

Bond Case Briefs

Municipal Finance Law Since 1971

Developing WIFIA's Guarantee Capabilities for Taxable Municipal Bonds.

Legislative developments threw a few disappointments at water infrastructure finance recently, but there is a way to make at least a little lemonade from two Congressional lemons.

Legislative developments threw a few disappointments at water infrastructure finance recently. But there is a way to make at least a little lemonade from two Congressional lemons.

Lemon 1: Restoration of Direct-Pay Bonds Cut from BBB

A provision to restore and expand direct-pay bonds was approved by House Ways & Means for inclusion in the Build Back Better (BBB) legislation earlier this year. This was one of three provisions to increase the flexibility and reduce the cost of municipal finance. The other two, also originally approved, would reinstate tax-exempt advance refunding and expand the small tax-exempt issuer exception. However, in the Congressional horse trading required to resize the BBB to \$1.75 trillion, direct-pay bonds and the other provisions were cut. Notwithstanding a compelling letter sent to Congress by thirty municipal groups (including AWWA, NACWA and WEF), the bond provisions are unlikely to be back in the final bill.

All the provisions would have benefited the US water sector, but the restoration of direct-pay bonds would have been especially useful for water infrastructure renewal. This is because they are taxable bonds that receive federal support in the form of a cash subsidy (not a tax-exemption) and can be bought globally by institutional investors. These investors are well-suited to finance long-lived assets, and they have a lot of appetite for US infrastructure in particular. Taxable bonds are also more flexible for innovative approaches that include impact and other pay-for-performance features which will interest the rapidly growing base of worldwide ESG and impact investors. Such risk-transferring features can be especially useful to water agencies in dealing with the infrastructure funding challenges of climate resilience and water equity.

Lemon 2: WIFIA Loan Program Authorization Flatlined in BIF

The recently passed \$1.2 trillion Bipartisan Infrastructure Framework (BIF) has a lot of great new and expanded funding provisions for the water sector. Drinking and Clean Water State Revolving Funds in particular got a big and well-deserved boost. The EPA's Water Infrastructure Finance and Innovation Act (WIFIA) loan program was also reauthorized at \$50 million per year for 2022-2026. But this authorization is slightly less than prior years. Relative to the other water-related provisions in the BIF that saw significant increases, this is disappointing.

The flatline of WIFIA's authorized funding is puzzling. The program has been remarkably successful since operational inception in 2018. Not expanding its resources would seem to indicate a perception that WIFIA has limited usefulness despite its initial success. This is somewhat understandable in light of WIFIA's portfolio to date. Almost universally, WIFIA loans are to highly rated water agencies that could have otherwise issued tax-exempt bonds. WIFIA loans have some

very valuable features, especially with respect to construction period interest rate management, but in many ways they're not very different from tax-exempt water revenue bonds. Perhaps the program is seen as filling a niche purpose and not as a source of transformational or uniquely valuable financing for US water infrastructure?

This perception is completely incorrect. WIFIA's legislative framework and its proven team are capable of much more. The portfolio to date should be seen as demonstrating WIFIA's capabilities in efficiently sourcing and executing loans with high-quality borrowers that have excellent alternatives in the capital markets, no mean feat for a federal loan program. That capability is certainly not limited to interest rate management products — and it shouldn't be. WIFIA is only getting started.

Making Lemonade: Developing WIFIA Guarantees for Taxable Municipal Bonds

Perhaps not much can be done legislatively in the near future to restore direct-pay bonds or expand WIFIA's authorization. But there is an immediately available path to improve both situations and prepare for the next opportunity in Congress: Develop WIFIA guarantees for taxable municipal bonds.

WIFIA has the capability to attach a US full-faith-and-credit payment guarantee to loans and bonds, including taxable municipal bonds. Such a guarantee has quantifiable value. For example, a federal AAA/AA+ guarantee on a 30-year bond that otherwise would have been rated Baa3/BBB- will save the issuer about 0.50% in interest a year, or about 20% of debt service on a present value basis. In principle, the value of the federal guarantee for lower rated investment-grade bonds is equivalent to the cash subsidy of a direct-pay bond. The value of a guarantee is of course more variable and situational than a direct-pay bond's cash subsidy payments because it will depend on transaction terms, market conditions, etc. But both mechanisms are forms of direct and monetizable federal support for taxable bonds.

The value of a federal guarantee is not limited to simply raising the credit quality of a standard bond issue. Innovative infrastructure projects and funding sources often have demonstrably sound credit characteristics but financing them in the bond market may be prohibitively costly simply because the story is (by definition) new and unusual. A WIFIA guarantee would make bonds with innovative features much more attractive to investors, which also will familiarize them with the new approaches and create interest in the unguaranteed versions. Jump-starting new markets is a classic role for federal loan programs, and WIFIA is especially well-positioned to do exactly that. Innovation is a central part of the program's mission — it's even in the name. Apart from its own expertise and credibility in large-scale infrastructure finance, WIFIA can directly access the climatic and other ESG resources of the EPA to analyze new approaches that private-sector investors can't consider until they're more developed. A WIFIA guarantee is effectively an imprimatur on several levels (not just financial) that could have a transformational impact on ESG and resilience water infrastructure investment.

Getting Ready for the Next Legislative Opportunity

Even apart from the benefits of near-term transactions themselves, developing WIFIA guarantees for taxable municipal bonds will advance a much larger objective for municipal and water infrastructure finance. Successful innovation always gets a lot of attention. Even a few transactions that combine innovative approaches with federal support for taxable municipal bonds will demonstrate the value and potential in both WIFIA and direct-pay bonds. It may be a few years before there's another legislative opportunity to expand WIFIA's resources and restore direct-pay bonds, but that time will come because the US municipal infrastructure challenge isn't going away. When it does, a track record of successful transactions, motivated stakeholders among both issuers and investors, and

proven capability for large-scale innovation will be very hard for Congress to horse trade away.

WaterWorld

by Chad Praul, John Ryan

Nov. 17, 2021

About the Authors: Chad Praul, P.E. is the Domestic Portfolio Director at Environmental Incentives, the only professional services Benefit Corporation that supports mission-driven champions to meet their environmental imperative. He provides expert support for local governments to develop water-related performance metrics and alternative procurement programs such as Pay-for-Performance and Community Based Public Private Partnerships (CBP3).

John Ryan is principal of InRecap LLC, a firm that is focused on federal loan program alternatives for the recapitalization of basic public infrastructure. He has an extensive background in structured and project finance. He recently served as an expert consultant to the U.S. Environmental Protection Agency.

Copyright © 2024 Bond Case Briefs | bondcasebriefs.com