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**Private Equity's Appetite for Infrastructure Could Put
State and Local Taxpayers and Services at Risk**

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With the country reeling from what many economists are calling the biggest economic crisis since the Great Depression, state and local governments are feeling the heat from falling tax revenue as foreclosures, bankruptcies, the credit squeeze, and social dislocation are rapidly increasing the need to provide a wide array of social services. What's more, the financial crisis comes just as states and municipalities are struggling to build and maintain our crumbling infrastructure, a need made even more critical by the recent high profile catastrophic failures of roads,¹ bridges,² and levees.³ According to the American Society of Civil Engineers, it will take \$1.6 trillion to bring infrastructure in the United States back to good condition.⁴

“An efficient, well-planned and developed infrastructure is essential if America is to compete in the global economic marketplace. We need to build America's future, brick by brick.”

—Gov. Ed Rendell, Pennsylvania
http://investininfrastructure.org/newsroom/BAF_event_022408.pdf

Is it any wonder, then, that elected leaders are hard at work looking for ways to finance their pressing infrastructure needs? The topic is on the agenda for the U.S. Conference of Mayors⁵ and the National Governors Association.⁶ On Capitol Hill, leaders in both the House and Senate have started to explore ideas to increase funding to rebuild America's crumbling backbone.⁷ There is, however, a growing recognition that addressing the long-term neglect of these assets also presents a great opportunity to put the American economy back on track. As Senator Christopher Dodd has pointed out, “At a time when we're worried about rising unemployment rates and declining confidence in this country, infrastructure projects have the dual effect of putting people to work – and usually at pretty good salaries and wages – while also creating a sense of optimism, of investing in the future.”⁸

One approach that more and more elected leaders are exploring is to sell off assets to the private sector, including private equity firms. But state and local government leaders must be careful not to replicate the recklessness that led to current failures in our financial sector: excessive leverage, a lack of oversight and regulation, and a policy of treating assets as little more than pieces of paper. These same problems could plague private equity investment in infrastructure as well. *Thus, even as elected officials look to the private sector to supplement taxpayer investments in roads, waterworks, bridges, telecommunications, and transportation systems, they must practice discipline in choosing their partners. Specifically, it is important to assess whether partnering with private equity firms, which share many of the priorities and policies of the financial houses in the middle of the current economic crisis, could actually undermine efforts to strengthen and rebuild the public assets on which people in America depend.*

Private Equity's Bottom Line: A Red Flag for Infrastructure in the United States?

Private equity's mode of operation and focus on large profits appears to be at odds with the country's infrastructure needs:

- **Focus on revenue.** Private equity's primary responsibility is to generate high returns for investors and the firms' executives. One of the key strategies to meet this goal is to combine a relatively small amount under management in each fund with massive amounts of debt – a strategy that in the short-term can create new expenses in the form of interest payments. The Government Accountability Office (GAO) noted the potential concerns to users of privately owned infrastructure – that private companies may have a greater commitment to their own revenue enhancement rather than a long-term focus on the longevity and effectiveness of the asset. In its February 2008 report, the GAO highlighted the need for more “rigorous up-front analysis [to] better protect public interests” in highway public-private partnerships.⁹

Private equity, even more than other private owners, could be even more focused on extracting value from public assets due to the short-term nature of their funds and the fees that accompany them. Private equity infrastructure funds are short-term, closed-end vehicles with a typical term of 10-12 years. They charge a management fee and keep a percentage of the profits they generate, typically 20%, known as carried interest. To maximize their up-front profits, they especially may need to increase user fees, minimize operating costs or capital expenditures, and use high levels of debt to finance their investment.

- **Higher costs for the public.** Private equity ownership of infrastructure could drive up daily costs for the public. For example, the GAO noted, “It is likely that tolls will increase on a privately operated highway to a greater extent than they would on a publicly operated toll road.” Because a private owner is free to set tolls on a turnpike it owns or leases, the fees are likely to increase faster than if the road were publicly operated. And in areas where that are no other viable options for travel, commuters could see tolls increase to levels beyond even what is needed for a reasonable rate of return.¹⁰

Applying the same logic to assets other than highways, there is reason to be concerned that the same phenomenon could lead to onerous user fees at private equity-owned airports, higher charges to customers of private equity-owned electric plants or water treatment centers, and higher rates levied by private equity-owned telecommunications companies in an effort to increase profits. These high costs would benefit no one but the private equity firm.

- **Negative impact on jobs, wages, and consumer service.** Already, some regulatory bodies have rejected private equity buyout offers because of concerns about their future plans, including how jobs, wages and customer service would be affected. The Oregon Public Utility Commission rejected a 2005 buyout of Portland General Electric by private equity firm TPG Capital.¹¹ The Commission's decision came after internal documents on

the deal were leaked to the press, causing some to worry about possible layoffs and cuts in maintenance. The high debt burden and potential for a quick flip of the electric utility also were cited as major risks of the deal.¹²

In 2004, KKR attempted to acquire Tucson Electric Power (TEP) in Arizona for a record \$45 billion. One member of the Arizona Corporation Commission described KKR's response to the Commission's concerns as unsatisfactory, characterizing the private equity firm's promises to protect consumers and maintain the utilities' quality of service after the buyout as "vague and illusory." The commissioner felt that KKR, "a firm best known for its buy-and-flip philosophy, was a bad candidate for ownership of a utility that provides a necessity of life to millions of captive consumers." Ultimately, the commission decided the risks outweighed the potential benefits that would have come from the buyout and turned down the proposal.¹³

Case Studies: The Carlyle Group and KKR

In November 2007, the Carlyle Group announced it had completed creating its first infrastructure fund with equity commitments of \$1.15 billion.¹⁴ Fellow private equity giant KKR recently announced its own plans to begin investing in infrastructure assets.¹⁵ While both buyout firms are fairly new to infrastructure investments, an examination of their track records in past infrastructure, regulated utility investments, and other kinds of consumer industries demonstrates reason for concern about community impacts, costs, and the effect on the broader economy.

1. Private equity's reliance on debt could put public assets in danger of default.

Telecommunications technologies provide critical tools to people in 21st Century America. Telephone service, the internet, and radio and television airwaves power our businesses, disperse information, and connect us to one another. Most of these technologies were developed using public resources, many are regulated by public bodies, and all comprise important pieces of our country's infrastructure even when operated privately.

Private equity's business model of loading up its purchases with excess debt raises serious concerns, since company failures could leave consumers without these critical services. FCC Commissioner Michael Copps presciently warned in early 2008

"There are warning flags out there, yellow flags all over the damn place, and we ought to be looking at that."

— FCC Commissioner Michael Copps

that high debt levels were a risk for the well-being of the public's airwaves, "There is sufficient evidence in the macro economy to indicate there may be problems here and those problems may come into the telecommunications sector. There are warning flags out there, yellow flags all over the damn place, and we ought to be looking at that."¹⁶

The following case studies stand as cautionary tales for those considering public-private partnerships with the private equity industry and its practice of loading up the companies it buys with debt. Elected officials should exercise caution when leasing taxpayer-created and government-regulated businesses to firms that might increase the chance of default or

endanger critical services to consumers. If private equity-owned infrastructure projects default, taxpayers will be forced to pick up the tab, bailing out the financiers.

Carlyle's 2005 purchase of Hawaiian Telecom for \$1.65 billion is an example of how the highly leveraged debt model can go wrong.¹⁷ As the largest telecom provider in Hawaii, Hawaiian Telecom's services are critical to the state's residents.¹⁸ But more than a year after the buyout, Carlyle was failing to produce enough revenue¹⁹ to service its debt and fund capital expenses.²⁰ The company experienced financial losses of \$175.7 million in 2005 and \$144.6 million in 2006. It eliminated more than 100 positions in late 2007 and early 2008, further hindering progress at the company²¹ even as a new CEO was given over \$1 million in salary and bonuses for the current fiscal year.²² As early as December 2006, analysts speculated that the company didn't seem capable of developing the systems needed to function as a stand-alone business, reporting continuous delays in the development of fully functioning back office systems, numerous operational problems, and distractions for senior management.²³ In 2008, U.S. House Telecom Subcommittee Chairman Ed Markey announced plans to monitor telecom and media private equity deals to ensure the public interest is served, including Carlyle's buyout of Hawaiian Telecom.²⁴ Hawaii's Public Utilities Commission was reportedly investigating the company for poor customer service,²⁵ and bond-rating agencies were downgrading the company's ratings, warning of a "heightened probability" of default.^{26 27}

Similarly, a telecom company controlled by a private equity consortium including KKR has experienced debt-related problems. The 2006 buyout of Danish telecom company TDC was followed by a slew of troubling developments: the debt-to-assets ratio quadrupled from 18% to 72%; the credit rating was downgraded; and TDC announced a 5-6% annual staff reduction.²⁸ The cuts were described by one commentator as "mostly the result of private equity owners stripping assets for windfall gains."²⁹ According to one academic study: "It would appear from the evidence to date that the objective of the leveraged buyout of TDC is not to invest in TDC's growth and development, but rather to withdraw as much cash as possible from TDC through the combination of special dividend payments, management and financing fees, and finally the sale of a much smaller residual company."³⁰ Former Danish Prime Minister Poul Nyrup Rasmussen observed: "It is hard to imagine a worse match than private equity and a telephone company. The company needs substantial capital to keep investing in technical improvement. Private equity is interested in extracting that capital."³¹

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KKR's involvement with utility company Texas Genco has been described as "an old-fashioned private equity flip." It was a 13-month investment that added \$2.5 billion in debt to Texas Genco's books and saw a reduction in generating capacity that cut Texas' energy reserve levels, but earned KKR and its fellow private equity buyers a \$1 billion profit. A recent investment by

KKR, TPG, and Goldman Sachs in Texas utility Energy Future Holdings (formerly TXU) has raised similar concerns. High debt incurred during the buyout could mean even more price increases for consumers in the future, and there is speculation that the buyout could mark the beginning of a consolidation push that will further hurt consumers.

2. Private equity's priority on profit seems a poor fit with public service delivery.

A key aspect of public infrastructure is how services to the public contribute to the larger civic life of the community: roads allow residents to travel to work and goods to travel to market; water-treatment facilities improve public health; and reliable electric grids increase productivity, allow businesses to operate and create jobs, allow schools to function, and improve opportunity and quality of life across communities. The intangible aspects of infrastructure – the ability to provide reliable and high-quality service to the public – are as critical as the bricks and mortar. Therefore, it is instructive to look at previous examples of private equity firms' ownership of companies that provide important consumer services to assess their ability to own and operate public assets.

From 1997 to 2004, KKR invested in KinderCare, the leading provider of early childhood education and care.³² During that time, the company violated child care licensing rules, putting children in danger. According to the *Minneapolis Star Tribune*, between 2000 and 2003, a Minnesota KinderCare facility had 73 violations of child-care licensing rules, including at least one case of child abuse, and one of child neglect.³³ Reportedly, “A staff member threw milk in a child's face; a school-age child left the center unnoticed; another was sent home with an unauthorized adult; a toddler was left alone on the playground for about 15 minutes. There were dozens of problems with discipline, staffing, and record-keeping.”³⁴ Furthermore, reports indicate that in the years KKR owned KinderCare, several facilities in North Carolina and Alabama had their licenses suspended, revoked, or were cited for violations including inadequate supervision,³⁵ “child neglect,”³⁶ and “sanitation violations.”³⁷

In late 2007 Carlyle acquired HCR Manor Care,³⁸ one of the largest nursing home providers in the country with more than 37,000 resident beds, which depends on publicly-funded reimbursements for more than two-thirds of its revenues. In Pennsylvania, the *York Daily Record* recently reported that two residents at a Carlyle-ManorCare facility died in less than 5 months after its staff “didn't respond properly to a resident's serious medical symptoms,” according to state health department officials.³⁹ Because private equity firms often implement complex corporate structures that can obscure who controls and who is responsible for the nursing homes,⁴⁰ legislators in several states and at the federal level are concerned that victims of serious violations or instances of poor care may not have sufficient legal recourse. The Nursing Home Transparency and Improvement Act of 2008, introduced in Congress in February 2008, and legislation in states like Michigan⁴¹ and Maryland,⁴² are intended to provide increased transparency or greater information to the state about whether patient care is adequately protected in a private equity-style takeover of nursing homes.⁴³

Service delivery problems can have public safety consequences as well. NXP Semiconductors, acquired in 2006 by a consortium of private equity investors, including KKR and Bain Capital,⁴⁴

has vulnerabilities that threaten to compromise the security of subway systems and government buildings around the world. NXP's MiFare Classic chip is used to collect fares in subway systems in Boston, London, and Amsterdam, and is used as an access pass in office buildings, schools, hospitals, and government buildings around the world to control access to sensitive areas.⁴⁵ There are 1-2 billion of these chips in circulation.⁴⁶ Recently, researchers were able to crack the encryption that underlies the MiFare Classic chip with relative ease. According to a University of Virginia researcher, "It only takes a few minutes to break any card in particular...it takes minutes for subways and military installations alike."⁴⁷ A British security technologist said that the MiFare Classic chip uses "kindergarten cryptography" and that "anyone with any security experience would be embarrassed to put his name to the design."⁴⁸ This security breach can allow passengers to ride the subway for free in systems that use the affected chip, putting public dollars at risk. More importantly, however, it can allow unauthorized individuals to gain access to sensitive government areas, posing a risk to national security. NXP unsuccessfully sued to prevent the researchers from publicly releasing their findings.⁴⁹

3. Private equity's drive for quick returns could put U.S. jobs and local economies at risk.

With the current economic crisis, it is more important than ever to keep well-paying jobs in our communities. According to a new study by the CGI Coalition for Mission Results, keeping high-quality jobs in our communities close to the customers they serve is good for our cities and can lead to significant cost savings for companies.⁵⁰ But even as private equity firms and their portfolio companies bid on state assets like lotteries or data processing contracts, their track record of eliminating jobs raises serious concerns.

Nielsen, a media research company, was bought by a consortium including KKR in June 2006.⁵¹ Soon the company also announced thousands of layoffs and began outsourcing jobs.⁵² In October 2007, Nielsen announced a \$1.2 billion agreement with Indian outsourcing firm Tata Consultancy Services (TCS) to take over a portion of Nielsen's IT operations worldwide, including a segment of operations in Florida.⁵³ Hundreds of jobs have been eliminated at one Florida facility, and some employees have been asked to train their TCS replacements (or to "transfer technical knowledge," in the company's phrasing).⁵⁴ Similarly, the layoffs by Hawaiian Telecom could potentially increase unemployment, increasing the burden on Hawaii's publicly funded social services and healthcare system⁵⁵

In some cases, a failure by private equity firms to invest in capital improvements has created or worsened safety problems, both in the workplace and in the surrounding communities. In May 2007, Carlyle and other investment partners completed the acquisition of Kinder Morgan, one of the largest energy transportation, storage and distribution companies in North America.⁵⁶ With a poor safety track record, Kinder Morgan-operated pipelines had been involved in numerous significant incidents that began prior to its acquisition by Carlyle.⁵⁷ For example, the company paid over \$5 million to settle claims connected to the discharge of more than 200,000 gallons of diesel fuel, jet fuel, and gasoline.⁵⁸ Moreover, the company paid over \$69 million to settle claims arising from explosions that killed multiple workers, and its subsidiary pleaded no-contest to criminal charges arising from the same incident, resulting in another \$10 million pay-out.⁵⁹ Besides the loss of life, these incidents have had an impact on sensitive ecosystems, habitat, and wildlife in the region.⁶⁰

Problems associated with Kinder Morgan pipelines have continued since the buyout. In July 2007, a pipeline owned by Kinder Morgan ruptured in a construction accident, spraying and spilling over 61,800 gallons of crude oil into a suburban neighborhood in British Columbia, Canada. Construction crews said the pipeline had been improperly marked.⁶¹ The carelessness has become a safety and environmental health burden not only on the workers and community, but also on consumers. In May 2008, hundreds of consumers were sold contaminated fuel at gas stations throughout California. It was reported that diesel fuel was mixed with unleaded gas before being sent to gas stations. The supplier said it obtained the gas from Kinder Morgan.⁶² And in June 2008, a crew working on a Kinder Morgan pipeline struck another pipeline, spilling almost 20,000 gallons of diesel fuel at a construction site in southern California.⁶³ After the buyout Carlyle had the opportunity to rectify the problems with Kinder Morgan, but instead it allowed the company to carry on with business as usual. As a result, more neighborhoods were polluted, more customers faced unreliable service, and more workers suffered dangerous working conditions.

4. Private equity's lack of accountability could risk community health and safety

Unlike elected officials who are answerable to voters, or publicly traded companies that must file detailed annual reports and are accountable to shareholders, private equity-owned firms have a lower threshold of accountability and are exempt from many of the public reporting requirements that apply to public companies. This lack of transparency makes it difficult to evaluate the impact of business decisions on employees, customers, or community members. Both Carlyle and KKR have been accused of failing to safeguard the community at large against real and potential hazards related to their investments.

Carlyle's first buyout using its infrastructure fund was of Synagro Technologies, "the largest recycler of organic, non-hazardous waste and wastewater residuals in the U.S."⁶⁴ The Company primarily services municipal governments and industrial customers.⁶⁵ Residents of communities near Synagro sludge dumping sites in numerous states have complained of terrible odors and serious health problems associated with Synagro's sewer sludge, and several local governments have pursued recourse against the company. In both Pennsylvania and Alabama, residents and local authorities have tried to ban the distribution of Synagro sludge after residents complained of foul odors, contamination, repeated infections, and other adverse health effects.⁶⁶ Recently, Synagro paid a \$27,000 penalty imposed by the Maryland Department of the Environment (MDE) for air quality and permit condition violations.⁶⁷

Similarly, Carlyle's Collingwood Ethanol has come under fire in a small town in Ontario, Canada, for emitting an unpleasant odor that residents say has had a negative impact on the quality of life and health in the area.⁶⁸ They complain about offensive odors and say they worry it may be responsible for breathing problems.⁶⁹ After more than a year of complaints and unsuccessful efforts by townspeople to reach a mutually-acceptable resolution, the mayor recently filed an application with a provincial court to temporarily shut down the Collingwood plant until the company addresses the situation.⁷⁰ Under a local ordinance, the plant could be closed for up to two years if the request is approved. The Ministry of the Environment also

served the Collingwood plant with two compliance orders in connection with the odor problem in August. Collingwood has appealed one of the orders.⁷¹ However, in light of these regulatory actions to hold Collingwood accountable, the company has finally begun taking steps to address the issue.⁷²

KKR owned companies also have faced potential legal action for polluting communities. KKR recently invested in Texas utility Energy Future Holdings.⁷³ The agreement allowed the utility to continue operating three plants using Texas lignite coal, which historically has been a particularly polluting form of coal,⁷⁴ and also called for the construction of new nuclear plants.⁷⁵ In July of this year, the Sierra Club and Environmental Integrity Project notified the EPA and Texas Commission on Environmental Quality that they intend to sue for failing to act on alleged “heat input” violations related to mercury at an Energy Future Holdings steam electric station.⁷⁶ In May, a group of environmental groups also sent a letter to Energy Future Holdings assuring the company, which has contended that mercury-reducing technologies are too costly, that, indeed “there are affordable technologies widely available today that can substantially reduce mercury and other toxic pollution.”⁷⁷

KKR led an investor group that purchased medical device maker Accellent in 2005.⁷⁸ History has borne suspicions community groups may have had surrounding the potential health impacts of KKR’s purchase of Accellent plants. Since 2005, a KKR-owned Accellent plant in Pennsylvania has emitted a potentially hazardous compound into surrounding communities, despite the fact that a safer alternative is available.⁷⁹ According to the EPA, the compound known as trichloroethylene (TCE) can have an impact on the human nervous system as well as create other health problems, and some studies have associated it with cancer risk. The EPA is currently assessing the cancer classification of TCE.⁸⁰

In 2005 and 2006, state regulators found higher-than-average levels of TCE in the air near two facilities, including one Accellent plant.⁸¹ While the competitor facility has reportedly pledged to discontinue the use of TCE, replacing it with a safer alternative, Accellent has agreed only to take some belated steps to reduce its emissions.⁸² Accellent also expressed doubt about its ability to meet the new standards, noting that doing so would have an “adverse impact on their financial position.”⁸³

Rebuilding America the Right Way

Private equity has clearly identified infrastructure as a promising new profit opportunity. Private equity firms have bid on public properties ranging from airports to toll roads in states spanning the country. But experts warn that state agencies may be short-sighted in selling these assets to private investors too cheaply.⁸⁴ For example, analysts have estimated that the corporate buyers of the Indiana Toll Road in 2006 will recapture their investment in year 15 of the 75 year lease, allowing them to make as much as \$21 billion in profits through the remainder of the contract – nearly five times the initial sales price.⁸⁵ At the same time, leaders in both the House and the Senate have introduced legislation to establish a National Infrastructure Bank to increase funding for infrastructure projects.⁸⁶ The plan prioritizes bringing private investors into public infrastructure, allowing banks to resell loans made to the states to the capital markets.⁸⁷

But the real promise of renewed investment in America's network of roads, waterworks, bridges and telecommunications pathways is its ability to stimulate the economy. Rebuilding America not only supports the local economies and communities that depend on these services, but also creates good-paying jobs and a resulting confidence and pride in our national economy. It is critical that we learn from the current crisis in our financial sector and do not allow the same reckless unchecked business practices that threaten our homes and our banks to do harm to our roads and our airports. We must ensure at both the state level, where assets are leased and bids are assessed, and the federal level, where coordinated investment decisions are made, that any private partners share a priority of quality services and strong long-term assets over quick profits.

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