Submission to the Committee on Ways & Means U.S. House of Representatives

on

Comprehensive Federal Tax Reform

by American Municipal Power, Inc. (AMP) and the Ohio Municipal Electric Association (OMEA)

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The Importance of Tax-Exempt Financing to Municipal Governments & Public Power Utilities

American Municipal Power, Inc. (AMP) and the Ohio Municipal Electric Association (OMEA) are jointly providing these comments to the House Ways & Means Committee in support of the continued structure and tax-exemption of municipal bonds, which finance the bulk of public infrastructure in the United States today. AMP is a wholesale electricity and services provider for 128 municipal electric system members in six states (Kentucky, Michigan, Ohio, Pennsylvania, Virginia, and West Virginia), as well as to the Delaware Municipal Electric Corp. OMEA serves as the legislative liaison to AMP and represents the state and federal legislative interests of Ohio municipal electric communities. AMP and OMEA appreciate the opportunity to provide these comments and look forward to working with the Committee and responding to any questions.

Overview

Tax-exempt bonds are the basic tool used by states, cities, counties, towns, universities, school districts, and other governmental entities to fund public purpose projects necessary to provide needed infrastructure and services. Today, three-quarters of the infrastructure investment in the U.S. is financed by state and local government bonds, including roads, bridges, sewers, hospitals, libraries, schools, town halls, police stations, electric and gas infrastructure for public power utilities, and every other government purpose investment made by state and local governments. Thus, the ability of these governmental entities to issue tax-exempt bonds so that they are attractive to investors is essential to the daily life of hundreds of millions of Americans and the economic vitality of our country.

As the Committee looks to reform the tax code, we urge retention of the current tax treatment of tax-exempt financing, which is now under the budgetary microscope as well. In addition, the Administration's FY 2014 budget request renews the previous attacks on the level of deductibility of tax-exempt bond interest for higher-income earners.

Reductions in the availability of tax-exempt financing to municipal governments, or increases in their cost of issuing tax-exempt bonds, would impose significant fiscal injury on these local governments and seriously impair their ability to maintain essential safety and services for their citizens. Consequently, this could increase pressure on municipalities to raise taxes and utility rates, which – if too high – can act to discourage homeownership, business retention, and other private investment in a community. Ultimately, taxpayer flight from high taxes could lead to more municipal bankruptcies and affect the municipalities' ability to receive strong investment-grade credit ratings when entering the marketplace.

Tangible Benefits Across the Board

The ongoing discussion of eliminating or altering the tax-exemption for municipal bonds is premised on the assumption that the cost to the federal government outweighs the benefits provided. However, if this assumption is incorrect, it follows that the conclusion also is incorrect.

Contrary to the perception that tax-exempt bonds only benefit high net-worth individuals, who may get preferential tax treatment because of their investment decisions, in reality, investors in lower tax brackets who hold mutual funds also often are investors in tax-exempt bonds (please see the table below). For example:

- More than half of all municipal bond interest paid to individuals is earned by those with *income of less than $250,000*.[1]

Individual Ownership of Municipal Bonds		
Income Group[2]	**Exempt Interest Earned[3]**	
	Amount	% of Total
Under $250,000	$39.4 billion	52%
$250,000 to $999,999	17.8 billion	24%
$1 million and Above	17.9 billion	24%
Total	**$75.2 billion**	**100%**

This misconception is most recently reflected in the Obama Administration's FY 2014 budget proposal, which – under the guise of "tax fairness" – would reduce the tax benefit associated with earning tax-exempt interest for higher-income earners. It is important to note, however, that even limiting the tax deduction for higher-income earners would be expected to result in fundamental changes in the municipal bond market that would impact all investors, not just those in the higher-income brackets.

- *All municipal bond holders* will be hurt by a new tax—even by proposals "targeting" upper-income earners.[4]

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[1] *Internal Revenue Service,* "Statistics of Income—2010: Individual Income Tax Returns" (2012).

[2] "Income Group" includes filers of all marital statuses. However, IRS data indicates that 65% of all exempt interest is paid to those filing as married-filing-jointly (see, *Id.* at 42); IRS data also indicates that roughly 50% of exempt interest is paid to those with income of less than $200,000.

[3] "Exempt Interest Earned" is equal to the amount of tax-exempt interest claimed on individual income tax returns in 2009; also, as much as 80% of municipal bond interest was paid to individuals either directly or through funds (*Board of Governors of the Federal Reserve,* "Flow of Funds Accounts of the United States" 99 (Dec. 6, 2012)).

[4] Michael Kaske, Bloomberg, "Tax Cap Threatens $200 billion Muni Loss, Citigroup Says" (Dec. 7, 2012)(reporting analysis that limiting the tax value of the exclusion for municipal bond interest will reduce the value of existing bonds in the secondary market); Brian Chappatta, Bloomberg, "Tax-Status Threat Fuels Worst Losses Since Whitney: Muni Credit" (Dec. 21, 2012).

More importantly, such a change would also likely alter the ability of state and local governments to access cost-effective financing, potentially jeopardizing essential infrastructure projects nationwide that would benefit all citizens, not just those in the higher-income brackets.

- *Citizens and ratepayers of all income levels* will pay higher taxes (or rates) because of increased state and local borrowing costs.[5]

Thus, while tax-exempt bonds are certainly considered by their investors as to their ability to provide an annual tax benefit, the short- and long-term benefits provided to issuing state and local governments – and their citizens – are far more important in the long term. One measurement that has apparently not been examined in detail by either the Joint Committee on Taxation or the Congressional Budget Office in their analyses of the costs and benefits of tax-exempt financing is on jobs in communities using tax-exempt financing for essential infrastructure projects like roads, government buildings, water treatment plants, etc. Without cost-effective financing options, such projects (and the jobs associated with them) could be scaled back, delayed, or cancelled, stalling needed economic development in a community.

Perhaps most importantly, the tax-exempt bond market is well-established – issuers can sell bonds to a waiting market that functions smoothly and has been successful for decades. The legal and regulatory process for tax-exempt bonds is also well-established: it ensures that states and localities meet stringent guidelines for issuing such bonds, while allowing investors easy, predictable access to a stable investment choice.

Municipal Bonds and Public Power

As units of state and local government, public power utilities are authorized to issue tax-exempt bonds to construct generation projects and improve the infrastructure necessary to distribute electricity. Every year, on average, public power utilities make $15 billion in new investments financed with municipal bonds. This includes investments in power generation, distribution, reliability, demand control, efficiency, and emissions controls – all of which are needed to deliver safe, affordable, and reliable electricity to customers.

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[5] Frank Sammartino, Congressional Budget Office, Testimony before the S. Comm. on Finance Hearing "Tax Reform: What it Means for State and Local Tax and Fiscal Policy" (Apr. 25, 2012)("Several analysts suggest that about 80 percent of the tax expenditures from tax-exempt bonds translates into lower borrowing costs for states and localities.").

Further, we stress that tax policy cannot be made in a vacuum, with only the bottom line of the federal deficit in focus. With regard to energy policy in particular, we note that tax policies can and do have far-reaching consequences for the amount and type of generation constructed, the reliability of the electric system, and other critically important aspects that currently can benefit from the use of tax-exempt financing.

AMP Project Tax-Exempt Financing

AMP has been active in the tax-exempt bond market on behalf of its members that subscribe for the output of the electric generation projects that AMP develops.

In these days of credit and capital market volatility, it is especially important that municipalities and public power utilities have the tools necessary to succeed. To ensure access to the most cost-effective financing options, AMP is committed to the financial soundness and creditworthiness of its members and monitors the financial position and credit scores of its members at least annually. AMP's financing efforts for capital projects are supported by its strong bond ratings and the financial soundness and creditworthiness of its member municipal electric systems. AMP bonds remain an attractive investment for bondholders. However, AMP continues to monitor developments in the markets for potential impacts on the borrowing ability of the organization and its members.

The volatility of current market conditions is creating hurdles for all types of generation projects, and delays to any of these projects may be detrimental to regional reliability, increase the ultimate cost of projects, and delay much needed economic development. Despite the continuing distress in the financial markets, AMP accessed the market for more than $4.97 billion from 2008 to 2012 to support generation project development and has plans for capital bond issuances during the 2013-2015 period. All projects currently under development are rated in the "A" category by the three major rating agencies: Standard & Poor's, Fitch, and Moody's.

AMP is currently undertaking an aggressive asset development and significant capital building program to construct a number of generating facilities. This effort is designed to mitigate its participating member municipal electric systems' exposure to the volatile wholesale electric market, and is part of a balanced portfolio of clean and renewable power supply assets. These generating facilities that have been financed include:

- A 23.26% AMP ownership interest in the 1,600 MW Prairie State Energy Campus coal-fired facility in Illinois. AMP has financed approximately $1.696 billion, of which $685.8 million was through Build America Bonds (BABs) which qualified AMP to receive $467.4 million in incentive payments from the Treasury Department over the term of the bonds. The project began commercial operation in 2012. In addition, at the peak of construction it employed over 4,200 construction workers, providing a significant boost to the region's economy.

- The ongoing construction of four run-of-the-river hydroelectric projects at existing locks and dams along the Ohio River, which will generate 313 MW. Three of the projects are located in Kentucky and one is located in West Virginia. The combined economic benefits already derived from the construction of these four projects – largely made possible because of tax-exempt financing – are considerable. Over their construction, the projects are expected to employ 800 – 1600 construction workers; these construction jobs are in addition to an estimated 60-90 new jobs that have been created due to new work for various suppliers. Once completed, AMP expects to hire 28-36 full-time skilled employees to operate the plants. In addition, contractors and suppliers from 12 separate states from Maryland to Oregon are involved with these projects, most notably:
    - Illinois – powerhouse construction and engineering consultation work
    - Michigan – powerhouse construction, general contractor, and site work
    - Ohio – cofferdam and powerhouse construction, road construction, construction equipment and services, transmission line work, and site work
    - Oregon – supplier of water control gates for all projects
    - Pennsylvania – supplier of generators and turbines for all projects
    - Texas – suppliers of transformers and rebar

- For these four run-of-the-river hydroelectric projects, AMP has financed approximately $2.73 billion, of which $2.22 billion was through BABs which qualified AMP to receive over $1.78 billion in incentive payments from the Treasury Department over the term of the bonds (these payments, however, are now being reduced by approximately 8.7% through sequestration – please see discussion of tax credit and direct payment bonds on p. 9). If retained, these savings would benefit the projects' participants and their customers.

- AMP completed and owns 94.84% of a natural gas-fired, combined cycle electric plant located at Fremont, Ohio, with a capacity of 512 MW (unfired) / 675 MW (fired), consisting of two combustion turbines, two heat-recovery steam generators, and one steam turbine and condenser. The Michigan Public Power Agency (MPPA) owns the other 5.16% of the plant. AMP financed its portion with approximately $546 million in revenue bonds, with $45.5 million being taxable (Central Virginia Electric Cooperative) and $525.5 million being tax-exempt bonds. The project was declared to be in commercial operation on January 20, 2012.

Municipal Bond Market in Perspective

The municipal bond market today is approximately $3.7 trillion (with about $300 billion in new issuances every year) and consists of approximately 46,000 governmental issuers. About 70% of the issuances of municipal bonds is new (as opposed to refinancings), with values of $10 million or less. Holders of municipal bonds are overwhelmingly retail investors (including direct investors – about 50% - and mutual funds – about 25%). Source: Federal Reserve as of December 31, 2011 – see Figure 1.

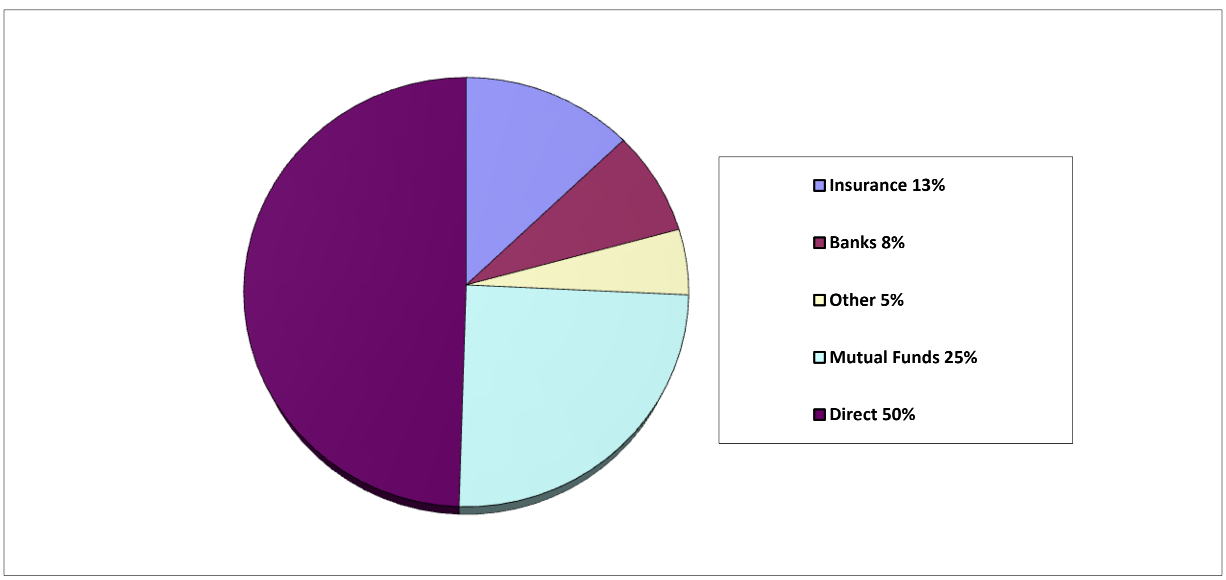

Figure 1. Municipal Bond Market by Investor Type

By comparison, the corporate bond market includes only about 5,700 issuers. The entry point into the corporate bond market is typically $200 million, with the median corporate bond issue valued at $210 million. In some cases, the entry point in the corporate bond market is much higher. For example, in July 2012, high-grade bonds issued in the corporate bond market averaged $500 million, with the smallest issuance at $100 million. Only about 5% of municipal bonds are issued for amounts of $200 million or more, with the vast majority of municipal bond issuances being much smaller – the median value is $7 million.

Given the disparities, it is unlikely that municipals could compete with corporate entities for investors should Congress enact changes that would alter or eliminate the current tax treatment of municipal bonds.

By helping to level the playing field in the bond markets for municipal issuers, tax-exempt bonds provide a stable, lower cost, and predictable source of financing to municipalities to invest in essential infrastructure. The stability of the municipal bond market reduces the inherent investment risk for municipalities and thus facilitates long-term planning and financial decision-making.

A Principle of Federalism?

From the very beginning of the nation, the various rights of the individual states have been maintained as a central principle of federalism in the United States. Under the Tenth Amendment to the Constitution (ratified in 1791), "powers not granted to the United States [federal government] by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people." Federal versus state or local taxing authority provided an early constitutional test. In 1819, Supreme Court Justice John Marshall wrote in the decision on *McCulloch v. Maryland* (17 U.S. 316) that "the power to tax involves the power to destroy," finding that states have no right to tax or otherwise "retard, impede, burden, or by any other manner control the operations of the constitutional laws enacted by Congress."

In 1895, the Supreme Court found that the reverse was also true – that the Constitution does not allow the federal government to interfere with state and local governance by taxing interest on state and local bonds (*Pollock v. Farmers Loan & Trust Co.* (157 U.S. 429). The *Pollock* decision established the doctrine of "intergovernmental tax immunity," whereby state and local governments are protected from federal interference into their respective borrowing power. It also provided the basis for legislation that eventually would become the 16th Amendment (1913), giving Congress the "power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several

States, and without regard to any census or enumeration." Thus, since the creation of the federal income tax in 1913, interest on government purpose municipal bonds has been excluded from federal income tax, just as interest on Treasury bonds has been excluded from state and local taxes.

More recently, however, in the 1988 decision in *South Carolina v. Baker* (485 U.S. 505), the Supreme Court found that the federal government's decision to exempt certain municipal bond interest from taxation *was in reality an explicit choice to subsidize those securities, and not a constitutional right* – thus removing the "intergovernmental tax immunity" constitutional protection previously established by the *Pollock* decision in 1895. While the *South Carolina v. Baker* decision essentially left municipal securities without constitutional protection from federal taxation, Congress has – until recently – refrained from altering over 100 years of tradition of reciprocal tax immunity between state and local governments and the federal government.

Tax Credit and Direct Payment Bonds

Tax credit and direct payment bonds are sometimes touted as options that could replace tax-exempt bonds for municipalities. While AMP benefited from the use of BABs and Clean Renewable Energy Bonds (CREBs) during the recent economic downturn, they would be poor substitutes for the more well-established and robust traditional tax-exempt financing options. The recent imposition of sequestration provides an excellent example of the shortfalls of these financing options, as the federally authorized subsidy payments to AMP across all issuances are expected to be reduced by 8.7%, for a total of $3.3 million. The end result of this reduction is increased uncertainty for AMP as well as investors in its bonds, with equally troubling implications for future investment and business confidence. Further, the complicated rules and limited tax benefits of recent tax credit bond offerings appear to question the suitability of tax credit bonds to fill the role of traditional tax-exempt bonds, as some recent analyses suggest that borrowing costs could rise by 50 to 75 basis points in the current low-yield environment.

It has been noted that tax credit bonds are more difficult for small and medium-sized municipalities to issue because there is no widely established market (e.g., in 2009, a single investor bought 50% of the market). This could force states to set up authorities to issue these bonds on behalf of their municipalities. Tax credit bonds also suffer from uncertain demand and unattractive financial accounting, and are aimed at investors who have tax preferences, thus limiting their appeal. Thus, the market for these bonds has not been as liquid as that of traditional municipal bonds, in part because of their complex structure, potential risks that interest rates or federal subsidies could not be guaranteed over the long term, and potential risk that the issuing entity might default or be unable to make payments (the credit of BABs, for example, was backed by the municipality issuing the bond, not the federal government).

Consistent with the principle of federalism, some argue that state and local governments need to be able to raise capital independent of the federal government, and with the understanding that they are responsible for the obligations they incur. Tax credit and direct payment bonds skirt this principle, as the federal government pays the subsidy.

Moreover, unlike tax-exempt financing, tax credit and direct payment bonds are typically authorized for a short period and require successive actions by Congress to remain a viable financing tool. As noted previously, this creates considerable uncertainty for business and investors alike that is inconsistent with and harmful to the financing and infrastructure needs of local communities.

Summary Points

- The municipal bond market is well-established and provides stable and low-cost financing options for essential infrastructure projects.
- Tax reform proposals cannot be made in a vacuum and need to be assessed for all possible impacts on the interrelated segments of the economy, which is particularly applicable to the energy sector.
- Disruption of the current tax-exempt financing market would be detrimental for both issuers and investors alike.
- Municipalities will likely be priced out of the corporate bond market if they lose the ability to offer tax-exempt bonds to investors.
- Tax credit and direct payment bonds may provide appropriate benefits to certain investors, but they do not generally appeal to traditional municipal bond investors, including those who participate in the market through mutual funds. They would offer a poor substitute for traditional tax-exempt financing.

- Absent workable, low-cost financing options, municipalities will not be able to provide essential services or infrastructure improvements to their citizens. So-called "inefficiencies" cited for tax-exempt financing fail to recognize that even greater inefficiencies would be encountered if local financing and infrastructure decision-making all were to be abrogated to the federal government – a potentially real outcome if tax-exempt financing were to disappear as a tool for local governments.

For Additional Information

AMP appreciates this opportunity to share our comments with the Committee. Should the Committee have any questions or need additional information, please feel free to contact either of the following:

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