



January 22, 2003

Mayor Podesto and
Council Members Johnston, Nickerson, Martin, Ruhstaller, Giovanetti, and Nomura
City of Stockton
425 N. El Dorado Street
Stockton CA 95202

Subject: Independent Technical Review of Proposed Water Sector Privatization

Honorable Mayor and Council Members:

This letter and attachments presents the results of our independent technical review of the proposed privatization of water, wastewater, and stormwater services in Stockton. We performed this analysis with the support of a charitable foundation because we are active participants in the international discussion of the benefits and risks of privatization in the water sector. But as described in my letter to you dated October 18, 2002, the Pacific Institute is neither for nor against privatization in general. This letter is being sent to you simultaneous with its public release. No one outside the Institute has reviewed the report or been informed of its conclusions prior to release.

Our review supports the following conclusions:

- The potential savings from privatization in Stockton have been greatly overstated. For example, our analysis found that continued City operations would be less expensive than private contract operations (negative \$1.7 million net present dollars).
- Potential capital cost savings are significant, but less than suggested by advocates of privatization. Because the largest capital cost savings items are associated with expansion of the wastewater treatment plant to meet new effluent standards, the City could privatize the treatment plant expansion or the entire plant and capture the majority of potential savings.
- Privatization of the water system would not yield measurable financial benefits.
- The relative balance of benefits and risks is still very uncertain because new risks, such as those associated with contract enforcement, have not been evaluated.

Please feel free to contact me with any questions or concerns.

Sincerely,

Gary H. Wolff, P.E., Ph.D.
Principal Economist and Engineer

Independent Review of the Proposed Stockton Water Privatization January 2003

Performed by:

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About the Institute

Founded in 1987 and based in Oakland, California, **The Pacific Institute for Studies in Development, Environment and Security** is an independent, nonprofit organization that provides research and policy analysis on issues at the intersection of sustainable development, environmental protection and international security. Our vision and mission statements, and additional organizational materials, are available at: www.pacinst.org .

Acknowledgements

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Independent Review of the Proposed Stockton Water Privatization

January 2003

Summary of Findings and Conclusions

Those who advocate privatization in Stockton claim large savings. For example, the \$175 million of nominal-dollar (dollars of each year, unadjusted for time value of money or inflation) cost savings over the 20-year contract reported by the City's consultant -- Alternative Resources Incorporated (ARI) -- in their October 1st, 2002, evaluation report term has been widely cited by advocates for privatization. However, the net present value of cost savings estimated by ARI (Table 6-1) -- the savings expressed in today's dollars using assumptions about future inflation and interest rates -- is about \$97 million without improvements in existing City operations and about \$86 million with improvements.

Our estimate of the net present value of savings over a 20-year contract term is much different than \$86 million; in fact negative. In fact, we estimate that private operation of Stockton's water facilities would cost Stockton an additional \$1.7 million, versus a savings of \$39 million estimated using ARI's assumptions. Our estimate varies from ARI's for two reasons: 1) we've used actual historic inflation rates, and 2) we've assumed energy costs for continued City operations to be the same as the energy costs in the highest bidder's proposal, rather than the unrealistically large cost figure used by HDR based on spending during the energy crisis year of 2001-2002.

Capital cost savings are likely to be in excess of \$20 million but not as large as the \$54 million in ARI's analysis (see ARI Table 4-1 in their October evaluation report). This is because the ARI analysis compares actual bids for integrated design/ build (DB) work against planning level budget estimates for separate design and construction contracts. Nonetheless, estimated capital costs savings from the OMI/ Thames proposal are substantial.

About \$19 million of these savings are from an innovative proposal to expand the wastewater treatment plant using wetlands followed by nitrifying biotowers. OMI/ Thames appears to be well qualified to implement this approach and seems to offer strong performance guarantees. These guarantees and qualifications are critical, however, since the City's wastewater design consultant (Parsons/ Carollo, September 2002) previously excluded wetlands followed by an additional nitrification step from further consideration because it would cost significantly more, in their opinion, than other alternatives if it were designed to achieve the nitrogen effluent standard as reliably as other alternatives.

Consequently, we suggest that the City consider privatizing the expansion of the wastewater treatment plant as a separate decision from privatization of other operations and capital improvements. The largest capital savings are in this area; and the rationale for savings is clearest here as well (a contractor prepared to take a technology risk and insure the City against failure).

With respect to the remainder of the privatization decision, the relative balance of risks and benefits is still very uncertain. But operational savings are small if not negative and new risks from privatization are only now entering the public dialogue and decision process. For example, contract enforcement risk couldn't be fully evaluated prior to release of the draft contract.

One piece of objective information that would be useful is an evaluation of the capital costs of facilities using a design/ build (DB) approach with City operation rather than the traditional public works approach of separate design and construction contracts prior to City operation. Estimating City costs under the first approach would allow a fair comparison to be made against the design/ build/ operate/ transfer (DBOT) approach used in the privatization RFP. Once this comparison is made, and the

contract has been available long enough for all interested parties to understand the net risks associated with it, the overall balance of benefits and risks for privatization can be better assessed.

Background

The City of Stockton is considering a privatization of its water, wastewater, and storm water systems. This does not include the water system and services currently provided by Stockton Water Services, a private company that has served parts of Stockton for many years.

Privatization takes many forms. In this case, the proposed privatization of City facilities and operations has the following major characteristics:

- Water system assets would continue to be owned by the City. This includes new assets to be built by the contractor with an estimated capital cost in the range of \$58-\$112 million.
- New assets would be financed by the City, but designed, built, and operated by the contractor until the contract term expires or the contract is renewed.
- The contract would be for 20 years. Compensation would be on a fixed fee basis with an automatic annual increase based on changes in two price indices: the consumer price index for all urban consumers in the US, and the consumer price index for energy in the San Francisco-Oakland-San Jose Metropolitan Service Area.
- Some number of current Stockton Municipal Utility District (MUD) employees would review and approve design plans for capital improvements, enforce City ordinances, and perform other residual duties such as contract oversight, water sector planning, and water conservation programs. HDR (2002) indicates that 21 of the 144.24 currently budgeted full-time equivalent positions (filled and vacant) would be retained for this purpose.
- Billing and revenue collection responsibilities are uncertain at present. The low bidder – OMI/Thames Water – proposes that billing and revenue collection continue to be performed by City staff, but under contract to OMI/Thames.
- The City would retain water-related rate decision-making authority.

Potential Benefits of Privatization

The privatization decision was apparently set in motion by concerns that existing operations were not efficient enough, and by a need to upgrade facilities – especially wastewater facilities – to satisfy regulatory requirements. Proponents of privatization claim large financial savings will result from contract operations and maintenance, and from a private design/build/operate/ transfer (DBOT) approach to capital improvements. The City's consultants -- Alternative Resources Incorporated (ARI) and Hawkins, Delafield & Wood – in their October 1st, 2002, evaluation report estimate the net present value of cost savings to be about \$97 million without improvements in existing City operations and about \$86 million with improvements (Table 6-1). They also claim that the City's risk exposure is reduced by privatization.

We reviewed these claims grouped into three areas: operating cost savings, capital cost savings, and risk exposure. Our findings are presented below, followed by some suggestions about how the City might continue from here as it tries to evaluate the benefits and risks of various privatization options.

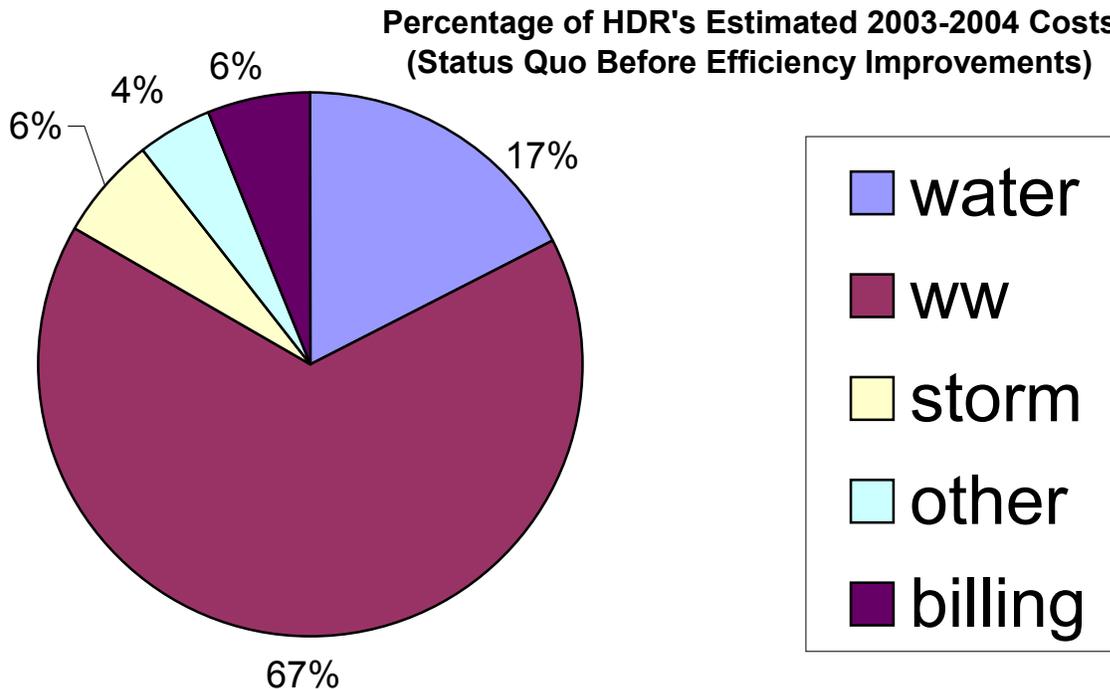
Operating Cost Savings

In order to assess the operational cost savings from the OMI/ Thames bid, we needed to re-create HDR’s baseline estimate of operational costs. We followed the procedure described by HDR, which uses a mix of actual and budgeted expenditures from several years, and inflation factors for energy and non-energy costs, to arrive at an operational cost estimate for 2003-2004. Our re-created estimate is \$20.044 million, which is only 0.44% different than HDR’s estimate of \$20.129 million. This minor difference reflects some small assumption or adjustment made by HDR that is either not in their documentation or that we are failing to understand exactly. Since efficiency improvements are not implemented until 2004-2005 in HDR’s spreadsheets, this estimate is for projected status quo operations in 2003-2004 without efficiency improvements.

	Labor	Energy	Other	Totals
Water	\$1.789	\$1.105	\$0.596	\$3.491
Wastewater	\$6.527	\$2.428	\$4.265	\$13.220
Stormwater	\$0.522	\$0.367	\$0.342	\$1.231
Other	\$0.519	\$0.000	\$0.376	\$0.895
Billing	\$0.641	\$0.000	\$0.567	\$1.208
Totals	\$9.999	\$3.900	\$6.146	\$20.044

Table 1: Pacific Institute’s Re-Creation of HDR’s FY03-04 Baseline Cost Estimate

Figure 1, based on this re-creation, shows that about 2/3 of Stockton’s water system operational expenditures are for wastewater services. Water services account for 17% of projected expenditures; stormwater for 6%; billing for 6%; and other (mostly indirect administration) for the remaining 4%.



We used the re-creation of HDR's estimate of baseline operational cost to evaluate the impact of changing assumptions about inflation, energy expenditures, and other issues. We also reviewed the assumptions used by ARI and HDR. With respect to future inflation and the cost of energy for baseline operations, we think the assumptions used are either unrealistic (energy) or without a clear rationale (inflation).

Energy expenditures in the HDR baseline, even after implementing efficiency improvements, were more than \$600,000 per year greater than the highest bidder's (Stockton Water Service) estimate of energy expenditures (about \$3.2 million per year). It is not realistic to believe City operations will use \$3,825,000 of energy in today's dollars when the bidders propose expenditures varying from \$1,953,289 to \$3,194,026 (ARI Table 4-1). Apparently, the HDR estimate of City energy expenditures (which is the source of the City energy use figure in ARI Table 4-1) was based on extremely high expenditures during the energy crisis year of 2001-2002, and does not account for declines in energy prices since then.

In addition, the inflation rates used to project operational costs from 2003-2004 through 2023-2024 differ significantly from historical rates over the last 20 years. Unless there is a clear rationale for the future to be different than the past, the least biased assumption is to use history as a guide. Doing so is standard practice in cost/ benefit analysis.

ARI/ HDR escalate labor and other non-energy costs at 2.5% and energy costs at 3.0%. But the actual historical change in the CPI less energy for all urban consumers over the last 20 years (1982-2002) has been 3.4% (see Bureau of Labor Statistics data series ID: CUSR0000SAOLE). The actual historical change is important because the MUD union labor contract calls for wages to increase by 80% of the change in the CPI for all urban consumers, or 2.5% per year, whichever is greater, not 100% of the change. Given ARI's choice of 2.5% as the future annual change in non-energy CPI, the contract language is irrelevant to the savings calculation. But if actual future increases in the CPI are 3.4%, OMI/ Thames will get a 3.4% adjustment while MUD workers would get only 2.7%, since 80% of 3.4 is 2.7.

The historical annual change in the CPI-energy for the SF-OAK-SJ Municipal Service Area (MSA) over the 17 years of available data (1984-2001) has been 2.3% (see Bureau of Labor Statistics data series CUUSA422SA0E). The 17 years of data include the large increases of recent years, as well as the sharp increases and declines historically that tend to characterize energy prices. There is no good rationale we are aware of to use 3.0% per year for energy inflation in the savings estimation. ARI, to the best of our knowledge, hasn't presented a clear rationale for their use of 3.0% for energy inflation or 2.5% for labor inflation.

Finally, the cost of water services is not composed entirely of labor and energy. In fact, using our re-creation of HDR's estimates (Table 1), 31% of the cost of services is other expenses (50% is labor, 19% is energy). Examples of other expenses are chemicals for treatment plant operations, replacement equipment and spare parts, and other types of intermediate products used in industrial settings. But Consumer Price Indices are inappropriate for these types of expenses because the CPIs measure the retail costs of goods and services purchased by households, not wholesale purchases of goods and services by businesses. Retail indices are fine for energy and labor cost escalators, but the cost of chlorinated compounds used in disinfection, or replacement parts for pumps and motors, for example, will not change over time in lockstep with these indices. In fact, capital equipment costs are specifically excluded from the Bureau of Labor Statistic's CPI calculation.

The producer price index (PPI) is a better measure of how much the costs of these types of goods will increase over time. The historical annual change in the US PPI for intermediate materials less food and energy has been 1.7% over the last 20 years (Bureau of Labor Statistics data series WPUS0P3200).

Intermediate materials have not increased in price nearly as rapidly as labor or retail energy. Again, we recommend using the least biased assumption possible – that the future is like the past – unless a clear rationale is provided for the future to be different. And no such rationale has been provided with respect to intermediate materials like those used in treatment plants.

After making these four adjustments (initial energy cost and three adjustments in inflation rates), we find that the estimated net present value of savings from the OMI/ Thames bid is around negative \$1.7 million (see the third and fourth columns of Table 2). This is far lower than the \$39 million of savings found using the ARI/ HDR assumptions (see the first and second columns of Table 2). *Due to uncertainty in the numbers, our finding is equivalent to saying that the OMI/ Thames proposal and continued City operation are about equivalent in terms of operational costs over 20 years.*

Fiscal Yr Ending June 30:	Baseline Efficiency (HDR 2002 Table G-1)	OMI/ Thames Bid (October 2002)	Adjusted Baseline Efficiency	Adjusted OMI/ Thames Bid
2004	\$20,128,955	\$19,590,017	\$18,289,955	\$18,459,017
2005	\$20,560,640	\$20,092,393	\$18,609,818	\$19,134,424
2006	\$20,772,715	\$20,607,708	\$18,707,795	\$19,796,464
2007	\$23,760,902	\$21,136,295	\$21,557,034	\$20,481,697
2008	\$24,488,938	\$21,678,499	\$22,153,393	\$21,190,943
2009	\$25,281,043	\$22,234,672	\$22,807,939	\$21,925,049
2010	\$26,006,166	\$22,805,175	\$23,391,212	\$22,684,893
2011	\$26,831,322	\$23,390,380	\$24,067,649	\$23,471,383
2012	\$27,600,752	\$23,990,668	\$24,684,003	\$24,285,461
2013	\$28,392,318	\$24,606,429	\$25,316,717	\$25,128,101
2014	\$29,405,424	\$25,238,063	\$26,159,827	\$26,000,312
2015	\$30,248,237	\$25,885,983	\$26,831,029	\$26,903,138
2016	\$31,115,288	\$26,550,609	\$27,520,080	\$27,837,662
2017	\$32,064,987	\$27,232,376	\$28,283,259	\$28,805,003
2018	\$32,984,079	\$27,931,727	\$29,010,752	\$29,806,321
2019	\$34,044,937	\$28,649,117	\$29,868,583	\$30,842,817
2020	\$35,020,633	\$29,385,016	\$30,637,976	\$31,915,735
2021	\$36,125,739	\$30,139,902	\$31,524,938	\$33,026,361
2022	\$37,160,907	\$30,914,268	\$32,338,170	\$34,176,030
2023	\$38,225,850	\$31,708,619	\$33,173,146	\$35,366,121
Net Present Value of Costs at 5.5% Interest	327,059,837	287,856,461	291,520,128	293,230,849
Projected Operational Savings:				
Comparison With Consultant Assumptions:		\$39,203,376		
Comparison With Adjusted Assumptions (1):				-\$1,710,720

(1) Adjusted assumptions are: \$630,000 lower initial energy for City operations; inflation adjustors match historic experience; wastewater flows, BOD and TSS loadings increase as in HDR (2002) p. G-1; billing is performed by City.

Table 2: Estimates of Net Present Value of Costs for Stockton Water Systems Operations

The City's efforts to "re-engineer" its operations over the last few years (plus HDR's efficiency recommendations for the next few years) have apparently been successful. This point is also supported by HDR's (2002, p.B-4) statement that current staffing levels are appropriate based on a computer program based comparison with industry benchmarks.

It should also be noted that City operations might be even less expensive than in the HDR estimate. We are not in a position to assess City operational budgets and future spending requirements in detail; such as the opportunities to reduce chemical and miscellaneous costs mentioned in our October 18 letter. Such future savings (or cost increases) are asymmetrical depending on whether the City privatizes operations or not. Under private operation, the City is protected against cost increases but cannot capture future cost saving opportunities. Under public operation, the City loses the cost guarantees under the contract, but can continue to work to identify and capture cost savings opportunities.

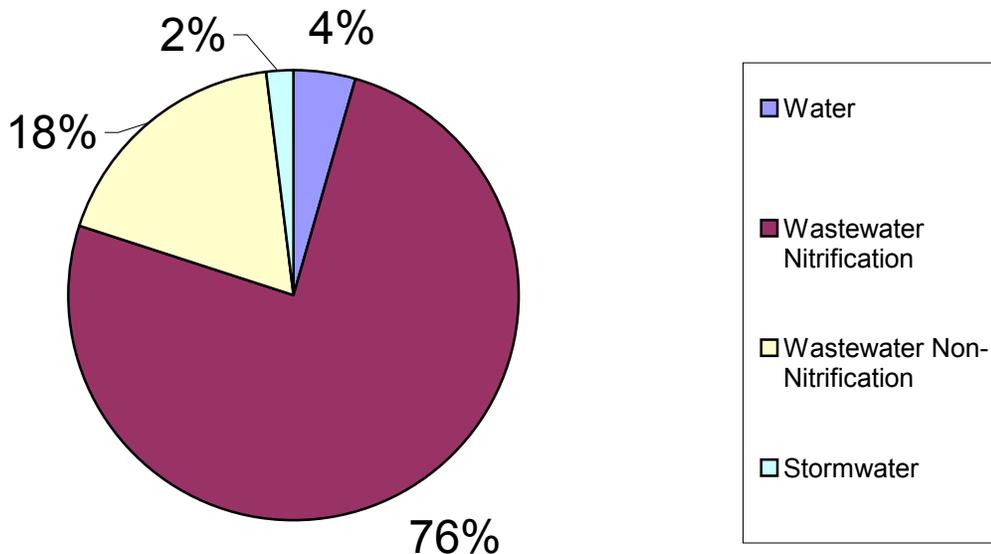
In summary, *most of the estimated operational cost savings claimed by advocates of privatization in Stockton depend on the assumptions made about future escalations in the cost of operations.* Using the least arbitrary assumptions – actual historical changes over the last 20 years in the US CPI, the energy CPI for the SF-OAK-SJ MSA, and the US PPI for intermediate goods less food and energy -- leads to two striking conclusions:

- There is little difference between the net present value of continued public operation and private operation by OMI/Thames, and
- Public operation might be less expensive.

Capital Cost Savings

A breakdown of anticipated initial capital expenditures for Stockton's water sector is provided by HDR (2002) in Tables E-1 through E-3. We present them as percentages in Figure 2. Investment to achieve new nitrogen standards dominates the City's investment needs (76%). Total wastewater investments account for 94% of investment needs (76% + 18%). Water investment needs are only 4% of the total; stormwater only 2%.

Figure 2: Relative Importance of the HDR-Estimated Initial Capital Improvements



ARI (October 2002) has compared the capital cost proposal of bidders with capital cost estimates under the status quo (no privatization) prepared by HDR Engineering (HDR, 2002). On its face, the low bidder’s proposal would save the City about \$54 million (Table 3). More than 98% of the apparent savings are in wastewater. Apparent savings in water services, alone, are about \$125,000.

Category of Investment	OMI/ Thames	Stockton Water Services	USFOS	HDR Baseline
Water	\$ 4,690,368	\$ 7,039,000	\$ 5,973,593	\$ 4,814,100
Wastewater Nitrification	\$36,392,514	\$55,688,000	\$55,001,500	\$ 84,355,700
Other Wastewater	\$15,432,385	\$21,738,000	\$18,505,234	\$ 20,679,150
Stormwater	\$ 1,432,860	\$ 2,126,000	\$ 3,466,493	\$ 2,110,000
Totals	\$57,948,127	\$86,591,000	\$82,946,820	\$111,958,950
Amount Greater Than Low Bid	\$ 0	\$28,642,873	\$24,998,693	\$ 54,010,823

Note: wastewater nitrification in OMI/ Thames is WW39 – WW37; that is, it reflects the proposed additional improvement that saves about \$5 million more than the base proposal

Table 3: Capital Cost Proposals and Estimates (data from ARI, October 2002, Table 4-1)

Unfortunately, the \$54 million apparent savings involves at least two “apples to oranges” comparisons. First, the HDR estimate is based on a traditional public works approach of separate design and construction contracts, with eventual operation by City staff. It is also a planning level estimate, with all

of the contingencies that are typically used in such estimates. Those who have worked for municipal government know that underestimating the cost of capital improvements is viewed as a serious mistake; while receiving bids lower than the planning level cost estimate is a very welcome event. In this case, the planning level estimates include a 25% construction contingency and another 30% for engineering, legal, administrative, and construction change orders. At least some of these costs are not included in the OMI/ Thames bid but should be planned for (as a contingency) even if OMI/ Thames is hired.

In contrast, the OMI/Thames bid was submitted under competitive pressure, using a design/ build/ operate/ transfer (DBOT) approach. There are two ways in which the DBOT approach is more cost effective than the traditional approach:

1. A design/ build (DB) contract is more cost effective than separate design and build contracts. DB contracts, potentially, can achieve even greater savings in capital cost than DBOT contracts, because the DB contractor doesn't have to underwrite the risk of operations over a lengthy time period.
2. Requiring operation by the design/ build contractor or a business affiliate serves as a financial "check" against the competitive pressure to build the project as inexpensively as possible, with possible operational or maintenance problems later

The National Research Council (NRC, 2002, pp. 72-73) reports that DBOT contracts for wastewater and water facilities in Seattle, Washington and Washington Borough, New Jersey, offered savings from 16-41 percent of the estimated cost of a conventional design, build, and operations approach.

Second, in addition to the different procurement approach, the OMI/Thames proposal is for a different wastewater treatment technology than was used to estimate the cost of continued City operation. OMI/Thames proposes a wetland followed by nitrifying biotowers, while the HDR estimate is for a nitrifying activated sludge facility. HDR chose nitrifying activated sludge because it was the lowest cost way of achieving the regulatory objectives that was deemed by the City's consultant design team to be reliable. Indeed, Parsons/Carollo said in a technical memorandum dated August 2002 (appendix A-1 in Parson/Carollo 16 September 2002):

"Wetlands for nitrification to 2 mg/L effluent ammonia was considered not reliable during cold weather months, therefore requiring an additional nitrification step following the wetlands. This additional nitrification step caused the wetlands alternatives (Alternative 11) to exceed the costs of other alternatives." (p. 1)

Hence the OMI/Thames and Parsons/ Carollo estimates of cost for wetlands followed by additional nitrification differ substantially. OMI/Thames claims this is the lowest cost option and offers to provide it. Parsons/ Carollo say it is not lowest cost, but significantly more expensive, once measures to ensure adequate reliability of effluent quality have been accounted for.

The potential savings of \$19 million from innovative treatment technology may be real. OMI/ Thames appears to be well qualified to implement their innovative approach and seems to offer strong performance guarantees. These guarantees and qualifications are critical, however, since the City's wastewater design consultants specifically said they felt that this type of treatment would be more, not less, expensive.

The savings from using a DBOT approach rather than traditional separate design and construction contracts may also be real. But they are only some part of the \$35 million of apparent savings not attributable to innovative technology (\$54 million - \$19 million). The \$35 million is partially a figment

of an inappropriate comparison, partially the result of a DBOT approach. And since operational cost estimates are about the same over the year term (above), the savings from DBOT are probably also available from a design/ build (DB) approach with City operation of the completed facilities. Hence the City might be able to capture the real savings hidden in the \$35 million figure without privatizing operations.

In summary, with respect to the capital cost part of Stockton's privatization decision, hiring OMI/Thames or any of the other bidders to provide capital improvements in the wastewater system would be financially superior to the traditional public works practice of separate design and construction contracts. However, \$54 million of net present value savings is unrealistically high, and at least \$19 million of those savings depend on OMI/ Thames being right about the reliability of their proposed treatment process, or the City being able to costlessly and successfully enforce the contract for many years against a company that took a risk, failed, and is perhaps losing money as a result.

Assessment of Risk

ARI and Hawkins, Delafield & Wood rightfully point out (October 2002) that some risks currently borne by the City would be transferred to the contractor under privatization. Transfer of risk is a benefit of privatization. But new risks are created by public-private partnerships. One needs to look at the net risk impact, not just the risks that are transferred from the City to a contractor.

For example, a contract that says that risk has been transferred is not the same as an actual transfer of risk. The City must enforce the contract in order to actually shed risks that it believes are transferred away under the contract. This "contract risk" is not mentioned in the consultant evaluation of risk, but is a large new risk that privatization entails. The cost to enforce a multi-million contract against a partner who will lose money if they comply with the contract, as interpreted by the City, is never zero, and can entail literally millions of dollars of legal fees or damages while the dispute is resolved. Given that contract disputes are reported to have taken place between OMI and the Cities of Rialto, East Cleveland, and Norwalk, Connecticut, this risk is real and needs to be assessed.

To see this risk in practice, ask: "Who is responsible for repair of a collapsed sewer main in year 10 of the contract? Is this part of the "as is risk" assumed by the contractor? "As is risk" applies to the condition of assets at the beginning of the contract period. Since even a video-examination of every sewer line in the City cannot identify every type of weakness (e.g., partial corrosion of reinforcing bars within the concrete sidewall of the main), some ambiguity in the "as is risk" will exist.

Also ask: "Who is responsible for damages resulting from upstream sewer overflows before the sewer main is full restored?" These seem to be a City responsibility, since "consequential damages" are specifically excluded from the contract. But such damages could – at least in economic theory -- be much greater with a contract operator rather than City operations since the contract operator is not responsible for them and therefore has less incentive to minimize them than does a municipal operator.

Furthermore, ask: "Is the sewer main collapse the result of an uncontrollable circumstance, defined in essence in the draft contract as any act, event, or condition that is beyond the reasonable control of the contractor?" The definition of uncontrollable circumstance excludes mechanical failure of equipment, but a sewer main collapse is arguably not an equipment failure (RFP, March 2002). The definition also excludes problems resulting from contractor negligence or "failure to exercise reasonable care or diligence." But the level of sewer main maintenance that is reasonable over the next 10 years is a range, not an exactly defined set of actions. Private operators experience financial pressure to do only the bare minimum: it is "their money" at stake. In contrast, City crews and managers may push for a higher level

of maintenance within the reasonable range. Of course they may overshoot by accident or “gold plate” their maintenance budgets, to the public detriment.

A full analysis of risk transfer is difficult and complex. *And we are not saying that the net transfer of risks under the contract will be disadvantageous to the City. But it could be.* The City’s privatization consultants have not performed a comprehensive analysis of net risk transfer. Instead, they have pointed out that some risks are transferred under the contract while seemingly failing to point out that a privatization contract in and of itself creates new contractual and incentive risks that City operation does not involve.

A second set of new risks are those associated with MUD supervision of the contractor. The “residual” functions of the MUD after privatization are not well defined, as commented on by former Director of Municipal Utilities Morris L. Allen in a memorandum to City Manager Lewis dated October 23, 2002. HDR’s baseline report (2002) lists the MUD staff positions that are anticipated to remain after privatization, but doesn’t describe how this list was arrived at. It looks like they simply retained some existing managerial and planning staff. But, as the National Research Council (2002) explains, doing this would be a mistake:

“When a public utility’s operations are handed over to the private sector, the public agency’s importance in running the agency does not diminish, but the way the agency performs its role changes dramatically. For local government, it becomes a question of contract management versus traditional program management. When a contractor provides the operations, the local government organization’s focus is on contract management. The talents and skills needed for contract management are significantly different than the talents and skills needed for traditional operations management. The importance of reorganizing for contract management must be recognized. After all, if an agency could not capably manage itself, it probably would not be able to immediately change and effectively manage outside contractors.” (p. 66)

As we noted in our previous letter to the City Council (attached), the regulatory apparatus in the United Kingdom was under funded and understaffed in the first five years or so after privatization. Excessively high profit levels and inadequate service performance were characteristic of the early years of privatization in the UK. There is a lesson there: the transition from municipal operation to private operation involves risks that have not been identified or evaluated by Stockton’s consultants. Perhaps those risks are manageable and well worth taking; perhaps not.

A third set of new risks are those associated with “taking back” operations should that ever be necessary. The draft contract, to its credit, contains a payment clause that defines the compensation the contractor is entitled to if the City chooses to terminate the contract. But the potential cost to the City of taking back operations is not merely the payment under this clause. It includes the cost of finding, hiring, and training operational managers and workers. In the even of a termination with cause, the contractor is unlikely to be helpful during the “reverse” transition; and new staff would likely be required in a hurry. This risk has been reduced in some place by simultaneously operating part of the water infrastructure with municipal staff and other parts of the system with contract staff.

Fourth, the City’s consultants claim that risks associated with operational performance will be diminished by privatization. That is true to the extent that performance benchmarks are defined in the contract and contract guarantees are enforceable. However, literally hundreds of benchmarking standards exist for water and wastewater utility operations (see, for example, IWA 2001 and 2002). Municipal government may or may not be satisfying these standards, but at least it can be held accountable in any budget cycle by officials who decide to look up and apply the standards.

In contrast, performance standards that are not specified in the contract are difficult to add at a later time. Private operation offers a higher performance risk unless an extensive set of numerical standards is established at the beginning. And even then, standards should be upgraded every 5-10 years as service needs and industry practices change, but doing so is more difficult with a contract operator than with municipal staffing.

Finally, the risk of high future inflation should be mentioned. The contract guarantees that the service fee will increase in step with inflation. The MUD's current labor contract provides a 20% hedge against wage inflation. In general, municipal operational budgets can and are trimmed during periods of severe inflation, but that will not be possible with a private contractor.

Overall, the analysis of risk presented by the City's consultants is one-sided. It rightfully claims that some important risks currently borne by the City would be transferred to the privatization contractor, legally. It rightfully points out that the City will retain some risks it currently bears. But it fails to point out that some new risks are created by privatization, and it fails to evaluate the net impact on risk of privatizing water services in Stockton.

Suggested Next Steps

The biggest potential financial benefits of privatization in Stockton seem to be with respect to the treatment plant expansion. Consequently, we suggest that the City consider privatizing the expansion of the wastewater treatment plant as a separate decision from privatization of other operations and capital improvements. The largest capital savings are in this area; and the rationale for savings is clearest here as well (a contractor prepared to take a technology risk and insure the City against failure). The City could also consider privatizing the entire wastewater plant and sewer system. As figures 1 and 2 show, the vast majority of money in this decision is wastewater related.

Overall, the relative balance of risks and benefits is still very uncertain. But operational savings are small if not negative, and new risks from privatization – such as contract enforcement risk -- are only now entering the public dialogue and decision process. An assessment and discussion of the net risk impact under the recently released contract would be useful.

Another piece of information that would be useful is an evaluation of the capital costs of facilities using a design/ build (DB) approach with City operation rather than the traditional public works approach of separate design and construction contracts prior to City operation. Estimating City costs under the first approach would allow a fair comparison to be made against the design/ build/ operate/ transfer (DBOT) approach used in the privatization RFP. When this fair comparison is available, and the contract has been available long enough for all interested parties to review it, the relative balance of risks and benefits for privatization of part of all of Stockton's water-related facilities could be better assessed.

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