

## Funding And P3s For Water Infrastructure Projects: Part 1

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This two-part series discusses funding and public-private partnerships (P3s) related to U.S. water infrastructure projects. Here, in part 1, we describe the key existing sources of funding available at the federal, state and local levels. In part 2, we will initially discuss the use of P3s in the water sector to fill funding gaps and as an alternative procurement method. Then we will describe proposed enhancements by stakeholders to the funding mix, including through the Water Resources Development Act (WRDA) that is currently pending before Congress, and consider the impact of certain of such enhancements on the P3 market.



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### Introduction

The overall condition of U.S. water infrastructure is poor and is worsening. Many of the nation's more than 150,000 water systems were constructed 50 to 100 years ago. There are approximately 240,000 water main breaks annually, or about 650 per day, or once every two minutes. According to recent estimates by the U.S. Environmental Protection Agency, funding needs for water infrastructure capital improvements total more than \$650 billion over the next 20 years.[1] The American Water Works Association puts this figure at \$1 trillion over the same period.[2]

While the funding gap is clear, many of the nation's more than 50,000 utilities are unable to pay for necessary upgrades, let alone new facilities that may increase efficiency and harness key resources. Municipal budgets are constrained and, while external financing is available, utilities and other stakeholders have complained the options are too limited.

This article, in two parts, outlines the key financing sources that may be tapped by water utilities, and efforts that are being made to enhance or expand these sources, including pursuant to the proposed WRDA, which is currently pending before Congress and which lawmakers are expected to finalize this year.[3] It also outlines the role of P3s as a funding source and as a procurement tool by water utilities. While P3s have so far been underutilized in the water sector, the application of private capital to water projects is likely to increase if certain of the funding enhancements proposed in the Senate's version of the WRDA are implemented — provided that appropriate investment opportunities exist.

### Existing Funding Sources

Customer fees and surcharges generally comprise the principal source of revenues for water utilities. They can be applied directly to fund operation and maintenance expenses, and they can also be monetized to support debt financing for the same purpose. Certain forms of debt financing can be

implemented directly by the relevant municipality. Other alternatives require the support of state or federal governmental units and, in certain cases, the involvement of private entities. Grants, which are generally available in relatively small amounts, can provide additional assistance. Summaries of the principal existing funding sources are provided below.

## **Local Government Sources**

The key funding sources that are implemented directly by local utilities are (1) tax-exempt municipal bonds and (2) tax increment financings.

### **1. Tax-Exempt Municipal Bonds**

#### *Revenue Bonds*

Municipal bonds are the principal financing tool for local governments seeking to fund capital costs related to water infrastructure. At least 70 percent of water utilities rely on municipal bonds or other debt financing to fund capital improvements.[4] However, there is significant variation by issuer. While larger cities have been successful in taking advantage of the low pricing and long tenor of such bonds, smaller cities and rural communities have encountered difficulties accessing the market. These bonds typically take the form of revenue bonds backed by user fees, and the interest earned by investors is tax-exempt.

#### *Private Activity Bonds*

Private activity bonds (PABs) are a type of tax-exempt municipal bond. Instead of being issued to finance facilities solely for public use, they are issued for the benefit of, or due to the substantial participation of, private entities. PABs offer long-term financing at interest rates which are typically fixed and lower than comparable taxable options. They have increasingly been used as a funding tool for infrastructure projects. In the transport sector, where there have been a number of recent successes in implementing P3s, PABs have become an indispensable source of financing for developers of projects procured on an availability payment basis, given the capital cost benefits to the public authority responsible for the performance payments that fund the developer's debt service obligations.

In the water sector, bonds are eligible for tax-exempt treatment if they are issued to fund (a) facilities for the furnishing of water (e.g., drinking water supply systems), or (b) sewage facilities. While there have been far fewer PABs issued than in the transport sector, their use is likely to become more regular with the increasing diversification of P3s, which has included a focus on water infrastructure. In addition, whereas a public sector "conduit" issuer is required for transport PABs, private water companies or developers can serve as issuers of water PABs, as long as (1) the project is owned by a governmental unit or (2) the rates charged have been approved by a political subdivision of the community in which it is located.[5] This can provide additional flexibility.

A significant limitation on the use of PABs in the water sector is the federally mandated volume cap, which limits the aggregate amount of PABs that can be issued on an annual basis for certain types of facilities. The volume cap is determined annually, is indexed to inflation and is allocated among states based on population. Any unused cap amount may be carried forward by a state for three years, after which it expires. For 2016, the volume cap per state is the greater of (1) \$100 multiplied by the state's population and (2) \$302.88 million, and the total volume cap for the 50 states, Washington, D.C., and Puerto Rico is \$32.5 billion.[6]

In addition, states have their own allocation processes for PABs within the cap, which can present additional barriers to their use in the water sector. The preponderance of PAB volume caps, for example, tends to be allocated to housing-related activities or education loans.[7]

## **2. Tax Increment Financing**

Tax increment financing (TIF) is an economic development tool available to local governments to finance public infrastructure improvements, including water projects, as follows: A municipality creates a TIF authority and designates the community where the program will be applied (the TIF district). The TIF works by locking in the taxable worth of real property in the TIF district at the value it holds at the time authorizing legislation for the program is approved. Tax payments made by taxpayers in the TIF district on the increased value of their property are “captured” by the TIF authority and applied to the construction of a project or to repay construction financing.

If the program is successful, the improvements will spur further investment and increases in property value, which increases the tax base and leads to more TIF revenue to pay for public projects. TIF has more difficulty, and tends to lose public support, when property values decrease or other events result in the TIF authority having insufficient proceeds to make its bond payments.

## **Federal Sources**

As in the transport sector, federal funds are critical inputs to states to support their water infrastructure improvements. The principal sources are appropriations by Congress to the Clean Water State Revolving Fund (CWSRF) and the Drinking Water State Revolving Fund (DWSRF and, together with the CWSRF, the SRFs).

Other key sources include (a) rural development water and environmental programs (WEP) provided by the U.S. Department of Agriculture and USDA’s Rural Infrastructure Opportunity Fund; (b) community development block grants (CDBGs) provided by the U.S. Department of Housing and Urban Development; (c) Title XVI program funds provided by the Bureau of Reclamation (BOR) of the U.S. Department of the Interior; (d) grants and contracts on a regional basis such as those provided by the Appalachian Regional Commission (ARC); (e) contributions from the U.S. Army Corps of Engineers (ACE); and (f) grants from the Economic Development Administration (EDA) of the U.S. Department of Commerce. Several of these sources are not water sector-specific, which can cause a competition for scarce funds among stakeholders in different sectors.

### **1. SRFs**

The SRFs are the largest source of federal financial assistance for U.S. water infrastructure. Since their inception in 1972 and 1996, total CWSRF and DWSRF assistance exceeds \$100 billion and \$20 billion, respectively. For fiscal year 2016, approximately \$1.4 billion in CWSRF assistance and \$865 million in DWSRF assistance was made available through appropriations.[8] The SRFs are capitalized by EPA grants enabled by federal appropriations.

States must provide a 20 percent match of the federal funds and manage the programs. Each state and Puerto Rico has both a CWSRF and a DWSRF (Washington, D.C., receives direct grant funding from the EPA). The CWSRFs are typically used to fund wastewater, stormwater or recycled water projects, while the DWSRFs are typically used for drinking water projects. The SRFs are essentially environmental

infrastructure banks providing low-interest loans to eligible recipients. Draws are made as project costs are incurred. Repayments of principal and interest are transferred back to the SRFs to finance new projects. This process creates a revolving door of funded projects.

Significant flexibility is given to states to structure their SRFs. SRF assistance can fund up to 100 percent of project costs and loan tenors may be up to 30 years. Assistance may take the form of loans, refinancing, purchasing, or guaranteeing local debt and purchasing bond insurance. States set the loan terms, including interest rates ranging from 0 percent to then current market rates. For small or disadvantaged communities, assistance can take the form of grants, principal forgiveness and negative interest rate loans. States also may issue revenue bonds to leverage the SRFs, with repayment secured by future SRF proceeds, to increase the amount that can be disbursed to municipalities in a single transaction.

Despite the SRFs' key role, stakeholders have raised several concerns about the program, including the following:

- **Eligibility:** Federal law requires that CWSRF funds be disbursed only to public sector entities, subject to certain exceptions for “resiliency” projects. In addition, while private water companies are eligible recipients of DWSRF loans under federal law, only about 50 percent of states have made private entities eligible for such credit extensions.
- **Funds Availability:** SRF appropriations by Congress have essentially been flat since the financial crisis, due principally to (a) spending caps imposed by federal budget acts, and (b) general deficit reduction pressures.
- **State Credit Extensions Limited:** Although federal law does not impose limitations on the size of credit extensions, states have generally limited amounts disbursed to individual projects under the SRFs. As a result, water authorities for small and medium sized communities have tended to be the most frequent recipients, thus limiting the assistance provided by the SRFs to larger projects.
- **Federal Requirements:** Recipients of federal funds must comply with a handful of federal laws (such as Davis-Bacon wage requirements, “Buy America” provisions and environmental review under the National Environmental Policy Act) in implementing projects, which may (a) increase project costs for recipients, and (b) limit a state’s flexibility in structuring loan or grant terms.

## 2. ACE

The ACE undertakes civil works in connection with water resource projects to facilitate three principal needs: navigation, flood damage reduction and aquatic ecosystem restoration. Specific projects are typically authorized pursuant to “water resource development acts” on a biannual basis, with Congressional appropriations being made annually. Both the Senate and House versions of the WRDA, for example, would authorize approximately 30 ACE projects, and would deauthorize several others that are no longer deemed necessary. Cost sharing between the ACE and the relevant state or local entity is common, with the portion being borne by the ACE varying by project.

## 3. WEP and Rural Infrastructure Opportunity Fund

Pursuant to the WEP, the USDA provides grants, loans or loan guarantees to rural communities with populations of 10,000 or less to develop, construct or improve water and wastewater infrastructure. For FY 2016, WEP invested \$1.66 billion in grants and loans in 959 projects.[9] WEP funding can be important to these communities because, as noted above, rural water authorities can have difficulty accessing the municipal bond market.

WEP also provides funding to organizations that provide technical assistance and training to rural communities in connection with their water and wastewater activities. WEP grants were also used to capitalize the Rural Water Loan Fund, which is managed by the National Rural Water Association, a not-for-profit organization that makes low-interest loans to small water and wastewater utilities to fund short-term repairs, small capital projects and predevelopment costs associated with larger projects.[10]

The U.S. Rural Infrastructure Opportunity Fund, a public-private initiative, was created in 2014 to facilitate private investment in rural infrastructure projects, including water and wastewater systems. CoBank, which committed \$10 billion, is the fund's anchor investor, Capitol Peak Asset Management manages the funds, and the USDA and other federal agencies identify appropriate projects. The fund has made investments in 11 investments in eight states to finance water system upgrades.[11] CoBank also makes direct loans to not-for-profit organizations, municipalities and investor-owned water utilities.

#### *4. CDBG*

Through the CDBG program, HUD finances local community development activities that expand economic opportunities, principally for low- and moderate-income areas. Water and wastewater projects are eligible for assistance. Over a one-, two- or three-year period, as selected by the grantee, not less than 70 percent of CDBG funds must be used for activities that benefit low- and moderate-income persons.

In addition, each activity to which CDBG proceeds are applied must (a) benefit low- and moderate-income persons, (b) prevent or eliminate slums or blight, or (c) address urgent community development needs for which other funding is not available. Funds are appropriated annually by Congress. For FY 2016, approximately \$3 billion in CDBG funds were made available.[12]

#### *5. Title XVI*

The Reclamation Wastewater and Groundwater Study and Facilities Act of 1992, which appears as Title XVI of P.L. 102-575, provides authority for the BOR's water recycling and reuse program. Part of the BOR's mandate is to identify opportunities to reclaim and reuse wastewaters and naturally impaired ground and surface water in the western states and Hawaii.

Through the Title XVI program, the BOR provides partial grants to municipalities, with the federal share being limited to 25 percent of total project costs. In 2014, an estimated 378,000 acre-feet of water was recycled through Title XVI projects. Since 1992, when the program was initiated, approximately \$639 million in federal funds have been provided through Title XVI for the design and construction of water recycling projects, with such amounts leveraging \$2.4 billion in funding from nonfederal sources.[13]

The BOR separately provides funds to municipalities, which must be repaid with interest, to support rural water supply projects, typically as part of larger irrigation, flood control and hydroelectric power projects.[14]

## 6. EDA

Through its Public Works program, the EDA makes grants to state, county, and local entities and not-for-profit organizations for water and sewer projects, in order to create jobs and promote long-term competitiveness in economically distressed communities. While EDA assistance typically is not permitted to exceed 50 percent of the cost of the project, some projects may receive additional funding of up to 30 percent based on the relative needs of the region in which the project will be located, as determined by the EDA.[15]

## 7. Regional Sources

Congress has made funds available to the Appalachian region through the ARC. The ARC is an economic development agency that represents a partnership of federal, state and local government. Established by Congress in 1965, the ARC is composed of the governors of the 13 Appalachian states[16] and a federal co-chair, who is appointed by the president. Local participation is provided through multicounty local development districts.

The ARC awards grants from funds appropriated to it annually by Congress. For FY 2016, approximately \$146 million was made available.[17] Grants are awarded to state and local agencies and governmental entities (such as economic development authorities), local governing boards (such as county councils), and not-for-profit organizations (such as schools and organizations that build low-cost housing). The ARC makes hundreds of investments a year, including in water and wastewater improvement projects, which is a key investment priority for the agency.

### **Other State Sources**

In addition to the required state match for SRFs and cooperation by states in the administration of the other federal programs described above, most states have established programs to support their municipalities in the improvement of their water assets, in particular given the economic, environmental and public health risks of water system degradation. This assistance typically takes the form of grants that fund upgrades or new facilities which have a strategic priority for the relevant state. These funds serve to complement the other available sources.

New facilities typically include significant state contributions, whether they are procured on a P3 basis or through traditional means. For example, in the Fargo-Moorhead (North Dakota/Minnesota) Flood Diversion P3 Project (Fargo Project), discussed further in part 2, a combined city-county authority is expected to fund periodic payments over time to the private developer through both traditional appropriations and existing city and county sales and use tax revenues.

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[1] Claudia Copeland, CONG. RESEARCH SERV., R43315, Water Infrastructure Financing: The Water

Infrastructure Finance and Innovation Act (WIFIA) Program (Feb. 9, 2016), at 1.

[2] American Water Works Association, Buried No Longer: Confronting America's Water Infrastructure Challenge, at 4, <http://www.awwa.org/Portals/0/files/legreg/documents/BuriedNoLonger.pdf>.

[3] The Senate's version of bill passed on a vote of 95-3. The full text of the Senate's bill can be found at [http://www.epw.senate.gov/public/\\_cache/files/3d509d03-6266-4cc7-b05c-894d4152eeaa/bills-114s2848es.pdf](http://www.epw.senate.gov/public/_cache/files/3d509d03-6266-4cc7-b05c-894d4152eeaa/bills-114s2848es.pdf). The House of Representatives' version of the bill passed on a vote of 399-25. The full text of the House's bill can be found at <https://www.congress.gov/114/bills/hr5303/BILLS-114hr5303rds.pdf>.

[4] Claudia Copeland, Steven Maguire & William J. Mallett, CONG. RESEARCH SERV., R42467, Legislative Options for Financing Water Infrastructure (June 1, 2016), at 1.

[5] *Id.* at 17.

[6] *Id.*

[7] See, e.g., Robert Puentes & Patrick Sabol, Building better infrastructure with better bonds, Brookings Report (Apr. 22, 2015), <https://www.brookings.edu/research/building-better-infrastructure-with-better-bonds/>.

[8] See Claudia Copeland, CONG. RESEARCH SERV., R48371, Funding for EPA Water Infrastructure: A Fact Sheet (June 19, 2015); Congress Trims SRF Funding in FY 2016 Plan; EPA Funding Remains Steady, Water Utility Infrastructure Management (Dec. 21, 2015), <http://uimonline.com/index/webapp-stories-action/id.1634/archive.yes/Issue.2015-12-01/title.congress-trims-srf-funding-in-fy2016-plan;-epa-funding-remains-steady>; Environmental Protection Agency, How the Drinking Water State Revolving Fund Works <https://www.epa.gov/drinkingwatersrf/how-drinking-water-state-revolving-fund-works#tab-1>.

[9] U.S. Department of Agriculture, Rural Utilities Services Water and Environmental Programs, Annual Progress Report, Fiscal Year 2015, at 6-7.

[10] Similar rural loan programs are administered by other not-for-profit organizations, including Communities Unlimited and the Rural Communities Assistance Corporation.

[11] U.S. Department of Agriculture, News Release, White House Rural Council Announces \$10 Billion Private Investment Fund to Finance Job-Creating Infrastructure Projects in Rural America (July 24, 2014), <http://www.usda.gov/wps/portal/usda/usdamediafb?contentid=2014/07/0158.xml&printable=true>; U.S. Department of Agriculture, News Release, USDA Announces First Private Sector Investments through U.S. Rural Infrastructure Opportunity Fund, <http://www.usda.gov/wps/portal/usda/usdahome?contentidonly=true&contentid=2015/07/0218.xml> (July 28, 2015).

[12] See CPD Appropriations Budget, [http://portal.hud.gov/hudportal/HUD?src=/program\\_offices/comm\\_planning/about/budget](http://portal.hud.gov/hudportal/HUD?src=/program_offices/comm_planning/about/budget).

[13] U.S. Senator Kirsten E. Gillibrand, A Guide to Water and Wastewater Funding Programs (2015), at 5; U.S. Department of Interior, Bureau of Reclamation, Title XVI Water Reclamation and Reuse,

<http://www.usbr.gov/watersmart/title/>.

[14] Gillibrand, *supra* note 13, at 4.

[15] *Id.* at 13.

[16] These states include West Virginia, New York, Pennsylvania, Ohio, Maryland, Kentucky, Virginia, North Carolina, Tennessee, South Carolina, Georgia, Alabama, and Mississippi.

[17] Appalachian Regional Commission, FY 2017 Performance Budget Justification (Feb. 2016), at 3, <https://www.arc.gov/images/newsroom/publications/fy2017budget/FY2017PerformanceBudgetFeb2016.pdf>.