UNDERSTANDING AND EVALUATING

Privatization in the Power Sector

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In recent years, some private-sector entities, policy makers, the media and others have discussed or taken action on increasing the private sector’s involvement in the provision of public facilities and services. Privatization includes a wide spectrum of activities, from contracting out maintenance and/or operations to outright ownership, but are typically structured as long-term concession leases. While much of this privatization activity (also known as public-private partnerships or “P3s”) has focused on the water sector and other types of infrastructure, some local governments and public power utilities are looking at these types of arrangements. Some private equity firms have approached public utilities and expressed interest in entering into long-term privatization contracts.

Inserting private interests into the development and maintenance of public infrastructure has often proven to be counterproductive – and even disastrous – when adequate care isn’t taken to protect the public interest.

Taking lessons from the water sector, this guide can help public power advocates, policy makers, and other stakeholders better understand and analyze privatization proposals, contracts, and related legislation. It describes critical issues related to power utilities and includes a list of key questions stakeholders can raise to examine whether a privatization proposal advances the community interest. While this is not an exhaustive list of questions, it provides a useful framework to help evaluate privatization deals in the utilities sector.

WHAT ARE PUBLIC-PRIVATE PARTNERSHIPS?

“Privatization,” “public-private partnership,” and “P3” are imprecise terms that can refer to different types of contractual arrangements between a governmental entity and a private entity. While these terms can be used interchangeably, privatization advocates prefer to use the terms “public-private partnership” and “P3” because public response to the term “privatization” is more often negative.

In the utilities sector, privatization deals are usually structured as long-term concession lease agreements. In this type of contractual agreement, the private entity takes over the operations and maintenance of an existing utility and private capital is used to finance system improvements and other projects. The private entity receives the right to collect revenues associated with the system in exchange for an upfront fee to the governmental entity. These types of contracts typically last between 30 – 50 years.

Publicly owned electric utilities often partner with private sector entities to co-own power plants or transmission lines or to purchase electric power. These arrangements are well-known, transparent, and offer defined mutual benefits to both parties. This paper is not directed at these types of partnerships.
RISKS OF PRIVATIZATION SCHEMES IN THE UTILITY SECTOR

Advocates tout concession or leases to private entities as ways to address needed new infrastructure, but it is no panacea. A closer examination raises issues that warrant careful consideration for decision makers looking to undertake these types of privatization schemes.

**Loss of local control over policy planning decisions**

Many P3 contracts include clauses that limit or eliminate the community’s ability to make critical decisions about local goals and direction. These contract clauses often last for decades, limiting the locality’s ability to set policy related to energy and the utility or to conduct meaningful planning toward long-term goals while guaranteeing corporate profits by insulating the company from many revenue risks. For example, utility privatization contracts may specify a minimum amount of energy that the company will charge for, regardless of how much energy the community actually uses, disincentivizing the enactment of important conservation and energy efficiency policies that could save customers money.

**Profits drive decisions about what gets built**

Private investors naturally demand rates of return that require a profitable revenue stream. In the utility sector, these are projects that generate a profitable level of electric revenues through ratepayers. Simply put, the private sector cannot be relied upon to provide investment for the many critical infrastructure needs that are not profitable, such as smaller projects, repair projects, or projects in rural areas. For example, aging infrastructure in need of replacement are much more common in the lowest-income cities. Replacement and repair projects, which comprise much of the country’s critical infrastructure projects, don’t attract private investors. But neglecting these projects can have profound negative consequences.

**Limited access and affordability**

Even when the private sector entity promises the opposite when pitching these arrangements P3 contracts often raise rates and make affordability schemes more difficult to create. In practice, privatized projects have resulted in much higher costs for residents, making it increasingly difficult for residents with lower incomes to pay their bills, thus reducing equitable access to this critical public asset. According to the American Public Power Association, residential customers of investor-owned utilities pay 11% more than customers of public power utilities — for the average U.S. household, that is $176.79 saved each year with a public power utility or about $15 per month.

For example, in 2012, Bayonne, New Jersey, entered into a concession lease agreement of its municipal water system to the multinational water corporation Suez and the private equity firm Kohlberg Kravis Roberts (KKR). Water rates in Bayonne have risen nearly 50% since the contract was signed. The private entities originally indicated that water rates would remain the same for the first several years, however, this was not the case. Four years into the contract, water rates had risen nearly 28%. By late 2019, water rates in Bayonne had risen nearly 50% since the contract was signed. Even during the COVID-19 pandemic, with many people

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struggling to make ends meet, bills increased by 4.1%. The 40-year contract guarantees Suez and KKR more than half a billion dollars in revenues, so water rates have had to increase to make up the difference between the estimated and actual water usage. The contract guarantees an 11% rate of return for investors for 40 years.

Cutting corners

In an effort to contain costs and maximize profits, private entities may skimp on quality updates, constrain staffing, stagnate workers’ wages, and forgo other important inputs. Taking an example from the water sector, the city of Atlanta signed an agreement with United Water to operate and maintain the city’s water system in 1999. After taking over the system, the company cut the number of employees in half (from more than 700 to just over 300) and decreased the amount of training provided to remaining employees. Service quality declined as the system became inundated with frequent breakdowns, including an epidemic of water main breaks and occasional “boil only” alerts. The number of work orders and maintenance requests significantly increased in most parts of the system and the company failed to respond to these problems in a timely manner. In turn, the company complained that the system was in further disrepair than they originally understood and that it lost at least $10 million annually. In 2003, both parties walked away from the contract.

Reduced labor standards

In P3 arrangements, any cost savings that the private entities promise often derive, at least in part, from reduced wages and benefits for workers who build infrastructure and who operate and maintain public assets. In these types of arrangements, permanent operations and maintenance workers may become private sector workers with lower wages and reduced health and pension benefits.

Reduced contributions to local economy

Beyond the direct costs of these deals, there are also broader impacts to the local economy and community. Private entities might not provide state and local governments with the financial benefits that the public utility does. The American Public Power Association found that when all taxes, tax equivalents, and other contributions to state and local governments are considered, public power’s contributions, as a percent of electric operating revenues, were 13% higher than those of investor-owned utilities. Additionally, the public utility may provide enhanced services to the locality and residents of the community, such as hanging holiday lights or banners, maintaining streetlights and traffic signals, providing tree trimming services, sharing electrical equipment with other city departments, and much more. These types of services may not be within the scope of a contract with a private entity, even though these services can provide community beautification and economic benefit to the locality.

Loss of transparency and public input

Many P3 projects are marked by scant transparency and proceed with little or no opportunities for public input, including from the communities most impacted by the deal. Private entities have a fiduciary duty to put their owners’ interests first, meaning decisions made by private entities might not reflect the interests and priorities of the local community.

9. Ibid.
QUESTIONS FOR EVALUATING PRIVATIZATION PROPOSALS

The following questions can help identify key issues in proposed utility privatization deals. This is not a complete and exhaustive list, but the questions provide a framework for evaluating a privatization proposal.

STATE OF THE SYSTEM

- How does the system currently meet community needs?
- Are there problems with the current system? Has there been a thorough analysis of these issues, including causes of the issues and possible solutions? Potential issues to examine include:
  - Are there maintenance needs and/or additions to the system that need to be addressed?
  - Is the system affordable to residents and other users?
  - Does the system provide safe and reliable electricity to its customers?
  - Is the system resilient to changing climate and other changing environmental conditions?
  - Does the system promote energy efficiency?
  - What is the demographic make-up of the workforce that staffs the system? For example, is the workforce aging? Does the workforce represent the diversity of the community?
  - What problem(s) does the proposed privatization seek to solve? Has there been an analysis of how the existing public system can address these problems without privatization?

FUNDING AND FINANCING

- Are rates adequate to pay for system maintenance? How have rates changed over time? If not, is it feasible (in terms of affordability to residents, politically, regulatorily, etc.) to increase rates?
- Has a rate analysis been undertaken to understand how rates could be adjusted to meet capital needs?
- Do utility and city leaders (and other decision-makers) have a thorough understanding of the governmental entity’s financial position and ability to take on new debt via municipal bonding, given the governmental entity’s current bond rating and current debt load? Does the governmental entity face any problems in accessing tax-free municipal bonds as a source of financing for any the proposed improvements to the system? Tax-free municipal bonds are a cheaper source of financing than private equity financing, which can have an interest rate three to five times higher than traditional municipal bond financing.
- What other governmental funding and financing streams can be used to meet capital needs?
- Does the private entity have the financial capability to adequately maintain the system and/or finance necessary improvements?
COMPARING OPTIONS AND CONTRACTUAL CONSIDERATIONS

- Has the governmental entity prepared an economic analysis describing potential revenues and expenses if the asset remains in public hands? The analysis should account for any anticipated improvements to the public system that would increase efficiencies, etc.

- If the proposal includes the privatization of the existing system, has the governmental entity performed or contracted for a valuation of the asset? If so, how was the valuation determined and what methodology was used? The methodology can dramatically increase or decrease the valuation range. It may be necessary to get outside expertise to review the valuation and methodology, including the assumptions used and the details of the calculations.

- What are the specific assumptions in the valuation, feasibility study, or similar cost analysis regarding cost savings and could they impact quality of service, workforce compensation, or inhibit public policy options? Methodology can dramatically alter the results of these types of analyses. It may be necessary to get outside expertise to review the analysis, including the assumptions used, identified risk factors, and calculation details.

- Does any cost analysis consider non-financial public interest criteria, including social and economic impacts, affordability and accessibility to low-income communities, job quality, environmental impacts, and accountability and transparency measures?

GOVERNMENTAL ENTITY’S BUDGET

- How will the governmental entity compensate the private entity in the proposed P3? Will the private entity have rights to the payments from utility customers? Will the governmental entity provide regular payments to the private entity? Will there be other payment mechanisms and/or a hybrid approach of more than one compensation scheme?

- What are the implications of the compensation schemes to the governmental entity’s budget?

- What are the transaction costs that the governmental entity will incur with a P3 approach, such as costs associated with the procurement process and oversight of the contractor for the life of the contract? Are these costs accounted for in the cost comparison/analysis?

- Will the governmental entity incur hidden costs through privatization? For example, private sector jobs associated with the privatized system that pay low wages or fail to provide health insurance benefits may result in an increase to another part of a governmental entity’s budget, such as an increased need for social safety net services.

- Beyond operation of the utility, what other types of services does the public utility provide for the community? For example, does the public utility provide tree trimming services, hang lights for special events, maintain streetlights, share electrical equipment with other city departments, etc.? How will the locality provide these services if a private entity takes over the utility? How much will it cost the locality to procure the in-kind services it receives from the public utility?

- Does the public utility share services with other departments, such as shared billing or IT services? If the utility is privatized, how will these services get distributed? How much will it cost the locality to sever any shared services between the utility and other city departments?

- Does the existing asset currently provide revenue to the governmental entity? If the asset currently provides net revenue to the budget, how will that revenue be replaced?

- Does the public utility provide payments in lieu of taxes or other tax equivalent payments to the locality? If so, does the private entity plan to make these payments to the locality at the same payment rates? If so, will these payments increase if the system expands or rates increase?
If a lease/sale of an existing system requires investors to make a large upfront payment to the governmental entity, are there budget restrictions that prevent the funds from being used too quickly?

How will the proposed privatization deal impact the governmental entity’s bond rating? Are there risk factors associated with the deal that could impact the utility’s future cost of borrowing?

**LEGAL, REGULATORY, AND EXISTING CONTRACTUAL CONSIDERATIONS**

- Are there local or state laws that apply to privatization or P3 arrangements that must be taken into account in any potential deal?
- Are there local, state, or federal regulations or programs related to the system that could apply to, or affect, a potential privatized system?
- Who will have oversight over the utility if it is privatized?
  - Will the Public Utility Commission (PUC) have some level of oversight over the utility if it is privatized? If so, how will the PUC regulate a proposed privatized utility? What are the potential operational and financial impacts of this regulation?
  - Will the city council or utility board still have oversight over the system if it is privatized? If so, how and to what extent will this body continue to provide oversight over the utility?
- How does the proposed privatization potentially impact the governmental entity’s agreements or cooperative efforts between itself and other nearby governmental entities? Are there cooperative agreements or joint environmental efforts that could be disrupted if a private entity takes over the utility?
- Does the utility have any contracts or is party to any contracts with a joint action agency? If so, do these contracts have any limitations or require any payments to be made if the utility is privatized and no longer public?

**AFFORDABILITY**

- What are the potential short-term and long-term impacts on rates and other charges to customers with the proposed privatization scheme? Corporate profits, dividends and income taxes can add 20% to 30% to operation and maintenance costs.\(^\text{16}\)
- What are the short-term and long-term impacts on rates and other charges on customers if the system stays public?
- How will utility rates be determined for the life of the contract under the privatized system?
- What effect will significant or rapid rate increases have on the public? Will rate increases affect equity of access to electricity?

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Are there low-income programs and/or payment forgiveness programs designed to help vulnerable or struggling customers who are unable to make payments? Are these programs sufficient to meet the needs of the community? Will these programs exist under a privatized system? How will they be made known to the community?

**DEMOCRATIC CONTROL AND INCENTIVES**

- Does the contract contain clauses that could run counter to future public planning and policy decisions? For example, does the contract require the governmental entity to pay for a minimum amount of energy, regardless of actual usage?

- How long does the contract last? What are the potential impacts of a decades-long contract? For example, is the community likely to set any longer-term targets or goals that could require cooperation or collaboration with the utility during the contract timeframe? What types of policies and decisions might be delayed or hampered through the life of the contract?

- Does the contract include termination and “buy back” clauses, which lay out how the governmental entity can take back the system? Does the contract specify the amount the municipality would pay to end the contract early?

**CONTRACTING STANDARDS, OVERSIGHT AND MONITORING, AND AGENCY CAPACITY**

*Agency Capacity*

- Does the governmental entity have the necessary experienced staff, elected officials or board members, and/or other relevant personnel to negotiate a good deal for the public?

- Does the governmental entity have the necessary and experienced staff to ensure that outside analyses performed by consultants, etc. are fair and sound?

*Consultants*

- Should or does the governmental entity hire consultants to assist with parts of the deal?

- How are contracts with consultants, lawyers, and other third parties structured? Do they collect fees for services rendered or for successful completion of deals, regardless of the outcome for the governmental entity?

- Do the consultants, lawyers, or other third parties have any conflicts of interest? What is their track record and background with these types of contracts?

- Have the private contractors, investors, or consultants made campaign contributions to relevant decision makers?

*Contract Standards*

- Does the contract contain specific operations and maintenance standards, including a hand-back provision that specifies the minimum condition for the electric system when it is returned to the public at the end of the contract term?

- Does the contract include performance standards that ensure a high-quality utility operates to meet the needs of the community?

- Does the contract include provisions related to default and bankruptcy of a private contractor to protect the state and the public in case the project or a private entity financially fails?
Does the contract ensure that the private entity will make adequate investments in the system throughout the life of the contract to ensure that the utility is reliable and safe?

How much control does the private entity have over determining what improvements are made and when they are made to the system? How much control does the governmental entity have over ensuring that key projects or improvements to the system are made in a timely manner?

Does the contract include termination and “buy back” clauses, which lay out how the governmental entity can take back control of the system? Does the contract specify how the amount the governmental entity would pay to buy back control of the system will be calculated?

**Oversight and Accountability**

Does the contract contain robust oversight provisions, including establishing regular reporting requirements and rights of the governmental entity to inspect and audit the electric system?

Does the governmental entity have sufficient number of well-trained staff to oversee and monitor the privatization contract for the life of the contract?

What rights does the governmental entity have to review and restrict refinancing, or sale of interest, by the private entity?

**PUBLIC PARTICIPATION/TRANSPARENCY**

Does the contract contain appropriate and accessible mechanisms for the public and utility customers to provide feedback and comments on operation of the system for the life of the contract?

Are there adequate and meaningful forums for public input during the initial proposal stage and any subsequent procurement, such as public hearings or public comment periods?

Do the public and legislative or other decision-making bodies have access to the information they need to evaluate the privatization proposal?

**CUSTOMER SERVICES AND COMMUNITY**

Does the contract specify who customers can call if they have a problem with service? Does the contract specify customer service staffing levels and/or other important standards of reliable and timely customer services?

Does the contract require local offices to stay open and be available and accessible to customers?

Does the contract ensure the safety of the community and require the private entity to engage in robust community education efforts about safety?

**ENVIRONMENTAL HEALTH AND SUSTAINABILITY**

Does the contract include performance standards that specify environmental outcomes that the system must achieve?

Does the contract contain provisions that might encourage or discourage conservation and environmental resilience measures?
If the community expresses interest in new programs around sustainability and environmental health, such as solar programs, etc., will the private entity be responsive and invest in these types of measures or new technologies? How will the contract ensure that the private entity is responsive to the needs and desires of the community, even if these types of programs require substantial investment?

## WORKFORCE BENEFITS AND STANDARDS

- What will the potential impacts be on the existing and/or future workforce, including both the construction workforce and the long-term system operations and maintenance workforce?
- Are the workers currently unionized and does the collective bargaining agreement or government policy contain clauses that require workforce retention and/or retraining?
- If there is new construction involved in the proposal, is there any guarantee for how many jobs will be created, specificity about what the wages and benefits will be for these jobs? For the existing system, how will the number of jobs and compensation change once control is shifted to the private sector?
- How will the private entity ensure the safety of employees? Does the contract specify how much training employees will receive throughout the life of the contract, what type of safety equipment and protocols will be required, etc.?
- What is the track record of the private entity(ies) being considered? Does the private entity(ies) have any record of noncompliance with relevant federal, state, or local laws or regulations, including health and safety, labor and employment, and licensing laws, that could affect the employees, worksite, or performance of the contract?
- Who will receive any new jobs? Are there opportunities for a proposed project to include policies, programs, or agreements that ensure that residents in surrounding areas are offered employment and career training opportunities?