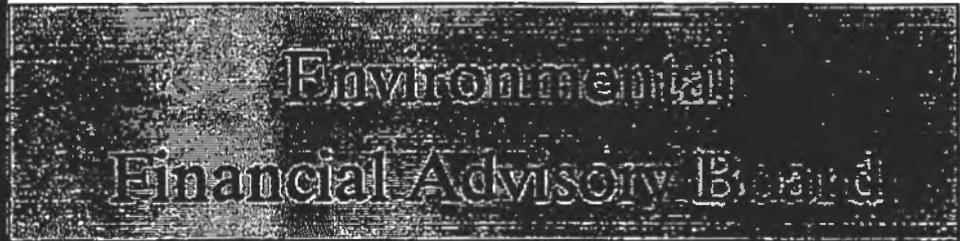


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Chair

**Richard B. Geltman**  
Vice Chair

**Herbert Barrack**  
Executive Director



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**IMPLEMENTING THE ENVIRONMENTAL  
FINANCE ASPECTS OF THE NORTH AMERICAN  
FREE TRADE AGREEMENT**

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This report has not been reviewed for approval by the U.S. Environmental Protection Agency; and hence, the views and opinions expressed in the report do not necessarily represent those of the Agency or any other agencies in the Federal Government.

**April 1994**

Printed on Recycled Paper

APR 29 1994

Honorable Carol M. Browner  
Administrator  
U.S. Environmental Protection Agency  
Washington, D.C. 20460

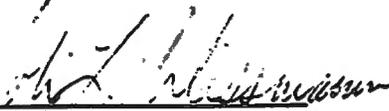
Dear Administrator Browner:

On behalf of the Environmental Financial Advisory Board (EFAB), we are very pleased to transmit to you the EFAB Report, "Implementing the Environmental Finance Aspects of the North American Free Trade Agreement." This report serves as a follow-up to a 1993 Board report on environmental financing along the U.S./Mexican border that we developed to support the negotiation and subsequent approval of NAFTA.

In this report the Board addresses specific finance activities to facilitate the implementation of the NAFTA side agreement for border environmental infrastructure. We believe that special purpose districts, either public or private, should be created in Mexico to deliver environmental infrastructure services, and that the financing of such districts be based on user fees, to the greatest extent possible. The districts will need realistic and sound credit criteria to evaluate the financing of projects. The private sector should be encouraged to participate in paying for projects along the border, including leveraging government funds appropriated for such projects. Furthermore, we suggest in the Report that electric utility billing systems be considered as a viable means to collect user charges for the water and wastewater services.

The above recommendations are particularly timely in assisting the current binational efforts, i.e. the Border Environmental Cooperation Commission (BECC) and the North American Development Bank (NADBank), to create and maintain a quality environment along the border. The Board offers its assistance to the Administrator in your capacities as a director of the BECC and of the NADBank, including the creation of credit standards for project funding and the review of individual project funding applications. We are available at your convenience to discuss this report and to provide any further analyses you may require.

Sincerely,

  
Robin L. Wiessmann  
Chair, Environmental  
Financial Advisory Board

  
Herbert Barrack  
Executive Director, Environmental  
Financial Advisory Board

**Report of the  
Environmental Financial Advisory Board  
of the  
United States Environmental Protection Agency**

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**Implementing the Environmental Finance Aspects  
of the  
North American Free Trade Agreement**

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In 1992, the Board approved a report ("the 1992 Report") of the International Committee ("the Committee") to the Administrator regarding the financing of environmental infrastructure along the Mexican Border. The 1992 Report was intended to assist the Administrator in her efforts in support of the negotiation and approval of the North American Free Trade Agreement ("the NAFTA" or "the Agreement").

Subsequently, the NAFTA was, in fact, approved by the governments of the United States and Mexico. In its final form, the NAFTA contains a separate side agreement which addresses the financing of environmental infrastructure along the border. The side agreement creates a financing mechanism which is to be funded at a level of \$450,000,000 with an additional \$2,550,000,000 of call capital. If these funds can be leveraged at only a 2:1 ratio, there will be over \$6,000,000,000 available for environmental infrastructure projects along the border. At a 3:1 leverage ratio, there would be over \$9,000,000,000 available. Since official estimates of financing needs are in the \$5 - 7 billion range, this means that the projected funding should be more than adequate to meet all of the environmental infrastructure needs contemplated by the NAFTA. This is an event of truly historic significance in

the international effort to create and maintain a quality environment on a global basis.

Now that the NAFTA has been duly approved, the Committee resolved to issue a follow-up report dealing with the environmental finance issues in the NAFTA.

This report has two sections. The first section reviews the events concerning the NAFTA between the two reports. The second section contains six recommendations to the Administrator in terms of the role she will play in the implementation of the NAFTA.

The six recommendations are:

- \* That special purpose districts, either public or private, be created in Mexico to deliver environmental infrastructure services.

- \* That the financing of such districts be based, to the greatest extent possible, on user fees.

- \* That the user fees charged for water and wastewater services be integrated into the electric utility billing and collection system, to the end that non-payment of any of the three user charges would be grounds for the termination of electrical service to the non-paying customer.

- \* That, to the greatest extent possible, the resources of the private sector be used to pay for environmental infrastructure projects along the border.

- \* That, in determining the role of the private sector in the effort to build environmental infrastructure along the border, the utmost consideration be given to private sector means of leveraging the funds of the governments of the United States and Mexico appropriated for such purposes.

\* That the first order of business in financing environmental infrastructure along the border should be to create realistic and sound credit criteria for the financing of projects on behalf of special purpose districts.

In addition to the six recommendations, the Committee also offers its services to the Administrator to assist her in the creation of realistic and sound credit criteria and for the evaluation of individual funding applications for environmental infrastructure projects along the Mexican border.

## SECTION ONE

The 1992 Report, after having been referred to the Administrator, became one of many resource documents for an intergovernmental group formed by Dr. Alice M. Rivlin, Deputy Director of the Office of Management and Budget, under the leadership of Jeffrey R. Schafer, Assistant Secretary of the Treasury for International Affairs, to advise the Administration on the environmental finance aspects of its negotiations with the Government of Mexico on the NAFTA.

The NAFTA negotiations were successfully concluded and the Agreement was signed by the Presidents of the United States and Mexico. The President of the United States then submitted the Agreement to the Congress for ratification. On November 17, 1993, the U.S. House of Representatives voted to approve the Agreement. Anticipating a favorable vote, as well, in the United States Senate (which, in fact, occurred on November 20, 1993), the Committee convened in Washington, D.C., on November 19, 1993, to formulate advice to the Administrator on the implementation of the environmental finance aspects of the Agreement.

At its meeting, the Committee heard presentations from Jonathan Z. Cannon, Assistant Administrator for Administration and Resource Management of the U.S. Environmental Protection Agency (USEPA); Dr. John E. Petersen, President of the Government Finance Group, Inc.; Congressman Jim Kolbe of Arizona; Jeffrey R. Schafer, Assistant Secretary of the Treasury for

International Affairs; Congressman E. (Kika) DeLaGarza of Texas, Chairman of the House Agriculture Committee; Mario Aguilar, General Representative of the Secretariat for Social Development (SEDESOL) of the Government of Mexico; Lynn Fischer, Policy Analyst, Natural Resources Defense Council; and Lawrence I. Sperling, Senior Attorney-Advisor, International Enforcement Program, Office of Enforcement, USEPA.

## SECTION TWO

The Committee has reviewed the Agreement and makes a series of observations and recommendations to the Administrator concerning the implementation of the environmental finance aspects of the accords.

The Committee notes that under the NAFTA, the responsibility for financing environmental infrastructure pursuant to the Agreement was divided between two new binational agencies, the Border Environmental Cooperation Commission (BECC) and the North American Development Bank (NADBank).

The Agreement envisions the BECC as an agency whose responsibility it is to work with communities to generate needed environmental infrastructure projects. The BECC's role will then be to coordinate the planning and financing of these projects and then to "certify" them for funding to the NADBank. The BECC will have a ten-member binational board of directors on which the Administrator will serve. The BECC will be required to consult with an 18-member Advisory Council, of which nine members will come from each country.

The NADBank will be capitalized with \$225,000,000 of cash each from the United States and Mexico, with an additional \$1,275,000,000 of callable capital from each. Ninety percent of the banks funds will be used to finance environmental infrastructure projects. The stated purpose of the NADBank is to fund, "as appropriate", projects "certified" by the BECC. The NADBank is to have a six-member board, three from each country. It is expected that the

Administrator will serve as one of the U.S. directors of the NADBank. In addition, for the purposes of loans or guaranties certified by the BECC, it is also expected that the U.S. representatives to the NADBank will be instructed in accordance with the procedures of the National Advisory Committee on International Monetary and Financial Policies, as established by Executive Order Number 11269 of February 14, 1966, and that for these purposes the Administrator shall also be a member of National Advisory Committee.

The Committee also cites what it feels are two of the most important preambulatory clauses to the Agreement. The first affirmed "that, to the extent practicable, environmental infrastructure projects should be financed by the private sector, . . . ". The second affirmed "that, to the extent practicable, environmental infrastructure projects in the border region should be operated and maintained through user fees paid by polluters and those who benefit from the projects, and should be subject to local or private control".

In the 1992 Report, the Committee recommended that the financing of environmental projects along the border, to the greatest extent possible, be based on user fees. It also recommended that sub-sovereign finance mechanisms based on user districts be created as the instrumentalities to finance such projects. The Committee notes that the preamble to the Agreement calls for both user fee financing and the utmost local control. In this regard, the Committee, therefore, recommends:

- 1) That the BECC encourage the creation of special purpose districts (or corporations in the case of private ownership) as the sub-sovereign finance mechanisms by which environmental infrastructure projects are financed through the NADBank; and,

- 2) That, to the greatest extent possible, user fees be the financial basis of such districts.

At the November 19, meeting, the Committee noted the observations of Dr. Petersen that there appeared to be an active and widespread tradition of billing and collection for electric power in Mexico along the border area. Dr.

Petersen also noted that under Mexican law, the penalty for non-payment of electricity bills is termination of service; whereas it is not possible to terminate water service for non-payment.

The Committee also noted that in areas along the border with neither water nor sewer service there was little or no tradition of paying for sewerage and that payments for potable water were often made to random vendors on a daily basis.

Therefore, in order to assure a solid financial base for newly created special purpose districts, the Committee recommends:

3) That the user fees charged for water and wastewater services be integrated into the electric utility billing and collection system, to the end that non-payment of any of the three user charges would be grounds for the termination of electrical service to the non-paying customer.

Next, the Committee notes that both the 1992 Report and the preamble to the Agreement call for the involvement of the private sector as far as is feasible. The Committee, therefore, reiterates its recommendation:

4) That, to the greatest extent possible, the resources of the private sector be used to pay for environmental infrastructure projects along the border.

In this regard, the Committee noted that the NADBank is capitalized with \$450,000,000 of cash and \$2,550,000,000 of callable capital. In accord with the 1992 Report, and in order to achieve the maximum leverage of the paid-in capital and the lowest probability that the callable capital will ever, in fact, need to be called, the Committee recommends:

5) That the utmost consideration be given to private sector means of leveraging the funds of the governments of the United States and Mexico appropriated to the NADBank through the use of private financial guaranty insurance or of supplemental private capital.

The Committee noted most importantly that if the capital of the NADBank can be leveraged at a 3:1 or even 2:1 ratio, there should be more than enough funds available to meet all of the estimated \$5 - 7 billion of environmental infrastructure needs along the border. This would be an event of truly historic significance not only for the United States and Mexico, but also for the entire international effort to improve environmental quality. It is therefore imperative that the NADBank have a sound overall financial structure and that each individual loan be made on a financially sound basis as well.

Finally, the Committee observes that although the BECC is, on the one hand, required to "certify" projects to the NADBank, the NADBank is, on the other hand, only required to fund such projects "as appropriate".

The Committee noted several instances where there were organizations where the loan origination function was not well coordinated with the loan approval function. When this happens there can be grave problems. In a business context such problems can be readily dealt with and minimized. But, the NAFTA is a major political issue, as are the environmental problems on the border. The BECC and the NADBank were created for one purpose only: to provide a financial solution to these problems. The public will have high expectations that the BECC/NADBank will, in fact, solve many of the problems.

Therefore, if there is any conflict between the credit criteria of the BECC and the credit criteria of the NADBank, then there could be very serious political repercussions that will not be easy to resolve. This is especially significant since the Administrator will serve as a director of both the BECC and the NADBank, and will be a member of the National Advisory Committee which instructs the U.S. directors of the NADBank with respect to their votes on individual projects, as well. The Committee recommends, therefore, that these matters be addressed before they become problems. Therefore, in order to assure a smooth working relationship between the two agencies, the first order of business should be the development of realistic and sound credit criteria which the BECC, the NADBank and the NAC all agree on before these criteria are promulgated in final form to the public.

Furthermore, it is in the interests of all that such criteria be designed in such a way as to allow the maximum leveraging of the NADBank's funds. In this way, the maximum dollar value of environmental projects will be able to be financed and the maximum environmental amelioration will ensue, given the finite resources of the NADBank.

To this end, the Committee recommends:

6) That, as its first order of business, the BECC should create realistic and sound credit criteria for the financing of projects on behalf of special purpose districts in order to allow the greatest dollar amount of environmental improvement projects to be funded by leveraging the finite financial resources of the NADBank.

In making the above recommendations to the Administrator, especially the recommendation concerning the creation of realistic and sound credit criteria for NADBank loans, the Committee offers its assistance to the Administrator, in conjunction with the Environmental Finance Center at the University of New Mexico, to advise her on her work as a director of the BECC, including the creation of credit standards for project funding and the review of individual credit applications, and on her work in reviewing individual project funding applications as a director of the NADBank and a member of the National Advisory Committee, and for any further or continuing efforts she may require in this regard.

\* \* \* \* \*

In conclusion, the Committee believes that the NAFTA is one of the most important milestones of economic progress for the entire Western Hemisphere in the Twentieth Century. It also believes that the environmental finance aspects of the Agreement, if properly implemented, will ensure that the border area will enjoy a legacy of vastly improving environmental quality. Therefore, the Committee offers the above recommendations as part its continuing effort to assist in the implementation of the Agreement and to bring the benefits of quality environmental infrastructure to the border area.