

The process during each interview identified and contacted representatives from different sectors of the water and wastewater industry. In total, nearly 100 interviews were performed with private company representatives, state and federal regulators, attorneys and industry organization representatives. A majority of these interviews were conducted with cities and companies that have participated in contractual or asset sales agreements. Tables 5 and 6 below summarize the "reasons for" and "impediments to" privatization as reported by cities and companies in the interviews:

Table 5

Reasons for Privatization

Texas Cities	National Cities	Companies
To keep up with demand growth	Economies of scale	Savings
Costs of maintenance & upgrades	Service needs	Improved services
Comply with increasing EPA standards	Infrastructure needs	Need for infrastructure solutions
Need for technical expertise	Financial	Meet Federal regulations
Savings	Regulatory compliance	Poor condition of systems
Service quality	Technical expertise	Inability to afford improvements
Financial needs	Costly, inefficient city operations	Economies of scale
Current costs to serve customers	Inability to afford improvements	Inefficient, costly city operations
		Willingness of owners to sell
		Community development
		Employee opportunities for T&D

Table 6

Impediments to Privatization

Texas Cities	National Cities	Companies
Private operators may be profit oriented and cut service quality	Concern about giving up control	Resistance to change by municipal decision-makers
City operators may have a higher focus on quality and services	Union resistance	Fear of losing operational control
Accountability, customer service, and quality control need improvement	Perception that there is no need	Concern about controversy for selling assets
Desire to keep local administrative control	Resistance to change	Resistance by utility staff
Labor concerns	Regulatory	Fear of job loss
		Historically operations were run by staff
		Consultants promoting improved internal efficiency over privatization
		City places regulatory priority on solid waste and wastewater over water

B. Discussion

Listed below is an outline of each interview phase that was preformed for investigating strategic issues in water and wastewater privatization and competition. Following this outline is a detailed description of the work performed and results that were gained during each interview phase.

Interview Phases

Phase 1: Texas water industry associations and companies were interviewed to determine the current level of water service privatization, competition and marketing efforts within city membership in the State of Texas.

Phase 2: Local Texas cities identified in Phase 1 were interviewed to determine "best practices" of existing privatization, competition and marketing efforts within the State of Texas.

Phase 3: EPA and IRS representatives were interviewed to evaluate how current and pending Presidential Executive Orders and Revenue Procedures promote privatization and/or competition.

Phase 4: EPA, AWWA, AMWA and other industry representatives were interviewed to assist in identifying a minimum of 60 privatization, competition and market strategies that have been implemented around the nation.

Phase 5: 60 cities around the country were contacted and 39 interviews were performed to learn about individual city experiences in implementing privatization, competition and market strategies.

Phase 6: Selected TNRCC, TML and private legal counsel were interviewed to identify potential statutory amendments to facilitate privatization and/or competition.

C. Survey Results

As described above, each survey phase attempted to identify specific impressions and findings by the different industry stakeholder groups. The results from each phase of interviews reflect consensus and minority opinions on the successes and failures of different competitive strategies.

Although each phase of surveys targeted different stakeholder groups (Texas cities, private companies, national cities, regulatory agencies, industry associations, legal community) the questions in each interview focused on essentially similar competitive strategy issues. These questions included what types of strategies have been implemented, rationale for considering a competitive marketing strategy, strengths and weaknesses of each strategy, customer satisfaction, bill impacts and implementation impediments.

Listed below is a description of the interview processes, participants, comments, findings and policy issues that were accomplished during each survey phase:

Phase 1: Survey of Texas Water Industry Associations

The first round of interviews focused on Texas water industry associations. Representatives of these associations were interviewed to identify local Texas governments and private companies that are currently implementing privatization and competitive market strategies. The interviews also investigated the types of agreements being implemented by their membership. A summary of the Phase 1 interviews is provided below in Table 7.

Table 7

Phase 1 Interviews - Survey Results	
Purpose	Water industry associations and companies operating in Texas were interviewed to learn about current practices and membership in Texas.
Needs	Costly operations Municipal inefficiency Poor conditions of existing systems Willingness of small owners to sell Federal environmental regulations
Benefits	Economies of scale Increased operations efficiency Improve condition of systems Environmental compliance
Barriers	Lost ability to re-invest earnings Resistance to losing control Fear of job loss Resistance to sell assets
Conclusion	Cost savings, operational efficiencies, system improvements, and environmental compliance are possible through the company's expertise, experience, economies of scale and experience.

Texas water industry associations surveyed to determine privatization within their membership are listed below in Table 8.

Table 8

Interviewed Texas Water Industry Associations

- Texas Natural Resource and Conservation Commission (TNRCC)
- Texas Municipal League (TML)
- Texas Municipal Utilities Association (TMUA)
- Texas Water Conservation Association (TWCA)
- Texas Rural Water Association (TRWA)
- Texas Water Utility Association (TWUA)
- Association of Water Board Directors (AWBD)
- Association of Metropolitan Water Agencies (AMWA, contacted but not available)

Responses: With the exception of the TNRCC, no Texas water industry association maintained an inventory or possessed a thorough knowledge of membership who had privatized or entered into private contractual agreements. However, each association did cooperatively provide information about the identities of cities, companies, issues and privatization agreements to the best of their understanding. Based on these interviews and research, an extensive listing of the cities and companies active in privatization agreements in Texas was developed. A comprehensive listing of these participating cities is provided in the Appendix.

Reasons for privatization: Water industry association representatives identified economies of scale, municipal inefficiency, poor conditions of existing systems, willingness of small system owners to sell and inability to meet Federal regulations as known reasons that cities have entered into privatization agreements.

Barriers to privatization: Water industry association representatives stated that rural system's ability to re-invest earnings to keep systems in good shape, political resistance to losing operational control, fear of job loss and local dissention about the sale of assets represented reasons that certain cities were resistant to privatization.

The TNRCC provided extensive information about regulations, cities and companies that are involved in contractual wastewater and water service agreements. Numerous companies that manage wastewater facilities also managed water systems.

Examples of Texas city governments involved in privatization agreements are shown in Table 9. The listings were developed during interviews with water industry associations, the TNRCC and industry research. As described above in the "Responses" section, a complete listing of Texas

cities identified as participating in competitive market strategies is provided in the Appendix under "Texas Cities"

.

Table 9

Texas Cities with Competitive Marketing Agreements

- Aledo
- Angleton
- Arcola
- Austin
- Bastrop
- Bexar Met. Wat. Dist.
- Brushy Creek MUD
- Burkburnett
- Colmesneil
- Corpus Christi
- Dallas
- Del Rio
- Donna
- Elgin
- Fort Worth
- Frost
- Freeport
- Galveston
- Georgetown
- Gladewater
- Harker Heights
- Hockley
- Houston
- Huntsville
- Ingleside
- Katy
- Lampasas
- Leander.
- McAllen
- Mercedes
- Odem
- Orange
- Pampa
- Panhandle
- Pasadena
- Smithville
- Stephenville
- Temple
- Tomball
- Tyler
- Waco
- Weslaco
- Willow Park
- Woodcreek
- Vernon

Private operating companies identified as serving cities in Texas under contractual service agreements are listed in Table 10 according to the interviews with water and wastewater association representatives.

Table 10

Private Companies and Water Agencies with City Agreements

- PSG (Professional Services Group)
- OMI (Operations Management Inc.)
- EarthTech
- Eco Resources
- Aquasource
- United Water Services
- LCRA (Lower Colorado River Authority)
- Severn Trent ST Environment. Services

Contracts: Interviews with Texas and national water industry associations and the TNRCC indicated knowledge of only contractual service agreements with private companies and small system sales in Texas. None of the organizations could identify specific terms of lease, sale or managed competition agreements.

Phase 2: Survey of "Best Practice" Privatization and Competition in Texas Cities

The second set of interviews contacted Texas cities and private operating companies to identify the strengths, weaknesses, and competitive marketing strategies as implemented in Texas.

In this round of interviews, Texas cities and companies were contacted to understand the rationale and issues associated with implementing competitive marketing water and wastewater strategies. The surveys also examined the different types of contractual agreements currently performed in Texas. The summaries of the Phase 2 interviews are provided in Table 11 below.

Table 11

Phase 2 Interviews - Survey Results	
Purpose	Texas cities identified during Phase 1 interviews were contacted to learn about "best practices" operations contracts.
Needs	Meet demand Inefficient & costly city operations Improve existing systems Meet maintenance & upgrade costs Meet environmental regulations Technical skills Savings Improved services Inability to pay for improvements
Benefits	Meet growing demand Meet maintenance costs Compliance with EPA standards Obtain technical expertise Savings Improve existing systems Improve service quality Company economies of scale Employee opportunities for training
Barriers	Concern about company profit orientation Belief city operators are more quality focused Concern about company accountability Concern about customer service and quality Concern about losing administrative control Resistance to change by decision-makers Fear of losing operational control Resistance to selling assets Resistance by staff-fear of job loss Interest in improving internal efficiency Priority of waste operations over water
Conclusion	Virtually all cities expressed satisfaction with operation contracts. Quality is appropriate. Agreements allow cities to lock in savings. Comprehensive terms and detailed language are essential for successful results. Important contract terms and rights include accountability, enforcement and monitoring. With good contracts, benefits result through economies of scale, improved system management, technical expertise, cost effective operations, maintenance and improvements. Estimated savings between 20% to more than 40%.

Texas Interviews - Cities

Eighteen Texas cities were interviewed to understand their privatization, competition and marketing practices. Table 12 lists the cities that were interviewed.

Table 12

Texas Cities Interviewed

- Angleton
- Austin
- Bexar MWD
- Burkburnett
- Corpus Christi
- Dallas
- Del Rio
- Elgin
- Fort Worth
- Freeport
- Georgetown
- Houston
- Huntsville
- Pampa
- Round Rock
- San Benito
- Stephenville
- Temple

The survey questions focused on the underlying issues and rationale for each city's decision to implement a competitive strategy. Contractual agreements, terms, conditions, perceived strengths and weaknesses were examined. An aggregated listing of "reasons" and "impediments" to privatization was provided earlier on page 34 in Tables 5 and 6.

Table 13

Reasons that Texas Cities use Privatization

- Costs of maintenance and upgrades.
- Ability to keep up with growing demand.
- Compliance with increasing EPA wastewater standards.
- Need for technical expertise.
- Savings.
- Service quality.
- Financial needs.
- Current costs to serve customers.

Impediments to Privatization: Impediments to successful competitive marketing strategies as identified during interviews with Texas cities are listed below in Table 14.

Table 14

Impediments to Privatization Identified by Texas Cities

- Private operators may be profit oriented and cut service quality.
- City operators may have a higher focus on quality and services.
- Accountability, customer service & quality control need improvement.
- Local administrative control and labor concerns.

Results: Satisfaction with contract operations was expressed by all cities with one exception. Quality of service received from contract service providers was appropriate and all cities, but one, stated that they intend to continue working with their private contract service providers. No cities were planning to increase the level of contractual services above current service levels in the near term.

One city stated dissatisfaction with its contract service company and no longer uses a private company for its water and wastewater operations. It stated that the contract did not have performance, monitoring and dispute resolution clauses. Ultimately, complaints on water taste and smell arose and the city decided to not renew its agreement.

Another city briefly considered privatization, but for internal reasons decided to continue its current municipal utility operations.

Contract Types-Terms and Conditions: The term of contractual agreements ranged from 2 to 10 years with most being five years with a renewal option. This trend toward of longer term contracts has been facilitated with the passage of IRS Revenue Procedure 97-13 in 1997 that allows longer contracts without endangering tax-exempt municipal debt.

The strategy of longer term deals with renewal terms allows cities to lock into savings for ten or more years if they wish, or to choose to terminate their agreement if it can find a better deal or dissatisfied. Most cities agreed that carefully structured contractual language and contract terms were essential for an effective agreement. Specificity in contract language was essential to promote good contract performance, enforce accountability and avoid misunderstandings. Additional comments stated the need to identify responsible parties in the contract for personnel, materials, specific duties, exit terms, performance clauses and enforcement provisions.

The Appendix "Texas Survey" summarizes the responses of Texas cities that participated in interviews. The cities are broken out according to size to show how different sized cities are entering into privatization agreements.

Surveys of Private Companies

Six private companies and one public water supply agency were interviewed. As with the survey of Texas cities, companies were interviewed to understand the rationale, issues, benefits and impediments to implementing competitive water and wastewater strategies. Interviews included examination of the types of contractual agreements, terms, conditions, strengths and weaknesses. The companies and public supply agency interviewed are listed earlier in Table 10.

Rationale: Comments from companies in Table 15 showed a consistency among the reasons that competitive strategies were implemented.

Table 15

Company Reasons for Privatization

- Savings.
- Improved services.
- Need for improved infrastructure solutions.
- Meet Federal regulations.
- Poor condition of existing systems.
- Inability by city to afford improvements.
- Economies of scale
- Inefficient, costly city operations
- Willingness of small system owners to sell
- Community development
- Employee opportunities for company T & D

Barriers: The primary impediments to competition identified by company representatives are described in Table 16.

Table 16

Impediments to Privatization Identified by Companies

- Resistance to change by municipal decision-makers (fear of losing control, controversy about selling assets.)
- Resistance by utility staff (fear of job loss, historically operations were run by staff.)
- Priority on improving internal efficiency over privatization
- City/regulatory priority on solid waste/wastewater over water.

Types of Contractual Agreements, Terms and Conditions: Table 17 shows the particular types of contractual agreements that companies offer to cities:

Table 17

Market Strategies Offered by Companies

♦	Contract operation and maintenance
♦	Design, Build, Operate
♦	Design, Build, Operate, Own
♦	Lease
♦	Sale

Contracts ranged from short term (30 to 60 day renewal) to more than 25 years. Most companies stressed that longer-term deals allowed cities and companies greater flexibility to plan capital upgrades and improvements and enabled greater savings and efficiencies.

Benefits: Savings to cities from contractual agreements are possible due to economies of scale, better system management and technical expertise in operations, maintenance and infrastructure improvements. Companies stated that longer-term contracts Company estimates of savings run from 20% to more than 40%.

Marketing Strategy: From a marketing strategy perspective, one clear and common theme among all companies was the need to be flexible in structuring individualized service offerings that satisfy particular cities' needs and a willingness to tailor individualized agreements. Most companies preferred contract operations agreements over asset sales and lease agreements.

Phase 3. EPA/IRS Surveys: Orders and Procedures Promoting Privatization and Competition

Overview

In the third round of surveys, EPA, AMWA and industry leaders were interviewed regarding the effectiveness of Executive Orders 12803, 12875 and 12893 in promoting privatization and competitive strategies.

In addition to the results of the interviews, extensive research documentation on EPA Executive Orders 12803, 12875, 12893 and IRS Revenue Procedure 97-13 were developed. The Appendix "Regulations" contains official copies of the Presidential Executive Orders 12803, 12875, 12893 and IRS Revenue Procedure 97-13. Table 18 summarizes the findings of this phase.

Table 18

Phase 3 Interviews - Survey Results	
Purpose	EPA and IRS representatives were contacted about Executive Orders and IRS Revenue Procedures intended to promote competition and privatization.
Results	IRS Revenue Procedure 97-13 is most effective in promoting public/private partnerships. 97-13 allows longer-term contracts without risk to tax-exempt debt. Executive Order No. 12803 encourages lass government interference in contracts.
Conclusion	IRS 97-13 best improves privatization opportunities by longer term agreements. Regarding E.O.12803, there is concern that EPA's position on jurisdiction over contract agreements with concession fees will cause delays and discourage contracts.

Interviews with EPA and industry representatives confirm that among Executive Orders 12803, 12875 and 12893, Executive Order 12803 (E.O. 12803) clearly has played the most relevant role in promoting privatization and competition. The intent of E.O. 12803 is to encourage federal agency cooperation with public/private partnership agreements and to remove impediments to competition. Currently, controversy regarding E.O. 12803 centers on EPA's announced position on jurisdiction over particular types of contractual agreements that are being defined as "leases."

Interviews with EPA, cities and industry representatives uniformly confirm that IRS Revenue Procedure 97-13 is also playing a significant role in removing barriers to competitive agreements between municipalities and private operators. Replacing past IRS rules that limited contract terms to five years (without risking tax exempt status), Revenue Procedure 97-13 allows up to twenty-years for management contracts without affecting the tax-exempt status of municipal debt. This change increased the attractiveness of private contracts by affording parties increased latitude to plan and implement system improvements within the contract.

Executive Order 12803

The President issued E.O. 12803 in 1992 in an attempt to improve opportunities for the benefits of competition at State and city levels and to promote private sector investment for infrastructure improvements.

The intent of E. O. 12803 as implemented by the Environmental Protection Agency-EPA and as promulgated by the Office of Management and Budget (OMB) is to encourage private sector partnerships with cities for infrastructure modernization, expansion and increased opportunities to privatize infrastructure assets.

Language of E.O.12803 explicitly prescribes the role of federal agencies in supporting the intent of the Order to meet the following objectives:

1) Federal financing of infrastructure should not impede private market financing and competitive practice efficiencies.
2) States and cities should have the maximum possible freedom to make decisions regarding their federally funded infrastructure assets.
3) Privatization transactions should not result in unreasonable charges to users.
4) Federal administrative agencies should review and modify procedures to encourage appropriate asset privatization, to assist and encourage State and cities' privatization efforts.
5) Federal administrative agencies should act to approve and grant exceptions to the disposition requirements regarding infrastructure payment proceeds from asset sales or leases.

Regarding the repayment of infrastructure debt, E.O. 12803 stipulates that states and cities are first in the order of precedence to receive proceeds from asset sales and leases. Remaining asset sale or lease proceeds will be used to pay back the undepreciated portion of the grant to the federal government through a grant deviation application using the appropriate IRS accelerated depreciation schedule. Subsequent to these repayments, any remaining proceeds must be used to pay for additional infrastructure investment or for debt or tax reduction. E.O. 12803 rules apply only to infrastructure sales and lease agreements. If no sales or lease agreements are made, EPA approval is not required.

At this point in time, one key area of disagreement exists between the EPA and cities and private companies that centers upon EPA's claimed jurisdiction over "lease-type" contractual agreements.

In this regard, the EPA stated in its April 1998 Guidance on the Privatization of Federally Funded Wastewater Treatment Facilities that contract agreements with up-front concession payments are lease-type agreements that come under EPA jurisdiction for approval. Since the EPA believes that concession fees always encumber the asset, contracts with concession fees do not meet Title II Clean Water Act requirements that federal grants can only be awarded to 100 percent publicly owned treatment works.

The basis of this position is that OMB Circular A-102 requires that federal grantees not encumber the title of facilities while the government grant fund balance remains unextinguished. Under OMB rules, leases (with up-front concession fees) and asset sales are viewed as dispositions of federally funded property because they transfer the title or use the title as a form of collateral. Consequently, property acquired under a grant cannot be used by the city to draw on the federal equity invested in the facility to raise additional capital until the grant funds are paid off.

According to the EPA's construction grant regulations, when a city sells or encumbers ownership by leasing a facility that has received grant funds, the city must request a deviation from certain grant regulations and repay the grant funds. The EPA's construction grant regulations identifies the grant deviation process as the appropriate mechanism for extinguishing the federal grant balance in the funded asset. Approval of a grant deviation application by the EPA a finding by the EPA that the city is complying with specific EPA grant requirements allows cities to engage in lease and sale arrangements with private companies by terminating the balance of federally funded facility assets.

Upon approval by the EPA, revenue from the sale or lease concession fees can be used to retire outstanding wastewater facility debt, for infrastructure investment, or for general property tax relief. However, the transfer price paid for a wastewater facility represents a private investment in the facility. The private owner will need to recoup its investment and return through user fees, which may be higher than the municipal billing rates. In addition, upon the sale of the asset, the city will no longer receive revenue from retail services tendered by the asset. Therefore, in evaluating the expected gains and losses of an asset sale or lease, the city must integrate the cash flow impacts of the agreement into the city's financial statements and audit process.

In addition, in considering to sell its water and wastewater systems, cities must also consider the treatment of outstanding bonded debt in the sale of the asset. There is risk that under an asset sale, the tax exempt status of bonds sold to finance the facility may become taxable under the 1986 Tax Act. The city must carefully explore the specific steps that can be taken to avoid making tax-exempt bonds subject to tax by the IRS. It is essential that the city retain professional legal and financial advice on these matters to clearly understand its exposure regarding compliance with tax regulations.

Regarding the issue of receiving EPA approval through the grant deviation process, interviews with private industry and city representatives indicated disagreement regarding the EPA's interpretation and implementation of E.O. 12803.

Private industry representatives contend that not all concession fees place an encumbrance on federally funded infrastructure. Their concern is that EPA's incorrect position will unnecessarily discourage city interest in entering contractual agreements.

Cities will be deterred from contract operation agreements because of concern that EPA review will cause unnecessary delays that will cause cities to lose out on potential long-term savings and infrastructure improvement opportunities. This concern is based on past experiences of delays in the federal grant process.

A consensus of city and private industry representatives state that the EPA's definition of lease-type contracts is overly broad and not supported by legal precedent since a concession fee does not automatically place a legal encumbrance on infrastructure, unless specifically stated in the agreement. An up-front contract payment to the city by the company represents a discounting to present value of the anticipated savings that the private operator can offer the city over the term of its service agreement.[24]

Parties contend that the EPA's position on jurisdiction over lease-type agreements is inconsistent with the direct purpose of E.O. 12803 to provide state and cities greater freedom to privatize infrastructure assets. While E.O. 12803 seeks to remove barriers to the achievement of economic efficiencies through additional private market financing, the EPA has created a barrier to privatization of infrastructure assets by requiring federal review of all operating or management agreements that include up-front payment or periodic payments.

Private industry and city representatives contend that projected savings benefits can be split up to both inject up-front revenues for municipal improvements to result in lower user fees and improve long-term planning for increased efficiency.

Regarding E.O. 12803, the parties' positions on asset ownership and opportunities to implement improvements is consistent with the benefits under Internal Revenue Service (IRS) Revenue Procedure 97-13 that allows management contracts to extend to 20 years, instead of the previous 5 year maximum limitation.

[24] Letter, Water Industry Council response to EPA, Bingham Dana, Counsel to Water Industry Council, May 29, 1998. accessed November 5, 1998 online at the Water Industry Council Web site, http://www.waterindustry.org/neietc-a2.htm

IRS Revenue Procedure 97-13

New IRS tax regulations under IRS Revenue Procedure 97-13 were approved on May 16, 1997. IRS Revenue Procedure 97-13 makes it easier for municipalities to enter into long-term arrangements with private parties to operate and maintain water and wastewater infrastructure by allowing longer term deals without impacting the tax-exempt status of governmental purpose bonds.

In the past, the Federal Tax Reform Act of 1986 was an impediment to privatization because it limited public use agreements to 5 years or less. Due to the importance in remaining tax-exempt over the repayment term of their tax-exempt bonds and SRF loans, cities continue to place a priority on maintaining ownership of the wastewater facility in order to meet the conditions allowed by the IRS's "management contract" rules.

Revenue Procedure 97-13 permits management contracts for public utility property, including water and wastewater treatment plants for up to 20 years without endangering the tax-exempt status of outstanding municipal wastewater debt.

Under Revenue Procedure 97-13, 20 year contracts are allowed if at least 80 percent of the city's payments to the private operator are in the form a periodic fixed amount over the asset's useful life. This stipulation limits the amount of net profit that may be provided to the private company. Under IRS rules the more that contractual compensation is based on a fixed fee, the longer the contract term that will be allowed.

Executive Order 12875

On October 26, 1993, E.O. 12875 was approved for the purpose of directing Federal agencies to review their regulatory requirements for reducing federal mandates and increasing flexibility in applying for waivers to Federal requirements. The goal of E.O. 12875 is to allow cities more flexibility to design solutions without excessive micro-management and unnecessary regulation. The purpose of E.O. 12875 is to help remedy the inefficiencies from federal mandates that have resulted in increased costs to state and cities.

Based on conversations with EPA representatives, while the general policy objectives of E.O. 12875 are consistent with the objectives of E.O. 12803, E.O. 12875 does not have as much impact on actual competition implementation as E.O. 12803.

The language of E.O. 12875 states that increased costs, complexity and delays in waiver applications and approval from Federal requirements hinder state and cities from working with federal programs to meet specific needs. E.O. 12875 instructs federal agencies to receive input from public sector stakeholders regarding unfunded mandate regulations. E.O. 12875 recommends increased federal flexibility in allowing governments to get waivers from Federal mandates. It also recommends reducing unfunded mandates that are not required by statute, with the exception of funds necessary to pay direct costs incurred by the state and cities provided by the federal government.

Executive Order 12893

E.O. 12893 encourages investment and improvements to infrastructure facilities and programs (including direct Federal infrastructure expenditure and environmental protection), private sector participation and increased effective state and local programs.

Benefits and costs of infrastructure investments should be measured qualitatively and quantitatively, including life-cycle analysis and analysis of capital and O&M costs. Efficient infrastructure management is to be in accordance with operational and management practices that improve the return from investments.

According to the interviews with EPA staff, even though E.O. 12893 encourages private sector participation in infrastructure investment and management, it does not have effect on implementation nearly as much as E.O. 12803 for enabling improved water and wastewater public/private competition based partnerships.

Phase 4. Survey EPA, AWWA and AMWA to identify 60 privatization, competition and market strategies in the country. Develop a survey and interview for the rationale, strengths, weaknesses, ratepayer impacts and results.

Overview

Based on interviews with EPA, AWWA, AMWA, industry representatives and industry research, a listing was developed of sixty geographically dispersed national cities that have implemented privatization and competitive agreements. A summary of this phase is summarized in Table 19. The 60 national cities are identified in Table 20:

Table 19

Phase 4 Interviews - Survey Results	
Purpose	EPA, AWWA, AMWA and other representatives were contacted to identify 60 cities that have implemented privatization, competition and other competitive market strategies in the nation.
Results	The surveys identified a nationally dispersed group of 60 cities that have implemented privatization and competition agreements that were contacted in Phase 5.

Table 20

National Cities Implementing Competitive Strategies

- Alpena, MI
- Anchorage, AK
- Atlanta, GA
- Berkley Heights, NJ
- Bessemer, AL
- Birmingham, AL
- Booneville, IN
- Bridgeport, CT
- Buffalo, NY
- Burlingame, CA
- Camden, NJ
- Cape Giradeau, MO
- Charlotte, NC
- Cheboygan, MI
- Chicago, IL
- Cincinnati, OH
- Cranston, RI
- Dale City, VA
- Danbury, CT
- Easton, PA
- Edison, NJ
- Evansville, IN
- Farmington, NM
- Franklin, OH
- Gary, IN
- Hawthorne, CA
- Hoboken, NJ
- Indianapolis, IN
- Jersey City, NJ
- Kenner, LA
- Manalapan, NJ
- Miami Conservancy
- Milwaukee, WI
- New Haven, CT
- New London, CT
- New Orleans, LA
- Newark, NJ
- North Brunswick, NJ
- Oak Ridge, TN
- Oklahoma City, OK
- Orange County, CA
- Petaluma, CA
-
- Pine River, MN
- Portage, MI
- Rockland, ME
- San Diego, CA
- Santa Rosa, CA
- Schaumburg, IL
- Schenectady, NY
- Seattle, WA
- Sioux City, IA
- Taunton, MA
- Toronto, OH
- Tulsa, OK
- Vancouver, WA
- Wauwatosa, WI
- West Haven, CT
- West Lafayette, IN
- West New York, NJ
- Wilmington, DE

Subsequent to identifying 60 national competitive strategies, a survey questionnaire was developed for use in interviewing the cities. Key areas of focus in the survey questionnaire are described in Table 12.

Table 21

National Survey Issues

- What types of strategies have been implemented?
- What is the city's rationale for implementing its strategy?
- What is the structure of the contractual agreements?
- Are customers satisfied?
- Have bills been impacted?
- Have there been system improvements?
- What benefits and risks exist?
- Has legislation affected the agreements?

Phase 5. Interview 60 National Cities that have Implemented Privatization, Competition and Marketing Strategies

Process

In conducting the survey, 60 national cities were contacted. At least four calls were made to each city. Follow-up certified mailings and an additional round of telephone calls were made to all non-responding cities in an attempt to complete interviews with all 60 cities. Pursuant to the above procedure, a success rate of 65% was accomplished with 39 completed interviews. A summary of these interviews is provided below in Table 22.

Table 22

Phase 5 Interviews - Survey Results	
Purpose	60 cities identified in Phase 4 were contacted to learn about their specific privatization, sale, lease and managed competition experiences.
Needs	Existing costly operations Inefficient city operations Inability by cities to afford improvements
Benefits	Operational savings Economies of scale Service needs Infrastructure needs Financial assistance Regulatory compliance Technical expertise Need for savings in operations Economies of scale Technical capabilities Bulk purchasing savings Efficient use of labor Estimated savings from 20 to 50%
Barriers	Fear of giving up control Union resistance Belief privatization is not needed Resistance to change
Conclusion	Cities that have needs for cost savings, improvements, environmental compliance, technology expertise or financing benefited from competitive solutions. Each city's unique needs made each solution unique. Cost savings, operational benefits and technical capabilities were clearly reported under operations contracts. Carefully written contracts with specificity in language, terms, expectations, monitoring, accountability, and enforcement are necessary.

Discussion

Each of the 39 national interviews yielded valuable information about each city's unique experience in implementing a competitive water and wastewater strategy. Significantly, while each city's individual circumstance was different, from a policy perspective strategic consistencies arose among many of the respondents regarding the implementation and results of their strategies. The following discussion attempts to summarize the key consistencies and unique exceptions that arose from the round of national interviews.

Types of strategies implemented

Interviews with cities in the national survey identified specific forms of contractual agreements according to the following groups. Table 23 breaks-out the number of cities that are participating in each type of competitive strategy.

Table 23

National Survey: Types of Competitive Strategies Implemented

Type of Agreement	Number of Participants
Managed Competition	5
Contract Operation and Maintenance (existing)	20
Design, Build, Operate	1
Sale	4
Did Not Implement Competitive Strategy	9

Contract terms

Contract duration ranged from 3 years to 20 years in duration. Although cities contemplated both short and long-term agreements in their decision process, upon contract finalization, respondents were evenly split between their preference for long-term and short-term agreements. While some cities valued long-term agreements for increased ability to plan capital improvements and increase savings over the term of the contract, other cities preferred short-term agreements to maintain flexibility of choice.

Rationale and benefits

Table 24 lists the most frequently reported reasons for implementing a competitive strategy according to cities in the national survey.

Table 24

National Cities' Reasons for Implementing Competitive Strategies

- Savings
- Economies of scale
- Service needs
- Infrastructure needs
- Financial
- Regulatory compliance
- Technical expertise
- Costly, inefficient city operations
- Inability to afford improvements

Savings to the city: Virtually all cities in the interview confirmed their need to accomplish savings in the operation of their water and wastewater systems. While some cities could not quantify savings from the privatization agreement, estimated savings according to many cities ranged from 20 to 50%.

Economies of scale: A number of cities identified the benefits of a company's economies of scale in offering technical capabilities, bulk purchasing savings and efficient use of labor as reasons to expect savings.

Service needs: Many cities identified increasing financial pressure to maintain quality services and believed private operations would meet this need. During the interviews, the broad majority of respondents expressed satisfaction with improved or comparable operation and maintenance services.

Infrastructure needs: According to many interviews, existing water and wastewater infrastructure were in need of costly improvements. These cities valued the companies' ability to implement effective, efficient infrastructure improvements.

Financial: Consistent with the need for system improvements, most of the same cities also had concern about their financial capability to fund capital improvements without private sector cooperation in the project. Many of these cities found that company participation in the project did facilitate payment structures that accomplished repayment of federal funds, infrastructure improvements and transfers to the general fund for other city needs.

Regulatory compliance: The need to improve current and future regulatory compliance

requirements was a major factor in particular cities' decision to pursue a contractual agreement with a private company.

Technical expertise and capabilities: Many cities expressed concerns about their limited technical capabilities and identified their need for improved technical expertise and operational capability to manage complex treatment requirements. All respondents believed that in-house technical capabilities helped resolve regulatory compliance problems, facilitated lower costs and improved services.

Costly, inefficient city operations: Many cities confirmed that their ultimate decision to pursue a competitive strategy was impacted by the belief that current city operations were costly and inefficient.

Impediments

Factors that were identified by respondents as impediments in their implementation of a competitive strategy are summarized in Table 25.

Table 25

National Cities' Impediments to Implementing Competitive Strategies

- Concern about giving up control
- Union resistance
- Perception that there is no need.
- Resistance to change
- Regulatory

Although no individual impediment to competition was identified by a majority of respondents, the explanations below were individually identified during the interviews as impediments to implementing a competitive strategy by particular cities.

Concern about giving up control: Inherent reluctance by city managers and leadership to relinquish decision-making authority was cited as an impediment to implementing competitive strategies.

Union resistance: In cities that had union representation of municipal utility employees, resistance by unions to implement private contracts directly reflected the fear of losing jobs and dilution of union power.

Perception that there is no need: A few respondents stated that city managers and leadership did not believe the city had a need to implement a competitive strategy.

Resistance to change: Certain respondents stated that reluctance and resistance to implement a new strategy was evidenced by managers and leadership.

Regulatory: One respondent acknowledged being affected by EPA's claim to jurisdiction for approving contracts with up-front concession fees under E.O.12803. To avoid coming under EPA jurisdiction the city specifically invested in legal assistance to structure a 20-year contractual agreement for equivalent financial benefits and capital improvements as to a concession fee agreement. To avoid the risk of delay under the EPA review process, the city structured a payment schedule with the company to implement revenue and capital improvement goals by redesigning payments and restructuring other costs incurred by the company.

Phase 6. Interview TNRCC, TML and private legal counsel to identify potential statutory amendments to facilitate privatization and/or competition

In the sixth round of surveys, attorneys and professionals from the legal and contract divisions of the TNRCC, the Texas Municipal League and selected private counsel were interviewed to identify potential statutory amendments to facilitate privatization and/or competition. A summary of these interviews is provided below in Table 26.

Table 26

Phase 6 Interviews - Survey Results	
Purpose	TNRCC, TML and private legal counsel were interviewed to identify potential statutory amendments to facilitate privatization and/or competition.
Results	No attorney offered recommendations for changes to existing Texas statutes for improving opportunities for privatization and/or competition. However, during the course of the interviews other issues were raised that may be relevant. Regarding Executive Order 12803 opinions were divided on the appropriateness of the EPA's claim of jurisdiction for review and approval of contracts with concession fees. On the issue of procurement, opinions were divided regarding Texas Code requirements for competitive bidding. The issue or regionalization received favorable comments regarding the TNRCC's recently approved amendment to Chapter 291 of the TAC for a positive acquisition adjustment and base rate recovery of acquisition costs. It is clearly believed that this approval will facilitate mergers, consolidations and regionalization.

The scope of this phase of the workplan was to interview attorney's for recommendations regarding potential statutory amendments to facilitate privatization and/or competition.

The scope of work does not include a full legal review of existing statutes for recommended amendments to facilitate privatization and/or competition.

Since the author is not an attorney, no conclusions were drawn from the interviews and readers should not rely on the interview summaries as accurately identifying the legal considerations of privatization of public infrastructure.

Texas Statutory Issues

The question posed to selected Texas private and government attorneys during this survey phase was whether each counsel had any suggestions for statutory amendments to facilitate privatization and/or competition. No recommendations were made in response to this question. However, during the discussions, other issues came related to privatization and competition. The discussions below describe these other issues that were raised.

Regionalization

Senate Bill 1 (SB 1) was passed by the 75th Texas Legislature, to provide a comprehensive framework for managing the state's water resources under Texas water law. In supporting the intent of SB 1, the TNRCC proposed and approved amendments effective February 4, 1999 that implement competitive changes to Chapters 290 and 291 of the Texas Administrative Code (TAC).

The intent of these amendments is to promote, among other things, financial regulations that allow the TNRCC to approve filed requests for financial recovery of a positive acquisition adjustment for the costs associated with acquiring another system (including utility plant, property and equipment acquired from a retail public utility in a sale and transfer of utility service areas). The rulemaking's goals include facilitating mergers and sales of water and sewerage utility systems to achieve benefits under regionalization and privatization that include removing disincentives to consolidation and regional service.

In conducting its rulemaking process, the TNRCC held focus group meetings and hearings regarding the proposed Texas Administrative Code (TAC) amendments to comply with the requirements of the Safe Drinking Water Act Amendments of 1996 and Articles 5 and 6 of Senate Bill 1 as passed by the 75th Legislature in 1997.

Competitive Bidding

During the phase 6 interviews, the issue of statutory requirements for competitive bidding was raised. In particular, the discussion focused on instances where a city wants to enter into a contract with a private operating company for the provision of water or wastewater services. Often in such cases, cities may be required by their local statutes to issue a competitive bid solicitation (if the contract cost exceeds statutory limits.) Concern exists that at reasonably low levels of acquisition costs ($25,000), competitive bids may cost more in time and expense than potential saving through the process.

Legal opinions during phase 6 surveys offered that competitive bidding for water and wastewater operations is a legal and statutory issue of dispute in Texas that has been litigated and appealed in Texas courts. Each city should review their own city code to see if their purchasing rules follow state procurement guidelines as exemplified in Texas Government Code Title 10, § 2155 (see Appendix).

In support of lessening competitive bidding requirements for municipal water and wastewater contracts, one interview identified "BROWNING-FERRIS, INC., Appellant, v. The CITY OF LEON VALLEY et al., Appellees" as precedent that competitive bids may not be required under Texas statute (the garbage collector quit over a contract dispute and garbage was accumulating.) In this case one Texas court found that the timely collection of garbage was a public health necessity and that the garbage collection constituted a condition that was needed to preserve and protect public health in a timely, efficient and effective manner, thereby excluded from Title 10 of the Texas Government Code. Therefore, the city's garbage contract with a private firm did not have to go through the delays of competitive bidding.

In this interview it was offered that certain water and wastewater services currently competitively bid may meet similar standards for preserving and protecting public health in a timely, efficient and effective manner, thus also deserving of a comparable exclusion from competitive bidding requirements under Title 10 of the Texas Government Code.

A differing opinion in this matter offered that the above decision may not be relevant and does not justify excluding water and wastewater contracts from requirements for competitive bidding. The case in question was viewed as a narrow decision based on what the court regarded as an emergency situation and that although water and wastewater

projects are crucial, they rarely meet the criteria of "emergency" in posing a sudden threat to public health.

Regarding competitive bidding in general, another interview indicated that although local governing boards can set thresholds on procurement limits different than state thresholds, Title 10, Subtitle D (formerly 601.B) of the Texas Government Code (if adopted by local procurement statute), requires a competitive bid solicitation whenever more than $25,000 is to be paid in a contract.

Another comment cited the anti-monopolistic provisions of Article I, Sections 17 and 26 of the Texas Constitution as legal basis for opposing contracts without competitive bidding for essential commodity services.

Finally, a different party stated when maintenance contracts are for less than state limits, the contract does not come under the Professional Services Act. When maintenance contracts exceed the state threshold, a competitive bid is needed. However, it has been noted in actual practice, districts often manage to circumvent this requirement through spot improvement clauses in agreements with private operators.

The competitive bidding requirements issue centers on whether in particular instances state and local solicitation requirements cause improved results or cause inefficiency and extra cost. It is possible that benefits may be possible through improvements to the competitive bidding requirements that streamline procurement procedures in cases where delays may cause larger costs than potential savings. In this regard, cities and the legislature may find it relevant to address whether and how existing procurement statutes may be affecting the goals of privatization and competition.

Federal

Implementing E.O. 12803: Regarding the EPA's implementation of E.O. 12803, interviews with legal counsel were divided regarding the appropriateness of the EPA's current position of jurisdiction over concession fee agreements as leases that require EPA approval and removal of federal interest in funded assets.

One attorney agreed with the EPA's interpretation and saw the similarity in principle that a concession fee was like a lease payment that paid off debt. In this regard, the attorney found the EPA's position to be appropriate because the concession fee worked like a sale

or lease-back payment where the city was taking value for the asset. In this way, the concession fee was like a rent and the city was paying for the total cost of the services and asset to the company.

However, another attorney did not believe that a concession fee constituted a "lease-type" agreement, since there were no encumbrance on the asset of the utility through the contractual agreement for services between the city and the company. The concession fee reflected one up-front payment that was reflected in the net present value of the contract's payment stream over its contract term. There is no ownership of the asset by the company. Consequently, the EPA was incorrect in its guidance and position regarding jurisdiction over "lease-type" contractual agreements.

Conclusions

Summary

If a city's water and wastewater system's operations are efficient and their infrastructure is in good condition and in compliance with state and federal laws, there probably is not a need to consider competitive market options.

However, if the city has needs for operational savings, system improvements, regulatory compliance, technology and labor expertise or financing, then competitive strategies will likely be of benefit.

In choosing a competitive market strategy, there is not one simple answer. Public acceptance, political concerns and other unique circumstances will also influence each city's decision-making process regarding which competitive strategy best meets its particular needs.

Based on these competitive considerations, if the city's needs are significant or urgent, then an operations contract is probably the short-term path to pursue, unless it wants to sell its system to another operator, as is facilitated under the TNRCC's new acquisition rules. Examples of conditions for contracting or selling include sanctions by the EPA for compliance violations, infrastructure upgrading and improvement needs, labor expertise and technical deficiencies, debt and financing concerns, need for savings or if the city has no interest in operating the utility.

However, if the city is interested in continuing to operate its water and wastewater systems, it may choose to first implement an employee managed competition strategy. By investing numerous years and reasonable expense on internal preparation, the city can empower municipal employees to perform self-evaluation and improvement measures in preparation to compete in a selection process against private companies.

The major reasons that cities identified for considering competitive market water and wastewater strategies include need for regulatory compliance, improved savings, infrastructure requirements, financial funding requirements and need for technical expertise. Table 27 below describes the benefits and risks associated with each competitive marketing strategy.

Table 27

Benefits and Risks of Competitive Market Strategies

Managed Competition

Benefits
Cooperative purchasing/contracting
Performance based incentives
Resale of by-products
Selling services
Cross-training efficiencies
Staff reductions through attrition
Bureaucratic reform
Scheduled maintenance
Reduced inventory costs
Instrumentation and automation

Risks
Weaker performance enforcement
Financial risk
Regulatory risk
Labor and technical needs
Long lead time preparation

Operations Contracts

Benefits
Savings over municipal costs
Operations experience
Problem solving success
Technology & skills expertise
Regulatory compliance
Capital improvements
Enforcable performance

Risks
Contract risk:
- Financial control
- Monitoring
- Communications
- Enforcement

Leases

Benefits
Infrastructure financing
Rate stabilization
Debt reduction
Expertise
Focus on other priorities

Risks
Loss of oversight
Loss of operational control
Loss of enforcement
EPA approval and need to eliminate federal interest

Asset Sales

Benefits
Financial
Retire debt
Improve infrastructure
Economies of scale
Technical expertise
Accelerated debt depreciation
Lowers city responsibility

Risks
No monitoring
Rate risk
Loss of control
No contractual recourse
No decision authority
Legal, regulatory, financial risk
Loss of tax-exempt bond status
Higher regulatory requirements

Successful Strategies – Criteria / Common Reasons

The majority of cities interviewed stated that their competitive strategies provided solutions to each town's specific needs. Criteria or reasons provided cited overall savings, improved operating efficiency, regulatory compliance and customer satisfaction as the most frequently reported findings that cities gave as criteria for successful competitive strategies. Table 28 below summarizes the criteria, or common reasons given most commonly by cities as proof that their competitive market strategy for improving water and/or wastewater services are successful.

Table 28

Criteria / Reasons for Successful Competitive Strategies

Reduced operation cost Increased operational efficiency Improved system condition Meet environmental regulations Serve growing demand Rate stability	Acquired technical capabilities Improved services Pay for improvements Build infrastructure Financial assistance

Discussion

Results of surveys with Texas and national cities indicated that the vast majority of competitive marketing strategies in Texas and the nation are contractual agreements with private companies.

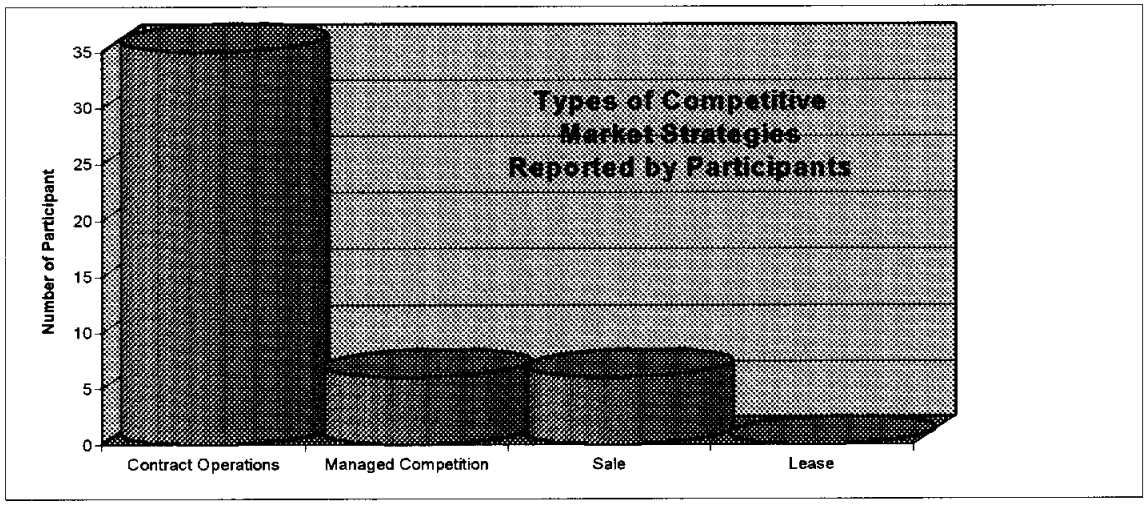

Figure 3

Figure 3 shows that of 57 Texas and national cities that were interviewed, 35 entered into contractual operation agreements with private companies, 6 implemented managed competition, 0 executed a lease and 6 system sales were performed.

Success of Contractual Agreements

In addition to the above for cities' successful experiences with contractual agreements, one city additionally reported that after the agreement was implemented, municipal employees expressed strong interest in joining the private operating company.

Regarding contract structure, the most commonly reported issue as essential to a successful contract was the need for explicit and comprehensive contract language and terms.

Specific contract terms recommended by many cities included performance, monitoring, reporting, review and penalty requirements and clauses. In addition, commenters also recommended provisions to update the terms of the contract for changes, detailed language on cost responsibilities and payment schedules as other important elements of a contractual agreement.

In facilitating operations contracts, cities identified IRS Revenue Procedure 97-13 as the most effective regulatory incentive to competition because it allows long-term contractual agreements. A majority of cities identified the ability to enter into long-term contracts as a valuable means to increase efficiency, planning, savings and infrastructure improvements.

Among all of the cities interviewed, there was a reasonably even split between cities' preferences for implementing short-term versus long-term agreements. According to individual management preference, some cities liked short-term agreements because they afforded more opportunities to choose another supplier while providing incentives to the company to perform. Conversely, other city managers saw value, increased benefits and savings through longer-term deals that allowed improved long-term, cooperative planning with the company to implement infrastructure improvements and stabilize rates.

Other Successful Strategies

Although very few cities have sold or leased their systems to private companies, the few examples of system sales and leases indicate satisfaction with the results. Barriers to system sales and leases primarily reflected management and public concerns about losing ownership and ultimate control of their municipal utility facilities

The surveys and research also identified that particular cities have implemented municipal employee improvement "managed competition" programs as a strategy. In instances where managed competition has been implemented, cities appear satisfied with the results. According to interviews, the three primary impediments to implementing managed competition strategies are that city employees must win competitive bid proposals against private competitors, the high costs and extensive lead time necessary to prepare municipal employees to compete and the motivation and willingness of city employees.

Recommendations

Summary

As a result of the interviews and research in this engagement, the report offers three recommendations for cities that are considering privatization and competitive market options. During the interviews of selected private and government legal counsel to identify potential statutory amendments to facilitate privatization and/or competition, no recommendations for changes to existing Texas statutes were offered. A full legal review of existing statutes would be needed to appropriately identify recommendations for changes to existing statutes to facilitate privatization.

The first recommendation proposes that cities perform a self-evaluation to assist in deciding whether a city can benefit from privatization or competitive market strategies. This evaluation process recommends an inventory of self-appraisal, performance benchmarking and an internal capability analysis.

The second recommendation proposes a three-step process to choose a competitive strategy. First, the city must decide on a path and timeline for implementing a competitive water and/or wastewater strategy. This choice must include an up-front decision on whether or not to make a significant investment of time and finances for municipal employee preparation prior to competing against private companies.

Second, if the city chooses to support a municipal employee preparation process, it must commit the appropriate resources to its municipal employees for strategic planning and improved processes.

Third, the study provides a detailed listing of performance and qualifications requirements for use in comparing and evaluating competitive proposals.

The third recommendation presents an inventory of key contractual and financial considerations that the city should consider in constructing a contractual agreement.

Discussion

A. Recommendation #1: Evaluating Need / Checklist of Key Needs

Listed below are ten questions for cities to self-evaluate the capabilities of their water and wastewater system operations, finances and compliance. These questions elevate key issues for cities to consider in evaluating whether their utility systems are in need of improvement[25]:

Efficiency: Are the municipal water and wastewater systems as efficient as the best run utilities?

Financing improvements: Will the city be able to finance needed improvements?

Rates: Will rates increase if the city implements needed capital improvements?

Compliance: Are the city's water and wastewater systems currently, or expected to be out of compliance with Federal and State regulations?

Technology: Do municipal, management and staff have the technical expertise to perform improvements, operations and maintenance?

Cost of service: Are the water and wastewater systems recovering their costs of service?

Economies of scale: Is there room to lower operations and procurement costs under larger economies of scale?

Load growth: Is the city's population expected to increase and require infrastructure improvements?

Safety & management: Are management and staff appropriately skilled to ensure all safety requirements for performance reliability?

Benchmarking and Assessing Internal Capabilities

If answers to the above questions indicate the city's water and wastewater systems have need for improvement, then the city should proceed with a benchmarking and self-evaluation process to identify its areas of need. This process will assist in verifying whether the city can improve efficiencies and make infrastructure improvements through internal or private market strategies[26].

Benchmarking involves comparing a city's business practices, core services and system operations to other top-performing operations, preferably of a similar sized system. Performing this appraisal requires breaking out the water and wastewater system's costs of service, rates

[25] New England Interstate Environmental Training Center, "Draft Outline, 'Contract Operations Guidance Document' Getting From Here to There", accessed November 5, 1998 online at the Water Industry Council Web site, http://www.waterindustry.org/neietc-a4.htm

[26] *Managed Competition*, Association of Metropolitan Sewerage Agencies, Washington, D.C., 1997.

and production levels for comparison against other comparable, well functioning utilities. The analysis of comparative financial and supply performance criteria will help show whether operations are cost efficient or not.

Self-evaluation of internal performance involves management review of the city's water and wastewater utility track record of performance and costs. This management review process involves review of regulatory filings, compliance, and operating costs. The result will be a useful management communications and information tool for improving performance. Listed below are examples of benchmarking and self-evaluation criteria that will help the city identify whether it is operating efficiently or whether competitive marketing strategies can provide improved performance and savings.

Operating expense analysis: Internal variance analysis and external comparisons of unitized costs of specific cost centers with other utilities may help identify areas of operational and cost inefficiency.

Capital improvements: Evaluate whether system capital improvement needs have been performed in the past or deferred. Include expected capital improvements that are expected to occur in the future for maintenance, upgrade and compliance purposes.

Rates: Compare water and wastewater rates and bills to comparable cities. Synchronize this analysis with the evaluation of operating and capital expenses to identify whether customers are being charged non-competitive rates.

Budget analysis: Check city budgets to determine if the city's water and wastewater costs of service are being covered by revenues. Look at past and prospective operating costs.

Compliance: Assess whether the water and wastewater systems are in compliance or whether they have a history of violations with regulatory requirements.

Repeating Problems: Identify whether operation and maintenance, budget variances and safety problems frequently recur.

Labor: Evaluate whether the city's utility staff possess the training and skills to meet current and expected water and wastewater infrastructure and operating performance requirements according to State and Federal regulations. Areas to check include turnover and attrition, training and qualifications, certification as required, accident and safety reports.

Forecasted needs: Project future water and wastewater customer needs using population, commercial and industrial growth expectations. Evaluate whether new and expected compliance and treatment requirements will affect future system performance needs.

B. Recommendation #2: Preparing for Competition

Choosing a Path to Competition

Based on the decision that water and wastewater efficiencies and savings can be accomplished, the city must then decide the measures it wants to consider for improving its systems. The city must decide whether to allow its municipal management and employees to compete with private operating companies to provide services to the city. The Flowchart in Figure 4 shows the sequence of steps a utility faces in preparing to choose a competitive strategy.

Figure 4

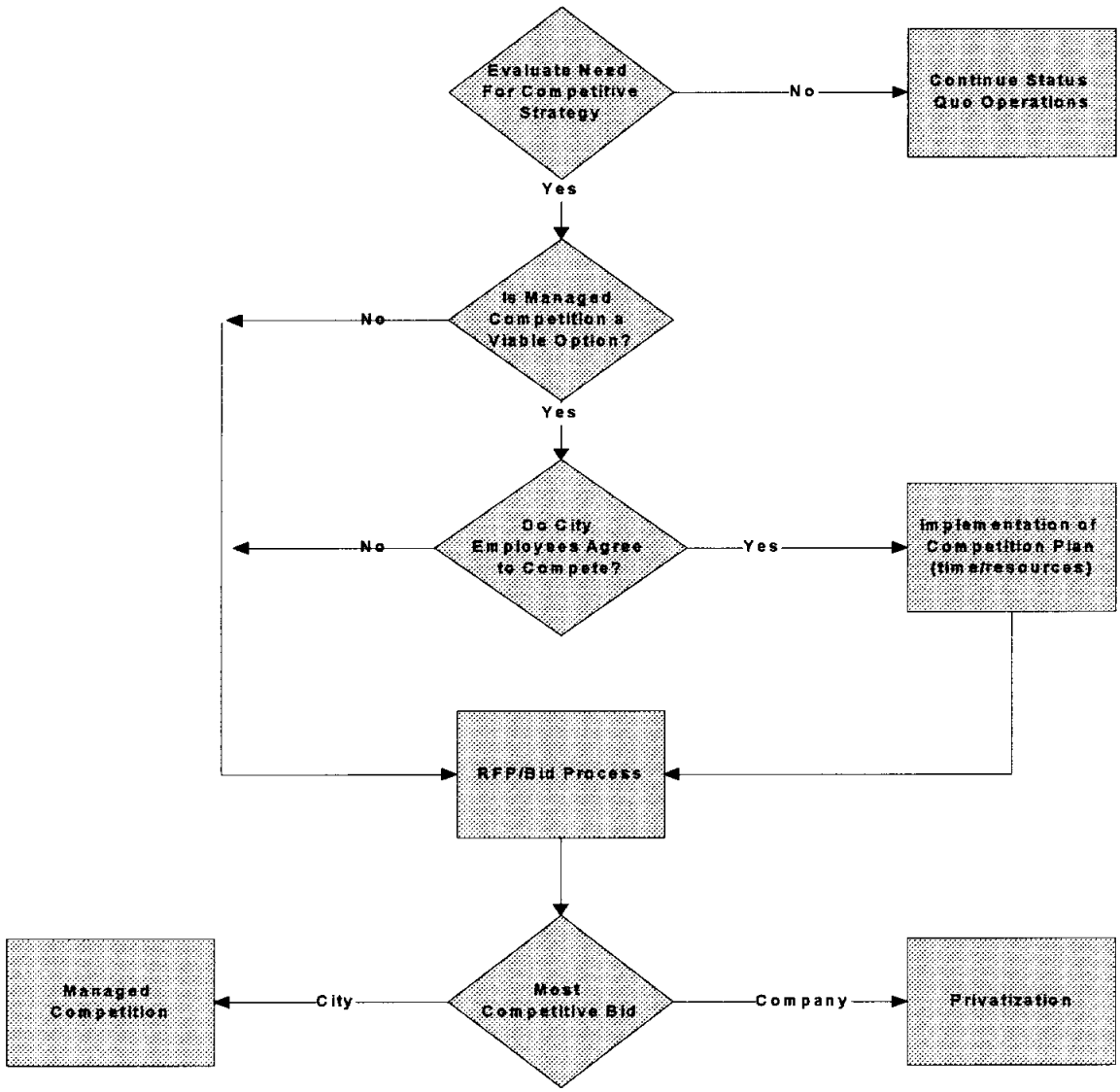

Figure 4 shows that the city may decide to immediately seek private sector competitive market solutions. Basis for this choice may be that the city has serious or urgent compliance, operational or infrastructure needs that cannot be solved internally. Under this path, the city must identify what improvements are needed and then develop a comprehensive solicitation and contract for bidding and negotiation. Under this approach, the city private sector options include contract operations, system sale or lease agreements.

Under the second path, the city pursues a managed competition strategy that allows municipal employees to develop an improvement plan. Under this approach, the city must make a material up-front commitment to invest time and resources to assist municipal employees train and develop competitive marketing plans. Managed competition requires a lead-time of between one to three years for preparation. As seen in the Charlotte, North Carolina managed competition case study in the Appendix "Case Studies", employees were allowed three years for planning and preparation prior to competing in a competitive bid solicitation with private operating companies.

According to the Association of Metropolitan Sewerage Associations (AMSA), a comprehensive managed competition process will require between $300,000 to $500,000 to fund, and can take numerous years (up to five-years) to complete. Additional, non-quantifiable costs will also be incurred as employees divert productive time to managed competition preparation[27].

At the conclusion of the municipal employee preparation process, a competitive bid solicitation should be conducted between interested public and private competitors to document budget costs and performance requirements. The competitive selection process ensures that the most appropriate and qualified strategy is selected.

If the city's managed competition strategy is awarded selection, it is strongly recommended that the budget costs of the bid be established as the benchmark for compensation incentives for the employees in the absence of a legally enforceable contract as would be offered to a private company. This recommendation was successfully implemented by the City of Charlotte, North Carolina in its managed competition program. The risk of non-performance increases greatly under managed competition if the department is not held to specific, measurable performance and budget goals.

[27] *Managed Competition*, Association of Metropolitan Sewerage Agencies, Washington, D.C., 1997.

Preparation of Municipal Employees under Managed Competition

Deciding to invest time and money into a managed competition process is a critical decision in the city's competitive process.

Reasons to allow municipal employees to prepare for a competitive bid solicitation may include political and management considerations as well as the magnitude of compliance, infrastructure, savings and efficiency needs. Potential advantages from managed competition include that municipal employees are more familiar with the infrastructure systems, municipal utility operations do not have to generate shareholder return, they are tax exempt and have access to tax-exempt financing and loans under state revolving fund programs[28].

In organizing prior to competition, AMSA recommends that municipal employees implement five stages in its competitiveness process. Table 29 summarizes the stages and estimated time to perform each stage[29].

Table 29

Stages in Managed Competition Preparation

- Understand current conditions relative to competitiveness.
- Build awareness of competitiveness among staff/stakeholders (2-3 months.)
- Coordinate strategies and performance targets (6-9 months.)
- Plan department changes, promote internal competitiveness (8-12 months.)
- Implement methods, responsibilities and technology plans (18-36 months.)
- Improve practices, responsibilities, plans and performance.

Soliciting Competitive Proposals - Importance for Detail

Soliciting competitive proposals is essential for a successful contractual agreement. A well planned and explicit competitive solicitation will attract accurate, low cost, effective bids.

Not surprisingly, a well developed competitive bid solicitation is appreciated by potential bidders because it enables bidders to improve the accuracy and appropriateness of their proposals by reducing uncertainty about the city's expectations. Increased certainty enables bidders to better estimate their profit margin in the proposal and lower bid prices. Listed below are important details that should go into a competitive proposal solicitation.

[28] *Evaluating Privatization*, Association of Metropolitan Sewerage Agencies, Washington, D.C., 1996.
[29] *Thinking, Getting, Staying, Competitive*, A Public Sector Handbook, Association of Metropolitan Sewerage Agencies, Washington, D.C., 1996. p. 18-19

Soliciting Competitive Proposals - Elements of the Solicitation

The solicitation is the blueprint that provides information to prospective bidders about the numerous aspects of the proposed contract requirements. Scope of services, purpose, term of contract, performance targets, legal and payment are examples of key elements of a solicitation. It is essential that the solicitation clearly and precisely specify what services are to be performed and priced.

The proposal format should also be clearly defined to facilitate similar formatting among the proposals. Similar formatting will ease the review of bid proposals and provide a common framework with clear benchmarks for the bidder. It is strongly recommended that the city should retain experienced professional and legal assistance in developing the solicitation to assure it accomplishes the city's goals. In addition, the solicitation should be announced and well circulated, allowing adequate time for prospective bidders to prepare effective proposals.

Table 30 summarizes the issues that should be described in a solicitation. This list provides the reader with an example of a "proposal format." It is important to note that many of the elements of the solicitation should also be included as elements in the final contractual agreement[3031].

Table 30

Components of a Competitive Solicitation

- Purpose
- Organization / corporate profile (Overall firm qualifications, financial strength)
- Scope of services
- Term of contract
- Performance history (list of clients and references)
- Administration (principals)
- Management and Staffing (Personnel and technical qualifications)
- Description of how services are to be provided (in-house staff, contract services)
- Operating responsibilities (permitting, regulatory, plant operations laboratory, violations)
- Maintenance responsibilities (planning, scheduling, routine, preventive, corrective, system)
- Technical approach and operations workplan
- Evaluation criteria
- Cost parameters
- Definition of terms
- Description of selection process and timeline
- Date of proposal meeting / site visits procedure
- Format for proposals

[30] New England Interstate Environmental Training Center, "Draft Outline, 'Contract Operations Guidance Document' Getting From Here to There", accessed November 5, 1998 online at the Water Industry Council Web site, http://www.waterindustry.org/neietc-c1.htm

[31] *Managed Competition*, Association of Metropolitan Sewerage Agencies, Washington, D.C., 1997.

The Scope of Services is probably the most important section of a solicitation for explaining the city's expectations to potential bidders. It will provide the framework for the municipality's performance expectations. Responses to the Scope of Services will probably be a key basis for selecting a service provider.

The city must expend significant efforts in preparing the description of its scope of services to ensure it accurately reflects the city's water and/or wastewater facility and operational needs. Table 31 lists key elements that should be included in the contract's Scope of Services[32]:

Table 31

Elements in a Scope of Services

- Description of the facilities (incl. water & wastewater collection / distribution systems.)
- Description of the types of services/improvements to be provided by the bidder.
- Regulations and administrative requirements.
- Reporting responsibilities.
- Maintenance budget.
- Requirements for sludge and water treatment.
- Capital budget.
- Description of the purchasing process and responsibilities.
- Performance standards.
- Compliance guarantee by the contractor.
- Terms for equipment management and ownership.
- State requirements for contract approval.
- Procedures for changes in the scope of services.
- Contact persons.

To better understand potential savings and quality of performance under each proposal, it is recommended that cost should be itemized in each proposal according to the following categories[33]:

- Labor
- Overhead
- Chemicals
- Supplies
- Sludge & treatment
- Technical support

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[32]New England Interstate Environmental Training Center, "Draft Outline, 'Contract Operations Guidance Document' Getting From Here to There", accessed November 5, 1998 online at the Water Industry Council Web site, http://www.waterindustry.org/neietc-c1.htm

[33] New England Interstate Environmental Training Center, "Draft Outline, 'Contract Operations Guidance Document' Getting From Here to There", accessed November 5, 1998 online at the Water Industry Council Web site, http://www.waterindustry.org/neietc-c2.htm

Evaluation criteria and scoring: In requiring specific criteria to be included in all proposals enables the city to evaluate, weigh and score proposals. Prior to promulgating the solicitation, the city should determine the weighting and scoring method that will be used in evaluating the criteria and proposals. It is important that the city also weigh each proposal in total, to account for the completeness, responsiveness, and understanding of the project's responsibilities[34].

C. Recommendation #3: Contractual Elements

The third set of recommendations presents an inventory of key contractual and financial considerations that the city should seriously consider using in a contractual agreement once the city has selected a strategic option.

Following the review of all bids and the selection for award of a competitive bid, the city must complete negotiations of its contractual agreement with the selected company. The contract places a legal obligation on both the city and the company for performance and payment obligations. Consequently, both parties will require legal representation in the finalization of the agreement[35].

The following list is offered as an example of proposed elements to be included in a contract. It is not intended to be exhaustive and other key contractual issues not listed in the listing below may be equally or more appropriate for inclusion. To repeat, it is strongly recommended that the city retain expert, experienced legal representation in the final construction of the contract.

Scope of services: Work to be performed by the contractor.

Staffing: Description of minimum staffing requirements, hiring and dismissal of current public employees.

Additional services: Tasks that will fall under the contractor's obligations for service, probably performed previously by municipal employees.

Maintenance, training and safety schedule: Maintenance and inspections to be performed by the contractor to maintain the facility reliability and to protect the community's health.

Capital improvements and repairs: The contract should include a procedural timeline for implementing planned capital improvements, performance criteria, liability for non-performance.

Force Majeur: Factors beyond control must be explicitly defined in the contract.

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[34] *Managed Competition*, Association of Metropolitan Sewerage Agencies, Washington, D.C., 1997.

[35] New England Interstate Environmental Training Center, "Draft Outline, 'Contract Operations Guidance Document' Getting From Here to There", accessed November 5, 1998 online at the Water Industry Council Web site, http://www.waterindustry.org/neietc-c3.htm

Assignment of risk: The contract must explicitly identify what risks belong to the operator regarding performance as well as identify conditions that are beyond the operator's control regarding the performance of contractual responsibilities.

Ongoing reporting requirements and Identification of accountable company officers: Specific lines of accountability and communications for ongoing reporting of performance, complaints and billing.

Audit of contractor's billing records: The owner must have the right to audit the contractor's billing records associated with the contractual agreement.

Regulatory, reporting and complaint responsibilities: Accountability for specific regulatory filings with local, state and federal governments including identification of accountable company representatives that are responsible for each filing. Responses to complaints and other reporting responsibilities should also belong to the operating company.

Emergency notifications: Specific emergency procedures, including authorities and contact persons under emergency conditions.

Insurance requirements: Specific responsibilities for all required insurance coverage programs including explanations of facility coverage, premium payment and liability responsibilities.

Ownership: Identification of equipment suppliers and ownership. Specific description of each party's responsibilities for supplying payment of materials and equipment, including ownership during and after the term of the contract.

Severability and termination: Provisions and acceptable reasons for either the city or company to exit the contract prior to the expiration date.

Indemnification clause: To identify which party is responsible for regulatory penalties and fines.

Cost: The amount agreed between the city and the company for services to be rendered.

Payment schedule: Terms of payment to the company for services rendered.

Performance penalties: Fines or other penalties that can be levied against the contractor for not meeting the terms of the contract and other legal responsibilities for operating the facility.

Transition conditions between contracts: Liability of both the municipality and the company at the end of a contract and prior to a new contract either with the existing company or a new company.

Accepted proposal: A complete copy of the bid prepared by the contractor should be attached to the contract.

Definition section: The contract will include glossary of key word definitions.

Subsequent to performing the contractual agreement, performance monitoring and communications are necessary by the city to ensure that performance by the company is in compliance with the terms agreement.

As previously discussed, monitoring requirements will depend on many factors. Age and condition of the water and wastewater facilities, company qualifications of the firm, diligence and capability of the city to monitor performance are examples of matters that will dictate the level of the city's performance monitoring responsibilities. To the level of monitoring that is warranted the city should maintain regular review of financial indicators, site visits, reports and ongoing communications to assess compliance. These monitoring responsibilities should be performed by either city staff, shared with other cities or with third-party private company employees.

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Summary of Survey Results
Texas

Population: (5,000 to 19,999)

City	Description
Angleton	Five-year O&M contract was implemented for savings, compliance and improved services. City is not completely satisfied with company services and has received complaints. Contract contains exit clauses, performance criteria and dispute resolution sections. RFP's were solicited but not from employees. E.O.12803 and IRS 97-13 influenced outsourcing decision.
Burkburnett	City and citizens have experienced improved services and satisfaction with company. Medium term deals promote stable workforce and service quality. Contract contains exit clauses, performance criteria, enforcement/dispute resolution and capital improvement provisions.
Elgin	The City sold its wastewater facility in 1994. Rationale was financial. City considered contracting but infrastructure upgrade requirements dissuaded companies from service agreements. City has considered regionalization and participated in studies with buyer on regionalization.
Freeport	Five-year contract provides water treatment, wastewater collection, distribution and meter reading. City needed to upgrade infrastructure due to state compliance regulations. City not pleased with customer service. Contract does not have performance criteria, accountability, monitoring clauses. Maintenance has declined.
Pampa	City has five-year renewable contracts. City likes longer-term contracts to improve infrastructure upgrades. City has trouble retaining personnel. Trained staff leave. City is satisfied with service. Reason for contract was for expertise and savings. Local barriers to contract services. Contract has improvement, enforcement, dispute resolution, performance and exit clauses.
Stephenville	Five-year contract for wastewater treatment. Reason: company us more efficient, has technical expertise, manage "red tape," better resources. City prefers shorter contracts to match changes in council. Politics impede long-term deals. City is satisfied with company services. Contract has exit, performance criteria, enforcement/dispute resolution and capital improvement terms.

Population: (20,000 to 79,999)

City	Description
Del Rio	City found itself behind the power curve in wastewater regulation compliance. The City has had a traditionally difficult time attracting skilled labor. OMI currently operates both of the City's wastewater treatment plants. The City had a five-year contract and is now in year two of a three year renewal. The City is currently considering taking back operations sighting additional cost savings as the reason.
Round Rock	LCRA purchased the City's two wastewater treatmemt facilities for $23.7 million. Round Rock joined a regional wastewater approach to providing sewer service and the prospect of lower rates for customers. LCRA and the Brazos River Authority will jointly operate the wastewater facilities.
Huntsville	City under contract for water services since late 1970's. City likes longer-term deals to ensure water right commitments. Rationale: to acquire better, more reliable water supplies. City likes employee bidding to improve understanding of all costs of services. Important to maintain coordination with the company. Good coordination is essential to successful relation with supplier.
Georgetown	Five-year contract has five-year renewal based on IRS 97-13. Reason for contract was for company expertise and to keep up with water developments. City is satisfied with contractual agreement. All employees were offered company jobs at same or better pay. Positive results of water contract have convinced City to privatize its wastewater system. Savings of 25% to 30%.
San Benito	City had 2-year management contracts water/wastewater systems. Rationale: economic, to save on the cost of operations. City issued an RFP. Contract did not have performance, monitoring or dispute resolution clauses. City was not satisfied with service, taste and smell complaints. City ended contract and operates systems now. However, City is satisfied with its solid waste contract.
Temple	Five-year contract was solicited to reduce City management stress, savings and infrastructure improvements. City's solicitation included employee bid, which came in 2nd place. Recommends that prior to selecting a company, cities should do extensive research, references, and include precise expectations in RFP. City likes longer-term deals for savings.

Summary of Survey Results
Texas

Population: (80,000 to 2,00,000)

City	Description
Austin	City instituted a 2-phase internal assessment process to evaluate efficiency and benefit opportunities. City will not seek company privatization proposals due to resistance by union, council. Phase 1 benchmarked costs against comparable utilities. City is currently in phase 2 to identify streamlining and management plan to achieve results of competition within next five-years.
Bexar MWD	District has entered a 10-year contract with 10-year renewable term for D-B-O (design-build-operate) of a surface water treatment plant. Reason: district wanted the new plant quickly. IRS 97-13 played some role in the contract structure. Contract has exit, performance, enforcement and dispute resolution clauses. RFQ was distributed prior to company selection.
Corpus Christi	City evaluated managed competition and meetings with private service providers regarding privatization opportunities. Staff was going to bid against companies. An internal study was performed to identify improvements. It was decided that overall, the system was in good shape and operating efficiently. It was decided to not proceed with any competitive options.
Dallas	City is currently evaluating portions of wastewater system to privatize. City will not contract out core competency to protect system integrity. Currently bidding out for handling of bio-solids. City is seeking a 3-year contract. This allows the City to control increase costs that must be funded through the annual operating budget. Long-term deals pose more financial risks.
Fort Worth	Two water and wastewater services are privatized: biosolids handling and meter reading. Reason: biosolids contract brought on by diminishing space at landfills. The contractors have a dewatering and re-use program. The contract was a D-B-O and City owns plant. Meter reading contract is due to cost savings opportunities.
Houston	Five-year private contract for water treatment plant operations after a competitive bid solicitation that included a municipal employee managed competition proposal. Competition strategy has resulted in budget savings. Recommend: carefully structured contract language for services, responsibilities, contract administration, quality control and quality assurance measures.

Internal Revenue Service
Revenue Procedure 97-13

SECTION 4. EFFECTIVE DATE

This revenue procedure is effective for all open years.

SECTION 5. EFFECT ON OTHER REVENUE PROCEDURES

Rev. Proc. 95–21 is amplified, in part, and modified, in part.

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26 CFR 601.601: Rules and regulations. (Also Part I, §§ 103, 141, 145; 1.141–3, 1.145–2.)

Rev. Proc. 97–13

SECTION 1. PURPOSE

The purpose of this revenue procedure is to set forth conditions under which a management contract does not result in private business use under § 141(b) of the Internal Revenue Code of 1986. This revenue procedure also applies to determinations of whether a management contract causes the test in § 145(a)(2)(B) of the 1986 Code to be met for qualified 501(c)(3) bonds.

SECTION 2. BACKGROUND

.01 *Private Business Use.*

(1) Under § 103(a) of the 1986 Code, gross income does not include interest on any state or local bond. Under § 103(b)(1) of the 1986 Code, however, § 103(a) of the 1986 Code does not apply to a private activity bond, unless it is a qualified bond under § 141(e) of the 1986 Code. Section 141(a)(1) of the 1986 Code defines "private activity bond" as any bond issued as part of an issue that meets both the private business use and the private security or payment tests. Under § 141(b)(1) of the 1986 Code, an issue generally meets the private business use test if more than 10 percent of the proceeds of the issue are to be used for any private business use. Under § 141(b)(6)(A) of the 1986 Code, private business use means direct or indirect use in a trade or business carried on by any person other than a governmental unit. Section 145(a) of the 1986 Code also applies the private business use test of § 141(b)(1) of the 1986 Code, with certain modifications.

(2) Corresponding provisions of the Internal Revenue Code of 1954 set forth the requirements for the exclusion from gross income of the interest on state or local bonds. For purposes of this revenue procedure, any reference to a 1986 Code provision includes a reference to the corresponding provision, if any, under the 1954 Code.

(3) Private business use can arise by ownership, actual or beneficial use of property pursuant to a lease, a management or incentive payment contract, or certain other arrangements. The Conference Report for the Tax Reform Act of 1986, provides as follows:

> The conference agreement generally retains the present-law rules under which use by persons other than governmental units is determined for purposes of the trade or business use test. Thus, as under present law, the use of bond-financed property is treated as a use of bond proceeds. As under present law, a person may be a user of bond proceeds and bond-financed property as a result of (1) ownership or (2) actual or beneficial use of property pursuant to a lease, a management or incentive payment contract, or (3) any other arrangement such as a take-or-pay or other output-type contract.

2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II–687–688, (1986) 1986–3 (Vol. 4) C.B. 687–688 (footnote omitted).

(4) A management contract that gives a nongovernmental service provider an ownership or leasehold interest in financed property is not the only situation in which a contract may result in private business use.

(5) Section 1.141–3(b)(4)(i) of the Income Tax Regulations provides, in general, that a management contract (within the meaning of § 1.141–3(b)(4)(ii)) with respect to financed property may result in private business use of that property, based on all the facts and circumstances.

(6) Section 1.141–3(b)(4)(i) provides that a management contract with respect to financed property generally results in private business use of that property if the contract provides for compensation for services rendered with compensation based, in whole or in part, on a share of net profits from the operation of the facility.

(7) Section 1.141–3(b)(4)(iii), in general, provides that certain arrangements generally are not treated as management contracts that may give rise to private business use. These are—

(a) Contracts for services that are solely incidental to the primary governmental function or functions of a financed facility (for example, contracts for janitorial, office equipment repair, hospital billing or similar services);

(b) The mere granting of admitting privileges by a hospital to a doctor, even if those privileges are conditioned on the provision of de minimis services, if those privileges are available to all qualified physicians in the area, consistent with the size and nature of its facilities;

(c) A contract to provide for the operation of a facility or system of facilities that consists predominantly of public utility property (as defined in § 168(i)(10) of the 1986 Code), if the only compensation is the reimbursement of actual and direct expenses of the service provider and reasonable administrative overhead expenses of the service provider; and

(d) A contract to provide for services, if the only compensation is the reimbursement of the service provider for actual and direct expenses paid by the service provider to unrelated parties.

(8) Section 1.145–2(a) provides generally that §§ 1.141–0 through 1.141–15 apply to § 145(a) of the 1986 Code.

(9) Section 1.145–2(b)(1) provides that in applying §§ 1.141–0 through 1.141–15 to § 145(a) of the 1986 Code, references to governmental persons include section 501(c)(3) organizations with respect to their activities that do not constitute unrelated trades or businesses under § 513(a) of the 1986 Code.

.02 *Existing Advance Ruling Guidelines.* Rev. Proc. 93–19, 1993–1 C.B. 526, contains advance ruling guidelines for determining whether a management contract results in private business use under § 141(b) of the 1986 Code.

SECTION 3. DEFINITIONS

.01 *Adjusted gross revenues* means gross revenues of all or a portion of a facility, less allowances for bad debts and contractual and similar allowances.

.02 *Capitation fee* means a fixed periodic amount for each person for whom the service provider or the qualified user assumes the responsibility to provide all needed services for a specified period so long as the quantity and type of services actually provided to covered persons varies substantially. For example, a capitation fee includes a fixed dollar amount payable per month to a medical service provider for each member of a health maintenance organization plan for whom the provider agrees to provide all needed medical services for a specified period. A capitation fee may include a variable component of up to 20 percent

of the total capitation fee designed to protect the service provider against risks such as catastrophic loss.

.03 *Management contract* means a management, service, or incentive payment contract between a qualified user and a service provider under which the service provider provides services involving all, a portion of, or any function of, a facility. For example, a contract for the provision of management services for an entire hospital, a contract for management services for a specific department of a hospital, and an incentive payment contract for physician services to patients of a hospital are each treated as a management contract. See §§ 1.141–3(b)(4)(ii) and 1.145–2.

.04 *Penalties* for terminating a contract include a limitation on the qualified user's right to compete with the service provider; a requirement that the qualified user purchase equipment, goods, or services from the service provider; and a requirement that the qualified user pay liquidated damages for cancellation of the contract. In contrast, a requirement effective on cancellation that the qualified user reimburse the service provider for ordinary and necessary expenses or a restriction on the qualified user against hiring key personnel of the service provider is generally not a contract termination penalty. Another contract between the service provider and the qualified user, such as a loan or guarantee by the service provider, is treated as creating a contract termination penalty if that contract contains terms that are not customary or arm's- length that could operate to prevent the qualified user from terminating the contract (for example, provisions under which the contract terminates if the management contract is terminated or that place substantial restrictions on the selection of a substitute service provider).

.05 *Periodic fixed fee* means a stated dollar amount for services rendered for a specified period of time. For example, a stated dollar amount per month is a periodic fixed fee. The stated dollar amount may automatically increase according to a specified, objective, external standard that is not linked to the output or efficiency of a facility. For example, the Consumer Price Index and similar external indices that track increases in prices in an area or increases in revenues or costs in an industry are objective external standards. Capitation fees and per-unit fees are not periodic fixed fees.

.06 *Per-unit fee* means a fee based on a unit of service provided specified in the contract or otherwise specifically determined by an independent third party, such as the administrator of the Medicare program, or the qualified user. For example, a stated dollar amount for each specified medical procedure performed, car parked, or passenger mile is a per-unit fee. Separate billing arrangements between physicians and hospitals generally are treated as per-unit fee arrangements.

.07 *Qualified user* means any state or local governmental unit as defined in § 1.103–1 or any instrumentality thereof. The term also includes a section 501(c)(3) organization if the financed property is not used in an unrelated trade or business under § 513(a) of the 1986 Code. The term does not include the United States or any agency or instrumentality thereof.

.08 *Renewal option* means a provision under which the service provider has a legally enforceable right to renew the contract. Thus, for example, a provision under which a contract is automatically renewed for one-year periods absent cancellation by either party is not a renewal option (even if it is expected to be renewed).

.09 *Service provider* means any person other than a qualified user that provides services under a contract to, or for the benefit of, a qualified user.

SECTION 4. SCOPE

This revenue procedure applies when, under a management contract, a service provider provides management or other services involving property financed with proceeds of an issue of state or local bonds subject to § 141 or § 145(a)(2)(B) of the 1986 Code.

SECTION 5. OPERATING GUIDELINES FOR MANAGEMENT CONTRACTS

.01 *In general.* If the requirements of section 5 of this revenue procedure are satisfied, the management contract does not itself result in private business use. In addition, the use of financed property, pursuant to a management contract meeting the requirements of section 5 of this revenue procedure, is not private business use if that use is functionally related and subordinate to that management contract and that use is not, in substance, a separate contractual agreement (for example, a separate lease of a portion of the financed property). Thus, for example, exclusive use of storage areas by the manager for equipment that is necessary for it to perform activities required under a management contract that meets the requirements of section 5 of this revenue procedure, is not private business use.

.02 *General compensation requirements.*

(1) *In general.* The contract must provide for reasonable compensation for services rendered with no compensation based, in whole or in part, on a share of net profits from the operation of the facility. Reimbursement of the service provider for actual and direct expenses paid by the service provider to unrelated parties is not by itself treated as compensation.

(2) *Arrangements that generally are not treated as net profits arrangements.* For purposes of § 1.141–3(b)(4)(i) and this revenue procedure, compensation based on—

(a) A percentage of gross revenues (or adjusted gross revenues) of a facility or a percentage of expenses from a facility, but not both;

(b) A capitation fee; or

(c) A per-unit fee is generally not considered to be based on a share of net profits.

(3) *Productivity reward.* For purposes of § 1.141–3(b)(4)(i) and this revenue procedure, a productivity reward equal to a stated dollar amount based on increases or decreases in gross revenues (or adjusted gross revenues), or reductions in total expenses (but not both increases in gross revenues (or adjusted gross revenues) and reductions in total expenses) in any annual period during the term of the contract, generally does not cause the compensation to be based on a share of net profits.

(4) *Revision of compensation arrangements.* In general, if the compensation arrangements of a management contract are materially revised, the requirements for compensation arrangements under section 5 of this revenue procedure are retested as of the date of the material revision, and the management contract is treated as one that was newly entered into as of the date of the material revision.

.03 *Permissible Arrangements.* The management contract must be described in section 5.03(1), (2), (3), (4), (5), or (6) of this revenue procedure.

(1) *95 percent periodic fixed fee arrangements.* At least 95 percent of the compensation for services for each annual period during the term of the contract is based on a periodic fixed fee.

[illegible] renewal options, must not exceed the lesser of 80 percent of the reasonably expected useful life of the financed property and 15 years. For purposes of this section 5.03(1), a fee does not fail to qualify as a periodic fixed fee as a result of a one-time incentive award during the term of the contract under which compensation automatically increases when a gross revenue or expense target (but not both) is reached if that award is equal to a single, stated dollar amount.

(2) *80 percent periodic fixed fee arrangements.* At least 80 percent of the compensation for services for each annual period during the term of the contract is based on a periodic fixed fee. The term of the contract, including all renewal options, must not exceed the lesser of 80 percent of the reasonably expected useful life of the financed property and 10 years. For purposes of this section 5.03(2), a fee does not fail to qualify as a periodic fixed fee as a result of a one-time incentive award during the term of the contract under which compensation automatically increases when a gross revenue or expense target (but not both) is reached if that award is equal to a single, stated dollar amount.

(3) *Special rule for public utility property.* If all of the financed property subject to the contract is a facility or system of facilities consisting of predominantly public utility property (as defined in § 168(i)(10) of the 1986 Code), then "20 years" is substituted—

(a) For "15 years" in applying section 5.03(1) of this revenue procedure; and

(b) For "10 years" in applying section 5.03(2) of this revenue procedure.

(4) *50 percent periodic fixed fee arrangements.* Either at least 50 percent of the compensation for services for each annual period during the term of the contract is based on a periodic fixed fee or all of the compensation for services is based on a capitation fee or a combination of a capitation fee and a periodic fixed fee. The term of the contract, including all renewal options, must not exceed 5 years. The contract must be terminable by the qualified user on reasonable notice, without penalty or cause, at the end of the third year of the contract term.

(5) *Per-unit fee arrangements in certain 3-year contracts.* All of the compensation for services is based on a per-unit fee or a combination of a per-unit fee and a periodic fixed fee. The term of the contract, including all renewal options, must not exceed 3 years. The contract must be terminable by the qualified user on reasonable notice, without penalty or cause, at the end of the second year of the contract term.

(6) *Percentage of revenue or expense fee arrangements in certain 2-year contracts.* All the compensation for services is based on a percentage of fees charged or a combination of a per-unit fee and a percentage of revenue or expense fee. During the start-up period, however, compensation may be based on a percentage of either gross revenues, adjusted gross revenues, or expenses of a facility. The term of the contract, including renewal options, must not exceed 2 years. The contract must be terminable by the qualified user on reasonable notice, without penalty or cause, at the end of the first year of the contract term. This section 5.03(6) applies only to—

(a) Contracts under which the service provider primarily provides services to third parties (for example, radiology services to patients); and

(b) Management contracts involving a facility during an initial start-up period for which there have been insufficient operations to establish a reasonable estimate of the amount of the annual gross revenues and expenses (for example, a contract for general management services for the first year of operations).

.04 No Circumstances Substantially Limiting Exercise of Rights.

(1) *In general.* The service provider must not have any role or relationship with the qualified user that, in effect, substantially limits the qualified user's ability to exercise its rights, including cancellation rights, under the contract, based on all the facts and circumstances.

(2) *Safe harbor.* This requirement is satisfied if—

(a) Not more than 20 percent of the voting power of the governing body of the qualified user in the aggregate is vested in the service provider and its directors, officers, shareholders, and employees;

(b) Overlapping board members do not include the chief executive officers of the service provider or its governing body or the qualified user or its governing body; and

(c) The qualified user and the service provider under the contract are not related parties, as defined in § 1.150–1(b).

SECTION 6. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 93–19, 1993–1 C.B. 526, is made obsolete on the effective date of this revenue procedure.

SECTION 7. EFFECTIVE DATE

This revenue procedure is effective for any management contract entered into, materially modified, or extended (other than pursuant to a renewal option) on or after May 16, 1997. In addition, an issuer may apply this revenue procedure to any management contract entered into prior to May 16, 1997.

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26 CFR 601.601: Rules and regulations.
(Also Part I. §§ 103, 141, 145; 1.141–3, 1.145–2.)

Rev. Proc. 97–14

SECTION 1. PURPOSE

The purpose of this revenue procedure is to set forth conditions under which a research agreement does not result in private business use under § 141(b) of the Internal Revenue Code of 1986. This revenue procedure also applies to determinations of whether a research agreement causes the test in § 145(a)(2)(B) of the 1986 Code to be met for qualified 501(c)(3) bonds.

SECTION 2. BACKGROUND

.01 *Private Business Use.*

(1) Under § 103(a) of the 1986 Code, gross income does not include interest on any state or local bond. Under § 103(b)(1) of the 1986 Code, however, § 103(a) of the 1986 Code does not apply to a private activity bond, unless it is a qualified bond under § 141(e) of the 1986 Code. Section 141(a)(1) of the 1986 Code defines "private activity bond" as any bond issued as part of an issue that meets both the private business use and the private security or payment tests. Under § 141(b)(1) of the 1986 Code, an issue generally meets the private business use test if more than 10 percent of the proceeds of the issue are to be used for any private business use. Under § 141(b)(6)(A) of the 1986 Code, private business use means direct or indirect use in a trade or business carried on by any person other than a governmental unit. Section 145(a) of the 1986 Code also applies the private business

Executive Order 12803

Title 3
Executive order 12803 of April 30, 1992
57 FR 19063 / May 4, 1992

TEXT: By the authority vested in me as president by the laws of the United States of America, end in order to ensure that the United States achieves the most beneficial economic use of its resources, it is hereby ordered as follows:

Section 1. Definitions. For purposes of this order: (a) "Privatization" means the disposition or transfer of an infrastructure asset, such as by sale or by long-term lease, from a State or local government to a private party.

(b) "infrastructure asset" means any asset financed in whole or in part by the Federal Government and needed for the functioning of the economy. Examples of such assets include, but are not limited to: roads, tunnels, bridges, electricity supply facilities. mass transit, rail transportation, airports, ports. waterways, water supply facilities, recycling and wastewater treatment facilities, solid waste disposal facilities, housing, schools, prisons, and hospitals.

(c) "Originally authorized purposes" means the general objectives of the original grant program; however, the term is not intended to include every condition requires for a grantee to have obtained the original grant.

(d) "Transfer price" means: (i) the amount paid or to be paid by a

Sec. 3. Privatization initiative. To the extent permitted by law, the head of each executive department and agency shall undertake the following actions: (a) Review those procedures affecting the management and disposition of federally financed infrastructure assets owned by State and local governments and modify those procedures to encourage appropriate privatization of such assets consistent: with this order;

(b) Assist State and Local governments in their efforts to advance the objectives of this order; and

(c) Approve State and local governments' requests to Privatize infrastructure assets, consistent with the criteria in section 4 of this order and, where necessary, grant exceptions to the disposition requirements of the "Uniform Administration Requirements for Grants and Cooperative Agreements to State and Local Governments" common rule, or other relevant rules or regulations for infrastructure assets; provided that the transfer price shall be distributed, as paid, in the following manner: (i) State and local governments shall first recoup in full the unadjusted dollar amount of their portion of total project costs (including any transaction and fix-up costs they incur) associated with the infrastructure assets involved; (ii)

private party for an infrastructure asset, if the asset is transferred as a result of a competitive bidding; of (ii) the appraised value of an infrastructure asset, as determined by the head of the executive department or agency and the Director of the Office of Management and Budget, if the asset is not transferred as a result of competitive bidding.

(e) "state and local governments" means the government of any state of the United States, the District of Columbia. any commonwealth. territory, or possession of the United States, and any country, municipality, city, town. township, local public authority, school district, special district, intrastate district, regional or interstate governmental entity, council of governments, and any agency or instrumentality of a local government, and any federally recognized Indian Tribe.

Sec. 2. Fundamental Principles. Executive departments and agencies shall be guided by the following objectives and principles: (a) Adequate and well-maintained infrastructure is critical to economic growth. Consistent with the principles of federalism enumerated in Executive Order No. 12612, and in order to allow the private sector to Provide for infrastructure modernization and expansion, State and local governments should have greater freedom to privatize infrastructure assets.

(b) Private enterprise and competitively driven improvements are the foundation of our Nation's economy and economic growth.

if proceeds remain, then the Federal Government shall recoup in full the amount of Federal grant awards, associated with the infrastructure assets, less the applicable share of accumulated depreciation on such asset (calculating using the Internal Revenue Service accelerated depreciation schedule far the categories of assets in question); and (iii) finally, the State and local governments shall keep any remaining proceeds,

Sec. 4. Criteria. To the extent permitted by law, the head of an executive department or agency shall approve a request in accordance with section 3(c) of this order only if the grantee: (a) Agrees to use the proceeds described in section 3 (e)(iii) of this order only far investment in additional infrastructure assets (after public notice of the proposed investment) or for debt or tax reduction; and

(b) Demonstrates that a market mechanism, legally enforceable agreement, or regulatory mechanism will ensure that: (i) the infrastructure asset or assets will continue to be used for their originally authorized purposes; and (ii) user charges will be consistent with any current Federal conditions that protect users and the public by limiting the charges.

Sec. 5. Government-wide coordination and Review. In implementing Executive Order Nos. 12291 and 12498 and OMB Circular No. A-19, the Office of Management and Budget, to the extent permitted by law and consistent with the provisions of

Federal financing of infrastructure assets should not act as a barrier to the achievement of economic efficiencies through additional private market financing or competitive practices, or both.

(c) State and local governments are in the best position to assess and respond to local needs. States and local governments should, subject to assuring continued compliance with Federal requirements that public use be on reasonable and nondiscriminatory terms, have maximum possible freedom to make decisions concerning the maintenance and disposition of their federally financed infrastructure assets.

(d) User fees are generally more efficient than general taxes as a means to support infrastructure assets. Privatization transactions should be structured so as not to result in unreasonable increases in charges to users.

BACK TO POLICY HOMEPAGE

those authorities, shall take action to ensure that the policies of the executive department and agencies are consistent with the principles, criteria. and requirements of this order. me Office of Management and Budget shall review the results of implementing this order and report thereon to the President one year after the date of this order.

Sec. 6. Preservation of Existing m Authority. Nothing in this order is in any way intended to limit any existing authority of the heads of executive departments and agencies to approve privatization proposals that are otherwise consistent with law.

Sec. 7. Judicial Review. This order is intended only to improve the internal management of the executive branch, and is not intended to create any right or benefit, substantive or procedural, enforceable by a party against the United States, its agencies or instrumentality's, its officers or employees, or any other person.

/a/ George Bush

THE WHITE HOUSE

April 30, 1992.

Executive Order 12893

nondiscrimination requirements of laws covered by Executive Order No. 12250 shall be submitted to the Attorney General for review in accordance with that Executive order. In addition, the Secretary shall consult with the Attorney General regarding all regulations and procedures proposed to be issued under sections 4–401 and 4–402 of this order to assure consistency with coordinated Federal efforts to enforce nondiscrimination requirements in programs of Federal financial assistance pursuant to Executive Order No. 12250.

6–603. Nothing in this order shall affect the authority and responsibility of the Attorney General to commence any civil action authorized by the Act.

6–604. (a) Part IV and sections 501 and 503 of Executive Order No. 11063 are revoked. The activities and functions of the President's Committee on Equal Opportunity in Housing described in that Executive order shall be performed by the Secretary of Housing and Urban Development.

(b) Sections 101 and 502(a) of Executive Order No. 11063 are revised to apply to discrimination because of "race, color, religion (creed), sex, disability, familial status or national origin." All executive agencies shall revise regulations, guidelines, and procedures issued pursuant to Part II of Executive Order No. 11063 to reflect this amendment to coverage.

(c) Section 102 of Executive Order No. 11063 is revised by deleting the term "Housing and Home Finance Agency" and inserting in lieu thereof the term "Department of Housing and Urban Development."

6–605. Nothing in this order shall affect any requirement imposed under the Equal Credit Opportunity Act (15 U.S.C. 1691 *et seq.*), the Home Mortgage Disclosure Act (12 U.S.C. 2801 *et seq.*) or the Community Reinvestment Act (12 U.S.C. 2901 *et seq.*).

6–606. Nothing in this order shall limit the authority of the Federal banking agencies to carry out their responsibilities under current law or regulations.

6–607. Executive Order No. 12259 is hereby revoked.

Sec. 7. *Report.*

7–701. The Secretary of Housing and Urban Development shall submit to the President an annual report commenting on the progress that the Department of Housing and Urban Development and other executive agencies have made in carrying out requirements and responsibilities under this Executive order. The annual report may be consolidated with the annual report on the state of fair housing required by section 808(e)(2) of the Act.

WILLIAM J. CLINTON

THE WHITE HOUSE,
January 17, 1994.

Executive Order 12893 of January 26, 1994

Principles for Federal Infrastructure Investments

A well-functioning infrastructure is vital to sustained economic growth, to the quality of life in our communities, and to the protection of our environ-

ment and natural resources. To develop and maintain its infrastructure facilities, our Nation relies heavily on investments by the Federal Government.

Our Nation will achieve the greatest benefits from its infrastructure facilities if it invests wisely and continually improves the quality and performance of its infrastructure programs. Therefore, by the authority vested in me as President by the Constitution and the laws of the United States of America, it is hereby ordered as follows:

Section 1. Scope. The principles and plans referred to in this order shall apply to Federal spending for infrastructure programs. For the purposes of this order, Federal spending for infrastructure programs shall include direct spending and grants for transportation, water resources, energy, and environmental protection.

Sec. 2. Principles of Federal Infrastructure Investment.

Each executive department and agency with infrastructure responsibilities (hereinafter referred to collectively as "agencies") shall develop and implement plans for infrastructure investment and management consistent with the following principles:

(a) *Systematic Analysis of Expected Benefits and Costs.* Infrastructure investments shall be based on systematic analysis of expected benefits and costs, including both quantitative and qualitative measures, in accordance with the following:

(1) Benefits and costs should be quantified and monetized to the maximum extent practicable. All types of benefits and costs, both market and nonmarket, should be considered. To the extent that environmental and other nonmarket benefits and costs can be quantified, they shall be given the same weight as quantifiable market benefits and costs.

(2) Benefits and costs should be measured and appropriately discounted over the full life cycle of each project. Such analysis will enable informed tradeoffs among capital outlays, operating and maintenance costs, and nonmonetary costs borne by the public.

(3) When the amount and timing of important benefits and costs are uncertain, analyses shall recognize the uncertainty and address it through appropriate quantitative and qualitative assessments.

(4) Analyses shall compare a comprehensive set of options that include, among other things, managing demand, repairing facilities, and expanding facilities.

(5) Analyses should consider not only quantifiable measures of benefits and costs, but also qualitative measures reflecting values that are not readily quantified.

(b) *Efficient Management.* Infrastructure shall be managed efficiently in accordance with the following:

(1) The efficient use of infrastructure depends not only on physical design features, but also on operational practices. To improve these prac-

tices, agencies should conduct periodic reviews of the operation and maintenance of existing facilities.

(2) Agencies should use these reviews to consider a variety of management practices that can improve the return from infrastructure investments. Examples include contracting practices that reward quality and innovation, and design standards that incorporate new technologies and construction techniques.

(3) Agencies also should use these reviews to identify the demand for different levels of infrastructure services. Since efficient levels of service can often best be achieved by properly pricing infrastructure, the Federal Government—through its direct investments, grants, and regulations—should promote consideration of market-based mechanisms for managing infrastructure.

(c) *Private Sector Participation.* Agencies shall seek private sector participation in infrastructure investment and management. Innovative public-private initiatives can bring about greater private sector participation in the ownership, financing, construction, and operation of the infrastructure programs referred to in section 1 of this order. Consistent with the public interest, agencies should work with State and local entities to minimize legal and regulatory barriers to private sector participation in the provision of infrastructure facilities and services.

(d) *Encouragement of More Effective State and Local Programs.* To promote the efficient use of Federal infrastructure funds, agencies should encourage the State and local recipients of Federal grants to implement planning and information management systems that support the principles set forth in section 2(a) through (c) of this order. In turn, the Federal Government should use the information from the State and local recipients' management systems to conduct the system-level reviews of the Federal Government's infrastructure programs that are required by this order.

Sec. 3. *Submission of Plans.* Agencies shall submit initial plans to implement these principles to the Director of the Office of Management and Budget ("OMB") by March 15, 1994. Agency plans shall list the actions that will be taken to provide the data and analysis necessary for supporting infrastructure-related proposals in future budget submissions. Agency implementation plans should be consistent with OMB Circular A–94 that outlines the analytical methods required under the principles set forth in section 2 of this order.

Sec. 4. *Application to Budget Submissions.* Beginning with the fiscal year 1996 budget submission to OMB, each agency should use these principles to justify major infrastructure investment and grant programs. Major programs are defined as those programs with annual budgetary resources in excess of $50 million.

Sec. 5. *Application to Legislative Proposals.* Beginning March 15, 1994, agencies shall employ the principles set forth in section 2 of this order and, at the request of OMB, shall provide supporting analyses when requesting OMB clearance for legislative proposals that would authorize or reauthorize infrastructure programs.

Sec. 6. Guidance. The Office of Management and Budget shall provide guidance to the agencies on the implementation of this order.

Sec. 7. Judicial Review. This order is intended only to improve the internal management of the executive branch and does not create any right or benefit, substantive or procedural, enforceable by a party against the United States, its agencies or instrumentalities, its officers or employees, or any other person.

WILLIAM J. CLINTON.

THE WHITE HOUSE,
January 26, 1994.

Executive Order 12894 of January 26, 1994

North Pacific Marine Science Organization

By the authority vested in me as President by the Constitution and the laws of the United States of America, including section 1 of the International Organizations Immunities Act (59 Stat. 669, 22 U.S.C. 288), and having found that the North Pacific Marine Science Organization is a public international organization in which the United States participates within the meaning of the International Organizations Immunities Act, I hereby designate the North Pacific Marine Science Organization as a public international organization entitled to enjoy the privileges, exemptions, and immunities conferred by the International Organizations Immunities Act. This designation is not intended to abridge in any respect privileges, exemptions, or immunities, which such organization may have acquired or may acquire by international agreements or by congressional action.

WILLIAM J. CLINTON

THE WHITE HOUSE,
January 26, 1994.

Executive Order 12895 of January 26, 1994

North Pacific Anadromous Fish Commission

By the authority vested in me as President by the Constitution and the laws of the United States of America, including section 1 of the International Organizations Immunities Act (59 Stat. 669, 22 U.S.C. 288), and having found that the North Pacific Anadromous Fish Commission is a public international organization in which the United States participates within the meaning of the International Organizations Immunities Act, I hereby designate the North Pacific Anadromous Fish Commission as a public international organization entitled to enjoy the privileges, exemptions, and immunities conferred by the International Organizations Immunities Act. This designation is not intended to abridge in any respect privileges, exemp-

Executive Order 12875

Executive Order 12874 of October 20, 1993

Establishing an Emergency Board To Investigate a Dispute Between The Long Island Rail Road and Certain of Its Employees Represented by the United Transportation Union

A dispute exists between The Long Island Rail Road and certain of its employees represented by the United Transportation Union.

The dispute has not heretofore been adjusted under the provisions of the Railway Labor Act, as amended (the "Act").

A party empowered by the Act has requested that the President establish an emergency board pursuant to section 9A of the Act (45 U.S.C. 159a).

Section 9A(c) of the Act provides that the President, upon such request, shall appoint an emergency board to investigate and report on the dispute.

NOW, THEREFORE, by the authority vested in me by section 9A of the Act, it is hereby ordered as follows:

Section 1. *Establishment of Board.* There is established, effective October 20, 1993, a board of three members to be appointed by the President to investigate this dispute. No member shall be pecuniarily or otherwise interested in any organization of railroad employees or any carrier. The board shall perform its functions subject to the availability of funds.

Sec. 2. *Report.* The Board shall report its findings to the President with respect to the dispute within 30 days after the date of its creation.

Sec. 3. *Maintaining Conditions.* As provided by section 9A(c) of the Act, from the date of the creation of the board and for 120 days thereafter, no change, except by agreement of the parties, shall be made by the carrier or the employees in the conditions out of which the dispute arose.

Sec. 4. *Expiration.* The board shall terminate upon the submission of the report provided for in Section 2 of this order.

WILLIAM J. CLINTON

THE WHITE HOUSE,
October 20, 1993.

Executive Order 12875 of October 26, 1993

Enhancing the Intergovernmental Partnership

The Federal Government is charged with protecting the health and safety, as well as promoting other national interests, of the American people. However, the cumulative effect of unfunded Federal mandates has increasingly strained the budgets of State, local, and tribal governments. In addition, the cost, complexity, and delay in applying for and receiving waivers from Federal requirements in appropriate cases have hindered State, local, and

tribal governments from tailoring Federal programs to meet the specific or unique needs of their communities. These governments should have more flexibility to design solutions to the problems faced by citizens in this country without excessive micromanagement and unnecessary regulation from the Federal Government.

THEREFORE, by the authority vested in me as President by the Constitution and the laws of the United States of America, and in order to reduce the imposition of unfunded mandates upon State, local, and tribal governments; to streamline the application process for and increase the availability of waivers to State, local, and tribal governments; and to establish regular and meaningful consultation and collaboration with State, local, and tribal governments on Federal matters that significantly or uniquely affect their communities, it is hereby ordered as follows:

Section 1. *Reduction of Unfunded Mandates.* (a) To the extent feasible and permitted by law, no executive department or agency ("agency") shall promulgate any regulation that is not required by statute and that creates a mandate upon a State, local, or tribal government, unless:

(1) funds necessary to pay the direct costs incurred by the State, local, or tribal government in complying with the mandate are provided by the Federal Government; or

(2) the agency, prior to the formal promulgation of regulations containing the proposed mandate, provides to the Director of the Office of Management and Budget a description of the extent of the agency's prior consultation with representatives of affected State, local, and tribal governments, the nature of their concerns, any written communications submitted to the agency by such units of government, and the agency's position supporting the need to issue the regulation containing the mandate.

(b) Each agency shall develop an effective process to permit elected officials and other representatives of State, local, and tribal governments to provide meaningful and timely input in the development of regulatory proposals containing significant unfunded mandates.

Sec. 2. *Increasing Flexibility for State and Local Waivers.* (a) Each agency shall review its waiver application process and take appropriate steps to streamline that process.

(b) Each agency shall, to the extent practicable and permitted by law, consider any application by a State, local, or tribal government for a waiver of statutory or regulatory requirements in connection with any program administered by that agency with a general view toward increasing opportunities for utilizing flexible policy approaches at the State, local, and tribal level in cases in which the proposed waiver is consistent with the applicable Federal policy objectives and is otherwise appropriate.

(c) Each agency shall, to the fullest extent practicable and permitted by law, render a decision upon a complete application for a waiver within 120 days of receipt of such application by the agency. If the application for a waiver is not granted, the agency shall provide the applicant with timely written notice of the decision and the reasons therefor.

(d) This section applies only to statutory or regulatory requirements of the programs that are discretionary and subject to waiver by the agency.

Sec. 3. *Responsibility for Agency Implementation.* The Chief Operating Officer of each agency shall be responsible for ensuring the implementation of and compliance with this order.

Sec. 4. *Executive Order No. 12866.* This order shall supplement but not supersede the requirements contained in Executive Order No. 12866 ("Regulatory Planning and Review").

Sec. 5. *Scope.* (a) Executive agency means any authority of the United States that is an "agency" under 44 U.S.C. 3502(1), other than those considered to be independent regulatory agencies, as defined in 44 U.S.C. 3502(10).

(b) Independent agencies are requested to comply with the provisions of this order.

Sec. 6. *Judicial Review.* This order is intended only to improve the internal management of the executive branch and is not intended to, and does not, create any right or benefit, substantive or procedural, enforceable at law or equity by a party against the United States, its agencies or instrumentalities, its officers or employees, or any other person.

Sec. 7. *Effective Date.* This order shall be effective 90 days after the date of this order.

WILLIAM J. CLINTON

THE WHITE HOUSE,
October 26, 1993.

Executive Order 12876 of November 1, 1993

Historically Black Colleges and Universities

By the authority vested in me as President by the Constitution and the laws of the United States of America, in order to advance the development of human potential, to strengthen the capacity of historically Black colleges and universities to provide quality education, and to increase opportunities to participate in and benefit from Federal programs, it is hereby ordered as follows:

Section 1. There shall be established in the Department of Education the President's Board of Advisors on Historically Black Colleges and Universities ("Board of Advisors" or "Board"), a Presidential advisory committee. The Board of Advisors shall issue an annual report to the President on participation by historically Black colleges and universities in federally sponsored programs. The Board of Advisors will also provide advice to the Secretary of Education ("Secretary") and in the annual report to the President on how to increase the private sector role in strengthening historically Black colleges and universities, with particular emphasis on enhancing institutional infrastructure and facilitating planning, development, and the use of new technologies to ensure the goal of long-term viability and enhancement of these institutions. Notwithstanding the provisions of any other Executive order, the responsibilities of the President under the Federal Advisory Committee Act, as amended (5 U.S.C. App. 2), which is applicable to the Board of Advisors, shall be performed by the Secretary, in

United States
Environmental Protection
Agency

Office of Water
(4204)

EPA 832-B-98-002
April 1998

EPA

Guidance on the Privatization of Federally Funded Wastewater Treatment Facilities

D R A F T

UNITED STATES ENVIRONMENTAL PROTECTION AGENCY
WASHINGTON, D.C. 20460

April 1, 1998

OFFICE OF
WATER

MEMORANDUM

Subject: Guidance on the Privatization of Federally Funded Wastewater Treatment Facilities

From: Haig Farmer
Privatization Coordinator
Municipal Support Division (4204)

To: All Interested Parties

I am pleased to provide you with a draft of the Agency's document entitled " Guidance on the Privatization of Federally Funded Wastewater Treatment Facilities". This guidance was designed to provide a general understanding of the privatization process and how local governments can privatize their federally funded wastewater facilities.

The guidance provides an overview of the wastewater public-private partnership process. The overview includes a history of privatization, the financial and non-financial issues associated with privatization, plus a description of the most common types of public-private partnerships.

The discussion on the financial factors affecting privatization addresses the issues of cost savings, tax status of debt, capital improvements, economic risks, and local/regional economic impacts. The non-financial factors discussed include regulatory compliance, labor, responsibility for capital improvements, municipal control, accountability and rate stability.

The guidance presents a discussion on how contract operations, lease, and sale types of privatization agreements are related to the Agency's grant regulations and Executive Order 12803. Contract operations type of arrangements usually cover a facility's operations, maintenance, equipment replacement and possibility capital improvements. Lease type arrangements occur when the private entity provides some type of payments to the local government. Sale arrangements involves the transfer of a facility's title to the private entity. Lease and sale type of arrangements must undergo review and approval by the Agency.

The guidance describes the information federal wastewater grantees should submit to the Agency for review of the proposed privatization agreement. This information is generally contained in an executive summary of the privatization agreement. The executive summary includes all salient facts about the privatization agreement such as: a general description of the privatization agreement, the permit arrangements, operational guarantees, public participation, changes in the debt structure for the wastewater facilities, the amount and intended use of funds received from the private entity, the Federal grant project costs contributed by the local government, coordination with State and Federal authorities, depreciation calculations for the Federal grant funds using the Internal Revenue Service Modified Accelerated Cost Recovery System depreciation schedules, the local government's oversight responsibilities, employee status under the privatization agreement, authority for establishing future user rates, and the impact of the privatization agreement on user fees with appropriate supporting data.

The Agency's criteria used to approve proposed privatization agreements is delineated in the guidance to facilitate local governments' understanding of the Agency's privatization objectives. The Agency reviews privatization agreements to ensure compliance with the intent of the Clean Water Act, the National Pollutant Discharge Elimination System program, the Resource Conservation and Recovery Act permit requirements, the requirements of Executive Order 12803, and protection of the wastewater users.

I am looking forward to receiving any comments you may have on the guidance. I am particularly interested in receiving your comments on the proposed change in the definition of contract operations to include all capital (operational and infrastructure) investments in the wastewater treatment facilities. Please provide your comments to me by June 1, 1998. My FAX number is 202/260-0116 and e-mail address is "farmer.haig@epamail.epa.gov". If you have any questions, please feel free to call me at 202/260-7279.

DRAFT

U.S. Environmental Protection Agency

Guidance On The Privatization Of Federally Funded Wastewater Treatment Facilities

April 1, 1998

CHAPTER 1

Introduction

For approximately 40 years, the federal government has been a full partner with the states and local governments in meeting the Nation's wastewater treatment needs. Since 1972, more than $67 billion of federal funds have been invested in wastewater treatment works through the Environmental Protection Agency's (EPA) Construction Grant Program. In 1987, Congress phased out the construction grants program, replacing it with the Clean Water State Revolving Fund (SRF) program.

The SRF program provides low-interest loans to communities for the construction of water pollution control infrastructure projects. Federal and state investments to date of more than $20 billion ensures that the SRF program will play an important role in funding water pollution control projects into the future. However, even with continued capitalization, the SRF program will not address all local government water pollution infrastructure needs, estimated to be about $137 billion, with $47 billion of the total for wastewater needs. As a result, it is important to fully explore other approaches to meet funding needs at the state and local level.

One approach to consider is the use of public-private partnerships that utilize private sector resources to finance wastewater treatment needs. The private sector has historically been involved in providing wastewater treatment related services to local governments. Whether providing basic wastewater treatment supplies (e.g., chemicals), maintaining a portion of the collection or treatment system under a contract, or providing contract operation and maintenance for all of a municipal's facilities, the private sector has served an important role in the effort to control water pollution across the country.

In 1992, a Presidential Executive Order (E.O. 12803) increased interest in using private sector financial resources to meet local government wastewater funding needs. E.O. 12803 directed federal agencies to remove regulatory or procedural obstacles to privatization that were under their control. It also allowed the accelerated depreciation of the federal government's financial interest in grant funded facilities and recovery of the local investment prior to recovery of any federal grant funds. At the same time, the Executive Order protected the existing public wastewater investment by requiring that (1) privatized federally funded facilities continue to serve their original purposes, (2) user charges remain reasonable and (3) lease or transfer prices be reviewed by federal agencies to help determine that they are fair and reasonable.

Although the vast majority of municipal wastewater facilities are publicly owned and operated, there are many examples of successful private operations of municipal facili-

ties. Privatization should be viewed as an option for providing wastewater treatment services that will work in some communities and not in others. The decision to privatize should be made by local governments and reflect a balanced evaluation of the financial and non-financial issues with the needs of the community. However, when federal funds were used to construct the wastewater facility, EPA must review and approve all lease and sale privatization arrangements of states and local governments.

Objectives

This guidance has three major objectives. First, it is intended to provide an overview of the privatization of Publicly Owned Wastewater Treatment (POTW) facilities that have been financed with money from EPA's Construction Grant program. This guidance will serve as a reference for communities and private companies that are interested in obtaining an introductory understanding of the privatization process. Second, this document provides an overview of the factors that should be considered by a community evaluating privatization, and finally, it describes the information a community must develop for EPA's review and approval of proposed privatization arrangements.

Summary of Potential for Public-Private Partnerships

The private sector has the potential to be a significant partner in the development of wastewater infrastructure in this country. The private sector has ready access to financial markets which could be made available for wastewater infrastructure needs when a local government enters into a private partnership arrangement to lease or sell its public wastewater facilities. Financial markets may find these investments attractive because the local government guarantees that it will pay its private partner a fixed service fee for wastewater treatment. The local government's guarantee also provides a form of assurance to the private lenders that their loan will be repaid by the borrower.

The decision by the local government to privatize its wastewater needs involves an evaluation of many financial and non-financial factors. A primary consideration is that any wastewater capital funds obtained through either government or private sources must be repaid by the wastewater users. Privatization is simply another source of capital funds available to local governments that must be repaid to the lenders. Thus, privatization is never a source of "free" capital.

The Agency believes the decision to privatize should be made by the local government based on its unique circumstances. In anticipation that some local governments will choose privatization, the Agency has worked closely with the Internal Revenue Service

and the Office of Management and Budget to remove federal administrative impediments to the privatization process. In addition, the Agency has streamlined its administrative procedures to assist wastewater construction grantees in complying with EPA construction grant regulations and E.O. 12803 requirements by delegating its review and approval authority to the Agency's Assistant Administrator for Water.

Organization of Guidance

This guidance provides an overview of the wastewater public-private partnership process. It presents the most common partnership arrangements, the financial and non-financial issues associated with privatization, plus a description of the EPA privatization review and approval process. The major sections of the guidance are:

Overview of privatization - discusses the history, the appeal of privatization, and the most common public-private partnership options.

Analysis of the factors affecting privatization arrangements - discusses the financial and non-financial factors encompassing public-private partnership arrangements.

The federal review and approval process - discusses the purpose of EPA's review and the factors considered in the approval.

Overview of Privatization

CHAPTER 2

The term privatization encompasses a broad range of private sector participation in public services. Partnerships between the public and private sectors in the water and wastewater industry range from providing basic services and supplies to the design, construction, operation, and ownership of public utilities. The primary focus of this guidance is local government's use of the private sector to finance and operate their wastewater facilities. The basic reasons that the public sector historically privatized services were to realize cost savings, utilize expertise, achieve efficiencies in construction and operation, access private capital, and improve the quality of wastewater services.

Local governments use private sector to finance and operate facilities.

As the pace of constructing water pollution control facilities escalated in the 1970s, due to federal and state environmental legislation and EPA's Construction Grant program, so too did the interest of the private sector in wastewater operations. In the 1980s the availability of tax incentives (tax-exempt debt and tax-deductible interest payments) for private investment in public utilities stimulated interest in the privatization of publicly owned wastewater treatment works (POTW). However, over time tax laws and IRS rulings that affect privatization have been modified. The Tax Reform Act of 1986 removed many of the tax incentives for public-private partnerships and reduced interest in certain types of privatization. Subsequent tax bills/rulings have restored many of the tax incentives lost in 1986. For example, the 1997 IRS Revenue Procedure 97-13 on Qualified Tax-Exempt Bonds allows management contracts for up to 20 years instead of the 5 year period previously allowed.

Executive Order 12803 was issued in 1992 to simplify federal requirements related to the sale or lease of federal grant-funded infrastructure facilities. Among its more important features, the Executive Order allows state and local wastewater treatment investments to be recovered from the proceeds of a lease or sale prior to any claim by the federal government for funds provided by EPA construction grants. Repayment of federal grants only occurs to the extent that the transfer price under a sale or concession fees under a lease is higher than the total state and local investment in the facility. Also, grants are recouped at their depreciated value. So in the event that all EPA construction grants are fully depreciated, there would be no federal grant recoupment but the privatization agreement would require EPA approval.

Other Executive Orders that affect privatization include E.O. 12875, which directs federal agencies to review their regulatory requirements with respect to wastewater priva-

tization, and E.O. 12893, which encourages agencies to seek public-private partnerships, and for agencies, in conjunction with state and local governments, to remove regulatory and legal barriers to privatization.

This guidance focuses special attention on the sale or lease types of privatization that require EPA review and approval under Executive Order 12803. The guidance also examines contract operations of local wastewater treatment facilities, which is currently the most common type of privatization.

The Current Level of Privatization

Historically public wastewater collection and treatment services have primarily been provided by local governments. However, small subdivisions and trailer parks have traditionally used privately owned and operated wastewater services since their inception. Unlike utilities such as electricity or natural gas, which have been viewed by the public as necessities to every household and local business, the demand for water pollution control most often reflected a region-wide need to address the threat of water pollution to public health. As a result, while the private sector often provided the utility services for gas and electric to the public, local governments provided wastewater services to ensure health protection for its citizens from municipal and industrial pollution.

There has been increased interest in public-private partnerships.

Over time the participation of the private sector in directly providing water-related services has grown within the United States. Public drinking water systems are frequently owned by a private company (over 40 percent of drinking water systems are private systems). Privatization of public wastewater treatment has been less common. It is somewhat difficult to obtain exact growth estimates for wastewater privatization because much of the information is proprietary. Recent industry newsletters and reports give a general indication that growth is occurring. One report indicates that in terms of dollars spent, less than 2 percent of the wastewater industry is privatized. Reports indicate that there are 280 small to mid-size (1 to 10 mgd) facilities and 40 large facilities (over 10 mgd) now using private partners for wastewater operations. Public-private contract operations are reported to have grown annually at a rate of 15-20 percent, and produced revenues of $0.4 billion out of the $23 billion expended for POTWs. Nearly all of the privatization has been in the form of contract operations. While many communities have explored the outright sale of facilities to private entities as allowed under E.O. 12803, this option has not been used in the wastewater area primarily because of discharge permit and tax-related issues. These issues are fully discussed in this guidance.

The Appeal of Privatization

In recent years, there has been increased interest in public-private partnerships. Local governments are becoming more focused on the benefits of privatization at the same time that the private sector is anxious to expand markets and revenues. Reasons for

the increase in local government interest in privatization include the desire to increase efficiency of local government operations, reduce costs of providing services, improve environmental protection, and access private capital for infrastructure investment.

Increased efficiency– Private companies may be able to operate facilities more efficiently while meeting permit limits. The private companies often will employ innovative operation and maintenance methods, and equipment for wastewater treatment, that require significant capital investment. The private sector is also able to draw on substantial experience in the operation of treatment facilities and take advantage of wholesale prices of supplies and materials needed for a facility's successful operation. The private company can frequently use its management expertise to stabilize user fees for the time period of the privatization agreement.

Cost reduction– Often the opportunity to realize cost savings is the primary reason that local governments are attracted to privatization. In many cases, private ownership/operation makes sense because it lowers costs. Depending on the type of privatization selected, surveys indicate the private treatment systems can operate at costs savings compared to public treatment systems. Capital cost savings can be substantial when the private partner uses advanced technology coupled with streamlined procurement and construction practices. Local governments that are able to identify and implement the cost-saving management techniques that would be undertaken by a private company may be able to reduce costs as much or more than the private sector. This can occur because the public sector has several cost-related advantages over the private sector. First, the public sector does not have to make a profit on operations and capital investments. Second, the public sector has better access to tax-exempt debt financing that results in lower borrowing costs for capital projects.

Environmental benefits– Some government facilities may have problems complying with discharge permit limits because of needed capital improvements, maintenance costs that exceed budgetary allocations, or difficulty in maintaining skilled personnel. Where local governments have had difficulty meeting permit limits, privatization may result in real environmental benefits. Private companies can readily make capital investments under the conditions of the service contract and dedicate highly skilled personnel to ensure efficient operation and compliance with facility discharge permit requirements.

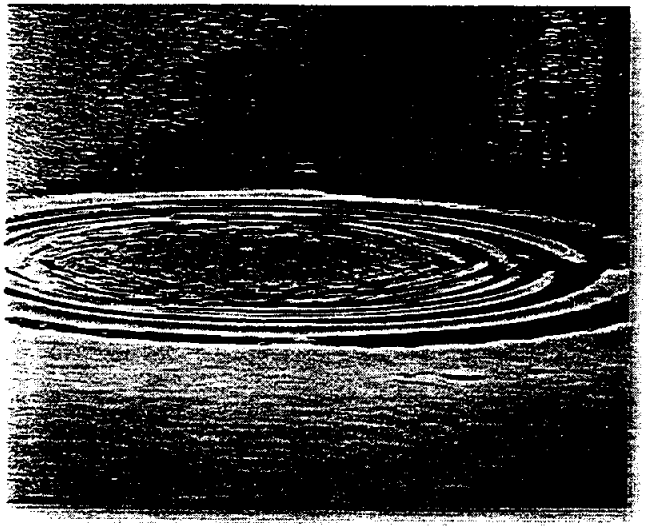
Access to capital– One of the major benefits of privatization is that it provides access to private sector capital. This may be an attractive feature of privatization for communities with limited access to capital markets. However, as with public financing, the use of private capital will require that user fees are increased sufficiently to recoup the capital investment plus interest. When privatization arrangements include capital investments in the form of an up-front transfer of funds (e.g., transfer price in an asset sale or concession fees in a lease arrangement), it can be viewed as a loan

from the private sector to the public entity comparable to the "home-equity" loans popular with home owners across the country. Up-front fund transfers from the private sector, or "facility-equity" loans, that are part of a privatization arrangement mean local wastewater users must repay the up-front funds plus interest to the private firm. An increase in user fees can result when the transfer price or concession fees exceed the outstanding local debt on the wastewater treatment facilities because of the "equity" that is taken out from the facility.

Types of Privatization

Municipalities seeking public-private partnerships have a range of options to consider from the status quo of continued municipal ownership and operation to complete private ownership and operation. Often a local government will evaluate the expected cost of continued public operation with various privatization proposals. Currently the most widely discussed types of wastewater privatization include contract operations, leases, and asset sales.

The specific application of each privatization type will vary by location, since local governments do not have the same conditions and requirements. For example, some communities may find privatization attractive because they are having difficulty meeting permit requirements due to lack of skilled personnel or extremely challenging water pollution treatment conditions. Other communities may wish to evaluate privatization when undergoing major facility expansions or rehabilitation in hopes of achieving greater economies by attracting competitive facility design, construction and operation bids from the private sector. Because privatization situations are not identical, this guidance focuses on a presentation of the general structure of widely used types of wastewater privatization and the factors leading to the selection of a privatization type. The determination of whether a privatization agreement is classified as a contract operations, lease, or sale type of agreement for the purposes of EPA review and approval of privatization agreements for grant funded wastewater facilities is based on the overall function of the contract as defined in its specific conditions. The nomenclature used by the local government to describe the privatization agreement does not influence the EPA's classification of the agreement.



Contract operations– For many years municipalities have used the flexibility of contracting with private entities for providing selected governmental functions ranging from janitorial services to vehicle fleet or equipment maintenance. Municipalities have found that contracting can be a good way to obtain services needed for a limited period of time, acquiring specialized skills not available in the municipal pool of employees, or as a way of introducing competition into the governmental services arena.

In the area of water pollution control, municipalities have employed many different levels of contract operations. In full contract operations, the private entity operates and maintains the wastewater treatment facility in its entirety. All aspects of the plant's operation and maintenance are performed by the private entity. The collection of user fees can also be assigned to the private entity while the authority for establishing user rates is retained by the public entity.

In partial contract operations, the private entity operates only certain areas of the facility. For example, a private entity can be contracted to haul sludge on an as needed basis, or maintain a plant's centrifical force extractors for a specific time period. The private entity has its obligations specified and limited through the terms of the contract. Normally the contract will specify a fixed fee for the specific services. Typically the contract fees increase annually with inflation or by another index.

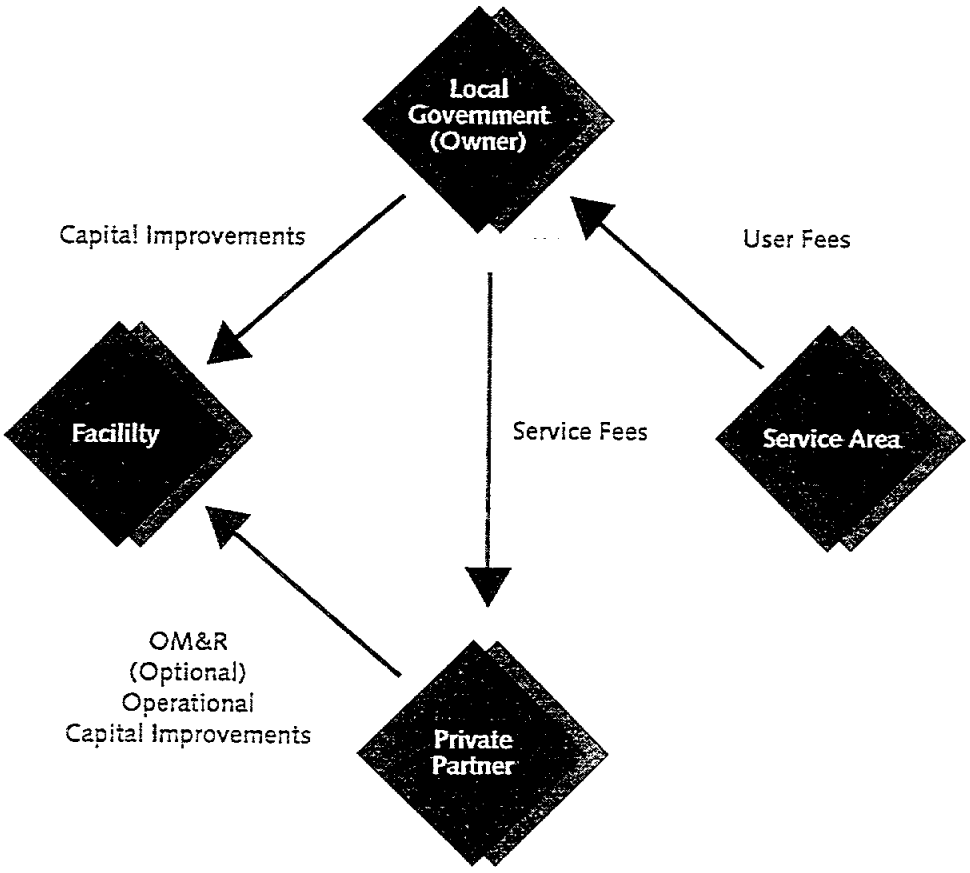
Under contract operations, the private entity operates and maintains the facility.

With contract operations types of arrangement, the facilities are operated for a fixed length of time. Until recently, Internal Revenue Service "management contract" rules for wastewater facilities financed with tax-exempt municipal bonds allowed a maximum of five years for contract operations without affecting the status of the municipal tax-exempt bonds. Private entities and local governments generally viewed this term as too short and limiting the economic benefits that could result from longer term contract arrangements. For example, with the assurance of a longer term contract, private entities are able to make a long-term commitment of expert staff or equipment to effectively operate and maintain a facility. Recent rule changes from the IRS (January 1997) have addressed this concern by allowing "management contracts" for wastewater treatment facilities of up to 20 years under specific contract conditions.

Contract operations arrangements between private entities and local governments that received EPA construction grants do not require Agency review and approval prior to signing the contract. The contract operations agreements may include cash transfers from the private entity to the municipality for the documented transaction costs the municipality incurs to establish the agreement or an amount of less than one percent of the present worth value of the contract. They may also include capital investments by the private entity provided the investments remain the sole property of the local government when construction is complete and the contractor would not have any claim on the facilities as a result of constructing the capital investment. Capital investments generally are expenditures for the purpose of improving operational efficiencies, and increasing the capacity or treatment levels of the facility. The contract operations agreements could provide for local government reimbursement of the contractor's capital investment in the event of premature contract termination.

A contract operations form of privatization agreement usually requires the private entity to operate and maintain the facilities for a specific time period (See Figure 1). Maintaining the facilities includes the repair, upgrade, or replacement of equipment so

Figure 1: Contract Operation



the facilities will continue to perform their originally intended purposes. Some local governments limit a private entity's equipment replacement costs under the contract to a specific dollar amount with the local government funding the costs above the specified amount. When the contract does not have an upper limit on equipment replacement costs, the private entity must carefully evaluate facility maintenance records to accurately establish its service fee for the contract.

Contract operations agreements can provide for contractor payments of either the documented, auditable contract transaction costs or an amount equal to one percent of the present value of the contract. When a cash transfer exceeds these amounts the contract is considered a lease under EPA regulations and E.O. 12803. A lease type of privatization agreement requires Agency review and approval prior to signing the contract. Under EPA's construction grant regulations, a concession type payment results in the private company encumbering the title to the facility. A privatization agreement that involves up-front or periodic payments to the government may be considered a contract operation type arrangement by some parties, however, EPA views these types of agreements as leases that must receive Agency approval.

Under contract operations, a local government will maintain unencumbered ownership of the facility at all times. The local government retains control over and responsibility for all capital investment in the wastewater facility, setting rates, collecting user fees, and enforcement of the municipal industrial pretreatment program (MIPP). The local government maintains primary responsibility for all interactions with the federal and state regulators. The private partner is paid a service fee to cover the costs of operation, maintenance, equipment replacement and capital investments as specified in the contract. Performance is maintained through close contract monitoring by the public partner and strict contract clauses that stipulate the actions to be taken in the event of nonperformance by the private entity. The clause usually includes financial penalties.

Leases– Historically, leases have been popular tools for local governments. The most common form is generally called an operating lease. Operating leases have provided governments with a way to obtain long-term use of equipment ranging from office equipment such as copying machines and desk top computers to heavy machinery for public works departments. Under this form of a lease the private leasing company, the lessor, purchases equipment and leases it to the government, the lessee. The lessor receives tax benefits related to depreciation of the equipment while the lessee is not required to treat the lease payment as debt, as would occur if the equipment were purchased.

Not all leases are operating leases. Each lease has different terms and conditions. The terms define the agreement and they vary from lease to lease. Under EPA construction grant regulations and E.O. 12803, all types of leases require EPA review and approval before a local government may enter a lease agreement when EPA grant funds were used to finance the wastewater facility. Leases result in some type of up-front, or periodic payments to the local governments. These payments are "concession fees," the private entity pays for the right to operate a facility. The fees are considered a form of lease payments from the lessor. The concession fees are generally used by the public owner for debt repayment, capital improvements or general tax relief. Yet another form of lease is the "design, build, and operate lease." In this scenario the lessor designs and constructs a facility on behalf of a public owner. These agreements usually provide that ownership of the facility will reside with the public entity, but the operation of the facility will be performed by the private company that builds it. The builder, by prior agreement, becomes the facility's lease operator.

Leases result in some type of payments to the local government

In addition to operating leases, tax-exempt leases have been widely used by state and local governments and have also become common in the industry. Tax-exempt leases are used by local and state governments as a way to purchase equipment or buildings. Several of the key reasons cited for use of tax-exempt leases are: 1) leases are a way to purchase equipment when local debt restrictions or the need for local voter approval make it cumbersome to obtain the required equipment or facilities, 2) leases do not

PRIVATIZATION EXAMPLE: CONTRACT OPERATIONS

Facility Ownership: Local government

Contract type: Contract operations for operation, maintenance, and equipment replacement over a 15 year time period

Facility constructed in part with federal grants: Yes

Up-front or periodic payments from private partner: Only documented, auditable contract transaction costs

Private partner invests in new capital improvements: Yes

Privatization arrangement under E.O. 12803: No, contract operation

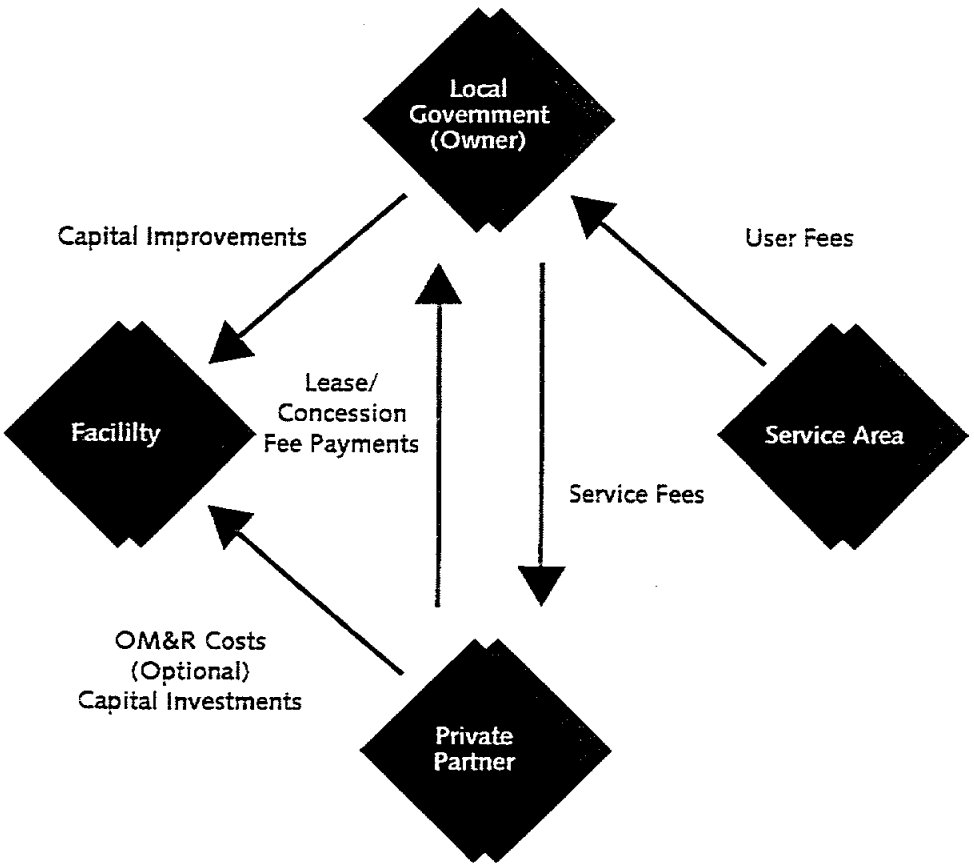
EPA review and approval: None: However, requires state notification of privatization agreement and modification of NPDES permit

Permittee: Local government and private company are copermittees on NPDES permit

have the transaction costs that are experienced when issuing local bonds. Under the tax-exempt lease, the local government makes lease payments that are defined as principal and interest to the lessor. Under federal tax law the interest portion of the payment is viewed as tax-exempt so lessors are willing to charge a lower interest rate to lessees. This tax advantage results in lower costs for the local or state governments.

The lease concept applicable to privatization of EPA funded wastewater treatment facilities differs from operating and tax-exempt lease structures. This type of wastewater lease structure establishes the contract terms for the local government, the owner of the facility, to enter into a lease agreement of the wastewater facility with a private partner. The private partner, as the lessee, frequently pays the local government a type of lease payment for the right to operate the facility for a specified period of time. The lease payment may be a one time, up-front payment, or periodic payments over the life of the lease. These payments are referred to as concession fees. The local government then pays the private partner an annual service fee to operate and maintain the facility. This annual service fee is comparable to the service fee paid under contract operations. However, the service fee under a lease includes an annual payment on the debt incurred by the private partner for concession fees. The lease arrangement allows the local government to retain ownership's responsibility over wastewater rate setting, collection of user fees, and the municipal industrial pretreatment program.

Figure 2: Lease



The Clean Water Act (Title II) established EPA's construction grants program and specifies that grants should be awarded to "publicly owned" treatment works. The term "publicly owned" has been established to mean 100 percent ownership by a public entity. When a private entity invests in a "publicly owned" federally grant assisted treatment works, the action triggers the compensation requirements of EPA's construction grants regulations.

OMB promulgated Circular A-102 to ensure consistency and uniformity among federal agencies in the administration of grants to state and local governments. One area of standardization is the uniform treatment of property acquired in whole or in part with federal funds, or whose cost was charged to a project supported by a federal grant. The uniform standards include a prescription for the use and disposition of property acquired under a grant. EPA administers these uniform administrative requirements through its general grant regulations at 40 CFR Parts 30 and 31.

OMB Circular A-102, Attachment M, requires that any federal grantee assure EPA that "it will not dispose of, or encumber its title or other interests in the site and facilities during the period of federal interest or while the government holds bonds, whichever is longer." When local governments applied for EPA grant assistance to fund local wastewater treatment works, they agreed not to dispose or encumber the proposed facilities during the period of federal interest. This means that property acquired under a grant can not be sold or pledged as collateral in the event the grantee needs to refinance the grant funded facility. This condition limits the grantee's ability to draw on the federal equity invested in the facility to raise additional capital during the period of federal interest. By giving this assurance the recipient agrees to retain the financial structure in place at the time of the grant award and relinquishes its option to financially restructure. This ensures the federal agency that the financial structure it approved at the time of grant award will not be changed.

OMB Circular A-102, Attachment N, requires that the "title to real property shall vest in the recipient subject to the condition that the grantee shall use the real property for the authorized purpose of the original grant as long as needed." This rule effectively limits the grantees use of its federally funded property, or discrete portions of that property, to its originally authorized purpose.

These rules regarding the deposition of federally funded property pose barriers to lease and sale types of privatization agreements for local governments which received EPA construction grant funds. These types of transactions are viewed as dispositions of federally funded property under OMB rules, because they temporarily or permanently transfer the facilities title or use the title as a form of collateral.

Executive Order (E.O.) 12803 was issued in 1992 to simplify the disposition of the federal interest in grant funded projects. The E.O. serves as a means for EPA to subordinate the federal financial interest in the facility to those of the local and state governments and allow the federal government to dispose of its interest in the wastewater facilities funded with federal construction grants. Therefore, when EPA approves a lease or sale privatization agreement, the Agency relinquishes its interest in the federally funded portion of the facility. However, the Agency still retains its interest in the NPDES and RCRA permit requirements on the facilities.

EXAMPLE: LEASE CONTRACT

Facility Ownership: Local government POTW

Contract type: Operations and maintenance, plus a concession type fee

Facility constructed in part with federal grants: Yes

Up-front or periodic payments from private partner: Yes

Privatization arrangement under E.O. 12803: Yes, lease

EPA review and approval: Yes–E.O. 12803 and EPA construction grant regulations–Grant deviation required

Permittee: Local government and private company are copermittees on NPDES permit

A contract arrangement involving private company cash payments must undergo review and approval by EPA to determine compliance with the specific EPA grant requirements and Executive Order 12803 prior to the local government signing a lease agreement. Lease arrangements of this type were approved in May 1997 for Cranston, Rhode Island and November 1997 for Danbury, Connecticut.

The duration of the lease may be affected by the presence of outstanding tax-exempt municipal debt on the wastewater treatment facility. If the local government used tax-exempt municipal bonds to finance any portion of the leased facility, then the term of a service contract may be restricted by federal IRS tax regulations just as they limit the term under a contract operation.

A lease/sale arrangment must undergo review and approval by EPA.

If the local government has no outstanding wastewater facility tax-exempt debt, or pays off wastewater facility debt prior to entering into the lease agreement then the term of the lease can be longer since the IRS requirements do not apply. It may be possible for a local government to retire outstanding debt out of available financial resources or a lease concession payment that is used to retire debt. The result is essentially refinancing of outstanding debt by swapping tax-exempt debt for payments to the private partner that reflect the private "investment" in the local government. This approach may be beneficial to the local government if the private partner is able to guarantee lower annual wastewater treatment costs for a longer time period than could be expected under continued governmental operation.

Asset sales– Asset sales have received a great deal of attention as a result of E.O. 12803 - Infrastructure Privatization. Under an asset sale (Figure 3), a local government sells a wastewater facility to a private partner. Revenue from the sale of the facility can be used to retire outstanding wastewater facility debt, for infrastructure investment, or for general property tax relief. When the local government retains the responsibility for wastewater user fees and pretreatment standards, the sale transaction between the private partner and the local government would include a multi-year service contract under which the private partner is paid an annual service fee for treat-

ment of the wastewater. When the private company has complete control over all aspects of the wastewater treatment facility, it is free to modify the equipment or treatment processes as necessary to reduce costs and/or improve performance.

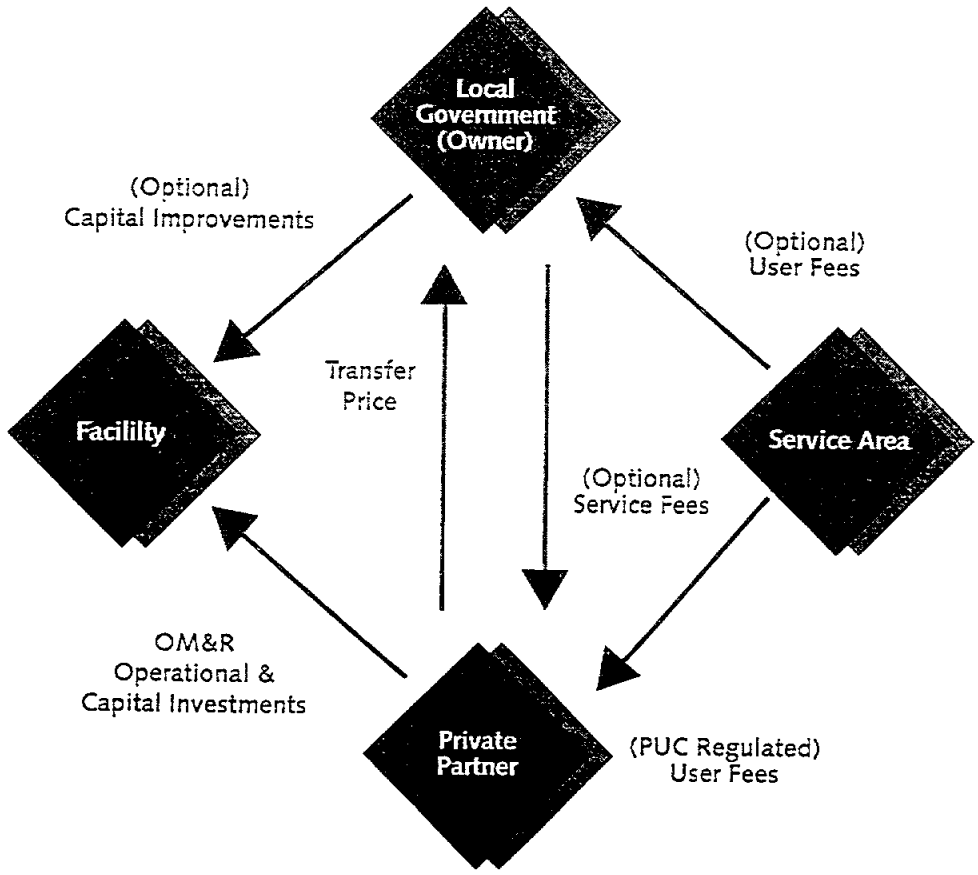
When the complete wastewater operations are under private ownership, the local public utility control boards usually approve user fees. The costs for capital investments are passed on to the public in the form of higher fees. A partial asset sale and lease agreement occurred in June of 1995 under E.O. 12803, when the private partner became responsible for the operations of the Franklin Area Wastewater Treatment Plant (Franklin, Ohio) owned by the Miami Conservancy District. A complete sale of all wastewater assets to a private entity was approved in August of 1997 for Fairbanks, Alaska. In Fairbanks, the private entity has total responsibility for wastewater services.

The transfer price paid for a wastewater facility represents an investment in the facility by the private partner. The private owner will need to recoup its investment plus interest through the service or user fees it charges to operate the facility. As a result it is inappropriate to view an asset sale as a way to free capital for other investments. It is, in fact, another financing source available to local governments comparable to individual homeowners borrowing against the equity in their home.

A simplified example helps to illustrate this point. If a local government sells a wastewater facility for a price of $1,000,000 and the facility has outstanding debt of $400,000, the government will receive net cash of $600,000 from the sale. However, a private partner will require repayment of its total $1,000,000 investment plus interest. So as part of the annual operating or user fee payment, the private partner will receive repayment of the $1,000,000 investment plus interest.

In summary, any payment a local government receives from the sale or lease of a wastewater infrastruc-

Figure 3: Asset Sale



ture asset is like a loan from the buyer or lessee which must be repaid with interest by the wastewater users in the form of additional user fees. Therefore, the value of any concession fees or sales price which exceeds the current debt on the wastewater infrastructure represents additional debt the wastewater users must repay.

If a local and state government wants to recoup all of its investment in a facility and sets a transfer price or concession fee to reflect that amount, the resulting annual service fees to the buyer or lessee could be very large and result in significant increases in user fees for all the wastewater treatment users.

EXAMPLE: ASSET SALE CONTRACT

Facility Ownership: Private company
Contract type: Asset sale contract
Facility constructed in part with federal grants: Yes
Up-front or periodic payments from private partner: Yes–Facility sale proceeds
Privatization arrangement under E.O. 12803: Yes, Asset sale
EPA review and approval: Yes–E.O. 12803 and EPA construction grant regulations–Grant deviation required
Permittee: Private company is permittee on NPDES, and possible RCRA, permit

Factors Affecting Privatization

This section presents a discussion on the financial and nonfinancial factors that affect a decision to privatize. A review of these factors helps to clarify what incentives and disincentives local governments have to privatize their wastewater facilities. Financial factors address issues of cost savings, tax status of debt, capital improvements, economic risks, and local/regional economic impacts. The non-financial factors include regulatory compliance, labor, responsibility for capital improvements, municipal control, accountability, and rate stability.

Financial Factors

For any public-private partnership to be successful, a number of financial issues must be resolved to the satisfaction of all participants. Specific financial concerns including outstanding municipal debt, user fees, and the cost of private capital have important implications on privatization agreements. Each participant in the arrangement, the local, state, and federal governments and the private operator, has a different perspective on the financial structure of public-private partnerships.

Each participant in a privatization agreement has a different perspective.

Cost savings– The ability of the private sector to reduce operating costs beyond what is practically achievable by the local government is a critical factor affecting the privatization decision. Private companies reduce costs by applying their expertise to all areas of engineering, construction, operations, and maintenance. Frequently, private companies can construct new treatment facilities at lower costs than is possible for local governments since the companies can streamline design, procurement and construction practices. Private companies may be able to apply advanced operating skills to reduce the use of chemicals and electricity in a facility while meeting or exceeding permit requirements. Private companies also may be able to lower operating costs by expertly maintaining the facility and, as a result, find it possible to operate the facility with fewer workers. In some circumstances local governments can use the same techniques to reduce operational costs.

User fees– The attraction of lower or stable user fees over the period of the privatization contract is one of the main reasons local governments explore privatization. Often privatization will result in a reduction in user fees with a guarantee that service charges from the private partner will remain stable with increases occurring only to reflect inflation or to reflect increased costs stemming from changes in regulatory requirements, treatment processes, or facility upgrades/expansions. Contract conditions that clearly state why and how changes in service fees will occur are important to the privatization process.

Capital costs– The tax status of existing and future wastewater debt is a factor in determining the ultimate costs and benefits of any privatization agreement. The ability of the existing wastewater debt to remain tax-exempt will depend on how the specific conditions of the privatization arrangement relate to IRS tax rules. In developing a privatization agreement, the parties must carefully follow IRS tax rules to avoid changing the status of existing tax-exempt municipal bonds to taxable private activity bonds. The IRS has defined very specific types of action local governments must meet to maintain the existing tax-exempt status of municipal bonds.

When private companies must acquire capital to fund improvements to the wastewater facilities, lease payments, concession fees, or transfer prices, the debt is usually acquired in the form of taxable private activity bonds. However, the IRS has defined certain limited situations where private companies can finance wastewater treatment facilities with the proceeds of tax-exempt "qualified private activity bonds".

Even though the nominal interest rate differential between tax-exempt and taxable bonds may be significant, the actual costs of the capital may not have a great impact on the privatization decision. The private party may be able to offset the higher capital costs by the tax deductibility of interest costs and depreciation expenses.

Up-front payment (concession fee, lease payment, or transfer price)– Up-front payments from a private partner to a local government may occur in privatization. In a lease arrangement it is usually called a "concession fee." It could be an initial payment or installment payments made as part of a lease arrangement or, in an asset sale, the transfer price provided up-front to complete the privatization transaction. Municipalities may use these up-front payments for other infrastructure investment, refund of outstanding debt, or general tax relief under E.O. 12803 privatization arrangements.

As discussed in the previous section, it is important to note that the transfer price, lease payment, or concession fee are equivalent to loans are from the private partner to the local government. Any funds provided by the private partner will need to be recouped through future user fees. Simply stated, up-front payments (transfer price or concession fees) are analogous to the home equity loans that are used across the country today. A private company provides a payment that reflects some level of the municipal investment in a facility and then the private company recoups the payment plus interest as a part of annual service fees charged to the municipality. As a result, privatization should not be viewed as a way to obtain sources of "free" capital. Instead, privatization should be viewed as one more source of capital financing for municipal wastewater investments.

Tax-exempt status of local debt– Most municipal wastewater debt is in the form of tax-exempt general obligation or revenue bonds, SRF loans, and other bonds or loans received to build the wastewater facility. As long as a municipality maintains ownership of the wastewater facility and the privatization agreement meets the conditions allowed by IRS "management contract" rules, government issued debt can remain tax-exempt over the repayment term. Tax-exempt public debt is repaid at attractive interest rates, currently around 6-8 percent.

The IRS rules that have recently been released provide additional flexibility to communities that wish to have their facilities operated under contract for an extended period of time while maintaining the tax-exempt status of their wastewater bonds. The new rules allow certain "management contracts" for "public utility property" (including wastewater treatment plants) of up to 20 years without endangering the tax-exempt status of outstanding municipal debt under certain operations arrangements.

Capital improvements may be the responsibility of the private sector.

Capital improvements– Capital improvements usually represent modifications to the wastewater facility to meet new discharge requirements, replace old infrastructure, provide services to a growing residential area, or meet economic growth needs by expanding the service area. Capital improvements are often costly and impose a financial burden on the local government. In privatization, depending on the terms of the privatization agreement, capital improvements may become the responsibility of the private sector. The private partner recovers the costs of its investment in capital improvements through increased service fees paid by wastewater users. The private partner's ability to use tax-exempt financing plus different engineering, procurement and construction practices can have a significant influence on capital improvement costs. The overall costs that result from capital improvements under privatization are important to consider and compare to costs that would result from financing and construction under continued public ownership and operation.

Economic impacts– The local impacts will vary depending on the type of privatization agreement. Overall impacts can include potential increases in local unemployment and loss of local government control over hiring of operations personnel. Privatization has often resulted in a reduction in the staffing levels because the private firm is able to efficiently manage the facility with fewer workers. This action will potentially affect union relations, local income levels, and the local businesses that the local labor forces patronize. However, to address this concern, the private partner will normally agree to hire most of the current employees, cooperate with labor organizations to secure job training and placement for the workers, and reduce the workforce through attrition. Frequently, the private partner has the ability to lower and stabilize wastewater rates which can contribute to the ability of the community to encourage economic growth.

Performance and liability– There are economic risks associated with meeting

National Pollutant Discharge Elimination System (NPDES) permit standards and the costs resulting from unexpected wastewater flow and loading variations. When a private partner assumes operating responsibility, they assume responsibility to meet permit limits under typical operation conditions. This responsibility is reflected by making the private partner a copermittee with the local government on the NPDES permit.

■ The private partner is a copermittee on the NPDES permit.

When a facility is privatized, the interests of both the local government and the private partner can be protected by defining normal operating conditions and stipulating what actions are taken to adjust service fees under different conditions, such as floods, atypical pollutant levels, or amendments to environmental regulations that increase operating costs.

Non-Financial Factors

In addition to financial factors, there are non-financial factors that affect the privatization decision. These factors include: regulatory compliance, local control, accountability, personnel impacts, responsibility for capital improvements, and the impact of state and local laws and regulations.

Regulatory compliance– When evaluating privatization, local governments must determine if private firms can operate the wastewater facility in a legal manner that maintains the facility's publicly owned treatment works (POTW) status. This is achieved when the local government retains ownership and the private operator is a copermittee on the NPDES permit. Under these conditions, the contract clearly assigns performance responsibility to the private operator. In the event of nonperformance, the contract would specify financial penalties to the private firm that would escalate in the event of continuing nonperformance. As copermittees on the NPDES permit, both private partner and the local government are responsible for any permit violations and resulting fines.

In the circumstances of an asset sale, where all components of the facility are sold to a private partner, the facility and any industrial dischargers to the facility would be regulated under the Clean Water Act and may be subject to requirements under the Resource Conservation and Recovery Act (RCRA). The private ownership status means that industrial pretreatment requirements under the POTW status of the Clean Water Act may be replaced by RCRA requirements. In such a situation, higher treatment costs may occur if the wastewater treatment facility is designated as a RCRA hazardous waste treatment, storage or disposal facility. When an asset sale occurs the private partner will have to apply for a new NPDES permit under its own name. The permit limits under private ownership will likely be similar to those of the previous POTW's permit. In the Franklin, Ohio arrangement, the facility retained its POTW status by the local government retaining ownership of a portion of the wastewater treatment process under a lease arrangement. The private owner of the Fairbanks, AK facility

will probably maintain the same NPDES permit limits, since the system does not have any hazardous waste discharges.

Local control– Under a public-private partnership, local governments yield control over the facility's daily operations to the private partner. However, through the service contract local governments can maintain control over important local issues such as user rates, industrial pretreatment programs, capital improvements/expansions, and modifications to the service area. Local control will vary depending on the type of privatization. Under an asset sale the local government yields ownership to the private partner and relinquishes control over the facility except in the event of a failure of the owner to perform as required. One significant issue that may affect an asset sale is the potential for oversight from state Public Utility Commissions (PUCs). PUCs often regulate investor-owned utilities such as privately-owned public water systems. PUC oversight governs a variety of cost related activities including user rates and debt issuance. The local government's control will be significantly reduced if the facility is subject to PUC oversight.

The level of oversight for the private partner will vary to reflect the level of concern that local governments have about the private partner's performance. Oversight activities such as local contract management, the level of performance reporting to the local government, or the use of an oversight board consisting of local authorities are negotiated as part of the privatization service agreement.

Public accountability– When a private company operates a local wastewater facility, there may be concern or a perception that they will not be as accountable as a public operator. Communities that have opted for privatization of their wastewater facility indicate that contract requirements with specific performance levels for the private operator in all areas of operations have worked to protect the public interest and to assure a high level of accountability. All service contracts established with private companies need to incorporate specific performance assurances that protect the environment. Local government may require a performance bond from the private partner to add additional assurance of performance. Under an asset sale, where PUCs have jurisdiction over privately owned public wastewater facilities, the private operator would be regulated and held accountable for PUC requirements.

Personnel impacts– The private company and local government need to consider how privatization will impact current wastewater plant personnel. Any expected reduction in staff, including the timing of the reductions and out-placement activities

must be included in contract negotiations. Because of the potential for significant personnel impacts, local governments have found it important to involve workers and unions in deliberations about privatization to explore any plans for personnel adjustments including new hires, salary and budget changes, and staff reductions. Current privatization arrangements have generally used attrition or transfers as the primary way to reduce the work force.

Capital improvements– Capital improvements or wastewater capacity expansions contribute to the continued economic success of the wastewater facility. The privatization agreement may address specific scheduled capital improvements during the life of the contract, including responsibility and financing arrangements. The contract negotiations determine who has the lead on capital improvements and how it will vary according to the specific situations.

State laws and regulations– State laws and regulations often have significant impacts on the form and conditions of privatization agreements like the type of service, term of contract, and contracting entity. These laws and regulations vary significantly across the country but most appear to be oriented toward allowing privatization of wastewater facilities. In cases where the form of privatization desired is not explicitly allowed under state laws, local governments will find it necessary to seek the necessary legal opinions on the feasibility of the specific desired privatization arrangement.

Overall administrative complexity of the transaction– Some of the overriding issues that affect privatization are the overall complexity of designing a privatization arrangement, negotiations between public participants and the private partner, and execution of the formal contract. In cases where there are multiple facility owners or participants in a wastewater treatment system, the privatization process is likely to take a longer period of time to accomplish. In the case of extremely large regional facilities with many participating communities the process may become so complex that it would be difficult to implement.

CHAPTER 4

Federal Requirements Affecting Privatization

Although many of the factors affecting privatization are local in nature, there are certain federal requirements that impact those decisions. IRS regulations, EPA construction grant regulations, NPDES permit requirements, and Executive Order 12803 come into play in choosing the type of privatization. Some of the federal regulations restrict certain privatization activities. For example, tax law restricts the use of tax-exempt debt for privately owned facilities. Other federal requirements present a challenge because they require that local governments seek approval for changes to ownership/operation of their POTW. EPA requirements apply only if the local government received federal wastewater construction grants. For example, sale of a facility that received construction grants through the Clean Water Act requires the local government to apply for a deviation from the EPA grant regulations and EPA review and approval under E.O. 12803. Various federal requirements can potentially add additional time for the local government to complete the privatization agreement. Each of the requirements and its influence on decision-making are discussed below.

IRS Regulation/Tax Law Affecting Use of Tax-Exempt Municipal Debt

In 1986, the Tax Reform Act influenced private investment in public infrastructure by removing or limiting many tax incentives. Specifically, the amendment eliminated the investment tax credit, scaled back accelerated depreciation and limited the use of tax-exempt debt financing. These changes virtually eliminated several "lease-buy" privatization arrangements and severely restricted the duration of management contracts under contract operations to five years. The main reason generally cited for these changes was that the financial incentives given to the private sector represented a very significant loss of tax revenues to the federal treasury.

As previously mentioned in Section III, recently released IRS rules provide additional flexibility to communities that wish to have facilities operated under a contract arrangement without the loss of the tax-exempt status of the wastewater bonds. The new rules allow certain "management contracts" for wastewater treatment plants of up to 20 years without endangering the tax-exempt status of outstanding municipal wastewater debt. For example, a 20 year "management contract" is allowed if at least 80 percent of the compensation provided to the private partner is in the form of a periodic fixed amount. This has the effect of limiting the amount of net profit that may be provided to the private partner.

EPA Regulations and Procedures

The Clean Water Act established the regulatory structure for local governments that received EPA grant funds to construct water pollution control facilities under the Agency's construction grant program. Through the Clean Water Act, local governments have received billions in federal construction grant funding to build POTWs that meet wastewater discharge permit limits established under the NPDES. The NPDES requirements of the Clean Water Act establish pollutant limits for discharges from POTWs and privately owned wastewater treatment facilities.

NPDES permittee designation– NPDES regulations require that a local government obtain an NPDES permit to discharge water from its wastewater treatment facilities. Under privatization, the private operator may be a co-permittee or the permittee of record. The private operator is a co-permittee with the local government on the facility's NPDES permit when the private operator is responsible for operating the entire wastewater facility under contract operations or lease type privatization agreements. If the facility becomes privately owned, the facility will no longer be a POTW and the private owner will be required to obtain a new NPDES or RCRA permit under its own name.

POTW designation– An important privatization consideration is the POTW status of the wastewater treatment facility. When a wastewater treatment facility loses the POTW status it is classified as a privately owned treatment works that is no longer subject to the requirements of a municipal industrial pretreatment program. A privately owned treatment facility may also be designated as a hazardous waste treatment, storage or disposal facility under RCRA and subject to more strenuous treatment standards. Local governments and private companies have indicated that the threat of losing the POTW status has been a significant concern when evaluating asset sale and lease arrangements.

Grant deviation procedures– EPA's construction grant regulations specify that when a grantee sells or encumbers ownership by leasing a facility that received grant funds, the grantee must request a deviation from certain grant regulations and possibly repay the grant funds. The grant deviation process is used to terminate the federal interest in facilities and allow the local government to enter a lease or sale privatization arrangement with a private entity.

EPA Review of Privatization Proposals

In 1992, Executive Order 12803 established a simplified framework for privatization of facilities funded with federal grants. The order has five purposes: (1) assist local privatization initiatives; (2) remove federal barriers to privatization; (3) increase the financial incentives for state and local governments by relaxing federal repayment requirements; (4) protect the public interest by ensuring reasonable user charges; and (5) establishing guarantees that the facility will continue to be used for its intended purpose.

Executive Order 12803 significantly modified the federal construction grant recoupment process. Under E.O. 12803 the local and state governments are the first to receive proceeds from an asset sale or lease concession fees. If the transfer price or concession fee for the facility is higher than the state and local investment, then federal construction grants are repaid at their depreciated value up to a maximum of the transfer price or concession fee. Federal grants are depreciated using the IRS fifteen year accelerated depreciation schedule. The Executive Order results in repayment of federal grants at a much lower level that would have resulted under EPA construction grant regulations.

Executive Order 12803 simplified privatization of facilities funded with federal grants.

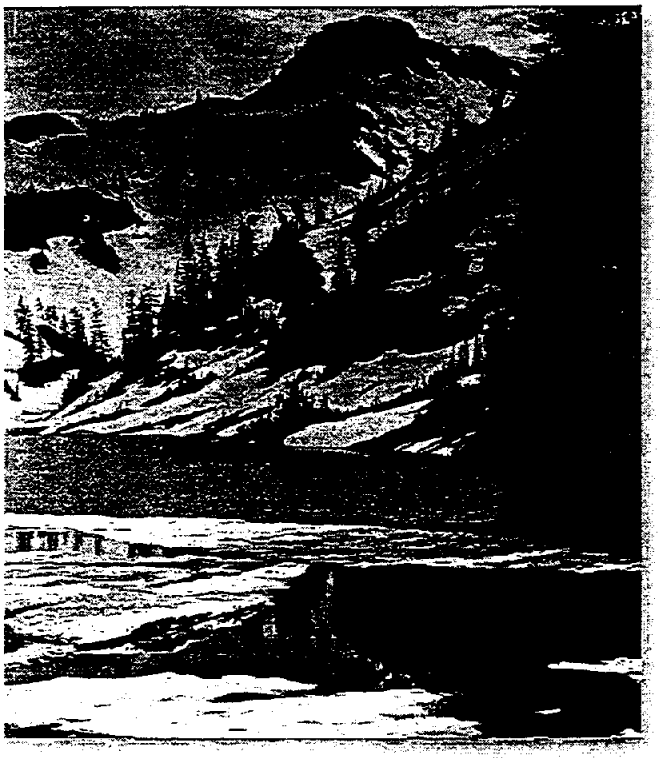
When an EPA construction grantee decides to pursue an asset sale or lease type of privatization agreement, it will be necessary to submit a request for a deviation from EPA's Construction Grant regulations and request EPA review and approval of the privatization arrangement under E.O. 12803. Several communities have undergone the EPA review and approval process to date:

Franklin Area Wastewater Treatment Facility (Franklin, OH) - lease and partial asset sale completed in 1995
Cranston, Rhode Island wastewater treatment system - lease completed in 1997
Fairbanks, Alaska - lease and total asset sale completed in 1997
Danbury, Connecticut - lease completed in 1997

The first step in seeking EPA review and approval for a proposed lease or sale type of privatization agreement, prior to signing the contract with the private entity, is the submission of five copies of both the proposed privatization contract and the executive summary of the privatization agreement to the Agency's Director of the Office of Wastewater Management in Washington D.C. At the same time, the local government must submit a request for a grant deviation from EPA construction grant regulations to the applicable EPA Regional Office. The deviation request should be included with two copies of the privatization agreement and the Executive Summary.

Executive Summary

The executive summary should address the salient information that is relevant to EPA's review and approval of the privatization agreement such as: a general description of the privatization agreement, service area, permit arrangements, operational guarantees, public participation, changes in the debt structure for the wastewater facilities, amount and intended use of funds received from the private entity, grant project costs contributed by the local government, state, and EPA, the depreciation calculations for the Federal grant funds, local government's oversight responsibilities, employee status under the privatization agreement, authority for establishing future user rates, impact of the privatization agreement on user fees, and coordination with State and Federal authorities. Each of these subject areas should be supported with appropriate data.



Privatization agreement– The general description of the privatization agreement should discuss the important objectives and clauses of the privatization contract. Some of the topics that should be included in the discussion are the contract start date, term of the contract, contract entities, amount of funds to be received by the different entities, various contract controls to assure performance or limit liability, new construction, and other significant topics. The general description should contain a discussion of the procurement process used to select the private entity and the names of other companies involved at different stages of the process.

Service area– The executive summary should describe the general physical boundaries of the wastewater system and its relationship to established political entities. This description should present information on the population served by the wastewater facilities, number of residential households, percentage of households, commercial, industrial, and governmental users in the system, type of wastewater treatment, physical condition of the sewer system and treatment facilities, any planned or required construction, and other pertinent facts.

Permit arrangements– A discussion of the permit arrangements should address the wastewater discharge responsibilities of the various entities and their status on the NPDES or RCRA permit. The entity responsible for the various functions under the Municipal Industrial Pretreatment Program (MIPP) should be identified in this discussion. Any contract or other controls used to assure compliance with the discharge permit and MIPP should be described in general terms.

Operational Guarantees– The executive summary should describe the various operational guarantees that will be established to assure that: (1) the wastewater facilities will be operated in an effective manner to achieve compliance with the conditions of the wastewater discharge permit, (2) the industrial pretreatment standards will remain in place and enforced, (3) the facilities will be maintained in a satisfactory manner to avoid deterioration of the facility during the contract period, and (4) the facilities will continue to provide uninterrupted wastewater services in the event of contract default by the private entity. This discussion should address any monetary or other penalty that will be used to encourage compliance by the private entity.

Public Participation– A discussion of the public participation conducted by the local government to acquire support for the privatization agreement should address the number of public notices, the number and content of the public hearing, any newspaper coverage of the privatization agreement, the timing of the public discussions, the level of public participation, and any other relevant facts.

Debt Structure– The executive summary should include a discussion of any changes in the debt structure of the wastewater facilities that will occur as a result of the privatization agreement. The discussion should describe the current debt position for the wastewater facilities and how any concession fee or transfer price will be used to reduce or eliminate existing wastewater debt.

Use of Funds– A discussion on the amount and intended use of funds received as a result of the privatization agreement should include all of the funds received from the private entity. The specific contract language or methods of payments used in the privatization agreement, or any auxiliary agreement, to convey funds to the local government is not a relevant factor in determining which funds should be addressed in the executive summary. If any funds are received by the local government from the private entity, the executive summary should identify the amount and intended use of these funds. The value of the funds should be stated in terms of both present worth and total value.

Project Costs and Depreciation Calculations– Cost data should be included in the executive summary displaying the amounts of funds contributed by the local, state, and Federal governments for the EPA construction grant projects involved in the privatization agreement. The summary should include the calculations used to determine the depreciated value of the Federal grant funds using the IRS Modified Accelerated Cost Recovery System, 15 year, half-year convention schedule. The depreciated value calculations should be based on the dates the EPA grant funded projects were placed in service. A table combining the various calculations used to determine any repayment amount for Federal funds should be presented in the summary (See Appendix C).

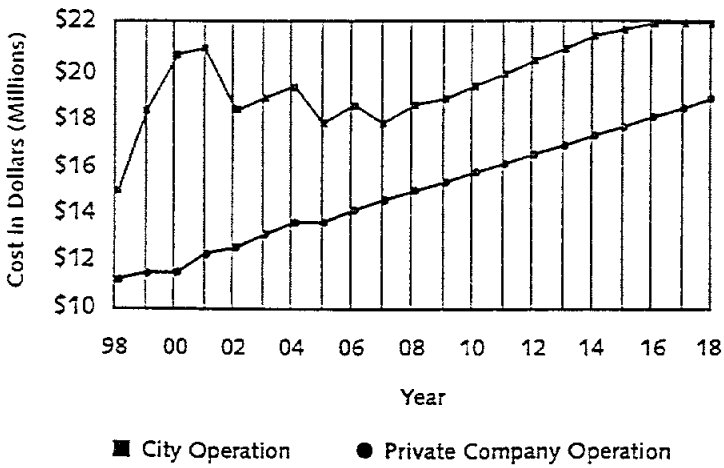
Oversight Responsibility– The executive summary should discuss the process the local government will use to administer the privatization contract to assure effective and adequate operation and maintenance of the wastewater facilities. This discussion should describe the NPDES permit, the MIPP, and the RCRA permit responsibilities that will be retained by the local government and the oversight actions the local government will use to assure that the private entity will preform the transferred responsibilities.

Employee Status– The employment status of current wastewater employees under the privatization agreement should be fully described in the executive summary. This discussion should address the local government's and private entity's personnel arrangements undertaken to assure a smooth transition of the wastewater facilities operations to the private entity. The status of employee's benefits, including retirement and retention privileges, should be included in the discussion.

Authority For User Rates– The entity that will be responsible for establishing and collecting the wastewater user fees should be identified in the summary. A discussion of the process used to assure adequate collection of revenues for the payment of the private entity's service fee and any other wastewater expenses should be included in the executive summary.

Impact On User Fees– The executive summary should contain information on the impact of the privatization agreement on future wastewater user fees. This information should focus on the projected user fees to be incurred by residential wastewater users over the life of the privatization agreement. The analysis should present projected data and graphs which compare the annual and total costs of wastewater treatment under local government and private operation (See Figures 4 & 5). The data should identify the total cost savings that will result from the privatization agreement. This information should be expressed in total dollars and present worth dollars. The analysis should include data and graphs of the projected residential user costs and the projected user costs per household as a percentage of median household income (See Figures 6 & 7). The projected residential user costs should be an expression of both nominal and inflation adjusted values. The summary should contain a description of the assumptions used to calculate the projected costs.

Figure 4: Comparison of Annual Costs



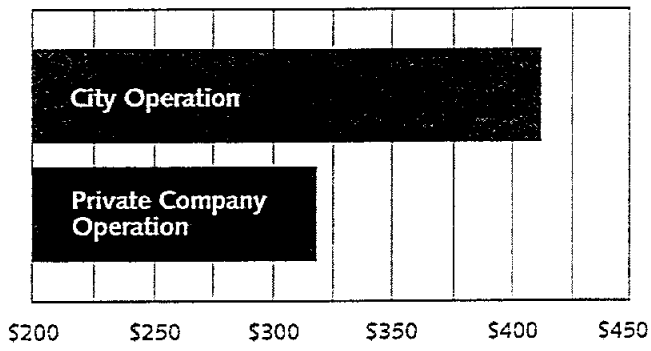
State and Federal Coordination– Any discussions the local government has had with state or Federal environmental agencies dealing with the

privatization agreement, the wastewater facilities, or wastewater discharge issues should be described in the executive summary. This discussion could include such issues as construction needs for improving wastewater treatment levels, increasing capacity, combined sewer overflows, or other pertinent issues.

Executive Summary Data

Data presentation in the executive summary can be as simple as providing graphs and charts that summarize information and providing copies of pertinent information, legal documents, public notices and public information. For example, the graphs in Figures 4 & 5 are a simple illustration of the total costs of wastewater treatment under public operation versus private operation. The objective of any data is to clearly convey important information.

Figure 5: Wastewater System Cost Comparison
Cumulative Costs 1998–2018



CHAPTER 6

EPA Approval of Privatization Proposals

The EPA requirements for approval of proposed privatization arrangements focus on protection of the environment and the wastewater user, compliance with the requirements of E.O. 12803, and approving the appropriate deviations from EPA's construction grant regulations.

Compliance with the Clean Water Act

The overriding intent of the Clean Water Act (CWA) is to improve the condition of rivers, lakes, and other water bodies by requiring that wastewater discharges meet standards for designated uses such as recreation and aquatic life support. In accordance with the CWA, EPA reviews privatization proposals to ensure compliance with the intent of the CWA, the NPDES program, and RCRA permit requirements.

The proposed privatization agreement will be reviewed to assure that the contract language addresses the process that will be followed in the event that the community wishes to expand the facility or make modifications to comply with future environmental protection requirements. The contract's procedures for addressing a failure of the private company to perform will be reviewed to assure adequate guarantees are provided for continued wastewater services. In addition, the plant must continue to be used for its intended purpose. The permit responsibilities for each party will also be reviewed to assess the penalty provisions for non-compliance by the private entity. In a lease arrangement, EPA's approval will be conditioned on the local community and the private entity being named as co-permittees on the NPDES permit. When an EPA construction grant funded facility is sold to a private company, the private company will be the sole permittee.

Federally-required industrial pretreatment standards would be maintained by the local community under contract operations and lease type privatization agreements. The local community would maintain oversight and enforcement responsibilities for the local pretreatment program. When the wastewater facilities are sold, the private owner may be required to have a RCRA permit instead of a NPDES permit. Therefore, a sale agreement would address the hazardous waste issue in the executive summary.

EPA recognizes that the privatization permit conditions under the CWA can only be met after the lease/purchase has been consummated with the private entity. When the conditions are fulfilled, the grantor would notify EPA. Upon receipt of notification, EPA's approval will be considered final and complete.

Impacts of Privatization Proposal on User Fees

Requests for approval require documentation of the current and proposed user fee rate structure and arrangements for increases in the future. The documentation of the user fee structure should include detailed information on all assumptions, data, and methods used for determining future fees. An assessment should be performed on any rate increase to determine if it is reasonable based on the specific conditions of the community. A complete analysis should take into account the CPH and MHI. Other items that should be included in the user fee analysis are:

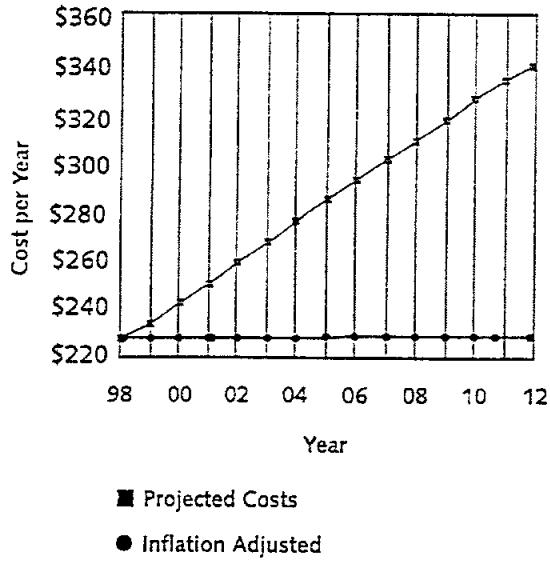
- Financial projections that show the annual revenues (user fees and other), expenses (operating and capital financing), and resulting projected costs for typical residential users. The assumptions incorporated into the projections should be included for review. Typically user fees will be computed as:

$$\frac{\text{Total Cost x Residential Usage (\%)}}{\text{Total Households}}$$

- Graphical representation showing projected user rates for 10 and 20 years. Graphical representations are a good way to communicate the effect of the privatization agreement on the public. Figure 6 provides an illustration of a projected user fee graph.

- Projected user rates per household as a percent of median household income. This information will help illustrate the effect of the privatization agreement on household affordability. It is generated with the user fee information discussed above, and the local government's Median Household Income (MHI) statistic that is developed in the census of governments taken every ten years by the U.S. Bureau of Census. Because the MHI is developed only every ten years, it will be necessary to adjust the latest MHI to current dollars before the user charge as a percent of MHI indicator can be developed. This is accomplished by multiplying the latest MHI by an "adjustment factor" that reflects annual Consumer Price Index (CPI) inflation experienced nationally. The inflation adjustment actor can be found in Appendix A or developed with the following formula:

Figure 6: Projected Residential Costs



$$\text{MHI Adjustment Factor} = (1+\text{CPI})^{\text{Current Year-Census Year}}$$

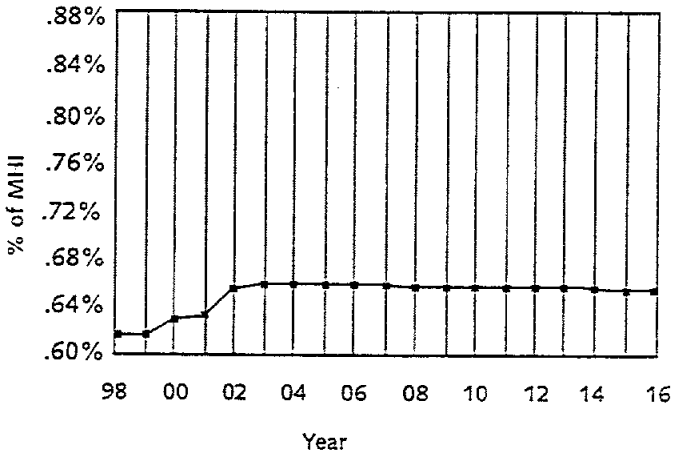
$$\text{Adjusted MHI} = \text{MHI} \times \text{Adjustment Factor}$$

A local government's MHI is adjusted to a current level by multiplying the MHI by the adjustment factor. For example, if a permittee's MHI was $30,000 in the 1990 census year, the average annual CPI since 1990 was 4 percent and the current year is 1992, the following calculation would be made to adjust the MHI to current dollars:

$$\text{Adjustment Factor} = (1+.04)^{1992-1990} = 1.0816$$

$$\text{Adjusted MHI} = \$30{,}000 \times 1.0816 = \$32{,}448$$

Figure 7: Cost per Household as % of MHI
Years: 1998-2018



So if projected user fees under the privatization agreement result in costs averaging $350 per year the indicator would be computed as follows:

$$\text{User Fees as \% of MHI} = \text{Projected User Fees/Adjusted MHI}$$
$$= \$350/\$32{,}448$$
$$= 1.1\%$$

It is also important to show what will happen to the affordability of user charges over time. A graph showing the projected user charges as a percent of MHI over a 20 year period should be included to meet this requirement. Figure 7 illustrates this graph.

Public Notification and Hearings

In the interest of protecting the rate payers, EPA will evaluate whether the grantee has provided public notice and held public hearings that presented valid estimates of wastewater rates and proposed uses of any funds received by the local government from the private entity. EPA will review the privatization data used in the public hearings.

As part of the public notice process, grantees should provide all users of wastewater facilities with a notice describing the repayment of any concession fees or funds provided in the privatization arrangement. The notice needs to state that a portion of the annual service fees payable by the local government out of the sewer user fees will be allocated to reimburse the private company for the concession fee or other funds. (See appendix A for an example.) A copy of the notice should be included in the Executive Summary of the privatization agreement submitted to EPA.

Compliance with E.O. 12803

The E.O. 12803 requires guarantees or assurances that the privatized facilities will be used for their original intended purpose, even in the event that the private entity becomes insolvent. There should also be an explanation and documentation of the POTW's valuation process in a sale arrangement and details of the proposed distribution of any proceeds. EPA's review will ensure that funds acquired from a lease or a sale of assets are used for infrastructure costs, debt reduction, or tax relief. EPA will also require that disbursement of funds is either a condition of the privatization approval or fixed by local ordinance.

EPA will evaluate the competitive procurement procedures required under section 1(d) of E.O. 12803. The executive summary should describe how the proposal and award process was accomplished, describing the solicitation process (request for proposals, invitation to bidders, etc.), number of submissions, the evaluation undertaken including the criteria used to rank proposals, and the final award. The Executive Order requires that transfer prices for facilities that are sold or leased through a negotiated process rather than a competitive bidding process be reviewed by the Office of Management and Budget. In addition, for transactions that are not accomplished though a competitive bidding process, the net asset value of the facility will need to be established through an independent third party (e.g., National Appraisers Association).

The EPA will review the impacts of the privatization agreement on user fees.. This is accomplished by comparing the projected cost per household as a percent of MHI against accepted benchmarks of affordability. Recent EPA guidance on the assessment of wastewater financial capability provides useful benchmarks that can be used in reviewing the affordability of proposed privatization arrangements. The benchmarks, taken from EPA's *Combined Sewer Overflows-Guidance for Financial Capability Assessment and Schedule Development* (EPA 832- 13-97-004) are as follows:

Financial Capability Evaluation– Annual Cost Per Household as a Percent of Median Household Income Benchmarks

Level	Financial Impact
<1 percent	Low
1-2 percent	Mid-Range
>2 percent	High

The executive summary should contain the federal construction grant history for the privatized facilities. The summary should provide the federal grant amounts, date of award, date the facility initiated service, and the amount of depreciation under IRS schedules. Appendix C contains examples of depreciation calculations, including the computation of a Federal repayment value, and associated IRS schedule for 15-year property used for depreciation calculations.

Grant Deviation Requirements

The E.O. 12803 simplified the process for disposition of the federal interest in federally funded wastewater treatment facilities, when an EPA grantee wants to enter into a lease or sale type of privatization agreement with a private entity. The grant deviation process is the legal means the Agency uses to accomplish the action. Any wastewater facility funded with EPA grant funds will require a deviation from the Agency's construction grant regulations prior to consummation of a sale or lease contract.

Depending on the date of issuance of the construction grant and the type of privatization agreement, there are different grant regulations that will need a deviation. If a grant was issued under the Code of Federal Regulations revised July 1, 1983, then deviations from 40 CFR 30.810-4 is needed to dispose of the federal interest for a lease or sale type of agreement. Grants that were issued under the Code of Federal Regulations revised January 1, 1972, require a deviation from 40 CFR 30.800 and 30.810-3. This grant deviation is required to nullify the general grant condition requiring the grantee not dispose of or encumber title or any other interest in a facility during the period of federal interest, or while the government holds bonds, whichever is longer (OMB circular A-102 Uniform Requirements for Assistance to State and Local Governments). When a grant was issued under the 1968 Code of Federal Regulations, a deviation is required from 18 CFR 601.27(1), which requires that a grantee have a fee simple or such other estate or interest in the site of the project, and rights of access sufficient to assure undisturbed use and possession for the purpose of construction and operation for the estimated life of the project.

In addition, 40 CFR 30.810-5(d)(2)(i) and (ii) (1983) state in part, that any POTW financed in part with EPA funds, may retain title, with the federal restrictions removed, if it compensates the federal government an amount determined by applying the federal percentage of grant participation in the net cost of the project, to the current fair market value of the property, or if the POTW owner sells the project under guidelines provided by EPA, using proper sales procedures that provide for competition to the extent practicable, and result in the highest possible return, and pay the federal government an amount computed by applying the federal percentage of grant participation in the net cost of the project to the proceeds from sale.

The grant regulations also state that EPA must be compensated for its share of expendable personal property when such property is either sold or used for non-federally sponsored activities, 40 CFR 30.810-8 (1983). A similar provision of the Code of

Federal Regulations is 40 CFR 30.800-3 (1972). This section states that title to movable or fixed equipment, materials or supplies are subject to the equitable interest of the United States unless otherwise provided by law or regulation or the grant agreement. If no such provision exists, payment to the United States would be the grant proportion of the fair market value of the property at the time of the final accounting. The Director of the Grants administration Division at EPA Headquarters is authorized by EPA regulations to approve requests for grantees to deviate from the EPA construction grants regulations. The deviations requests should be submitted to the Environmental Protection Agency's Project Officer at the Regional Office, who will forward the request to the Director of Grants Administration with a recommendation for approval or disapproval. The request should include two copies of the same documentation submitted to the Office of Wastewater Management.

CHAPTER 7

Regional and State Involvement in the Privatization Process

EPA Headquarters coordinates its review of a grantee's privatization request with EPA regional and state staffs involved with the privatization process. The EPA will determine if the EPA regional or state staffs have any concerns or if any additional information is needed to fully evaluate the proposed privatization arrangements. The EPA grantee should provide its state environmental agency with a copy of its privatization agreement and executive summary at the same time the data is submitted to EPA for review and approval. The EPA privatization coordinator at EPA Headquarters works to coordinate the Agency's review, approval, and grant deviation process with EPA's Regional Office and Headquarters Grants Administration. The EPA's Regional Office usually coordinates its review with state representatives.

Appendix A

Adjustment Factors

Year \ Rate	0.005	0.01	0.015	0.02	0.025	0.03	0.035	0.04	0.045	0.05	0.055	0.06	0.065	0.07	0.075	0.08	0.085	0.09
1	1.0050	1.0100	1.0150	1.0200	1.0250	1.0300	1.0350	1.0400	1.0450	1.0500	1.0550	1.0600	1.0650	1.0700	1.0750	1.0800	1.0850	1.0900
2	1.0100	1.0210	1.0302	1.0404	1.0506	1.0609	1.0712	1.0816	1.0920	1.1025	1.1130	1.1236	1.1342	1.1449	1.1556	1.1664	1.1772	1.1881
3	1.0151	1.0303	1.0457	1.0612	1.0769	1.0927	1.1087	1.1249	1.1412	1.1576	1.1742	1.1910	1.2079	1.2250	1.2423	1.2597	1.2773	1.2950
4	1.0202	1.0406	1.0614	1.0824	1.1038	1.1255	1.1475	1.1699	1.1925	1.2155	1.2388	1.2625	1.2865	1.3108	1.3355	1.3605	1.3859	1.4116
5	1.0253	1.0510	1.0773	1.1041	1.1314	1.1593	1.1877	1.2167	1.2462	1.2763	1.3070	1.3382	1.3701	1.4026	1.4356	1.4693	1.5037	1.5386
6	1.0304	1.0615	1.0934	1.1262	1.1597	1.1941	1.2293	1.2653	1.3023	1.3401	1.3788	1.4185	1.4591	1.5007	1.5433	1.5869	1.6315	1.6771
7	1.0355	1.0721	1.1098	1.1487	1.1887	1.2299	1.2723	1.3159	1.3609	1.4071	1.4547	1.5036	1.5540	1.6058	1.6590	1.7138	1.7701	1.8280
8	1.0407	1.0829	1.1265	1.1717	1.2184	1.2668	1.3168	1.3686	1.4221	1.4775	1.5347	1.5938	1.6550	1.7182	1.7835	1.8509	1.9206	1.9926
9	1.0459	1.0937	1.1434	1.1951	1.2489	1.3048	1.3629	1.4233	1.4861	1.5513	1.6191	1.6895	1.7626	1.8385	1.9172	1.9990	2.0839	2.1719
10	1.0511	1.1046	1.1605	1.2190	1.2801	1.3439	1.4106	1.4802	1.5530	1.6289	1.7081	1.7908	1.8771	1.9672	2.0610	2.1589	2.2610	2.3674
11	1.0564	1.1157	1.1779	1.2434	1.3121	1.3842	1.4600	1.5395	1.6229	1.7103	1.8021	1.8983	1.9992	2.1049	2.2156	2.3316	2.4532	2.5804
12	1.0617	1.1268	1.1956	1.2682	1.3449	1.4258	1.5111	1.6010	1.6959	1.7959	1.9012	2.0122	2.1291	2.2522	2.3818	2.5182	2.6617	2.8127
13	1.0670	1.1381	1.2136	1.2936	1.3785	1.4685	1.5640	1.6651	1.7722	1.8856	2.0058	2.1329	2.2675	2.4098	2.5604	2.7196	2.8879	3.0658
14	1.0723	1.1495	1.2318	1.3195	1.4130	1.5126	1.6187	1.7317	1.8519	1.9799	2.1161	2.2609	2.4149	2.5785	2.7524	2.9372	3.1334	3.3417
15	1.0777	1.1610	1.2502	1.3459	1.4483	1.5580	1.6753	1.8009	1.9353	2.0789	2.2325	2.3966	2.5718	2.7590	2.9589	3.1722	3.3997	3.6425
16	1.0831	1.1726	1.2690	1.3728	1.4845	1.6047	1.7340	1.8730	2.0224	2.1829	2.3553	2.5404	2.7390	2.9522	3.1808	3.4259	3.6887	3.9703
17	1.0885	1.1843	1.2880	1.4002	1.5216	1.6528	1.7947	1.9479	2.1134	2.2920	2.4848	2.6928	2.9170	3.1588	3.4194	3.7000	4.0023	4.3276
18	1.0939	1.1961	1.3073	1.4282	1.5597	1.7024	1.8575	2.0258	2.2085	2.4066	2.6215	2.8543	3.1067	3.3799	3.6758	3.9960	4.3425	4.7171
19	1.0994	1.2081	1.3270	1.4568	1.5987	1.7535	1.9225	2.1068	2.3079	2.5270	2.7656	3.0256	3.3086	3.6165	3.9515	4.3157	4.7116	5.1417
20	1.1049	1.2202	1.3469	1.4859	1.6386	1.8061	1.9898	2.1911	2.4117	2.6533	2.9178	3.2071	3.5236	3.8697	4.2479	4.6610	5.1120	5.6044

Appendix B

Example: Public Notice

This notice is intended to advise all sewer users paying fees for services provided at the Hillsboro Wastewater Treatment Facility (Facility), that the City has entered into an operations and maintenance service agreement with XYZ Inc. The agreement provides for a SXX million contract advance payment from XYZ Inc. to the City. The City will place SXX million in the City's General Fund. The remaining SXX million will be placed in the City's dedicated Sewer Fund to help stabilize future user fees, as well as meet obligations to maintain and improve the Facility. A portion of the annual service fee payable by the City to XYZ Inc. out of sewer user fees, will be allocated to reimburse XYZ Inc. for the contract advance payment.

Appendix C

Federal Grant Repayment
For the Sale/Lease of Wastewater Treatment Facilities

EPA Construction Grants	Award Date	Placed in Service	
	6/04/73	7/19/76	$5,971,074
	10/29/74	1/31/76	$8,863,868
	9/21/83	12/28/84	$1,952,370
	Total		$16,787,312

Local Costs for 1973 Project	$1,238,220
Local Costs for 1974	$1,134,270
Local Costs for 1983 Projects	$220,450
2,692940 - 2,472,490 = 220,450	
TOTAL Local Costs	$2,692,940

Type of Privatization	Sale	Lease
Accounting Value of Wastewater Facilities	$2,500,000	NA
Concession Fee (Lease)	$0	$2,000,000
Transfer Price Wastewater Facilities (Present Value of Sale Fee)	$5,000,000	$0
Less Total Local Costs	$2,692,940	$2,692,940
Less State Cost Repayment	$0	$0
Residual Value of Sale/Lease Fee (Concession/Sale Fee - Local & State Costs)	$2,307,060	$692,940
Depreciated Value of EPA Grants	$288,170	$288,170
Amount City Owes Federal Treasury	$288,170	$0

Depreciation Schedule for $1,952,370 Grant
Placed in Service 12/28/84 (MARCS) and a 1996 Transaction Date

1984	.05	97,618.50	1,854,751.50
1985	.095	185,475.15	1,669,276.35
1986	.0855	166,927.63	1,502,348.72
1987	.077	150,332.49	1,352,016.23
1988	.0693	135,299.24	1,216,716.99
1989	.0623	121,632.65	1,095,084.34
1990	.0590	115,189.83	979,894.51
1991	.0590	115,189.83	864,704.60
1992	.0591	115,385.06	749,319.62
1993	.0590	115,189.83	634,129.79
1994	.0591	115,385.06	518,744.73
1995	.0590	115,189.83	403,554.90
1996	.0591	115,385.06	288,169.84

Note: EPA grants placed in service during 1976 are fully depreciated using MARCS, 15 year, half-year convention schedule.

Internal Revenue Service Table A-1 Depreciation for 15- year Property
Half-Year Convention

Depreciation Rate for Recovery Period	
Year	15-year
1	5.00%
2	9.5
3	8.55
4	7.7
5	6.93
6	6.23
7	5.9
8	5.9
9	5.91
10	5.9
11	5.91
12	5.9
13	5.91
14	5.9
15	5.91
16	2.95

INDEX

CHAPTER 291
WATER RATES

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CHAPTER 291
UTILITY REGULATION
SUBCHAPTER A : GENERAL PROVISIONS

§§291.1 - 291.9, 291.11, 291.12, 291.14 - 291.15
Effective February 4, 1999

§291.1. Purpose and Scope of this Chapter.

This chapter is intended to establish a comprehensive regulatory system under Texas Water Code Chapter 13 to assure rates, operations, and services which are just and reasonable to the consumer and the retail public utilities, and to establish the rights and responsibilities of both the retail public utility and consumer. This chapter shall be given a fair and impartial construction to obtain these objectives and shall be applied uniformly regardless of race, color, religion, sex, or marital status. This chapter shall also govern the procedure for the institution, conduct and determination of all water and sewer rate causes and proceedings before the commission. These sections shall not be construed so as to enlarge, diminish, modify, or alter the jurisdiction, powers, or authority of the commission or the substantive rights of any person.

Adopted January 13, 1999 Effective February 4, 1999

§291.2. Severability Clause.

The adoption of this chapter will in no way preclude the commission from altering or amending it in whole or in part, or from requiring any other or additional service, equipment, facility, or standard, either upon complaint or upon its own motion or upon application of any utility. Furthermore, this chapter will not relieve in any way a retail public utility or customer from any of its duties under the laws of this state or the United States. If any provision of this chapter is held invalid, such invalidity shall not affect other provisions or applications of this chapter which can be given effect without the invalid provision or application, and to this end, the provisions of this chapter are declared to be severable. The commission may make exceptions to this chapter for good cause.

§291.3. Definitions of Terms.

The following words and terms, when used in this chapter, shall have the following meanings, unless the context clearly indicates otherwise.

(1) **Acquisition adjustment** -

(A) The difference between:

(i) the lesser of the purchase price paid by an acquiring utility or the current depreciated replacement cost of the plant, property, and equipment comparable in size, quantity, and quality to that being acquired, excluding customer contributed property; and

(ii) the original cost of the plant, property, and equipment being acquired, excluding customer contributed property, less accumulated depreciation.

(B) A positive acquisition adjustment results when subparagraph (A)(i) of this paragraph is greater than subparagraph (A)(ii) of this paragraph.

(C) A negative acquisition adjustment results when subparagraph (A)(ii) of this paragraph is greater than subparagraph (A)(i) of this paragraph.

(2) **Affected county** - A county:

(A) that has a per capita income that averaged 25 % below the state average for the most recent three consecutive years for which statistics are available and an unemployment rate that averaged 25 % above the state average for the most recent three consecutive years for which statistics are available; and

(B) any part of which is within 50 miles of an international border.

(3) **Affected person** - Any retail public utility affected by any action of the regulatory authority; any person or corporation, whose utility service or rates are affected by any proceeding before the regulatory authority; or any person or corporation that is a competitor of a retail public utility with respect to any service performed by the retail public utility or that desires to enter into competition.

(4) **Affiliated interest or affiliate** -

(A) any person or corporation owning or holding directly or indirectly 5.0% or more of the voting securities of a utility;

(B) any person or corporation in any chain of successive ownership of 5.0% or more of the voting securities of a utility;

(C) any corporation 5.0% or more of the voting securities of which is owned or controlled directly or indirectly by a utility;

(D) any corporation 5.0% or more of the voting securities of which is owned or controlled directly or indirectly by any person or corporation that owns or controls directly or indirectly 5.0% or more of the voting securities of any utility or by any person or corporation in any chain of successive ownership of 5.0% of those utility securities;

(E) any person who is an officer or director of a utility or of any corporation in any chain of successive ownership of 5.0% or more of voting securities of a public utility;

(F) any person or corporation that the commission, after notice and hearing, determines actually exercises any substantial influence or control over the policies and actions of a utility or over which a utility exercises such control or that is under common control with a utility, such control being the possession directly or indirectly of the power to direct or cause the direction of the management and policies of another, whether that power is established through ownership or voting of securities or by any other direct or indirect means; or

(G) any person or corporation that the commission, after notice and hearing, determines is exercising substantial influence over the policies and action of the utility in conjunction with one or more persons or corporations with which they are related by ownership or blood relationship, or by action in concert, that together they are affiliated within the meaning of this section, even though no one of them alone is so affiliated.

(5) **Agency** - Any state board, commission, department, or officer having statewide jurisdiction (other than an agency wholly financed by federal funds, the legislature, the courts, the Workers' Compensation Commission , and institutions for higher education) which makes rules or determines contested cases.

(6) **Allocations** - For all retail public utilities, the division of plant, revenues, expenses, taxes, and reserves between municipalities, or between municipalities and unincorporated areas, where such items are used for providing water or sewer utility service in a municipality or for a municipality and unincorporated areas.

(7) **Base rate** - The portion of a consumer's utility bill which is paid for the opportunity of receiving utility service, excluding stand-by fees, which does not vary due to changes in utility service consumption patterns.

(8) **Billing period** - The usage period between meter reading dates for which a bill is issued or in nonmetered situations, the period between bill issuance dates.

(9) **Class of service or customer class** - A description of utility service provided to a customer which denotes such characteristics as nature of use or type of rate.

(10) **Code** - The Texas Water Code.

(11) **Corporation** - Any corporation, joint-stock company, or association, domestic or foreign, and its lessees, assignees, trustees, receivers, or other successors in interest, having any of the powers and privileges of corporations not possessed by individuals or partnerships, but shall not include municipal corporations unless expressly provided otherwise in the Texas Water Code.

(12) **Customer** - Any person, firm, partnership, corporation, municipality, cooperative, organization, or governmental agency provided with services by any retail public utility.

(13) **Customer service line or pipe** - The pipe connecting the water meter to the customer's point of consumption or the pipe which conveys sewage from the customer's premises to the service provider's service line.

(14) **Facilities** - All the plant and equipment of a retail public utility, including all tangible and intangible real and personal property without limitation, and any and all means and instrumentalities in any manner owned, operated, leased, licensed, used, controlled, furnished, or supplied for, by, or in connection with the business of any retail public utility.

(15) **Incident of tenancy** - Water or sewer service, provided to tenants of rental property, for which no separate or additional service fee is charged other than the rental payment.

(16) **License** - The whole or part of any commission permit, certificate, registration, or similar form of permission required by law.

(17) **Licensing** - The commission process respecting the granting, denial, renewal, revocation, suspension, annulment, withdrawal, or amendment of a license, certificates of convenience and necessity, or any other authorization granted by the commission pursuant to its authority under the Texas Water Code.

(18) **Main** - A pipe operated by a utility service provider which is used for transmission or distribution of water or to collect or transport sewage.

(19) **Mandatory water use reduction** - The temporary reduction in the use of water imposed by court order, government agency, or other authority with appropriate jurisdiction. This does not include water conservation measures which seek to reduce the loss or waste of water, improve the efficiency in the use of water, or increase the recycling or reuse of water so that a water supply is made available for future or alternative uses.

(20) **Member** - A person who holds a membership in a water supply or sewer service corporation and who is a record owner of a fee simple title to property in an area served by a water supply or sewer service corporation, or a person who is granted a membership and who either currently receives or will be eligible to receive water or sewer utility service from the corporation. In determining member control of a water supply or sewer service corporation, a person is entitled to only one vote regardless of the number of memberships the person owns.

(21) **Membership fee** - A fee assessed each water supply or sewer service corporation service applicant which entitles the applicant to one connection to the water or sewer main of the corporation. The amount of the fee is generally defined in the corporation's bylaws and payment of the fee provides for issuance of one membership certificate in the name of the applicant, for which certain rights, privileges, and obligations are allowed pursuant to said bylaws. For purposes of Texas Water Code, §13.043(g), a membership fee is a fee not exceeding approximately 12 times the monthly base rate for water or sewer service or an amount that does not include any materials, labor, or services required for or provided by the installation of a metering device for the delivery of service, capital recovery, extension fees, buy-in fees, impact fees, or contributions in aid of construction.

(22) **Municipality** - A city, existing, created, or organized under the general, home rule, or special laws of this state.

(23) **Municipally-owned utility** - Any retail public utility owned, operated, and controlled by a municipality or by a nonprofit corporation whose directors are appointed by one or more municipalities.

(24) **Person** - Any natural person, partnership, cooperative corporation, association, or public or private organization of any character other than an agency or municipality.

(25) **Physician** - Any public health official, including, but not limited to, medical doctors, doctors of osteopathy, nurse practitioners, registered nurses, and any other similar public health official.

(26) **Point of use or point of ultimate use** - The primary location where water is used or sewage is generated; for example, a residence or commercial or industrial facility.

(27) **Potable water** - Water that is used for or intended to be used for human consumption or household use.

(28) **Premises** - A tract of land or real estate including buildings and other appurtenances thereon.

(29) **Public utility** - The definition of public utility is that definition given to water and sewer utility in this subchapter.

(30) **Purchased sewage treatment** - Sewage treatment purchased from a source outside the retail public utility's system to meet system requirements.

(31) **Purchased water** - Raw or treated water purchased from a source outside the retail public utility's system to meet system demand requirements.

(32) **Rate** - Includes every compensation, tariff, charge, fare, toll, rental, and classification or any of them demanded, observed, charged, or collected, whether directly or indirectly, by any retail public utility, or water or sewer service supplier, for any service, product, or commodity described in the Texas Water Code, §13.002(23), and any rules, regulations, practices, or contracts affecting any such compensation, tariff, charge, fare, toll, rental, or classification.

(33) **Ratepayer** - Each person receiving a separate bill shall be considered as a ratepayer, but no person shall be considered as being more than one ratepayer notwithstanding the number of bills received. A complaint or a petition for review of a rate change shall be considered properly signed if signed by any person, or spouse of any such person, in whose name utility service is carried.

(34) **Reconnect fee** - A fee charged for restoration of service where service has previously been provided. It may be charged to restore service after disconnection for reasons listed in §291.88 of this title (relating to Discontinuance of Service) or to restore service after disconnection at the customer's request.

(35) **Retail public utility** - Any person, corporation, public utility, water supply or sewer service corporation, municipality, political subdivision or agency operating, maintaining, or controlling in this state facilities for providing potable water service or sewer service, or both, for compensation.

(36) **Retail water or sewer utility service** - Potable water service or sewer service, or both, provided by a retail public utility to the ultimate consumer for compensation.

(37) **Safe drinking water revolving fund** - The fund established by the Texas Water Development Board to provide financial assistance in accordance with the Federal program established pursuant to the provisions of the Safe Drinking Water Act and as defined in Water Code, §15.602.

(38) **Service** - Any act performed, anything furnished or supplied, and any facilities used by a retail public utility in the performance of its duties under the Texas Water Code to its patrons, employees, other retail public utilities, and the public, as well as the interchange of facilities between two or more retail public utilities.

(39) **Service line or pipe** - A pipe connecting the utility service provider's main and the water meter or for sewage, connecting the main and the point at which the customer's service line is connected, generally at the customer's property line.

(40) **Sewage** - Ground garbage, human and animal, and all other waterborne type waste normally disposed of through the sanitary drainage system.

(41) **Standby fee** - A charge imposed on unimproved property for the availability of water or sewer service when service is not being provided.

(42) **Tap fee** - A tap fee is the charge to new customers for initiation of service where no service previously existed. A tap fee for water service may include the cost of physically tapping the water main and installing meters, meter boxes, fittings, and other materials and labor. A tap fee for sewer service may include the cost of physically tapping the main and installing the utility's service line to the customer's property line, fittings, and other material and labor. Water or sewer taps may include setting up the new customer's account, and allowances for equipment and tools used. Extraordinary expenses such as road bores and street crossings and grinder pumps may be added if noted on the utility's approved tariff. Other charges, such as extension fees, buy-in fees, impact fees, or contributions in aid of construction (CIAC) are not to be included in a tap fee.

(43) **Tariff** - The schedule of a retail public utility containing all rates, tolls, and charges stated separately by type or kind of service and the customer class, and the rules and regulations of the retail public utility stated separately by type or kind of service and the customer class.

(44) **Temporary water rate provision** - A provision in a utility's tariff that allows a utility to adjust its rates in response to mandatory water use reduction.

(45) **Test year** - The most recent 12-month period for which representative operating data for a retail public utility are available. A utility rate filing must be based on a test year that ended less than 12 months before the date on which the utility made the rate filing.

(46) **Utility** - The definition of utility is that definition given to water and sewer utility in this subchapter.

(47) **Water and sewer utility** - Any person, corporation, cooperative corporation, affected county, or any combination of those persons or entities, other than a municipal corporation, water supply or sewer service corporation, or a political subdivision of the state, except an affected

county, or their lessees, trustees, and receivers, owning or operating for compensation in this state equipment or facilities for the production, transmission, storage, distribution, sale, or provision of potable water to the public or for the resale of potable water to the public for any use or for the collection, transportation, treatment, or disposal of sewage or other operation of a sewage disposal service for the public, other than equipment or facilities owned and operated for either purpose by a municipality or other political subdivision of this state or a water supply or sewer service corporation, but does not include any person or corporation not otherwise a public utility that furnishes the services or commodity only to itself or its employees or tenants as an incident of that employee service or tenancy when that service or commodity is not resold to or used by others.

(48) **Water rationing** - Restrictions implemented to reduce the amount of water which may be consumed by customers of the system due to emergency conditions or drought.

(49) **Water supply or sewer service corporation** - Any nonprofit, corporation organized and operating under the Texas Water Code, Chapter 67, that provides potable water or sewer service for compensation and that has adopted and is operating in accordance with by-laws or articles of incorporation which ensure that it is member-owned and member controlled. The term does not include a corporation that provides retail water or sewer service to a person who is not a member, except that the corporation may provide retail water or sewer service to a person who is not a member if the person only builds on or develops property to sell to another and the service is provided on an interim basis before the property is sold. For purposes of this chapter, to qualify as member-owned, member-controlled a water supply or sewer service corporation must also meet the following conditions.

(A) All members of the corporation meet the definition of "member" under this section, and all members are eligible to vote in those matters specified in the articles and bylaws of the corporation. Payment of a membership fee in addition to other conditions of service may be required provided that all members have paid or are required to pay the membership fee effective at the time service is requested.

(B) Each member is entitled to only one vote regardless of the number of memberships owned by that member.

(C) A majority of the directors and officers of the corporation must be members of the corporation.

(D) The corporation's by-laws include language indicating that the factors specified in subparagraphs (A)-(C) of this paragraph are in effect.

(50) **Wholesale water or sewer service** - Potable water or sewer service, or both, provided to a person, political subdivision, or municipality who is not the ultimate consumer of the service.

Adopted January 13, 1999 Effective February 4, 1999

§291.4. Cooperative Corporation Rebates.

Nothing in this chapter prevents a cooperative corporation from returning to its members the whole or any part of the net earnings resulting from its operations in proportion to their purchases from or through the corporation.

§291.5. Submission of Documents.

All documents to be considered by the executive director under this chapter shall be submitted to the Utility Rates and Services Section, Water Utilities Division, Mail Code 153, Texas Natural Resource Conservation Commission, P.O. Box 13087, Austin, Texas 78711-3087. Unless otherwise provided in this chapter, an original and four copies shall be submitted.

Adopted December 6, 1995 Effective January 10, 1996

§291.6. Signatories to Applications.

(a) All applications shall be signed by a corporate officer, partner, proprietor, their attorney-at-law, or the principal executive officer or ranking elected official of a governmental entity, or other person having representative capacity to transact business on behalf of the retail public utility. If the signer is not a corporate officer, partner, proprietor, their attorney-at-law, or principal executive officer or ranking elected official of a governmental entity, the application must contain written proof that such signature is duly authorized.

(b) Applications shall contain a certification stating that the person signing has personally examined and is familiar with the information submitted in the application and that the information is true, accurate, and complete.

Adopted December 6, 1995 Effective January 10, 1996

§291.7. Filing Fees.

Each application, petition, or complaint which is intended to institute a proceeding before the commission shall be accompanied by the appropriate filing fee as required by the Texas Water Code, §5.235 and §13.4521, and costs of mailing notice, if any.

(1) A rate change application filed with the commission under the Texas Water Code, §13.187, must be accompanied by the appropriate filing fee as follows:

(A) fewer than 100 connections-$50;

(B) 100-200 connections-$100;

(C) 201-500 connections-$200; or

(D) more than 500 connections-$500.

(2) An application for a certificate of public convenience and necessity under Texas Water Code, §13.244 must be accompanied by an application fee of $100.

(3) An application for sale, assignment, or lease of a certificate of convenience and necessity under the Texas Water Code, §13.251, or notice of intent to sell, acquire, lease, or rent or merge or consolidate a water or sewer system under the Texas Water Code, §13.301, must be accompanied by the appropriate fee as follows (one fee will suffice for both applications):

(A) fewer than 100 connections-$50;

(B) 100-200 connections-$100;

(C) 201-500 connections-$200; or

(D) more than 500 connections-$500.

(4) The fees required in paragraphs (1), (2) and (3) of this section are in lieu of the $100 filing fee required by the Texas Water Code, §5.235, which should accompany all other applications and petitions. A filing fee is not required for appeals or complaints filed under the Texas Water Code, §13.043(b) or §13.187(b).

Adopted December 6, 1995 Effective January 10, 1996

§291.8. Administrative Completeness.

(a) Notice of rate/tariff change, report of sale, acquisition, lease or rental or merger or consolidation, and sale, assignment of, or lease of a certificate, and applications for certificates of convenience and necessity shall be reviewed by the staff for administrative completeness within ten working days of receipt of the application. A notice or an application for rate/tariff change, report of sale, acquisition, lease or rental or merger or consolidation, and applications for certificates of convenience and necessity shall not be deemed to have been filed until received by the commission, accompanied by the filing fee, if any, required by statute or commission rules, and a determination of administrative completeness is made. Upon determination that the notice or application is administratively complete, the executive director will notify the applicant by mail of that determination. If the executive director determines that material deficiencies exist in any pleadings, statement of intent, applications, or other requests for commission action addressed by this chapter, the notice or application may be rejected and the effective date suspended until the deficiencies are corrected.

(b) In cases involving proposed rate changes, the effective date of the proposed change must be at least 30 days after:

(1) the date that an application and notice are received by the commission, provided the application and notice are determined to be administratively complete as filed;

(2) the date the application and notice are determined to be administratively complete for previously rejected applications and notices; or

(3) the date notice is delivered to each ratepayer, whichever is later.

(c) In cases involving a proposed sale, acquisition, lease, or rental or merger or consolidation of any water or sewer system required by law to possess a certificate of convenience and necessity, the proposed effective date of the transaction must be at least 120 days after the date that an application is received by the commission and public notice is provided, unless notice is waived for good cause shown.

Adopted December 6, 1995 Effective January 10, 1996

§291.9. Agreements To Be in Writing.

No stipulation or agreement between the parties, their attorneys, or representatives, with regard to any matter involved in any proceeding before the commission shall be enforced, unless it shall have been reduced to writing and signed by the parties or representatives authorized by these sections to appear for them, or unless it shall have been dictated into the record by them during the course of a hearing, or incorporated into an order bearing their written approval. This section does not limit a party's ability to waive, modify, or stipulate any right or privilege afforded by this chapter, unless precluded by law.

§291.11. Informal Proceedings.

(a) Any hearing involving a retail public water or sewer utility as defined in §291.3 of this title (relating to Definitions of Terms) may be conducted as an informal proceeding when, in the judgment of the presiding officer, the conduct of a hearing under informal procedures will:

(1) result in savings of time or costs to all parties;

(2) lead to a negotiated or agreed settlement of facts or issues in controversy; and

(3) not prejudice the rights of any party.

(b) If during an informal proceeding, all parties reach a negotiated or agreed settlement which in the judgment of the presiding officer settles all facts or issues in controversy, the proceeding shall not be a contested case under the Texas Administrative Procedure and Texas Register Act, Texas Civil Statutes, Article 6252-13a, and no proposal for decision nor detailed findings of fact and conclusions of law are required.

(c) If the parties do not reach a negotiated or agreed settlement of all facts and issues in controversy, the presiding officer may adjourn the informal proceeding and reconvene it as a contested case hearing under standard hearing procedures as otherwise provided for in this chapter.

§291.12. Burden of Proof.

In any proceeding involving any proposed change of rates, the burden of proof shall be on the provider of water and sewer services to show that the proposed change, if proposed by the retail public utility, or that the existing rate, if it is proposed to reduce the rate, is just and reasonable. In any other matters or proceedings, the burden of proof is on the moving party.

§291.14. Emergency Orders.

(a) The commission may issue emergency orders, with or without a hearing:

(1) to compel a water or sewer service provider that has obtained or is required to obtain a certificate of public convenience and necessity to provide continuous and adequate water service, sewer service, or both, if the discontinuance of the service is imminent or has occurred because of the service provider's actions or failure to act. These orders may contain provisions requiring specific utility actions to ensure continuous and adequate utility service and compliance with regulatory guidelines;

(2) to compel a retail public utility to provide an emergency interconnection with a neighboring retail public utility for the provision of temporary water or sewer service, or both, for not more than 90 days if service discontinuance or serious impairment in service is imminent or has occurred; and/or

(3) to establish reasonable compensation for the temporary service required under subsection (a)(2) of this section and may allow the retail public utility receiving the service to make a temporary adjustment to its rate structure to ensure proper payment.

(b) The commission or executive director may also issue orders under Chapter 35 of this title (relating to Emergency and Temporary Orders and Permits; Temporary Suspension or Amendment of Permit Conditions):

(1) to appoint a temporary manager under Texas Water Code, §5.507 and §13.4132; and/or

(2) to approve an emergency rate increase under Texas Water Code, §5.508 and §13.4133.

(c) If an order is issued under this section without a hearing, the order shall fix a time, as soon after the emergency order is issued as is practicable, and place for a hearing to be held before the commission.

Adopted November 18, 1998 Effective December 10, 1998

§291.15. Notice of Wholesale Water Supply Contract.

(a) Notification. A district or authority created under Texas Constitution, §52, Article III, or §59, Article XVI, a retail public utility, a wholesale water service, or other person providing a retail public utility with a wholesale water supply shall provide the commission with a certified copy of any wholesale water supply contract with a retail public utility within 30 days after the date of the execution of the contract.

(b) Information. The submission must include the amount of water being supplied, term of the contract, consideration being given for the water, purpose of use, location of use, source of supply, point of delivery, limitations on the reuse of water, and any other condition or agreement relating to the contract. The certified copy of the contract should be submitted to the Water Utilities Division of the commission.

Adopted January 13, 1999 Effective February 4, 1999

SUBCHAPTER B : RATES, RATE MAKING AND RATE/TARIFF CHANGES

§§291.21 - 291.32, 291.34
Effective February 4, 1999

§291.21. Form and Filing of Tariffs.

(a) Approved tariff. No utility shall directly or indirectly demand, charge, or collect any rate or charge, or impose any classifications, practices, rules, or regulations different from those prescribed in its approved tariff filed with the commission or with the municipality exercising original jurisdiction over the utility, except as noted in this subsection. A utility may charge the rates proposed under the Texas Water Code, §13.187(a) (relating to Statement of Intent to Change Rates) after the proposed effective date, unless the rates are suspended or the commission or a judge sets interim rates. The regulatory assessment required in Texas Water Code §5.235(n) does not have to be listed on the utility's approved tariff to be charged and collected but shall be included in the tariff at the earliest opportunity. A person who possesses facilities used to provide water utility service or a utility that holds a certificate of public convenience and necessity to provide water service which enters into an agreement pursuant to Texas Water Code §13.250(b)(2), may collect charges for wastewater services on behalf of another retail public utility on the same bill with its water charges and shall at the earliest opportunity include a notation on its tariff that it has entered into such an agreement.

(b) Requirements as to size, form, identification, minor changes and filing of tariffs.

(1) Tariffs filed with applications for certificates of convenience and necessity.

(A) Every public utility shall file with the commission the number of copies of its tariff required in the application form containing schedules of all its rates, tolls, charges, rules, and regulations pertaining to all of its utility service when it applies for a certificate of convenience and necessity to operate as a public utility. The tariff shall be on the form the commission prescribes or another form acceptable to the commission.

(B) Every water supply or sewer service corporation shall file with the commission the number of copies of its tariff required in the application form containing schedules of all its rates, tolls, charges, rules, and regulations pertaining to all of its utility service when it applies for a certificate of convenience and necessity to operate as a retail public utility.

(2) Minor Tariff Changes. Except for an affected county, a public utility's approved tariff may not be changed or amended without commission approval. An affected county can change rates for water or wastewater service without commission approval but must file a copy of the revised tariff with the commission within 30 days after the effective date of the rate change.

(A) The executive director may approve the following minor changes to tariffs:
(i) service rules and policies;

(ii) changes in fees for customer deposits, meter tests, return check charges, and late charges, provided they do not exceed the maximum allowed by the applicable sections;

(iii) implementation of a purchased water or sewage treatment provision, a temporary water rate provision in response to mandatory reductions in water use imposed by a court, government agency, or other authority, or water use fee provision previously approved by the commission;

(iv) surcharges over a time period determined by the executive director to reflect the change in the actual cost to the utility for sampling costs, commission inspection fees, or at the discretion of the executive director, other governmental requirements beyond the utility's control;

(v) addition of the regulatory assessment as a separate item or to be included in the currently authorized rate;

(vi) addition of a provision allowing a utility to collect wastewater charges pursuant to an agreement under the Texas Water Code, §13.250(b)(2); or

(vii) rate adjustments to implement authorized phased or multi-step rates or downward rate adjustments to reconcile rates with actual costs.

(B) The addition of an extension policy to a tariff or a change to an existing extension policy does not qualify as a minor tariff change because it must be approved or amended in a rate change application.

(3) Tariff Revisions and Tariffs Filed With Rate Changes. The utility shall file three copies of each revision or in the case of a rate change, the number required in the application form. Each revision shall be accompanied by a cover page which contains a list of pages being revised, a statement describing each change, its effect if it is a change in an existing rate, and a statement as to impact on rates of the change by customer class, if any. If a proposed tariff revision constitutes an increase in existing rates of a particular customer class or classes, then the commission may require that notice be given.

(4) Each rate schedule must clearly state the territory, subdivision, city, or county wherein said schedule is applicable.

(5) Tariff sheets are to be numbered consecutively. Each sheet shall show an effective date, a revision number, section number, sheet number, name of the utility, the name of the tariff, and title of the section in a consistent manner. Sheets issued under new numbers are to be designated as original sheets. Sheets being revised should show the number of the revision, and the sheet numbers shall be the same.

(c) Composition of tariffs. A utility's tariff, including those utilities operating within the corporate limits of a municipality, shall contain sections setting forth:

(1) a table of contents;

(2) a list of the cities and counties, and subdivisions or systems, in which service is provided;

(3) the certificate of convenience and necessity number under which service is provided;

(4) the rate schedules;

(5) the service rules and regulations, including forms of the service agreements, if any;

(6) the extension policy;

(7) an approved water rationing plan; and

(8) the form of payment to be accepted for utility services.

(d) Tariff filings in response to commission orders. Tariff filings made in response to an order issued by the commission shall include a transmittal letter stating that the tariffs attached are in compliance with the order, giving the application number, date of the order, a list of tariff sheets filed, and any other necessary information. Any service rules proposed in addition to those listed on the commission's model tariff or any modifications of a rule in the model tariff must be clearly noted. All tariff sheets shall comply with all other sections in this chapter and shall include only changes ordered. The effective date and/or wording of the tariffs shall comply with the provisions of the order.

(e) Availability of tariffs. Each utility shall make available to the public at each of its business offices and designated sales offices within Texas all of its tariffs currently on file with the commission or regulatory authority, and its employees shall lend assistance to persons requesting information and afford these persons an opportunity to examine any of such tariffs upon request. The utility also shall provide copies of any portion of the tariffs at a reasonable cost to reproduce such tariff for a requesting party.

(f) Rejection. Any tariff filed with the commission and found not to be in compliance with these sections shall be so marked and returned to the utility with a brief explanation of the reasons for rejection.

(g) Change by other regulatory authorities. Tariffs must be filed to reflect changes in rates or regulations set by other regulatory authorities and shall include a copy of the order or ordinance authorizing the change. Each utility operating within the corporate limits of a municipality exercising original jurisdiction must have a copy of its current tariff which has been authorized by the municipality on file with the commission.

(h) Purchased water or sewage treatment provision.

(1) A utility which purchases water or sewage treatment or pays water use fees to an underground water conservation district may include a provision in its tariff to pass through to its

customers changes in such costs. The provision shall specify how it is calculated and affects customer billings.

(2) This provision must be approved by the commission in a rate proceeding. A proposed change in the method of calculation of the provision must be approved in a rate proceeding.

(3) Once the provision is approved, any revision of a utility's billings to its customers to allow for the recovery of additional costs under the provision may be made only upon issuing notice as required by paragraph (4) of this subsection. The executive director's review of a proposed revision is an informal proceeding. Only the commission, the executive director or the utility may request a hearing on the proposed revision. The recovery of additional costs is defined as an increase in water use fees or in costs of purchased water or sewage treatment.

(4) A utility that wishes to revise utility billings to its customers pursuant to an approved purchased water or sewer treatment or water use fee provision to allow for the recovery of additional costs shall take the following actions prior to the beginning of the billing period in which the revision takes effect:

(A) submit a written notice to the executive director; and

(B) mail notice to the utility's customers. Notice may be in the form of a billing insert and shall contain the effective date of the change, the present calculation of customer billings, the new calculation of customer billings, and the change in charges to the utility for purchased water or sewage treatment or water use fees. The notice shall include the following language: "This tariff change is being implemented in accordance with the utility's approved (purchased water)(purchased sewer)(water use fee) adjustment clause to recognize (increases)(decreases) in the (water use fee)(cost of purchased)(water)(sewage treatment). The cost of these charges to customers will not exceed the (increased) (decreased) cost of (the water use fee)(purchased)(water)(sewage treatment)."

(5) Notice to the commission shall include a copy of the notice sent to the customers, proof that the cost of purchased water or sewage treatment has changed by the stated amount, and the calculations and assumptions used to determine the new rates.

(6) Purchased water or sewage treatment provisions may not apply to contracts or transactions between affiliated interests.

(i) Effective date. The effective date of a tariff change is the date of approval by the executive director unless otherwise stated in the letter transmitting the approval or the date of approval by the commission, unless otherwise specified in a commission order or rule. The effective date of a proposed rate increase under §13.187 of the code is the proposed date on the notice to customers and the commission, unless suspended and must comply with the requirements of §291.8(b) of this title (relating to Administrative Completeness).

(j) Tariffs filed by water supply or sewer service corporations. Every water supply or sewer service corporation shall file, for informational purposes only, one copy of its tariff showing all rates that

are subject to the appellate jurisdiction of the commission and that are in force for any utility service, product, or commodity offered. The tariff shall include all rules and regulations relating to or affecting the rates, utility service or extension of service or product, or commodity furnished and shall specify the CCN number and in which counties or cities it is effective.

(k) Surcharge.

(1) A surcharge is an authorized rate to collect revenues over and above the usual cost of service.

(2) A surcharge to recover the actual increase in costs to the utility for sampling, inspection fees or other governmental requirements beyond the control of the utility may be collected over a specifically authorized time period without being listed on the approved tariff if specifically authorized for the utility in writing by the executive director or the municipality exercising original jurisdiction over the utility.

(3) A utility shall use the revenues collected pursuant to a surcharge only for the purposes noted and handle the funds in the manner specified according to the notice or application submitted by the utility to the commission, unless otherwise directed by the executive director. The utility may redirect or use the revenues for other purposes only after first obtaining the approval of the executive director.

(l) Temporary water rate.

(1) A utility's tariff may include a temporary water rate provision which will allow the utility to increase its retail customer rates during periods when a court, government agency, or other authority orders mandatory water use reduction measures which affect the utility customers' use of water service and the utility's water revenues. Implementation of the temporary water rate provision shall allow the utility to recover from customers revenues the utility would otherwise have lost due to mandatory water use reductions in accordance with the temporary water rate provision approved by the commission. If a utility obtains a portion of its water supply from another unrestricted water source or water supplier during the time the temporary water rate is in effect, the rate resulting from implementation of the temporary water rate provision must be adjusted to account for the supplemental water supply and to limit over-recovery of revenues from customers. A temporary water rate provision cannot be implemented by a utility if there exists an available, unrestricted, alternative water supply which the utility can use to immediately replace, without additional cost, the water made unavailable because of the action requiring a mandatory reduction of use of the affected water supply.

(2) The temporary water rate provision must be approved by the commission in a rate proceeding before it may be included in the utility's approved tariff or implemented as provided in this subsection. A proposed change in the temporary water rate must be approved in a rate proceeding. A utility that has filed a rate change within the last 12 months may file a request for the limited purpose of obtaining a temporary water rate provision.

(3) A utility may request a temporary water rate provision using the formula in this paragraph to recover 50% or less of the revenues that would otherwise have been lost due to mandatory

water use reductions through a limited rate proceeding. The formula for a temporary water rate provision under this paragraph is:

TGC = temporary gallonage charge
cgc = current gallonage charge
r = water use reduction expressed as a decimal fraction (the pumping restriction)
prr = percentage of revenues to be recovered expressed as a decimal fraction (i.e. 50% = 0.5)
TGC = cgc +[(prr)(cgc)(r)/(1.0-r)]

(A) The utility must file a temporary water rate application prescribed by the executive director and provide customer notice as required in the application, but is not required to provide complete financial data to support its existing rates. Notice must include a statement of when the temporary water rate provision would be implemented, the classes of customers affected, the rates affected, information on how to protest the rate change, the required number of protests to ensure a hearing, the address of the commission and the time frame for protests and any other information which is required by the executive director in the temporary water rate application. The utility's existing rates will not be subject to review in the proceeding and the utility will only be required to support the need for the temporary rate. A request for a temporary water rate provision under this paragraph is not considered a statement of intent to increase rates subject to the 12 month limitation in §291.23 of this title, (relating to Time Between Filings.)

(B) The utility must be able to prove that the projected revenues that will be generated by the temporary water rate provision are required by the utility to pay reasonable and necessary expenses that will be incurred by the utility during the time mandatory water use reductions are in effect.

(4) A utility may request a temporary water rate provision using the formula in paragraph (3) of this subsection or any other method acceptable to the commission to recover up to 100% of the revenues that would otherwise have been lost due to mandatory water use reductions.

(A) If the utility requests authorization to recover more than 50% of lost revenues it must submit financial data to support its existing rates as well as the temporary water rate provision even if no other rates are proposed to be changed. The utility must complete a rate application and provide notice in accordance with the requirements of §291.22 of this title (relating to Notice of Intent To Change Rates). The utility's existing rates will be subject to review in addition to the temporary water rate provision.

(B) The utility must be able to prove that the projected revenues that will be generated by the temporary water rate provision are required by the utility to pay reasonable and necessary expenses that will be incurred by the utility during the time mandatory water use reductions are in effect; that the rate of return granted by the commission in the utility's last rate case does not adequately

compensate the utility for the foreseeable risk that mandatory water use reductions will be ordered; and revenues generated by existing rates do not exceed reasonable cost of service.

(5) The utility may place the temporary water rate into effect only after:

(A) the temporary water provision has been approved by the commission and included in the utility's approved tariff in a prior rate proceeding;

(B) there is an action by a court, government agency, or other authority requiring mandatory water use reduction measures which affect the utility's customers' use of utility services; and,

(C) issuing notice as required by paragraph (7) of this subsection.

(6) The utility can readjust its rates using the temporary water rate provision as necessary to respond to modifications or changes to the original order requiring mandatory water use reductions by reissuing notice as required by paragraph (7) of this subsection. The executive director's review of the proposed implementation of an approved temporary water rate provision is an informal proceeding. Only the commission, the executive director, or the utility may request a hearing on the proposed implementation.

(7) A utility that wishes to place a temporary water rate into effect shall take the following actions prior to the beginning of the billing period in which the temporary water rate takes effect:

(A) submit a written notice, including a copy of the notice received from the court, government agency, or other authority requiring the reduction in water use, to the executive director; and

(B) mail notice to the utility's customers. Notice may be in the form of a billing insert and shall contain the effective date of the implementation and the new rate the customers will pay after the temporary water rate is implemented. The notice shall include the following language: "This rate change is being implemented in accordance with the temporary water rate provision approved by the Texas Natural Resource Conservation Commission to recognize the loss of revenues due to mandatory water use reduction ordered by (name of entity issuing order). The new rates will be effective on (date) and will remain in effect until the mandatory water use reductions are lifted or expired. The purpose of the rate is to ensure the financial integrity of the utility. The utility will recover through the rate (the percentage authorized by the temporary rate) % of the revenues the utility would otherwise have lost due to mandatory water use reduction by increasing the volume charge from ($ per 1,000 gallons to $ per 1,000 gallons)."

(8) A utility must stop charging a temporary water rate as soon as is practical after the order which required mandatory water use reduction is ended but in no case later than the end of the billing period which was in effect when the order was ended. The utility must notify its customers of the date that the temporary water rate ends and that its rates will return to the level authorized before the temporary water rate was implemented.

(9) If the commission initiates an inquiry into the appropriateness or the continuation of a temporary water rate, it may establish the effective date of its decision on or after the date the inquiry is filed.

Adopted January 13, 1999 Effective February 4, 1999

§291.22. Notice of Intent To Change Rates.

(a) In order to change rates which are subject to the commission's original jurisdiction, the applicant utility shall file with the commission an original completed application for rate change with the number of copies specified in the application form and shall give notice of the proposed rate change by mail or hand delivery to all affected utility customers at least 30 days prior to the proposed effective date. Notice shall be provided on the notice form included in the commission's rate application package and shall contain the following information:

(1) the utility name and address, current rates, the proposed rates, the effective date of the proposed rate change, the increase or decrease requested over test year revenues as adjusted for test year customer growth and annualization of test year rate increases, stated as a dollar amount, and the classes of utility customers affected. The effective date of the new rates must be the first day of a billing period, which should correspond to the day of the month when meters are typically read, and the new rates may not apply to service received before the effective date of the new rates;

(2) information on how to protest the rate change, the required number of protests to ensure a hearing, the address of the commission, and the time frame for protests; and

(3) any other information which is required by the executive director in the rate change application form.

(b) The governing body of a municipality or a political subdivision which provides retail water or sewer service to customers outside the boundaries of the municipality or political subdivision shall mail or hand deliver individual written notice to each affected ratepayer eligible to appeal who resides outside the boundaries within 30 days after the date of the final decision on a rate change. The commissioners court of an affected county which provides water or sewer service shall mail or hand deliver individual written notice to each affected ratepayer eligible to appeal within 30 days after the date of the final decision on a rate change. The notice must include at a minimum, the effective date of the new rates, the new rates, and the location where additional information on rates can be obtained.

(c) Notices may be mailed separately, or may accompany customer billings. Notice of a proposed rate change by a utility must be mailed or hand delivered to the customers at least 30 days prior to the effective date of the rate increase.

(d) The applicant utility shall mail or deliver a copy of the statement of intent to change rates to the appropriate officer of each affected municipality at least 30 days prior to the effective date of the proposed change. If the utility is requesting a rate change from the commission for customers residing outside the municipality, it must also provide a copy of the rate application filed with the commission to the

municipality. The commission may also require that notice be mailed or delivered to other affected persons or agencies.

(e) Proof of notice in the form of an affidavit stating that proper notice was mailed to customers and affected municipalities, and stating the dates of such mailing, shall be filed with the commission by the applicant utility as part of the rate change application. Notice to customers is sufficient if properly stamped and addressed to the customer and deposited in the United States Mail at least 30 days before the effective date.

(f) Standby Fees. A utility may request in a rate change application that standby fees be approved for property or lots for which the utility has previously entered into an agreement to serve or construction of water or sewer utility facilities has already begun or been completed if the developer owning the property at the time the rate change application is filed is given individual written notice by certified mail of the request and an opportunity to protest.

(g) Emergency rate increase in certain circumstances. After receiving a request, the commission or executive director may authorize an emergency rate increase under Texas Water Code, §5.508 and §13.4133 and Chapter 35 of this title (relating to Emergency and Temporary Orders and Permits; Temporary Suspension or Amendment of Permit Conditions) for a utility:

(1) for which a person has been appointed under Texas Water Code, §13.4132; or

(2) for which a receiver has been appointed under Texas Water Code, §13.412; and

(3) if the increase is necessary to ensure the provision of continuous and adequate services to the utility's customers.

(h) Line extension and construction charges. A utility shall request in a rate change application that its extension policy be approved or amended. The application shall show the proposed tariff, and other information requested by the executive director. The request may be made with a request to change one or more of the utility's other rates.

Adopted November 18, 1998 Effective December 10, 1998

§291.23. Time Between Filings.

Unless the commission requires it to deliver a corrected statement of intent, a utility or two or more utilities under common control or ownership may not file a notice of intent to increase rates more than once in a 12-month period except:

(1) to implement an approved purchase water pass through provision;

(2) to adjust the rates of a newly acquired utility system; or

(3) to comply with a commission order;

(4) to adjust rates authorized by §291.21(b)(2) of this title (relating to Form and Filing of Tariffs); or

(5) unless the regulatory authority determines that a financial hardship exists. A utility may be considered to be experiencing a financial hardship if revenues are insufficient to:

(A) cover reasonable and necessary operating expenses; or

(B) cover cash flow needs which may include regulatory sampling requirements, unusual repair and maintenance expenses, revenues to finance required capital improvements or, in certain instances, existing debt service requirements.

Adopted December 6, 1995 Effective January 10, 1996

§291.24. Jurisdiction Over Affiliated Interests.

The commission has jurisdiction over affiliated interests having transactions with utilities under the jurisdiction of the commission to the extent of access to all accounts and records of those affiliated interests relating to such transactions, including, but in no way limited to, accounts and records of joint or general expenses, any portion of which may be applicable to those transactions.

§291.25. Rate Change Applications, Testimony and Exhibits.

(a) A change in rates under the Texas Water Code, §13.187, is initiated by the submission of a rate filing package which consists of a rate/tariff change application form, or such other forms as prescribed by the commission, a statement of intent to change rates, and a copy of the notice the applicant has provided to customers and other affected parties.

(b) A utility filing for a change in rates under the Texas Water Code, §13.187, shall be prepared to go forward at a hearing on the data which has been submitted under subsection (a) of this section and sustain the burden of proof of establishing that its proposed changes are just and reasonable.

(c) An original of the completed rate filing package and the number of copies specified in the application form shall be submitted and filed with the commission. In the event that the proposed rate change becomes the subject of a hearing, the commission may require or allow, in addition to copies of the rate filing package, prefiled testimony and exhibits in support of the rate change request.

(d) The book data included in the schedules and information prepared and submitted as part of the filing shall be reported in a separate column or columns. All adjustments to book amounts shall also be shown in a separate column or columns so that books amounts, adjustments thereto, and adjusted amounts will be clearly disclosed, and any separation and allocation between interstate and intrastate operations shall be fully disclosed and clearly explained.

(e) All intervenors or protestants shall file the specified number of copies of their prepared testimony, if required, and exhibits within the time period specified by the judge assigned to the application.

(f) If required to prefile testimony, the executive director shall prefile, except for good cause, the prepared testimony and exhibits of its witnesses eight days prior to the final hearing but shall not otherwise be required to present its case prior to that time, except upon the granting of motions for discovery.

(g) The items in the rate filing package may be modified on a showing of good cause.

Adopted January 13, 1999 Effective Date February 4, 1999

§291.26. Suspension of Rates.

(a) Failure to properly complete the rate application or comply with the notice requirements and proof of notice requirements may result in suspension of the rate change by the commission or the executive director. The utility shall not renotify its customers of a new proposed effective date until the utility receives written notification from the executive director that all deficiencies have been corrected.

(b) The effective date of any rate change may be suspended by the commission or the executive director if the utility does not have a certificate of convenience and necessity or a completed application pending with the commission to obtain or to transfer a certificate of convenience and necessity.

Adopted December 6, 1995 Effective January 10, 1996

§291.27. Request for a Review of a Rate Change by Ratepayers Pursuant to the Texas Water Code, §13.187(b).

(a) Petitions for review of rate actions filed by ratepayers pursuant to the Texas Water Code, §13.187(b), shall contain the original petition for review with the required signatures. Each signature page of a petition should contain in legible form the following information for each signatory ratepayer:

(1) a clear and concise statement that the petition is an appeal of a specific rate action of the water or sewer service supplier in question as well as a concise description and date of that rate action; and

(2) the name, telephone number, and street or rural route address (post office box numbers are not sufficient) of each signatory ratepayer (the petition shall list the address of the location where service is received if it differs from the residential address of the signatory ratepayer).

(b) Ratepayers may initiate a review of a rate change application by filing individual complaints rather than joint petitions. Each complaint should contain the information required in subsection (a) of this section.

(c) In order for a review to be initiated under subsection (a) or (b) of this section, complaints must be received from a total of 1,000 or 10% of the affected ratepayers, whichever is less.

§291.28. Action on Notice of Rate Change Pursuant to the Texas Water Code, §13.187(b).

The commission may conduct a public hearing on any application.

(1) If, within 60 days after the effective date of the rate change, the commission receives a complaint from any affected municipality, or from the lesser of 1,000 or 10% of the ratepayers of the utility over whose rates the commission has original jurisdiction, or on its own motion, the commission shall set the matter for hearing. If after hearing, the commission finds the rates currently being charged or those proposed to be charged are unreasonable or in violation of law, the commission shall determine the rates to be charged by the utility and shall fix the rates by order.

(2) If a hearing is scheduled, the commission may require the utility to provide notice of the time and place of the hearing to its customers through a billing insert or separate mailing.

(3) If the commission does not receive sufficient customer complaints or if the executive director does not request a hearing within 120 days after the effective date, the utility's proposed tariff will be reviewed for compliance with the Code and the provisions of this chapter. If the proposed tariff complies with the Code and the provisions of this chapter, it shall be stamped approved by the executive director or his designated representative and a copy returned to the utility. The executive director may require the utility to notify its customers that sufficient complaints were not received to schedule a hearing and the proposed rates were approved without hearing.

(4) The executive director or commission may request additional information from any utility in the course of evaluating the rate/tariff change request, and the utility is required to provide that information within 20 days of receipt of the request, unless a different time is agreed to. If the utility fails to provide within a reasonable time after the application is filed the necessary documentation or other evidence that supports the costs and expenses that are shown in the application, the commission may disallow the nonsupported expenses.

(5) If the commission sets a rate different from that proposed by the utility in its notice of intent, the utility shall include in its first billing at the new rate a notice to the customers of the rate set by the commission including the following statement: "The Texas Natural Resource Conservation Commission, after public hearing, has established the following rates for utility service:".

(6) If the commission conducts a hearing, it may establish rates different from those currently being charged or proposed to be charged by the utility, but the total annual revenue increase resulting from the commission's rates shall not exceed the greater of the annual revenue increase provided in the customer notice or revenue increase that would have been produced by the proposed rates except for the inclusion of reasonable rate case expenses. The commission may reclassify a portion of a utility's proposed rates as a capital improvement surcharge if the revenues are to be used for capital improvements or are to service debt on capital items.

Adopted August 21, 1996 Effective September 20, 1996

§291.29. Interim Rates.

(a) The commission or judge may on a motion by the executive director or by the appellant under the Texas Water Code, §13.043 (a), (b), or (f), as amended, establish interim rates to remain in effect until a final decision is made.

(b) At any time after the filing of a statement of intent to change rates under the Texas Water Code, §13.187, as amended, the executive director may petition the commission or judge to set interim rates to remain in effect until further commission action or a final rate determination is made. After a hearing is convened, any party may petition the judge or commission to set interim rates.

(c) Interim rates may be established by the commission or judge in those cases under the commission's original or appellate jurisdiction where the proposed increase in rates could result in an unreasonable economic hardship on the utility's customers, unjust or unreasonable rates, or failure to set interim rates could result in an unreasonable economic hardship on the utility.

(d) In making a determination under subsection (c) of this section:

(1) The commission or judge may limit its consideration of the matter to oral arguments of the affected parties and may:

(A) set interim rates not lower than the authorized rates prior to the proposed increase nor higher than the requested rates;

(B) deny interim rate relief;

(C) require that all or part of the requested rate increase be deposited in an escrow account in accordance with rules set forth in §291.30 of this title (relating to Escrow of Proceeds Received Under Rate Increase); or

(2) The commission may remand the request for interim rates to SOAH for an evidentiary hearing on interim rates. The presiding judge will issue a non-appealable interlocutory ruling setting interim rates to remain in effect until a final rate determination is made by the commission.

(e) The establishment of interim rates does not preclude the commission from establishing, as a final rate, a different rate from the interim rate.

(f) Unless otherwise agreed to by the parties to the rate proceeding, the retail public utility shall refund or credit against future bills all sums collected in excess of the rate finally ordered plus interest as determined by the commission in a reasonable number of monthly installments.

(g) Unless otherwise agreed to by the parties to the rate proceeding, the retail public utility shall be authorized by the commission to collect the difference, in a reasonable number of monthly installments, from its customers for the amounts by which the rate finally ordered exceeds the interim rates.

(h) The retail public utility must provide a notice to its customers including the interim rates set by the commission or judge with the first billing at the interim rates with the following wording: "The Texas Natural Resource Conservation Commission (or judge) has established the following interim rates to be in effect until the final decision on the requested rate change (appeal) or until another interim rate is established."

(i) If the commission or judge establishes interim rates or an escrow account in a proceeding under Texas Water Code, §13.187, the commission must make a final determination on the rates within 335 days after the effective date of the interim rates or escrowed rates or the rates are automatically approved as requested by the utility in its application.

Adopted January 13, 1999 Effective February 4, 1999

§291.30. Escrow of Proceeds Received Under Rate Increase.

(a) Rates received during the pendency of a rate proceeding.

(1) During the pendency of its rate proceeding, a utility may be required to deposit all or part of the rate increase into an interest-bearing escrow account with a federally insured financial institution, under such terms and conditions as determined by the commission.

(2) The utility shall file an original and three copies of a completed escrow agreement between the utility and the financial institution with the commission for review and approval by the executive director.

(3) If necessary to meet the utility's current operating expenses, or for other good cause shown, the executive director may authorize the release of funds to the utility from the escrow account during the pendency of the proceeding.

(4) The executive director, except for good cause shown, shall give all parties-of-record at least 10 days notice of an intent to release funds from an escrow account. Any party may file a motion

with the commission to enjoin the executive director's proposed release of escrow funds or to establish different terms and conditions for the release of escrowed funds.

(5) Upon the commission's establishment of final rates, all funds remaining in the escrow account shall be released to the utility or ratepayers in accordance with the terms of the commission's order.

(b) Surcharge revenues granted by commission order at the conclusion of a rate proceeding.

(1) A utility may be required to deposit all or part of surcharge funds authorized by the commission into an interest-bearing escrow account with a federally insured financial institution, under such terms and conditions as determined by the commission.

(2) Prior to collecting any surcharge revenues that are required to be escrowed, the utility shall submit for executive director approval an original and three copies of a completed escrow agreement between the utility and the financial institution. If the utility fails to promptly remedy any deficiencies in the agreement noted by the executive director, the executive director may suspend the collection of surcharge revenues until the agreement is properly amended.

(3) In order to allow the utility to complete the improvements for which surcharge funds were granted, the executive director may authorize the release of funds to the utility from the escrow account after receiving a written request including appropriate documentation.

Adopted December 6, 1995 Effective January 10, 1996

§291.31. Cost of Service.

(a) Components of cost of service. Rates are based upon a utility's cost of rendering service. The two components of cost of service are allowable expenses and return on invested capital.

(b) Allowable expenses. Only those expenses which are reasonable and necessary to provide service to the ratepayers shall be included in allowable expenses. In computing a utility's allowable expenses, only the utility's historical test year expenses as adjusted for known and measurable changes will be considered.

(1) Components of allowable expenses. Allowable expenses, to the extent they are reasonable and necessary, and subject to this section, may include, but are not limited to, the following general categories:

(A) operations and maintenance expense incurred in furnishing normal utility service and in maintaining utility plant used by and useful to the utility in providing such service (payments to affiliated interests for costs of service, or any property, right, or thing, or for interest expense shall not be allowed as an expense for cost of service except as provided in the Texas Water Code, §13.185(e));

(B) depreciation expense based on original cost and computed on a straight line basis over the useful life of the asset as approved by the commission. Depreciation shall be allowed on all currently used depreciable utility property owned by the utility except for property provided by explicit customer agreements or funded by customer contributions in aid of construction. Depreciation on all currently used and useful developer or governmental entity contributed property shall be allowed in the cost of service;

(C) assessments and taxes other than income taxes;

(D) federal income taxes on a normalized basis (federal income taxes shall be computed according to the provisions of the Texas Water Code, §13.185(f), if applicable);

(E) the reasonable expenditures for ordinary advertising, contributions, and donations; and

(F) funds expended in support of membership in professional or trade associations provided such associations, contribute toward the professionalism of their membership.

(2) Expenses not allowed. The following expenses shall not be allowed as a component of cost of service:

(A) legislative advocacy expenses, whether made directly or indirectly, including, but not limited to, legislative advocacy expenses included in professional or trade association dues;

(B) funds expended in support of political candidates;

(C) funds expended in support of any political movement;

(D) funds expended in promotion of political or religious causes;

(E) funds expended in support of or membership in social, recreational, fraternal, or religious clubs or organizations;

(F) funds promoting increased consumption of water;

(G) additional funds expended to mail any parcel or letter containing any of the items mentioned in subparagraphs (A)-(F) of this paragraph;

(H) costs, including, but not limited to, interest expense of processing a refund or credit of sums collected in excess of the rate finally ordered by the commission; and

(I) any expenditure found by the commission to be unreasonable, unnecessary, or not in the public interest, including, but not limited to, executive salaries, advertising expenses, rate case

expenses, legal expenses, penalties and interest on overdue taxes, criminal penalties or fines, and civil penalties or fines.

(c) Return on invested capital. The return on invested capital is the rate of return times invested capital.

(1) Rate of return. The commission shall allow each utility a reasonable opportunity to earn a reasonable rate of return, which is expressed as a percentage of invested capital, and shall fix the rate of return in accordance with the following principles.

(A) The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties.

(B) The commission shall consider the efforts and achievements of the utility in the conservation of resources, the quality of the utility's services, the efficiency of the utility's operations, and the quality of the utility's management, along with other relevant conditions and practices.

(C) The commission may, in addition, consider inflation, deflation, the growth rate of the service area, and the need for the utility to attract new capital. In each case, the commission shall consider the utility's cost of capital, which is the composite of the cost of the various classes of capital used by the utility.

(i) Debt capital. The cost of debt capital is the actual cost of debt.

(ii) Equity capital. The cost of equity capital shall be based upon a fair return on its value. For companies with ownership expressed in terms of shares of stock, equity capital commonly consists of the following classes of stock.

(I) Common stock capital. The cost of common stock capital shall be based upon a fair return on its value.

(II) Preferred stock capital. The cost of preferred stock capital is its annual dividend requirement, if any, plus an adjustment for premiums, discounts, and cost of issuance.

(2) Invested capital, also referred to as rate base. The rate of return is applied to the rate base. Components to be included in determining the rate base are as follows:

(A) original cost, less accumulated depreciation, of utility plant, property and equipment used by and useful to the utility in providing service:

(i) Original cost shall be the actual money cost, or the actual money value of any consideration paid other than money, of the property at the time it shall have been dedicated to public use, whether by the utility which is the present owner or by a predecessor;

(ii) Reserve for depreciation is the accumulation of recognized allocations of original cost, representing recovery of initial investment, over the estimated useful life of the asset. Depreciation shall be computed on a straight line basis over the expected useful life of the item or facility;

(iii) The original cost of plant, property, and equipment acquired from an affiliated interest shall not be included in invested capital except as provided in the Texas Water Code, §13.185(e);

(iv) Utility property funded by explicit customer agreements or customer contributions in aid of construction such as surcharges may not be included in original cost or invested capital.

(B) working capital allowance to be composed of, but not limited to the following:

(i) reasonable inventories of materials and supplies, held specifically for purposes of permitting efficient operation of the utility in providing normal utility service;

(ii) reasonable prepayments for operating expenses (prepayments to affiliated interests shall be subject to the standards set forth in the Texas Water Code, §13.185(e); and

(iii) a reasonable allowance up to one-eighth of total annual operations and maintenance expense excluding amounts charged to operations and maintenance expense for materials, supplies, and prepayments (operations and maintenance expense does not include depreciation, other taxes, or federal income taxes).

(3) Items not included in rate base. Unless otherwise determined by the commission, for good cause shown, the following items will not be included in determining the overall rate base.

(A) Miscellaneous items. Certain items which include, but are not limited to, the following:

(i) accumulated reserve for deferred federal income taxes;

(ii) unamortized investment tax credit to the extent allowed by the Internal Revenue Code;

(iii) contingency and/or property insurance reserves;

(iv) contributions in aid of construction; and

(v) other sources of cost-free capital, as determined by the commission.

(B) Construction work in progress. Under ordinary circumstances the rate base shall consist only of those items which are used and useful in providing service to the public. Under exceptional circumstances, the commission may include construction work in progress in rate base to the extent that the utility has proven that:

(i) the inclusion is necessary to the financial integrity of the utility; and

(ii) major projects under construction have been efficiently and prudently planned and managed. However, construction work in progress shall not be allowed for any portion of a major project which the utility has failed to prove was efficiently and prudently planned and managed.

(d) Recovery of positive acquisition adjustments.

(1) For utility plant, property, and equipment acquired by a utility from another retail public utility as a sale, merger, etc. of utility service area for which an application for approval of sale has been filed with the commission on or after September 1, 1997, and that sale application closed thereafter, a positive acquisition adjustment will be allowed to the extent that the acquiring utility proves that:

(A) the property is used and useful in providing water or sewer service at the time of the acquisition or as a result of the acquisition;

(B) reasonable, prudent, and timely investments will be made if required to bring the system into compliance with all applicable rules and regulations;

(C) as a result of the sale, merger, etc.:

(i) the customers of the system being acquired will receive higher quality or more reliable water or sewer service or that the acquisition was necessary so that customers of the acquiring utility's other systems could receive higher quality or more reliable water or sewer service;

(ii) regionalization of retail public utilities (meaning a pooling of financial, managerial, or technical resources which achieve economies of scale or efficiencies of service) was achieved; or

(iii) the acquiring system will become financially stable and technically sound as a result of the acquisition, or the system being acquired which is not financially stable and technically sound will become a part of a financially stable and technically sound utility;

(D) any and all transactions between the buyer and the seller entered into as a part or condition of the sale are fully disclosed to the executive director and were conducted at arm's length;

(E) the actual purchase price is reasonable in consideration of the condition of the plant, property, and equipment being acquired; the impact on customer rates if the acquisition adjustment is granted; the benefits to the customers; and, the amount of contributions in aid of construction in the system being acquired;

(F) in a single or multi-stage sale, the owner of the acquired retail public utility and the final acquiring utility are not affiliated. A multi-stage sale is where a stock transaction is followed by a transfer of assets in what is essentially a single sales transaction. A positive acquisition adjustment is allowed only in those cases where the multi-stage transaction was fully disclosed to the executive director in the application for approval of the initial stock sale. Any multi-stage sale occurring between September 1, 1997, and the effective date of these rules is exempt from the requirement for executive director notification at the time of the approval of the initial sale, but must provide such notification within 60 days of the effective date of these rules; and

(G) the rates charged by the acquiring utility to its preacquisition customers will not increase unreasonably because of the acquisition.

(2) The amount of the acquisition adjustment approved by the regulatory authority, shall be amortized using a straight line method over a period equal to the weighted average remaining useful life of the acquired plant, property, and equipment, at an interest rate equal to the rate of return determined under subsection (c) of this section. The acquisition adjustment may be treated as a surcharge and may be recovered using non-system-wide rates.

(3) The authorization for and the amount of an acquisition adjustment can only be determined as a part of a rate change application.

(4) The acquisition adjustment can only be included in rates as a part of a rate change application.

Adopted January 13, 1999 Effective February 4, 1999

§291.32. Rate Design.

(a) General. In fixing the rates of a utility, the commission shall fix its overall revenues at a level which will permit such utility a reasonable opportunity to earn a reasonable return on its invested capital used and useful in rendering service to the public, over and above its reasonable and necessary operating expenses (unless an alternative rate method is used as set forth in §291.34 of this title (relating to Alternative Rate Methods), and preserve the financial integrity of the utility.

(b) Conservation.

(1) In order to encourage the prudent use of water or promote conservation, water and sewer utilities shall not apply rate structures which offer discounts or encourage increased usage within any customer class.

(2) After receiving final authorization from the regulatory authority through a rate change proceeding, a utility may implement a water conservation surcharge using an inclining block rate or other conservation rate structure. A utility may not implement such a rate structure to avoid providing facilities necessary to meet the commission's minimum standards for public drinking water systems. A water conservation rate structure may generate revenues over and above the utility's usual cost of service:

(A) to reduce water usage or promote conservation either on a continuing basis or in specified restricted use periods identified in the utility's tariff in order to:

(i) comply with mandatory reductions directed by a wholesale supplier or underground water district; or

(ii) maintain acceptable pressure or storage during drought periods, or other water rationing conditions authorized by an approved water rationing plan;

(B) to generate additional revenues necessary to provide facilities for maintaining or increasing water supply, treatment, production, or distribution capacity.

(3) All additional revenues over and above the utility's usual cost of service collected under paragraph (2) of this subsection:

(A) must be accounted for separately and reported to the executive director, as requested;

(B) are considered customer contributed capital unless otherwise specified in a commission order; and

(C) may only be used in a manner approved by the executive director for applications not subject to hearing under Texas Water Code, §13.187(b).

(c) Volume charges. Charges for additional usage above the base rate shall be based on metered usage over and above any volume included in the base rate rounded up or down as appropriate to the nearest 1,000 gallons or 100 cubic feet, or the fractional portion of the usage.

(d) Surcharges.

(1) Capital improvements. In a rate proceeding, the commission may authorize collection of additional revenues from the customers to provide funds for capital improvements necessary to provide facilities capable of providing adequate and continuous utility service, and for the preparation of design and planning documents.

(2) Debt repayments. In a rate proceeding, the commission may authorize collection of additional revenues from customers to provide funds for debt repayments and associated costs, including funds necessary to establish contingency funds and reserve funds. Surcharge funds may be collected to

meet all of the requirements of the Texas Water Development Board in regard to financial assistance from the Safe Drinking Water Revolving Fund.

Adopted January 13, 1999 Effective February 4, 1999

§291.34. Alternative Rate Methods.

(a) To ensure that retail customers receive a higher quality or more reliable water or sewer service, to encourage regionalization, or to maintain financially stable and technically sound utilities, the commission may utilize alternate methods of establishing rates. The commission shall assure that rates, operations, and service are just and reasonable to the consumers and to the utilities. The executive director may prescribe modified rate filing packages for these alternate methods of establishing rates.

(b) Single issue rate change. Unless a utility is using the cash needs method, it may request approval to increase rates to reflect a change in any one specific cost component. The following conditions shall apply to this type of request.

(1) The proposed effective date of the single issue rate change request must be within 24 months of the effective date of the last rate change request in which a complete rate change application was filed.

(2) The change in rates is limited to those amounts necessary to recover the increase in the specific cost component and the increase will be allocated to the rate structure in the same manner as in the previous rate change.

(3) The scope of a single issue rate proceeding is limited to the single issue prompting a change in rates. For capital items this includes depreciation and return determined using the rate of return established in the prior rate change proceeding.

(4) The utility shall provide notice as described in §291.22(a)-(e) of this title (relating to Notice of Intent to Change Rates), and the notice shall describe the cost component and reason for the increased cost.

(5) A utility exercising this option is required to submit a complete rate change application within three years following the effective date of the single issue rate change request.

(c) Phased and multi-step rate changes. In a rate proceeding, the commission may authorize a phased, stepped, or multi-year approach to setting and implementing rates to eliminate the requirement that a utility file another rate application.

(1) A utility may request to use the phased or multi-step rate method:

(A) to include the capital cost of installation of utility plant items that are necessary to improve service or achieve compliance with commission regulations in the utility's rate base and operating expenses in the revenue requirement when facilities are placed in service;

(B) to provide additional construction funds after major milestones are met;

(C) to provide assurance to a lender that rates will be immediately increased when facilities are placed in service;

(D) to allow a utility to move to metered rates from unmetered rates as soon as meters can be installed at all service connections;

(E) to phase in increased rates when a utility has been acquired by another utility with higher rates;

(F) to phase in rates when a utility with multiple rate schedules is making the transition to a system-wide rate structure; or

(G) when requested by the utility.

(2) Construction schedules and cost estimates for new facilities which are the basis for the phased or multi-step rate increase must be prepared by a licensed professional engineer.

(3) Unless otherwise specified in the commission order, the next phase or step cannot be implemented without verification of completion of each step by a licensed professional engineer, agency inspector, or agency subcontractor.

(4) At the time each rate step is implemented, the utility must review actual costs of construction versus the estimates upon which the phase-in rates were based. If the revenues received from the phased or multi-step rates are higher than what the actual costs indicate, the excess amount must be reported to the executive director prior to implementing the next phase or step. Unless otherwise specified in a commission order or directed by the executive director, the utility may:

(A) refund or credit the overage to the customers in a lump sum; or

(B) retain the excess to cover shortages on later phases of the project. Any revenues retained but not needed for later phases must be proportioned and refunded to the customers at the end of the project with interest paid at the rate on deposits.

(5) The original notice to customers must include the proposed phased or multi-step rate change and informational notice must be provided to customers and the executive director 30 days prior to the implementation of each step.

(6) A utility that requests and receives a phased or multi step rate increase cannot apply for another rate increase during the period of the phase-in rate intervals unless:

(A) the utility can prove financial hardship; or

(B) the utility is willing to void the next steps of the phase-in rate structure and undergo a full cost of service analysis.

(d) Cash needs method. The cash needs method of establishing rates allows a utility to recover reasonable and prudently incurred debt service, a reasonable cash reserve account, and other expenses not allowed under standard methods of establishing rates.

(1) A utility may request to use the cash needs method of setting rates if:

(A) the utility is a nonprofit corporation controlled by individuals who are customers and who represent a majority of the customers; or

(B) the utility can demonstrate that use of the cash needs basis:

(i) is necessary to preserve the financial integrity of the utility;

(ii) will enable it to develop the necessary financial, managerial, and technical capacity of the utility; and

(iii) will result in higher quality and more reliable utility service for customers.

(2) Under the cash needs method, the allowable components of cost of service are: allowable operating and maintenance expenses; depreciation expense; reasonable and prudently incurred debt service costs; recurring capital improvements, replacements, and extensions which are not debt-financed; and a reasonable cash reserve account.

(A) Allowable operating and maintenance expenses: only those expenses which are reasonable and necessary to provide service to the ratepayers shall be included in allowable operations and maintenance expenses and shall be based on the utility's historical test year expenses as adjusted for known and measurable changes and reasonably anticipated, prudent projected expenses.

(B) Depreciation expense: depreciation expense may be included on any used and useful depreciable plant, property, or equipment which was paid for by the utility and which has a positive net book value on the effective date of the rate change.

(C) Debt service costs. Cash outlays to an unaffiliated interest necessary to repay principal and interest on reasonably and prudently incurred loans. If required by the lender, debt service costs may also include amounts placed in a debt service reserve account in escrow or as required by the commission, Texas Water Development Board, or other state or federal agency or other financial institution. Hypothetical debt service costs may be used for:

(i) self-financed major capital asset purchases where the useful life of the asset is ten years or more. Hypothetical debt service costs may include the debt repayments using an amortization schedule with the same term as the estimated service life of the asset using the prime interest rate at the time the application is filed;

(ii) prospective loans to be executed after the new rates are effective. Any pre-commitments, amortization schedules or other documentation from the financial institution pertaining to the prospective loan must be presented for consideration.

(D) Recurring capital improvements, replacements, and extensions which are not debt-financed. Capital assets, repairs, or extensions which are a part of the normal business of the utility may be included as allowable expenses. This does not include routine capital expenses which are specifically debt-financed.

(E) Cash reserve account: a reasonable cash reserve account, up to 10% of annual operation and maintenance expenses, shall be maintained and revenues to fund it may be included as an allowable expense. Funds from this account may be used to pay expenses incurred before revenues from rates are received and for extraordinary repair and maintenance expenses and other capital needs or unanticipated expenses if approved in writing by the executive director. The utility shall account for these funds separately and report to the commission as required by the executive director. Unless the utility requests an exception in writing and the exception is explicitly allowed by the executive director in writing, any funds in excess of 10%, shall be refunded to the customers each year with the January billing either as a credit on the bill or refund accompanied by a written explanation which explains the method used to calculate the amounts to be refunded. Each customer shall receive the same refund amount. These reserves are not for the personal use of the management or ownership of the utility and may not be used to compensate an owner, manager, or individual employee above the amount approved for that position in the most recent rate change request unless authorized in writing by the executive director.

(3) If the revenues collected exceed the actual cost of service, defined in subsection (d)(2) of this section, during any calendar year, these excess cash revenues must be placed in the cash reserve account described in subsection (d)(2)(D) of this section and become subject to the same restrictions.

(4) If the utility demonstrates to the executive director that it has reduced expenses through its efforts, and has improved its financial, managerial, and technical capability, the executive director may allow the utility to retain 50% of the savings which result for the personal use of the management or ownership of the utility rather than pass on the full amount of the savings through lower rates or refund all of the amounts saved to the customers.

(5) If a utility elects to use the cash needs method, it may not elect to use the utility method for any rate change application initiated within five years after beginning to use the cash needs method. If after the five-year period, the utility does elect to use the utility method, it may not include in rate base, or recover the depreciation expense, for the portion of any capital assets paid for by customers

as a result of including debt service costs in rates. It may, however, include in rate base, and recover through rates, the depreciation expense for capital assets which were not paid for by customers as a result of including debt service costs in rates. The net book value of these assets may be recovered over the remaining useful life of the asset.

Adopted January 13, 1999 Effective February 4,1999

Summary of Survey Results
National

Contract Operation

	City	State	Description
1	Atlanta	GA	Financial need to support billion dollar capital improvement program caused need to increase rates or decrease costs. Workforce reduction through attrition and retirement. 20-year contract is performance based with pass throug provision and exit clauses.
2	Berkeley Hts.	NJ	Contract term is for five-years with five-year renewal option. Contract contains performance and exit clause. Medium length contract affords flexibility. Need for contract was to replace departing operator and need for expertise. Responsibility is managed between City and company.
3	Boonville	IN	Need for contract was due to wastewater plant being out of compliance with EPA. Contract was extended from 3 to ten-years for expertise and need for capital improvement program to refurbish wells and new wastewater treatment plant. Rates have increased 40% over 1980's. Employees like the security of longer term contract.
4	Buffalo	NY	Five-year contract keeps City employees, but under company direction was extended five-years. The City's budget decreased from $14 million to $9 million. City lowered rates but should have saved money for future improvements. Union opposed working under company management. Key to was getting the workforce to cooperate in the negotiation.
5	Cape Girardeau	MO	O&M contract was needed when City purchased water utility from a company in 1992. The City did not have personnel, equipment or experience. City likes five-year contract to motivate company. Savings from energy, chemicals and administration management. Better technology and expertise have increased efficiency and accelerated savings.
6	Cheboygan	MI	Five-Year O&M contract is for water and wastewater services. No labor reductions because utility is small. Reason for contract is for savings and expertise. Savings in repair and maintenance have financed a D-B-O treatment plant. Benefits: 5%-10% budget savings, no rate increases, upgraged managemend benefits. Company mitigates liabilities.
7	Easton	PA	Reason for contract was to get utility back on track from serious EPA violations. Resistance from City employees and counter-productive internal instructions have threatened recovery. If doing it over, City would 100% privatize, Since company involvement, the City has made a complete turnaround regarding quality.
8	Evansville	IN	Ten-year contract with ten-year renewal option. By 2/99, all water/wastewater functions will be privatized Savings to be $18M to $20M. City is happy with savings and expertise. Contract was to streamline operations and reduce staffing. Managed competition may result in similar results, but impeded by salary limits to attract expertise.
9	Farmington	NM	Five-year O&M contract was extended to 8 years. Rationale for contract was economic. The City is happy with the contract. Consensus of employees are happy with the contract and most enjoy working for the company due to expanded opportunities. Allowing labor to bid in RFP would be worthwhile. Look to preserve employee benefits.
10	Hoboken	NJ	Reasons for contract was for capital improvements, tax relief from concession fee and poorly performing labor force. ten-year contract was extended to 20-years. Long-term deal extends capital improvement plan and locks in service improvements. City is happy with company partnership. Ongoing contract management is very important.
11	Indianapolis	IN	Contract administration & oversight are essential to a successful long-term deal. Contract was extended ten-years due to IRS 97-13. Budget review of current employee duties before closing is important. Monitoring, controls, reports of maintenance avoid future capital improvements. $65 million savings in last five-years. Key is successful union negotiation.
12	Milwaukee	WI	Ten-year deal is expected to save $140 million (30%.) Terms: fixed-fee payments, employee protections, $2 million in up-front capital improvements and community development. Reason: cost savings and contractor expertise. City hired a consultant for a feasibility study of options. Benefits also included more focus on other City needs by staff.
13	New London	CT	Five-year contract has resulted in $10 million in savings and 25% rate decreases. Contract administration is essential to long-run success. Contract language must be precise & detaile on responsibilities. The deal has been favorable to City. Employee morale has improved under company. Cross training, opportunities, better loyalty by company.
14	New Orleans	LA	Five-year contract with 1-year extensions. Reason: need for technical expertise. City has saved $1million a year since privatizing. Employees were either hired by company or reassigned. Extensive preparation, diligent ongoing contract management, performance monitoring and ongoing dispute resolution with company is essential.
15	Oklahoma City	OK	Five-year contract solves problem of inefficiency and high costs in wastewater plant. Tighter EPA standards also increased need. Budget has decreased by $4 million. Important elements in the agreement include effective contract administration, company prequalification and adequate repair and maintenance provisions.
16	Portage	MI	Five-year O&M contract for water and wastewater services. City is responsible for capital improvement plan. Savings are estimated to be $3 million over five-years. Key issues are contract administration and union negotiations. Employees were offered City or company employment or severance/retirement packages.

Summary of Survey Results
National

17	Seattle	WA	Fifteen-year deal has 2 five-year renewal options and exit provisions. Rationale: improve savings and expertise. Agreement is for a drinking water D-B-O (design-build-operate). Savings estimated at $70 million over twenty five-years. Keys: capital improvements in payment schedule, auditing, cost sharing terms. Prior preparation by City is important.
18	Taunton	MA	Twenty-year fixed price D-B-O deal provides major upgrades, solves City's need to resolve EPA problems and need for operational expertise. Labor is satisfied with the long-term nature of the agreement. Benefits include better assessment of operations and capital problems. Asset management improved.
19	Vancouver	WA	City had O&M contract for wastewater facility since 1978. Original need was due to lack of expertise and City's inability to compete for technical expertise, and company's better training. Now, increaseing EPA requirments continue pressure on system. Contract contains first version of lump sum contract that has a set-aside for maintenance.
20	West Haven	CT	City is at end of five-year O&M deal. IRS 97-13 allows the City to evaluate benefits of a long-term deal. Even though the City is satisfied with its current company, it is preparing a RFP for the best price. Rationale for contract was for expertise and major EPA fines. Only problem is that repair and maintenance costs have exceeded budget every year.
21	Wilmington	DE	Twenty-year O&M contract includes capital improvements. Reason: capital improvements and savings. City issued an RFP, no resulting layoffs, many employees joined company. Benefits: capital investment by company, $1 million savings per year. Impediments: E.O.12803 requiement for EPA approval of concession fee causes harmful delays to the process.

Managed Competition

	City	State	Description
1	Charlotte	NC	Five-year managed competiton water/wastewater MOU implemented after five years of internal preparation. Prior to RFP, benchmarking identified savings potential. City employee preparation for five-years befor RFP went out. City employees won the RFP. Savings of $4 million are expected. Incentives include performance bonus/penalties, exit clause.
2	Chicago	IL	City had managed competition water and wastewater program for core services for past 4 years. After RFP, City outsourced non-core services like billing and meter reading. IRS 97-13 encouraged long-term oursourcing of non-core services, capital improvements. Attrition, cross training and technology efficiency patterned after private sector.
3	San Diego	CA	Preparation for managed competiton started 3 years ago. Benchmarking was difficult since few large plants have been privatized. RFP was developed, but a union sued and bid was dropped. Internal optimization process was implemented instead. Savings were identified, but cost of optimization process almost negated savings.
4	Santa Rosa	CA	City has been working on a managed competition process for about five-years. Initially a consulting firm made some general recommendations. The City has tried to develop cross-training in maintenance skills, but has met with employee resistance to change. Savings through keeping staff level constant during significant customer growth.
5	Tulsa	OK	The City decided to solicit bids for operating its wastewater treatment plant. Employees of the City bid and won the contract. The City has not documented many significant cost savings from the process.

Sale

	City	State	Description
1	Franklin	OH	In 1996, the City selected a company to design, build, own and operate a water treatment facility.
2	Miami Conservancy Dist	OH	Miami Conservancy District got grant funding and built the wastewater plant in 1972. As a flood control agency, it contracted operations out in the mid-1980's and sold the in 1995 to the operator's holding company. A key issue in the sale was how much time the City needed to get EPA approval under E.O. 12803, approximately 30 months.
3	West Lafayette	IN	The City has a private water provider. There is no contract and the system was sold many years ago. The wastewater facility is still owned by the City.

Charlotte, NC

Managed Competition

Overview

The City of Charlotte established a policy to actively pursue opportunities including competition and outsourcing to reduce the costs of providing public services. Water and wastewater services are provided for Charlotte and Mecklenburg County by the Charlotte-Mecklenburg Utility Department (CMUD) which operates all three water treatment plants and five wastewater treatment plants serving the area. The CMUD service area serves approximately 500,000 persons. The City's motivation for adopting cost reduction policy in serving customer was its continuing wastewater treatment costs.

Backgound - Preparation for Competition

In 1990, the City put together a taskforce to determine potential cost savings for the water and wastewater utility by comparing cities of similar characteristics involved in contract operations. Results of the rough "benchmarking" exercise illustrated potential estimated savings of 20-50% for the City. Each department then had the responsibility of developing a five-year competition plan that would ultimately lead to the aforementioned savings. The City provided roughly $500,000 for consulting, cross training, technical, and management assistance resources to prepare the City for competition with private contractors. In addition, the labor force was constricted through attrition during the five-year plan. Resulting labor issues were minimal since there is no union.

The Competition and Procurement Processes

In addition to its "right-sizing" process, the City has also embraced using outside competition in its procurement process. To explore cost savings opportunities via privatization, CMUD initially offered one water treatment plant and one wastewater treatment plant for contract operations. The procurement process included a qualifications phase to develop a short list of qualified bidders and a technical proposal to evaluate operational capabilities and potential cost savings. CMUD then also developed its own proposal to compete with the contract operator's proposals.

Strong efforts were made to ensure comparable evaluations and rankings of all proposals. Evaluation criteria included cost, relevant company experience, experience and qualifications of staff, technical resources of each company, financial resources of each company, performance history, project understanding and contracting suggestions. Numerous sub-criteria were developed for each primary criteria issue. In the evaluations and rankings, cost was given

primary weight based on a net present value comparison of the proposed annual fees for each year of the five year contract.

A six member evaluation team was assisted by an independent consulting team to manage the procurement process and to assist in the evaluation of qualifications and cost proposals that were submitted.

Results

In 1996, of all contracts put out to bid, the City won all but one contract. The price proposed by CMUD's "in-house" team was substantially lower than the lowest private sector bid and predicted approximately 30% savings over its prior year budget.

The City's in-house proposal included several approaches for reducing operating costs including staff reductions, increased automation, and improved process control equipment. A separate cost center and special cost reporting requirements were set up to track the performance of the City in meeting cost savings goals specified in the proposal for plant operation. Failure to meet the cost savings would mean that the City's contract could be terminated and operation of the plants would be offered again for privatization. Performance incentives were developed making employee bonuses contingent on cost savings above the savings specified in the proposal. The interview indicated that since 1996, the utility has saved about $9 million annually.

Keys to Success (i.e. efficiency and cost savings)

- The five-year competition plan was driven by the departments. It is a "bottom-up" approach that bypasses politically driven short-term decision making.
- Employees were given time and resources to bid competitively.
- The City realized that they didn't have to "reinvent the wheel." "Tried and true" methods of cost cutting and efficiency were examined and followed.
- Financial incentive programs were implemented. "Gain sharing" is an incentive program provided to City personnel if they win the contract. Under the "gain sharing" plan, employees ratably share 50% of each dollar saved from their department's budgeted bid. Some departments have enjoyed the financial success of "gain sharing" and others have dealt with the dismay of bidding too competitively.
- Open communications between the City and all potential bidders helps foster an atmosphere of cooperation and fair competition.
- An objective evaluation process that is fair for all bidders is essential to attract qualified bidders and minimize the risk of legal challenges. An objective and quantified process helps differentiate proposals.

- A two-step procurement process, first for qualifications, and then for proposals can help streamline the process, particularly if a large number of proposals are anticipated. Qualifications submittals are easier and less expensive for firms to prepare, and facilitate the City's job of initially screening out candidates to a short list. By soliciting RFPs exclusively from the short list, the City's evaluation process will be accelerated.
- The RFP should include a draft service agreement to further define the proposed scope of services and responsibilities to be performed. The draft service agreement should be comprehensive and explicit. The information in the draft service agreement will allow bidders to develop specific recommendations for operating and maintaining the facility. It will also provide a more consistent basis for comparing proposals and lead to fewer problems in negotiating a final agreement.
- Internal evaluation of indirect costs associated with the in-house proposal can be complex. Guidelines for evaluating these costs will be important to ensure a level playing field among all bidders.
- Careful definitions of maintenance requirements and specifications of costs to be assumed by the contractor and by the City provide an important foundation for high quality proposals. This will help parties to more clearly understand their respective cost responsibilities. It will also assist the city in evaluating each proposal's cost-effectiveness.
- If a public entity is given the opportunity to propose on a competitive basis with private sector providers, opportunities for significant cost savings are possible from both public and private bidders.

Policy Issues

The most significant policy issue in the competition and procurement processes for the city was to ensure an objective and fair evaluation of proposals, including the in-house municipal proposal. The City was keenly aware that the process had to be equitable and entirely fair to all bidders in order to attract qualified bidders and avoid possible legal challenges. The City was circumspect to avoid treating the in-house municipal employee bidding team and its proposal with preference.

Careful planning of the procurement process was also important. Issues included independence and separation between the proposing team and the evaluation team. Detailed direct and indirect municipal cost separation and allocation was important to assure all of the in-house employee team's operating costs were included under the scope of operations identified in the RFP.

Concerns about fairness and public perception required emphasis on equal treatment for all competing parties throughout the process. Companies were strongly encouraged to provide input and comments during the procurement process. A draft RFP was submitted to all potential bidders for review and comment including a draft service agreement with specific instructions on how proposals were to be prepared and submitted. The issue of maintenance costs and bidder cost responsibilities were clearly defined in the contract's requirements for corrective, preventive, and predictive maintenance, including limits on maintenance costs for inclusion in the proposal.

Seattle

Design Build Operate

Background - Preparation for Competition

The City originally planned to follow the traditional approach in building water treatment facilities. Based on pre-design work the City anticipated total costs of $156 million dollars.

The City eventually sought a DBO partnership. The rationale was based on the creation of an environment to create a synergism of expertise and cost savings.

Results

Although the company is only 6 months into the build phase, the project has progressed on time and budget. Use of the DBO (design-build-operate) process has derived an estimated $70 million dollars or 40% in cost savings for the City over a 25 year time frame.

Keys to Success (i.e. efficiency and cost savings)[1]

- Close Relationship between designer and constructor, leading to:
  - a more economical design;
  - application of cost saving construction techniques;
  - elimination of owner mediation to resolve disputes between the designer and constructor; and
  - purchase of critical components able to start prior to final design completion
- Operational efficiencies, such as:
  - highly automated facilities;
  - bulk purchasing of supplies and material; and
  - introduction of new technology by large operating firm, thereby driving down long-term operating costs.
- Incentives for the contractor to design and build a reliable facility
- Competitive market savings, due to:
  - keen international market interest
  - qualified competitors wanting to establish a long-term market niche
- Negotiation Process
  - Clarity and detail of a draft agreement
  - Risk posture/allocation
  - Minimize amount of contingency in their prices

[1] http://www.ci.seattle.wa.us/util/dw/tolt/Projsum.htm

Indianapolis, IN

Operations & Maintenance Contract

Background - Preparation for Competition

In November of 1993, the City of Indianapolis signed a 5 year public/private partnership for the City's two wastewater treatment plants. Through a competitive bid process, the City fleshed out the company that exceeded environmental thresholds while providing substantial potential annual cost savings.

Results

The City has saved about $65 million in the last 5 years or 35% annually. In addition to the cost savings and environmental compliance, the City has been very pleased with the increased expertise gained from the company.

Keys to Success (i.e. efficiency, cost savings)

- Contract administration:
  - can make or break a potentially successful long-term relationship. The City's Contract Administrator has been one who appeals to all parties.

- Examination of all O&M costs by line item prior to entering the contract.
  - Employees and equipment that perform tasks in multiple departments must have their costs properly allocated prior to contract execution to avoid cross subsidization.

- Negotiation with the union.
  - The company promised that all employees would at least maintain their current salary and title status. One hundred people were essentially cut from the workforce overnight (320 to 215). Roughly half of the one hundred workers took severence packages and the other half took new positions within the City.

- Realization that the company is in the contract to make a profit
  - The City monitors the quality of water and the maintenance system by performing audits to verify the company is at least maintaining standards set forth within the contract.

Franklin, OH

Sale

Background – Preparation for Competition

The City of Franklin was the largest provider of the wastewater treatment plant owned by the Miami Conservancy District (MCD). MCD's primary function is flood control, however they financed the wastewater treatment plant because they had the ability to obtain grant funding for the project. MCD never really wanted to get into the business, so they immediately contracted operations and maintenance services to EOS Wheelabrator. In 1995 the asset was sold for $6.85 million to U.S. Filter who also acquired EOS Wheelabrator.

Results

Employees remained constant because of the acquisition of EOS Wheelabrator. The City continued to bill customers in the same fashion. Rates were cut by 28% with increases tied only to inflationary adjustments.

Keys to Success

- Preparation of materials for the request for approval under 12803.
- Federal Issues resolved:
  - IRS Regulations pertaining to municipal bond repayment
  - NPDES permit status
  - Implementation of the Municipal Industrial Pretreatment Program
- Local Issues resolved:
  - Contract negotiation
  - User rates
  - Valuation methodology selected for the plant repurchase at the end of the contract

Cranston, R.I.

Lease

Background

The City of Cranston made the decision in 1989 to contract out the OM&M (operations maintenance and management) of the secondary wastewater treatment facility to PSG (Professional Services Group).

In 1996, the City decided to expand its public private partnership endeavors due to a higher level of need for capital improvements. In March of 1997, the City executed a 25-year lease transaction. The total lease arrangement is valued at $400 million. The lease agreement includes repair and capital improvements to the plant and collection system, as well as satisfying a consent decree to upgrade to advanced treatment.

Results of Competition

The OM&M partnership reduced operation costs and significantly improved plant effluent quality. The City ultimately saved about $4 million over the life of the 5-year OM&M agreement.

The lease agreement was approved by the EPA under Executive Order 12803. The deal included a $48 million concession fee and $74 million over the course of the 25-year contract. These funds are being used to:

- repay a loan from the general fund to the sewer enterprise fund;
- eliminate the City budget deficit; and
- defease general obligation debt carried in the sewer fund.

Keys to Success

- Since leases are included in E.O. 12803:
  - The City had to obtain a federal construction grant deviation since they received EPA grant funds to originally construct the facility.
  - Prepare additional materials for EPA approval.
- Conducted successful negotiations and maintained relationships with:
  - unions (PSG originally guaranteed employment to all City staff for one year. Since the lease agreement, staff has increased and union contracts renewed);
  - ratepayers (Resolved concerns through open information and communication.)
  - City Council (Prepared and clearly presented findings and recommendations on competitive bids)

- regulatory agencies (under E.O. 12803 the City was prepared for approval with the EPA.)

Comprehensive Listing of Texas Cities

with Contract Operations Agreements

- Abbott
- Aledo
- Alice
- Angleton
- Arcola
- Austin
- Avinger
- Bastrop
- Bexar Met. Water District
- Blum
- Brushy Creek MUD
- Bullard
- Burkburnett
- Bynum
- Callisburg
- Colmesneil
- Corpus Christi*
- Dallas
- Del Rio
- Donna
- Elgin
- Fort Worth
- Frost
- Freeport
- Fulshear
- Galveston
- Georgetown
- Gladewater
- Goodrich
- Grandview
- Gregory
- Harker Heights
- Hillcrest Village
- Hockley
- Houston
- Huntsville
- Ingleside
- Italy
- Lakeport
- Katy
- Kingwood
- Lampasas
- Leander
- Lindsay
- Malone
- McAllen
- Mercedes
- Mertens
- Nacogdoches
- New Waverley
- Odem
- Orange
- Ore City
- Palacios
- Pampa
- Panhandle
- Pasadena
- Portland
- Rio Vista
- Round Rock
- Roxton
- San Benito
- San Marcos
- Smithville
- Stephenville
- Tatum
- Temple
- Tomball
- Tyler
- Vernon
- Waco
- Weslaco
- Westlake
- Willow Park
- Woodbranch Village
- Woodcreek

* Considered, but did not implement a contract.

VERNON'S

TEXAS CODES ANNOTATED

GOVERNMENT CODE TITLE 10

1999

Pamphlet

with Tables and Index

Important Notice:

Retain this Pamphlet with your set of Vernon's Texas Codes Annotated following volume 6 of the Government Code pending publication of a fully annotated edition of Title 10 of the Government Code

WEST GROUP

(6) making recommendations to state agencies to simplify contract specifications and terms to increase the opportunities for small business participation;

(7) working with state agencies to establish a statewide policy for increasing the use of small businesses;

(8) assisting state agencies in seeking small businesses capable of supplying goods and services that the agencies require;

(9) assisting state agencies in identifying and advising small businesses on the types of goods and services needed by the agencies; and

(10) assisting state agencies in increasing the volume of business placed with small businesses.

Added by Acts 1995, 74th Leg., ch. 41, § 1, eff. Sept. 1, 1995.

Historical and Statutory Notes

Prior Laws:
Acts 1987, 70th Leg., ch. 374, § 1.
Vernon's Ann.Civ.St. art. 4413(301), § 5.005.
Acts 1989, 71st Leg., ch. 4, § 3.01.
V.T.C.A., Government Code § 481.105.
Acts 1993, 73rd Leg., ch. 906, § 1.16.
Vernon's Ann.Civ.St. art. 601b, § 3.281.

§ 2155.074. State Business Daily; Notice Regarding Procurements Exceeding $25,000

Text of section as added by Acts 1997, 75th Leg., ch. 508, § 1

(a) Except as provided by Subsection (n), this section applies to each state agency making a procurement that will exceed $25,000 in value, without regard to the source of funds the agency will use for the procurement, including a procurement that:

(1) is otherwise exempt from the commission's purchasing authority or the application of this subtitle;

(2) is made under delegated purchasing authority;

(3) is related to a construction project; or

(4) is a procurement of professional or consulting services.

(b) In this section, "department" means the Texas Department of Commerce.[1]

(c) The department each business day shall produce and post a business daily in an electronic format. The department shall post in the business daily information as prescribed by this section about each state agency procurement that will exceed $25,000 in value. The department shall also post in the business daily other information relating to the business activity of the state that the department considers to be of interest to the public.

(d) The department shall make the business daily available on the Internet through its information service known as the Texas Marketplace or through a suitable successor information service that will make the information available

on the Internet. The department and each state agency shall cooperate in making the electronic business daily available.

(e) To accommodate businesses that do not have the technical means to access the business daily, governmental and nongovernmental entities such as public libraries, chambers of commerce, trade associations, small business development centers, economic development departments of local governments, and state agencies may provide public access to the business daily. A governmental entity may recover the direct cost of providing the public access only by charging a fee for downloading procurement notices and bid or proposal solicitation packages posted in the business daily. A nongovernmental entity may use information posted in the business daily in providing a service that is more than only the downloading of information from the business daily, including a service by which appropriate bidders or offerors are matched with information that is relevant to those bidders or offerors, and may charge a lawful fee that the entity considers appropriate for the service.

(f) The department and other state agencies may not charge a fee designed to recover the cost of preparing and gathering the information that is published in the business daily. These costs are considered part of a procuring agency's responsibility to publicly inform potential bidders or offerors of its procurement opportunities.

(g) A state agency shall post in the business daily either the entire bid or proposal solicitation package or a notice that includes at a minimum the following information for each procurement that the state agency will make that is estimated to exceed $25,000 in value:

(1) a brief description of the goods or services to be procured and any applicable state product or service codes for the goods and services;

(2) the last date on which bids, proposals, or other applicable expressions of interest will be accepted;

(3) the estimated quantity of goods or services to be procured;

(4) if applicable, the previous price paid by the state agency for the same or similar goods or services;

(5) the estimated date on which the goods or services to be procured will be needed; and

(6) the name, business mailing address, and business telephone number of the state agency employee a person may contact to obtain all necessary information related to making a bid or proposal or other applicable expression of interest for the procurement contract.

(h) The state agency shall continue to either:

(1) post notice of the procurement in accordance with Subsection (g) until the latest of 21 calendar days after the date the notice is first posted; the date the state agency will no longer accept bids, proposals, or other applicable expressions of interest for the procurement; or the date the state agency decides not to make the procurement; or

(2) post the entire bid or proposal solicitation package in accordance with Subsection (g) until the latest of 14 calendar days after the date the bid or proposal solicitation package is first posted; the date the state agency will no longer accept bids, proposals, or other applicable expressions of interest for the procurement; or the date the state agency decides not to make the procurement.

(i) A state agency may not award the procurement contract and shall continue to accept bids or proposals or other applicable expressions of interest for the procurement contract for at least 21 calendar days after the date the state agency first posted notice of the procurement in accordance with Subsection (g) or 14 calendar days after the date the state agency first posted the entire bid or proposal solicitation package in accordance with Subsection (g), as applicable. The minimum time for posting required by this subsection and Subsection (h) does not apply in an emergency requiring the state agency to make the procurement more quickly to prevent a hazard to life, health, safety, welfare, or property or to avoid undue additional cost to the state.

(j) A contract or procurement award made by a state agency that violates the applicable minimum time for posting required by Subsections (h) and (i) is void.

(k) Each state agency that will award a procurement contract estimated to exceed $25,000 in value shall send to the department:

(1) the information the department requires for posting in the state business daily under this section; and

(2) a notice when the procurement contract has been awarded or when the state agency has decided to not make the procurement.

(*l*) The department may adopt rules, prescribe forms, and require information to administer this section. The department shall send any proposed rules to the governor, Legislative Budget Board, comptroller, state auditor, and commission for review and comment. The department's rules shall require that each state agency, to the extent feasible, shall directly and electronically post its own notices or solicitation packages under Subsections (g) and (h).

(m) The requirements of this section are in addition to the requirements of other law relating to the solicitation of bids, proposals, or expressions of interest for a procurement by a state agency. This section does not affect whether a state agency is required to award a procurement contract through competitive bidding, competitive sealed proposals, or another method.

(n) This section does not apply to a state agency to which Section 51.9335 or 73.115, Education Code, applies.

Added by Acts 1997, 75th Leg., ch. 508, § 1, eff. June 1, 1998.

[1] The Texas Department of Commerce is abolished and its powers and duties are transferred to the Texas Department of Economic Development. A reference in law to the Texas Department of Commerce means the Texas Department of Economic Development. Acts 1997, 75th Leg., ch. 1041, § 52(b).

For text of section as added by Acts 1997, 75th Leg., ch. 1206, § 6, see § § 2155.074, post.

Historical and Statutory Notes

Sections 2 and 3 of Acts 1997, 75th Leg., ch. 508 provide:

"Sec. 2. The minimum posting time requirement of Subsections (h) and (i), Section 2155.074, Government Code, as added by this Act, and the provisions of Subsection (j), Section 2155.074, Government Code, as added by this Act, apply only to a procurement contract awarded on or after July 1, 1998.

"Sec. 3. This Act takes effect June 1, 1998, except that the Texas Department of Commerce may adopt rules, procedures, and forms and make agreements necessary to administer this Act beginning September 1, 1997."

§ 2155.074. Best Value Standard for Purchase of Goods or Services

Text of section as added by Acts 1997, 75th Leg., ch. 1206, § 6

(a) For a purchase of goods and services under this chapter, each state agency, including the commission, shall purchase goods and services that provide the best value for the state.

(b) In determining the best value for the state, the purchase price and whether the goods or services meet specifications are the most important considerations. However, the commission or other state agency may, subject to Subsection (c) and Section 2155.075, consider other relevant factors, including:

(1) installation costs;

(2) life cycle costs;

(3) the quality and reliability of the goods and services;

(4) the delivery terms;

(5) indicators of probable vendor performance under the contract such as past vendor performance, the vendor's financial resources and ability to perform, the vendor's experience or demonstrated capability and responsibility, and the vendor's ability to provide reliable maintenance agreements and support;

(6) the cost of any employee training associated with a purchase;

(7) the effect of a purchase on agency productivity; and

(8) other factors relevant to determining the best value for the state in the context of a particular purchase.

(c) A state agency shall consult with and receive approval from the commission before considering factors other than price and meeting specifications when the agency procures through competitive bidding goods or services with a value that exceeds $100,000.

Added by Acts 1997, 75th Leg., ch. 1206, § 6, eff. Sept. 1, 1997.

For text of section as added by Acts 1997, 75th Leg., ch. 508, § 1, see § § 2155.074, ante.

§ 2155.081. Vendor Advisory Committee

(a) The commission may establish a vendor advisory committee. The purpose of the committee is to represent before the commission the vendor community, to provide information to vendors, and to obtain vendor input on state procurement practices.

(b) The committee is composed of employees from the commission and vendors who have done business with the state who are invited by the commission to serve on the committee. The commission shall invite a cross-section of the vendor community to serve on the committee, inviting both large and small businesses and vendors who provide a variety of different goods and services to the state. Article 6252–33, Revised Statutes, does not apply to the size or composition of the committee. The commission shall set staggered terms for the members of the committee.

(c) The committee may establish its own rules of operation but shall post notice of and hold its meetings in accordance with Chapter 551.

Added by Acts 1997, 75th Leg., ch. 1206, § 6, eff. Sept. 1, 1997.

§ 2155.082. Providing Certain Purchasing Services on Fee-For-Service Basis

(a) The commission may provide open market purchasing services on a fee-for-service basis for state agency purchases that are delegated to an agency under Section 2155.131, 2155.132, 2155.133, or 2157.121 or that are exempted from the purchasing authority of the commission. The commission shall set the fees in an amount that recovers the commission's costs in providing the services.

(b) The commission shall publish a schedule of its fees for services that are subject to this section. The schedule must include the commission's fees for:

(1) reviewing bid and contract documents for clarity, completeness, and compliance with laws and rules;

(2) developing and transmitting invitations to bid;

(3) receiving and tabulating bids;

(4) evaluating and determining which bidder offers the best value to the state;

(5) creating and transmitting purchase orders; and

(6) participating in agencies' request for proposal processes.

Added by Acts 1997, 75th Leg., ch. 1206, § 6, eff. Sept. 1, 1997.

[Sections 2155.083 to 2155.130 reserved for expansion]

SUBCHAPTER C. DELEGATIONS OF AND EXCLUSIONS FROM COMMISSION'S PURCHASING AUTHORITY AND CERTAIN EXEMPTIONS FROM COMPETITIVE BIDDING

§ 2155.131. Delegation of Authority to State Agencies

The commission may delegate purchasing functions to a state agency.

Added by Acts 1995, 74th Leg., ch. 41, § 1, eff. Sept. 1, 1995.

Historical and Statutory Notes

Prior Laws:
Acts 1979, 66th Leg., p. 1908, ch. 773, § 3.06.
Acts 1987, 70th Leg., ch. 263, § 1.
Vernon's Ann.Civ.St. art. 601b, § 3.06(b).

§ 2155.132. Purchases Less Than Specified Monetary Amount

(a) A state agency is delegated the authority to purchase goods and services if the purchase does not exceed $15,000. If the commission determines that a state agency has not followed the commission's rules or the laws related to the delegated purchases, the commission shall report its determination to the governor, lieutenant governor, speaker of the house of representatives, and Legislative Budget Board.

(b) The commission by rule may delegate to a state agency the authority to purchase goods and services if the purchase exceeds $15,000 . In delegating purchasing authority under this subsection or Section 2155.131, the commission shall consider factors relevant to a state agency's ability to perform purchasing functions, including:

(1) the capabilities of the agency's purchasing staff and the existence of automated purchasing tools at the agency;

(2) the certification levels held by the agency's purchasing personnel;

(3) the results of the commission's procurement review audits of an agency's purchasing practices; and

(4) whether the agency has adopted and published protest procedures consistent with those of the commission as part of its purchasing rules.

(c) The commission shall monitor the purchasing practices of state agencies that are making delegated purchases under Subsection (b) or Section 2155.131 to ensure that the certification levels of the agency's purchasing personnel and the quality of the agency's purchasing practices continue to warrant the amount of delegated authority provided by the commission to the agency. The commission may revoke for cause all or part of the purchasing authority that the commission delegated to a state agency. The commission shall adopt rules to administer this subsection.

(d) The commission by rule:

(1) shall prescribe procedures for a delegated purchase; and

(2) shall prescribe procedures by which agencies may use the commission's services for delegated purchases, in accordance with Section 2155.082.

(e) Competitive bidding, whether formal or informal, is not required for a purchase by a state agency if the purchase does not exceed $2,000, or a greater amount prescribed by commission rule.

(f) Goods purchased under this section may not include:

(1) an item for which a contract has been awarded under the contract purchase procedure, unless the quantity purchased is less than the minimum quantity specified in the contract;

(2) an item required by statute to be purchased from a particular source; or

(3) a scheduled item that has been designated for purchase by the commission.

(g) A large purchase may not be divided into small lot purchases to meet the dollar limits prescribed by this section. The commission may not require that unrelated purchases be combined into one purchase order to exceed the dollar limits prescribed by this section.

(h) A state agency making a purchase under this section for which competitive bidding is required must:

(1) attempt to obtain at least three competitive bids from sources listed on the master bidders list that normally offer for sale the goods being purchased; and

(2) comply with Subchapter E.[1]

Added by Acts 1995, 74th Leg., ch. 41, § 1, eff. Sept. 1, 1995. Amended by Acts 1997, 75th Leg., ch. 1206, § 7, eff. Sept. 1, 1997.

[1] V.T.C.A., Government Code § 2155.261 et seq.

Historical and Statutory Notes

Acts 1997, 75th Leg., ch. 1206, in subsec. (a), inserted "and services", substituted "$15,000" for "$5,000", and substituted "If the commission determines that a state agency has not followed the commission's rules or the laws related to the delegated purchases, the commission shall report its determination to the governor, lieutenant governor, speaker of the house of representatives, and Legislative Budget Board." for "The agency may, however, use the commission's services for those purchases."; in subsec. (b), inserted "and services", substituted "$15,000" for "$5,000", and inserted "In delegating purchasing authority under this subsection or Section 2155.131, the commission shall consider factors relevant to a state agency's ability to perform purchasing functions, including:", and added subds. (1) to (4); added subsec. (c); redesignated former subsec. (c) as subsec. (d) substituted "prescribe procedures by which agencies may use the commission's services for delegated purchases, in accordance with Section 2155.082" for "may delegate to the comptroller the commission's authority under Subchapter F to audit purchases and purchase information if the purchases do not exceed $500 or a greater amount prescribed by the commission"; redesignated former subsec. (d) as subsec. (e), and substituted "$2,000" for "$1,000"; redesignated former subsecs. (e) and (f) as subsecs. (f) and (g), respectively; redesignated subsec. (g) as subsec. (h), and in subd. (1) inserted "listed on the master bidders list".

Prior Laws:

Acts 1979, 66th Leg., p. 1908, ch. 773, § 3.08.
Acts 1981, 67th Leg., p. 2265, ch. 546, § 1.
Acts 1989, 71st Leg., ch. 108, § 1.
Acts 1991, 72nd Leg., 2nd C.S., ch. 8, § 2.03
Vernon's Ann.Civ.St. art. 601b, § 3.08.

§ 2155.133. Delegation of Authority to Institution of Higher Education

(a) At the request of an institution of higher education or other agency of higher education, the commission shall delegate to the institution or agency authority to purchase goods and services for research projects from state funds appropriated to the institution or agency for that purpose.

(b) An institution or agency acting under delegated authority shall follow the commission's monetary limits and procedures regarding competitive bidding in the purchase of research goods and services. The institution or agency may also consider other factors in making purchases, including quality, reliability, expected life span, and compatibility with existing equipment.

(c) In this section, "institution of higher education" and "other agency of higher education" have the meanings assigned by Section 61.003, Education Code.

Added by Acts 1995, 74th Leg., ch. 41, § 1, eff. Sept. 1, 1995.

Historical and Statutory Notes

Prior Laws:

Acts 1987, 70th Leg., ch. 263, § 1.
Vernon's Ann.Civ.St. art. 601b, § 3.06(a), (c).

§ 2155.134. Group Purchasing Programs

(a) An institution of higher education, as defined by Section 61.003, Education Code, may purchase goods through a group purchasing program that offers discount prices to institutions of higher education.

(b) The commission shall adopt rules that allow institutions of higher education or state agencies to make purchases through group purchasing programs except when the commission determines within a reasonable time after receiving notice of a particular purchase that costs more than $100,000 that a better value is available through the commission.

(c) The rules must provide for commission determination of compliance with state laws and commission rules on purchasing from a historically underutilized business.

(d) This section does not affect other authority granted to an institution of higher education under this subtitle.

Added by Acts 1995, 74th Leg., ch. 41, § 1, eff. Sept. 1, 1995. Amended by Acts 1997, 75th Leg., ch. 1206, § 8, eff. Sept. 1, 1997.

Historical and Statutory Notes

Acts 1997, 75th Leg., ch. 1206, in subsec. (b), substituted "institutions of higher education or state agencies to make purchases" for "purchases to be made", and substituted "that costs more than $100,000" for "lower price".

Prior Laws:

Acts 1993, 73rd Leg., ch. 684, § 14.
Vernon's Ann.Civ.St. art. 601b, § 3.061.

§ 2155.204. Local Government Purchasing Program

The commission's provision of purchasing services for local governments is governed by Subchapter D, Chapter 271, Local Government Code.[1]

Added by Acts 1995, 74th Leg., ch. 41, § 1, eff. Sept. 1, 1995.

[1] V.T.C.A., Local Government Code § 271.081 et seq.

[Sections 2155.205 to 2155.260 reserved for expansion]

SUBCHAPTER E. MASTER BIDDERS LIST

§ 2155.261. Applicability

This subchapter:

(1) applies to a purchase or other acquisition under this chapter or Chapters 2156, 2157, and 2158 for which competitive bidding or competitive sealed proposals are required;

(2) applies to a state agency that makes a purchase or other acquisition under this chapter or Chapters 2156, 2157, and 2158, including the commission and an agency that makes an acquisition under Section 2155.131 or 2155.133; and

(3) does not apply to a purchase or other acquisition made by the commission under Subchapter A, Chapter 2156.

Added by Acts 1995, 74th Leg., ch. 41, § 1, eff. Sept. 1, 1995.

Historical and Statutory Notes

Prior Laws:
Acts 1991, 72nd Leg., 2nd C.S., ch. 8, § 2.05.
Acts 1993, 73rd Leg., ch. 684, § 18.
Vernon's Ann.Civ.St. art. 601b, § 3.101(a).

Cross References

Purchases by state agencies less than specified monetary amount, see V.T.C.A., Government Code § 2155.132.

§ 2155.262. Uniform Registration Form

(a) The commission shall develop a uniform registration form for applying to do business with the commission or with another state agency.

(b) The commission and each state agency shall make the form available to an applicant.

(c) The form must include an application for:

(1) certification as a historically underutilized business;

(2) a payee identification number for use by the comptroller; and

(3) placement on the commission's master bidders list.

(d) A state agency shall submit to the commission each uniform registration form that it receives. The commission shall send to the comptroller a copy of each uniform registration form.

Added by Acts 1995, 74th Leg., ch. 41, § 1, eff. Sept. 1, 1995.

Historical and Statutory Notes

Prior Laws:
Acts 1991, 72nd Leg., 2nd C.S., ch. 8, § 2.05.
Acts 1993, 73rd Leg., ch. 684, § 18.
Vernon's Ann.Civ.St., art. 601b, § 3.101(b), (c).

§ 2155.263. Commission to Maintain Centralized Master Bidders List

(a) The commission shall maintain a centralized master bidders list and annually register on the list the name and address of each vendor that applies for registration under rules adopted under this subchapter. The commission may include other relevant vendor information on the list.

(b) The commission shall maintain the centralized master bidders list in a manner that facilitates a state agency's solicitation of vendors that serve the agency's geographic area.

(c) The centralized master bidders list shall be used for all available procurement processes authorized by this subtitle and shall also be used to the fullest extent possible by state agencies that make purchases exempt from the commission's purchasing authority.

Added by Acts 1995, 74th Leg., ch. 41, § 1, eff. Sept. 1, 1995. Amended by Acts 1997, 75th Leg., ch. 1206, § 10, eff. Sept. 1, 1997.

Historical and Statutory Notes

Acts 1997, 75th Leg., ch. 1206, inserted "centralized" throughout the section; and added subsec. (c).

Prior Laws:
Acts 1991, 72nd Leg., 2nd C.S., ch. 8, § 2.05.
Acts 1993, 73rd Leg., ch. 684, § 18.
Vernon's Ann.Civ.St., art. 601b, § 3.101(d).

§ 2155.264. Agency Solicitation of Bids or Proposals for Acquisition Over $15,000

A state agency that proposes to make a purchase or other acquisition that will cost more than $15,000 shall solicit bids or proposals from each eligible vendor on the master bidders list that serves the agency's geographic region. A state agency may also solicit bids or proposals through the use of on-line electronic transmission or the electronic commerce network.

Added by Acts 1995, 74th Leg., ch. 41, § 1, eff. Sept. 1, 1995. Amended by Acts 1997, 75th Leg., ch. 494, § 2, eff. Sept. 1, 1997.

Historical and Statutory Notes

Acts 1997, 75th Leg., ch. 494, added the last sentence.

Prior Laws:
Acts 1991, 72nd Leg., 2nd C.S., ch. 8, § 2.05.
Acts 1993, 73rd Leg., ch. 684, § 18.
Vernon's Ann.Civ.St., art. 601b, § 3.101(d).

§ 2155.265. Access to Master Bidders List

(a) The commission shall make the master bidders list available to each state agency that makes a purchase or other acquisition to which this subchapter applies.

(b) The commission shall make the list available either electronically or in another form, depending on each state agency's needs.

Added by Acts 1995, 74th Leg., ch. 41, § 1, eff. Sept. 1, 1995.

Historical and Statutory Notes

Prior Laws:

Acts 1991, 72nd Leg., 2nd C.S., ch. 8, § 2.05.
Acts 1993, 73rd Leg., ch. 684, § 18.
Vernon's Ann.Civ.St., art. 601b, § 3.101(e).

§ 2155.266. Registration and Renewal Fee

(a) The commission may charge a person applying for registration on the master bidders list a registration fee and may charge a registrant an annual renewal fee in an amount designed to recover the commission's costs in:

(1) making and maintaining the master bidders list; and

(2) soliciting bids or proposals under this subchapter.

(b) The commission shall set the amount of the fees by rule.

Added by Acts 1995, 74th Leg., ch. 41, § 1, eff. Sept. 1, 1995.

Historical and Statutory Notes

Prior Laws:

Acts 1991, 72nd Leg., 2nd C.S., ch. 8, § 2.05.
Acts 1993, 73rd Leg., ch. 684, § 18.
Vernon's Ann.Civ.St., art. 601b, § 3.101(f).

§ 2155.267. Commission Rules and Procedures Regarding Master Bidders List

(a) The commission shall adopt procedures for:

(1) making and maintaining the master bidders list; and

(2) removing an inactive vendor from the list.

(b) The commission shall establish by rule a vendor classification process under which only a vendor able to make a bid or proposal on a particular purchase or other acquisition may be solicited under this subchapter.

Added by Acts 1995, 74th Leg., ch. 41, § 1, eff. Sept. 1, 1995.

Historical and Statutory Notes

Prior Laws:

Acts 1991, 72nd Leg., 2nd C.S., ch. 8, § 2.05.
Acts 1993, 73rd Leg., ch. 684, § 18.
Vernon's Ann.Civ.St., art. 601b, § 3.101(g), (h).

§ 2155.268. Use of State Agency Bidders List

(a) A state agency may maintain and use its own bidders list only if the commission determines by rule that the agency has specialized needs that can best be met through maintaining and using its own specialized bidders list.

(b) The commission by rule may prescribe the categories of purchases or other acquisitions for which a state agency's specialized bidders list may be used.

(c) A state agency may supplement the bidders list with its own list of historically underutilized businesses if it determines that the supplementation will increase the number of historically underutilized businesses that submit bids.

(d) A state agency may purchase goods and services from a vendor who is not on the bidders list if the purchase price does not exceed $5,000.

Added by Acts 1995, 74th Leg., ch. 41, § 1, eff. Sept. 1, 1995. Amended by Acts 1997, 75th Leg., ch. 1206, § 11, eff. Sept. 1, 1997.

Historical and Statutory Notes

Acts 1997, 75th Leg., ch. 1206 added subsec. (d).

Prior Laws:
Acts 1991, 72nd Leg., 2nd C.S., ch. 8, § 2.05.

Acts 1993, 73rd Leg., ch. 684, § 18.
Vernon's Ann.Civ.St., art. 601b, § 3.101(i).

§ 2155.269. Waiver

The commission by rule may establish a process under which the requirement for soliciting bids or proposals from eligible vendors on a bidders list may be waived for an appropriate state agency or an appropriate purchase or other acquisition under circumstances in which the requirement is not warranted.

Added by Acts 1995, 74th Leg., ch. 41, § 1, eff. Sept. 1, 1995.

Historical and Statutory Notes

Prior Laws:
Acts 1991, 72nd Leg., 2nd C.S., ch. 8, § 2.05.

Acts 1993, 73rd Leg., ch. 684, § 18.
Vernon's Ann.Civ.St., art. 601b, § 3.101(j).

§ 2155.270. Agency Assistance With Bidders List Issues

The commission may assist a state agency with issues relating to a bidders list.

Added by Acts 1995, 74th Leg., ch. 41, § 1, eff. Sept. 1, 1995.

Historical and Statutory Notes

Prior Laws:
Acts 1991, 72nd Leg., 2nd C.S., ch. 8, § 2.05.

Acts 1993, 73rd Leg., ch. 684, § 18.
Vernon's Ann.Civ.St., art. 601b, § 3.101(j).

[Sections 2155.271 to 2155.320 reserved for expansion]

TEXAS WATER DEVELOPMENT BOARD

February 22, 1999

Mr. Jack E. Stowe, Jr.
President
Reed-Stowe & Co., Inc.
1651 N. Collins Boulevard, Suite 115
Richardson, Texas 75080-3658

Re: Review Comments for Draft Report Submitted by Reed-Stowe & Co. (Contractor), Inc., TWDB Contract No. 99-483-275, "Water Marketing Strategies"

Dear Mr. Stowe:

Staff members of the Texas Water Development Board have completed a review of the draft report under TWDB Contract No. 99-483-275 as shown in the comments, the report is unacceptable as written. The Contractor should revise the report based on the comments from the Executive Administrator shown in Attachment 1. The Contractor should then provide the Executive Administrator with the revised draft final report for further review.

Please contact Ms. Danna Stecher, the Board's Contract Manager, at (512) 936-0854 if you have any questions about the Board's comments.

Sincerely,

Tommy Knowles
Deputy Executive Administrator
Office of Planning

cc: Danna Stecher, TWDB

ATTACHMENT 1
TEXAS WATER DEVELOPMENT BOARD

REVIEW COMMENTS: REED-STOWE & COMPANY, INC.
Contract No. 99-483-275

The following are Board Staff comments:

- The title of the report should be changed to "Market Strategies for Improved Service by Water Utilities" since the report has little to do with "water marketing" as most people think of the term.

- The Executive Summary is more like a brief introduction instead of a summary of the report. The Executive Summary should summarize the complete report in a few pages. Please redo the Executive Summary so it summarizes the report from beginning to end, in a few pages. The use of tables, charts and/or graphs in this summary is highly recommended.

- Please develop a list of acronyms that are used within the report (e.g., AWWA =American Water Works Association). The list of acronyms should be placed immediately after the Table of Contents.

- There is good information in the report; however, the good information is sometimes hard to find within the report. For example, in Chapter 1 on page 5, the four types of competitive marketing strategies are listed and defined. A sentence could be added to page 5, such as the following: "The characteristics, benefits and risks of these four competitive marketing strategies are discussed in more detail in Chapter 3." Also on page 5, the page numbers to find these individual discussions could be added, such as, managed competition is discussed on page 14, contract operations on page 17, etc. The whole report should be made more "user friendly".

- In Chapter 3, a comprehensive table and/or tables listing the benefits and risks of the four competitive marketing strategies should be developed and presented in the report.

- The contractor should show advantages and disadvantages of each method of water marketing. Although Chapter 3 lists "benefits and risks" of the methods, there is no discussion or a comparative evaluation of the methods. The contractor needs to extend the discussion to the required conclusions.

- The contractor has an appendix showing examples of some privatization, by size of population in selected areas, but this is just a description of the "how" they privatize. There are no lists anywhere in the report of "successful" efforts and why they are so.

The contractor should at least set criteria for judging success (lowering rates, better service ratings, etc.) and then **analyze** the common reasons these examples are successful.

- The contract requires the contractor to identify any desirable or necessary changes to state and local statutes that would encourage voluntary privatization. The report includes some discussion of IRS rules and other ad hoc topics, but does not include such an identification of Texas statutes that apply in this area. This element of the report is totally inadequate.

- Pages 10-11 and 53-57 were reviewed by the Board's Legal staff for legal sufficiency. The statements regarding federal and state laws are incorrect or misleading. A court case is cited to tell us that emergency conditions are excluded from the Government Code. We aren't told what this has to do with cities, which are governed by the Local Government Code. Rules have been confused with statutes and the opinions of unnamed sources are quoted extensively. Additionally, there are too many sentences that carry misinformation or strange statements that seem to have no point. An example is on page 10, paragraph two: "The EPA's "Guidance" defined contractual agreements fees as "lease-type" agreements it up-front concession payments had been made to the city." The nature of the writings in the report suggests that the pages were neither produced nor checked by an attorney, and the Board should in no way rely on the information in the report as accurately identifying the legal considerations of privatization of public infrastructure.

- Pages 10-11 and 53-57 should be completely rewritten, with assistance from counsel.

- In Chapter 4, there is much information that is spread throughout the chapter. Some of the information should be gathered together and presented in a summary form that would make it easier for the reader to absorb. For example, page 37 has "Reasons that Texas Cities use Privatization"; page 38 has "Impediments to Privatization Identified by Texas Cities"; page 39 has "Company Reasons for Privatization"; and page 40 has "Impediments to Privatization Identified by Companies". These previous four lists should be summarized in a single table where the reader can easily make a comparative analysis. The contractor should not limit his revisions to the preceding example, but should consider summarizing other information throughout the report in tables, charts and/or graphs.

- Pgs. 1-2 and 57 - What is the status of the "positive acquisition adjustment"?

- Pg. 1 - IRS Procedure 97-13 did not reproduce completely, or a page is missing in the draft.

- Pg. 3 - What about involvement of other agencies in providing infrastructure capital -

USDA, HUD, EDA...

- Pg. 4 - Discussion is limited to federal share of SRF. More important, what is the total Texas SRF capital available.

- Pg. 5 - definition of managed competition is unclear.

- Pg. 8 - first para - could we get a chart or table with ownership and customer statistics?

- Pg. 8 - last para - TWDB has been financing local water facilities since late 50's...

- Pg. 10 - first para - please include this EPA position paper in the regulations appendix.

- Pgs. 10-11, 55-56 - It is suggested that this discussion about competitive bidding be eliminated, and just use the solicitation process indicated on p. 69... Why would we question the validity of soliciting bids or RFP's when the whole issue is competition? If we seek to limit competition among private service providers, aren't we seeding our same troubles?

- Pg. 17 - Charlotte case study needs more detailing in the appendix.

- Pg. 21 - Staffing should detail individuals by name and their qualifications

- Pg. 23 - Address integration of such a contract into the owner's financial statements and audit process.

- Pg. 34 - Please provide the listing indicated in "Responses".

- Pg. 58, third paragraph does not make sense. The paragraph needs to be rewritten.

- The chart on page 58 needs clarification. The title of the chart is simply "Results of Texas and national surveys". Are the results for "competitive market strategies", or something else? The left-hand side of the chart should be labeled to indicate the identity of the numeric values that are presented in the chart. Is "O&M Contract" the same as "Contract Operations"? If this chart is summarizing competitive market strategies, what happened to "lease agreements"?

- Chapter 6 (Recommendations) should include a discussion related to legislative or regulatory changes that might need to occur to support the research findings of the study.

TEXAS WATER DEVELOPMENT BOARD

May 3, 1999

RECEIVED
MAY 10 1999
BY:

Mr. Jack E. Stowe, Jr.
President
Reed-Stowe & Co., Inc.
1651 N. Collins Boulevard, Suite 115
Richardson, Texas 75080-3658

Re: Water Research Contract Between Reed-Stowe & Co. and the Texas Water Development Board (Board), TWDB Contract No. 99-483-275, Review Comments for Revised Draft Report "Market Strategies for Improved Service by Water Utilities"

Dear Mr. Stowe:

Staff members of the Board have completed a review of the revised draft report under TWDB Contract No. 99-483-275. As stated in the above referenced contract, Reed-Stowe & Company will consider incorporating comments from the EXECUTIVE ADMINISTRATOR shown in Attachment 1 and other commentors on the revised draft final report into a final report. Reed-Stowe & Company must include a copy of the EXECUTIVE ADMINISTRATOR's comments in the final report.

The Board looks forward to receiving one (1) unbound camera-ready original and nine (9) bound double-sided copies of the Final Report on this planning project. Please contact Ms. Danna Stecher, the Board's Contract Manager, at (512) 936-0854 if you have any questions about the Board's comments.

Sincerely,

Tommy Knowles, Ph.D., P.E.
Deputy Executive Administrator
Office of Planning

Cc: Danna Stecher, TWDB

ATTACHMENT 1
TEXAS WATER DEVELOPMENT BOARD

Review Comments: REED-STOWE & COMPANY
TWDB Contract No. 99-483-275

P. 10 If the 7,000 privately owned utility information could not be confirmed with the author, was it confirmed with TNRCC?

P. 32-3 the discussion of financial benefits is not clear-headed. Because any federally funded assets can be depreciated, does not mean they can be given away or sold without reimbursement to EPA. All residual value of facilities must be accounted for. This was part of the Board's comments on the first draft - address the integration of a management or operating contract into the owner's financial statements and audit process. The issue of any outstanding bonded debt and its treatment in a sale of the utility must be more clearly stated. While the debt may track the asset, there are many legal restrictions on such a transfer. Also remember that if the asset is sold, so is the revenue production attributed to that asset. While it is stated this "free(s) up municipal debt capacity", the accuracy of this statement is challenged.

P. 72 add audit to contract elements: the owner must have the right to audit records of the contractor.

P. 4 under Phase 4 Interviews, "page___" should be completed.

P. 5 the table heading: "Recommended Contractual Terms" should be "Recommended Contractual Elements". Other references to "terms" within content should be changed to elements.

P. 8 second paragraph, last line, "empower" should be changed to "yield", "produce", "generate" or something of that vein.

P. 11 fourth paragraph, the reference in time "Prior to federal involvement, the Texas Water Development Board ~~has been~~ (was) financing" is misleading. The federal government was financing both local and regional water projects before the Board was created; therefore, delete the phrase "Prior to federal involvement".

P. 12 second paragraph, **the State Revolving Fund** didn't exist until 1987. Hence, it didn't assume more importance, it **was created** (PL 100-4) specifically **to phase-out construction grants** in FY 1990.

P. 12 fourth paragraph, third line, "it" should be "if".

P. 14 first paragraph, second line, delete comma and add a colon after "four general categories".

P. 16 sixth line, "I" should be "If".

P. 15 second paragraph, first line, "Specifiaclly" should be "Specifically".

P. 15 second paragraph, fourth line, delete "the" between "key" and "advantages".

P. 17 first paragraph, second line, colon after "improvements" should be a period.

P. 31 fourth line, the use of the word "defease" is strongly discouraged. It is a term of "art" in the bond and security industry. Suggest the use of reduce, retire, or refund, as appropriate. Other references to the term in context should be changed appropriately.

P. 32 last paragraph, "defeasement" should be replaced or deleted.

P. 39 Table 9, some of the city names are wrong: "Georgecity" should probably be "Georgetown", "Lampassas" is correctly spelled "Lampasas", and "Huple" must be an error since a city by that name does not exist in Texas.

Additionally, the city names under the section "Texas Cities" has Lampasas spelled incorrectly, and the City of Huple is again listed. The city of Frost is listed two times, and the city of "Coldspringmsneil" is an error and needs to be corrected.

P. 45 third paragraph, "the federal government passed" should be replaced with "the President issued" or "President Bush issued".

P. 46 fourth paragraph, the discussion isn't clear how the EPA ruling impacts the current situation. No construction grants have been awarded since 1990. The awards were grants, not loans. Any grant award would have occurred already.

P. 46 fifth paragraph, third line, is the use of the word "interest" meant to indicate ownership? If so, a better word could have been utilized.

P. 56 second paragraph, first line, "writer" should be "author".

P. 56 the third paragraph should be deleted. It adds nothing to the content of the report.

P. 57 the third paragraph, third line, a verb, such as "review", should be added after "Each city should...".

P. 59 fifth paragraph, fifth line, please correct the formatting error.

P. 60 last line, another formatting error, please place title of section on next page.

P. 61 first paragraph, fifth line, add "by" between "commonly" and "cities".

P. 62 first paragraph, first line, "experienced" should be "experiences".

P. 71 last paragraph, second line, "weighed" should be "weigh".

P. 73 first line, sentence needs to be rewritten.

P. 57 the writer cites a lawsuit Browning-Ferris, Inc. v. City o f Leon Valley et al as precedent that competitive bids are not required under Texas statute. This is not a true statement. The most that can be said is that at least one Texas court found that the timely collection of garbage was a public health necessity and that the garbage contract did not have to go through the delays of competitive bidding. (In this case, the garbage collector quit over a contract dispute and garbage was stacking up).

There is no justification for reading into this case that water and wastewater contracts (which are not even mentioned in the case) are excluded from requirements for competitive bidding. If the writer wants to mention the case, he should note that the case involved uncollected garbage and was a narrow decision based on what the court regarded as an "emergency" situation. It is established law that emergencies are excluded from competitive bidding requirements. It's just that while water and wastewater projects are sorely needed, even crucial, they rarely meet the criteria of "emergency", that is, unexpected and posing a sudden threat to public health.

P. 64 The Chapter 6 discussion should include a brief discussion, similar to that on page 4, that private legal counsel were interviewed to identify potential statutory amendments to facilitate privatization and/or competition, and no recommendations for changes to existing Texas statutes were offered by the private legal counsel.

In the Section entitled "Case Studies", first page of Charlotte study, second paragraph, third line, "exorcise" should be "exercise".

Under the Section "Case Studies", second page, sixth line from the bottom, "biding" should be "bidding".

Under the Section "Case Studies", third page, first line, "qualications" should be "qualifications".