

## 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.

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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

funds by half, to the lowest level since 1975, at a time when more than two-thirds of the metros in the country have not yet recovered the jobs lost during the recession.

A recent Government Accountability Office report was pessimistic. Tax revenues for states and localities, it predicted, "will remain below the 2007 historical high through 2060 due to the projected modest growth in receipts." It concluded that the declining fiscal conditions mean that state and local governments will "need to make substantial policy changes to avoid growing fiscal imbalances in the future."

So what will those policy changes be? Not surprisingly, the different approaches in the states will reflect the schism in Congress. The red states are more likely to lower income and corporate taxes, cut spending and refuse to cooperate with Obamacare. The blue states already have raised taxes to close budget gaps and invest in education and infrastructure, as well as set up their own health-care exchanges.

A number of red states—Kansas, Louisiana and Nebraska, among them—are trying to cut or eliminate income taxes by increasing sales taxes, with the idea that the switch will attract investment and eventually pay for itself. The problem is that sales taxes are regressive, slower to revive from downturns, and no longer track consumption since they rarely cover services.

Judging from past experience, it is the tax cutters who bear the burden of proof. Most prominently, George W. Bush passed the largest tax cut in U.S. history in 2003, but his term in office proved to be one of the least economically successful of any president since World War II.

Still, we need to keep an open mind. Washington is hopelessly mired in the muck, but states are not. We now are experiencing the highest concentration of partisan power in states since the 1940s, with one party in charge in 43 states. So lots of experiments are in the works. We'll have to see how they turn out. **G**

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## Putting the Pressure On

The White House has a plan to win over even the most anti-Obamacare states.

Some states aren't going along with the Affordable Care Act, and not surprisingly, the White House isn't too happy about that. If every state expands Medicaid and sets up its own health exchange, the law will work better, the White House argues. So how can the administration convince Republican state officials who are vehemently opposed to Obamacare to come around? They've got a few ideas.

One, in particular, is pretty cunning. About 20 states aren't expanding Medicaid to 138 percent of the poverty line and will have the feds run their exchanges instead of setting up their own. When residents below the poverty line in those states go to the exchange to apply for insurance—probably oblivious to the fact that they will not be covered—they'll get a special note from the federal government that reads, "Sorry, you can't get health insurance because your state didn't expand Medicaid." (The wording will likely be more diplomatic than that, but that's the essence of it.)

The move has Republican officials rolling their eyes at what they say is a blatantly political move. "It's not inaccurate, but it's certainly petty," says Tony Keck, South Carolina's health and human services director. His state has opted not to expand Medicaid, but it is developing contingency plans to assist confused customers on Oct. 1, when the exchanges open. "They can say whatever they want when they're on the stump, but it's a little bit different when it's taxpayer-funded," he says. "When somebody calls us, we're not going to put them through a political commercial."

The exchange gimmick is part of the Obama administration's broader plan to lobby even the reddest states to buy into Obamacare. The health reform law allows states to take more control of their exchanges in later years—and insurers have said they'll push them to do it. States can also always change their minds about the Medicaid expansion, though they'll miss out on one year of 100 percent federal funding if they don't expand until 2015.

Making the health reform law work is crucial to Obama's ultimate legacy, so the administration needs to win over resistant states. The U.S. Department of Health and Human Services (HHS) held a conference call with reporters in July to publicly urge leaders in Florida—where Gov. Rick Scott and the state Senate agreed to the Medicaid expansion, but the House refused—to finish the job. Florida, with its more than a million people who would qualify for expanded Medicaid, would be a big win for the administration.

"States can improve health, protect families from financial ruin, ensure doctors and hospitals get paid for the care they deliver, and boost the economy," Paul DiGuaraldi, HHS director of intergovernmental and external affairs, told reporters. "We're still hopeful that Florida will take advantage of this generous offer."

Still, Keck says that the White House's tactics could have the opposite effect. They make it politically harder for state officials to come around when they resort to games like the exchange message. "I'm sure if you polled nonexpansion states," he says, "there aren't a lot of warm and fuzzies between them and the administration."



**Tony Keck: "It's certainly petty."**

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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

### 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.

scheduled. After that, 70 percent of annual rate increases are fixed with the rest tied to an inflation index.

#### ✓ 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

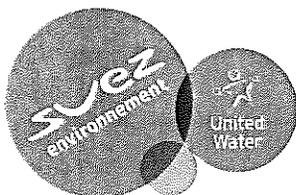
While there are clearly significant opportunities for P3s in water, these partnerships can benefit state and local governments in a host of other areas as well, including electricity generation and distribution; education, health care and correctional facilities; garbage disposal and resource recovery; 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.

#### About United Water

United Water is one of the nation's leading environmental companies, providing water and wastewater services to approximately 5.5 million people in the United States. In addition to owning and operating 16 water and wastewater utilities, United Water operates 90 municipal and industrial water and wastewater systems through innovative public-private partnerships and contract agreements. Founded in 1869, United Water is a subsidiary of SUEZ ENVIRONNEMENT.

#### About SUEZ ENVIRONNEMENT

Natural resources are not infinite. Each day, SUEZ ENVIRONNEMENT (Paris: SEV, Brussels: SEVB) and its subsidiaries deal with the challenge of protecting resources by providing innovative solutions to industries and to millions of people. SUEZ ENVIRONNEMENT supplies drinking water to 97 million people, provides wastewater treatment services for 66 million people and collects the waste produced by 50 million people. SUEZ ENVIRONNEMENT has 79,550 employees and, with its presence on a global scale, is a world leader exclusively dedicated to environmental services. SUEZ ENVIRONNEMENT, reported sales turnover of 14.8 billion Euros (\$19.6 billion USD) at the end of financial year 2012.



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By David Levine

# Reining in Health-Care Costs

California tackles runaway hospital pricing with a competitive experiment.

America has the highest health-care costs in the world, and nothing illustrates the problem more clearly than the irrational world of hospital pricing, where the same service with the same outcome can vary exponentially in cost. But the state of California has brought some clarity to this issue, and the rest of the country—both the public and private sectors—is taking notice.

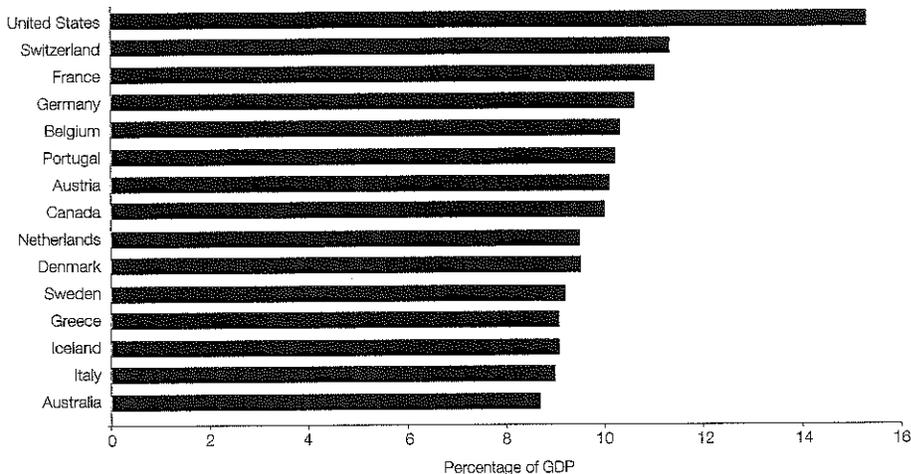
In 2008-2009, executives with the California Public Employees' Retirement System (CalPERS), which manages the nation's largest pension and health benefits program, drilled down to find the biggest health-care cost drivers. Given the average ages of their 1.3 million members, arthritis was predictably high on the list. "We dug into it a little more and saw that price variation among hospitals for [single-joint replacement] surgery varied from about \$15,000 to around \$100,000, with the same outcomes," says Ann Boynton, deputy executive officer for CalPERS Benefit Programs Policy and Planning. "There really was no excuse for that variation in pricing."

So CalPERS asked Anthem Blue Cross, its health insurance carrier, to find a better approach. Analyzing data from hospitals throughout the state, Anthem settled on an average price of \$30,000 for single knee and hip replacement. The group identified hospitals—from large medical centers to smaller community hospitals—in each of the state's 58 counties that could meet both that price point and geographic demand. Beginning in 2011, CalPERS told members that if they went to these approved centers, insurance would cover it all, save for the usual 20 percent coinsurance. If they didn't, members had to pay the difference.

How did it work? The average amount Anthem paid to hospitals for a joint replacement dropped from \$34,742 to \$25,611, an overall savings of about \$5.5 million during 2011 and 2012, with no loss of quality. Yes, that represents barely a drop in California's overall \$6.6 billion annual health insurance bucket. But the modest savings has led to a more significant revelation: Pricing is not tied to quality, says Boynton. In fact, that's the problem. It's still not clear what pricing is linked to. "We want to find things that are market-changing," she says, "so the people of California can change behavior in a positive direction. That's an important aspect of what we do as a government purchaser."

As with any market-changer, there was pushback. Members expressed concern that their doctors didn't have admitting privi-

## Outspending Everyone Else



**America's health-care costs significantly exceed what other countries spend, yet the quality of care is about the same.**

leges in the program hospitals or that they would have to travel farther. But no one was concerned enough, Boynton says, that they opted to pay the difference. "We think this was successful because now people had real skin in the game."

Surgeons were surprised to learn the wide differences in hospital costs. "They knew what they got paid but not what the hospitals are charging," she says. "This was a good example of shining a light into a dark corner."

For other states or localities looking at competitive pricing models, Boynton says that "your plan partner is crucial for success. Anthem's willingness to participate was very instrumental." Communication with members is also critical. "You don't want people getting shocking, horrifying medical bills out of the blue," she says. "Preauthorization intervention—so members are well informed as they move into this kind of process—you can't underestimate how important that is."

Be prepared for serious blowback from high-priced hospitals too. "We had some fairly irritated hospital CEOs," she says. The upside, though, is that the prices they charged for hip replacements also declined dramatically, from an average of \$43,308 in 2010 to \$27,149 in 2012.

Funny how competition works. "Government's ability to find ways to change the economic dynamics by forcing change," says Boynton, "is incredibly important." **G**

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SOURCE: ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT HEALTH DATA 2008  
NOTE: FOR COUNTRIES NOT REPORTING 2008 DATA, DATA FROM PREVIOUS YEARS IS SUBSTITUTED.