ALLEN & OVERY

Infrastructure Investment and Jobs Act: Opportunities for Private Capital in the Water Sector

Key takeaways for water infrastructure investors

The Infrastructure Investment and Jobs Act (the **IIJA**) was signed into law by President Biden on November 15, 2021 and provides for a USD105bn public investment in U.S. water infrastructure. These funds will be allocated to several new, and reauthorized, grant and loan programs with the goal of rebuilding and maintaining aging water and wastewater systems around the country.

The IIJA's water-related provisions are split into two sections: (1) regionally-specific initiatives that focuses on supporting western states currently suffering from drought, and (2) initiatives that aim to support water infrastructure more generally across the U.S. Consistent with the core overall themes of the IIJA, both of these water-related sections also have a particular focus on preparing U.S. infrastructure for the effects of climate change and on the development of infrastructure in rural communities.

In this article, the second of a series exploring the impact of the IIJA across sectors, we identify the provisions of the IIJA which we believe to be of greatest interest to investors in the water sector. On one hand, the IIJA does not provide as many clear private investment opportunities in the water sector as it does in (for example) the energy and transport sectors. Yet at the same time, the influx of long-overdue funding into the U.S. water sector is likely to drive demand for relevant service providers, materials and skills and create a number of indirect opportunities to deploy private capital.

Direct Opportunities – Federal Funding Match Requirements

The direct opportunities that the IIJA creates for private investment in water infrastructure mostly come from "federal funding match" requirements, which states and municipalities have to meet in order to receive grant funding under the IIJA.

Federal funding match requirements require a state or municipal recipient to match a certain percentage of any grant they receive with its own capital investment in the same project. For example, if a USD10m grant has a 50% match requirement, it means that the recipient must provide a USD5m investment into the same project that is being funded by the USD10m grant. This is where the opportunity for private investment arises. For most programs, states and municipalities are free to use private capital as the funding source in order to meet these match requirements (rather than needing to fund it from their own public budgets).

The IIJA allocates large sums of money to several water-related grant programs that contain federal funding match requirements, including:

– USD400m for WaterSMART grants, which are to be used for water management projects in the western U.S. – this program has a 100% federal funding match requirement

– USD280m allocated for sewer and stormwater capture projects – up to 45% of the costs of any project that is funded by this program may come from private funds

– USD450m for large scale water recycling projects in the western U.S. – federal funding can only account for 25% of the costs of any project that is funded by this program

In terms of private capital deployment, the potential limitation of federal funding match opportunities is that many of the potential investments are relatively small (less than USD10m). That said, a portfolio approach has often yielded good results in the water sector in the past and is likely to be a powerful tool in this case too. Investors who can replicate a successful project structure across a number of municipalities or authorities will have opportunities to leverage federal funding to build valuable, diversified portfolios.

WIFIA Reauthorization – Modest Uplift, Continued Commitment

Another opportunity for the private sector that the IIJA touches on is the reauthorization of funding for the Water Infrastructure Finance and Innovation Act (WIFIA). WIFIA is a federal loan and guaranty program administered by the EPA that aims to accelerate investment in U.S. water infrastructure by providing long-term and low-cost loans for large and important water infrastructure projects. Importantly, private entities are eligible to receive WIFIA loans.

WIFIA funding can be used for projects that will repair or replace aging water distribution or waste collection facilities, community water systems and treatment works. WIFIA loans range in sizes from USD16m to USD700m. The IIJA only provides for USD50m annually of additional funding through fiscal year 2026, which seems insignificant as compared to the USD6.5bn of funding that the EPA planned on providing under WIFIA during fiscal year 2021. However, it still represents a continued commitment from the federal government to a program that could be very useful to private entities looking to invest in big water projects that have a significant need for debt financing.

Water Service Firms – Ripe for Further Investment?

Aside from the specific opportunities described above, sustained increases in public spending pursuant to the IIJA will likely generate long-awaited momentum in the water sector and indirectly lead to private investment opportunities.

Most state governments and municipalities that receive federal funding under the IIJA will not have the in-house expertise to self-deliver the projects for which that funding is earmarked. As a result, they will need to contract out the design, construction and O&M of their new, state of the art water infrastructure. This will drive up demand for private water engineering and consultancy services, civil construction contractors and O&M firms (and accordingly, will encourage such firms to look for additional investors to help them expand to cover new opportunities and upgrade their sustainability and tech credentials in the process).

This trend is one to watch for private equity firms and other investors who wish to increase their exposure to the U.S. water and utilities sector. Whether through joint ventures, acquisitions or other modes of investment, there are likely to be some interesting private sector opportunities arising from increased government activity in the water sector over the next 5-10 years.

Significant Funding Gaps Remain – Private Capital to the Rescue?

Finally, it is worth emphasizing that the USD105bn allocated to the water sector by the IIJA is not nearly enough to cover the USD1tn of investment that the American Society of Civil Engineers believes is needed through 2029 in order to maintain U.S. water infrastructure in a state of good repair.

For this reason, there is little chance that IIJA grant programs will out-compete or replace private capital in the sector, particularly on larger projects (such as the recently closed USD2.8bn Fargo-Moorhead Flood Diversion P3 Project) for which federal grant funding can only account for a small slice of the overall capital structure.

Even on a smaller scale, as thousands of municipalities across the country become increasingly concerned about their aging water infrastructure (and as environmental compliance standards continue to tighten), municipal administrators will need to look to private capital to make up the gap when public funding either falls short or isn't available. While the nature of these transactions may not suit all investors, firms with a proven track record of partnering with the public sector and local communities will be well placed to take advantage of these opportunities.

Further information

We will continue to monitor the implementation of the IIJA and related infrastructure regulations, and will continue to publish articles exploring the potential opportunities associated with the IIJA. If you have any questions or are interested in learning more, please reach out to the A&O team.

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