



# Private Equity, Public Inequity:

## The Public Cost of Private Equity Takeovers of U.S. Water Infrastructure

Fact Sheet • August 2012

Investment bankers and other Wall Street players want to take over public water services to wring quick profit from communities that are often already strapped for cash.<sup>1</sup> By 2012, financial behemoths including JPMorgan Chase and the Carlyle Group managed investment funds that owned water and sewer systems across the United States (see table on page 2). This is part of a larger trend: Private equity players, armed with more than \$185 billion,<sup>2</sup> are aggressively targeting infrastructure worldwide.<sup>3</sup>

### Growing Private Equity Appetite for Water

Since the mid-2000s, when the private equity craze for infrastructure took off,<sup>4</sup> there have been half a dozen large private equity takeovers in the U.S. water sector (see table on page 2). As a result of these deals, investment banks and private equity firms manage the companies that provide water and sewer services to millions of people across the country, and their reach is growing. At least four sizeable deals, including three privatizations, were on the horizon for 2012 and 2013. Private equity players anticipate that ongoing fiscal difficulties will drive many other local governments to privatize their water services.<sup>5</sup>

### Pushing Privatization

The finance industry is promoting water privatization as a way to help local governments pay for budget shortfalls and improvement projects. They advise local officials to enter into large, complex deals that transfer control of public services to financiers in exchange for an upfront payment.<sup>6</sup> In essence, these upfront payments are high-interest loans that residents and businesses must repay through their water bills. It is “taxing through the tap” and a costly and inefficient way to raise capital.<sup>7</sup>

### Key Problems With Private Equity Takeovers

**Squeezing Dry:** Private equity players seek high profits. Infrastructure funds generally have targeted returns of at least 12 to 15 percent a year,<sup>8</sup> and they often make even more money when they resell assets to other investors. In the United Kingdom, for example, private equity investors typically made annualized returns of 15 to 30 percent when they sold their stakes in privatization projects.<sup>9</sup>

**Driving Up Public Costs:** Private equity players use a variety of tactics to meet their profit goals. In privatization deals, they may use sneaky contract provisions and contract renegotiations to shift risks and costs to the public.<sup>10</sup> When they own water utilities, they could overbuild infrastructure projects or buy other systems to drive up water prices and inflate their earnings.<sup>11</sup>

**Excessive Borrowing:** Private equity players usually borrow a lot of money to pay for a deal. This practice, known as leveraging, increases a firm’s profitability and reduces its



income tax responsibility.<sup>12</sup> Loans and other debt typically cover 60 to 90 percent of a private equity takeover.<sup>13</sup> Such highly leveraged deals are risky and costly. The interest rate on bonds and other loans usually increases, and if the company goes bankrupt, governments may have to step in and bail out the water utility.<sup>14</sup>

**Avoiding Taxes:** Private equity players are notorious income tax avoiders and evaders.<sup>15</sup> For example, in the last five years, the Carlyle Group made more than \$4 billion in profit but paid an effective income tax rate of only 2 percent.<sup>16</sup>

**Cutting and Running:** Private equity players usually flip assets within a decade, and they often sell their stake in a privatization deal before the contract ends.<sup>17</sup> Highstar Capital decided to sell Utilities, Inc., a U.S. water company, less than six years after acquiring it,<sup>18</sup> and in 2011, the Carlyle Group's infrastructure fund took over Park Water Company with the intention of reselling it within five years.<sup>19</sup>

**Hiding Behind Closed Doors:** Private equity takeovers restrict transparency and accountability. They usually have inordinately complex ownership structures that can involve a series of holding companies or special corporate entities. This makes it difficult to discern who is ultimately making the big decisions.<sup>20</sup> Privately held businesses also do not have to comply with many federal financial disclosure requirements, and private contractors are not subject to state sunshine laws requiring open meetings and public access to certain information about public services.<sup>21</sup>

## Conclusion

Private equity takeovers of water are an alarming development. These financial players focus on short-term profits and may seek to flip assets after driving down service quality and driving up prices. Households and local businesses could end up paying much more while services deteriorate. Given these risks and costs, governments should not auction off control of their water and sewer services to bankers

## Ten Major Private Equity Takeovers of U.S. Water and Sewer Services

YEAR	PRIVATE EQUITY PLAYER	VALUE	TARGET
2006	AlG Highstar Capital II, LP (via Hydro Star, LLC)	\$192.5 million (purchase price)	Utilities Inc., a private water company serving more than 300,000 water and sewer customers in 17 states <sup>25</sup>
2006	BC Investment Management Corp. and CAI Capital Management (via 0745848 B.C. Ltd.)	\$111 million (purchase price)	Terasen Water and Utility Services including 50% of Fairbanks Sewer & Water, Inc., a private water company serving Fairbanks, Alaska <sup>26</sup>
2007	Macquarie Bank (via Macquarie Utilities, Inc.)	\$578 million (purchase price)	Aquarion Water Company, a private water company serving about 200,000 customers in Conn., Mass. and N.H. <sup>27</sup>
2008	Alinda Capital Partners with PERC Water Corp. (via Santa Paula Water, LLC)	\$62 million (est. capital investment)	Santa Paula, Calif., water recycling facility, privatization through a 30-year design- build-operate-finance contract <sup>28</sup>
2010	JPMorgan Investment Management and Water Asset Management investment funds (via SW Merger Acquisition Corp.)	\$275 million (purchase price)	Southwest Water Company, a publicly traded water company serving more than a million people in nine states <sup>29</sup>
2011	Carlyle Infrastructure Partners (via Western Water Holdings)	\$102 million (purchase price)	Park Water Company, a privately held water company serving more than 225,000 people in Mont. and Calif. <sup>30</sup>
Pending*	Table Rock Capital (via Rialto Water Services)	\$170 million (capital investment)	Rialto, Calif., water and sewer systems, privatization through a 30-year concession <sup>31</sup>
Pending*	BC Investment Management Corp. and CAI Capital Management (via Corix)	Undisclosed	Utilities, Inc., a private water company serving more than 290,000 customers in 15 states <sup>32</sup>
Pending*	KKR with United Water (via Bayonne Water Joint Venture, LLC)	\$150 million (upfront payment)	Bayonne Municipal Utilities Authority, N.J., water and sewer systems, privatization through a 40-year concession <sup>33</sup>
Pending*	BC Investment Management Corp. and CAI Capital Management (via Corix)	\$20 million (est. transaction value)	Lower Colorado River Authority, Texas, 18 to 20 water and sewer systems, privatiza- tion through a sale <sup>34</sup>

\* Pending as of August 2012



or other private financial interests. It is an irresponsible and fiscally unsound way to meet budgetary needs.

## Better Solutions

**Public-Public Partnerships:** Cash-strapped communities can instead explore public-public partnerships to reduce the cost and enhance the performance of their public water and sewer services. Two or more public sector water utilities can join forces on a not-for-profit basis and leverage their shared capacities. The public sector partners pool resources, buying power and technical expertise to improve service and reduce costs.<sup>22</sup> Compared to public-private partnerships, these public sector partnerships are more efficient, effective and equitable.<sup>23</sup>

**Public Funding:** The federal government can support public sector utilities by providing a dedicated source of funding for the Drinking Water and Clean Water State Revolving Funds and by reauthorizing the Build America Bonds program. Build America Bonds are an efficient way to lower local government borrowing costs and to appeal to a broader range of investors, including pension funds.<sup>24</sup>

A renewed federal commitment and responsible public management of our nation's water and sewer systems are the best ways to ensure safe and affordable water service for all.

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