

**UNITED STATES ENVIRONMENTAL PROTECTION AGENCY  
ENVIRONMENTAL FINANCIAL ADVISORY BOARD**

**SEP 28 2001**

Honorable Christine Todd Whitman  
Administrator  
U. S. Environmental Protection Agency  
Washington, D.C. 20460-0001

Dear Administrator Whitman:

We are pleased to provide you the latest report of the Environmental Financial Advisory Board (EFAB), "*Arbitrage Relief Would Increase Funds Available to Meet Critical Water and Sewer Funding Needs.*" Its principal author is Sonia Toledo, Managing Director, Public Finance Department, Lehman Brothers. Ms. Toledo is chair of EFAB's Public Finance Workgroup.

Recent environmental financing studies have found that the nation faces significant and growing water and wastewater infrastructure costs. State and local governments shoulder by far the largest portion of this infrastructure burden. EFAB believes the federal government should explore ways to help these governments address this funding challenge. One way would be to remove federal restrictions to the efficient management, investment and operations of federally-funded drinking water and wastewater infrastructure programs.

In that regard, the enclosed report examines the idea of removing Internal Revenue Code arbitrage restrictions on the federal and state dollars used to fund the Clean Water and Drinking Water State Revolving Funds. Arbitrage is the difference between the interest rates at which bond proceeds are borrowed and the interest rates at which they are invested. Generally, the Internal Revenue Code requires that arbitrage earned on the investment of tax-exempt bond proceeds be rebated to the federal government.

Freedom from arbitrage restrictions would have a significant, positive impact on funding for these public-purpose State Revolving Funds. Further, since federal statute controls the use of monies held in the Funds, any arbitrage earnings could only be used for authorized environmental purposes. From a federal budget perspective, the change would make additional funding available immediately without a corresponding immediate budgetary impact. Of course, federal receipts of arbitrage rebate payments from the State Revolving Funds would fall over time.

In a broader sense, we believe that the consideration of tax and financial issues such as the Internal Revenue Code's arbitrage rebate restrictions have long been, and continue to be, of considerable importance to EPA and its programs. In this regard, we suggest that you consider naming a senior Agency headquarters official with financial expertise as a permanent liaison with the Department of the Treasury. Such an individual could meet regularly with Treasury and Internal Revenue Service officials to communicate and represent EPA's interests across all of its environmental programs.

We hope that you will find the report and our suggestions constructive and useful. The Board is prepared to discuss its findings and recommendations, and to take any follow-up actions that are consistent with its charter. If you or your staff have questions regarding the report, or would like to arrange a meeting, please let us know. We greatly appreciate the continuing opportunity to serve the Agency.

Sincerely,



Robert O. Lenna  
Chair



A. Stanley Meiburg  
Executive Director

Enclosure

cc: Linda Fisher, Deputy Administrator  
Tracy Mehan, Assistant Administrator for Water  
Michael W. S. Ryan, Deputy Chief Financial Officer  
Joseph L. Dillon, Comptroller

# Environmental Financial Advisory Board

## EFAB

Robert Lenna  
Chair

A. Stanley Meiburg  
Executive Director

## Members

Hon. Pete Domenici  
Terry Agriss  
George Brewster  
George Butcher  
Pete Butkus  
Michael Curley  
Michael Deane  
Michael Finnegan  
Evan Henry  
Anne Pendergrass Hill  
Martin Kamarck  
Stephen Mahfood  
Langdon Marsh  
John McCarthy  
George Raftelis  
Arthur Ray  
Andrew Sawyers  
James Smith  
Sonia Toledo  
Jim Tozzi  
Billy Turner  
Mary Ellen Whitworth  
Joseph Young

---

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

---

### FINAL REPORT

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.

*September 2001*

*Printed on Recycled Paper*

# **UNITED STATES ENVIRONMENTAL PROTECTION AGENCY ENVIRONMENTAL FINANCIAL ADVISORY BOARD**

## ***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 **B** 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 Funds' 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.



UNITED STATES ENVIRONMENTAL PROTECTION AGENCY  
WASHINGTON, D.C. 20460

NOV 16 2001

OFFICE OF  
WATER

Mr. A. Stanley Meiburg  
Executive Director  
Environmental Financial Advisory Board  
U.S. Environmental Protection Agency  
Region IV  
61 Forsyth Street, S.W.  
Atlanta, Georgia 30303-3104

Dear Mr. Meiburg:

Thank you for your letter of October 5, 2001, transmitting the Environmental Financial Advisory Board's (EFAB) latest advisory report, "*Arbitrage Relief Would Increase Funds Available to Meet Critical Water and Sewer Funding Needs*" (report number EPA-EFAB-PF-01-03). Administrator Whitman asked me to reply to your letter and provide you with comments on the report.

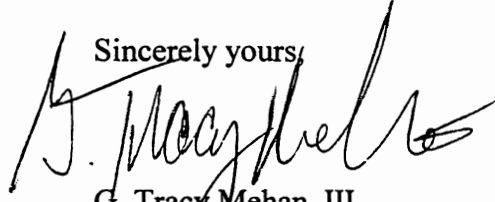
As you know, the Agency has undertaken a review of future water and wastewater needs and current infrastructure investment. The Administrator has identified infrastructure as one of her priorities and is committed to fostering a dialogue with stakeholders over the best approaches to maintaining critical infrastructure services.

The Board's recommendations concerning arbitrage restrictions are a timely addition to the discussion the Agency would like to have with its stakeholders and Congress about the appropriate roles for Federal, State, and local governments, and the private sector in addressing the Nation's infrastructure needs. In reviewing the Board's recommendations, we agree that the Drinking Water and Clean Water State Revolving Fund programs potentially could accrue substantial benefits by lifting the arbitrage restrictions for drinking water and wastewater infrastructure investment.

As you are aware, statutory and regulatory authority for the application and interpretation of arbitrage requirements falls under the jurisdiction of the Department of Treasury. As such, we encourage you to advise Treasury of your concerns and recommendations for changes in the requirements applicable to water infrastructure investment. We would also like to offer to participate with you in any of these discussions.

Again, thank you for your suggestions and your commitment to working with the Agency to find innovative financing solutions. We look forward to working with you on this matter. If you have further questions, please feel free to contact me or call Michael B. Cook, Director, Office of Wastewater Management, at (202) 564-0748.

Sincerely yours,



G. Tracy Mehan, III  
Assistant Administrator