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Private finance steals the day in California

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The decision by the city of Santa Paula in California to leave the funding of a new MBR plant to the private sector shows a bold new direction in the financing of US water infrastructure.

The financing of public projects in the US is changing. The recent decision by the Californian city of Santa Paula to ask a private equity fund to raise the capital to fund a new 12,870m3/d water recycling facility, rather than secure tax-exempt financing itself, typifies this change. What happened in Santa Paula is one of the many incarnations of the credit crisis which has been wreaking havoc in the financial world, and it could be the start of a new trend.

Mark Prybutok, the former Citigroup banker now working as a director at Alinda, was heavily involved in negotiating the financial arrangements between Alinda, the city, and operations contractor PERC. “When, earlier this year, interest rates for municipalities went higher, it became difficult for municipalities to issue bonds at any price. We think it could be the first of many deals that we will be able to do,” he told GWI.

Following the downgrading of the bond insurers which guarantee much of their debt, US municipalities saw their cost of funding rise steeply during the early part of this year. Now, municipalities seem increasingly keen to transfer as much risk as possible to the private sector, and the Santa Paula decision shows that they are willing to pay up for the privilege.

The winning offer to design, construct, finance and operate a water recycling facility based on private finance was made by a consortium led by PERC (Pacific Environmental Resources Corp.), with Alinda as financial partner. It won against an apparently cheaper offer made by Veolia Water North America, which would have been funded through tax-exempt finance (see GWI April 2008 p64).

According to a city council memorandum dated 13 April 2008, “the designs proposed appear functionally equivalent and meet industry standards”. The same document goes on to recommend that the Veolia consortium be awarded the contract, taking note of the fact that, assuming a 6% discount rate, the net present value of the Veolia bid resulted in a final offer of USD127.4 million, whereas the PERC/Alinda offer came in at an npv of USD149.7 million.

The decision to award the deal to the PERC/Alinda team naturally stirred up the mob (or at least the cyber-mob) against Santa Paula City Council. The explanation given by the council was that the higher cost is counterbalanced by a lower risk profile. Although the risk cannot be completely transferred from the municipality to the private sector (in the case of the contractors going bankrupt, the municipality would lose its investor and would be forced to issue a new tender), the biggest attraction of the PERC/Alinda offer is that the market, construction and operational risk are borne by the private sector, and will not sit on the municipality’s balance sheet. Transferring as much risk as possible to the private sector means leaving a less risky inheritance to future administrations, and in this sense, the decision of the council is particularly long-sighted.

With bond insurers not offering the same level of credit enhancement that they once did, and with

US municipalities scrambling to cover budget gaps in the light of declining tax revenues (see story p26), leaving the private sector to fund key water infrastructure projects is beginning to look like a very attractive option. If it can happen in California, it can happen anywhere.