GOVERNING INSTITUTE

Issue Brief

Transforming Water Management in Local Government

How public-private partnerships can unlock hidden asset values in municipal water systems

Water main breaks have become a consistent occurrence for cities across the country that — depending on their size — can create a calamitous impact for citizens and government leaders alike. But they are also a very visual effect of a much bigger problem that occurs below the surface, and often under the radar: our crumbling water system infrastructure.

This growing need for infrastructure improvements to local water systems is pervasive and urgent. U.S. cities deal with nearly 250,000 water main breaks a year and sewage overflows threaten drinking water. According to an estimate by the American Water Works Association, the price tag to fix aging water systems will be as high as $1 trillion through 2035. This is leading — or has already led – to increasing water bills for consumers. The American Society of Civil Engineers (ASCE) gave a "D" grade in its 2013 Report Card on America's drinking water and wastewater infrastructure.

The GOVERNING Institute recently surveyed state and local government leaders about their needs for water infrastructure improvements. Eighty-one percent of respondents expected to make significant investments in water and wastewater infrastructure, while 62 percent of respondents said that they have significant upgrades or replacements already planned over the next 24 months.

But these improvements, replacements and general maintenance don't come cheap and local governments, which are still reeling from the recession, often have more pressing day-to-day issues that capture their attention and their dollars. Budgets are constrained, and increasing taxes and water rates on similarly stressed taxpayers and rate-payers are an unpleasant option. Nor is the federal government a likely source of funding as much as it used to be. Fifty-six percent of those surveyed by the GOVERNING Institute said funding is the most significant barrier they face in water infrastructure projects.

The GOVERNING Institute recently surveyed government leaders about their needs for water infrastructure improvements:

81% of respondents expected to make significant investments in water and wastewater infrastructure.

62% have significant upgrades or replacements planned over the next 24 months.

56% said finance is the most significant barrier they face in water infrastructure projects.

So how do states and municipalities pay for these much-needed projects with money so tight?

To help answer this question, in June 2013, GOVERNING hosted a meeting of local government leaders, experts and private sector executives to discuss the future of water management. During the "Transforming Water Management: *Building a Future Leveraging Existing Resources*" event, many leaders returned to the same conclusion on the best way forward: public-private partnerships (P3s).

Why P3s Now?

A decade ago, municipal governments may have been able to fund water improvement themselves with tax-exempt bonds. But times have changed, said Bradford S. Gentry, director of the research program on Private Investment and the Environment at Yale University. The interest rate differential favoring tax-exempt bonds over taxable financing has been reduced considerably, creating an opportunity for private investors.

By partnering with a private water utility, local government entities can unlock the monetary value hidden in their water assets, obtain financing to pay for infrastructure projects and acquire the latest tools in technology innovations — all while retaining ownership of their systems. Once unlocked, this money can be used to not only fund infrastructure projects and improvements, but other budgetary needs, ranging from unfunded pension liabilities to libraries. The unlocked money can also be used for important projects that drive economic development.

P3s: Not an Either/Or Scenario

In the past, some P3s received an undeserved reputation as being bad for government, with critics alleging that taxpayers had given away an important asset to a profit-making company and that public sector employees lost their jobs to private sector workers.

But Stephen Goldsmith, former mayor of Indianapolis and currently a professor at Harvard's Kennedy School of Government, said there are several false choices for governments when it comes to P3s. The first false choice is viewing this as a choice between public and private sectors. Goldsmith said it's more about how to integrate the two together.

"The best run systems are the most amenable to integrating the best of both public and private," said Goldsmith, who

entered a P3 during his tenure as mayor to operate Indianapolis' wastewater treatment facilities and sewage collection system. "We were smart enough to know we were good, but not great and wanted to improve."

The second false choice is that the only way for government to save money is by being hostile to labor. In Indianapolis, Goldsmith said, municipal unions were unreceptive to the P3 at first; they were angry and scared. But after the deal was signed, workers compensation claims dropped 80 percent and no government workers lost their jobs during the transition. "This doesn't need to be done on the backs of labor," he said.

The third false choice is that the government entity will lose control and ownership of its water system if it enters into a P3 with a private utility. But Goldsmith said "that's just an item in the contract," noting that it is critical for the government side to be well prepared to look out for its interests, not just at contract signing but throughout the life of the deal.

Joseph P. Baumann Jr., counsel for the Bayonne Municipal Authority in New Jersey, which recently entered into a P3, noted that many such partnerships have failed due to their lack of oversight.

Benefits of P3s to Local Government

Done right, public-private partnerships provide many benefits to local governments, among them:

✔ Upfront payments to fund infrastructure projects and other budgetary needs

In its P3, the Bayonne Municipal Authority in Bayonne, N.J., received an initial upfront payment of $150 million, which will be used to eliminate the authority's existing debt and half of the city's debt. The private partner is committed to investing another $157 million over the life of the 40-year contract.

Allentown, Pa., earlier this year agreed to lease its water system to a partner. The lease gives control of the system to the partner for 50 years in exchange for a $220 million upfront payment, which Allentown plans to use to eliminate its unfunded pension liability, estimated at $160 million. The money will also be used to pay off $30 million of city water and sewer system debt and add $20 million to the city's general fund.

"We received money to fix other structural deficits that could have eventually bankrupted the city," Allentown Mayor Ed Pawlowski said at the GOVERNING event.

✔ Rate predictability

Bayonne water customers were facing a 30 percent rate increase shock following several years of no rate increases. According to its P3 arrangement, in exchange for an initial rate increase of 8.5 percent, or about $5 a month per residence, rates will be frozen until 2015, when a 3.5 percent increase is scheduled. After that, 70 percent of annual rate increases are fixed with the rest tied to an inflation index.

The Next Phase in P3s: Regional Authorities

Public-private partnerships can play an important role in the creation and implementation of regional water authorities and watershed areas, which often involve many players and require the cooperation of various governmental entities, each with its own narrow interests.

In addition to providing financing and technical expertise, the involvement of the private sector can often offer a means to get all of the various political subdivisions to work together effectively. "The private company can serve a diplomatic role to get various political subdivisions to join together into a regional authority," Anthony Coscia, chairman of the United Water Board of Directors, said.

✔ Access to the latest technology

With just 31 employees, Bayonne's water department didn't have access to or the expertise to take advantage of the latest innovations, Baumann said. But its P3 arrangement will include the installation of a new wireless meter reading system that transmits data directly from homes into the customer billing system, as well as other monitoring systems to help reduce water loss from leakage, prioritize pipe replacement and improve operational efficiency.

Deals like Bayonne's "combine creative financial engineering and operational excellence," Goldsmith said.

✔ Higher credit ratings

Shortly after Bayonne signed its P3 contract, Moody's Investors Service raised the city's debt outlook from negative to stable. Moody's also called Allentown's lease of its water system a "credit positive" for the city.

Moving Forward with P3s

While there are clearly significant opportunities for P3s in water, these partnerships can benefit state and local governments in a host of other areas as well, including electricity generation and distribution; education, health care and correctional facilities; garbage disposal and resource recovery; and even municipal parking meters. The most important thing from the government's perspective is that it must first understand what it is trying to accomplish, whether that be providing ongoing monetary savings, financing infrastructure improvements, improving access to technology or establishing predictable rates. Once realistic goals are set, the agency can establish what it must do to protect its interests throughout the life of the agreement.