

Water and Wastewater Private Activity Bonds

Legislation to aid municipalities in the challenge of replacing and upgrading water infrastructure by bringing water projects out from under the federally mandated state volume caps on these qualified project Private Activity Bonds (PABs).

ISSUE OVERVIEW

LEGISLATIVE STATUS

- On January 14, 2009 Rep. Bill Pascrell (D-NJ) introduced H.R. 537, the Sustainable Water Infrastructure Investment Act. Pascrell's bill would bring water and wastewater projects out from under the volume cap on private activity bonds (PABs).
- The Bush Administration has endorsed this project also, including it in their proposed budgets in FY 2008 and FY 2009.

This follows years of bi-partisan Congressional interest in the issue. In the 107th, 108th, 109th and 110th Congresses substantively identical bills were introduced by both Democrats and Republicans. In the 109th Congress the bill attracted 35 co-sponsors, roughly equally divided between the parties, including six Ways and Means Committee members.

The revenue impact is nominal; a mere \$34 million over five years and \$214 million over ten years while potentially leveraging as much as \$6 *billion* dollars in private capital every year, according to EPA.

THE WATER INFRASTRUCTURE CHALLENGE

Cities, towns and utilities face a major challenge over the next several decades replacing their aging and worn out water infrastructure. The Congressional Budget Office, EPA and others have put the price tag in the hundreds of billions of dollars. This situation is the result of some unfortunate timing; many different generations of water infrastructure put in service over the last hundred years are all coming to the end of their useful lives at about the same time. But the situation is also the result of inadequate planning; some municipalities and utilities didn't properly prepare for this foreseeable situation.

In addition to infrastructure replacement, these same cities, towns, and utilities are facing increased environmental costs associated with tightening regulations flowing from the Safe Drinking Water Act, the Clean Water Act, and other important health and environment federal and state statutes.

Considering government budget deficits and general opposition to new taxes, government (federal, state) cannot be expected to cover the costs of meeting this challenge and replacing our infrastructure. The cost of meeting this challenge will therefore inevitably fall on utilities and

their customers. Consequently, utilities must take the lead in addressing this challenge by using the many organizational, managerial and financial tools at their disposal to keep costs under control and demonstrate to their customers that they are following the most effective, efficient path possible.

Many of these tools available to meet the challenge involve greater private-sector participation in the provision of various water services. The private sector has proven to be important and effective player in meeting municipalities' challenges and goals, and greater access to Private Activity Bonds (PABs) will increase the private-sector options available to municipalities.

REMOVE WATER PRIVATE ACTIVITY BOND CAP

Private Activity Bonds (PABs) are a form of financing whereby a private entity partners with state or municipal government to receive tax-exempt financing for a project (in this case water) that is in the general public's interest (as defined by law). The projects being financed can be either privately owned or government owned.

Under the Congressional mandated rules governing PABs, there is a limited total dollar amount of PABs that can be issued by a given state. This limitation -- or "cap" -- is based on the state's population. However, there are many different kinds of projects -- not just water -- that are subject to the same PABs cap. So water projects must compete with housing or electric generation projects, (etc.) for the same limited "cap".

Historically water projects have "lost out" in this competition to more politically popular projects. And unless the rules governing PABs are changed, the percent of PABs going to water projects is not expected to increase even though the need for such investment in water infrastructure projects will dramatically increase in the coming years.

Congress should consider and pass legislation that would bring water and wastewater projects out from under the state volume caps.

ADVANTAGES TO AMERICANS, MUNICIPALITIES AND GOVERNMENT ENTITIES

Depending on the specific project, bringing water projects out from under the PAB state volume cap will:

1. Make this form of financing more readily available to help all utilities meet the infrastructure replacement challenge;
2. Result in lower cost project financing, helping to control water rates;
3. Free the municipal partner from limitations on tax-exempt financing put in place in IRS "Revenue Procedure 97-13";
4. Spread virtually all financial risk to the private sector;
5. Have no adverse effect on a municipality's tax-exempt bond rating, freeing up traditional tax exempt municipal bonds for other uses; and
6. Facilitate more multi-year water projects.

ISSUE BACKGROUND, DETAIL, AND ARGUMENTS

STATE AND LOCAL BONDS – THE BASICS

State and local governments often issue debt instruments in exchange for the use of individuals' and businesses' investment capital. This debt obligates state and local governments to make interest payments for the use of this capital and to repay, over time, the amount borrowed along with interest. State and local governments finance capital facilities with debt rather than current tax revenues because current revenues are not large enough to provide the money that must be spent in the short term to build most capital projects.

The federal government subsidizes the cost of most state and local debt by excluding the interest income from federal income taxation. This tax exemption of interest income is granted in part because of the belief that state and local capital facilities will not be built if state and local taxpayers have to pay the full cost.

This state and local debt is issued as bonds, to be repaid over a period of time greater than one year and perhaps exceeding 20 years, and as notes, to be repaid within one year. “General Obligation Bonds” are secured by the promise to repay with general tax revenue, and “Revenue Bonds” are secured with the promise to use the stream of revenue generated by the facility built with the bond proceeds. Most debt is issued to finance new capital facilities, but some is issued to refund a prior bond issue (usually to take advantage of lower interest rates).

PRIVATE ACTIVITY BONDS

The federal tax code classifies state and local bonds as either governmental bonds or private activity bonds. Generally, the interest on state and local governmental bonds is exempt from federal taxation, whereas the interest on most private activity bonds is not tax exempt.

Governmental bonds are for projects that benefit the general public and are issued by government entities. Private activity bonds (PABs) are issued by private entities with state or municipal government approval. When the bonds are used for projects that benefit the general public, called “qualified private activities,” the bonds can be tax exempt.

Tax-exempt bonds for governmental purposes and for qualified private activities are special because, unlike corporate bonds or U.S. Treasury bonds, the bond buyer does not have to include the interest income from the bond in federal gross taxable income. The bond buyer is willing to accept a lower interest rate because the interest income is not subject to federal income taxes. The lower interest rate arising from the tax-exempt status subsidizes state and local investment in capital projects. For example, if the taxable bond interest rate is 7.00%, the after-tax return for a taxpayer in the 35% income tax bracket who buys a taxable bond is 4.55%. Thus, a tax-exempt bond that offers a 4.55% interest rate would be just as attractive to the investor as the taxable bond, all else being equal.

The federal government uses two primary means to restrain the use of state and local debt for private activities: an annual state volume cap limit (or separate national aggregate limit) and

restrictions on the type of qualified private activities. Since private activity bonds were defined in 1968, the number of eligible private activities has been gradually increased from 12 activities to 21. (See chart below)

Qualified Private Activities

Type of Private Activity (Italicized activities must be owned by the issuing government to qualify)	Subject to Volume Cap
<i>Airports</i>	No
<i>Docks and wharves</i>	No
<i>Mass commuting facilities</i>	Yes
Water furnishing facilities	Yes
Sewage facilities	Yes
Solid waste disposal facilities	Yes/No ^a
Qualified residential rental projects	Yes
Local electric energy or gas furnishing	Yes
Local district heating and cooling facilities	Yes
Qualified hazardous waste facilities	Yes
High-speed intercity rail facilities	Yes ^b
<i>Environmental enhancements of hydroelectric generating facilities</i>	No
Qualified public educational facilities	No ^c
Qualified green building and sustainable design projects	No ^c
Qualified highway and surface freight transfer facilities	No ^c
Mortgage revenue bonds	
Qualified mortgage bond	Yes
Qualified veterans' mortgage bond	No
Qualified small issue bond	Yes
Qualified student loan bond	Yes
Qualified redevelopment bond	Yes
Qualified 501(c)(3) bond	No

a. Exempt from the cap if governmentally owned. Subject to the cap if privately owned.

b. 25% of the bond issue is included in the cap. If the facility is owned by a governmental unit, no cap allocation is required. In addition, if the facility is not governmentally owned, to qualify for tax-exempt status, the owner must elect not to claim any depreciation deductions or investment tax credits with respect to the property financed with the bonds.

c. Educational facility bonds are subject to a separate cap: the greater of \$10 per capita or \$5 million. Green building bonds are subject to a national aggregate amount of \$2 billion through the expiration of the program, scheduled for October 1, 2009. Highway

bonds are subject to the following annual issuance limits: \$130 million in 2005; \$750 million each year for 2006 through 2009; \$1.87 billion in 2010; and \$2 billion each year for 2011 through 2015, zero thereafter.

In the 109th Congress, the "Gulf Opportunity Zone Act of 2005" (GOZA 2005, P.L. 109-135) included several modifications to private activity bond rules that are intended to help rebuild the Gulf Coast region after the 2005 hurricanes. In particular, under provisions in the GOZA 2005, the states of Alabama, Louisiana, and Mississippi are allocated additional private activity bond volume through January 1, 2011, granted relaxed eligibility rules for mortgage revenue bonds, and afforded the opportunity to advance refund outstanding tax-exempt bond debt.

QUALIFIED WATER AND WASTEWATER PABS

A facility can be qualified as a "facility for the furnishing of water" only if the water from the facility is made available to the general public. As noted previously, the water facility can also offer the water to agricultural and industrial users, but it must be available to all residential users in the service area. Furthermore, if the facility is privately owned, the rates charged by the water company must be approved by a state agency, such as a public utility commission.¹ Similar restrictions apply for "sewage facilities". Fortunately, these restrictions themselves are not likely to constrain access to PABs for most water projects. However the caps will. As water utilities ramp up their infrastructure investments, their demands for PABs will far exceed the caps.

There is ample precedence to bring water projects out from under the cap. For example, the current rules remove from the volume cap: qualified veterans' mortgage bonds; qualified 501 (c)(3) bonds; exempt facility bonds for financing airports, docks and wharves, and environmental enhancements of hydroelectric generating facilities; and 75% of exempt facility bonds for high-speed intercity rail facilities. Some facilities, such as solid waste disposal facilities, can be excluded from the volume cap provided all of the financed property is government owned.² Finally, a bond that is issued to refund another tax-exempt bond is excluded, provided the amount of the new bond does not exceed the amount remaining on the refunded bond.³

WHY BRING WATER PROJECTS OUT FROM UNDER THE CAP?

While traditional methods for financing water and wastewater facilities are available, the growing magnitude of the investments that must be made dictates that public officials seek out a wider range of solutions including financing tools that encourage private-public partnerships. These partnerships allow the development of more cost-effective projects using non-recourse financing while minimizing project risk to taxpayers.

Unfortunately, under the current volume cap restrictions for private activity bonds, water and wastewater infrastructure projects, which are seen as less politically attractive than other projects, are often not being funded with PABs. In most states the vast majority of PABs go to education and housing. In a number of key states, such as California, no PABs have been

¹ IRC Section 142(e)

² IRC Section 146(h). See also Treas. Reg. Section 1.103(n)-2(T), Q-10

³ IRC Section 146(i)(1)

authorized for water and wastewater infrastructure in recent years. This situation will only get worse as water utilities ask for more and more PABs to meet their burgeoning capital investment needs.

As stated above there are number of advantages to bringing PABs out from under the cap:

1. The change will make this form of financing more readily available to help all utilities meet the infrastructure replacement challenge.

As detailed above the accelerating pace of investment by all utilities to replace and renovate their aging infrastructure is unprecedented. Low interest rate financing like PABs is an essential tool for keeping costs down while making the needed investments. Other financing tools like tax-exempt municipal bonds, SRF loans, and conventional bonds each have unique limitations some of which are avoided with PABs. The more financing choices available to utilities, the more likely customers will get the lowest rates that are feasible as well as other benefits.

2. The change will result in lower cost project financing, helping to control water rates.

As stated above, with PABs the bond issuer pays a lower interest rate (because the interest is not taxable to the bond buyer). The result is lower costs for a given project financed with PABs that can be passed on to water utility customers in their rates. (It should be noted that with many utilities, especially privately-owned utilities, the pass through of such savings is required by Public Utility Commissions and other oversight boards.)

A given project can be financed with traditional tax-exempt government bonds and achieve similar savings but this financing comes with other limitations and disadvantages not associated with PABs (discussed below).

3. The change will free a municipal partner in a public-private partnership from limitations on tax-exempt financing put in place in IRS “Revenue Procedure 97-13”.

One way a municipality can use the private sector is through a public-private partnership. A typical model can be for a municipality to sign a contract with a private company to build and/or manage and operate a water utility. As stated above, all involved with such partnerships want to ensure the lowest costs for the customer, including project financing costs. This has usually meant that traditional tax-exempt municipal bonds are used so that customers benefit from the lower interest rates. However, such government bonds come with certain government imposed limitations.

The federal government has an interest in preventing abuses such as municipalities building facilities using governmental tax-exempt debt and then effectively transferring the rights and benefits of ownership to a private party through a very long term and favorable services contract. The primary way the federal government balances these interests is through IRS Revenue Procedure 97-13. This allows municipalities to use traditional governmental tax-exempt debt for water public-private partnerships but durations are limited to twenty years and payments to the

private partner must be primarily in the form of a “periodic fixed fee,” as opposed to “incentive fee”.

While the relatively new ability to enter into longer-term contracts (since 1997) has been a positive development for municipalities and the industry, the limitations discussed above, that apply if municipal tax-exempt bonds are used, significantly curtail innovations in the design of the partnership that may benefit the utilities’ customers, including incentive fees and longer terms, both of which can save money.

Financing public-private partnerships with PABs will free them from these limitations, allowing for greater incentives for increased performance from the private partner. All this will ultimately enhance the benefits and advantages of public-private partnerships realized by the utility and its customers.

4. Bringing water projects out from under the cap on PABs will spread virtually all financial risk to the private sector.

With traditional government tax-exempt bonds the municipality is the bond issuer and is therefore responsible for paying the bond buyer back, with interest. So all risk is assumed by the municipality, and by extension the citizens.

However, with PABs the bond issuer is NOT the municipality but the private sector partner. It is the private sector issuer who is responsible for paying back the bonds and assumes all the associated financial risk.

5. Issuing more PABs will have no adverse effect on a municipality’s tax-exempt bond rating, freeing up traditional tax exempt municipal bonds for other uses.

Because a municipality’s rating on its tax exempt municipal bonds is determined in part by the amount of such bonds outstanding, many municipalities cannot issue an unlimited number of these bonds without risking having their debt rating lowered, which would cause a rise in the interest rates they must pay on the debt they issue. With investments rising, utilities must issue more and more debt. To reduce the risk of having their debt rating lowered, municipalities can use PABs in lieu of government bonds, because on PABs the payback risk is with the private entity that issues the bond, not the municipality. Consequently, municipalities’ bond ratings will not be adversely affected. This will give the municipality more flexibility to use its municipal bonds on other important projects.

6. The proposed change in the tax code will facilitate more multi-year water projects.

Under current law the total dollar amount of PABs that can be approved by a state or municipality is set each year, the PABs that are approved provide funding for one year, and on projects needing multi-year funding, new PABs must be approved each year, provided cap is available. This introduces complexity and uncertainty to the financing of multi-year projects,

which is a disincentive to use PABs. Obviously, if water projects are removed from the annualized cap, this ceases being an issue.

CONCLUSION

In the 1990s, policymakers were able avert a crisis in solid waste management field that has similarities to the water infrastructure replacement crisis by removing solid waste facilities from the cap. This change resulted in the generation of over \$20 billion in private-sector financing.

If Congress removes the cap for private activity bonds for water and wastewater infrastructure, the result would be to unleash untapped resources to meet the emerging water infrastructure crisis. Removing the state volume cap will result in lower cost financing that is passed on to water customers, will encourage public-private partnerships to spread risk and encourage innovation, will reduce government's project management burdens, and make multi-year projects funded with PABs more feasible.