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Three Water P3s Reach Financial Close in December, 2012

United Water, KKR Seal A 40-Year P3 In Bayonne, N.J.

The Bayonne, NJ, Municipal Utilities Authority (BMUA), loaded with debt and facing double-digit rate increases to keep its system running, found a soft landing this month in a 40-year concession with Kohlberg Kravis Roberts & Co (KKR) and United Water that solves the city's failing credit problem and holds rates near where they would be in a public solution.

So says the city's financial advisor Dennis Enright, of NW Financial Services, Hoboken, NJ. "Their offer came pretty close to the cost of Bayonne refunding its tax-exempt debt itself," he says.

The joint venture reached financial close Dec. 21 on a $175-million debt-equity financing with two-thirds of that 20-year bank debt arranged by RBC.

The franchise agreement with the city guarantees revenues, including pass-throughs, force majeure and unexpected capex, but does not guarantee returns to the private investors, which won the debt an investment-grade rating from Fitch.

There will be no state regulation of the private franchise, which covers billing, collection and O&M and management of distribution and collection systems, stormwater and CSO. Regional utilities provide wastewater treatment and water supply.

United Water's management contract is with KKR. Efficiency savings and new revenues over the medium term are expected to come from private operating efficiencies; staff reductions from 30 to 19 over a one-year transition; capital investments; increased water sales of about $3 million a year from announced real estate developments; and about $1 million annually from remetering to capture unbilled water.

About $7 million of the proceeds will be invested quickly to replace meters and upgrade billing and collection. Going forward, a fixed amount will be spent on other capital projects identified by KKR and United Water. The budget will be set annually and unspent funds will roll forward.

The BMUA will continue to exist and will be funded with $500,000 per year, indexed, for its costs to administer the concession agreement.

All of BMUA's debt, about $125 million, was refinanced with taxable bank loans and are no longer a contingent liability of the city; $6.5 million of the proceeds is set aside for rate stabilization; and about $18.5 million went to the utilities authority.

"It's going to have a huge credit rating impact on the city," says attorney Joseph P. Baumann Jr., chairman of McManimon, Scotland & Baumann, who conceived the deal.

Baumann has advised N.J. governments on a number of New Jersey water deals and represented the city in its negotiations with United Water and KKR. Kent Rowey of Allen & Overy, represented KKR.

The agreement reached with KKR and United Water "is good for the water industry," says Enright. "It's a well-balanced deal that took all the public concerns into account. It provides for reasonable rates over time and reasonable returns to investors over time."

Having the financial partner at the table made negotiating returns far easier than when financial and long-term operating interests are combined, Enright says. Specific rate increases were negotiated against a return model that includes pass-throughs and projected revenue gains: "We know what the returns are and that they are reasonable," he says.

"They're [KKR] real professionals," he says, "very different from most people on the private side."

Benefits

Among other things, the private solution:

> eliminates Bayonne's contingent liability for debt on the BMUA and a large waterside redevelopment project that's on the BMUA's books.

> brings in co-investor United Water under a 40-year contract with KKR to upgrade, operate and maintain the capital-starved system and cure inefficiencies. That includes a town wide remetering and other improvements under a fixed-price agreement.

> brings rate-payer stability to a troubled public utility in a working-class enclave of 63,000 residents on Newark Bay, just south of Jersey City. The most recent rate increase by the city was in 2006 when water and sewer charges went up 27%. Under the concession, rates for water and sewer charges are contractually set to increase 8.5% in year one (about $5 per month), zero in years two and three, 3.75% in year four and by an inflation-index formula after that. There is no state regulation of the rates. n

Jersey City Rides Its Ratepayers

When Jersey City formed its Municipal Utilities Authority (JCMUA) in 1998 to manage the struggling city's water system, it not only collected a one-time profit for the city, but the agreement also called for annual franchise payments to the city.

Those payments have grown from $9 million to $16 million annually now. In addition, water and wastewater rate increases to support a string of revenue bonds have left the independent public authority with roughly $275 million in debt.

Using the JCMUA as a conduit to fund city operations is sapping the strength of one of the city's key agencies. "They've bled it dry," says a city advisor.

The Jersey City council retains the right to approve rates, so is on the hook for shortfalls in the JCMUA's budget.

United Water signed a management contract for the city's water system in 1996, two years before JCMUA was created. It's performance is widely praised in the industry, but it may be having the perverse effect of enabling the city to increase its reliance on JCMUA's ratepayers. n

Remetering Lessons

Revenue gains from replacing old meters with new one are almost impossible to predict. Modest increases are forecast in the revenue model used to set rates in Bayonne, N.J. But a remetering of North Bergen, NJ's water system as part of a concession in 1996 ultimately led to the unseating of the mayor and most of the council when water costs went through the roof.

US Water, partly owned by Bechtel and Kiewit, defeased the city's debt and paid the city $7 million at closing for a 20-year concession covering the city's 10-mgd water plant and wastewater collection system. As hoped, unaccounted-for water dropped from 38% to 21% and billable water jumped by 27%. The concession agreement allowed a 6% first-year increase.

A consumer-voter revolt occurred when the combined effect appeared on water bills. The city's mostly Democratic voters threw out their Democratic mayor and most of the council in favor of an inexperienced slate of Republicans. Democrats regained control in the next election cycle, once the rate shock receded. n

Four Lessons From Bayonne's P3

by Joseph P. Baumann, Jr.

The recent closing of a 40-year Concession Agreement between the Bayonne Municipal Utilities Authority and a United Water/KKR joint venture promises to become a template for future water and wastewater P3s. Crafted to play to the strengths of the public and private sectors, this transaction respects the fiduciary responsibility owed by Bayonne's elected and appointed officials to the ratepayers and the return on capital owed to the joint venture Concessionaire. It does this by, among other things, avoiding four significant pitfalls associated with other P3 transactions, namely:

Avoid Private Sector Windfalls

Generally, public water and wastewater systems ultimately answer to only one constituency—their ratepayers. Unlike the private sector, which must strike a balance between ratepayers and shareholders, often with a government entity serving as mediator through it power to approve rates, the public sector lacks the "yin" to the ratepayers "yang". The result is delayed capital maintenance combined with a bumpy approach to rate setting. On the other hand, turning rate setting responsibility over to the private sector could result in an equally unacceptable result; a private sector windfall. In Bayonne, the solution became a rate- setting formula that guarantees annual capital investments for the system; fixed, predictable, annual rate increases for the ratepayers; and a known annual revenue path for the Concessionaire. Thus, through the Concession Agreement, the known shortfalls of a public sector system have been addressed while a private sector "windfall" has been limited. Further, through the use of the guaranteed revenue path, the parties were able to minimize the cost of private sector debt and equity for the transaction.

Avoid Artificial Risk Shifting

Allocating risks among the parties in a P3 transaction often represent the most hotly negotiated terms in the agreement. For the public sector, however, the costs associated with these allocations are often not well understood. As a result, attempts to shift risks outside the control of the private party, to the private party, come at a steep price both in terms of the return expected and the contingencies required. And, in fact, the price is rarely worth the benefit. In Bayonne, the Concession Agreement leaves these risks where they already reside, with the ratepayer thus assuring a much more efficient P3.

Avoid Overburdening the P3 Transaction

The most successful P3s recognize their limits. Extracting value from inefficient systems to address short term financial issues rarely serves the long term interests of ratepayers (who ultimately pay the cost of short term fixes) or the Concessionaire who becomes the face for rate increases that come long after the benefit has passed. Rather, as in the case of Bayonne, retiring debt or making major upfront capital improvements, directly address the problems P3s are designed to address. Bayonne's use of the upfront concession fee to retire over $125 million in debt assured ratepayers that rates will remain reasonable over the term of the Concession Agreement.

Avoid A Lack of Ongoing Oversight

Designing an oversight mechanism, and perhaps more importantly, an annual, inflation adjusted funding source for such public sector oversight, may be perhaps, the most important component of any P3. Time and again, the failure of P3s can be attributed to a lack of a consistent, ongoing, diligent oversight of the P3 agreement and the private sector's performance thereunder.

Joseph P. Baumann Jr., is Chairman of McManimon, Scotland & Baumann, LLC. He has represented governments throughout the Northeast in crafting P3s for public water, wastewater and solid waste systems.

Rialto, Calif., Closes $177 Million Utilities P3

by Neil V. Callahan, VP SAIC, city financial advisor

In early 2010, the City of Rialto, Calif. began pursuing a rather uncommon proposition; it desired to pursue a competitively procured concession for their water and wastewater utilities. In March of 2010 the City issued an RFP for either a water, wastewater, and recycled water utility concession or for an operations, maintenance and management qualified management contract.

A special-purpose company, Rialto Water Services, LP, ("RWS") was selected in the fall of 2010 and a contract was negotiated by mid-year 2011. In June of 2011, the "Concession Agreement" a "Service Contract for the Design, Construction and Financing of Upgrades and for the Operation of the Rialto Utility Authority Wastewater Facility and Water Facility" came to vote before the City Council. After multiple hours of briefings on the Concession Agreement and impassioned public input, the City Council vote was a tie and the measure was not approved, but without prejudice.

In March of 2012 after multiple public workshops, and endorsement by the City's Public Works Advisory Committee, the City Council again reconsidered approval of the Concession Agreement, which was approved.

Once approved by the City Council, California's Proposition 218 required the resulting rate impacts be placed before the public for a protest vote. Despite some organized public opposition, the Proposition 218 vote was unsuccessful in overturning the proposed rate increases. The financial close for the project financing occurred in November of 2012 and the commencement of the transition of operation to the Concessionaire's Operations and Maintenance ("O&M") contractor took place on November 30, 2012.

Rialto's principal drivers for seeking a Public-Private-Partner to finance and manage its utilities were the difficulty of sustaining the City's political focus on unseen assets and back-office types of utility needs, including employee retention, the revenue pressures on a 100,000-resident city limiting municipal management staff, the increasing management expertise needed to sustainably manage a utility cost efficiently, and the desire to leverage some of the City's previous investment in water and wastewater assets that were contributed to the Rialto Utility Authority.

The City wanted to transfer responsibility for operation, maintenance and management of the systems to Rialto Water Services and its primary subcontractor, Veolia Water West Operating Services. In addition, they sought the implementation of an industry-leading asset management and preventive and predictive maintenance program to drive cost-efficient capital investments that assure the best life-cycle cost for delivered services. Further, the City sought the services of a company highly experienced with implementing utility CIP projects to implement the capital improvements necessary to assure sustainable levels of water and wastewater services, providing predictable costs and budgeting. Lastly, the Concession Agreement offered the potential to stabilize rate increases over the long term.

The financing for the project will be for a total of $177 million and will be a combination of $146 million in Private Activity Bonds plus $26 million in private equity capital for the project. This configuration of bonds and equity provided a cost of capital for the project comparable to those projected for future issuance of RUA debt. The use of the funds includes paying off $26.5 million for repayment of existing debt, a payment to the RUA of a $35 million concession fee, funding a $41 million capital improvement program and a total of approximately $74.5 million in funding for reserves, financing costs, rate stabilization and development costs. The bonds for the project were sold at a 5.5% interest rate and were investment rated. RWS was required to pay off the existing RUA debt consistent with requirements of the IRS tax codes.

The security for the financing involved a granting of a first pledge of, security interest in, and lien on all of the “user fees” that are payable to the Concessionaire. There is no security interest in any City-owned utility system asset. Consequently, the City will continue to own 100% of all existing and future utility systems assets over the 30-year term.

One of the major challenges to overcome in a non-recourse financed water and wastewater concession project is how to address the desired contract performance standards and City’s objective of transferring the operation, maintenance and capital maintenance cost risks with the bondholder’s need not to take open-ended or undefined cost risks associated with aged collection and distribution systems.

This set of conditions is generally referred to as the as-is risk. To overcome these as-is risk transfer issues, the deal had to be structured around implementing a structured approach to preventive, predictive and corrective maintenance management with specific cost reporting and a comprehensive asset-management program intended to produce long-term savings in repair and emergency maintenance costs.

The asset management requirements for capital assets in the concession agreement drives cost-efficient capital investments that are intended to assure getting the best life-cycle cost for delivered services. The as-is risk is a shared responsibility but is transferred over time to RWS during the initial five years of the agreement.

Neil V. Callahan, VP Water, Environment & Transportation, at SAIC was the business and technical advisor and rate consultant to the City of Rialto. for the development and negotiations of the Concession Agreement.

Feds Fail To Nail United Water In Gary

Concluding a two-year investigation by six federal and state agencies, a U.S. District Court in Indiana on Nov. 9 cleared United Water of all charges against two United Water employees for sampling violations at a city-owned wastewater treatment plant in Gary, Ind.

If convicted, the company's former plant manager and superintendent faced up to five years in prison on a conspiracy count and two years for each felony violation of the Clean Water Act, as well as a criminal fine of up to $250,000 for each count.

The federal suit alleged 26 instances of E. coli sampling violations related to the company's procedures for chlorinating discharges from the 80-mgd activated sludge treatment plant.

"The government's claim is, at best, a disagreement about operating and monitoring methods, with no allegation of environmental harm," Robert Iacullo, United Water president, said in a news release in 2010. "Trying to make a crime out of this disagreement is an abuse of prosecutorial discretion."

The federal case was investigated by the Northern District of Indiana Environmental Crimes Task Force, including agents from the Criminal Investigation Division of the U.S. Environmental Protection Agency, the FBI, the Coast Guard and the Indiana State Police.

The case was handled by an assistant prosecutor in the U.S. Attorney's Office for the Northern District of Indiana and by the Justice Department's Environmental Crimes Section.

United Water paid Gary a $10-million concession fee in 1998 to win a 10-year contract to operate the plant, two lift stations, and a 360-mile collection system. A five-year renewal was signed in 2008. Because of high industrial flows, the plant treats the equivalent of about 250 mgd. Discharges to the Grand Calumet River improved steadily during United Water's 12 years of management, says Brent Fewell, United Water's vice president for environmental compliance.

The company's $52-million, five-year O&M contract was terminated for convenience in July 2010 by the Gary Sanitary District whose new director asserted that the financially distressed city could save money by shifting to public operation.

Allentown, Pa., Water P3 Referendum

It appears likely that a referendum vote will be needed in November to approve a long-term lease of the water and wastewater system in Allentown, Pa. Nevertheless, an RFP will be presented in February to some or all of the seven groups undergoing qualifications diligence by advisor PFM and city agents.

The city is moving quickly with plans to lease its utilities before its legacy pension obligations overwhelm the budget. An RFQ was issued in late July. The city council had planned to vote on a resolution in September to issue an RFP with a draft agreement to finalists. Opponents have obtained enough signatures to put language for the referendum before the city council for a vote in May.

Mayor Ed Pawlowski is championing a lease to an outside authority or company as a way to quickly raise the $100 million to $250 million the city needs to avoid cutting services. Pension obligations are expected to grown to $23 million annually by 2015, a four-fold increase since 2005.

Part of Allentown's fiscal problem is due to its guaranteeing the debt of an independent authority for a hockey rink it never built. Harrisburg did the same for a money-losing trash incinerator, and Scranton backed authority debt for downtown parking garages.

Twenty-one Pennsylvania municipalities are designated as officially distressed by the state, and over 100 more are on the "active intervention" list. Altoona is the most recent, Pittsburgh is the largest, and Harrisburg is the most notorious.

n Wwtr DBO Ready In E. Providence

As part of its 10-year DBO contract, United Water recently completed $52 million in improvements to a regional wastewater treatment plant in East Providence, RI, at a cost consultants say is $13 million less than public delivery of the improvements.

The only other bidder in 2010 was a venture of Veolia, CDM Inc., and Gilbane Building Co., based in Providence. The city is being advised by Malcolm Pirnie Inc. The estimate for public delivery and operation of the upgrade is $65 million.

The upgrade is part of a larger project that involves pumping stations and pipes to meet an April 2007 consent decree governing discharges into Narragansett Bay.

The work is being funded with a $10-million loan at 2.5% subsidized by federal stimulus funds; $28 million in loans at 4.5% from the Rhode Island Clean Water Finance Agency; and market-rate municipal bonds.

Carlsbad Desal Financing Closed

In late December, Poseidon Resources (Channelside) LP closed a $922-million debt-equity financing and secured all funding needed to build its Carlsbad, Calif., desalination project.

The sale of tax-exempt private bonds caps a decade-long development effort by Poseidon's investors to start construction of the largest seawater-desalination plant in the Western Hemisphere. The new plant is projected to increase rates for an average household by $5-7 per month.

Private equity investor Stonepeak Infrastructure Partners provided the remainder of the project capital, $188 million. The deal negotiated by the San Diego County Water Authority (SDCWA) with Poseidon was developed to yield a target internal rate of return overall of 9.38%-9.45%, depending on the actual bond interest rate at closing.

Stonepeak's return will depend on Poseidon's ability to manage the completion risk, to ensure that the plant performs efficiently, and to meet SDCWA's production demands and water quality standards. SDCWA estimates that if Poseidon meets all performance standards for the water production system, it could achieve an equity return of up to 13%.

The 50-Mw reverse osmosis seawater treatment plant will be co-located at the site of the Encina power station on the California coast, north of San Diego.

The project is designed to provide San Diego County with a locally-controlled, drought-proof supply of high-quality water that meets or exceeds all state and federal drinking water standards.

A joint venture between subsidiaries of Kiewit Corp. and J.F. Shea Construction Inc. will provide engineering, procurement and construction (EPC) services for the desalination plant and a 10-mile pipeline under a fixed-price contract. Their subcontractor, IDE Americas Inc., will design the reverse osmosis plant and handle O&M under a 30-year contract.

Signing of the EPC and O&M contracts coincided with the close of the sale of $734 million in tax-exempt bonds issued by the California Pollution Control Financing Authority on behalf of Poseidon and SDCWA, with underwriting led by JP Morgan.

About $560 million of the debt is Private Activity Bonds (PAB) for building the desalt plant. The balance, $174 million in Governmental Purpose Bonds, will pay for construction of the conveyance pipeline, which SDCWA will own and operate.

The financial close followed the signing of a 30-year water purchase contract by SDCWA on Nov. 29, almost 30 months after the regional wholesaler’s board approved a term sheet for the agreement. n