



# BGR Outlook on Orleans

April 2000

## Privatization of Sewerage and Water Board Operations

### Introduction

This edition of Orleans Outlook examines the financial health of the New Orleans Sewerage and Water Board (S&WB) and the role privatization can play in improving the S&WB's "bottom line." Faced with financing hundreds of millions of dollars for sewer system repairs mandated by a 1998 federal consent decree, the S&WB recently increased sewer rates by 30%. It is also considering privatization to curtail expenditures and free up funds to devote to the repair work.

BGR does not take a position on S&WB privatization in this report; the concept is still being developed by the S&WB. We do, however, identify the issues that should be addressed in that process, many of which require attention regardless of whether the S&WB proceeds with privatization.

When analyzed in the context of the capital improvements mandated by the consent decree, it is clear that privatization would not eliminate the need for the recent 30% sewer fee increase. While there is considerable room to improve efficiency in S&WB operations, the potential savings are unlikely to avert additional rate increases. The sheer magnitude of the capital need is simply too great. Finally, the sewer fee increase will not raise funds for projected water

treatment plant improvements, nor will it contribute to the \$100 million of local money required to match hundreds of millions of available federal money to improve the capacity of the city's drainage system.

### Background

In 1998, the S&WB settled a lawsuit filed by the U.S. Environmental Protection Agency to force the city's sewer system to comply with pollution control regulations. The settlement, in the form of an enforceable federal consent decree, started a 13-year process that will require about \$455 million to fix New Orleans' aging sewer system. Federal grants are possible (but not guaranteed) for up to \$100 million of this; the balance must be raised locally.

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The strain of funding the consent decree comes at a time when the S&WB is pressured by other financial demands:

- ◆ Day-to-day maintenance of an aging infrastructure buried in unstable soils. Much of the 3,000 miles of New Orleans' water and sewer system is more than 50 years old. Drainage pumps and the electrical generating plant that powers them were built at the turn of the century, and are still in service.
- ◆ Major water treatment plant improvements to comply with new drinking water standards.
- ◆ Capital improvements to increase the drainage system capacity.

In October 1998, in response to the consent decree, the S&WB asked the New Orleans City Council to approve a 42% sewer fee increase staged in five annual increments: 17%, 13%, 4%, 4%, and 4%. (See BGR's February 1999 Orleans Outlook report, *The Sewerage & Water Board's Fee Proposal*, under Publications at [www.bgr.org](http://www.bgr.org)). The fee increase languished for a year and a half with no action by the council, putting the S&WB and the city government in danger of incurring fines as high as \$10,000 per day for violating the consent decree. However, on March 2, 2000, and only after intense debate, the City Council approved a one-step 30% sewer fee increase.

In a move unrelated to the consent decree, the S&WB also proposed a new drainage fee in October 1998 to generate the local match that would leverage over \$300 million in federal funds for drainage capacity improvements. The City Council has not yet acted on that proposal.

## Structure of the S&WB

The S&WB's ability to satisfy mounting financial demands is hampered by a cumbersome decision-making process that drains executive and managerial resources from the substantive work of the S&WB.

Although the S&WB is ostensibly an independent agency, its operation is tightly entwined with city government. Of the Board's 13 members, four are elected city officials, and seven others are appointed by the mayor with council approval. The remaining two are members of the Board of Liquidation, City Debt, appointed by the mayor on that board's recommendation. The mayoral appointees serve staggered nine-year terms.

Elected officials dominate the S&WB's leadership and committee structure. Currently, one councilman-at-large chairs the Board's Sewer and Water Committee; the other chairs the Drainage Committee. A district councilmember chairs the Finance Committee, and the mayor is the S&WB President. This dominance is amplified by the fact that major S&WB construction contracts must be approved by the City Council.

The S&WB's six committees require a large number of staff (up to 20) and consultants at each committee meeting. Disagreements over committee jurisdiction result in month-to-month delays as undecided issues bounce from committee to committee, then to the full Board.

State law requires the S&WB to set user fees, subject to the City Council's ratification. With four elected officials on the S&WB, electoral pressures can exert a strong influence to delay action on rate increases. When the S&WB voted in October 1998 to recommend increasing sewer fees by 42%, the three City Council members

sitting on the S&WB voted “for,” yet the City Council did not act on increasing fees until 18 months later.

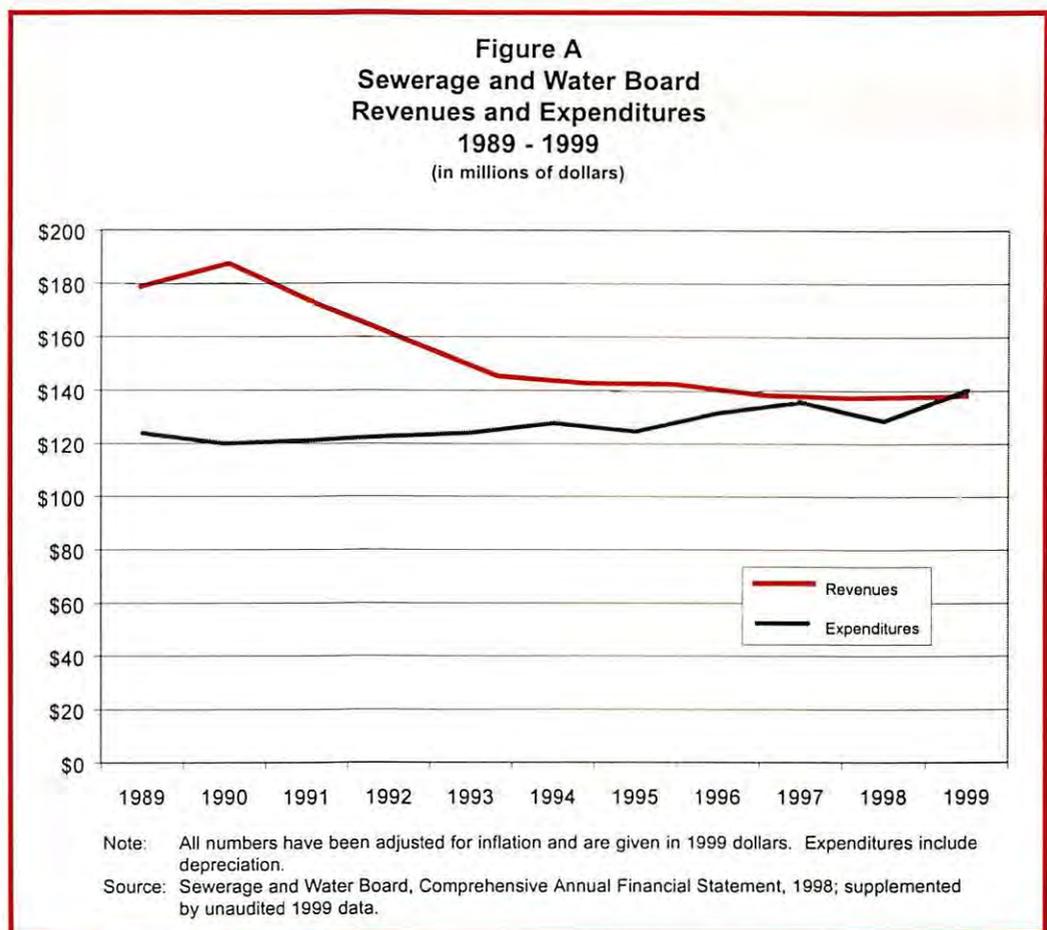
The 1998 sewer and drainage fee proposals came at a politically inopportune time. They would have added to the burden of a new property service charge the city was seeking in 1998. (See BGR’s *Review and Analysis of the Real Property Service Charge Proposed by the City of New Orleans* under Publications at [www.bgr.org](http://www.bgr.org).) The service fee was defeated by the voters.

Another entanglement between the S&WB and the city is a complex agreement governing responsibilities for subsurface drainage. The agreement addresses design and construction of water, sewer, and drainage lines when the city reconstructs a street, and sets up a system to account for the costs involved. The agreement was renewed most recently in July 1992. Constructing drainage lines over 36” in diameter is the S&WB’s responsibility while the city is responsible for constructing or reconstructing the balance. Despite this division of construction responsibility, the S&WB agreed to maintain the smaller lines “if the Board has funds available and the legal authority to

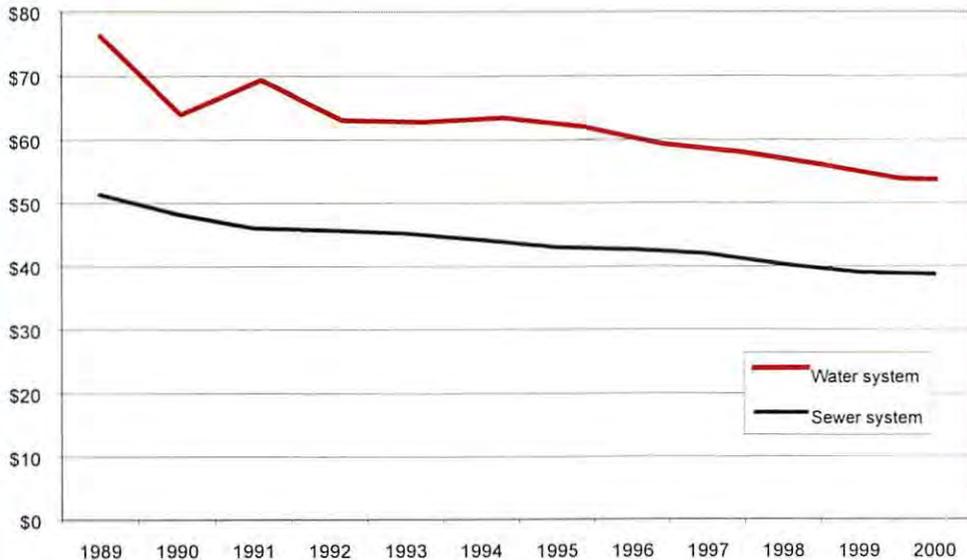
use same.” This maintenance responsibility is a contentious issue. The S&WB staff has recommended discontinuing this work as a cost-saving measure.

## Historical Trends

Since 1989, the S&WB’s revenue (excluding the proceeds of bond issues) has declined over 23% in real dollars. During the same period, inflation adjusted expenditures (including depreciation) have grown by about 13%.<sup>1</sup> See Figure A. In growing community, an expanding customer base typically yields increasing revenue without increasing rates. In contrast, the S&WB customer base has been stagnant at about 139,000 since 1993.



**Figure B**  
**Sewerage and Water Board**  
**Service Fee Revenues**  
**1989 - 2000**  
(in millions of dollars)



Note: All numbers have been adjusted for inflation and are given in 1999 dollars.

Source: Sewerage & Water Board, Statements of Budgeted Revenues and Expenditures, 1989 through 2000

The sewer and water systems are funded by service fees. Adjusted for inflation, the revenue from these fees has steadily declined over the last 10 years. See Figure B. Until the March 2000 fee increase, sewer rates had not changed since 1986. Water rates have remained unchanged since 1990. The Board has in reserve a 12% rate hike for the water system approved by the City Council in the early 1980's as the fifth of a five-step increase. The 12% was originally slated to become effective in 1990, but because some capital improvements were postponed, the Board has held the increase in abeyance.

While the public may have the perception that S&WB bills have increased since then, the perception may be due to changes in sanitation/garbage collection charges imposed by the City of New Orleans (currently \$11.00 per month). The S&WB merely serves as a collection

agent for this fee, which is passed through to the city.

Drainage is funded with property tax, currently at 22.59 mills. The voters rejected an extension of a four mill tax in 1992, reducing drainage revenues by about \$6 million per year. The only recent growth in tax revenue for drainage has been through an overall growth in the property tax base.

## Current Financial Picture

The S&WB's total operating budget for 2000 is \$99.3 million.<sup>2</sup> By system, budgeted expenses are:

Sewer	\$33.4 million
Water	46.5 million
Drainage	19.4 million
<b>TOTAL</b>	<b>\$99.3 million</b>

The S&WB maintains a five-year capital plan, which is updated annually. The 2000-2004 capital plan was essentially out of date when it was adopted in December 1999, primarily because estimates for sewer system rehabilitation are significantly greater than the figures shown in the plan. The S&WB staff and consultants have apprised the council of the more realistic numbers, which are reflected in Table 1.

Although it is a single entity, state law requires the S&WB's three main functions to operate as separate cost centers. Sewer, water, and drainage each have dedicated revenue sources that may be used only within that system.<sup>3</sup> For each system, the net revenue after operating expenditures is available for debt service and capital improvements, but only for that particular service.

## Sewerage Collection and Treatment

Approximately 76% (\$44.1 million) of the 2000 sewer capital budget is to satisfy the consent decree. Another 15% (\$8.5 million) is to upgrade the Algiers wastewater treatment plant to comply with an earlier EPA administrative order. The balance of the sewer capital budget is the sewerage systems' share of general budget items and an emergency reserve.

In the consent decree, the S&WB and the city committed to a strict timetable for rehabilitating the sewer system. Table 2 provides an overview of the capital costs and major deadlines, which are staged on a basin-by-basin schedule. (A basin is a geographic area served by a distinct section of the sewer system.)

The S&WB's original estimate of \$250 million for consent decree capital requirements proved far too low. Initial work in the Lakeview Basin indicates more breaks than anticipated, and that an economical trenchless repair technique is not feasible to the extent originally planned. Currently, the S&WB

**Table 1**  
**Sewerage and Water Board**  
**Capital Program by System**  
**2000 - 2004**

(in millions of dollars)

	2000	2001	2002	2003	2004	Total
Water System	\$ 17.6	\$ 28.6	\$ 29.5	\$ 11.1	\$ 11.0	\$ 97.8
Sewer System	58.0	57.7	58.2	59.2	62.2	295.3
Drainage System	127.3	101.9	126.6	72.3	123.0	551.1
<b>TOTAL</b>	<b>\$ 202.9</b>	<b>\$ 188.2</b>	<b>\$ 214.3</b>	<b>\$ 142.6</b>	<b>\$ 196.2</b>	<b>\$ 944.2</b>

Source: Sewerage & Water Board Adopted Capital Program, as amended, and as augmented by updated sewer system costs for 2001-2004 as provided to Sewer and Water Committee members January 10, 2000

consultants estimate that it will take over \$455 million to comply with the consent decree and to perform similar work in Algiers.

The S&WB's funding relief from the 30% sewer rate increase will be short-lived. By late 2001, sewer revenues available for capital improvements will be insufficient to meet consent decree commitments. Additional sewer fee increases will be needed in late 2001 and beyond. S&WB consultants estimate that under the status quo, an additional 12% increase each year will be necessary from 2001 through 2004. Cuts in S&WB operating expenditures can offset some of this, but even the most optimistic projections of privatization savings would not offset all of the projected increase.

## Water Treatment and Distribution

The S&WB treats 143 million gallons of Mississippi River water daily, but collects fees for only about half of it. By statute, the S&WB must provide free service to a number of public entities.<sup>4</sup> The largest single beneficiary of the free water is the office of the Criminal Sheriff (\$939,662 in 1999). Firefighting and sewer cleanout operations constitute a significant portion of the "free" water. The volume is

unmetered, and, therefore, the cost is unknown. More troubling are leaks in the system. The S&WB does not have a reliable estimate of the value of water lost through leaks, but it appears to be a substantial share of the “free” water.

Existing revenues are sufficient to support the water system capital needs in 2000. Beginning in 2001, the water system will probably require improvements that its current budget will not support. The existing authority for a 12% water rate increase, even if exercised in the near future, might not be enough to fund future EPA clean water regulations.

Sixty percent of the water system’s five-year capital program is earmarked for advanced water treatment facilities in 2001 and 2002. Improvements are scheduled at both the Eastbank and Westbank plants in response to increasingly stringent EPA requirements to remove pathogens (disease-causing organisms) as well as carcinogens. The regulations are still in flux, so further treatment changes (and capital expenditures) may be required.

## Drainage

With the distinction of being the only U.S. city below sea level, New Orleans could not have developed without an extensive drainage collection and pumping system. The existing system can remove roughly one inch of rainfall in the first hour, and an additional half-inch per hour after that.

Several so-called one-hundred-year floods in the past decade exceeded the system’s capacity and inflicted hundreds of millions of dollars in property damage. Responding to this problem in 1996, Congress authorized the multi-year Southeastern Louisiana Urban Flood Control Program (SELA) to provide 75% federal funding through the Army Corps of Engineers, but only

for projects that increase drainage capacity. (For a list of SELA projects planned for New Orleans, see BGR’s February 1999 report, *The Sewerage & Water Board’s Fee Proposal*, under Publications at [www.bgr.org](http://www.bgr.org).)

When combined with federal SELA money, the S&WB has \$127.3 million available to fund the drainage capital projects in 2000, which is more than adequate. It is in 2001 and beyond that existing drainage revenues will be insufficient to match available federal funds to upgrade drainage capacity. The drainage service fee proposed by the S&WB in 1998 was designed to close this gap.

The S&WB is not required to carry out the SELA projects. However, the SELA program is an opportunity to be seized: for the 25% match, New Orleans will reap 100% of the benefits.

## Closing the Capital Funding Gap

The S&WB is faced with a continuing demand for capital for all three of its systems. See Table 1. It can only meet this demand by increasing net income through higher user fees or taxes, decreasing expenditures, or a combination. (Prospects for any state assistance in the near future are dim.)

## Increasing User Fees

Existing water and sewer rates in New Orleans are moderate compared with other large jurisdictions. For example, Houston residents pay 24% more, while Birmingham users get a bill more than twice as high. Other jurisdictions—including some in the New Orleans area—have lower rates. But those jurisdictions are unlike New Orleans in a major respect: they subsidize user fees with other sources of revenue, and

**Table 2**  
**Sewerage and Water Board**  
**Sewer System Rehabilitation Capital Costs**  
**(through 2010)**

	Evaluation	Remedial Plan	Construction		Cost		
			Begin	End	(in millions of dollars)		
					Evaluate	Implement <sup>1</sup>	Total
<b>CONSENT DECREE COSTS:</b>							
1 Lakeview Basin	On schedule	On schedule	On schedule	12/14/01	\$ 1.0	\$ 26.2	\$ 27.2
2 CBD Basin	On schedule	On schedule	01/01/01	12/31/05	1.5	25.9	27.4
3 Gentilly Basin	On schedule	On schedule	01/01/02	12/31/04	2.4	26.1	28.5
4 Uptown Basin	On schedule	11/01/00	01/01/03	12/31/05	2.9	26.1	29.0
5 Mid-City Basin	04/01/01	11/01/01	01/01/04	12/31/06	2.7	26.1	28.8
6 Ninth Ward Basin	04/01/02	11/01/02	01/01/05	12/31/07	3.0	26.1	29.1
7 Carrollton Basin	04/01/03	11/01/03	01/01/06	12/31/08	3.0	26.1	29.1
8 N.O. East Basin	04/01/04	11/01/04	01/01/07	12/31/09	3.0	19.8	22.8
9 Southshore Basin	04/01/05	11/01/05	01/01/08	12/31/10	3.0	19.8	22.8
Capacity Improvements <sup>2</sup>					0.0	141.1	141.1
Shared Activities and Improvements <sup>3</sup>					0.0	47.2	47.2
<b>Non-Consent Decree Cost: Algiers Basin</b>					3.0	19.8	22.8
<b>Total Rehabilitation Capital Costs</b>							<b>\$455.8</b>
Encumbered, through 2/9/00							<b>45.6</b>
<b>New Funding Required through 2010</b>							<b>\$410.2</b>

1. Includes construction, contingencies, design, legal, administrative, and construction management costs. Does not include shared costs applicable to all basins; these costs are included in the shared capital line item.  
2. Includes collection system and treatment plant capacity improvements.  
3. Includes the cost of hydraulic modeling, remote sensing instrumentation for sewage flows (SCADA), pump station improvements, sewer annual contracts, streets program sewer rehabilitation, and program management.  
Source: Sewerage & Water Board

their user fees therefore do not reflect the true cost of service. For example, a half-cent sales tax and the city general fund subsidize the Baton Rouge sewer system. Jefferson Parish subsidizes its sewer and water rates with property taxes. St. Bernard Parish has a dedicated one-half-cent sales tax for sewer service.

In lieu of the five-step 42% sewer fee increase proposed in 1998, the S&WB and the City Council considered several stop-gap proposals in early 2000 and ultimately approved a one-step 30% increase. This is enough to satisfy the consent decree requirements for 2000 and most of 2001, but not beyond.

Even though the S&WB is currently on schedule under the consent decree, the 18 month delay in approving the fee increase seriously impacted the funds available for capital projects. Higher revenue does not immediately increase bonding capacity, which is limited by formulas tied to past and future net revenues. State law establishes two financial requirements: calendar year debt service may not exceed 77% of average net revenue for the two years before bonds are authorized, and rates must generate enough net revenue to cover at least 130% of future debt service.<sup>5</sup>

The S&WB can work around these constraints to some extent, but will incur additional financing costs in the process. Because the

30% rate increase has not been in place for the requisite period, the S&WB must resort to issuing bond anticipation notes in 2000 and 2001, to be repaid by the sale of future bonds. This puts the S&WB in the position of borrowing today to finance more borrowing tomorrow.

## Cutting Costs

Reductions in S&WB operating costs can offset some of the fee increases projected to support capital projects. The S&WB has commissioned several studies to identify potential savings, either through internal reorganization and work efficiency improvement, or through privatization.

In February 1999, the S&WB hired the national firm of EMA Service, Inc. to recommend efficiency improvements for the Networks Division, which performs minor and emergency repairs for all three systems. (Private contractors currently perform most major repairs.) EMA's November 1999 analysis found significant inefficiencies, including:

- ◆ The top-heavy organizational structure has one supervisor for every three workers.
- ◆ Most of the work is reactive and 40% more costly than preventative work.
- ◆ There are too many specialty crews.
- ◆ Equipment repairs take too long, and responsibility is split among departments.
- ◆ Poorly scheduled support activities (such as equipment maintenance and parts stocking) reduce the time work crews have available to spend on the repair jobs.

EMA's recommendations include eliminating the division of repair crews by system, assigning multi-skilled workers to smaller crews, and assigning work on a zone basis to

foster a sense of worker ownership of each service areas. Some of these recommendations have already been implemented, and the S&WB staff indicates that the efficiency improvements have helped reduce the repair backlog.

Implementing EMA's recommendations would cost \$1.2 million. EMA estimates that the resulting efficiency improvements would be equivalent to \$4 million a year. EMA's study was designed to improve efficiency rather than cut costs. Efficiency improvements per se will not translate into cost savings unless the workforce is reduced or other expenses are trimmed. Assuming these occur, EMA's recommendations have the potential for shaving three to five percentage points off user charges in the long term.

In March 2000, the Board voted to implement a revised version of EMA's proposal. One reason for the four month delay following EMA's recommendations in November 1999 was the time it took to present the proposal to five S&WB committees.

Separate from EMA's work, the S&WB staff has recommended additional cost cutting/cost-shifting measures. S&WB management recommended staff reductions and eliminating standby and overtime pay, with savings of over \$1.5 million. As a practical matter, some of these savings are being realized through attrition. Other proposals (along with the staff's estimated annual savings) include:

- ◆ Have the pension fund absorb its expenses (\$600,000).
- ◆ Repeal statutory prevailing wage requirement for construction contracts (\$1.5 million).<sup>6</sup> The S&WB is the only agency to which this applies. A similar requirement previously imposed on the city has long since been repealed.

- ◆ Purchase natural gas for the power plant on the open market (\$3 million). The S&WB attempted this in 1995, but was rebuffed in court on the grounds that open market purchase would violate NOPSI's exclusive gas franchise.
- ◆ Rebid the wastewater treatment plant operating contract (\$750,000 to \$1.0 million).
- ◆ Discontinue free service (\$4.3 million).
- ◆ Shift catch basin cleaning to the city's work force (\$3.9 million).

The Board has already rejected some of the recommendations, some require legislative approval, and some have legal problems. Further, the last two proposals would only shift expenses to other public entities rather than save money in the aggregate. The ratepayers /taxpayers of Orleans Parish would ultimately foot the bill.

## Role of Privatization

Privatization is not new to the S&WB. Wastewater treatment plant operations have been privatized since 1992. Computer operations in the central office, security, and janitorial services are contracted. Street repairs necessitated by utility work are generally let out to private companies. The S&WB plans to invite proposals to privatize a new power plant.

It was only recently that the S&WB began to consider privatizing the sewer and water collection and distribution network, which includes the thousands of miles of pipe under the streets of New Orleans. Privatizing this network activity is totally new to the S&WB, and is largely new to other parts of the country. Although there are many examples of privatized water and sewer treatment plants, privatized network operations are unusual.

On June 8, 1999, the S&WB engaged Verner Liipfert (a Washington, D.C. law firm which also advises the City Council's Utility Committee), teamed with Camp Dresser & McKee, Inc., Deloitte & Touche LLP, and Essential Environmental Engineering, Inc. Verner Liipfert engaged a local attorney, William Broadhurst, to assist in the effort. This team, collectively called the "financial advisor," was selected without a competitive procurement process. The S&WB asked the financial advisor to provide "an accurate analysis of the factors affecting the Systems' user fees . . . if SWB adopts any of the alternatives available for operating the Systems." The contract does not include the drainage system or the power plant and electrical transmission system.

The original financial advisors' contract had a maximum price tag of \$100,000 plus expenses. The contract was amended twice. In July 1999, it was extended and increased by \$75,000; in February 2000, it was extended and increased again by \$150,000 to its current amount of \$325,000 plus expenses.

The financial advisor has produced two reports thus far. Both reports describe the experiences of utility privatization contracts in other areas of the country, but neither report analyzes how those experiences apply to New Orleans. The second (the more comprehensive of the reports) consists largely of news clippings about systems in other communities depicted as privatized success stories.

The report offers four examples of privatized management, operations, and maintenance: Atlanta (water only), Indianapolis, Milwaukee, and New Haven (sewer only). The reports do not provide data on how the 20 to 40% savings claimed for privatization in other communities was calculated. BGR's review indicates that none of the privatizations highlighted in the

report provide a solid basis to estimate potential savings here. The examples of privatization savings presented in the reports do not present situations easily transferable to New Orleans. The “comparables” are not comparable.

Neither report analyzes where S&WB privatization savings would occur, nor does either estimate what the savings might be. Instead, the analyses simply assume the S&WB would save 20 to 40% of operating and maintenance costs, and calculate the fee impact of this assumed savings.

Under the more optimistic savings estimates, the financial advisor indicates that privatization could almost eliminate the need for a fee increase (including, by implication, the recent 30% increase). Based on more recent information, BGR disagrees with this conclusion. The financial advisor’s estimates assumed capital needs that were significantly lower than current estimates, and assumed \$4.0 million more in EPA funding than is actually available in 2000.

The possibility of future savings through some form of privatization will not help the S&WB fund construction work presently required by the consent decree. By statute, “no contract or expenditures of any kind shall ever be made in anticipation of any surplus of either construction or maintenance fund.”<sup>7</sup> Savings from privatization must be “in the bank” before they can be used to fund construction contracts.

One of the problems with applying a 20 to 40% rate savings to New Orleans is that the savings illustrated by the financial advisor have not been achieved in comparable situations. Such savings have been reported where treatment plants—not networks—dominated the privatized scope of work. Here, the wastewater treatment plants are already privatized.

Self-contained treatment plants lend themselves to privatization. They are clearly defined, readily inspected facilities with well-known operating parameters that a contractor can directly control. They can be automated. The scope of work is largely determinable. In contrast, network operations involve facilities that are almost totally underground and subject to deterioration and damage from largely uncontrollable forces such as unstable soils, heavy bus and truck traffic, and adjacent construction activities.

The Verner Liipfert team has recommended packaging all sewer and water functions together in a “global” privatization. As a result, the S&WB has postponed rebidding private operation of its sewerage treatment plants. Since 1992, a private contractor has been operating the sewerage treatment plants, originally under a five-year contract, now extended on a year-to-year basis. The S&WB staff estimates probable annual savings of \$750,000 to \$1 million on the \$7 million contract if it were rebid.

The financial advisor’s recommendation to proceed with privatization did not address the specific steps necessary to get there, nor did the reports analyze the legal constraints (such as state purchasing laws and civil service requirements) on privatizing.

The tenor of the financial advisor’s reports produced so far has been more a promotion of privatization than a dispassionate analysis of how it applies to the S&WB. This is a concern. Key members of the financial advisor team either participate in joint ventures holding privatization contracts in other parts of the country, or have clients who do so. While these firms are nationally recognized in their fields, the fact that they are advising the S&WB on privatization when they or their clients are potential bidders raises the possibility of

conflicts of interest that have not yet been publicly addressed. Further, even though Verner Liipfert is a law firm, it is unclear whether Verner Liipfert is operating under a lawyer-client relationship with the S&WB, which would impose a particularly strong obligation to disclose and resolve potential conflicts.

On the basis of the first two reports, the S&WB decided to have the financial advisor develop a plan for a managed competition procurement. Managed competition is a variant of privatization in which private companies and the existing S&WB staff would bid against each other. While privately managed utilities have some advantages, staff-managed systems also have some, such as the advantage of not having to pay taxes or produce a profit for shareholders. Public workers tend to win bids when service is labor-intensive, and private contractors tend to win when the service is technological or capital-intensive.

The contract amendment to develop a managed competition procurement plan directs the financial advisor to “present options and recommendations for a scope for the procurement, outline criteria for a RFP/RFQ and proposed contract... determine a time line... outline the S&WB’s responsibilities... and develop a cost budget for the process.” The report is due in mid-May.

As of this writing, managed competition remains merely a concept. Neither the S&WB nor its consultants have articulated how managed competition will be implemented within the existing legal framework governing the S&WB. It is unclear how the employees can organize to operate the systems, particularly in view of constitutional and home rule charter constraints that vest the Civil Service Commission with the authority needed to restructure the workforce. The Board has

considered (but not acted on) providing outside assistance for the employees to develop their managed competition bid.

The next report from the financial advisor may address some of these issues, but the most recent amendment to the consulting contract does not require it to do so in any detail.

## **Impact of Civil Service**

All but five of the S&WB’s 1,375 employees are classified civil servants. The constitutionally independent New Orleans Civil Service Commission has considerable power over privatizing or restructuring the S&WB. The commission’s regulations prohibit privatization without the commission’s prior approval.<sup>8</sup> (The Commission approved the privatization of the S&WB’s wastewater treatment plants in 1992.)

Thus far, civil service has not been addressed in the financial advisor’s analyses; and EMA has only begun to evaluate the role of civil service in implementing efficiency improvement recommendations. How civil service reacts will affect how well the S&WB staff can compete with private contractors in a managed competition procurement.

BGR understands that the S&WB staff has initiated discussions with the Civil Service Commission’s staff. It would be prudent for the S&WB to continue the dialog and involve the Civil Service Commission itself to reach a clear understanding of what the commission will and will not approve.

## **Job Retention**

For the cities used as examples of privatization savings, the financial advisor noted “a significant amount of the savings were the result of

sizable employee reductions....” Some members of the S&WB have indicated publicly that they favor a “no layoff” provision in a privatization contract, a common clause in the transfer of public utilities to private, for-profit management.

Approximately 57% of the S&WB budget is devoted either directly or indirectly to personnel costs. To the extent that this is “off limits” in the privatization process, the potential for savings through privatization will be reduced. Additionally, the city’s own workforce may be disrupted if S&WB employees are protected by “bumping” less senior employees in other civil service jobs with the city – a right afforded them under civil service rules.

Planned attrition can ease the impact of privatization on the existing workforce. Attrition at the S&WB historically occurs disproportionately among the low skill laborer positions, which does little to thin out the overpopulated supervisory ranks. However, the EMA study noted that the higher skilled employees are in the supervisory levels, and that redeploying these workers to field operations could improve performance.

## Open Issues

In approaching privatization, the S&WB must decide on several major issues:

- ◆ Scope: Will the contract be limited to the networks, or will it include water and sewer treatment plants? Will drainage be included? What about planning and engineering functions, or equipment maintenance? Will privatization include “back office” functions such as billing and collection?
- ◆ Number of contracts: For a given scope, should privatization be implemented under one or multiple contracts? Repairing underground pipes requires different expertise than operating a water treatment plant. Equipment maintenance demands yet another set of skills. A single “global” privatization contract may appear to be easier to bid and manage from the S&WB’s perspective, but only a small number of firms nationwide are in the business of operating large utility systems. Fewer still have experience with both treatment and networks. If discrete components of the S&WB were privatized, it would open up the process to more competitors, and could avoid dependence on a single contractor.
- ◆ The procurement process: Privatization contracts are typically negotiated with contractors selected through a preliminary process to screen for qualified bidders. The low bidder does not necessarily win. Unless managed with the utmost integrity and openness from its inception, the procurement process will be rife with opportunities for political influence and patronage. If a bidder is considered to have the “inside track,” the perceived bias could discourage potential competitors.
- ◆ Up-front payments: In Atlanta, the winning water system contractor paid the city \$10 million to get the contract. An up-front payment has been discussed at some of the S&WB and City Council meetings. An immediate infusion of cash is attractive, but an up-front payment would not be free. The S&WB customers would ultimately absorb the cost over the term of the contract.
- ◆ Unexpected repair and replacement cost: Who would bear the cost of unforeseen repairs and replacements? The extent of

future repairs and maintenance for the S&WB's far-flung network is unpredictable. After a contract is awarded, the contractor would have many opportunities to demand change orders that can potentially erode the savings that privatization offers.

- ◆ Planning and implementing capital improvements: Conflicts are likely to develop between the Board and a private management company over identifying and paying for capital repairs as opposed to classifying the work as maintenance. Would the S&WB or the contractor be responsible for the design, funding, and construction of capital repairs, especially when required by new environmental regulations?
- ◆ Work induced by street repairs: Who would pay for or perform sewer, water, and drainage line repairs when streets are opened by the city? At present, the S&WB performs major line replacements concurrently with the city's street repair work, which saves money in the long run. A private company would not have the same incentive to follow this practice.
- ◆ Regulatory risk: Who would pay fines if federal or state environmental standards were violated? Who will pay if the fine is the result of an accident or an unforeseen tightening of regulations?
- ◆ Inflation risk: What cost-of-living increases (if any) will be allowed in water and sewer rates or in management fees? Private management contracts customarily include inflation adjustment provisions.
- ◆ Customer fees: Would the private contractor or the Board set fees for non-recurring services such as inspections, meter installations, and the like?
- ◆ Force majeure events: What events, such as a hurricane or major accidental damage to facilities, would excuse non-compliance with contract requirements? Who would provide and pay for service in the interim?
- ◆ Tort liability: Who would be responsible for compensation judgements arising out of unforeseen events such as sewer backups or construction damage? Claims against the S&WB are a major cost. (The largest claim pending is an \$11 million award on appeal to the Louisiana Supreme Court. The provision for S&WB claims in the last three years has ranged from 5 to 8% of S&WB revenues.)
- ◆ Financial strength of the contractor: What level of assets and equity would be required of the contracting company? How liquid? Will a parent company be "on the hook" if the contracting company defaults on any provision?
- ◆ Default provisions: What constitutes a default, and what remedy would be available to the Board? Who would provide service to customers while the contractor is in default?
- ◆ Penalties and incentives: What constitutes superior service and what should the incentives be to encourage improvements? (IRS requires at least 80% of the private company's total annual compensation to be based on a periodic fixed fee. This limits flexibility for performance incentives.)
- ◆ Management and audit: How would the S&WB manage and audit the private contractor? The long-term ability of the S&WB to manage a private contractor will be critical to the success of any privatization effort. The remaining post-privatization S&WB staff could easily be

“outgunned” by a private contractor’s larger, more highly paid staff and professional consultants.

## Conclusion

The S&WB is beset with problems that have developed over a long period of time. While the difficulty of funding the consent decree is the most immediate, it is only one of a larger set of problems that neither a rate increase nor privatization will solve. In fact, privatization may actually draw attention away from the underlying problems, and could create a host of additional issues.

The S&WB’s own studies provide abundant evidence that its practices are inefficient. Substantial savings could be achieved (or more work performed) without privatization by reorganizing and changing management practices, at least in theory. In reality, the collective difficulty of S&WB management, the Board, and the City Council to move decisively will make this type of change laborious. It is unlikely for the Board and its staff to achieve significant cost savings internally unless legal, institutional, and operational constraints are addressed.

Privatization cannot significantly reduce costs without cutting jobs, either through attrition or layoffs. Any appearance of savings without personnel cutbacks is likely to mask hidden costs or contract loopholes that would allow a private contractor to recoup profits otherwise eroded by maintaining the existing workforce.

Privatization of sewer and water functions will not fund the local matching share of federal money available for drainage improvements. In fact, it could actually eat into the funds available

for construction by forcing the drainage budget to support a larger share of S&WB overhead costs.

A private contractor will have an intrinsic incentive to minimize its cost, even at the expense of the long-term integrity of the city’s infrastructure. The S&WB—more precisely, its ratepayers—will have to foot the bill for rehabilitation work if a private contractor allows the system to deteriorate. A contractor will be obliged to perform only what is in the contract, but the S&WB must keep the systems running under any and all conditions. The S&WB has performed this function with demonstrable inefficiency; nonetheless, the city’s sewer, water, and drainage systems have served New Orleans continuously for a century. And for more than a decade, these systems have operated without a rate increase.

Whether privatization is a “good deal” for ratepayers will depend entirely on how a future contract is written and managed. Privatization contracts typically exceed hundreds of pages. Minor omissions or linguistic twists can open the door to change orders and contract claims that can wipe away promised savings.

In effect, privatization is the process of granting a monopoly for a public health function. If substantially all of the S&WB operations are privatized, there is a risk of becoming dependent on a single contractor, and the S&WB could be at a serious long-term disadvantage if this risk is not addressed in the procurement process.

Ultimately, privatization cannot rectify the S&WB’s deep-seated political, institutional, and managerial problems. A host of unanswered questions remain about how it would be implemented, and about whether long term savings will be realized in practice. The contract may

cost less than current operations, but it does not necessarily follow that there will be savings when the cost of overseeing the contract and the cost of performing the work that “falls through the cracks” of the privatization contract are counted.

Privatization would still be subject to the vagaries of the intertwined system of running the S&WB that involves the managerial staff, the Board itself, the City Council, and (on key employment issues) the Civil Service Commission. It is a system of institutionalized inefficiencies dominated by diffuse and sluggish decision-making. While there are reasons to embrace privatization, there are also reasons for the public to be wary of the contractor selection process, the negotiated contract itself, and how the S&WB will manage it.

## Endnotes

1. S&WB expenditures grew modestly through 1997. Since then, a hiring freeze resulted in the workforce dropping from an all-time high of 1,650 in 1997 to about 1,375 at present, almost exclusively through attrition. This reduction moderated expenditure growth in 1998, but expenditures grew in 1999, primarily due to the cost of services and utilities, and the provision for claims.
2. The operating budget does not include bookkeeping entries for depreciation totaling \$28.4 million for all three services.
3. The requirements for dedicating revenues on a service-by-service basis are found in LRS 33:4121(A)(3) for sewer; 33:4096(A)(3) and (B)(8) for water; and 33:4121, 4137, and 4147 for drainage.
4. The free water and sewer mandates are in LRS 33:4096(A)(1) and 33:4121(A)(1).
5. Debt service coverage ratios are addressed in LRS 33:4121(B)(2) and 4121(D) for sewer; and 33:4096(B)(2) and 4096(D) for water.
6. The prevailing wage provision is in LRS 33:4085 B(2).
7. LRS 33:4089 prohibits spending in anticipation of a surplus.
8. Rule III.6.4. of the Civil Service Commission regulations address privatization.

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## **Privatization of Sewerage and Water Board Operations**

### **Quick View**

- ◆ A 1998 federal consent decree requires the Sewerage and Water Board (S&WB) to spend about \$455 million over 13 years to repair New Orleans' aging sewerage system.
- ◆ To fund the consent decree requirements, the S&WB and the City Council recently approved a 30% sewer fee increase. This will be sufficient for 2000 and most of 2001, but not beyond.
- ◆ The S&WB is considering privatizing the sewer and water systems (but not drainage) to reduce costs and free up funds to devote to capital improvements. The current plan is to follow a managed competition process in which private companies and the existing S&WB employees would bid against each other.
- ◆ There is no good estimate of how much privatization would reduce S&WB costs. However, even under optimistic projections based on the experience of other cities, increasing sewer fees would still be necessary.
- ◆ New EPA regulations will require costly improvements to water treatment plants. To pay for these improvements, the S&WB will probably have to exercise its existing authority to impose a 12% water rate increase
- ◆ Over \$300 million of federal funds are available on a three-to-one basis to pay for major drainage improvements. Current drainage revenue is adequate to match these funds in 2000, but beyond that, additional revenues will be needed to take full advantage of federal funding.