Arbitrage Relief Would Increase Funds Available to Meet Critical Water and Sewer Funding Needs

Scope of Needs

A number of recent environmental financing studies have placed water and wastewater infrastructure costs at staggering levels outlining the critical importance of additional funding sources to meet these basic environmental needs. Both the Environmental Protection Agency (EPA) and the non-profit Water Infrastructure Network studies have identified the looming water and drinking water infrastructure funding gap at around $23 billion annually over the next 20 years.

State and local governments shoulder by far the most significant portion of public sector environmental infrastructure needs. For example, these governments have financed 87 per cent of water supply and wastewater capital investments since 1956. The ability of state and local governments to continue to shoulder this burden in the face of large and growing infrastructure funding needs will become increasingly difficult, particularly if consideration is given to water and sewer rate affordability.

The Board believes that the federal government should explore ways to help states and local governments bridge this funding gap. Recognizing the impediments that exist to establishing a trust fund structure with dedicated taxes or to increasing appropriations for environmental infrastructure, alternative approaches merit consideration. One such alternative would be to remove restrictions attached by the Internal Revenue Code to the management, investment and treatment of monies in existing, federally-funded state drinking water and wastewater infrastructure programs.

Arbitrage and Arbitrage Rebate Defined

The most important Internal Revenue Code restriction in question relating to municipal bonds involves a financial concept known as arbitrage. Arbitrage is the difference between the interest rates at which bond proceeds are borrowed and the interest rates at which the proceeds are invested. Positive arbitrage earnings occur when governments borrow funds at tax-exempt rates by issuing municipal bonds and then invest the funds received from the issues in higher earning taxable securities. Generally, the Internal Revenue Code requires that arbitrage earned on the investment of tax-exempt bond proceeds must be rebated or remitted to the federal government. The rebate is basically a 100 per cent tax on investment earnings that exceed an issue’s bond yield.

Arbitrage and the State Revolving Fund Programs

The Internal Revenue Code currently imposes the arbitrage earnings restrictions on the federal and state match dollars used to fund the Clean Water and Drinking Water State
Revolving Funds. Freedom from the restrictions would have a meaningful and immediate positive impact on funding for environmental projects. Since the federal government restricts the use of monies held in these public-purpose State Revolving Funds to the environmental uses authorized by federal statute, arbitrage earnings derived from the Funds could only be used for federally-authorized purposes. The result would be additional funding for environmental projects without any increase in dedicated federal funds or appropriations.

In particular, current Internal revenue Code restrictions affect three important areas of State Revolving Fund financial operations:

**Treatment of Reserve Funds.** Under current regulations, a State Revolving Fund which provides a 33 per cent subsidy to municipalities for undertaking environmental projects authorized under the Act would need to dedicate a $33 million debt service reserve fund to provide $100 million in project funds to municipal entities. The $33 million provides interest earnings which in effect serve to subsidize the loan to 67 per cent of the bond yield. Most, if not all, of these reserves are funded with federal grants and state matching funds, not bond proceeds. If the State Revolving Fund’s reserves were not subject to rebate, the same $33 million capital investment would yield $103 million in project funds while keeping the same level of subsidy in place.

**Advance Refundings.** Because of the treatment of federal capitalization grants and state matching funds under the Code, a State Revolving Fund may not be able to take advantage of advance refundings like other governmental purpose issuers. In a reserve fund model such as the one described above, a refunding would trigger a transfer of debt service reserves to the lower-yielding refunding issue. This transfer either eliminates or substantially reduces savings from the refinancing to the Fund and its borrowers by forcing a reduction in reserve fund earnings to the lower yield on the refunding bonds.

The foregone savings to State Revolving Funds and municipalities financing water and sewer improvements across the nation are significant and affect states as varied as New York, Connecticut, Massachusetts, Missouri, Michigan and Colorado. In this regard, New York’s Environmental Finance Corporation which manages the state’s Clean Water and Drinking Water Revolving Fund programs, has provided a case study report to EPA’s Office of Water outlining in detail the extent of the limitations imposed on advance refundings by the arbitrage provisions.

**Project Funds.** Similarly, under current regulations a State Revolving Fund that leverages its capitalization grants has to limit the amount of earnings its bond-funded loan accounts can earn to the yield on the bonds. If the Fund was able to earn as much as it could outside of the Code’s spenddown restrictions, less bonds would need to be issued to finance a like amount of project costs since interest earnings on project funds would be able to meet a greater share of loan demand.

**Benefits of Arbitrage Relief**
If one believes that the federal government should continue to assist states and local governments in addressing the funding challenges associated with essential water and sewer infrastructure investments so that water and sewer rates will remain affordable throughout the nation, the discussed amendments to the Internal Revenue Code make sense. From a federal budget perspective, the changes would make additional funding available immediately, accelerating infrastructure investment. Furthermore, this new leverage would be made available without a corresponding immediate impact on the federal budget. Of course, the federal government’s receipt of arbitrage rebate payments from the Clean Water and Drinking Water State Revolving Funds would fall over time.

**Rebate Numbers.** Some interested parties have examined the potential impact of lifting existing federal arbitrage restrictions on the Clean Water and Drinking Water State Revolving Fund programs. For example, the Council of Infrastructure Financing Authorities, the national trade association that represents most of the State Revolving Fund organizations (44 states, the District of Columbia, and the Commonwealth of Puerto Rico), has estimated that if arbitrage restrictions were lifted for the State Revolving Funds programs the states could earn an additional $100 - $200 million annually on their capitalization funds. The Council further estimates that these earnings, if leveraged, would permit an additional $200 - $400 million annual investment in badly needed water and sewer infrastructure projects.

EPA’s Office of Water (OW) has examined the impact of federal arbitrage restrictions on its Clean Water State Revolving Fund Program. OW has used its planning model to compare project disbursement figures by this Program under current arbitrage restrictions to possible disbursements in the absence of arbitrage restrictions. Using conservative assumptions, the comparison indicates that the states could generate significant additional dollars in project disbursements over time if the Internal Revenue Code’s arbitrage restrictions were lifted for the Clean Water State Revolving Fund Program.

**EFAB Recommendation**

The Board believes that states and local governments should continue to shoulder the principal burden of financing essential water and sewer infrastructure investments. However, the Board also believes that some federal support will be necessary if these governments are to continue in this role and assure that water and sewer rates remain affordable across the nation. To help achieve these goals, the Board strongly urges that EPA support amending the Internal Revenue Code to provide that monies contributed to the federally-created Clean Water and Drinking Water State Revolving Funds be freed from the arbitrage earnings restrictions. As noted earlier, any arbitrage earnings derived from the Funds could only be used for purposes authorized by the Clean Water and Safe Drinking Water Acts.