Portfolio Media. Inc. | 111 West 19th Street, 5th Floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Funding And P3s For Water Infrastructure Projects: Part 2

Law360, New York (October 18, 2016, 11:02 AM EDT) --

Paul J. Epstein

In part 1 of this two-part series, we discussed key existing sources of funding for water utilities at the federal, state and local levels. Here, in part 2, we will initially discuss the use of public-private partnerships (P3s) in the water sector to fill funding gaps and as an alternative procurement method. Then we will describe proposed enhancements by stakeholders to the funding mix, including through the Water Resources Development Act (WRDA) that is currently pending before Congress, and consider the impact of certain of such enhancements on the P3 market.

Water P3s

Although both U.S. transportation and water assets are facing immense infrastructure deficits, to date there have been far fewer P3s in the water sector. In the post-financial crisis period, this seems less for want of available capital than a dearth of appropriate projects. The use of private capital and expertise by municipal water authorities has frequently taken the form of short-term (1- to 5-year) service contracts or medium-term (5- to 20-year) operation and maintenance contracts (or design-build-operate-maintain (DBOM) arrangements), rather than long-term design-build-finance-operate-maintain (DBFOM) concession arrangements.

Given their constrained budgets, the focus of water authorities has been on improving the management of their water or wastewater systems, rather than on new capital investment. Where such capital investment is included, the scale of the project is often not sufficient to attract private equity and debt capital. The combination of these elements has limited the scope of services procured to the private sector.

The DBFOM P3s that have been implemented often have had a “monetization” element, requiring an upfront payment to the authority by the private developer. Two examples are the Bayonne (New York) and the Rialto (California) water-wastewater projects, both of which reached financial close in 2012, in which the developer made an up-front payment to the authority, which amounts were applied to pay for needed improvements, to stabilize water rates and/or repay debt of the municipality. Similar to transportation deals, the up-front payment serves as consideration for a real property interest (typically documented as a lease) in the water system and the right to collect revenues from the system over the concession term, which in the case of Bayonne is 40 years and Rialto is 30 years. The developer assumes responsibility for all water system operations and for providing capital for infrastructure maintenance and upgrades during the term. The public authority retains legal ownership of the assets, contractual oversight and control over water rates.

The Fargo project, which is currently in procurement, is being structured on an "availability payment" basis, where the developer receives periodic payments from the authority during the operating period for keeping the relevant facility "available" and meeting performance criteria. In these projects, the authority can defer the payment of significant capital costs until after construction, and spread such amounts over the term in accordance with an agreed schedule. The private partner takes the risk that the authority is able to make these payments.

While the contribution of private capital under P3s can act as a source of funding (or funding deferral) for water utilities as described above, the "value for money" for DBFOM projects is also driven by the developer's ability to enhance project design, bring technical expertise to complex projects, improve the project schedule, reduce operation and maintenance costs over the term, and assume material risk from the public sector. These benefits not only can bring fiscal stability to the authority but also allow it to deploy limited capital and resources to other areas.

The diversity of projects in the water sector has increased recently as more authorities consider the P3 delivery method given the benefits it offers over the asset's useful life. Consider the Fargo project, which is part of a larger flood risk management project undertaken by the local authority in partnership with the U.S. Army Corps of Engineers (ACE), the total project costs of which are estimated at $2.1 billion.

Because the ACE's budget for this project is limited and specialized expertise is required for design, construction and operation, the local authority decided to "split" the delivery of services between the ACE, which will be responsible for building an embankment to act as a levee for flood waters, and the private partner, which will be responsible for building and operating the diversion channel and related infrastructure, including road and rail bridges and multiple aqueducts. By lowering long-term lifecycle costs and improving performance, the expertise of the private sector team can enhance the value of the project for the authority and residents of the flood zone.

A two-pronged delivery method is also being considered for the Grand Prairie irrigation project P3 in Arkansas, which would involve the transportation of water from river to farm in eastern Arkansas. While the ACE has invested over $200 million in federal funds in the project on a portion of the pump station, canals, pipelines, farm storage and distribution facilities, the local authority is seeking a private partner to provide funding and expertise for completing the project and operating the pumping and distribution system over a 50-year period so that water is delivered to depleted areas.

Other authorities are currently implementing P3 projects to mitigate drinking water supply issues. In Texas, the San Antonio Water System (SAWS) has entered into a development and water purchase arrangement with a private partner to purify and transport water located in aquifers over approximately 150 miles from Burleson County to San Antonio. Financial close is expected this year. In California, the Santa Clara Valley County Water District has shortlisted private developer teams for a project that would involve the construction of a pipeline to transport water to refill aquifers whose capacity has been strained as a result of drought (in addition to the separate expansion of the district's purification facility).

Proposed Enhancement of Existing Funding Sources

Based on industry input, several proposals have been made by industry stakeholders and Congress members to enhance or expand the existing funding sources for U.S. water projects that we discussed in part 1 of this article. Below is a summary of the key developments.

Modification to Existing Sources

Stakeholders have suggested that Congress increase annual appropriations to the Clean Water State Revolving Fund (CWSRF) and the Drinking Water State Revolving Fund (DWSRF and, together with the CWSRF, the SRFs) and to modify the CWSRF to make private water authorities eligible for its benefits. There has also been significant, vocal support for the abolishment of the state volume caps on water PABs. Lifting the cap would place water on a par with airports, highways, bridges, tunnels and solid waste disposal facilities, none of which are not subject to volume caps (although highway PABs are subject to an aggregate national cap of $15 billion).

New Sources

Efforts have also been made to expand the ambit of government credit programs to build on the success of the Transportation Infrastructure Finance and Innovation Act (TIFIA) program in the transport sector. These efforts include water-specific programs as well as those affecting multiple sectors.

1. WIFIA

The most significant recent development has been the passage of the Water Infrastructure Finance and Innovation Act (WIFIA). Congress authorized WIFIA as a five-year pilot program in the Water Resources Reform and Development Act of 2014 (WRRDA), and it was amended in December 2015 pursuant to the Fixing America's Surface Transportation (FAST) Act to allow tax-exempt funds, including PABs, to finance construction costs together with WIFIA credit.

Under WIFIA, EPA[1] is authorized to provide long-term, low-interest loans to fund drinking water and wastewater projects at a total subsidy cost of $175 million, beginning with $20 million for fiscal year 2015 and increasing to $50 million for FY 2019. The subsidy cost is the "estimated long-term cost to the government of a direct loan or loan guarantee, calculated on a net-present-value basis, excluding administrative costs."[2] While estimates vary, WIFIA's subsidy costs have been projected to be between 1.53 percent and 10 percent of loan value, meaning that a $20 million subsidy cost allocation would support between $200 million and $1.2 billion in loans.[3] Such leveraging of federal funds (and the fact that the loans must be repaid) means that WIFIA loans will have significantly less impact on the federal budget than would comparable grants.

Because projects must have eligible project costs of at least $20 million, WIFIA would seem to offer the most benefit to larger projects. However, the floor is lowered to $5 million for projects in rural areas with a population of 25,000 or less, and individual projects can be aggregated to meet the required thresholds.

The program has generated great interest among stakeholders. In the same way that the Transportation Infrastructure Finance and Innovation Act has become an indispensable part of the capital structure for transportation projects, WIFIA has the potential to be an important funding source in the water sector. Key program elements are substantially similar to those of TIFIA, including its eligible borrowers, which include governmental entities as well as private sector entities seeking to fund project costs in connection with P3s.

The EPA will determine eligibility based on a project's creditworthiness and dedicated revenue sources for repayment. Selection criteria will include the national or regional significance of the project, the

extent of public or private financing in addition to WIFIA assistance (and the extent to which other federal assistance could be reduced), the use of new or innovative approaches (e.g., P3 structures), and the extent to which a project serves regions with significant energy development or production areas or significant water resource challenges.

The principal barrier to WIFIA's implementation is that, although the program was authorized in 2014, Congress has yet to appropriate funds to permit lending. The Senate's version of the WRDA would appropriate $70 million to the EPA for this purpose, thus freeing up between $700 million and $4.2 billion in loan capacity under WIFIA. However, $20 million of the subsidy amount cannot be applied to projects funded with tax-exempt (or tax credit) bonds, including PABs.

Stakeholders have also proposed (a) extending the program's expiry date (given that it has been more than two years since the program was established) and (b) to lift the cap on the portion of project costs that may be funded by WIFIA loans, which, like TIFIA, is 49 percent. The Senate's version of the WRDA addresses the first point by removing the WIFIA program's "pilot" designation. While this change provides a sense of permanence, this may be merely precatory as no additional funds were authorized beyond 2019. As to the second point, the Senate's bill states that the 51 percent portion of project costs required to be funded by non-WIFIA sources may include costs incurred and in-kind contributions made to the project before receipt of the loan, which may provide more flexibility in structuring. The Senate's bill also would permit WIFIA loans to fund up to 80 percent of project costs for emergency projects, with SRF funds being available for the balance.

Another uncertainty is whether, once implemented, WIFIA would complement other federal funding programs or result in their downsizing. In particular, some local authorities fear that the appropriation of federal funds for WIFIA could lead to less funds being available for the SRFs, thereby reducing support for smaller water projects that do not qualify for other forms of assistance, including WIFIA or tax-exempt bonds. Three developments should assuage this fear. First, pursuant to the WIFIA statute, when a WIFIA application is received, the EPA must provide the relevant state SRF with a "right of first refusal" to provide funds to the project on no less favorable terms to WIFIA. This element seems to point to the ongoing capitalization of the SRFs. Second, the SRFs, acting as borrower, could support themselves by using WIFIA funds creatively to finance a group of smaller projects. Third, as described in the following section, a dedicated fund has been proposed on a bipartisan basis to provide continuing support to the SRFs.

2. Water Infrastructure Investment Trust Fund

Given the variability in appropriations for the SRFs, some legislators have suggested a federal water trust fund, which would be a protected source of revenues to help states replace, repair and rehabilitate critical facilities. The Senate's version of the WRDA proposes a Water Infrastructure Investment Trust Fund (WIITF). The WIITF would be capitalized by contributions from a voluntary labeling system that allows the producers of consumer goods to indicate to their customers that they are contributing to WIITF at a cost of three cents per unit. Details of this system, including how producers are expected to transfer amounts to the WIITF, are not specified in the bill. Monies on deposit in the fund would be used to capitalize the SRFs on a 50-50 basis.

However, the WIITF could only disburse funds during a given fiscal year if the appropriations to the CWSRF for that fiscal year are at least equal to the average annual appropriations to the CWSRF over the previous five years. The purpose of this limitation is not entirely clear, given the potential usefulness of WIITF funds in years where there is a shortfall in SRF appropriations.

3. National Infrastructure Bank

Proposals for a national infrastructure bank (NIB) have received some support from stakeholders in the water sector as an alternative to WIFIA. Several bills proposing the establishment of an NIB have been introduced over the last several years by President Barack Obama and Congress members on both sides of the political aisle, without gaining much traction. Water projects have been envisioned as eligible for assistance in all such proposals. In addition, both presidential candidates support an NIB or similar national infrastructure fund.

Proposals for an NIB have differed significantly in capitalization, governance and credit terms. While none have been envisioned as independent, each would be a discrete entity with a large balance sheet and a dedicated staff. Bonds issued to capitalize the NIB would likely appeal to long-term investors such as U.S. pension funds that are not investors in PABs. Similar to the way PABs are allocated within states, there would likely be competition for allocations among projects and across sectors (e.g., transportation, telecom, social, water), which could limit the value of an NIB for less prominent projects.

4. Flint-Related and Other WRDA Proposals

As a response to the water contamination crisis in Flint, Michigan, the Senate's version of the WRDA would appropriate more than $200 million that could potentially be applied to mitigate lead contamination. In particular, $100 million would go to the DWSRFs, an additional $50 million would go to lead-related health programs, and the $70 million appropriated to WIFIA could also be used for projects addressing contamination. The House bill authorizes $170 million in aid to Flint and other communities for infrastructure improvements, but such amounts would be subject to future appropriation.

In response to municipalities' concerns over limited funding through the SRFs, the Senate bill also would authorize several new grant programs administered by the EPA to fund water and wastewater improvements, including $1.8 billion for control of sewer overflows and stormwater discharges, $1.4 billion to help assist small and disadvantaged communities with the cost of complying with drinking water regulations, and $500 million to develop innovative water technologies.

Conclusion: Impact of Proposals on P3s

Based on the strong bipartisan support for the WRDA in both the Senate and the House, lawmakers are optimistic about passage of the bill this year.[4] Other than the proposed Flint aid, the House's version of the bill does not contain the water/wastewater proposals that have been proposed by the Senate. Those provisions were not included in the bill previously approved by the House Transportation and Infrastructure Committee, and there was no time to further consider them because the inclusion of Flint aid in the WRDA was part of a package of last-minute agreements to avoid a government shutdown at the end of September.[5]

Thus, discussion of these provisions will occur in November, after the presidential elections, when the two chambers meet "in conference" to agree on a final bill. Congressional staff will work during the October recess to find common ground on a set of proposals. Given the bipartisan momentum on the WRDA and both presidential candidates' strong support for national infrastructure spending to support jobs, the dire state of water infrastructure, and the attention the sector's difficulties have garnered in the wake of the Flint crisis, support for the sector seems unlikely to erode post-election.

Several of the proposed water/wastewater provisions included in the Senate's version of the bill could facilitate private investment, including through P3s. Funding water projects through WIFIA, especially alongside PABs, is likely to drive capital costs down, resulting in benefits to municipalities from greater competition among potential investors. The prospect of higher up-front payments (in the case of monetization deals) or lower performance payments (in the case of availability payment deals) could create incentives for further consideration of P3s by municipalities. The proposed EPA grant programs and additional support for the SRFs through a WIITF could increase the flow of funds to projects in small and disadvantaged communities. This could enable WIFIA funds to be applied to larger projects, which are more likely candidates for P3s given their scale and complexity. If implemented in a future bill, lifting the volume cap on water PABs could provide further incentives for private investment in these projects.

Ultimately the impact of the above enhancements on P3s would depend on the existence of projects appropriate for private investment. Given the small scale and varied needs of the nation's water systems, bringing appropriate projects to market will require creative thinking by local authorities, and assistance from all relevant stakeholders. These efforts could include not only the proactive engagement by the private sector with respect to potential projects but also input from other governmental authorities, including those operating in areas such as transportation, as to the value of alternative project delivery.

The continued participation of the ACE in projects such as Fargo and Grand Prairie that have a P3 component, and its willingness to consider P3s for other projects,[6] could create further investment opportunities. Outreach by the EPA will also be important. Specifically, the agency's familiarity with water systems and key stakeholders through its regulatory role could lay the groundwork for dialogue with local utilities regarding available funding options and alternative delivery methods, including through P3s.

—By Paul J. Epstein, Shearman & Sterling LLP

Paul Epstein is counsel at Shearman & Sterling in New York.

[1] Under the WRRDA, Congress authorized the ACE to administer the WIFIA with respect to water resources projects, such as flood control, storm damage mitigation, navigation improvement and environmental restoration. It is not yet clear, however, the extent to which ACE will participate in the program.

[2] Federal Credit Reform Act of 1990, Pub. L. 101-508, title XIII, §13201(a), 104 Stat. 1388 (1990).

[3] Copeland, supra note 1, at 4; Senate Committee on Environment and Public Works, Report to Accompany S.2848 (Water Resources Development Act of 2016) (noting that OMB has estimated a credit risk for WIFIA as low as 1.53 percent in its FY 2017 budget proposal), https://www.congress.gov/114/crpt/srpt283/CRPT-114srpt283.pdf.

[4] See Jordan Carney, Senate passes funding bill to avoid shutdown, THE HILL (Sept. 28, 2016, 3:26 p.m.), http://thehill.com/blogs/floor-action/senate/298329-senate-passes-funding-bill-to-avoid-

shutdown.

[5] See Melanie Zanona, House passes waterways bill with Flint aid, THE HILL (Sept. 28, 2016, 6:22 p.m.), http://thehill.com/policy/transportation/298396-house-passes-waterways-bill-with-flint-aid.

[6] The WRRDA established a P3 pilot program that would allow up to 15 ACE projects to be implemented by non-federal entities, in order to help relieve the backlog of authorized ACE projects. Funds have not yet been appropriated by Congress for this program.
