Something To Think About

Recent Changes To The Public Finance Market Provide Alternative Financing Solutions For Public/Private Partnerships

Opportunity

Amidst the economic crisis and ongoing, severe budgetary challenges, state and local governments face significant requirements to modernize all manner of facilities and vital infrastructure. To facilitate and incentivize the funding of these requirements through the Public Finance market and stimulate the economy, a variety of bond programs are available under the American Recovery & Reinvestment Act (ARRA) of 2009 and other recent legislation. The availability and marketability of these new programs and instruments, together with current low interest rates has resulted in historically low cost financing for state and local governments during a challenging capital market environment. ***Developers and/or state and local agencies who are active in public/private partnerships (PPP) should take note as these new programs and instruments, subject to specific requirements and restrictions, may potentially provide alternative financing solutions to allow state and local government PPP projects to move forward.***

Recent Changes To The Public Finance Market

In response to the recession and credit crunch, a number of new financing tools and incentives are available under the American Recovery & Reinvestment Act (ARRA) of 2009 for state and local governments, which are traditional issuers of tax-exempt bonds. A summary of a few of the more notable programs is provided below.

› **Build America Bonds (BABs)** - ARRA authorizes this new program which allows state and local governments to issue taxable bonds in 2009 and 2010 to finance any capital expenditures for which they otherwise could issue tax-exempt government bonds. Issuers can elect to issue either taxable tax-credit or tax-exempt bonds for governmental purposes. The taxable tax-credit bond option would allow issuers to either receive a 35 percent reimbursement of interest paid from the federal government (DIRECT PAYMENT) OR provide a 35 percent tax credit to investors (TAX CREDIT). In other words, the issuer benefits either indirectly (federal tax credit for investors) or directly (interest subsidy payments to Issuer). It should be noted that the cost of time to administer may be high and non-compliance with tax-exempt bond rules may be costly. No private activity (i.e., must be a governmental purpose) is allowed, and bonds must be issued by December 31, 2010. More than $150 billion of BABs are projected to be issued by the end of 2010. There is no limit on the amount of debt that may be issued.

› **Recovery Zone Bonds** – ARRA authorizes a new category of private activity bond that has been created for use in "recovery zones," which are designated areas with significant unemployment, poverty and home foreclosure rates. The bonds, which must be issued before January 1, 2011, would have to be used for economic development within a "recovery zone." States are allocated borrowing authority based on relative job loss in 2008. California's allocation, for example, may be in the range of $300 million. Authority within each state would be allocated among metropolitan areas and counties on a similar basis. There are two types of recovery zone bonds, which are briefly described below.

1. **Recovery Zone Economic Development Bonds (RZEDB)** – A taxable government bond to be issued for governmental purposes of promoting development or other economic activity including public infrastructure and construction of public facilities or job training and educational facilities. The issuer is the sole recipient of the Federal subsidy (a percentage of the interest cost); the issuer cannot choose to give the tax credit to the investor. The subsidy amounts to a refundable credit equal to 45 percent of interest costs. This program is similar in structure to the Direct Payment of BABs; however only $10 billion in bonds has been authorized for this purpose.

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2. **Recovery Zone Facility Bonds (RZFB)** – A new category of tax exempt facility bonds for the acquisition of property within a recovery zone for the use of a "qualified business." A qualified business is defined to include any trade or business except residential rental facilities or other specifically listed "bad projects," for example golf courses, massage parlors, and gambling facilities. Counties and large municipalities can issue these bonds for projects that are "for-profit" that would not historically qualify for tax-exempt financing; for example, large manufacturing plants, distribution centers, hotels, and research parks can be financed with these bonds. RZFBs may be issued for any depreciable property: (a) that was acquired after the date of designation of a recovery zone, (b) the original use of which occurs in the recovery zone; and, (c) substantially all of the use of the property is in the active conduct of a qualified business. The Recovery Act authorized $15 billion in bonds for this purpose.

› **Expansion of Tax-Credit Bond Programs** – Availability of tax-credit bond programs for state and local public agencies expanded significantly after passage of the Recovery Act. Under a tax-credit bond program, a public agency issues a taxable bond, and the investor receives a tax credit at a rate set by the Treasury. These programs are intended to provide an interest-free loan to the public agency issuer, since they are only responsible for paying the principal of the bond. In 2009, Congress amended the tax credit bond rules to permit tax credits to be sold separately from the related bond; a "stripping" provision would increase the benefits and marketability of tax credit bonds. These programs have typically been small and targeted for specific purposes, such as rebuilding after natural disasters like Hurricane Katrina. The Recovery Act increases annual allocation amounts and creates a new program, but these bonds also must be issued before January 1, 2011. The new and expanded programs are focused on education and energy including: Qualified School Construction Bonds, Qualified Zone Academy Bonds (QZABS), Clean Renewable Energy Bonds (CREBS), and Qualified Energy Conservation Bonds (QECBS).

› **Tax-Exempt Bond Program** – Industrial Development Bonds (IDBs) finance small-issue manufacturing. As a result of the Recovery Act, the definition of small-issue manufacturing has been expanded to include projects involving not only the manufacture or production of tangible personal property, but also the creation or production of intangible property, such as patents, trademarks, formulas and designs. Certain limitations and restrictions have been eliminated by the Recovery Act which will allow manufactures to broaden their projects to include warehouses, distribution facilities and testing facilities as well as assist high tech manufacturing businesses, such as software development and biologics. There is a state volume cap applicable to IDBs

In summary, among the many features and regulations of these various bond programs, perhaps the most important upfront distinctions to understand may be: (1) who can issue, (2) the types of projects permitted and (3) the tax credit features and/or federal tax treatment. Identified below are a few of the common elements to these new programs authorized under the ARRA.

› **Time Limitations & Volume Caps** – Depending on the specific program, authorization under ARRA is for a limited time (typically until January 1, 2011) with the intention of promoting economic recovery in the U.S. Access and volume allocation varies by state and specific program. Authorization under these programs may ultimately be extended by Congress beyond 2010.

› **Issuer-friendly –** A main objective of the various programs and tools authorized under ARRA is to assist and incentivize state and local government issuers with low cost financing via the public finance markets. The state decides which local entities are granted authority to issue bonds under these programs.

› **Primarily Governmental** – The various bond programs authorized under ARRA are primarily governmental in nature. This means that private activity rules apply and that permitted projects under each program must be carefully reviewed. Recovery Zone Facility Bonds are a notable example of a bond program which allows for qualified private activity.

› **Tax-Credit vs. Tax-Exempt** – Generally, these federal bond programs rely on either a tax- credit or tax-exempt structure to assist issuers/borrowers in financing capital projects at lower borrowing costs and incentivize investors.

The Congressional Budget Office estimates that 91% of spending will happen by the end of 2011. California's allocation under ARRA is estimated at $85 billion. However, this estimate may be aggressive as in reality state and local government entities may be slower to utilize allocations under these programs for a variety of reasons.

Tax-Exempt Bond vs. Interest Subsidy BAB - Example of Benefit to Issuers /Borrowers

A very simplistic illustration of the cost benefit in the form of interest savings to an issuer/borrower of an interest subsidy BAB versus a tax-exempt bond structure is provided below.

Tax-Exempt Bond	*Build America Bond (Interest Subsidy)*
Principal Amount = $1,000	Principal Amount = $1,000
Interest Rate = 5%	Interest Rate = 7%
Term – 20 years	Term – 20 years
Annual Interest Payments	Annual Interest Payments
Balloon Principal Payment	Balloon Principal Payment

Year	*Interest*	*Interest Subsidy*	*Net Interest Payments*
Year 1	$50	-	$50
Year 2	$50	-	$50
Year 3	$50	-	$50
Year 4	$50	-	$50
Years 5-20	$800	-	$800
Total	**$1,000**	**-**	**$1,000**

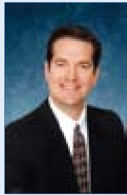
Year	*Interest*	*Interest Subsidy*	*Net Interest Payments*
Year 1	$70	$24.5	$45.5
Year 2	$70	$24.5	$45.5
Year 3	$70	$24.5	$45.5
Year 4	$70	$24.5	$45.5
Years 5-20	$1,120	$392	$728
Total	**$1,400**	**$490**	**$910**

This example shows the cost benefit to the issuer/borrower of an interest subsidy BAB versus a traditional tax-exempt bond in the form of reduced interest payments, albeit in a very simplistic manner. Of course there are other factors such as administrative costs, and compliance and structuring issues to consider before definitively determining if a BAB is the lowest cost option and optimal structure for financing a capital project.

In Summary

The Recovery Act provides a significant level of funding for projects across a variety of sectors to create jobs and improve the economy, especially in depressed areas. Direct funding is available for private activity and there are business opportunities for the private sector resulting from the government funding of public projects. However, time is of the essence as most of the funds are to be allocated and spent during 2009 and 2010, although extended authorization may be granted. Depending on the situation, these new bond programs and changes to existing tax-credit bond programs can be used to fund state and local infrastructure and facility requirements. Potentially, these programs can also be used as alternative financing solutions for projects accomplished through public-private partnerships.

For further information:



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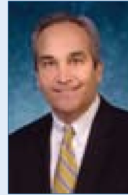

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