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Working Party No. 2 on Competition and Regulation

ROUNDTABLE ON COMPETITION AND REGULATION IN THE WATER SECTOR

-- United States --

The attached document is submitted by the delegation of the United States to the Working Party No. 2 of the Competition Committee FOR DISCUSSION under Item IV at its forthcoming meeting on 10 February 2004.

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ROUNDTABLE ON COMPETITION AND REGULATION OF WATER SUPPLY

Submission of the United States

1. Provision of water and wastewater services in the U.S. is handled at the local level, with little federal oversight other than environmental regulation, including water safety standards, although federal financing plays an important role in the industry. Competitive forces have recently begun to affect the sector:

> The water industry has and will continue to display many characteristics of monopoly. Nevertheless, the water industry in the late 1990s has felt the forces of competition. Water utilities are competing with themselves and with others in a number of venues, including: extending services to unserved or underserved areas; engaging in acquisitions and mergers (voluntary); bidding for operations contracts; bypassing the utility (including self-supply); purchasing water on wholesale markets; trading water rights (alternative uses); maintaining a service and quality image (bottled water); promoting public versus private ownership; contesting markets, ownership, takeovers; and participating in convergence acquisitions.[1]

Structure of the U.S. Water Industry

2. The structure of the U.S. water industry is described in *Privatization of Water Services in the United States: an Assessment of Issues and Experience*, National Research Council, National Academy Press (2002), pp. 2-3:

> Historically, water services were initially delivered by private providers in many cities in the United States, such as Boston, New York, and Philadelphia. As these and other larger U.S. cities grew, water services became a core function of local government. This trend accelerated largely because of a legislative change after World War I, when Congress exempted interest payments on municipal bonds from federal income tax. This assured that municipalities could issue bonds at lower interest rates than those for taxable bonds.
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> The U.S. water industry today is highly diversified. As of 1999, there were nearly 54,000 community water systems in the United States. ... The vast majority of these systems serve small populations. In fact, 85 percent of U.S. community water systems serve only 10 percent of the population served by community water systems.
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> Investor-owned water supply utilities (i.e., "private utilities") accounted for about 14 percent of total water system assets in the United States in 1995. Investor ownership of wastewater utilities is more limited than investor ownership of water supply utilities, in part because of extensive federal funding of wastewater treatment plants that began after World War II. Investor-owned water supply and wastewater facilities are subject to state economic regulation that oversees rates charged, evaluates infrastructure investments, and controls profits. In contrast, private contract arrangements under public ownership are not subject to state economic regulation. According to the National Association of Water Companies (NAWC), the proportion of water services in the United States provided by

[1] Beecher, Janice A., Privatization, Monopoly, and Structured Competition in the Water Industry: is there a Role for Regulation?, paper presented at the 1999 American Water Works Association Annual Conference.

private water companies, whether measured by customers served or volume of water handled, has remained close to 15 percent since World War II.

The term "privatization" covers a wide spectrum of water utility operations, management, and ownership arrangements. The four major classes of privatization options can be characterized as (1) private provision of various services and supplies such as laboratory work, meter reading, and supplying chemicals; (2) private contracting for water utility plant operation and maintenance (both 1 and 2 are often referred to as "outsourcing"); (3) negotiating a contract with a private firm for the design, construction, and operation of new facilities (this option is referred to as design, build, and operate, or DBO); and (4) outright sale of water utility assets to a private company. In the United States, the contracting of management and operations to a private provider (outsourcing) has been more common than the sale of utility assets to private companies. No major U.S. city has sold its utility assets in recent decades, although some smaller water utilities have done so.

Issues Relating to Privatization

3. The National Research Council addressed a number of issues in the conclusions to its study of privatization of water services in the United States:

Water services privatization takes many forms, and no one type fits all situations, complicating the choices that communities face if they consider reorganizing their water and wastewater-utilities. The range of choice extends from (1) "outsourcing" of various services such as provision of supplies and meter reading; (2) private contract operation and maintenance of existing plants; (3) contracts for the integrated design, construction, and subsequent operation of new facilities (DBO contracts); and (4) sale of public utility assets to investor-owned companies that take responsibility for all operations, maintenance, and expansion of services. Outright sale of public assets has been infrequent in the United States except for "regionalization" of small utilities. Nonetheless, investor-owned companies have historically played and continue to play an important role in providing water services in the United States.

Private contractors are often large companies with extensive experience and expertise that they can bring to bear on local operations. Contractual arrangements usually give them greater freedom in dealing with the workforce, which is often the greatest single source of cost savings. Large operating savings have, indeed, been achieved under existing contracts. Under some circumstances, private companies can provide needed capital. Also, private operators, being under contract or owning the utility, are often farther removed from local politics. This has the advantage of less political intervention in matters of technical management, but can lead to less transparency and accountability.

The largest gains from the new water utility privatization environment in the United States are likely to come from improved operations of the majority of water utilities that will remain publicly owned. The presence of private alternatives has clearly motivated improved performance on the part of public utilities. "Contestability" for public utilities has been ratcheted up by the existence of attractive private alternatives. Some larger public systems are actively working with smaller suburban utilities to provide better water sources and better management. This form of regionalization promises to yield large benefits.

Small-to medium-sized utilities face the greatest challenges and problems and are prime candidates for availing themselves of private services. Small and medium-sized utilities often lack needed expertise to meet today's high standards for drinking water and wastewater treatment. Consolidation and regionalization of small-to-medium sized utilities holds great promise for improved performance. New management, communication, and monitoring technologies create opportunities for economies

of scale and scope. The small water utilities that comprise 85 percent of all water utilities could benefit from physical consolidation or provision of services through regionalization. Both are being provided by leading public utilities as well as by private companies specializing in assistance to small utilities.

Procurement processes through which private services are solicited are increasingly standardized, reducing uncertainty on both the public and private sides. The challenge is to find ways of standardizing procedures to reduce costs while not infringing on the freedom of municipalities or contractors to propose innovative approaches.

Communities often express concerns when considering privatization options, which include possible impacts on public goods such as environmental protection, water quality protection, transparency of decision processes, and openness to public input. The capacity to take over operations in case of contractor failure to perform is an issue, as is the need for the municipality to develop the capability to monitor the work of the contractor—a set of skills that differs from those needed for ordinary municipal operation. Concern for the continued employment and welfare of the utility workforce is often expressed. Possible loss of services provided by the water utility for other municipal departments (e.g., snow removal, flood-control measures, drainage systems) is a concern at times. In a longer time perspective, there are concerns about maintenance of water-shed lands, protection of raw water sources, and provision of recreational opportunities, as well as public health, under privatization. Reservoir and watershed lands are often highly valuable, and there may be pressure to develop these lands if privately owned. However, privatization of operations and maintenance need not imply turning over ownership of land and water rights.

Another concern is that water rates charged to customers following privatization have in some instances gone up. But rates can move in either direction, depending on the financial condition of the utility, the cost savings realized, and near–term improvements and investments called for under the contract. Historically, public utility water rates have been only loosely tied to costs, while public officials have sometimes been unwilling to charge appropriate prices because of a tradition of underpricing. However, customers appear to highly value reliability and quality, and surveys have shown customers have a significant willingness to pay for high-quality services.

The term “privatization” tends to evoke the presence of a competitive environment with the attendant advantages of competitive markets, especially in the U.S. setting of markets that are frequently quite competitive. However, the “natural monopoly” attributes of water services (capital intensity, high costs of duplicating infrastructure) make competition of the usual type unlikely or impossible.[2] Strong competition is likely to exist at the point in time when private proposals are submitted, and competition may continue along the boundaries of the service area. But during the contract period, continued monitoring of performance is needed to protect against failures to perform according to the contract. Conditions of the contract must substitute for active year-to-year competition. Investor-owned utilities (assets privately owned) are subject to regulation by state commissions but these commissions frequently lack the resources to oversee all utilities, especially under newer forms of

[2] In the arid conditions prevailing in much of the western U.S., a very large portion of water consumption is not for household use, but rather for irrigation of urban lawns and gardens, yet all of this water is processed to the level required for household use. The estimates range as high as 75%. Under these circumstances, there may be potential savings available from investment in parallel water distribution systems at least for high use customers -- with the additional distribution system being used for less fully processed water to be used for irrigation of urban lawns and gardens. Such investment opportunities might well be opened to private firms which would then compete with the public system to serve the demand for urban irrigation. Recent drought conditions in the great basin area has raised interest in this possibility.

ownership. In the case of publicly owned utilities, the supposition is that city government will monitor performance and prevent abuses.

There are elements of an "uneven playing field" in the competition between public utilities and private operators, especially relating to the availability of capital funds. Municipalities can issue tax-free bonds that carry lower interest rates than private bonds or loans. They often have access to "state revolving funds" not available to private firms. Until recently, there have been legal constraints on the private operation of physical plants that have been financed through public funds. ... It is thus a major public policy debate whether the subsidies to public utilities thus provided are justified by public good advantages of public ownership and operation or whether they constitute an economically inefficient and unfair financial framework. Several financial reforms are now being debated that would tend to level the financial playing field.[3]

The use of water markets to effect transfers of water from lower-valued to higher-valued uses is a different form of privatization that has long existed in the western United States but that is becoming increasingly important in all parts of the country. Utility managers, public or private, will have to learn to deal with these institutional innovations. These transfers can be temporary or permanent and are usually from agriculture to urban uses. The use of systems of water ownership and marketing that were developed in western states is expanding to other parts of the United States to allow the voluntary transfer of established water rights or contracts to new permanent or emergency uses. Water markets are subject to some degree of state supervision to protect other water users and various social and environmental values that can be impacted by changes in water use. Acquisition of water supplies through water markets will require collaboration of utility managers with state regulatory agencies.[4]

Antitrust Enforcement Related to Water Supply

4. In 1998 the Department of Justice and the City of Stilwell, Oklahoma reached a settlement that prohibited the City from withholding water service from city residents who wanted to purchase electricity from other electric companies. The agreement settled a civil antitrust lawsuit filed by the Department against the City and the Stilwell Area Development Authority. The complaint alleged that Stilwell forced local customers to buy its electricity by refusing to provide them with water and sewer services unless customers also agreed to purchase their electricity from the City. Stilwell was the sole supplier of water and sewer services within the city limits. The complaint alleged that this "all-or-none" utility policy prevented consumers from receiving the benefits of competition from a rural electric cooperative that was seeking to serve new customers in Stilwell. Under the settlement, the City may no longer use its water and sewer monopoly to suppress competition from other electric companies.

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3 When water systems are owned by municipalities, the municipality may elect to use some tax revenues to pay for part of the water system. This may be more efficient than charges that cover all costs (if one abstracts from the economic distortions caused by the added tax burden). One variation is to charge usage rates that cover the average variable costs of the system. Tax revenue then pays for the fixed costs, mostly physical plant. To the extent that usage is price sensitive, this may be a closer approximation to marginal cost pricing and may involve less distortion of consumption than average cost pricing.

4 Privatization of Water Services in the United States: an Assessment of Issues and Experience, National Research Council, National Academy Press (2002), pp. 110-113.