When Markets Fail to Deliver: An Examination of the Privatization and Deprivatization of Water and Wastewater Services Delivery in Hamilton

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Introduction:

The rise of New Public Management (NPM) and its faith in the 'market' in the early 1980s led governments to search for alternative methods in the delivery of public services. The fundamental philosophy was that governments should rethink what they do, and how they do it. Under this philosophy, it was suggested that governments should devote their attention to policy development and allow organizations or agents outside government to undertake service delivery (Osborne and Gaebler 1993). The search for new methods in service delivery culminated in what is referred to as Alternative Service Delivery (ASD) (Ford & Zussman 1997). ASD, according to the Treasury Board of Canada, is the designing of the best means of delivering programmes and services to meet government objectives in a manner relevant to the needs and values of Canadians (TBS 1995:6). The most widely used definition of ASD is that by Ford and Zussman (1997). The two defined ASD as "the creative and dynamic process of public sector restructuring that improves the delivery services to clients by sharing governance functions with individuals, community groups and other government entities" (6). A number of scholars have identified different forms of ASD. According to Zussman (2002) ASD may consists of a number of policy instruments including privatization, contracting out, public-private partnerships, and franchising.

In Canada, ASD was fully embraced at all levels of government. We find these methods being used extensively in a number of areas such as garbage collection, delivery of energy and water, and transportation infrastructure (Hrab 2004a; 2004b; McDavid 2001; O'Connor 2002; Ohemeng 2006; Zussman 2002). The idea behind ASD was that the market would eventually deliver service more efficiently than public sector institutions. This idea stemmed from a number of criticisms that were leveled against the public bureaucracy over the years by politicians, academics, and the public in general. The public bureaucracy was charged with an array of crimes: failure to perform; abuse of power; repression of employees, clients, and people in general; and, being muddled, confused, expensive, unresponsive, bloated, and self-destructive to the extent that it is now seen as a "splendid hate object" that must be reformed or even destroyed (Goodsell 1983; Caiden 1991; Peters & Savoie 1994). It is against this backdrop that ASD became an acceptable alternative to the public bureaucracy in service delivery.

Notwithstanding the perceived efficiency of the market, however, many forays into the realm of ASD have been less than successful. At times, the market has failed to deliver services in the manner envisaged by its advocates. This is reflected in the case of the City of Hamilton's water and wastewater services after almost a decade of private sector delivery. What accounts for the failure of the market to deliver the service? What explains the subsequent choice by the City of Hamilton to take back service delivery from the private sector?

Using Charles Wolf Jr.'s model of nonmarket failure as the theoretical framework, we argue that the market is far less efficient than its proponents have asserted. This is especially true when there is a monopoly over service delivery. The Hamilton case is very intriguing in that service delivery by the private sector was to be a model of ASD for other municipalities to emulate. More importantly, the case has sparked considerable debate, both for and against the merits of privatization.

We begin the paper by examining privatization as a method of ASD, and Wolf's theory of nonmarket failure. This is followed by a discussion on the methodology used in the study. The next section deals with the background and the rationale behind the adoption of privatization as an ASD mechanism for water and wastewater service delivery in Hamilton during the early 1990s. Finally, we analyze the reasons behind the shelving of the privatization initiative and the return to public sector delivery.

Conceptualizing Privatization:

The literature on privatization as a form of ASD is vast, yet there is much confusion as to what the term actually means (Bailey 1987). Scholars have interpreted the concept differently, and most often, according to how privatization as a policy is implemented by a particular government. The controversy over the definition of the concept has arisen as a result of the failure of many observers to distinguish between the primary policy decision of governments to *provide* a service and the secondary decision to *produce* a service (Biersteker 1990; Kolderie 1986). For some, privatization simply refers to the transfer of public enterprises to the private sector, thereby strengthening the role of the private sector in national economies (Boycko et al. 1996; Butler 1991; Cook 2001).

For others, privatization is more than the mere transfer of public enterprises to the private sector. Such scholars see privatisation as encompassing a wide variety of activities, which government(s) may undertake. These include any loosening of government controls, the sale of a minority or majority interest in a state owned enterprise to private buyers, the delegation of management responsibility for a state-owned enterprise to private managers, and the relaxation of a state monopoly to allow private entry into the market. Such scholars also classify the introduction of “user fees” to hitherto free government-provided services as a form of privatization (Kay &Thompson 1986; Savas 1987; Yarrow 1986). Sclar (2001: 3) has described privatization as “initiatives to introduce market relationships into the bureaucratic production of public services. The intention is to force public bureaucracies to be governed by the same competitive forces that make private markets socially beneficial.”

Kernaghan and Siegel (1999) have adopted a more comprehensive definition of the concept[1]. They assert that the concept may be used in two dimensions, that is, in both a narrow and broad dimension. Privatization in its narrowest sense encompasses the whole or partial sale of state-owned companies. However in the broadest sense, it denotes the actions to reduce the role of governments and the use of market forces to produce a more competitive economy. In this sense, it may take the form of deregulation, public-private partnerships, trade liberalization, or the increased contracting out of government services. For the purpose of this paper, we employ the broader definition of the concept as outlined by Kernaghan and Siegel (1999).

Privatization, as an ASD mechanism, has been justified on economic, political, and social grounds. Economically, privatization appeals to the notion of competitive contractual behaviour as emphasized by advocates of standard market models (Osborne and Gaebler 1993). The fundamental assumption is that it promotes the efficiency and effectiveness needed in service delivery, and relieves governments of the financial burden associated with distressed public services (Bienen and Waterbury 1989; Hrab 2004b). As such, privatization is expected to enable governments to operate in a more business-like

[1] See also John D. Donahue, *The Privatization Decision: Public Ends, Private Means*, New York: Basic Books 1989.

manner. Politically, privatization projects the idea that governments are saving taxpayers money by allowing other (more efficient) actors to engage in the delivery of public services. Socially, privatization has been justified on the grounds that democratic governments are no longer the vehicle to solve the world's social problems (Sclar 2001; Hrab 2004b). As a result, privatization brings all social actors, including the private-for-profit sector, the private-not-for-profit sector, and the community at large into the realm of democratic governance.

In spite of such perceived benefits, many have expressed serious reservations regarding the use of privatization as a tool for ASD (Donahue 1989; Hart et al. 1997; Sclar 2001; Schmidt 1996; Starr 1987). One major argument for privatization centers on the theory of principal-agent relationships. Many of the proponents of privatization have justified their argument on the basis that once government is both the owner and the producer/deliverer of a service, it makes it difficult to monitor the activities of its agents, *i.e.*, the bureaucracy. They argue that such problems can be overcome by engaging the private sector through legalistic contractual arrangements. However, the flaw in this argument lies in what some scholars have identified as a problem of incomplete contractual arrangements (Hart et al. 1997; Schmidt 1996). Incomplete contracts may affect the delivery of service through informational asymmetry, which may tilt in favour of the private contractor. This undermines the contractual relationship between the principal (government) and the agent (private firm), and stems from the principal's inherent inability to develop comprehensive, forward-looking contractual arrangements with the agent.

Another problem with privatization is the incentive for the private sector to cut costs in order to maximize profit. There are a number of ways that are used to achieve this objective. The primary one is to focus on reducing labour costs through retrenchment, *i.e.*, employee cut-backs, lower wages, and the "greater use of part-time workers with fewer fringe benefits" (Starr 1987: 129). A more important consideration, however, is that there is rarely any evidence regarding the quality of privatized services "thereby making it difficult to judge whether lower costs result from greater efficiency or deteriorating quality" (Starr 1987: 129).

Finally, there is also the issue of competition in service delivery. Proponents of privatization argue that because public sector organisations have a monopoly over service delivery, they lack the impetus to be efficient. However, as Sclar (2001: 69) notes, public contracting "occurs in a variety of market and public-agency settings that rarely approximate the textbook model of competition. Most public contracting takes place in markets that range from no competition (monopoly) to minimal competition among very few firms (oligopoly)." Furthermore as asserted by Sclar et al. (1989: 26):

> The textbook model of competition is devoid of political and social constraints: the real world is crammed with them. In the world of textbook economics, prices and quality are the outcome of non-coercive, competitive market forces. In the world of real actors, competitors do simply win or lose on the bases of product and price. They use any and every social and political at their command to maintain market share. All of these factors must be considered in any thorough policy analysis of the pros and cons of such radical change as [water delivery] privatization.

Certainly, in many situations and especially in the utility sector, there is little or no market competition at all. Privatization of such services simply moves them from public monopoly to private monopoly. Hence, "public agencies that have privatized into sectors where there is intense competition in a given market indeed tend to be more efficient: those public agencies privatized into less competitive environments tend to be less efficient" (Valauskas 1999: 4).

Charles Wolf's Theory of NonMarket Failure:

A number of scholars have developed various theories to explain the failure of the state in service delivery (Bozeman 2002; Dollery and Worthington 1996; Le Grand 1991; Vining and Weimer 1990; Wolf 1979). In other instances, scholars have also explained why government intervenes in the economy and this is what has been described as market failure (Bator 1958; Donahue 1989; Zerbe Jr. & McCurdy 1999). The general perception is that government is less efficient in service delivery leading to the assumption that the market should be used for this purpose (World Bank 1995).

One of the most prolific and respected writers who has used the nonmarket failure theory is Charles Wolf. Over the years, Wolf has produced a number of books and articles explaining why it is important to use the market instead of the government (public) in service delivery. His theory of nonmarket failure, first published in 1979 in an article titled "A Theory of Nonmarket Failure: Framework for Implementation Analysis" identifies four major factors, or sources, of nonmarket failure. These factors are (a) internalities and private goals, (b) redundant and rising costs, (c) derived externalities, and (d) distributional inequity. Wolf's identification of these factors was based on various characteristics of supply and demand conditions. In a sense, the theory "mirrors the orthodox methodology followed in the theory of market failure…" (Dollery and Worthington 1996: 28).

In explaining how internalities and private goals affect service delivery, Wolf contended that governments lack performance indicators, similar to those available to private sector firms, to determine consumer behaviour and profit-and-loss as they relate to the successful delivery of services. Public sector agencies, according to this theory, "lack any bottom-line evaluation mechanism equivalent to profit or loss for appraising success" (Dollery & Worthington 1996: 29). To overcome these problems, Wolf (1979: 116) noted that public agencies "must develop their own standards, or internalities" to measure efficiencies in service delivery. He argued that the problem with public sector agencies is that they "often develop internalities that do not bear a very clear or reliable connection with the ostensible public purpose which the agencies were intended to serve" (116).

On his second point, redundant and rising costs, Wolf claimed that public sector organisations have the tendency to exhibit redundant costs. While the private sector has the incentive to increase production and reduce cost over time due to competition and the need to generate profit, this is not the same with regard to public agencies. The notion is that public agencies are monopolistic agencies, thus they have less incentive to lower cost, raise productivity, or realize the economies of scale (124).

Wolf's third factor is what he described as "derived externalities". He contended that often there is strong political pressure for intervention in market activities, which generates unanticipated side effects. This pressure creates a demand for action before there is time or knowledge to consider the side effects of such action. Further, these side effects are usually far removed in space and time from the original policy target. In other words, "governments are interested in finding solutions that are politically attractive without much recourse to the administrative and economic [consequences] of such decisions" (Ohemeng 2005).

The final point Wolf raised relates to "distributional inequity". By this, he suggested that "nonmarket activities, whether intended to overcome the distributional inequities of market outcomes or to remedy other inadequacies in the market's performance, may themselves generate distributional inequities" (128). These nonmarket activities may give some public actors authority or power over others, which provides the opportunity for abuse or inequity. Such activities may also result in distributional inequities based on income, benefiting some at the expense of others.

This theory has been criticized by many scholars for not adequately addressing problems associated with government failure (Dollery & Worthington 1996; Le Grand 1991; Vining & Weimer 1991; Williamson 1979). However, we believe that the theory presents a hypothetical perspective that must be explored in order to explain the privatization and de-privatization of water delivery services in Hamilton. Thus, our assumption is that by focusing on this theory, we will be able to explain the inadequacies associated with the use of the market model, in areas of service delivery where we feel a strong public presence should be maintained.

Methodology of the Study:

In this section, we shall briefly discuss the methodology used in obtaining the information for the research. To fully understand the decision of the political authorities in Hamilton to bring back water and wastewater service delivery to in-house operation, we first decided to interview a number of people who were involved in the privatization episode. These people included former councilors and bureaucrats who were involved in the early stages of the decision-making process. Secondly, we chose to interview all of the present councilors with the aim of identifying the factors that led to de-privatization, or the decision not to renew the contract with the private sector in 2005. In order to suppress our biases, we also decided to interview officials of the private firm that delivered the service until it reverted back to the City's control. Further, we opted to interview (contact) some of the firms that put in bids when the contract came up for renewal in 2004.

For the study, we employed qualitative analysis. This method, according to Carroll and Siegel (1997: 28), "relies upon logical generalization and involves a non-random sample and often fewer contacts or observations" of personnel or events than quantitative analysis, which normally involves large numbers of cases or aggregate data. Qualitative analysis is also largely an investigative process where the researcher gradually makes sense of a social phenomenon by contrasting, comparing, replicating, and cataloguing the objects of study. It is "a mixture of the rational, serendipitous, and intuitive in which the personal experiences of the organizational researcher are often key events to be understood and analyzed as data" (Maanen 1979: 520). We also utilized a snowball sampling technique whereby "a group of research participants are gathered by first contacting one member of the target group or population, then asking that person to put the researcher in touch with other members and so on" (Baxter-Moore, et al. 1994: 377). This technique was used to identify some of the personnel interviewed.

Letters requesting interviews were sent to all identified persons and groups; however, not all responded positively to our request. Out of 15 present council members that letters were sent to, only 6 (including the mayor) responded favorably to our request. Of the former councilors and bureaucrats solicited for interviews, we received a positive response from two. All past and present bureaucrats to whom letters were sent simply refused to talk to us. Our request to interview officials of Ontario Clean Water Agency (OCWA) was also turned down[2]. We were, however, able to interview officials of American Water Services[3], as well as an official of the International Union of Operating Engineers (IUOE).

Issues Relating to Privatization and De-Privatization of Water and Wastewater Service Delivery in Hamilton:

The first part of this section provides the background to the privatization experience. The second part discusses the politics and process of de-privatization.

The early 1990s was a difficult period in terms of regional economic development for Hamilton-Wentworth. The provincial government, which many regions had depended upon during economic difficulties, was also facing a number of constraints as a result of the economic downturn, which affected provincial transfers to the regions. It was against the backdrop of these economic difficulties and the need to regenerate economic growth, which led the Region to examine the possibility of public-private partnerships (PPP) in service delivery. The impetus for this new direction in policy was influenced by the prevailing international wisdom of using the private sector as the engine of economic growth.

As local politicians mulled over the issue of economic growth, Philips Environmental Inc. (PEI) and Philips Utility Management Company (PUMC)[4] submitted an unsolicited proposal "to operate the Region's water and wastewater treatment plants, pumping stations and reservoir on a contract basis…" The proposal also made a number of key guarantees to enhance the economic development of the region (Hamilton Spectator 1994). At the time, according to Brubaker (2003: 3), "Hamilton's water and wastewater system was poorly managed, over staffed, and persistently out of compliance with provincial regulations."

In September of 1994, the Chief Administrative Officer of the Region of Hamilton-Wentworth recommended that Regional Council accept the proposal by the two companies. This recommendation was debated by the Council, and by a unanimous vote, it was agreed that the Region's water systems (water and wastewater treatment plants) be turned over to PUMC for operation. The proposal was also supported, for the most part, by about 150 of the Region's union and management workers who were to be hired by the company.

[2] OCWA had put in a bid at the time the water service delivery contract came up for renewal.
[3] American Water Services was the private firm which was delivering the service when the contract came up for renewal in 2004. This is a subsidiary of American Water Services Inc.
[4] PUMC was a subsidiary of Philip Environmental Inc.

In December of 1994, the Region signed a 10-year, $180 million contract agreement with PUMC.[5] The contract was in two parts: (a) a 10-year plant operations agreement; and, (b) a 2-year maintenance agreement, later replaced by an outstation agreement, which expired 2000 but had an automatic renewal until the end of 2004). The entire contract consisted of 25 Articles and covered over 85 pages, excluding schedules and addenda. The most important Articles were Articles 3 through 7, which stipulated how the facilities were to be managed and operated; how operating, maintenance, and capital expenditures were to be allocated; how compensation was to be paid to PUMC; how responsibilities were to be transferred from the Region to PUMC; and, the legal parameters surrounding any inventions and innovation undertaken by PUMC.

Under the contract, PUMC was to be operator and PEI was to guarantee the commitments with respect to the proposal. The deal included a guarantee of $500,000 in annual operating savings to regional taxpayers, the creation of 200 full-time jobs, a minimum $15 million investment into the community, and the promise to locate the company's head office in Hamilton. In addition to guaranteeing employees their present wages, and in some cases increasing their wages, the company also guaranteed pension entitlements and the promise of a profit-sharing plan. The company was also expected to establish an international training centre in the region to provide employment opportunities for co-op students from McMaster University and Mohawk College. Furthermore, the company was to create an environmental enterprise centre and match up to $2.5 million in provincial or municipal funding for the project (Region of Hamilton-Wentworth 1994; Peters 1994: C3).

In return, Philip was expected to run the plant and use it as a showcase to the rest of the world. Understandably, the deal at the time was hailed as the largest and the best public-private partnership of its kind in North America (Nolan 1995). However, "at the time the PUMC won the Hamilton contract, it had absolutely no record of accomplishment of running any equivalent sized water facility" (Anderson 1999: 3). In spite of this lack of experience, the Region decided to single source the contract to the company because of its connection with what one interviewee termed "local entrepreneurs". In this case, the region was not in any way concerned with the lack of expertise demonstrated by the company but rather was more concerned about support for a local initiative. According to Leo Gohier, the Region's Director of Water and Wastewater at the time, "the basis of the negotiations was essentially to develop a contract that would allow a local firm to develop expertise and experience in the contract operations of a major municipality's water and waste water facilities, while providing the [Regional Authority] with a vehicle for economic development" (Cited in Anderson 1999b: 19).

However, there were two areas of the contract that generated much debate: Article 4.05, which limited PUMC's responsibility for maintenance of facilities; and, Article 5.01 (sub-section VI) which provided additional monetary incentive to the company. Under Article 4.05, the Region was to be responsible for any maintenance cost over $10,000 per year. Under Article 5.01, if PUMC generated additional cost-savings, it would be shared on a 40/60% basis between the Region and the company. If the additional cost savings reached 20% of the annual budget, the company's share of cost-

[5] This section draws extensively on the actual contract agreement signed between the two parties on the 30th of December 1994.

saving would rise to 80%. Article 4.05 was controversial because, according to many, it allowed the company to procrastinate with respect to addressing maintenance issues until such time as the cost exceeded the stipulated $10,000 limit. A number of people argued that Article 5.01 was an incentive for PUMC to cut costs in many areas, most importantly labour (Anderson 1999b). Thus, the promise by PUMC to generate jobs, while at the same time being offered the incentive to save money, very rapidly became a bone of contention when the company began to reduce the number of employees at the Region's facilities.

By 1995, PUMC, according to Brubaker (2002), had fulfilled one half of the promises stipulated in its 1994 proposal. For instance, the company did locate its head office in Hamilton. However, instead of the company building new offices as promised, it refurbished part of an existing building. The company also invested nearly $6.5 million in the region, although it had promised to invest $15 million. Further, the company created only 100 jobs out of the 150 promised. Nonetheless, the Region was satisfied with this level of commitment (Brubaker 2002: 3).

In spite of the partial fulfillment of promises, PUMC encountered a host of problems associated with the management of the system. Between 1996 and 1999 there were a number of incidents relating to the Region's, and later the City's, wastewater system. The worst, in January of 1996, involved a pumping system failure at the main sewage treatment plant operated by PUMC, which backed up the Region's main sewer system. Over 50 homes and many businesses were flooded, and an estimated 135 million litres of raw sewage spilled into Hamilton harbour and the surrounding area. The spill was believed to be the worst ever in the history of Hamilton's wastewater treatment system (McNeil, 1996: A1).

As a result of the spill, there were 115 notices of claim, and 16 people launched lawsuits against Hamilton-Wentworth Region. However, in a written report by the Region's legal department eight months later, PUMC was deemed responsible for the spill, and consequently, the costs of legal action brought against the Region (Peters, 1996: A1). Notably, the Region ended up paying for all damages, the total amount reaching $2.5 million, which did not include the cost of clean-up at the treatment plant (Hoath, 2000). Many claimed that an already difficult situation was exacerbated by the fact that, under the contract, PUMC and the Region were both potentially liable for the damages caused by the spill (McNeil, 1996: A1).

About one year into the contract, problems also began to arise with the IUOE. Many employees at the sewage treatment plant were concerned about "unreliable and out-dated equipment, deterioration of plant conditions, health and safety concerns to employees and the public" and operation of the plant "at maximum environmental dangerous thresholds" (Hoath, 2000). Notwithstanding these operational issues, 30 employees had been laid off at the treatment plant by April of 1996 (Hoath 2000). This angered the union, as well as regional councilors, who were embarrassed by the fact that 23 of the staff cuts were undertaken without notifying the Region, the owner of the facility (Arnold, 1996: B2).

In August of 1997, the company laid off another 20 employees. Employee concerns surrounding the lay-offs were confirmed after reviewing the annual PUMC financial report. According to the IUOE's interpretation of the documents, the company had increased savings by $700,000 through staff downsizing. At the same time, repairs and maintenance had decreased by 25%, while transportation and disposal costs had increased by 500% (transportation being contracted to a subsidiary of Philip Services Corporation) (Hoath 2000). The labour issues came to a head in June of 1999 when the union went on strike over further efforts to downsize staff. Proposed lay-offs were to reduce the number of union members to 41, a drastic reduction from the original 127 members who were working for the region when the contract was awarded to PUMC five years previously (McGuinness, 1999: A5).

These issues were complicated by the fact that PUMC had been acquired one month previously (without any public tendering process) by Azurix Corp., a subsidiary of the Houston-based Enron Corporation.[6] With the acquisition of PUMC by Azurix, the latter was also expected to fulfill the rest of the promises made by PUMC, including the establishment of an environmental enterprise centre and an international training centre (Brubaker 2002). In addition, Azurix agreed to settle all outstanding insurance claims by homeowners and businesses against the Region without further cost to regional taxpayers (Hamilton Spectator 1999: A14). However, Azurix also faced a number of other problems including "the cleaning up of one of the messes made by the contract with PUMC -- the lawsuits arising from the spill of 180 million litres of sewage into Hamilton Harbour and the impacts on several dozen homeowners" (Oliveira & Tanner 1999: D12).

In 2001, American Water Works[7] acquired Azurix, for $141.5 million (US). American Water Works assumed $8.3 million in debt and gained a tax savings of $13 million, thus the value of the sale was about $136.8 million US (Prete 2001: A3). With this acquisition, Hamilton's water and wastewater contract was also taken over by the new company, although the City of Hamilton needed to approve the change in control (Boase 2001: A1). Councilors gave the go-ahead for the change in control after city staff reported they could find no justification to withhold consent. The staff argued that failing to approve the change "would jeopardize financial benefits to the city and invite a costly lawsuit" (McGuinness 2001: A9). There was considerable debate over the issue, since many councilors were uncomfortable about seeming to endorse the former Regional Council's decision to award the contract without tendering in 1994 (McGuinness 2001). However, to make their case to Hamilton Council quite plausible, AWS and Azurix engaged the services of former alderman Fred Eisenberger (Chair of the Hamilton Port Authority) to help win approval of the sale (McGuinness 2001).

It should be acknowledged that the takeover was not without further controversy. In fact, at the time American Water Works was taking over the Hamilton management contract from Azurix, it had agreed to a takeover bid by RWE, a large German utility firm. The deal was expected to close within the next couple of years. This meant that the City Council would be challenged once again with issues concerning contract transfer, as the original 10-year contract was due to expire in December of 2004. Jorge Carrasco, president of American Water Services (AWS), assured the City that AWS would maintain, and even expand, the company's presence in Hamilton. Carrasco asserted that the RWE takeover would be a stabilizing influence as the international water business

[6] The $107 million (US) acquisition by Azurix was intended to bail out the debt-ridden Philip Services Corp. (previously PEI), owner of PUMC. At the time, Philip Services owned 70% of PUMC, with the Ontario Teachers Pension Fund owning the remaining 30%.
[7] American Water Works and American Water Services are used interchangeably for the purposes of the study.

was beginning to consolidate. RWE would use AWS as a platform to expand in North America (McGuinness 2001).

In spite of the controversy surrounding the takeover of Azurix by AWS, the City decided not to oppose it on three main grounds. First, there were only three years left on the contract. Second, the City acknowledged that there would be full debate on the issue the following year on whether to take back operation of the treatment plants or establish a competitive bidding process for a new operating contract. Finally, there were enormous legal implications associated with breaking the contract. Hence, following the City's approval, American Water Works became the third company in seven years to manage Hamilton's water and wastewater services.

Between 2001 and 2004, the water issue continued to polarize the City, especially with the expiration of the original contract on the horizon, and the question of whether or not to continue using the private sector to manage the delivery of the service. In 2003, the Hamilton Public Works Department began to look at new arrangements for the operation of its water and wastewater treatment facilities. It was acknowledged that failure to have a new contract in place prior to its expiration, at the end of December 2004, would result in negotiations with the current operator (AWS) in order to extend the existing agreement.

In a report to the Public Works Infrastructure and Environment Committee, City staff provided five reasons for believing that negotiating an extension of the contract on a sole source basis was not in the City's best interest:

1. Extension of the contract would only be for a short period. This would leave the City in a poor negotiating position with respect to acceptable financial terms.
2. The City would have to renegotiate their tripartite agreement with AWS and the IUOE.
3. As the Collective Agreement between the IUOE and AWS was due to expire at the same time as the Water and Wastewater Operations Contract, a short-term extension would place AWS in a poor position to negotiate with the IUOE. It was anticipated that this would result in potential negative operating and financial repercussions to the City.
4. Continuation of the sole source contract with AWS was inconsistent with the intent of the Purchasing Policy of the City.
5. Potential cost savings from a competitive bidding process would be lost (City of Hamilton 2003: 2).

In the report, City staff also outlined two alternative approaches for the operation of the water and wastewater systems: a "Contract Model", and a "Municipal Model". These were evaluated using guidelines found within the City's ASD policy. The Contract Model required the City to begin the selection process for a new water and wastewater treatment operator as soon as possible. The Municipal Model would see the operation and maintenance of the systems re-assumed by the City, with transitional arrangements being made during 2004 (City of Hamilton 2003: 2).

The two approaches were evaluated in terms of eleven key criteria or objectives, which ranged from quality of service to protection of the City's long-term interests (City of Hamilton 2003). Both were able to meet the criteria; however, it was determined that the Contract Model was better able to meet the following specific objectives: “operating flexibility, innovation and efficiency; achieving best value; minimizing risk; and minimizing issues related to the contract transition process” (City of Hamilton 2003: 9).

The Public Works Committee in its deliberation over the issue voted 6-3 in favor of continuing the use of the Contract Model. The Chair of the Committee, however, described the decision as regrettable and argued for more public involvement, in what he considered an essential public service. Council did accede to the request for more public input prior to the final vote on the issue, which was to be taken on January 28, 2004. The public generally expressed reservations over the continued used of the Contract Model, and urged council to re-adopt the previous Municipal (in-house) Model (McGuinness 2004: A3).

Notwithstanding public concern over the issue, Hamilton City Council voted 9-6 favour in keeping its water and wastewater operations in private hands. Those supporting continuance of the Contract Model, including Hamilton Mayor Larry Di Ianni, hailed the decision as a victory that would save the City money, maintain reliable service, and ensure high safety standards (Puxley, 2004: A1). John Dolbec, CEO of Hamilton's Chamber of Commerce, acknowledged that the private contract would save the City money at a time when it faced a budget shortfall of $83-million. He contended that Council's decision demonstrated that it was serious about battling the shortfall, while at the same time looking for other ways to provide services to the community. He criticized those who argued in favor of the Municipal Model, by stating that "there [was] no rational reason why the city [should] consider increasing its bureaucracy by taking this back in-house" (Puxley 2004: A1).

Many people had hoped Council would consider bringing water operations back in-house after the contract expired. They argued that a basic necessity like water belongs in public hands where there is accountability on the part of the deliverers and no profit-driven motives. Councilor Chad Collins argued that the “public model offered the most accountability where no one can walk away from their responsibilities." He was, however, of the view that since council had decided to continue using the Contract Model, the City would have to live with the consequences. Stella Yeadon, of the Canadian Union of Public Employees (CUPE) argued that privatizing water operations had not clearly saved the city any money. Further, she felt that Council should have delayed its decision until more public input could be considered (Puxley 2004: A1).

Irrespective of the decision to continue with the Contract Model, the debate over the issue continued to ignite the community’s passion, and councilors continued to be inundated with complaints from their constituents. It must be added that the debate was fuelled further by the release of Justice O’Connor’s report in 2002 surrounding the infamous Walkerton tragedy, as well as the decision to proceed with construction of the controversial Red Hill Creek Expressway. The matter came to a head in April of 2004, when angry demonstrator besieged the City’s council chambers and disrupted a council meeting (Puxley 2004b: A1).

City Council maintained its stand on keeping the Contract Model and subsequently commenced a competitive procurement process for the selection of a contractor to operate and maintain its water and wastewater systems. In order not to commit the same blunders with respect to the previous contract, the City placed much more stringent requirements on its Request For Proposal (RFP). This was evident by the fact that during the process, the city received nearly 200 questions relating to the clarification of points and related concerns from bidders. Moreover, the RFP stipulated that each proposal would consist of a Financial submission and a Non-Financial (Technical) submission. The Financial submission would be considered only if a Non-Financial submission met a minimum score of 60% for each of three categories: business plan, operational plan, and transition plan.

The competitive procurement process was undertaken in two phases. The first consisted of a request for pre-qualification intended to identify operators with demonstrated experience in the field. In the second phase, qualified candidates were then requested to submit proposals and draft service agreement. When the RFP closed on July 29, the city had received submissions from two of the four proponents that were pre-qualified. One submission was an hour late and thus disqualified, while another pre-qualified proponent withdrew from the competition. Of the two remaining proposals that were opened, one was disqualified due to irregularities in its proposal. The remaining proposal (from AWS) was sent to an evaluation team for evaluation in accordance with the RFP process. However, while AWS' Non-Financial submission met the minimum score, it was determined that the Financial submission was not compliant with the RFP and was thus disqualified. Further, the Financial submission of AWS was more than double the value of the existing contract and far above the City's pre-determined budget range (City of Hamilton 2004).

AWS, eager to renew the contract with the City, had also submitted an alternative proposal. However, the City rejected this alternative proposal on the basis that it did not meet the minimum score for the Non-Financial/Technical submission as stipulated in the RFP. As such, AWS' Financial submission remained unopened. The procurement process authorized by the city thus failed to identify a proponent with the necessary qualifications to manage the system.

In the absence of a qualified proposal, Council authorized City staff to find ways to resolve the issue. Staff developed and evaluated three alternatives for the operation and maintenance of the water and wastewater treatment systems: undertake significant changes to the DSA and begin the RFP process anew; investigate the idea of a public-public partnership with other entities, such as the Hamilton Utilities Corporation; and, bring the operations back in-house. After a long deliberation on the three options, staff recommended the third option to Council, which was bringing the operations back under municipal control.

In an attempt to keep alive its bid for a new contract, AWS submitted two last-minute proposals to the City. The company also appealed to City Council's Corporate Administration Committee against the disqualification of its earlier bid and the recommendation to bring the operations back in-house. As well, AWS attempted to obtain an injunction to block Council's vote on the matter. The appeal and injunction were both denied, which ended a year-long effort directed toward securing a new 10-year contract for private operation of the City's water and wastewater systems. On September 15 2004, Hamilton Council voted and accepted the recommendation of City Staff. (McGuinness, 2004: A6)

Analyzing the Issues Involved in De-Privatization:

In this section, we analyze the reasons behind the failure of the Contract Model. Why did the City of Hamilton de-privatize its water and wastewater service? To answer this question, we return to Wolf's article in which he argued that private sector delivery of services is better than public sector delivery. He attributed this to (a) internalities and private goals, (b) redundant and rising costs, (c) derived externalities, and (d) distributional inequity. Wolf's identification of these factors was based on various characteristics of supply and demand conditions.

Wolf claimed that public agencies, unlike private sector firms, do not have standards or performance indicators to measure efficiencies in service. In the Hamilton case, this was untrue. Indeed, Hamilton had in place Baseline Performance Criteria (BPC), which complied with Ministry of Environment and Energy standards with respect to the operation of its water and wastewater facilities. These criteria were used as the standard with which to measure PUMC's performance under the contract. There is no evidence that PUMC or its successors developed any new or better performance measures/indicators at any time during the term of the contract. In fact, when people began to question the efficiency and effectiveness of PUMC over numerous spills and other related problems, the Region decided to absolve the company from blame. "Those are issues that would have happened, could have happened if the region was the operator as opposed to PUMC. I'm not sure we can necessarily blame PUMC for those," noted Fred Eisenberger, chair of the Region's environmental services committee, when the issue of PUMC's performance came up for debate (Hughes 1999: A6). Regional Chairman Terry Cooke supported Eisenberger's assertion: "We have a plant that is outdated, that needs improvement that is struggling to meet present and future ministry standards." He claimed that PUMC's performance as an operator should be evaluated separately from the overall performance of the plant. To Cooke, "the benchmark for the contract [was] relative to where [the Region] would have been, had [it] been managing the plant" (Hughes 1999: A6). However, it is obvious PUMC had assumed its operation with a clear knowledge as to the state of disrepair of the facility. Hence, there was no reason or excuse for them to be absolved from any responsibility emanating from infrastructure failure.

With respect to redundant and rising costs, Wolf argued that the private sector has incentive to increase production and reduce cost over time due to competition and the need to generate profit. These incentives are not present in the public realm. Wolf's argument is flawed, however, in terms of the characteristics of the good or service to be delivered. While his argument might be valid with respect to the *production* of goods or services in industrial and commercial organisations, it cannot possibly be applied in cases where a public good is being *provided*, and where monopoly exists over delivery. This is especially true in the area of water delivery. Unlike other services such as the delivery of electricity, there is no means to purchase the good in an open market. Delivery is entirely dependent on local facilities and infrastructure. Thus, the nature of the good is such that it does not lend or subject itself to the textbook notion of competition.

In the Hamilton case, there is no evidence that there was a reduction in costs, due to the fact that service delivery moved from public monopoly to private monopoly. First, while PUMC and its successors may have reduced costs in order for them to generate profit (by reducing labour cost), this was not reflected in water rates passed on to consumers. The Region and PUMC did make some savings through the closure of the Region's sludge incinerator, as it required $10 million dollars in repairs. PUMC trucked to the sludge to a landfill site, which saved $60 per ton on a production of about $150 tons per day. Although hailed as a financial gain for taxpayers, under the operating agreement that became effect in the previous year, PUMC itself received 60 per cent of the savings while the Region got 40 per cent (Poling 1996: B2). It is also notable that the decision to close the incinerator did not come from the Regional Council, but was made by PUMC and Regional bureaucrats (McNeil 1996: C2).

Second, while it was expected that competition would reduce cost, this was not the case in the bidding process for the contract in 2004. As previously stated, the financial proposal from AWS was more than double the value of the existing contract. The City had budgeted for approximately $20 million per year for the operation of the facilities, but AWS, the only qualified proponent, had submitted a bid for nearly $40 million. After the City rejected the original bid, AWS submitted an alternative bid of $13.2 million, which was less than the $13.5 million that it was projected to receive in 2004 under the old contract (McGuinness 2004).

The company blamed its failure to win the contract on unrealistic and extremely prescriptive demands made by the City, such a requirement to hold $100 million in environmental liability insurance. This ultimately drove up the bidding price of AWS.[8] Officials of AWS claimed that the City itself could not fulfill the requirements of the Draft Service Agreement. They also claimed that, had AWS won the contract, it would have been in non-compliance from day one. In fact, AWS simply felt that the City had already decided to return to in-house operation in view of the position of some councilors and many members of the community who were ideologically opposed to private sector involvement in water and wastewater services. City politicians, however, refuted this allegation.

Another reason cited by Wolf for nonmarket failure is "derived externalities." Strong political pressure for intervention in market activities often generates negative and unanticipated consequences. Wolf's argument is not different from other Public Choice theorists who claim that politicians implement programmes that may garner votes, and that the policy process is often captured by political constituencies. As a result, the best rational economic decision does not always prevail in the public dominion. To such theorists, using the private sector in service delivery will not only eliminate this problem, but also narrow the range of political and administrative decisions, and release the forces of production from the strong arm of the state bureaucracy. However, while Wolf and other Public Choice theorists are at odds with the 'supposed capture' of politicians and state bureaucrats by political constituencies, they tend to turn a blind eye to capture by private-sector actors.

The latter is clearly evident in the Hamilton case and is best illustrated by the debate over whether to contract out the water and wastewater services operation in 1994. At the time that the Region decided to use the private sector for service delivery, there was no market. In fact, the private sector effectively intervened in a nonmarket situation to create an 'artificial' market. As outlined earlier, the idea to involve the private sector emanated from the influence of New Public Management ideas, the prevailing economic

[8] Interview with officials of American Water Services

situation, and the corresponding emergence of influential local private actors interested in exploiting potential markets.

The emergence of these actors led to the capture of the local policymaking process. Indeed, the whole idea to use the market model in water and wastewater service delivery came from the private sector. In 1994, ex-Liberal MPP Stuart Smith brought his water company (Philips), charisma, and vision to the table. Certainly, it was his ideas and influence that spurred local politicians to take a serious look at the feasibility of using the market to deliver the service. In short, “council was smitten by Smith's experience, wisdom, and personality. In addition, along with the cool analysis of someone like Smith, there was the emotional rush from the dramatic rise of Philip Services, which was at the time an example of a small local company making it big in the world” (Wells 2004 A1). Terry Cooke, ex-chair of Regional Council, claimed that Council tried to support a local company "that was seen as on the cutting edge of developing a made-in-Hamilton water management business… It was the best judgment of the time, and I still believe the movement out of public hands that took a more entrepreneurial approach and leveraged investment in the plants was a good thing, and will stand the test of scrutiny" (Morse 2004, A4).

The idea of Wolf and other Public Choice theorists that political pressure is unidirectional (emanating from political constituencies) was also found to be flawed when we examined the contract review process in 2004. Evidence derived from interviews strongly indicates that city politicians and bureaucrats were caught in a frenzy of lobbying by powerful private interest groups such as the Hamilton Chamber of Commerce (HCC) and the Community Action Parkdale East Citizen's Group. The chairman of HCC, for example, continuously urged councilors and the citizens of Hamilton to set aside any ideologically motivated debates about whether it was best for governments to work with the private sector to address the needs of citizens, as such debates were not based on any rational evaluation of the issues and costs involved. The Community Action Parkdale East Citizens Group also supported the idea of private sector management. The chairperson of the group admitted that while the first the 10-year private-operator experiment had a number of problems at its inception, "it seems [the] marriage [was] finally working" (Wells 2004 A1).

Finally, Wolf mentioned distributional inequity, as an excuse for government intervention in market activities. He claimed, however, that public or government intervention generates greater distributional inequities based on influence and power in nonmarket areas. Wolf (130) argued that those who are adversely affected by public policy as a result of the lack of competing producers have “less direct and effective means of expressing dissatisfaction than is available to consumers of marketed output who can withhold purchases or shift them to other producers.” While this may be true with regards to the production of certain goods (*e.g.* industrial and commercial), we found no evidence of such claim in the delivery of water and wastewater service. Indeed, if such distributional inequities exist at all, the problem may lie with the absence of competitive market conditions.

In a liberal democratic environment, power resides with the citizenry and this is more evident and prevalent at the municipal level where local politicians do not contest elections based on party platforms, but on individual ingenuity and accountability. Citizens are more involved in power politics at this level and have greater influence in policy direction and decisions. Public-private partnerships create dual ownership problems and, therefore, the public finds it difficult to place blame (or praise) directly on rightful party. In addition, when monopoly exists over a service the public may not be able to express dissatisfaction through exit, *i.e*., shifting from one producer or deliverer to another. However, we argue that the public certainly has more voice when the monopoly is exercised by a public agency rather than a private firm.

According to Wolf the distributional inequities of influence and power reside specifically within the public realm. Our findings indicate that this is not always true. In the Hamilton case, the private sector wielded a good deal of influence and power over the decision-making process. This emanated from the cross-over of relevant policy actors from the public to the private sector. During the duration of the 10-year agreement, a significant portion of the City's politicians and staff left municipal politics and employment to join the firms that operated the City's facilities (Anderson 1999b). Some became consultants or lobbyists for those firms. For example, Fred Eisenberger, a former alderman and chair of the Region's environmental services committee was hired by AWS to lobby on the company's behalf for the 2005 contract. Others also shuttled between the private firms and the municipality. Jeff McIntyre, a former bureaucrat, moved back and forth between private firms (PUMC and Azurix) and the municipality, and finally ended up as an official of AWS.

This movement of actors from the public to the private sphere changed the dynamics of power and influence within the decision-making process. In describing how these movements affected councilors and bureaucrats in the decision-making process, one interviewee contended, "Such people knew, and still know, the working of the municipality. They were thus able to use their knowledge, power, and influence to lobby councilors, particularly newly elected ones whose knowledge and ideas of the management of the system were quite limited, to vote for the continuation of the contract model."

Conclusion:

The objective of this paper was to explore and explain the difficulties associated with public and private sector delivery mechanisms. While a number of scholars have argued strongly in favour of private sector service delivery, others have recommended the exercise of caution with respect to this approach. Our foregoing analysis indicates that the nature of the good or service to be delivered, as opposed to produced, influences the preferred delivery mechanism. Certainly, where the deliverer enjoys a monopoly over service delivery, as demonstrated in the case of Hamilton water and wastewater, then the ideal option may be public delivery. In short, while the market may promote the efficiency and effectiveness needed with respect to the delivery of some services, an environment that does not ensure the existence of a standard market model may be unable to overcome the perceived inadequacies associated with public sector delivery.

While this research does not dismiss the theory of nonmarket failure, we find it quite disturbing that the idea continuous to be seriously promoted without careful consideration of a number of associated issues, such as accountability and where there is no exit option available to consumers. In fact, we do not make a claim that our research has been able to expose the deficiencies of the market model in view of the fact we examined and analyzed a single case. We thus need to expand the number of cases.

Further, it is necessary to undertake a longitudinal study of the Hamilton case in order to compare and contrast the deficiencies associated with both the Market and Municipal Models.

Until such a research is completed, we cannot confidently dismiss Wolf’s theory of nonmarket failure with respect to goods that are not easily subject to market competition.

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