A Flood of Choices: Considering Privatization of Water Utilities

A look at the major factors in deciding on municipal water system management

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Image courtesy of Humberto Gunn

Municipalities with publicly-owned water systems, whether for drinking water or sewage, face a fundamental choice–retain control, contract for management (public-private partnerships, or PPP), or sell (full privatization). These government utilities are municipal utilities, operated as municipal departments, or municipal utility authorities (MUAs) serving one or more towns.

If the municipality keeps control or contracts out, they can make a different decision later. The decision to sell is essentially permanent.

In every case, the choice should not be made absent hard, public analysis.

WHAT ARE THE CRITICAL FACTORS FOR CONSIDERATION?

Two major questions should be answered. First, why change from public management? Second, what should be gained from private management?

We should be very clear in our understanding of one point. These decisions have nothing to do with who owns the water, and what operational standards must be met. The law is very clear—water resources of New Jersey are owned by the public and are managed on their behalf by the State of New Jersey. The drinking water and wastewater treatment quality standards are all the same regardless of ownership, as are construction standards.

So what really changes with ownership? The major changes may include:

1. The burden of management
2. The capabilities of the utility
3. The source and use of utility funds
4. Rate implications

Let's look at each of these changes in light of the two questions noted previously.

THE BURDEN OF MANAGEMENT New Jersey has more public community water supply utilities than municipalities. Some are small private companies, such as for mobile home parks. Others are large investor-owned utilities. Many are municipal utilities or MUAs. We have fewer public sewerage entities, nearly all of them government-owned.

Regardless of municipal administration, the work of a municipal utility is overseen by the municipal governing body, few of which have real expertise in utilities. When all is going well, the tendency is to focus on more familiar municipal priorities, such as police. When things go bad or a major rate increase looms, it is understandable that elected officials seek ways to outsource management.

The smaller or poorer the municipality, the more likely this is to be true.

This is one reason we have municipal utility authorities (MUAs), which have appointed boards that can become familiar with utility issues. The MUA board can hire necessary expertise to run the utility. This system works well as long as no major issues slop over into the political realm.

Unfortunately, major rate increases, declining service quality, conflicts over service areas, and a desire to monetize utility assets bring MUAs into conflict with elected officials. The result again is that elected officials may opt for private management. In this case, both small municipalities and cash-starved ones (regardless of size) will be tempted to act.

What might they want to achieve through a PPP or sale? First, to be relieved of a responsibility that is complex, costly and diverting them from other major public priorities. Second, to limit or eliminate public liability for future costs. Third, to shift control to those perceived to have greater expertise, access to capital, or flexibility.

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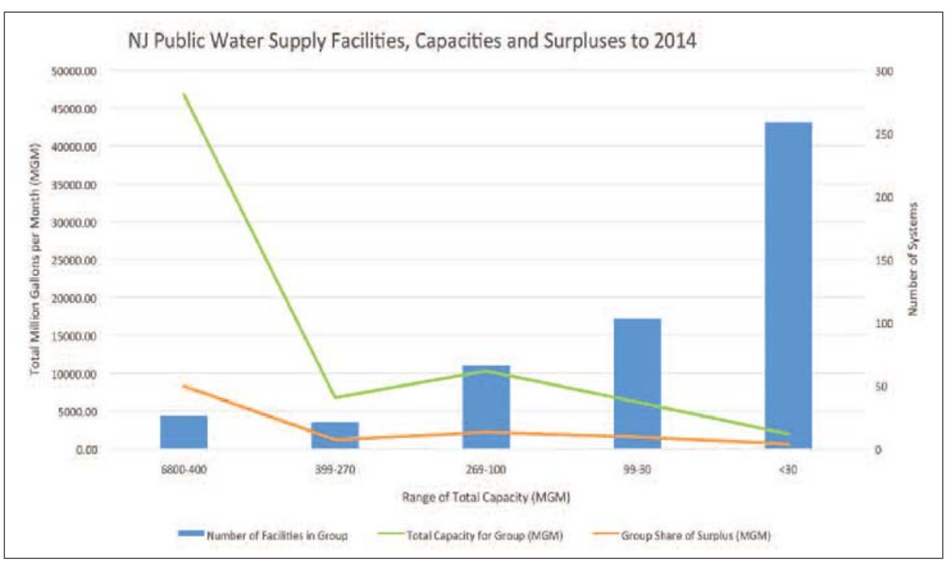
THE CAPABILITIES OF THE UTILITY Major players in the public and private sectors have told me that a water utility of sufficient size can be operated in a competent, cost-effective manner under public ownership. The simpler the system, the smaller that "sufficient size" will be. Unfortunately, what is possible doesn't always happen.



It is reasonable that larger organizations will have greater capabilities, as they are sufficiently complex to justify and afford staff with greater expertise. However, most large water utilities in New Jersey are investor-owned companies. Government utilities generally avoid mergers, acquisitions, public-public partnerships, and the like. They remain static while the private sector grows.

The desire for enhanced capabilities might drive elected officials toward private sector involvement. They generally neglect to investigate similar public sector opportunities, or give up due to lack of willing partners.

THE SOURCES AND USES OF UTILITY FUNDS Municipal utilities and MUAs may receive their funding directly from customers (through rates), from the municipal ad valorem tax (paid to the utility through the local budget), or both. Municipal utility and MUA revenues should serve utility purposes. However, under existing law municipalities may divert some revenues for other municipal purposes. Some do, some don't.

PPP firms get their funding through the contract. Going to a PPP contract may increase utility revenues through better collections, but may decrease revenues to the municipality by redefining what can be diverted. A private utility gets its funding from the ratepayers. Both PPP contracts and outright sales often come with upfront cash payments that benefit taxpayers by offsetting property tax revenue needs for a year or so, but are paid for by utility customers through rates long term.

A recent state law reduces oversight of these payments. All in all, that seems like a bad deal for ratepayers, but elected officials may see the funding as a boon that helps get them through another bad budget year.

RATE IMPLICATIONS Some interests oppose private ownership of water utilities, in part because of the profit motive. As noted above, elected officials can also find ways for government utilities to provide a "profit" but in this case it benefits taxpayers at the expense of ratepayers, who are not necessarily the same entities.

What the elected officials may hope for, especially in the case of a PPP, is that the private company will be able to reduce costs sufficiently to allow for their profit margin without a significant increase in rates. The rates are often specified in the PPP contract. However, those contracts also generally make the municipality responsible for major capital costs, either entirely or beyond a fixed amount in the contract. So, while one part of the rate may be fixed, another critical part is not—and that part is highly likely to grow as our infrastructure ages and crumbles. For a sale, the rates become the problem of the Board of Public Utilites, and the municipal officials are off the hook.

SO, DOES PRIVATIZATION COST MORE? The best response: To whom and for what? My team at Rutgers was unable to find a statewide inventory of water utility rates, and so compiled 2013 drinking water and sewer rates in municipalities with combined sewer systems, for a New Jersey Future study.

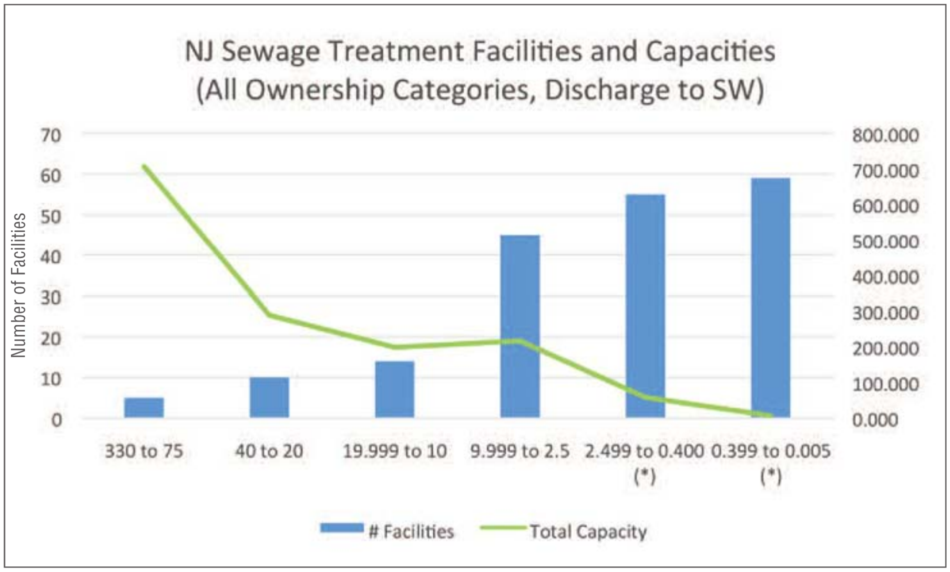
For a nominal household in municipalities with combined sewer systems use of 60,000 gallons per year, annual average drinking water costs of $380.

For investor-owned drinking water systems, the average annual cost for the utilities was $424, 11.6 percent higher.

None of the sewer systems were investor-owned utilities.

The problem with comparing rates is that we have no real sense of how well maintained each system might be. Are investor-owned rates higher because of greater capital investments, higher financing costs, or profit margins? The latter two can be determined, but the first one requires an understanding of the overall capital needs for both the government-owned and investor-owned systems, which are not generally available.

The problem with comparing rates is that we don't really know what we are comparing. The entire debate degrades into unsupportable claims. Therefore, municipalities are likely to use the four issues above as their benchmarks for decision making.



Well-run systems in financially sound municipalities are unlikely to be privatized—the problems that drive change don't exist, and so inertia will win. Problematic utilities, or those in fiscally-strained municipalities, offer perceived benefits. PPP contracts offload responsibility and gain short-term cash. For sales, negotiations set the price even though the utility may not have much real net worth (assets minus liabilities).

BPU and the Ratepayer Advocate no longer have much leverage to ensure a fair price, and so the costs probably will be folded into the broader rate structure of the private company. The result is that the rates of many people go up a little, and the rates of a few people could drop significantly. It's a local political win, but a societal loss.

FINAL THOUGHTS My conclusions include several points:

- Public enterprises should be able to match private sector capabilities but are too often constrained from doing so.
- Privatization can be a valid approach, but is certainly no panacea.
- Privatization is seen as a method to outsource problematic issues.

Finally, we lack the information to credibly compare costs of public and private ownership, in part because we lack decision-making systems that require analysis before action.

The views in the article have not been reviewed or endorsed by Rutgers University.