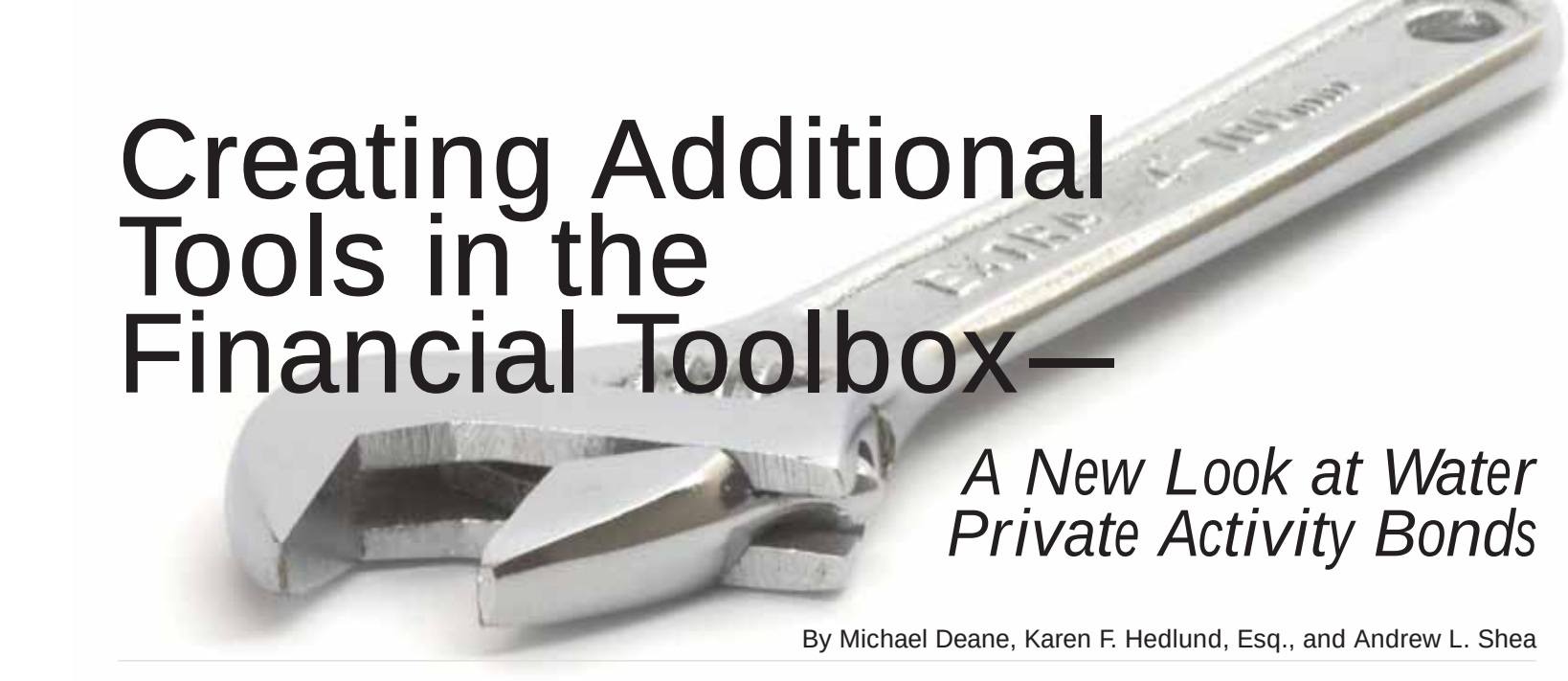

# Creating Additional Tools in the Financial Toolbox—

## *A New Look at Water Private Activity Bonds*

By Michael Deane, Karen F. Hedlund, Esq., and Andrew L. Shea

Since the early 1950s, the federal government has committed billions of dollars to support local efforts in constructing critical water and wastewater treatment facilities. Starting in 1987, Congress has provided a mix of capitalization grants for state revolving loan funds addressing state program priorities and grants for specific congressionally selected projects. However, even before Hurricane Katrina devastated the Gulf Coast, the U.S. Environmental Protection Agency (EPA) needs analysis documented a substantial gap between available federal, state and local funding resources in comparison with projected construction needs. While some water industry associations estimate funding requirements between $500 billion and more than $1 trillion dollars in the next 20 years for all water infrastructure, EPA has estimated the funding shortfall over the next 20 years to be $277 billion for drinking water and $181 billion for wastewater infrastructure. To address these requirements and shortfalls, local communities will need to increase system revenues through well-articulated rate increases and look to other financial assistance options.

Given this dramatic funding shortfall and the lack of a sustainable solution to this federal funding challenge, alternative financing measures should be pursued to ensure a reliable public-purpose infrastructure capable of meeting public health and ecosystem needs. This article explores the opportunity to use tax-exempt Private Activity Bonds (PABs) as an alternative financing mechanism in conjunction with innovative public-private partnerships as one of many complementary solutions to meeting the overall funding shortfall.

### Financing Options for New Infrastructure Projects

A myriad of funding and financing options is currently being discussed in Washington, D.C., before the House Transportation & Infrastructure Committee (*http://www.house.gov/transportation/water/06-08-05/06-08-05memo.html*) and Senate Environment & Public Works Committee (*http://thomas.loc.gov/cgi-bin/query/F?c109:1:./temp/~c109gOPvls:e923:*). It has become clear that while State Revolving Funds have performed admirably over the last two decades to generate a sustainable source of funding for needy communities, the $1.6 billion budgeted in FY2006 for water and wastewater infrastructure is falling short of the potential $13 billion funding gap. Moreover, Congress' lukewarm reception to a national bottle tax and other proposals to establish a water trust fund indicates that the federal government can no longer be looked to as a source of major grant funding programs for local water infrastructure projects. With the limited number of available tools in the financial toolbox, communities need to seek out newer, more flexible and useful means of financing water infrastructure.

### Private Activity Bonds — Where Do They Fit In?

From the various tax-exempt bond approaches to public-purpose water infrastructure, public entities are able to use

| Sale Date | Final Maturity | Issuer | State | Corporate or Institutional Backer | Amount of Issue ($ mils) | Issue Description |
|---|---|---|---|---|---|---|
| 1/31/2003 | 1/1/2032 | Moulton Water Works Board | AL | | 4.25 | Water Revenue Bonds |
| 11/17/2000 | 11/1/2006 | Fayetteville-Arkansas | AR | | 10 (called) | Water & Sewer Sys Subor Rev Bonds |
| 8/10/2004 | 10/1/2020 | Garland Co-Arkansas | AR | | 4 | Waterworks & Facs Bd Rev Bonds |
| 10/10/2003 | 9/1/2022 | Connecticut Development Auth | CT | Connecticut Water Co | 14.93 | Water Facs Refunding Rev Bonds |
| 9/2/2004 | 7/1/2028 | Connecticut Development Auth | CT | Davis Family SODAK LLC | 5 | Water Facility Ref Rev Bonds |
| 3/14/2002 | 3/1/2033 | Delaware Economic Dev Auth | DE | | 17 | Water Dev Refunding Rev Bonds |
| 5/14/2002 | 10/1/2031 | Tampa Bay Water | FL | | 108.39 | Utility Sys Var Rte Revenue Bonds |
| 8/10/2000 | 11/1/2020 | Lee Co Industrial Dev Authority | FL | Bonita Springs Utilities Inc. | 13.2 | Utility System Revenue Bonds |
| 1/14/2000 | 6/1/2029 | Niceville-Florida | FL | | 1.7 | Var Rte Wtr & Swr Rev Bonds |

governmental purpose bonds, while private entities such as investor-owned water utilities and public-private partnerships may use tax-exempt private activity bonds in addition to taxable bonds and private equity to fund new projects. Unfortunately, while IRS Revenue Procedure 97-13 enhanced the ability of communities to use governmental purpose bonds for certain operations and maintenance partnerships, it also severely limits private participation and incentives for enhanced environmental and economic performance. Private activity bonds allow more flexibility and efficiency to work with the private sector using performance-based contracting for operations as well as asset ownership. Moreover, private activity bonds can also be used in combination with private equity in a well-established form of infrastructure financing called project financing. In this case, the project being financed by the public-private partnership remains off the balance sheet (and hence, does not impact the credit rating) of the community being served by the partnership until such time as the public entity chooses to buy back the ownership of the infrastructure being financed.

## What Are PABs and Where Are They Used?

Tax-exempt PABs are financing tools that allow private-sector investment in public projects — the benefits of which are interest rates lower than conventional taxable financing, longer maturities, lower delivered cost of service and a readily available supply of capital. PABs have historically been used by public authorities when several criteria are triggered involving private participation in the activity being financed (long-term operations, industrial water supply, private ownership, etc). Private water utilities in the northern and central states have also been traditional users of PABs as required by their state-level public utility commissions.

### Tax Criteria for a PAB

- Interest on state or local "governmental purpose" bonds generally exempt from taxation
- Become a PAB and therefore taxable if either:

1) more than 10 percent of proceeds is for private business use and more than 10 percent of debt service is secured by or payable from property used for private business use; or

2) more than the lesser of $5 million or 5 percent of proceeds loaned to nongovernmental entity

### What is a Tax-Exempt PAB?

- Tax law provides exceptions for interest on certain PABs to be excluded from taxation
- One category of exception is "exempt facility bonds," including bond for: airports, docks and wharves, mass commuting facilities, water, sewage and solid waste facilities, some rental housing, some electric and gas facilities, district heating and cooling facilities, some hazardous waste facilities, high-speed intercity rail, some hydro projects, some educational facilities. This summer, Congress added highways and truck/rail intermodal facilities to the list of public-purpose projects for which private activity bonds may be issued.

In the past, PABs have been used to solve critical infrastructure problems including the solid waste disposal crisis in the 1980s, where the private sector invested more than $20 billion in new waste-to-energy facilities to avoid massive groundwater pollution and reduce the growing number of hazardous waste sites. A similar argument can be made that water PABs can provide an additional financing tool to facilitate up to $1 billion to $2 billion per year in financing that would have either been delayed or shelved due to lack of ability or willingness to commit funding or identify other financial sponsorship. (*visit http://www.house.gov/transportation/water/06-08-05/howard.pdf*)

Unfortunately, current federal tax law imposes limits on the amount of PABs that can be issued in each state on an annual basis (referred to as "state bond caps"). These caps have severely restricted the ability of local governments to use PABs as a funding alternative for water and wastewater infrastructure development. As a result, there has been limited availability within the "exempt facilities" category for water projects, industrial development bonds and all other categories. These projects received an allocation of only $1.6 billion in 2004 for all states, from a total allocation of $43 billion. Typically, water PABs average approximately $200 to $250 million per year with the majority of the allocation used by investor-owned utilities, although a number of public-private partnerships and public entities have used PABs for financing due to either water revenue criteria or initial ownership of the water infrastructure by the private partner.

## Historical Use

A look at the historical issuance of water and wastewater PABs for the last four years shows a diversity in locations and project types. While the magnitude of the bonding on a per project basis has been relatively small (largely due to limited availability), the use and public benefit for public water supply projects as well as for wastewater compliance across a number of important states is well noted. The largest water PAB issuance to date has been for the 25 million gallon per day Tampa Bay seawater desalination facility involving the issuance of $108 million in PABs and both private and then public ownership options. Under conventional financing, the water authority would not have had the flexibility to maximize its involvement with the competitive elements of the private sector for competitive operations and facility construction.

## Benefits of Using PABs

Use of tax-exempt bonds as a means of financing water and wastewater projects allows communities, water districts, river authorities, water supply and sewer service corporations and regional water management districts in addition to public-private partnerships and private water utilities the ability to access more affordable interest rates during the construction and debt repayment period for capital intensive projects. While activity to date has been limited primarily due to a state volume cap imposed by the federal tax code and by restrictions within each state by jurisdictions handling tax-exempt issuances, there is an opportunity in congress to remove the state bonds caps. The current allocation of $80 per resident, or a minimum of $233 million per state, creates an untenable situation where water projects as "exempt facilities" compete with other PAB uses for volume cap or allocation within each state. In many states where housing and student loans are provided with a majority of the allocation, a number of potential public conduit issuers have resigned themselves to not availing themselves of this attractive financing option. Removing the bond cap will allow more financing flexibility to these communities and avoid the politically contentious elements of bond allocation.

In addition, removing the bond cap will allow the public sector more flexibility in procurement options in leveraging the

private sector for developing, financing, owning and operating water and wastewater infrastructure. The figure identifies critical areas in the lifecycle of a capital intensive project where a public authority might cost effectively and cost efficiently delegate risk responsibility and management to the private sector under a

| Private Partner Risk Assumption/Return Profile | Governmental Purpose Bonds | Private Activity Bonds |
|---|---|---|
| Proposal Costs | Yes | Yes |
| Negotiation and Development Costs | Yes | Yes |
| Fixed Construction Costs | Possible | Yes |
| Technology/Performance Risk | Possible | Yes |
| Fixed Operating costs | Possible | Yes |
| Fixed Subordinate Debt Return | Possible | Yes |
| Debt Guarantee | Possible for limited amount typically subordinated | Yes |
| Equity Investment with Upside | No | Yes |
| Residual Value | No | Yes |

public-private partnership without violating IRS guidelines governing tax-exempt financing so long as the public entity has access to PABs.

## Current Legislative Initiative

On April 19, 2005, Rep. Clay Shaw (R-Fla.) introduced HR 1708 — the Clean Water Investment and Infrastructure Security Act of 2005 — co-sponsored by Reps. Davis (D-Fla.), Turner (R-Ohio), Thompson (D-Calif.), and English (R-Pa.). The bill would amend the Internal Revenue Code to remove private activity bonds for public-purpose water and wastewater facilities from the state bond volume cap (*http://thomas.loc.gov/cgi-bin/bdquery/z?d109:h.r.01708:*). As of this writing, more than two dozen bipartisan congressional supporters have signed on to the bill, while three dozen public entities and water industry associations have formally supported the legislative initiative now before the House Ways and Means Committee. A companion bill is being developed for consideration by the Senate Finance Committee. With the negligible $147 million revenue impact to the U.S. Treasury over 10 years for removing the bond cap as determined by the Joint Tax Committee for similar legislation in the 107th Congress, a number of congressional leaders see the benefits of this legislation establishing a "level playing field" for financing critical infrastructure based on the purpose served and not the ownership or management structure.

As proposed, the legislation could stimulate private capital investment beyond the "efficiency dividend" of simple contract operations to help fill EPA's "funding gap" for infrastructure development and improvement. In fact, the proposed tax act would remove the forced decision that a number of communities have faced between low-cost capital using government obligation bonds and higher-cost operations vs. high-cost capital using private or taxable debt with aggressively managed/low-cost operations. Whether assisting a river authority in Texas with cost efficiency and certainty in financing capital improvements or allowing a regional water management district in Florida to structure partnerships to optimize development, construction and operations "beyond" Rev. Proc. 97-13, the legislation will engender greater competition in the procurement process and allow for better risk allocation and management.

## Projected Level of Water Infrastructure PAB Activity

- Solid waste PAB issuances have equaled 41 percent of total solid waste issuances compared to 1 percent for water/wastewater since 1986
- Average total solid waste PAB issuances/year equaled $779 million compared to $238 million for water/wastewater since 1986
- Based on experience in the solid waste sector, we believe PAB issuance for water/wastewater projects would significantly increase and help expedite construction of new projects
- Actual issuance of PABs for water/wastewater projects will be based on the number of projects ready to be financed, particularly where the public sector wants the private sector to assume a greater role in assuming development, technology and performance risk
- With the elimination of bond cap for water/wastewater projects, it is reasonable to expect that $1 billion to $2 billion of PABs would initially be issued annually and could double or triple annually over time as the PPP water/wastewater industry matures

## Conclusion

PABs are just one tool, but an important one, that will provide our water quality administrators the ability to begin to meet the challenges of the next several decades. In addition to providing additional financial resources for critical water and wastewater projects, they support EPA's and our nation's pursuit of sustainable infrastructure solutions. For the question that must be answered is no longer just "Where is the money going to come from to 'fill the gap?' " but, equally as important, "How are we going to design, finance, construct, operate and manage our water infrastructure systems on a sustainable, life-cycle basis in order to prevent future gaps?" With a focus on flexibility, optimized project delivery and balanced risk management, private activity bonds can be a significant part of the answer.

Whether or not a community decides to use a public-private partnership to achieve its water supply objectives or water quality goals, simply stated, is a local decision. Removing the bond caps is one way to access a tested and proven tax-exempt bond financing structure to finance public purpose water infrastructure utilizing public-private partnerships for years to come.

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