Energy Services Coalition (ESC)

Biggest Bang for the Buck Leveraging Funds

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Build America Bonds and Alternative Financing Structures

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Build America Bonds and Alternative Financing Structures

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Overview of the Build America Bond Program

- The American Recovery and Reinvestment Act of 2009 (the "Act") creates two types of tax advantaged municipal securities known as Build America Bonds ("BABS").

  Issuer Subsidy BABS. Municipal issuers can sell taxable BABS and receive a subsidy directly from Treasury equal to 35% of the interest on the bonds.

  Investor Subsidy BABS. Alternatively, municipal issuers can sell taxable BABS and the investor receives a tax credit equal to 35% of the interest received. Since the tax credit is transferable, the investor is permitted to sell the credit to a third party.

Structuring Considerations

The Act provides significant debt structuring flexibility and places no restrictions on size, amortization, maturity, coupon type or callability of BABs

- **Size:** The taxable market prefers large transaction sizes which facilitate liquidity; a premium may be required for transactions below $100 million.
- **Amortization:** The taxable market prefers bullet maturities; traditional term bonds with mandatory sinking fund payments will sell at a slight yield premium to bullet maturities.
- **Maturity:** BABs can be sold with maturities up to thirty years in the taxable market.
- **Coupon Type:** BABs can be issued as current interest bonds (fixed floating, put bonds, floating rate notes), zero-coupon bonds and convertible zero-coupon bonds.

Additional Structuring Considerations

Bond Indenture:

- Principal Amortization
  - In light of the taxable market's preference for bullet maturities, issuers and bankers will need to work with counsel to determine how bullets, or 'balloon' maturities, are treated for the purposes of calculation debt service for a Rate Covenant, an Additional Bonds Test ("ABT") or a Debt Service Reserve Fund ("DSRF") requirement.

- Interest Rate
  - For Issuer Subsidy BABs, issuers and bankers will need to work with counsel to determine how the subsidy from the Treasury is treated for the purposes of defining pledged revenues or calculating debt services for a Rate Covenant, an ABT or a DSRF requirement.
  - For Investor Subsidy BABs, the coupon at which the bonds are sold would likely apply to such calculations .

- Such issues will need to be analyzed on a case-by-case basis.

Tax Considerations

- BABS can only be issued for purposes that are otherwise tax-exempt eligible. Therefore, BABs needs to comply with all arbitrage regulations, e.g. spend-down requirements, yield rebate and restriction rules, limits on DSRF funding, etc.
  - The issuer will need to file a Form 8038 and execute a form of tax compliance certificate given the requirement to comply with arbitrage regulations.

- Arbitrage yield calculation
  - For Issuer Subsidy BABs, interest is calculated at the applicable bond rate, less the amount of expected subsidy.
  - For Investor Subsidy BABs, interest is calculated at the applicable rate.
  - A blended arbitrage yield will be calculated when BABs are issued as a common plan of finance with tax-exempt bonds

- The interest on any Issuer Subsidy BABs and the tax credit on any Investor Subsidy BABs are treated for state income tax purposes as being exempt from Federal income taxation.

BABs Buyers

- BABs will expand and diversify the investor base for municipal bonds and help to replace lost market capacity from leveraged buyers who reduced their municipal holdings over the past year.

- Issuers of BABs will be able to capitalize on the relative credit strengths of, and low default rates associated with, municipal bonds versus corporate equivalent securities.
  - The best candidates for BABs are medium to large, highly-rated (strong 'A' or higher) issuers.

- Domestic corporate bond buyers, the most active purchasers of BABs, have seen a dramatic reduction in taxable investment grade new issues.
  - This lack of supply has driven recent tightening of spreads in this market.

- Major targeted investors in BABs include mostly domestic corporate investors, such as bond funds, insurance companies and asset management companies.

Recent Issuances

- Approximately $10 billion of BABs have been sold since February
- **May 28**
  - New Jersey Transportation Trust Fund - $270 million, 30-year taxable bonds priced to yield 240 basis points over benchmarks, or 7 percent
  - The Metropolitan Transit Authority of Harris County, Texas (rail car purchases) - $83 million, 30 year final maturity, priced at 240 basis points over the comparable-maturity Treasuries, or 6.984%.
    - $137 million in twenty-year tax-exempt bonds offered a 4.69% yield.
  - Denver Water - $44 million, 30-year taxable bonds priced at 6%.
    - Denver Water will pay 3.94 percent interest. That is less than the average 4.23 percent that Denver Water pays on its outstanding tax-exempt bonds.

BABs Criticisms

- 35% formula may not benefit the Government
  - Top federal income tax rate is 35% and many buyers are in lower tax brackets (i.e. municipal bond mutual funds)
  - If tax rates go up – BABs will be more attractive
- State of California sold $20 billion of BABs at above 7%
  - Effective borrowing rate of 4.7% versus G.O. bonds at 5.5% or more.
  - Looks good, but will the rebates last?
- Yields in secondary trades of BABS were approximately 25 basis points lower – huge profits for underwriters.

Alternative Contract Structures: Energy Performance Contracting

- Leverage: Investing time and resources to implement energy performance contract structures without borrowing money thus providing for infinite returns at no risk.
- Private ownership of public sector projects allows developers/vendors to realize the full value of Stimulus tax benefits.
- properly structured deliver the maximum leveraged benefits to the public and private Sectors

Alternative Financing Structures: Typical terms and conditions

- Performance-based operating agreement for energy efficiency (and renewables) – PPA's, Shared Savings
- Vendors must install, operate and maintain assets
- End users pay for commodity generated – i.e. electricity, energy savings
- Customer payments are based upon measured, realized savings or services delivered
  - Nothing stipulated
- Contract terms range from 5 to 20 years
- Contracts for efficiency and/or renewables
- Assets are privately owned
- Environmental benefits can be assigned to the customer
- Contracts typically contain end of term purchase or renewal options.

Alternative Financing Structures: Advantages to both Public and Private Sectors

- Operating Agreement vs. Balance Sheet Liability
- Preserve existing debt ratings and capacity
- "No risk" alternative to existing performance contracting structure
- Vendor shares commodity risk with its customers
- Vendors are tied to performance on a long-term basis
- Unlimited return on zero investment
- Private ownership allows for utilization of all available local, state and federal tax benefits
- Preserve or maximize available clean energy or Stimulus funds through leveraging

Alternative Financing Structures: Unique economic advantages to the Public Sector

Private Sector ownership provides additional local economy stimulus through:

- Properly structured ownership of energy assets allows for the maximum realization of all Stimulus tax benefits
- 'Sales Tax' states and municipalities will realize additional revenues through private ownership
- 'Income Tax' states will realize the benefits of additional income taxes paid by developers and manufacturers
- Local property/excise taxes on private asset ownership
- Public/Private sector balance sheet/debt ratings will not have any current or future consequence
- Increased job creation
- Contracting for new technologies will reap local benefits
- Power Purchase Agreements/Shared Savings Contracts structured deliver the maximum leveraged benefits to the Public and Private Sectors

New Technologies in the Public Sector

- Procurement regulations have not fostered implementation or acceptance of new or innovative technologies
- New companies with great new ideas lose their appetite for the prolonged approval and sales cycles
- Public entities now have the tools and funding to foster new energy efficiency and renewable energy technologies
- Consideration for innovative financial and contract structures for both new and old technologies
  - Must be a technology that can be measured and verified annually
  - Single technology contracts work best
- Public entities can become "investors" and reap significant rewards
- Public leverage should reap "private" rewards