Show Me the Money: Tools for Financing Infrastructure

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MEMORANDUM

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Show Me the Money: Tools for Financing Infrastructure

Contracting, Financing and Risk Considerations

Historically, public infrastructure projects such as potable water and sanitary sewer facilities were financed by localities through the issuance of public debt (i.e. debt that was backed by the full faith and credit and taxing power of the issuing municipality). In certain cases, when the proposed facilities would serve only a portion of a municipality, the properties served or benefited by the facility would be deemed as located within a special improvement district. The capital and operating costs of the facility would be paid by the property owners within that district, although the debt issued by the municipality to finance the construction and the equipping of the facility, would ultimately remain the general obligation of that municipality.

As the legal and regulatory requirements applicable to facilities of these kinds grew in scope and complexity, and construction costs rose generally, the ability of increasingly cash-strapped localities to finance needed facility upgrades, or new construction, and pass those costs along to its residents, grew increasingly problematic. Some municipalities looked to regional solutions, partnering with neighboring localities in constructing, operating and financing facilities that would serve a larger geographic region and, thus, achieve economies of scale. In other instances, where specific economic development projects and initiatives proved dependent upon the upgrading of existing, or the construction of new, facilities, localities looked to new legal or financial structures, including public/private partnerships ("PPP") in which the public and private sectors share in some ways in the costs, benefits, and potentially the risks of such undertakings.

The Historical Means of Facility Financing

As noted previously, public infrastructure projects have been—and largely continue to be—financed through the issuance of so-called general obligation debt, or "G.O. debt" (tax-exempt or taxable). This debt can take the form of short-term notes and/or long-term bonds. In either event, the debt is backed by the full faith and credit, and the general taxing power, of the issuing municipality. In the case of a special improvement district, the municipality would issue the debt on behalf of its improvement district to finance design, construction, and equipping of the facility. The facility could be self-operated with the municipality's labor force or, alternatively, by a private operator under contract.

G.O. debt has certain benefits. It is readily recognized and accepted in the market place as "plain vanilla" municipal debt. Transactional costs of financing are relatively nominal. G.O. debt generally enjoys lower interest rates because it is backed by the full faith and credit/taxing power of municipalities. Payment of debt service is not dependent upon market factors and, in New

York, if the debt is issued on behalf of a special district, the debt is excludable from calculation of the municipality's legal debt limit.

However, G.O. debt does not go far toward achieving one of the goals of "public/private partnerships", i.e. the allocation of risk. By its very nature, G.O. debt is overwhelmingly "public" in nature, minimizing the "private" aspect of any such transaction. It places most, if not all, of the financing burden (and potentially the operational risk) on the municipality's taxpayers. Moreover, in New York, municipalities have less flexibility under applicable law in structuring the financing to accommodate the requirements of a particular transaction.

Some Alternative Financing Structures

Issuance of Tax-Exempt Private Activity Bonds: One available alternative financing structure would utilize an existing, or to-be-formed, local development corporation (the "LDC") to finance construction of the proposed facility as a qualified tax-exempt private activity bond under the Internal Revenue Code (the "IRC"). In that instance, the municipality would enter in a ground lease and contract with the LDC to acquire, design, construct, equip, manage, and operate the facility. The LDC as an "on behalf" issuer, would issue bonds to finance the design and construction of the facility. The LDC would then enter into a contract with a private developer to design, construct, equip, manage, and operate facility. Payments from the developer to the LDC would be set designed to cover debt service on the bonds.

The utilization of private activity bonds is generally more consistent in structure and spirit with the PPP concept. The burden and risks of financing and operations, at least initially, rests principally on the private developer/operator. The debt of the LDC is not legally the debt of the underlying municipality and, therefore, the municipality's credit may not be at risk to cover the debt service on the financing. Finally, such debt is free of many of the restrictions applicable under state law to the structuring of G.O. debt, thus affording greater flexibility to meet market realities.

Private activity bonds, however, have certain risks and drawbacks attendant to them. They require volume cap allocation under the IRC. This method of financing almost always involves higher up-front transactional costs (more players—more transactional complexities). Interest rate on this form of debt can be higher, reflective of the credit, technological and/or operational risks associated with the project (translating, in turn, into higher operational costs, tipping fees, electric rates, etc.). Development costs associated with planning and construction may also prove to be higher (e.g. surety bond requirements; independent construction management/engineering costs). In the end, the municipality may not be entirely free of project and financing risks as the market may require that it provide some assurances or "guaranties" such as flow-control or "take or pay".

Tuxedo Farms Project: The Tuxedo Farms Project (the "Project") consisted of the construction of a wastewater treatment plant (the "WWTP") and related piping and pump stations (the "Improvements") in the Town of Tuxedo, New York (the "Town"). The WWTP provides sewer service to two districts within the Town (the "Districts"). In order to finance the construction of the WWTP and the Improvements, the Tuxedo Farms Local Development Corporation (the

"Issuer") issued $30,000,000 in Tuxedo Farms Local Development Corporation Revenue Bonds (Tuxedo Farms Project), Series 2015 (the "Bonds"). The revenue stream to pay debt service on the Bonds are Service Fees payable under the Sewer Service Agreement. The Service Fees are comprised of special assessments, which are subject to annual appropriation by the Town Board, levied on and collected from property owners within the Districts. The Town's obligation to pay Service Fees cannot exceed, in any Town fiscal year, the amount it will have collected from the special assessments lawfully levied therefor.

The structure implemented to finance the Project had not previously been utilized in New York State. This structure was advantageous for several reasons: (1) the Town was not required to incur any indebtedness; (2) the Project was financed at low cost tax-exempt rates; (3) the Town is not liable for the debt of the Issuer; and (4) the cost of the Project will be borne only by the parcels benefited within the Districts.

The WWTP was constructed on land owned by the Town and leased to the Issuer pursuant to the terms of a 99 year ground lease. The Issuer, the Town (on its behalf and on behalf of the Districts), Tuxedo Reserve Owner LLC (the "Developer") and the Tuxedo Sewer-Works Corp. (the "SW Corp") entered into a Sewer Services Agreement (the "Sewer Services Agreement"), pursuant to which the Issuer is obligated to operate and maintain the WWTP to serve the District. The Issuer, the Developer and the SW Corp entered into a Sewer Construction and Funding Agreement (the "Sewer Funding Agreement"), pursuant to which the SW Corp and the Developer are obligated, on behalf of the Issuer, to construct and equip the WWTP to serve the Districts. The WWTP and the Improvements are owned by the Issuer and not the Town.

The structure utilized the Issuer, a local development corporation established by the Town pursuant to Section 1411 of the Not-For-Profit Corporation Law, to issue the Bonds to finance the costs of the Project, pursuant to the terms of the Trust Indenture (the "Indenture"), by and between the Issuer and Wilmington Trust, National Association, as trustee (the "Trustee"). The powers of the Issuer are exercised by the board of directors. All directors are appointed by the Town by its Town Supervisor, ex officio, in its capacity as the member of the Issuer.

The Issuer retained MuniCap, Inc. (the "Administrator") to assist the Issuer with the performance of its responsibilities under the Indenture and the Sewer Services Agreement. The Administrator's services include, but are not limited to: (i) the determination and calculation of the annual special assessments pursuant to the Rate and Method (as hereinafter defined) and reporting such amounts to the Town, the Issuer, and the Trustee with a request to the Town to collect such special assessments; and (ii) the preparation of an annual report for submission to the Issuer containing a budget showing all Service Fees collected or to be collected and an explanation of the methodology employed to calculate the amount of special assessments to be levied by the Town.

The SW Corp is wholly owned by the Developer and was established by the Developer to be the licensed operator of the WWTP. The SW Corp is responsible for the operation and maintenance of the WWTP in accordance with the Sewer Services Agreement and may, upon the consent of the Issuer and the Town, engage a third-party operator of the WWTP; provided, however, such operator must be licensed in New York State and currently operate sewerage facilities similar in size and capacity as the WWTP.

Pursuant to the Sewer Services Agreement, the Issuer provides the Town, on behalf of the Districts, and the Town, on behalf of the Districts, accepts and pays for, sewer service. Under the Sewer Services Agreement, the Town is obligated to impose special assessments on property within the Districts in an amount sufficient to pay the Issuer for sewer service ("Service Fees"). The amount of special assessments to be levied against each parcel in the Districts, subject to the applicable provisions of the Town Law, is determined pursuant to the Rate and Method of Apportionment of Special Assessments (the "Rate and Method") prepared by the Administrator.

The term of the Sewer Services Agreement is the period commencing on the date of delivery of the Bonds and terminating on the earlier of: (a) the date of maturity of the Bonds, or (b) the date on which the Bonds are paid or provision for the payment thereof has been made as provided in the Indenture; provided, however, with respect to the agreements contained within the Sewer Services Agreement between the Town and the SW Corp, the term will not exceed 10 years, not including any renewals entered into, in accordance with Section 121 of the New York State Transportation Corporation Law.

Pursuant to the Sewer Funding Agreement, the Developer and SW Corp agreed with the Issuer and the Town to design and construct the WWTP. The Sewer Funding Agreement provides for the proceeds of the Bonds to be held by the Trustee under the Indenture and disbursed to the Developer or the SW Corp pursuant to a requisition procedure to pay costs of the WWTP. Under the Sewer Funding Agreement, the Issuer is obligated to fund the construction of the WWTP and Improvements solely from the proceeds of Bonds and any additional bonds that may be issued for such purpose. In the event the proceeds of the Bonds and any additional bonds are not sufficient to complete the WWTP and Improvements, the Developer is required to provide additional funding required for completion.

PILOT Increment Financing: A second municipal/self-financing tool is PILOT Increment Financing ("PIF"), which, in conjunction with revenue bond proceeds, can be used to fund public infrastructure improvements. PIFs allow local governments to create tax increment financing ("TIF") like districts and apply a portion of the proceeds of the PILOT Agreement negotiated with the developer to fund capital improvements related to the project. A PIF Agreement uses some or all of the future revenue from a development over a set term. PIFs, unlike TIFs, are useful because they create fixed dollar payments aimed at eliminating underwriting uncertainty. Taxing jurisdictions do not lose any current tax revenues and often share a portion of future revenues from the development while the developer waives his grievance rights. In sum, PIF financing creates a partnership among tax jurisdictions and private entities to foster economic development and growth in tax base.

The first step is determining the percentage of future revenues ("increment") needed to fund the costs of the public infrastructure project. Next, a formula is devised to determine: (1) the current base payments; (2) the amount of future revenues generated by the development; and (3) the amount needed for PIF debt servicing. Lastly, the project must secure affected tax jurisdiction approval to fund the PIF improvements and establish a fixed dollar PILOT with a PILOT Mortgage to secure those payments.

Garvies Point: The main focus of this project was the reclamation and transformation of 56 waterfront acres into 1,110 condominiums and apartments, public parks, marinas, piers,

restaurants, stores and offices, creating a mixed-use area for residents and visitors. The Glen Cove IDA and Local Economic Assistance Corp. approved a $283 million dollar bond to fund the parks, esplanade, marinas, road construction and other public amenities. The money used to service the debt comes from an estimated $615 million dollars in PILOT payments that RXR and condominium owners will pay over 40 years, with 46% of the revenue set aside to address bond debt service and the remaining 54% allocated between the City of Glen Cove, the Glen Cove City School District, Glen Cove Library and Nassau County. In addition, the rental building development sites will generate an additional $190 million dollars of revenue for 20 years from issuance of certificates of occupancy before returning to the non-exempt side of the tax roll. To appreciate the scale of the partial real property tax abatement, full property tax revenue over 40 years would have been $1.05 billion while the revenue from the PILOTs and rental building is projected at $805 million. That equates to a tax savings of approximately $245 million dollars. This Project would not have been economically viable if it were not for the PIF since the site was contaminated vacant land, which realized no tax revenue for decades.

<u>Energy Performance Based Contracting</u>**:** Under an Energy Performance Contract ("EPC"), an Energy Service Company ("ESCO") agrees to perform a variety of measures to reduce energy expenses and share the costs and savings with the local government**.** Payments are based in some fashion on the level of savings achieved. The EPC is a performance-based design/build contract, whereby the selected vendor will deliver a project scope of work detailed in the EPC. In many contracts the selected vendor can finance the project at a guaranteed fixed price with an annual operating expense that is guaranteed by the contractor. Under the EPC, the vendor must pay the County the difference between the energy savings realized and the actual cost of financing the project for the period that positive savings are not realized.

The EPC affords a number of potential benefits, particularly toward achieving the allocation or diminution of risks that municipalities seek in PPP arrangements. It generally requires little or no upfront expenditures required by the municipal government and overcomes the lack of local resources. It provides consolidation of responsibility for project development, implementation, maintenance, and monitoring (along with performance guarantees) with a single contractor. It can result in accelerated project implementation and provides increased incentives for persistence of savings. The risk of performance is transferred to the vendor. Access is afforded to specialized private-sector expertise to energy efficiency and renewable energy expertise and equipment. Finally, it allows for various financing options – private lease financing, municipal bonds and other low interest loans or grants such as those available through New York State Energy Research Development Authority.

The EPC does, however, place the municipality's credit, or the taxpayers, at risk to cover the debt service on the financing even with the non-appropriation language that must be included in a lease financing arrangement when it is used as the financing method. In addition, the infrastructure project will depend on the financial strength and long term viability of the selected contractor.

<u>NYS Environmental Facilities Clean Water State Revolving Loan Fund (NYSEFC CWSRF) Low Interest Loan Program</u>**:** The NYSEFC CWSRF provides low-interest rate short and long-term financing to municipalities to construct water quality protection projects. Funding is

available for both municipal-owned, conventionally designed, built and operated projects and energy performance contract financings. For eligible municipal entities, short-term loans of up to three (3) years and long-term fixed rate subsidized leveraged financings of up to thirty (30) years are available to complete the project financing. For projects eligible for the subsidy, NYSEFC offers subsidized rates for short-term loans and a fifty percent (50%) interest rate subsidy of the long-term leveraged financings. The market rate for leveraged financings is based upon the True Interest Cost of the New Money Recipients financed over thirty (30) years.

The NYSEFC CWSRF realizes lower interest rates by virtue of NYSEFC's AAA bond rating and the 50% interest rate subsidy. The amortization period on debt under the program may be longer (up to 30 years) than what might be acceptable under other forms of financing. The debt incurred by the municipality is excludable from calculation of its legal debt limit and the program can be combined with an EPC resulting in the positive benefits associated with the EPC financing arrangement.

The NYSEFC CWSRF program does, however, offer less flexibility in structuring financing transactions by virtue of limitations under the New York Local Finance Law, New York General Municipal Law and NYSEFC program requirements. As in the case of G.O. debt, it will require that the municipality maintain some property interest (fee title or leasehold) in the facility at all times while its debt is outstanding. Participation in the program will also result in slightly higher development costs associated with fulfilling NYSEFC requirements (MBE/WBE requirements, loan administration costs, etc.).