

### **TWV Podcast #037**

#### **Public-Private Partnership in the Water Industry with United Water's Bob Iacullo**

Show Notes at <http://thewatervalues.com/pod37>

**Intro:** Welcome to The Water Values Podcast. This is the podcast dedicated to water utilities, resources, treatment, reuse, and all things water. Now here's your host, Dave McGimpsey.

**Dave:** Hello and welcome to another session of The Water Values Podcast! As Joey said, I'm Dave McGimpsey. Thanks for joining me for this special Veteran's Day episode. Please keep our Veterans in your thoughts today and thank them for their service to this beautiful country.

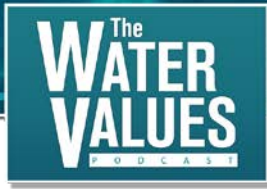
So if you're wondering how I made it through last week with double-booked hearings, I got a reprieve. Turns out the case I thought would never get settled had its hearing vacated to allow the parties to further discuss settlement. Time will tell on that one, but my other hearing ran its full course of Monday through Wednesday.

Every hearing has its funny moments, but the funniest moment from this one even caused the Chairman of the Commission to laugh pretty heartily. It was a solar energy hearing, and while the cold, hard record doesn't do it justice, it involved certain consumers, who it was argued would be thankful that a certain proposed solar product would be offered in a market that previously had no solar offerings and compared them with consumers of toilet paper in the Soviet Union who were simply happy that toilet paper was being provided as a product in the market. Absolutely hysterical and wish that was captured on video.

Now on to today's show. Bob Iacullo, an Executive Vice President at United Water, joins us. Like my interview with Lisa Sparrow of Utilities, Inc. last week, my interview with Bob was recorded at the National Association of Water Companies' Water Summit a few weeks ago. We'll take a deep dive into P3 or 3P agreements. Bob will give us his experience on a unique P3 agreement that United entered into in Bayonne, New Jersey, and we'll talk about different models for 3P agreements, including different terms, incentives and other aspects. There's a lot of private capital looking to get into the water industry, and a lot of it will likely come in through P3s, so listen up to see how it might happen.

With that said, let's get on with it. Open the valves, fasten your seatbelts and here we go.

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**Dave:** Bob, thanks very much for coming onto the Water Values Podcast; greatly appreciate your time. Could you start off by telling us a little about your background and how you got interested in water?

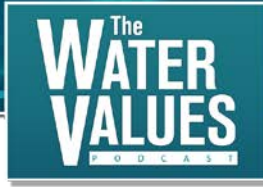
**Bob:** Sure, Dave, and thank you for giving me the opportunity. My name is Bob Iacullo. I'm the Executive Vice President for United Water. I've been with United Water for almost 35 years now. I actually started my career in the water industry. I worked for the New Jersey Board of Public Utilities for about 3-1/2 years, and I worked on some water cases and then had an opportunity to go to what was then called the Hackensack Water Company, which was the founding company for United Water. United Water has been in business since 1869. So, I've been fortunate enough to grow in the business and have seen United Water grow from being a regional company with operations just in northern New Jersey and southern New York to now where we have operations in 21 states across the country. And we not only own utilities, but we also operate water and wastewater utilities for municipal clients.

**Dave:** Perfect. And I think that's what I'd like to talk with you about today, and that is that model, that 3P, that public-private partnership model. I think it's great that you have this perspective of watching the company grow from a smaller company into a larger company and really developing a lot of 3Ps along the way. So, could you just give us a history of public-private partnerships in the water sector? Because it's my perception that 3P agreements are much more prevalent in, say, the transportation industry as contrasted with the water industry. Or at least there's a wider adoption in transportation than water.

**Bob:** Yeah, I would agree with that, Dave. But as it stands now, about 2,000 cities and towns across the United States have some form of P3 with water operations. But a little history, and a lot of it has to do with the demographics of the water industry itself, where in the United States 85% of the population receives their water from a municipal-type water system and on the wastewater side, it's 95%. So, for United Water, when we looked at, where is the growth going to be for us and the opportunities to continue to expand our footprint in the United States, we saw that it would be on the municipal side helping them operate and maintain their water/wastewater systems. So, we got into P3s back probably in the mid-1990s with some large operations like operating the water system for the City of Atlanta, the wastewater system for the City of Milwaukee. And those were what I would say were straight operation and maintenance-type contracts where they were long-term contracts, 20 years, which were allowed by the IRS in terms of being a qualified management contract. But they just provided that you would operate and maintain either the entire system or you might just operate and maintain a specific water/wastewater treatment facility.

**Dave:** It's interesting you brought the IRS into that. What is the IRS issue in terms of the 20-year agreement?

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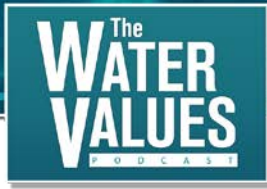
**Bob:** They'll only allow a qualified management contract to go out for 20 years. If you go beyond the 20 years, they look at it very differently, and it could cause an issue with the municipality, particularly if they have tax-exempt debt. They may have to do something which is called defease to debt, which could be very costly for them, particularly in this low interest rate environment. And there are some remedial actions that you could take, but it's one of the things that at least our company and others in the water industry are trying to promote, is to take another look at these qualified management contracts to either go beyond 30 years or provide for different remedial actions. So, a municipality wouldn't have to go through that process of having to defease or retire their tax-exempt debt. In particular, if you looked at United Water and the way we're structured, I would say we're structured to meet the needs of the entire U.S. water industry. And with United Water and its affiliates that means providing anything from water/wastewater treatment equipment to doing design-build-operate opportunities and then getting into O&M contracts and long-term leasing and also full ownership. And if we focus maybe on the long-term leasing, I could give an example where trying to go beyond the 20 years is really important.

**Dave:** I'd love to hear that.

**Bob:** In 2012, the City of Bayonne, New Jersey, went out for procurement. Bayonne is a town with a population of about 63,000 people. It's situated on a peninsula that's west of New York City and east of Newark, New Jersey. And they had decided to go out because they needed to do something with their water and wastewater systems. They hadn't made any significant investments in those systems in decades, their municipal utilities authority was highly leveraged, they had credit quality problems, and they needed to attract experienced and qualified personnel to run their systems, which they had trouble doing. So, they went out for procurement with specific objectives. They wanted to improve their customer service, improve the condition of their assets, look for rate stability, and also try to maintain jobs for their municipal utility employees. United Water and others submitted responses to that request for proposals.

And our response that we submitted was a solution that we felt would meet their needs. As a matter of fact, the model that we put together is termed "Solution". It's branded, with a tag line, "Investing in America's Future". And here's where the difference comes in between a straight operation and maintenance contract and this type of contract, which is actually called a concession contract. So, this contract is a 40-year contract. It involved Kohlberg Kravis Roberts, or KKR, and United Water to form in a joint venture to provide the financing mechanisms for the utility systems for the City of Bayonne. So the City of Bayonne, what we offered them was an upfront payment of \$150 million and that we would also invest in their system, in their infrastructure, over the 40-year period, over \$100 million. Roughly \$2.5 million a year, but we would also do some upfront capital investments particularly in terms of upgrading their meter reading system. And that's something with a 40-year contract you can do because of trying to amortize the investments that you make as opposed to a 20-year contract which is much shorter

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in duration and really limits the ability to make capital investments. So this worked out very well for the City of Bayonne. Within three months of signing the agreement, Standard & Poor's raised their credit outlook from negative to neutral. And that was the first time their credit outlook had been raised in a long period of years. And so far two years into the contract, it's been working very well.

**Dave:** I was just going to make a couple of observations about what you said. And I'll work backwards. The Standard & Poor's upgrade for Bayonne, did that impact the entire municipality or was it just specific to their water/wastewater debt?

**Bob:** Oh no, it will impact the entire City of Bayonne. So, that means for future borrowings, it should be less costly because the interest rates, all things being equal, will be less for them.

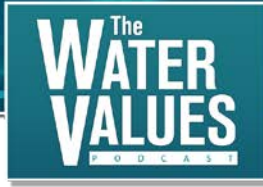
**Dave:** So, just a water/wastewater issue has essentially, by entering into this 3P agreement with the JV between United and KKR, you've been able to save the city money on other aspects of its financing. That is a very unique angle to take. Another thing I wanted to note was I really like the 40-year agreement as contrasted with the 20 just because, typically, at least for rate-making purposes, that seems to match the depreciation that the utility regulator will allow.

**Bob:** One thing I would note too, Dave, in New Jersey in particular, there is regulatory approvals that we need for these types of agreements. Back in the late 1990s, I believe it was, some bills were passed to set up a procedure for approvals by the New Jersey Board of Public Utilities, the Department of Community Affairs and the Department of Environmental Protection. So they do review these contracts to make sure they're balanced and fair particularly to the residents of those towns.

**Dave:** And what type of review? That's just a thumbs up/thumbs down? Does the regulator go in there and make changes? Or are there provisions in the 3P agreement that says if the regulatory body changes anything then it's...

**Bob:** It's, again, more of a review to make sure that it's a balanced and fair contract. The reviews are done in a fairly short period of time. But again, it's just to ensure that it's going to be a good contract overall. But I would say, particularly for a contract, Bayonne and even in more recent O&Ms, these towns are getting very sophisticated. They're bringing in advisors, attorneys of course. So, it's not as if they're going into these deals with their eyes closed, but very sophisticated. And the industry itself has matured in terms of trying to make sure that the terms and conditions are balanced for both the town, as well as the private operator.

**Dave:** Let me ask you, at the end of the 40-year period, what happens?



**Bob:** Presumably, at the end of the 40-year period, our hope and our expectation will be that the City of Bayonne would go out for renewal of that type of agreement. But at the end of the 40-year contract, the assets are still owned by the municipality. And, again, that's one of the big advantages of these type of agreements is the ownership of the facility never transfers. And particularly in water, we see this maybe a little more than wastewater, a significant reluctance to actually sell their assets. But here, in this instance, they control it. And I should mention another interesting aspect of the Bayonne deal was the rate increases over the 40-year period are laid out. There are some that are related to inflation as well as some fixed percentages. So, the town and people know what they're faced with over the 40-year period. And I give a lot of credit to the former Mayor of Bayonne who signed a contract, Mark Smith, for realizing that something needed to be done with their facilities to ensure their sustainability into the future.

**Dave:** Are they automatic rate increases or is it just, what's the rate increase mechanism?

**Bob:** There are automatic rate increases for the Bayonne agreement. Roughly 70% of the increase is fixed and 30% is related to whatever the rate of inflation would be based on CPI. And then there could be some adjustments if we need to invest more money than what was anticipated when the financial modeling was done. There is a mechanism to allow for an increase that might be in excess of what's already provided for. Likewise, if we were to see greater growth in the City of Bayonne than what was anticipated, that may cause rates actually to go down because we would be then collecting more revenue.

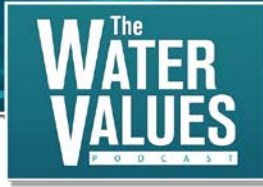
**Dave:** CPI, I'm curious, are you familiar with any other indices that could be used that would, say, I don't want to say better track, but I know there have been issues in other 3P agreements where CPI became an issue. Are there indices out there that track utility expenses specifically?

**Bob:** I'm not sure that there's one that track utility expenses particularly, but what we like to look at too is not always straight CPI on all the operating expenses but in particular labor expenses and relating them more to a labor inflation index. And then all the other expenses may be related to CPI. And, again, sometimes these will vary where it may not be 100% of CPI. It may be 75% of CPI for that period.

**Dave:** Fascinating stuff. You mentioned that this Bayonne agreement was a full concession agreement. We talked about straight O&M earlier. Could you just balance this out in terms of what constitutes a straight O&M, and at what level does it turn into a concession agreement?

**Bob:** Usually with an O&M agreement, the revenues will still be collected by the municipality. We may perform customer service related functions under an O&M-type agreement, but the revenues will still be, in effect, owned by the municipality. And they're paying the private operator, United Water, a fee for operating and maintaining their system. With a concession-type agreement, it's almost as if the private operator owns the system because we collect all the

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revenues, we pay all the expenses. So, the municipality is no longer paying us a fee to be involved. Our fee is in effect coming out of revenues minus the expenses, whatever it costs us to operate it. It also gives the ability on a concession-type agreement, again because of a longer term nature, to make capital investments into the system that you otherwise wouldn't do under shorter term type agreements. But an O&M agreement and concession, some of them provide the same type of benefits such as increased efficiencies and reductions in operating costs, better water quality or environmental aspects. So some of the benefits are the same, but I would say when you get into the realm of a concession-type agreement, because of the longer term nature, there's where you get the capital investment. There's where you get the more rate predictability and stability as well.

**Dave:** So if I'm a municipality or a government agency and I've got a utility and I'm looking for a 3P, what situation is going to cause me to go to a straight O&M versus a concession agreement?

**Bob:** Well, again, it really is based on the needs of the particular town and what it's looking to achieve. That's where, again, at United Water, we offer various alternatives to a municipality depending on what its goals and objectives and its needs are. So in the Bayonne situation where their need was one of, we need to invest in our infrastructure and we can't do it based on our current financial condition and so forth and bringing in the qualified operators, they determined that a concession-type agreement was the best for them. Others may look at it and say, well, we can manage the investment on our own. An example might be currently we've been operating the wastewater system for what had been the City of Indianapolis since the mid-1990s. Now that system was transferred over to Citizens Energy Group, but we still operate and maintain the wastewater system for them. But they're making all the capital investments in that system, not United Water.

**Dave:** That particular agreement is very interesting because the storm water – it's a CSO community, but the city maintains storm water responsibilities. Can you talk a little about, that's got to be a complex relationship. How does that work?

**Bob:** I'd say actually the relationship, yes, the storm water is still operated by the city. That's more of a relationship between the city than in Citizens Energy Group. But, again, being the city had formerly been our client, we have good relationships with them. Citizens Energy, I believe, has a high regard for us as an operator. Wastewater systems are complicated systems to operate, and I think they respect United Water's ability to do that very professionally and at a high level of performance.

**Dave:** How does the regulatory climate in a particular jurisdiction impact 3P agreements?



**Bob:** They really don't. In New Jersey, as I've mentioned, there's an initial approval process. But once they approve of that particular agreement, there is no longer any continuing jurisdiction over the P3. At that point, it's really up to the mayor, the city council, in effect to be regulating all aspects of it. And a lot of these P3s, too, include performance metrics and so forth so a municipality can track the company's performance. And in most cases, you're guaranteeing some level of performance. Other states that we operate in, they don't have a regulatory approval process like New Jersey's. New Jersey is definitely more robust than other states.

**Dave:** How about incentives?

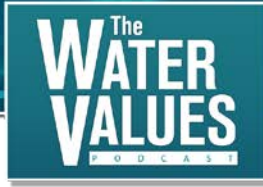
**Bob:** Incentives may come into play. The contract that we have in Indianapolis to operate their water and wastewater system includes incentives for us to achieve based on performance levels. And we've done very well out there achieving the targeted incentives. Others may just be, again, if it's an operation or maintenance contract that they're just paying us a straight fee to operate it, and it may not have any incentives associated with it. Or the concession-type agreement, the incentive there could be that if you can operate it even less costly than you might have thought to begin with, you'll have the ability to earn a better margin.

**Dave:** Let's backtrack a little bit and talk about the procurement process for these 3P agreements. What does a typical procurement process look like?

**Bob:** A typical one may be where the town decides that they need to do something, and they'll issue a request for proposals. Then give the public an opportunity to respond to them. They may have certain conditions and qualifications. Some actually may go out for a statement of qualifications first that says you need to have this level of experience operating a certain size water or wastewater treatment facility. And based on that, that would kind of limit the playing field as to who could be qualified to actually operate it. And then once they deem you to be qualified, then you would have the ability to submit a proposal based on usually what they're saying the scope of operations ought to be in terms of, again, do they want you just to operate a specific water treatment facility or do they want you to operate the entire distribution system, treatment facilities, provide customer service related activities as well.

So they may ask for that type of proposal. The proposals get submitted, and they'll have some kind of ranking criteria. I'm simplifying the process to a large degree. But then even once a contract is awarded, then there's still another ability to do another round of due diligence before you're actually signing a contract. And during the time period too, you're going through contract terms and conditions and so forth making sure that there is a balance between the risks that are being assumed by the party that could best manage them, whoever that may be. Some risks are better managed by the municipality; some risks are going to better managed by the private operator.

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**Dave:** A great high level overview of that. I wouldn't want to get too deep into the weeds on that because I think people might go to sleep. In this Bayonne contract that we've been talking about, you said you partnered with another entity. How does that relationship come together? How does the joint venture start?

**Bob:** In this case, KKR, Kohlberg Kravis Roberts, may have approached us at some point in time talking about different opportunities and being available to work with United Water. And then when this model was developed, in fact, we brought in KKR and created the joint venture. And it worked very well. From what I understand and going to different conferences and meetings, there seems to be a lot of private equity out there these days where these equities firms want to put their money to work and are willing to participate in these type of activities because of the lower risk profile that a water or wastewater operation would have. Let's say versus a transportation project, a toll road, where as we know, once tolls start increasing, people would find alternatives to that toll road. You don't see the same significant impact when water rates increase. People tend to use still the same amount. You may see a little drop off, but then after a period of time it recovers. So the risk profile seems to be fitting well with a lot of these private equity firms at this point in time.

**Dave:** That's good to know that a lot of capital is starting to flow into the water sector through 3Ps and otherwise. If we can, let's talk about wider adoption of 3Ps. You mentioned that there are about 2,000 3P agreements out there in the industry right now that cover 53,000 water utilities. What can be done to widen the adoption of 3P agreements?

**Bob:** There are some things underway right now at the federal level. President Obama had signed a presidential memorandum this past summer. And as part of that memorandum, he wanted the secretaries of his various departments to look at ways of either removing obstacles or trying to be innovative in attracting more private participation to deal with the nation's infrastructure issues, not only in water but as well in transportation and other areas. And so already, the Department of Transportation and the Treasury had already organized and hosted what they called an infrastructure summit that was held in Washington. United Water was invited to that meeting. And there were discussion on what could be done.

As a matter of fact, at least two of the panels highlighted the Bayonne model in terms of what can be done. But again, the Obama administration is looking, acknowledging the fact that the likelihood of federal grants and federal handouts is very slim. So how can we best attract more dollars flowing in to meet the significant infrastructure needs that we have over the next 20 to 30 years? So that's already ongoing, and that's a way of promoting more interest in P3s. The President also signed into law the Water Reform and Resources Development Act, which included Water Infrastructure and Financing Innovation Act as well, which is kind of structured off what they had in the transportation area, TIFIA, that has worked very well. The EPA is going through now trying to bring that program together. Appropriations haven't been made yet, but a

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key part of that is, again, trying to look at projects where you'd have an array of financings. So not just say government loans because that would still be part of it, loans from the federal government, but also tracking private equity to participate in these infrastructure needs, again creating more P3s. And then also our trade association, National Association of Water Companies, has been out there out front in terms of talking to different congressional leaders about some of the obstacles that we see that may prohibit the P3s that we spoke about earlier.

**Dave:** I'm glad you brought up WIFIA. I'm very interested to see how WIFIA plays out in terms of attracting and enhancing additional private capital coming into the water sector. We touched on a little bit concerning what can be done to help 3Ps out, but what do you see as the future of 3Ps?

**Bob:** Again, from my perspective and our company's perspective, I think it takes some of these wins that we've seen now like a Bayonne and how that's benefitted the citizens of that town and what it's meant to them. As I mentioned, there's another one that we're going to be starting in the beginning of next year. It's Middletown, Pennsylvania, a smaller community than Bayonne. And this one's a 50-year contract. So as you can see, there is starting to be more interest in these types of arrangements whether they be the long-term concession because Middletown will be a concession, or the O&M. We're also in January of next year beginning to operate the wastewater system for Nassau County, New York.

And I will tell you on that one, the environmental groups were very much behind a private operator coming in to bring that professionalism, that know how, that experience, the innovations, the technologies that a private operator can do as opposed to a municipality. So I think a lot of the burden I'd say is on the private operators to show that these work, but it also is going to take the elected officials, the mayors, to talk about the benefits. And fortunately, at the National Association of Water Companies' summit that I'm attending right now, former Mayor of Bayonne, Mark Smith, was on a panel and talked about why he did it and also the benefits that he saw that this type of an agreement brought to his town.

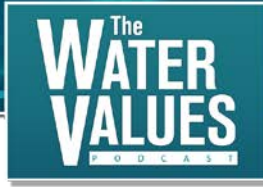
**Dave:** Great perspective on that. I just want to thank you very much, Bob, for coming out here and taking time out of your day to be interviewed. Really appreciate it. Before we go, though, can you tell folks who'd like to find out a little more about you and United Water, where they can go to do that?

**Bob:** Sure, you can go to our website, which is [unitedwater.com](http://unitedwater.com), or you can follow us on Facebook.

**Dave:** Awesome. Thanks very much, Bob. Really appreciate it.

**Bob:** Thank you, Dave.

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**Dave:** I hope you enjoyed that interview with Bob Iacullo. He was fantastic and shared a great deal of knowledge about 3P agreements.

Here are my takeaways. First, P3 or 3P agreements, whatever your preferred nomenclature, provide a lot of flexibility and avenues for capital to come into the market. They can be structured in a variety of ways to achieve the goals and desires of the public entity. One important thing I'd note is that I'm a big believer in the partnership model that P3s offer, but just as good fences make good neighbors, oversight and checks and balances will help make a good P3 agreement.

Another takeaway is the procurement process itself. Each state will be a little different, but generally, governments have some measure of flexibility in how they design their procurement process. The important thing is to communicate. Communicate with potential bidders, communicate within the administration and with other stakeholders, such as your city councilors, residents and customers. In order to lay a good foundation for a P3, you really need that buy-in from all of the stakeholders.

Finally, we've talked about WIFIA on this podcast previously, and Bob spontaneously brought up the Water Resources Reform and Development Act, of which WIFIA is a component, so it's good to see that the industry is trying to find ways to use the tools Congress provided to solve some of the nation's water infrastructure issues.

Well, you can check the Show Notes out for this session at <http://thewatervalues.com/pod37>. Leave a comment on the Show Notes or email me at [david@thewatervalues.com](mailto:david@thewatervalues.com). You can also tweet at me @DTM1993, and you can tweet about the podcast using #WaterValues. And don't forget to rate and please review the podcast on iTunes, Stitcher and other podcast directories. And please don't forget to tell your friends and colleagues about the podcast and to sign up for The Water Values Newsletter, which can be done at <http://thewatervalues.com>.

In closing, please remember to keep the core message of The Water Values Podcast in mind as you go about your daily business. Water is our most valuable resource. So please join me by going out into the world and acting like it.

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