MWD
METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA

BOARD ACTION

- **Board of Directors**
  Communications and Legislation Committee

April 10, 2007 Board Meeting

8-10

Subject

Authorize sponsorship of federal legislation for Tax Credit Bonds providing capital financing for new local projects

Description

Authorization is requested to sponsor legislation to create federal tax credit bonds for financing new desalination, groundwater treatment and water recycling projects. As a member of the New Water Supply Coalition (Coalition), Metropolitan is working with a diverse group of water supply agencies in the effort to develop federal legislative vehicles that enable this new approach. As proposed, tax credit bonds could reduce capital financing costs and improve cash flow for funding new recycling, groundwater treatment, and seawater desalination projects within Metropolitan's service area.

Background

Metropolitan's role as a regional facilitator includes obtaining state and federal financial assistance for local projects to help achieve regional supply reliability goals. The legislation proposed by the Coalition is consistent with this role.

The Coalition is focusing on obtaining federal financial assistance for desalination, groundwater treatment and recycling. Metropolitan and several member agencies are members of the Coalition. Director John Morris is a member of its board, representing Metropolitan.

Federal funding for local projects has principally come from the Title XVI program, which provides capital funding up to about $20 million per project from the U.S. Bureau of Reclamation. Title 16 involves a two-step process of federal authorization and then an appropriation of funds. Given budget constraints, the appropriation process has proven to be competitive and at times slower than necessary to advance construction. Additionally, member and local agency projects have been helped by state grants and State Revolving Fund loans for capital improvement financing. An attractive benefit of the tax credit bond approach is reducing funding uncertainty through a reduced reliance on the federal appropriations process.

Tax Credit Bond Summary

The Coalition is seeking to create legislation for Clean Renewable Water Supply tax credit bonds ("CREWS bonds") that would be used by water agencies to finance capital for new desalination, water recycling and groundwater treatment projects. The approach is modeled after existing tax credit bonds used to finance education, clean renewable energy and hurricane Katrina relief programs.

Under the proposed Tax Credit Bond approach, bond lenders provide zero-interest capital financing to water agencies for qualifying new projects, and in return receive annual tax credits. One possible provision of the legislation would allow agencies to repay the principal in a single balloon payment at the conclusion of the loan period, typically 20 years. Water agencies would have the option of refinancing the balloon payment through traditional tax-free bonds for another 20 years. This has the effect of spreading the cost to future beneficiaries when the project has fully matured. **Attachment 1** contains more information on the main principles of the Coalition's Tax Credit Bond Concept.

Water agencies would benefit from the capital financing through improved cash flows in the early years of a project's life, typically when costs are high and water production and revenue are low. Slow-to-develop water recycling projects and high-cost desalination projects would greatly benefit from tax credit bonds. As proposed, CREWS bonds would also provide significant federal assistance to projects under the tax code without having to contend with the annual federal appropriations process.

Proposed Legislation

As proposed, CREWS bond funds would be available for construction of new recycling, groundwater treatment and desalination projects. The bond term would be limited to 20 years, and the proceeds would have to be spent within five years of issuance. Qualified borrowers include governmental bodies and local water agencies.

Staff anticipates working with the Coalition as a primary sponsor. Metropolitan will be seeking California Members of Congress, particularly those with assignments on the House Ways and Means Committee or Senate Finance Committee, to introduce the bill.

Support Benefits

Metropolitan's support for the CREWS bond bill would help the new approach advance through the congressional legislative process. Over the next 20 years, Metropolitan's Local Resources and Seawater Desalination Programs will be pursuing development of about 300,000 acre-feet per year of new supply requiring capital investment in the range of $1.5 billion to $2 billion dollars. Member and retail agency capital financing could benefit from the availability of CREWS bonds to accomplish that financing with improved project cash flow.

Policy

By Minute Item 43021, dated June 9, 1998, the Board adopted the Local Resources Program.

By Minute Item 46491, dated December 13, 2005, the Board adopted the CEQA determination and approved Metropolitan's role of regional facilitator to address seawater desalination and other local projects, as set forth in the revised letter signed by the Interim CEO/General Manager on November 30, 2005.

California Environmental Quality Act (CEQA)

CEQA determination for Options #1 and #2:

The proposed action is not defined as a project under CEQA because it involves continuing administrative activities, such as general policy and procedure making (Section 15378(b)(2) of the State CEQA Guidelines). In addition, where it can be seen with certainty that there is no possibility that the proposed action in question may have a significant effect on the environment, the proposed action is not subject to CEQA (Section 15061(b)(3) of the State CEQA Guidelines).

The CEQA determination is: Determine that the proposed action is not subject to CEQA pursuant to Sections 15378(b)(2) and 15061(b)(3) of the State CEQA Guidelines.

CEQA determination for Option #3:

None required

Board Options

Option #1

Adopt the CEQA determination and authorize sponsorship for CREWS bond legislation.
Fiscal Impact: May augment local and Metropolitan funding for future Local Resources Programs and seawater desalination
Business Analysis: The proposed legislation could lower capital financing costs for recycling, groundwater treatment, and seawater desalination projects, and therefore help to advance new projects needed to sustain regional water supply reliability.

Option #2

Adopt the CEQA determination and authorize support for CREWS bond legislation.

Fiscal Impact: May augment local and Metropolitan funding for future Local Resources Programs and seawater desalination

Business Analysis: The proposed legislation could lower capital financing costs for recycling, groundwater treatment, and seawater desalination projects, and therefore help to advance new projects needed to sustain regional water supply reliability.

Option #3

Take no position on the CREWS bond legislation.

Fiscal Impact: None

Business Analysis: Non-support of the legislation could be perceived as lessening Metropolitan's role as a regional facilitator for local resources. The lack of Metropolitan support may reduce the possibilities for advancing the proposed legislation. The chances of future local projects benefiting from tax credit bonds will be reduced if the legislation does not move forward.

Staff Recommendation

Option #1

Linda Waade 3/29/2007

Linda Waade *Date*

Deputy General Manager, External Affairs

Jeffrey Kightlinger 3/29/2007

Jeffrey Kightlinger *Date*

General Manager

Attachment 1 – Coalition's Tax Credit Bond Concept

BLA #5331

Coalition's Tax Credit Bond Concept

Clean Renewable Water Supply Tax Credit Bonds

<u>Tax Credit Bond</u>: Provides zero-interest capital funding for eligible projects. Instead of interest payments, bondholders receive annual tax credits for the life of the loan. General characteristics:

1. Capital Financing for:
   a. Water recycling
   b. Brackish desalination
   c. Seawater desalination
   d. Recovery of contaminated ground water
2. Interest-free loan, where reductions in the federal government's tax revenues through credits provide the incentive for private investors to loan capital funds.
3. An option for no annual capital payments is under consideration. Under this option, a balloon payment of full principal is made upon maturity. Borrowing agency would only incur the project operation and maintenance cost during the life of the loan. Alternately, annual repayment of principal may be required.
4. Administrative rules to be set in the federal tax code.
5. Bondholder receives annual tax credit at a fixed rate set by the Treasury Department on the date of bond issuance. Annual tax credit equals Treasury rate multiplied by the loan amount. The bondholder may trade the loan and associated tax credits to willing buyers.
6. Bond proceeds to be expended within five years of date of issuance. Phased construction can be financed through phased bond issuance.

<u>Advantages</u>:

1. Federal support of capital financing of eligible local projects without federal appropriations process.
2. Reduces the financial burden associated with cash-flow problems that typically, occur in early years of recycled water project development when the customer base is typically small (i.e. annual costs are high and revenues are low).
3. Could reduce Metropolitan's Local Resources Project payments under the sliding-scale incentive payment approach.
4. Precedent set – federal tax credit bonds legislation has already been passed for:
   a. Qualified Zone Academy Bonds – $400 million limit
   b. Clean Renewable Energy Bonds – $800 million limit
   c. Gulf Zone Tax Credit Bonds – $350 million limit
5. Upon maturity, tax credit bonds obligations may be refinanced with traditional tax-exempt bonds.
6. At current interest rates, federal assistance would support in excess of 50 percent of capital financing for a 20-year tax credit bond compared to traditional tax-exempt bond funding.

Example:

Financing Structure	Principal ($ million)	Interest Rate	Life of Bond (years)	Principal & Interest ($ million)	Present Value of Debt Service ($ million)
Tax Credit Bond Program	$100	4.5%	20 + 20 *	$152.2	$35.3
Tax-Exempt Bond Issue	$100	4.5%	40	$214.5	$92.0
Savings				$ 62.3	$56.7

* Assumes refinancing after 20 years into a tax-exempt bond