

# **The Pitfalls of Privatization: Contracting Without Competition**

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**Abstract:** Most authorities agree that privatization works best with vigorous competition among alternative service providers. Such competition may be difficult to achieve for certain services such as public utilities, for which a limited number of private firms exist to bid. This research first considers the theoretical issues surrounding the use of private companies in natural monopolies. Then it provides an extensive examination of the problems that confronted one large city in its efforts to privatize its wastewater treatment system. Beset by lack of competitive bidding and growing costs, Oklahoma City eventually was forced to make major changes in its procedures for handling its sewage disposal plants. The city did not return to municipal operation, however, and the city is now satisfied with the current arrangement under which a private firm operates all four of its wastewater treatment plants.

Privatization's appeal is strong during a time when hard-pressed public officials search for ways to save money and provide services more efficiently. No matter what form privatization takes, the arguments for it are similar, primarily that public monopolies are inefficient and have little or no incentive to hold down costs. On the other hand, private firms, spurred on by competition, presumably will operate as efficiently as possible to increase their return on investment and ultimately will save taxpayers money. According to considerable literature, then, one of privatization's principal attractions is the use of competition to control costs, improve service delivery, or both. In Savas's words (1987, p. 251), "service delivery options are essential. Total dependence on a single supplier, whether a government agency or a private firm, is dangerous."

But what about so-called natural monopolies, where a single firm can most efficiently supply a good or service? Can privatization be applied here? The usual approach taken in the United States has been either to provide the service through a government-owned and -operated monopoly or to permit private provision under highly regulated conditions. Now, however, we see more and more examples of efforts to introduce competition for services considered natural monopolies. For example, Hanke and Walters (1987) note

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that today private companies supply about half the drinking water in France and Spain. Similar instances of privatizing public works in the United States are now appearing as well. Yet several issues and problems confront those who might wish to make greater use of private firms to deliver such local services as water supply or sewage treatment.

This paper begins with a review of the theoretical issues surrounding the introduction of competition to natural monopoly services, especially public utilities. Despite the widely acknowledged importance of competition in private-sector delivery, any attempt at privatizing public utilities presents special problems. The first part of the paper considers some of the obstacles associated with four approaches to using private providers of utility services, with special attention to contracting out. The second portion of the paper presents an extensive case study of one large city's efforts to make greater use of the private sector in its wastewater treatment. Although Oklahoma City currently has all of its sewage treatment facilities under private contract, it experienced a number of difficulties before settling on the present arrangement. The paper concludes with an assessment of Oklahoma City's experience in light of the theoretical literature dealing with public utility services.

### **The Theoretical Issues Surrounding Public Utility Services**

In considering the appropriate organizational structure for delivering public services, the literature sometimes reflects only a two-fold distinction—provision by public agencies or by private firms. Relying on a principal-agent model,<sup>1</sup> Donahue (1989, Chap. 3) discusses the relative advantages of using these two basic types of providers—civil servants or profit-seekers. He argues that the basic question to be answered is which of the two delivery modes will ensure that the agent (government department or private firm) likely will perform most cost effectively on the principal's (the public's) behalf. The real issue is accountability: Which arrangement is most likely to yield the results the customer seeks at a reasonable cost?

Donahue then discusses some of the complications and barriers to cost-effective operation by both types of providers. For private market exchanges, the theory holds that the principal enforces accountability by a constant evaluation of the output on a transaction-by-transaction basis. If performance is subpar, the principal terminates the relationship (or finds incentives to improve effectiveness) and seeks another agent. Competition thus plays a key part in guaranteeing acceptable performance. Donahue notes that the idealized model seldom works smoothly primarily because few private sector transactions are output- or performance-based. Most people are not entrepreneurs but wage earners; they work for some larger enterprise, and their performance may be compromised by a host of considerations. For example, organizations may offer few incentives for risk taking, and measuring the results of the exchange between principal and agent can be difficult. In most private-sector relationships, the principal does not pay on the basis of specific outputs but rather for someone's time, effort, or expertise. As a result, the

principal-agent linkage becomes attenuated. In Donahue's (1989, p. 41) words, "Once the bond between payment and ultimate results is severed, the agency relationship is vulnerable to breakdown."

Service provision by public bureaucracy brings accountability problems of a different sort. The most obvious contrast is the insulation of public agencies from market forces. The absence of competitive forces is commonly deemed the most fundamental weakness in bureaucratic accountability. Various schemes have attempted to improve public-sector performance, many of which were borrowed from the private sector, including pay-for-performance and forms of employee participation. Recently, more far-reaching efforts to enhance public accountability and cost effectiveness have arisen, including privatization (Moore, 1987; Rehfuss, 1989, p. 118). Above all, its proponents contend, privatization will encourage competition by forcing public enterprises to operate more efficiently. As Moore (1987, p. 61) puts it, "The injection of competition into the procurement process is the critical feature" of privatization that ensures expected cost savings.

Even in those fields of economic endeavor where competition has been largely excluded, many observers now push for new approaches. Partly fueled by the movement toward deregulation that arose in the late 1970s, some economists have begun to rethink the traditional means by which monopoly services are provided. In the public utility field, for example, alternatives to public ownership and government regulation are under serious consideration, approaches that inevitably require greater reliance on market forces and the use of private providers.

## **Privatizing Public Utilities**

Private provision of utility service can take one of four forms—private monopoly under government regulation, franchising, contracting out, or full privatization or load shedding.<sup>2</sup> Each of these warrants brief treatment, beginning with the most historically prevalent approaches, regulation and franchising.

### **Regulation**

The most frequent substitution for public ownership of utilities involves the use of a single private firm operating under close government supervision. Most economists consider utilities to be part of a class of enterprises referred to as natural monopolies, where one supplier can furnish a product or service at a lower cost than two or more firms serving the same geographic area (Poole, 1985, p. xi). In such cases, market entry by other firms supposedly would be wasteful and unprofitable, precluding effective competition. Yet the monopolist's market dominance poses a threat to price stability, bringing calls for government regulation to protect the public from price gouging. Although regulation putatively brought other benefits as well (see Berg & Tschirhart, 1988, pp. 6-11), control of monopoly prices arguably is the principal rationale for government involvement.

In recent years, some economists and policy analysts have begun to question the value of regulation, especially in those spheres where at least some competition might be possible (see the essays in Poole, 1985). Even traditional natural monopoly theory has been re-examined. As one author (Sharkey, 1982, p. vii) states, it was "no longer obvious, or self-evident, whether or not a given industry satisfies the conditions of natural monopoly." As the movement toward deregulation gathered momentum during the 1970s, events of the day, if nothing else, forced a reassessment of the benefits of regulation. The main concern was economic efficiency. Critics charged that government regulation inhibited innovation, contributed to delays in responding to changing market conditions, and forced utilities to adopt excessive capital-intensive technologies (see Averch & Johnson, 1962; Crew & Rowley, 1989, pp. 6-11; Schmalensee, 1979, Chap. 2). In short, regulation failed the test of efficiency; the public would be better served, many argued, with other more market-oriented approaches.

### **Franchising**

Franchises for public utilities have a long history. In critical ways, this strategy is similar to regulation; both often involve the use of a single provider operating for a long period in a limited geographic area under some degree of government control. Under a franchise agreement, the user pays the provider directly for the service, and the public authority may or may not control prices or service levels. With an exclusive franchise, frequently the approach with utilities, the public agency usually does establish rates. In nonexclusive franchises, the private firm may function in a competitive environment with customers choosing from multiple providers (Hatry 1983, p. 29).

Even where exclusive franchising has been the norm, competition may be injected under an arrangement called franchise bidding. Demsetz (1968) is usually credited with reviving interest in this approach. In effect, he argues that a publicly held competitive auction for a natural monopoly franchise would be superior to regulation. Under such an arrangement, private firms would submit bids on utility rate schedules, and municipal officials could select the lowest or best bid. Some version of franchise bidding often occurs in the cable television industry (see Hazlett, 1985, pp. 87-88).

Although franchise bidding may appear to be an attractive option in dealing with natural monopolies, several observers have raised questions about it. Schmalensee (1979, pp. 68-73), for example, fears that such an arrangement may not produce real competition. Apparently there is a limited number of potential bidders for utility franchises, making coordination among existing firms relatively easy. Schmalensee thinks bidding may be especially problematic at the conclusion of the franchise. He finds no references to any cases in which an existing supplier bid against other firms. Apparently the public agency renewed the franchise unless it was quite unhappy. In such a case, the franchise holder was simply told to leave at the end of the contract. Vickers and Yarrow (1988, pp. 110-115) identify other problems as well. These include the strategic advantage stemming from the superior knowledge possessed by the incumbent franchise holder, asset turnover, and the potential

for the existing supplier to underinvest near the end of the contract period. In effect, Vickers and Yarrow conclude that except for the simplest products and services, franchises have few advantages over the usual utility regulation (also see Williamson, 1976; for a contrary view, see Hanke & Walters, 1987).

### **Complete Privatization**

For public utilities, full privatization would entail either selling an existing system to a profit-seeking firm or granting a private company the right to build, own, and operate a utility. Although load shedding has not been widely employed in this country primarily because of the lack of widespread government ownership, some advocates of greater competition insist that government can do considerably more in allowing market forces to operate normally even for so-called monopoly services. Cornell and Webbink (1985, pp. 38-40), for example, discuss some ways to achieve greater competition in the utility field in the absence of government ownership or regulation. First, they favor the use of multiple franchises. Second, they say firms engaged in providing "network services," including telephone and electric services, should be forced to allow interconnections where multiple lines converge. Third, "inter-modal competition" should be encouraged. The consumer should benefit not only from competition within existing industry but also from competition across similar industries. Finally, they contend that monopoly power can be held in check by enforcing anti-trust restrictions.

Privatization might also involve an agreement by a local government, for example, to allow a profit seeker to provide a utility service by constructing, owning, and operating the facility. Customers would pay the public jurisdiction, which in turn would reimburse the private provider. Because of the novelty and complexity of this approach, the public utility field has seen only a few attempts at this version of full privatization. Johnson and Heilman (1987, p. 472) comment on an "unusually complex array of constraints" that confronted a small number of municipalities that were potentially interested in privatizing wastewater treatment. These included value conflicts over the appropriateness of private-sector provision of a government-owned monopoly, EPA and environmental restrictions, the question of economic viability because of the novelty of the approach, and the complexity of contractual language covering such issues as plant buy-back. As Johnson and Heilman observe, full privatization in local utility services, with its dominance by government providers, is an uncharted frontier with considerable uncertainty and complexity.

### **Contracting Out**

Under a purchase-of-service contract, the public authority retains ownership but awards a competitive bid to a private vendor for operation and maintenance. Savas (1987, pp. 135-136) describes the advantages such an arrangement offers New York City for a natural monopoly—street lighting. The city owns the lighting system but contracts with private firms in eight separate districts to maintain them; it receives power from yet another private firm.

Presumably, if done correctly, contracting out for the maintenance and operation of a public utility would yield all the potential benefits associated with any form of purchase-of-service agreement (Moore, 1987; Sharkansky, 1980). Still, contracting for public utility operations may present unusual problems that warrant special consideration. These might be discussed under the headings of competition and implementation.

*Competition for utility operation.* Just as with franchise bidding, municipalities contracting for the operation of a natural monopoly may encounter uncommon barriers to full competition. Four might be noted, several of which are interrelated. First is bidder *collusion*. Schmalensee (1979, p. 72) contends that the current structure of many public utility industries is conducive to coordination among existing firms. Considerable technical knowledge and expertise may be essential to enable an interested firm to bid intelligently on the operation of an electric utility or a sewage treatment plant, for example. Such facilities traditionally have been in government hands or under control of a few private companies. As with franchising, competitive bidding for an operating contract may be especially troublesome when the contract expires and the current holder bids against competitors. As one observer notes, "Initial suppliers often gain cumulative insider advantages" (Starr, 1987, p. 129).

A second but related matter concerns the *number of bidders*. Competition works best when the pool of potential suppliers is large. As indicated above, that is not likely to be the case with potential operators of public utilities. Even without direct collusion, the absence of abundant vendors may yield less than optimal results. *Corruption* (e.g., bribes, kickbacks, payoffs) is the third obvious concern. Although the potential for corruption in contracting is widely acknowledged, the opportunities for such behavior, including politically motivated bid rigging, should increase with fewer bidders. In response, Savas (1987, p. 257) insists that the best defense against corruption is "effective competition." But the fewer the suppliers, the less competitive the bidding is likely to be. Finally, *clear and complete specifications* are critical. This requirement may be less difficult for utility operation because measuring its output is easier than measuring other activities such as social services, for example.

*Implementing a contract for utility operation.* Implementing an operating contract for a public utility may also present novel problems. First, as with all contracts, close *monitoring* is essential. In the utility field, issues of health and safety may be especially salient. For instance, waterworks or wastewater treatment must meet state and federal requirements. Regardless of who operates the system, the owner (the public jurisdiction) is ultimately responsible. The longer the duration of the contract, which may be desirable with utilities, the easier it becomes for the public authority to become lax in its oversight. Such behavior might create unforeseen problems either with lack of proper maintenance or unexpected demands for price increases because of changing economic conditions. Second, with the merger of public and private interests, problems of *coordination* inevitably arise. By necessity, public officials and operating managers must maintain a close working relationship. However, as Schmalensee (1979, p. 78) notes, the two groups may have different objectives, and neither will have all the information available to the

other. In fact, he suggests that management incentives for distorting information flow may be substantial in dual-control systems. Finally, utility contracting must consider the *costs of failure* and the ease of replacing the existing supplier. Some vendors may fall below acceptable levels of quality or even go bankrupt. To deal with such possibilities, some localities that contract for solid waste collection, for example, keep part of the city's refuse collection system in-house. Such an option is more difficult for a natural monopoly. Contract cancellation for failure to perform could lead to a series of additional financial obligations for the public authority—new start-up costs, transitional costs, legal costs, and perhaps service disruption (Bailey, 1987, p. 150). A quick and simple replacement may be difficult, especially if the public agency has lost its in-house capacity.

### **Comparing Public and Private Provider Costs**

Regardless of the form privatization might take, its advocates almost always contend that market forces will compel public enterprises to operate more efficiently, yielding clear cost savings to the public. Yet previous research of utilities does not unequivocally confirm this expectation. In fact, one secondary analysis of a number of studies shows that public electric utilities were more efficient than private firms, most of which were closely regulated (Ross, 1988, p. 35). Regulation clearly does not create market-like incentives. To the contrary, private managers in a sheltered environment may behave much like their bureaucratic counterparts in the public sector. With a guaranteed rate of return, regulated private utilities have no more reason to search for savings than do public enterprises. Perry and Babitsky (1986) identify such a situation in urban bus transit, here they find purely private operation performed significantly better than other organizational arrangements. In fact, "contract-managed systems," with no competitive pressures, were no more efficient than publicly managed operations. Caves and Christensen's (1980) comparison of the relative efficiency of Canadian railroads, one public and one private, is also instructive. They uncover no evidence of inferior performance by the public line. Instead they conclude that the pressure of competition has overcome any tendency toward inefficiency resulting from public ownership.

Other researchers also have compared costs and service quality between public and private producers. Donahue (1989, p. 75) summarizes the results of water utility cost studies. Although these researchers generally rely on the same basic data and use similar analytic techniques, the results are quite mixed. Bruggink (1982), for example, finds lower operating costs for government-owned water utilities, while Crain and Zardkoohi (1978) show the private sector to be more efficient. Teeple and Glycer (1987), however, argue that if the models are carefully specified, no overall efficiency differences appear based on ownership. Apparently, the weight of evidence shows no tendency for private water utilities to be any more productive than public enterprises (Donahue, 1989, p. 75).

In sum, almost every researcher stresses the critical nature of competition in selecting an alternate service provider. Economist Dick Netzer (cited in Main, 1985, p. 94) says: "There is absolutely no advantage in replacing a

public monopoly with a private monopoly. What you really are after is competition.” Yet as natural monopolies, utilities confront special problems in achieving the desired degree of competitive bidding and in implementing contractual agreements. The following case shows how some of these issues unfolded in Oklahoma City’s effort to involve the private sector in its wastewater treatment.

### **Contracting for Sewage Treatment in Oklahoma City**

Oklahoma City is served by four sewage treatment plants. The newest facility, Cow Creek, was constructed in 1986 by a private firm, Spitz Development Oklahoma City Limited Partnership. The plant was owned and operated by this company until 1991. This firm is one of seven in which engineer Frederick J. Spitz has an interest and that at one time has been under contract with the city for handling wastewater treatment.<sup>3</sup> Spitz began designing sewage treatment plants for Oklahoma City in 1968. Between 1968 and 1987, his corporations received 25 contracts from the city to design, supervise construction, and/or operate sewage treatment plants. Before it made major changes in 1987, Oklahoma City was paying Spitz’s firms about \$9 million a year for treating wastewater and disposing of sewage sludge. What had begun as a fairly routine engineering contract for design of a small facility had mushroomed into a mammoth, multi-million-dollar contracting operation. Apparently few of these contracts were bid competitively. How did Oklahoma City find itself in such a position? What was the result of an arrangement in which firms associated with one individual dominated such a vital and costly city service? What happened when a new city manager initiated a study of the history of sewage treatment contracting in the city?

Fred Spitz began his career in civil engineering in the late 1950s, offering his services to local governments in central Oklahoma. In 1968, Oklahoma City selected Spitz to design the smallest of the city’s four sewage treatment plants, Chisholm Creek. The actual agreement was with one of Oklahoma City’s several public authorities, entities created essentially for issuing revenue bonds for public works projects. (Under state law, city governments may not issue such bonds.) Because it was a “professional service” contract, no formal competitive bidding was required. Following the initial 1968 agreement, the city gave Spitz another contract, without competitive bid, for disposing of the sewage sludge from Chisholm Creek and later from all the city’s plants. The city renewed that contract some eight times, apparently each time without any competitive bidding.

Then in 1982, Spitz received his first contract to operate a plant, one of Oklahoma City’s largest—Deer Creek. This negotiated agreement apparently was based on a 1980 proposal Spitz submitted at a time when the city seriously contemplated contracting its wastewater treatment. The city did not ask for formal bids but rather only issued a request for proposals. Although several companies expressed interest, the city did not award a contract in 1980. However, it used Spitz’s previous offer to negotiate a 1982 agreement for Deer Creek and a 1984 operating contract for a second plant.<sup>4</sup> By 1987, Spitz



was involved with three of the four municipal plants; the city itself continued to operate the smallest facility, Chisholm Creek. However, matters were soon to change.

The early 1980s brought trying times to Oklahoma City (1990 population of about 450,000) as the huge slump in energy prices created severe budgetary problems for city government. The failure of several attempts to increase the city sales tax from the late 1970s through the mid-1980s contributed even more to a sense of financial crisis. Among other difficulties facing the city was the compelling need to replace an aging and outmoded wastewater treatment plant in the far southwest part of town.<sup>5</sup> For years, the Oklahoma State Department of Health had urged the city to get rid of the decrepit facility. Finally, in August 1983 the health department issued an order allowing the plant to continue operating without penalty if the city began construction of a new plant by December 1984 and completed it by August 1, 1986. Otherwise, the state agency would impose a building moratorium on the south and west sides of the city pending a remedy of the problem.

In the face of two recent sales tax defeats and millions of dollars of capital improvement needs, the city now had to finance and construct a new wastewater treatment facility within 28 months. Some city council members thought the solution was to have one of the public authorities issue more revenue bonds. In fact, the city staff prepared a proposal for constructing the plant via revenue bonds. But the city manager soon advanced another idea. After considerable discussion of various options, city manager Scott Johnson, supported by the city engineer, recommended that the city consider a fully privatized project—a private corporation would finance, construct, own, and operate the sewage disposal facility. After several months of intensive study, the city council bought the notion. A new plant, Cow Creek, was soon to be born.

### **The Cow Creek Project**

Solicitation for the fully privatized project was general. The city initially asked for no financial data; rather, the applicants were to describe how they would put together a complete privatization package. They were to outline their experience, finance method, and proposed mode of operation. On June 20, 1984, the city received four proposals. Staff from the city manager's office, the community development department, and the water department formed a preliminary analysis team to evaluate the initial proposals. The panel selected two firms for further consideration—Fred Spitz and Associates and Parsons Engineering of Pasadena, CA. Because the solicitation was open-ended, it was difficult to make precise comparisons of the two proposals. Confusion arose, for example, over what each firm's operating budget included. Was electricity included? How was replacement capital budgeted? The council then sent a questionnaire to each company asking for more financial information. After a detailed presentation by the city's outside auditing firm, the council voted to negotiate a privatization contract with Spitz. Apparently Spitz's long-time experience with sewage treatment in Oklahoma City gave his firm the

edge. There is some indication, however, that city staff preferred the other bidder.

Under the final agreement dated December 1, 1984, Spitz would own the land, build the plant, and operate it for 15 years. The original operating fee was to be renegotiated annually based on changes in the consumer price index. The construction cost was projected to be about \$12.8 million, but the final total was more than \$23 million primarily because of interest and associated issuance costs. Spitz finished ahead of schedule, and the plant opened in June 1986, a month and a half before the health department deadline. For early completion, the city paid Spitz a bonus of \$200,000. Any time during the contract period, with 90 days notice, the city had the option to buy the plant at market value.

The Cow Creek arrangement clearly pleased most city officials. They undoubtedly thought they had solved a serious public works problem without going further into debt.<sup>6</sup> City Manager Johnson told the local newspaper: "What made privatization of the service more attractive for the city is the tax break made possible by the Economic Recovery Act of 1981. . . . Private contractors save money through the use of accelerated depreciation not available to government. The City government then benefits if these savings are reflected in the fees charged to it by the private sector" (*Daily Oklahoman*, 1984). Still, one member of the council opposed the privatization deal. Council member Jerry Gilbert commented, "The entire project is a rip-off of the taxpayers. The contract indicated the city can buy the plant back after 15 years at a fair market value, but no one knows what this value will be since the technology of wastewater may change in 15 years" (*Journal Record* [Oklahoma City], 1984). Gilbert stood alone in his opposition.

### **The System Breaks Down**

Despite the optimism surrounding Cow Creek, privatizing Oklahoma City's sewage treatment was causing trouble. The city's economy and resulting financial pressures soon brought a reassessment of a number of city operations, including wastewater treatment. In effect, the same conditions that led the city to consider privatizing Cow Creek soon caused city officials to search for other ways of cutting costs in virtually every area of city government. Soon after taking office in 1986, newly hired City Manager Terry Childers convened a management team retreat to consider areas ripe for innovation, improvement, and cost savings.<sup>7</sup> The group identified water and wastewater as possible areas for savings. The manager then initiated a program analysis to include a thorough assessment of the costs and operation of the city's system for treating sewage and disposing of sludge. The analysis also included a survey of costs associated with similar-sized sewage treatment plants in other cities.

Following several months of work, on June 23, 1987, the city manager issued a memorandum to the city council on the contracts for wastewater treatment. An appendix to the report provided 1985-86 comparative cost data for operation, maintenance, and sludge removal. The report shocked at least some of the council. It showed the four Oklahoma City plants averaging about \$540 per million gallons of wastewater treated, compared to a low of \$201 in

nearby Tulsa and to a high of \$375 for a large plant serving Dallas. Oklahoma City was apparently paying 26 percent to 126 percent more than other cities with similar plants. Moreover, the city's own operation was not any more cost-effective than its three privately managed plants. The manager's study highlighted three major areas of concern that presumably contributed to the excessive cost: (a) the potential for conflicts of interest under contracting guidelines, (b) lack of competitive bidding, and (c) questionable contractual arrangements.

*Conflicts of interest.* The city manager's memo describing the problems with wastewater treatment made no allegations of illegal actions. A chief concern was the lack of separation between plant design and operation. Since 1968, with one exception, the same firm that designed, engineered, and supervised plant construction ended up with a contract to operate those same facilities. Regardless of the technical competence of any given firm, such an arrangement appeared too cozy. By 1987, this arrangement was generating some \$9 million a year to one or another of the firms associated with Fred Spitz. In addition, the study showed that one company was the sole supplier of the majority of equipment to the plants designed by Spitz. In brief, the study found a "potential conflict of interest concerning the same engineer designing and operating a wastewater treatment plant."

*Lack of competitive bidding.* The document was especially critical of the city's handling of sewage sludge. The four plants generate more than 25,000 tons of sludge annually. In 1987, the city paid Spitz \$90 a ton for removal of the residue. The report noted that San Jose, CA paid only \$30 a ton. Apparently over the years the city awarded repeated sludge contracts to Spitz without competitive bidding. The city manager further observed other unusual arrangements in contract awarding. A review of the city's files showed the following development:

The usual scenario begins with a relatively insignificant study on design projects. Over time, the project evolves into a series of design alternatives, final design, and later construction for which Mr. Spitz provides the review and management. Later the project is quite often operated by Mr. Spitz with little meaningful input or changes suggested by staff (Childers, 1987, p. 3).

*Questionable contractual procedures.* The main concern here was Cow Creek. The report claimed that the final sale of construction bonds at \$23 million was "approximately twice as much as the original anticipated construction cost." An attached appendix provided details. The actual construction price for Cow Creek was only \$14.9 million; the balance of the cost was primarily for financing (interest and discount/issuance costs). Although in a literal sense the manager's report was correct regarding construction costs, in reality the extra amount appeared to be a legitimate cost associated with financing the project. The manager mentioned, too, that the city water department had recommended another corporation as the project contractor. Apparently the city's independent auditor had recommended Spitz. In effect, the report criticized much of the Cow Creek arrangement, implying throughout that the city was paying too much for its fully privatized project.

### **The 1987 Changes**

In response to the city manager's report, on July 7, 1987, the council created the Ad Hoc Committee for Contract Review (Childers & Ridings, 1988). The group held 14 meetings during which it examined contracts, interviewed experts, heard from city staff, and considered information from other cities. The committee corroborated virtually all the facts and assertions contained in the city manager's June 23 report. The group also talked to Spitz at length. At times, the hearings were acrimonious. According to one newspaper account, "On numerous occasions, through letters to the committee or during Spitz's personal testimony, committee proceedings turned into name-calling sessions between Spitz and city staff" (Singleterry, 1987). Although the city council stopped short of cancelling contracts with Spitz, it adopted a series of policy changes based on the committee's report, the most important of which are as follows:

1. No firm serving as design engineer for a major project would be eligible to operate that project.
2. All aspects of sewage treatment (including sludge) would be bid competitively.
3. The city would establish an effective means of reviewing and evaluating its contracts with private vendors.
4. The city would have to develop an in-house capability to manage the design and construction of public facilities.
5. The city would award cost-plus operating contracts only "on specific authorization in a particular case based upon a determined public need" (Childers & Ridings, 1988, p. 6).

Notice that the new policies all relate to ways of handling private contracts. The report said nothing about returning wastewater treatment to the municipal government.

Adopting the committee's recommendations was only the first step. Operating contracts for two plants were to expire in 1987 (Spitz still had Cow Creek, and the city retained one). Officials decided to ask for competitive bids for operating all three city-owned plants. Six firms as well as municipal employees bid on plant operation and sludge disposal. The low bid came from a private company, Professional Services Group (PSG) based in Houston. The city had estimated the advertised services at more than \$12 million a year based on current operating costs. The PSG bid was for less than \$8 million. The city manager calculated that the bid could save the city some \$24 million over five years.

Spitz decided not to bid in 1987. He said he had lost interest in wastewater treatment and had decided to retire to a condo in Vail, CO (Spitz, 1991). Sewage treatment was never his only business. At various times he was involved in low-cost housing construction, economic development, and other HUD-financed projects. In fact, Spitz erected the building that houses the city water and wastewater treatment department, again through an arrangement with one of the city's public trusts and without competitive bidding. Spitz has now resumed his engineering practice and is engaged in several new

ventures, including the use of new technology to evaluate the condition of streets and highways.

### **Oklahoma City's Current System for Sewage Disposal**

The city has been quite satisfied with the arrangement under which three of its plants are under contract to PSG. The director of Water and Wastewater Treatment Utilities, James Couch (1991), indicates that the anticipated savings in operational costs largely have been realized. Couch said that in 1991 the city was paying only about \$9 million a year in operating costs compared to more than \$11 million in 1987, even though the city has required the contractor to add more equipment during the past several years, resulting in higher operating costs.

A spokesman for PSG said he thought relations with the city were excellent and his company looked forward to bidding again in 1992, when the current contract expires. Asked why he thought PSG could operate so much more cheaply than the city anticipated, the current project manager listed several reasons, including the use of fewer employees, investment in plant automation, and more efficient use of energy and equipment (Berry, 1991). He also mentioned that his company operated about 250 plants around the country so that the various facilities were able to share knowledge and technology.

Meanwhile, matters were not going so well with Cow Creek. In March 1991, the Oklahoma City water trust announced it had taken over Cow Creek, the Fred Spitz-owned plant that city leaders had long suspected of costing too much. "The move is expected to save more than \$200,000 a year," according to Water Director Couch (Parker, 1991). The city has invoked the contractual provision allowing it to operate the plant for 90 days and also has given Spitz notice of its intent to assume ownership. In fact, the city trust immediately signed a contract with PSG to operate Cow Creek, again without competitive bidding.

City officials claim they do not owe Spitz any money because the amount of outstanding bond debt presumably exceeds Cow Creek's fair market value. Spitz maintains he has no problem with what the city has done thus far. "They have an option to purchase under the contract," he said (Spitz, 1991). But in April 1991, the Oklahoma City newspaper announced that the former owners of Cow Creek are asking for \$4.5 million in compensation following the city's takeover. Under the terms of the original agreement, both sides are to appoint separate appraisers to determine the plant's worth.

### **Why Spitz?**

Before concluding, we might consider why Spitz was so successful during his two decades of work for Oklahoma City. There were several apparent reasons. First, when the city was forced to meet new state standards for disposing of sewage sludge in 1968, it lacked the necessary trained personnel to operate its newly acquired equipment. Spitz had the expertise and was able to step in and help the city in its time of need. After that, subsequent contracts

to Spitz apparently became almost routine. Second, Spitz had an advantage in securing operational contracts for a couple of reasons. He had his foot in the door with the sludge disposal arrangement; he had been the designer of several projects to expand the city's treatment facilities; and he was the only firm in Oklahoma capable of plant operation. His proximity was important for other reasons as well. Not surprisingly, Spitz was active in local politics. In fact, former council member Jerry Gilbert (1991) maintains that the likeable engineer was a "major if not the No. 1 political contributor" to city council races. Finally, Spitz was considered a competent engineer who was also a good negotiator. Earl Potts, deputy director of the water department, said that there were never any improprieties in dealing with Spitz. He commented that Spitz was shrewd, knowledgeable, and did his homework. "His projects always worked," he said (Potts, 1991).

### **Conclusion**

Privatization is no panacea, as even its strong proponents usually concede. If done right, such advocates contend, considerable benefits can accrue. Doing it right almost always requires competition in some form, even if it involves forcing city departments to bid against outside vendors. But introducing competition to the operation of natural monopolies may pose special problems. Although contracting out facility operation may appear to be feasible, the literature offers several caveats, including the primary difficulty of ensuring truly competitive bids.

The Oklahoma City case illustrates some of the difficulties that may arise when a city turns to the private sector to handle a public utility. In the beginning, the city sought help externally not as a way of saving money but because it lacked competent personnel. The sums involved for disposing of sewage sludge were not large initially, so almost as a matter of convenience the city let the contractor continue to provide the service without competitive bidding. Once the private firm was in place, contracts for operating the wastewater treatment system came much more easily, generally through negotiation rather than formal bidding. Eventually external circumstances, namely severe fiscal pressures, caused the city to reassess its comfortable relationship with a series of private firms associated with one individual.

What larger lessons might we learn from Oklahoma City's somewhat troubled experience with privatizing its wastewater treatment? First, unless outside forces intervene, city departments may prefer to stick with an ongoing relationship they know rather than risk the vagaries of frequent bidding. As DeHoog (1984, p. 28) has observed with regard to contracting for social services, public officials are not interested in promoting the goals of contract advocates. Rather, they want to maintain existing relationships that are comfortable and do not threaten funding levels and established procedures. Second, for certain uncommon and technical services, such as utility operations, competition or cost savings may not be the dominant force leading to the use of private vendors. Regardless of the theoretically attractive arguments on behalf of competition, public officials are often propelled by other motives. In

Oklahoma City's case, the need for highly specialized personnel and equipment provided the initial impetus for contracting out the disposal of sewage sludge. In short, scholars and theoreticians may have oversold competition and its attendant cost savings as the main benefit and the primary motivation for privatization.<sup>8</sup> Surveys of local officials, for example, show that the lack of facilities and the need for technical expertise are likely to be at least as important as the cost savings that might come from contracting out (see, for example, Morgan, Meyer, & England, 1981).

The Oklahoma City case also may help identify several specific steps that might improve privatization. Beyond the importance of carefully written specifications and the necessity for frequent monitoring, cities should consider two actions—giving performance incentives and allowing municipal agencies to keep some of the “profits” where savings occur. In the case of public utilities where the number of bidders may not be large, the inclusion of performance incentives may be especially beneficial. In the Oklahoma City case, the contractor received a large bonus when the privatized sewage plant went on line ahead of schedule. No such incentives were incorporated in the operating contracts. In regard to the savings from contracting, Stein (1991, Chap. 7) has shown that though the agency may reduce costs, department heads have few incentives to pass those savings along to the city government. Thus, top city officials might acknowledge this inclination and willingly allow agency heads to retain some or all of the savings achieved from contracting out. Presumably such an arrangement would encourage city departments to consider contracting and providing greater incentives for effective monitoring, all of which would ultimately benefit the municipality.

Finally, in light of Oklahoma City's experience, we might reflect briefly on how contracting out compares with other possible alternatives to the traditional municipal monopoly for treating wastewater. Franchising offers similar advantages and disadvantages to contracting, but generally the franchise agreement is of longer duration. In addition, most city governments do not bill the customer directly for a franchised service. Although municipalities might be willing to relinquish that task, they probably should retain the billing for sewage treatment and add it to the water bill as is commonly done today. Why duplicate an existing billing system? In short, contracting out, when properly handled, seems to afford the city more flexibility and control than does franchising. Public regulation of privately owned sewage facilities, though historically rare, bears a close relationship to load shedding or full privatization in which the city gives up full ownership and control but retains some responsibility for service and rates. Although load shedding is not without some appeal, research on privatizing wastewater treatment facilities reveals a troubled history owed to health concerns, environmental regulations, and the complexity of the legal arrangements under which the facility is constructed, owned, and operated by a private firm. Unless privatization is carefully controlled, the Oklahoma City case suggests that full privatization may be more costly in the long run. Thus, despite Oklahoma City's troubles, if judiciously undertaken and closely monitored, contracting out seems preferable to other versions of privatization. When a municipality owns more than one treatment plant, competition may be easier to ensure. Several national firms apparently are eager to bid on such

contracts, and the city work force should not be excluded from the competition. Contract provisions and bidding are critical to securing an agreement that protects the public interest but permits a reasonable profit to a private vendor.

### Notes

- <sup>1</sup>For a discussion of principal-agent theory, see Moe (1984).
- <sup>2</sup>Regardless of the theoretical arguments and empirical evidence, few municipalities contract out the operation of public utilities. According to a recent survey by the International City Management Association (1989, p. 6), only 6 percent of cities and counties contract sewage collection and treatment to the private sector. The figure for sludge removal is 19 percent. The President's Commission on Privatization (1988), on the other hand, mentions that a private company manages government-owned water and sewer facilities for more than 95 communities in western Pennsylvania.
- <sup>3</sup>Much of the information in this section comes from Childers (1987).
- <sup>4</sup>The 1984 contract to operate the North Canadian wastewater facility was actually a joint venture between one of Spitz's firms and Professional Services Group, a Houston-based company that operates sewage plants nationwide.
- <sup>5</sup>This discussion draws primarily on Johnson (1985) and Etti-Williams (1987).
- <sup>6</sup>In actuality, Spitz could not secure financing for the entire Cow Creek project, so the funding was provided through a bond sale by the newly created Oklahoma City Development Trust. The city manager's 1987 memo (Childers, 1987, p. 5) observed that Cow Creek "was turned into a public project for all practical purposes due in part to Mr. Spitz's inability to totally privately fund the facility."
- <sup>7</sup>This account comes largely from Childers (1987) and Childers and Ridings (1988).
- <sup>8</sup>Recent surveys of city officials nonetheless do point up the importance of external and internal fiscal pressures to decrease costs as the primary reason for contracting out municipal services (see Morley, 1990, p. 44).

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