# [Bond Case Briefs]

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## [A Tale of Two Public-private Partnership Cities.]

In 2012, Hurricane Sandy hit hard in the working-class port city of Bayonne, N.J., flooding east side industrial areas and the former Military Ocean Terminal. Water from Newark Bay swept through six Public Service Electric and Gas Company (PSE&G) switching terminals, and cut power to the whole city. Many long-time residents, who had lived through numerous storms, said they had never seen one so devastating.

Bayonne, with a population of more than 60,000, was struggling even before Sandy, but the storm made it all the more difficult for the city to address its water woes on its own. The city was buying 17.6 million gallons of water per day from the North Jersey District Water Supply Commission, but only using half of it.

The water came from reservoirs 50 miles northwest of the city, delivered through an outdated aqueduct in need of frequent repair that the city could ill afford. Like many other cities, Bayonne had deferred maintenance on its water systems. Its excessive debt burden led to a poor credit rating that made further borrowing more expensive.

Patrick Sabol, a senior policy and research assistant at the Metropolitan Policy Program of the Brookings Institution, said that ideally, "Bayonne should have been able to get it together, but the reality is they couldn't take on new debt, even at high cost."

Bayonne's sewer system, pumping an average of 8.3 million gallons of wastewater daily, had similar challenges, including outdated infrastructure and outfalls that needed updating to meet federal regulations.

The Bayonne Municipal Utilities Authority (BMUA) needed a solution. Its options included selling its water utilities outright to a private company, or entering into either an operation-and-maintenance contract or a longer-term concession agreement. Only a few months after Sandy, the city chose the latter avenue — a joint venture partnership for both water and wastewater operations with Kohlberg Kravis Roberts (KKR) funding 90% of the effort with United Water, a unit of French giant Suez Environnement S.A.

While BMUA maintains ownership and the control of user rates, the joint venture made an initial payment of $150 million to the city. This infusion of capital was critically important to the city because it eliminated $130 million of existing debt and improved both the authority's finances and Bayonne's credit rating. In 2013, Moody's Investor Service upgraded Bayonne's bond rating from Baa1 with a negative outlook to Baa1 with a stable outlook, in particular citing the city's recent progress in reducing its debt burden through the lease-sale of the MUA operations.

KKR and United Water further pledged to funnel another $157 million into the water systems over the 40-year length of the contract, with about $2.5 million a year earmarked for maintenance and upgrades. That work began quickly with the cleaning and inspection (using television cameras) of many miles of water and sewer mains. Some 1,500 water hydrants are also being checked to make sure the fire safety infrastructure is reliable. Installation of new water meters, which greatly expedites the finding and repair of leaks, is also underway. The new meters can be monitored directly from the offices of United Water Bayonne, and telltale signs — heavy water use late at night, for instance — are being used to direct repair crews and inform customers of possible leaks on their property.

Tim Boyle, BMUA's executive director, said the initial efforts are part of extensive upgrades over the next several decades. "Remember, the city of Bayonne still owns the water and sewer systems, and it's Bayonne that benefits," he said. "We receive $2.5 million per year, which is a nice chunk of money guaranteed. What the partnership does is remove the need for political will for the maintenance of the system. It's hard to imagine politicians committing an equal amount of money to maintaining our water supply."

Water consumers are paying for some of the improvements: 8.5% rate hikes on both water and sewer bills were implemented in 2012 — the first BMUA increase since 2006 — and another 4% increase came in at the beginning of 2015. As a result of the 2012 increase, low-volume users saw their cost for 748 gallons of water increase from $4.29 to $4.65, and heavier users started paying $5.12, up from $4.72.

The authority said it would have had to raise rates even without its new agreement, but the hike was criticized by entities such as advocacy group Food & Water Watch.

In a report titled "Private Equity, Public Inequity," the group said that private equity players typically focus on short-term profits and may seek to flip assets after driving down service quality and driving up prices. That means households and businesses could end up paying more for inferior service.

Still, a report by NW Financial Group, a financial advisory and municipal underwriting firm, estimates that Bayonne's 4% annual rate increases are less than the 5% annual increases that New Jersey's regulated water utilities have averaged since the 1970s. The report also said that the new partnership is locked into "a fixed-rate increase schedule that assures modest future rate increases over the 40-year concession period."

At the Wharton conference, "Investing in America's Public Water Systems — Making Public-Private Partnerships Work," Patrick Cairo, a Suez Environnement senior vice president, said that Bayonne's water rates "will be a little north of inflation levels — any more than that and the system will start to unravel because of upset customers."

A law firm hired by BMUA estimated that the city could save almost $35 million over its 40-year contract, compared to operating the water utilities on its own. But a BMUA attorney cautioned that it is too early to say if those savings will actually be realized. So far, rate increases have occurred within the contractually agreed-upon amounts "and therefore — after four years — United Water is on track to realize the projected savings," Cairo said.

It is indeed early in the relationship among United Water, KKR and the citizens of Bayonne. So far, the rate increase has been an issue locally, but few have complained about inferior service. United Water, for its part, reports fielding positive consumer comments about access to information from the smart water meters it has installed.

**A Private Sector Lifeline for Rialto**

The city of Rialto, 60 miles from Los Angeles in the region's Inland Empire, provides water to 48,000 customers and sewer services to 100,000, with budgeted revenue of $37 million in fiscal 2014. As in

Bayonne, the existing system suffered from deferred maintenance, but there was also serious water contamination by the chemical perchlorate that was not detected until 1997. After a decade of litigation, the estate of a former fireworks manufacturer agreed to an $11 million settlement in 2014 for polluting the groundwater with toxic chemicals.

Because of the contamination, Rialto has had to purchase water at a high premium from other municipal operations, and main breaks became commonplace. The city found itself in a situation familiar to municipal managers across the country – the presence of large debts aggravated by the recession, and problems of compliance with federal standards.

According to "Private Capital, Public Good," a research paper from the Brookings Institution, Rialto's "historically underfunded system also struggled to meet pension liabilities, which were starting to weigh on the utility's ability to affordably raise capital in the tax-exempt market."

Andrew Sawyers, director of the office of wastewater management at the U.S. Environmental Protection Agency, said that state revolving loan funds and municipal bond financing often have not been sufficient to meet local needs. That was a factor in the creation of the EPA's Water Infrastructure and Resiliency Finance Center early in 2015. It is designed to be a resource for communities and municipal utilities that struggle with limited budgets.

In 2013, Rialto entered into a 30-year, $300 million public-private partnership (P3) agreement with Veolia Environnement S.A.'s Veolia Water as the operator of the project. Ullico, a labor-owned insurance and investment company, was the lead finance partner, along with Table Rock Capital. An agreement with labor unions ensured that all existing employees would keep their jobs for at least 36 months.

The structure of the concession agreement, which creates the new Rialto Water Services, is similar to that of Bayonne, but a significant difference is that Veolia has actually been a contracted operator for Rialto's water systems since 2002. The new partnership deepens the relationship, with operational, management and fee-collecting responsibilities, plus the obligation to upgrade the system in the first five years. The partners also agree to settle $27.4 million of the city's water-related debt, and provide a total of $35 million in cash.

The partners are guaranteeing 445 new construction jobs, and have committed to $41 million in capital improvement projects for Rialto's water infrastructure. They project savings of $2.5 million for the city over the first five years of the contract. By mid-2014, more than $525,000 had been invested in maintenance repairs, projects and upgrades. New water meters are being installed, and a treatment plant digester is being rehabilitated.

Veolia has improved the customer service call answer rate by 95%, installed a new computerized work order management system, and is using geographic information system technology to map and monitor the 260-mile collection system. These are not inconsequential benefits. The value of water privatization to communities like Rialto is "finding companies that are willing to make capital investments on their own dime — that's advantageous to constituents rather than onerous," said Tim Carden, managing director of PFM Group.

But Rialto also experienced a 15% rate increase, which went into effect on January 1, 2015. That amounts to a 30-cent increase on each 748-gallon unit of water. Mary Grant, a researcher for Food & Water Watch, said the city agreed to increase rates by about 115% from 2012 to 2016.

Jeff Murphy, portfolio manager for the Ullico Infrastructure Fund, said that the rate increase was "reasonable," given the necessity of upgrading the water system, and the efficiencies that Veolia brought to the operation. “The increases were lower than in surrounding communities that had raised rates,” he said. “The existing rate base was barely covering the operation, and was unable to pay for the capital improvements that had to be made.” He acknowledged that “raising water rates is not a popular thing to do.”

The West Valley Water District, a neighboring local public agency that provides drinking water to parts of Rialto, said the takeover was not to be blamed for the increases. The district said the need was based on a 2012 analysis –before Rialto Water Services was created – pointing out that “costs such as chemicals, lab fees and required permits were increasing. Since that time, those costs have in fact increased by an average of over 200%.”

Still, there is no question that Rialto’s water users will pay higher bills because of extensive capital improvement programs — the operators are going after profit, and the updates will not be a free benefit. But there also is no debate that those programs were both desperately needed and long deferred.

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Jun 10, 2015