

American Water Works
Association



ASSOCIATION OF
METROPOLITAN
WATER AGENCIES

CC:PA:LPD:PR (REG-129067-15)
Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

RE: Docket ID: IRS-2016-0009, Definition of Political Subdivision

The National Association of Clean Water Agencies (“NACWA”), the Association of Metropolitan Water Agencies (“AMWA”), the National Association of Flood and Stormwater Management Agencies (“NAFSMA”), the California Association of Sanitation Agencies (“CASA”), Water Environment Federation (“WEF”), and American Water Works Association (“AWWA”) respectfully request that the Treasury Department and the IRS redraft the recently released Proposed Regulations¹ that would create a new, more restrictive, and less clear definition of a “political subdivision” for tax-exempt bond purposes. In order to ensure that our members continue to have access to funding from tax-exempt bonds, it is imperative that the Proposed Regulations be redrafted so that they preserve the existing regulations and add on nothing more than a targeted rule that abandons the broad focus on public purpose and governmental control and focuses narrowly on special districts that are intended to perpetuate private control and remain politically unaccountable. At the very least, we urge Treasury to modify the Proposed Regulations to allow public stormwater utilities, flood control districts, drinking water agencies, and publicly owned treatment works, known as “clean water utilities,” to continue to qualify as political subdivisions and maintain their current and long-standing access to tax-exempt financing even though some may be controlled by multiple governmental entities that may not possess all three of the traditional sovereign powers or have board members who are removable only for cause.

Drinking water, clean water, and stormwater management utilities and regional flood control districts currently enjoy access to the tax-exempt financing markets, notwithstanding their varying governance structures.

¹ The Proposed Regulations were published in the Federal Register on February 23, 2016, at 81 Fed. Reg. 8870.

Though we do not maintain a compendium of the governance structures of our member agencies, we know that many if not all exercise a substantial amount of at least one of the three “sovereign powers” (taxation, eminent domain, and the police power). Others have been delegated a substantial amount of one or more of the three sovereign powers by one or more governmental entities with those sovereign powers, and many of those have governing boards appointed by multiple governmental entities. Of those that are governed by a board whose members are appointed by multiple governmental entities, we know that many have boards whose members may be removed from office only for cause and only in accordance with the laws of the jurisdiction that appointed that member, but in almost every such case, only governmental units have the ability to appoint or remove board members of our member entities.

Our member utilities and regional districts range from small rural water and sewer districts to some of the nation’s largest metropolitan drinking water, sewer, and stormwater management systems. The reasons for their governance structures are equally diverse. In some cases, they result from state statutory requirements. In others they result from inter-governmental agreements reflecting the need for shared responsibility and financial participation. In yet others, they result from the judicial resolution of disputes regarding several local governments’ rights and duties. None of these are any more or less of a “political subdivision” simply because of the governmental structure that has been determined either by the state or the local entities themselves.

Drinking water, clean water, stormwater management and regional flood control agencies throughout the nation depend on the lower-cost financing that they obtain through the tax-exempt debt market to finance water resources infrastructure for their consumers, ratepayers and taxpayers.

Like other public utilities and regional districts, most water systems rely on the lower-cost financing available through the tax-exempt bond markets to finance large portions of their water and sewer infrastructure to the public. The nation’s urban clean water agencies finance approximately \$25 billion a year in capital investments, a substantial portion of which derives from tax-exempt borrowing. In the period between 2003 and 2014, cities and towns issued \$258 billion worth of municipal bonds to fund water and wastewater infrastructure, representing approximately 16 percent of all municipal bond issuance for infrastructure projects over the period. Although the Proposed Regulations are prospective and would not affect these outstanding bonds, the current amount of outstanding tax-exempt bonds provides a preview of the likely future need for tax-exempt financing. Without access to tax exempt financing, many if not most of these entities would be unable to access sufficient capital to complete crucial infrastructure projects. In the case of clean water utilities, this represents a threat to public health and safety.

In particular, there is national consensus that the nation’s clean water, drinking water and stormwater infrastructure is woefully underfunded, so that the current amount of outstanding tax-exempt bonds probably understates future capital needs for water and sewer infrastructure in the U.S. For example, AWWA has estimated that communities will require at least \$1 trillion in new spending over approximately the next 25 years just to repair existing drinking water infrastructure, to say nothing of new facilities that will be required. On that point, NACWA and AWWA have estimated that required future spending on new facilities could be at least \$1 trillion by 2040. A 2011 survey by the US Environmental

Protection Agency estimated that drinking water systems would require \$384 billion and clean water systems would require \$298 billion over the next 25 years just to maintain current levels of service. And those estimates by the EPA do not take into account necessary improvements to address population growth. Moreover, as the recent events in Flint, Michigan and the drought conditions in our arid Western states have shown, merely maintaining current levels of drinking water and clean water infrastructure may not be acceptable in many cases. The low rates offered by tax-exempt municipal bonds are particularly critical to funding this needed infrastructure investment, as federal funding for the Clean Water and Drinking Water State Revolving Funds (SRFs) – the main federal programs that help cities and towns pay for water infrastructure improvements – continues to decline annually since reaching the stimulus-aided highs of 2009.

Many water systems could lose their status as political subdivisions under the Proposed Regulations and could therefore lose access to tax-exempt financing.

Under current law, many drinking water and clean water utilities qualify as political subdivisions because they have the power to exercise a substantial amount of at least one of the traditional sovereign powers; most commonly, the powers of eminent domain and public purpose. However, under the Proposed Regulations, many water systems likely would not continue to qualify as political subdivisions. Although Treasury and IRS officials have stated publicly that the Proposed Regulations are intended to be surgical and are intended to carve out the vast majority of entities that are political subdivisions under current law, in fact, the overbroad Proposed Regulations likely would ensnare many water systems that fall far outside the zone of concern that Treasury and the IRS are purporting to address.

The Proposed Regulations require an entity to meet the sovereign powers requirement, the public purpose requirement, and the control requirement. We would expect members drinking water, clean water, and stormwater management utilities and regional flood control districts that currently qualify as political subdivisions to continue to satisfy the sovereign powers requirement. However, for many members created under specific authorizations, it is unclear whether these powers will be treated as having been delegated “[p]ursuant to a State or local law of general application,” as the Proposed Regulations would require.

Many of our members would fail to meet the public purpose requirement under the Proposed Regulations.

As for the public purpose requirement, for certain water systems, particularly stormwater districts, bonds issued by the district may benefit particular parcels of land and particular property owners. Many wastewater utilities are undertaking massive infrastructure upgrades to comply with state and federal Clean Water Act consent decrees, aimed at reducing overflows from combined wastewater and storm sewers. These utilities are increasingly turning to more sustainable and affordable green infrastructure programs and innovative public-private partnerships to address their obligations. Many of these projects may either be located on private property, may indirectly benefit certain parcels more than others, or—in the case of public-private partnerships—directly benefit private entities engaged with the utility on the

project. Under the Proposed Regulations, these districts may provide “more than incidental private benefit” which will cause them to fail the public purpose requirement of the Proposed Regulations and place their access to innovative and sustainable solutions at risk.

More broadly, some water utility and water resource management operations will benefit private parties in some way. The nation’s drinking water and clean water utilities serve the public and governmental purpose of providing water and sewer services to homeowners, businesses, other governmental bodies and all other users of those services in their jurisdiction. They do so in compliance with myriad state laws limiting the extent to which publicly owned utilities can provide benefits to private businesses. To the extent they issue tax-exempt debt, they do so in compliance with the current well-developed body of federal tax law defining the availability of tax-exempt financing when any element of private business use is involved. Without in any way compromising their public character and mission, drinking water and clean water utilities inevitably create a multitude of relationships with private persons. Indeed, because every individual customer of these utilities is a private person, providing benefits to private persons is at the core of the utilities’ mission, and so those private benefits are inevitably more than incidental. The same is true of meeting the drinking water and clean water needs of business customers: Does the fact that a utility meets those needs and enables those businesses to function mean that it is providing them with a benefit that is more than incidental? What about the contractors and vendors from which a public drinking water or clean water utility must obtain the goods and services it requires to perform its public mission? Are they receiving a benefit that is more than incidental even when those goods and services are obtained under strict public contracting laws? The introduction of this proposed new and undefined public purpose requirement would create needless confusion and uncertainty for practically every public drinking water and clean water utility that relies on tax-exempt financing to meet its most basic and purely governmental purposes.

Many of our members would fail to meet the governmental control requirement under the Proposed Regulations.

Finally, as noted above, many water systems and water resource management districts have governing boards that are appointed by multiple governmental entities, and in many of those cases, board members can be removed only for cause. In addition, in many cases, not all of the governmental units that appoint the governing board have a substantial amount of all 3 of the sovereign powers, as the Proposed Regulations would require. For example, in California several local public agencies that provide water/wastewater service and currently utilize tax exempt financing operate as Joint Powers Authorities. These entities operate by agreement and generally have board members appointed by other local public agency members. There is concern that language in the Proposed Rule could jeopardize their ability to access tax exempt financing going forward. Several other types of local government entities in California are similarly structured and could be adversely impacted by the proposed rule. Many similarly structured water systems across the country likewise would not meet the control test.

If Treasury finalized the Proposed Regulations in their current form, many drinking water, clean water, and stormwater management utilities and regional flood control districts likely would not meet the sovereign powers requirement, the public purpose requirement, and the control requirement, and as a

result many of our members likely would not continue to qualify as political subdivisions under the Proposed Regulations. This would unnecessarily limit their access to tax-exempt financing and harm the public interest. As described in more detail below, this could have disastrous effects on our nation's drinking water and clean water infrastructure.

Recommendations

1. The Proposed Regulations must not be finalized in their current form.

The federal government has acknowledged in public comments that the Proposed Regulations are an administrative response to concerns about certain special districts that may remain privately controlled and politically unaccountable but nevertheless qualify as political subdivisions that can issue tax-exempt bonds. Drinking water, clean water, and stormwater management utilities and regional flood control districts differ from these special districts in every conceivable respect. Our members are publicly controlled, politically accountable, and they serve the public good by constructing and operating public infrastructure.

It is impossible to overstate, and frankly impossible to fully comprehend, the negative consequences that would flow from the loss of political subdivision status for our members if Treasury finalizes the Proposed Regulations without revisions to ensure the political subdivision status of our members. Water and sewer authorities are already facing unprecedented budget strains, and they must borrow to fund our country's future capital needs to address critical water infrastructure issues. The burden of maintaining and repairing aging water infrastructure while dealing with environmental mandates to address problems such as combined sewer overflows, lead pipe replacement, and urban flooding are already straining the financial resources of our water, sewer and stormwater utilities and their ratepayers. If Treasury, in its zeal to tackle what it concedes is a narrow abuse, strips our members of their ability to issue tax-exempt bonds, then the already tremendous financial burden borne by those utilities will worsen along with an already acute challenge of affordability, which is one of the US Environmental Protection Agency's concerns in the provision of water, sewer and stormwater services by state and local authorities. As a result, water systems will have to pare back their construction and repair plans, and postpone yet again critical infrastructure improvements.

Further, the fact that the Proposed Regulations would hamper the ability of our members to borrow in the tax-exempt bond market at a time when a national consensus is finally forming to confront the problem of poor water infrastructure, as the events in Flint, Michigan and the drought conditions in the West have so harrowingly shown, is unacceptable.

2. If Treasury must make new rules in this area, it should abandon the current approach to the public purpose and control requirements, and narrowly focus the rules on the real problem that it perceives.

If Treasury must make new rules in this area, then those new rules should abandon the broad public purpose and control requirements and instead actually focus on the stated goal of the Proposed

Regulations. The special districts that the federal government is targeting are an incredibly tiny portion of the world of issuers of tax-exempt bonds. If the federal government wants to create administrative rules to curtail those special districts, then it should keep the current political subdivision rules in place and instead focus any future changes narrowly on entities that are organized to perpetuate private control and remain politically unaccountable, such as the special districts that have drawn their focus.

If Treasury insists on including the public purpose and control requirements in some form, then Treasury should revise those provisions as set forth below. In addition to these specific comments, the Proposed Regulations should also make clear that the specific provisions of the Proposed Regulations do not apply for other tests for governmental status under the tax-exempt bond rules, such as the tests for “constituted authority” or “instrumentality” status.

a. Treasury should delete the “no more than incidental private benefit” provision in the public purpose requirement.

Treasury and IRS officials have stated publicly that they added the “no more than incidental private benefit” provision to clarify what the “public purpose” requirement means. But the provision does the opposite. Because all tax-exempt bond-financed projects benefit private entities to some degree, the provision at best casts into confusion the meaning of a public benefit, and at worst needlessly provides an opening for IRS agents examining a bond issue to question the ability of longstanding public infrastructure providers to continue doing so.

The rules should focus on whether or not an entity serves a public purpose, broadly construed, and once a public benefit has been established, that should be the end of the matter. Beyond that, Treasury already has a seasoned set of rules to deal with what it perceives to be excessive private involvement in a tax-exempt bond transaction – the private activity bond rules.

b. Treasury should clarify the control test to make clear that a political subdivision can have board members appointed by any number of public entities, without any one entity exercising majority control.

Additionally, Treasury should modify the control test to make clear that an entity that has no private participation on its board automatically satisfies the control test. Treasury should also revise the rules so that an entity can meet the control test based on governmental control by more than one governmental unit, even where no single governmental unit appoints a majority of the board, and even where some of the appointing members do not have all three of the sovereign powers. Entities such as these pose no danger of being politically unaccountable or designed to perpetuate private control, the qualities of special districts that have raised the concern that prompted the Proposed Regulations.

Moreover, as noted above, the governance structures of our member drinking water, clean water, and stormwater management utilities and regional flood control districts have been organized not for tax reasons, nor to provide benefits for private parties, but for a variety of state law considerations. These considerations include overarching state statutory requirements, inter-

governmental agreements where shared legal and financial responsibility is required, or the result of a resolution of judicial disputes. In no case, however, do these various structures present a rationale for diminished access to tax-exempt financing.

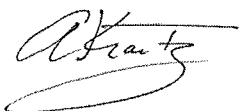
c. Treasury should clarify the control test to make it clear that the inability to remove board members without cause does not violate the control requirement.

The Proposed Regulations should be clarified to state that an entity can satisfy the control test if it has board members removable only for cause. The inability to remove board members without cause does not cause an entity to be politically unaccountable or designed to perpetuate private control.

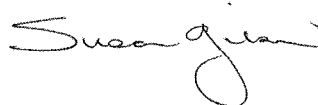
These changes to the public purpose and control requirements better reflect the reality of the matter. State and local governmental units supervise the entities to whom they have delegated sovereign powers in a wide variety of ways that reflect local legal preferences. Any attempt by the federal government to separate the good structures from the bad should provide broad exceptions that carve away the vast majority of political subdivisions from the disfavored few that are the subject of the federal government's concern.

Thank you for your consideration of these comments. On behalf of the undersigned organizations, please do not hesitate to contact Erica Spitzig, NACWA's Deputy General Counsel, at 202/533-1813 or espitzig@nacwa.org if you have any questions about these comments or would like to discuss further.

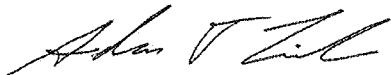
Respectfully submitted,



Adam Krantz
NACWA CEO



Susan Gilson
NAFSMA Executive Director



Adam Link
CASA Director of Government Affairs



Eileen O'Neill
WEF Executive Director



Tracy Meehan
AWWA Executive Director, Government Affairs



Diane VanDe Hei
AMWA Chief Executive Officer